PD-AAT-590

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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D.C. 20523

COSTA RICA

PROJECT PAPER

AGRICULTURAL AND INDUSTRIAL REACTIVATION

AID/LAC/P-311

Loan Number: 515-W-065
Project Number: 515-0233

UNCLASSIFIED

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROJECT DATA SHEET

1. TRANSACTION CODE: A (A = Add, C = Change, D = Delete)

Amendment Number:

DOCUMENT CODE: 3

2. COUNTRY/ENTITY: Costa Rica

3. PROJECT NUMBER: 515-0223

4. BUREAU/OFFICE: LAC 05

5. PROJECT TITLE (maximum 40 characters): Agricultural and Industrial Reactivation

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM DD YY 08 27 89

7. ESTIMATED DATE OF OBLIGATION (Under 'B,' below, enter 1, 2, 3, or 4)

A. Initial FY 86 B. Quarter 4 C. Final FY 86

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 86 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total						
(Grant)	(350)	( )	(350)	(350)	( )	(350)
(Loan)	(19,650)	( )	(19,650)	(19,650)	( )	(19,650)
Other U.S. 1.						
Other U.S. 2.						
Host Country						
Other Donor(s)					8,000	8,000
TOTALS	20,000		20,000	20,000	8,000	28,000

9. SCHEDULE OF AID FUNDING ($000)

A. APPRO-PRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	C. PRIMARY TECH. CODE 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. 2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	E. 2. Loan	F. LIFE OF PROJECT 1. Grant	F. 2. Loan
(1) SD	730	840	819			350	13,650	350	19,650
(2)									
(3)									
(4)									
TOTALS						350	13,650	350	19,650

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each): 840

11. SECONDARY PURPOSE CODE: 793

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code	INTR						
B. Amount	20,000						

13. PROJECT PURPOSE (maximum 480 characters).

To make credit available through private banks for on-lending to private businesses seeking to expand or upgrade their facilities for the production of non-traditional exports to extra-regional markets.

14. SCHEDULED EVALUATIONS

Interim MM YY 07 87 | MM YY | Final MM YY 07 89

15. SOURCE/ORIGIN OF GOODS AND SERVICES

☐ 000 ☒ 941 ☐ Local ☐ Other (Specify)

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ______ page PP Amendment.)

Controller
USAID/Costa Rica, Clearance, 8/27/86

17. APPROVED BY

Signature

Title: Mission Director
USAID/Costa Rica

Date Signed: MM DD YY 08 27 86

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION

MM DD YY 09 | | |

AGENCY FOR INTERNATIONAL DEVELOPMENT

UNITED STATES A.I.D. MISSION TO COSTA RICA

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or
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1000 San José, Costa Rica
Telephone 33-11-55
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Project Authorization

Name of Country: Costa Rica

Name of Project: Agricultural and Industrial Reactivation

Number of Project: 515-0223

Number of Loan: 515-W-065

Pursuant to Sections 103, 106 and 531 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the Agricultural and Industrial Reactivation Project for Costa Rica involving planned obligations of not to exceed Nineteen Million Six Hundred Fifty Thousand United States Dollars ($19,650,000) in loan funds ("Loan") and Three Hundred Fifty Thousand United States Dollars ($350,000) in grant funds ("Grant") over a three year period from the date of authorization, subject to the availability of funds and in accordance with the AID OYB/allotment process, to help in financing foreign exchange and local currency costs for the project. The planned life of the project is three years from the date of initial obligation.

The project ("Project") consists of the establishment of a rediscount facility at the Costa Rica Central Bank to provide credit through private banks for on-lending to private businesses seeking to expand or upgrade their facilities for the production of non-traditional exports.

The Project Agreement, which may be negotiated and executed by the officer to whom such authority has been delegated in accordance with AID's regulations and delegations of authority, shall be subject to the following essential terms, conditions and covenants, together with other terms and conditions as AID may deem appropriate.

1. Interest Rate and Terms of Repayment

The Central Bank of Costa Rica shall repay the Loan to AID in U.S. dollars within twenty-five (25) years from the date of first disbursement of the Loan, including a grace period of not to exceed ten (10) years. The Central Bank of Costa Rica shall pay to A.I.D. in U.S. dollars interest from the date of first disbursement of the Loan at the rate of

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(i) two percent (2%) per annum during the first five (5) years, (ii) three percent (3%) per annum during the second five (5) years, and (iii) five percent (5%) thereafter, on the outstanding disbursed balance of the Loan and on any due and unpaid interest accrued thereon.

2. Source and Origin of Goods and Services - (Loan)

Goods and services financed by AID under the Loan shall have their source and origin in countries of the Central American Common Market or in countries included in AID Geographic Code 941, except as AID may otherwise agree in writing. Ocean shipping financed by AID under the Loan shall be financed only on flag vessels of the United States, countries included in AID Geographic Code 941, or countries of the Central American Common Market, except as AID may otherwise agree in writing.

3. Source and Origin of Goods and Services - (Grant)

Goods and services financed by AID under the Grant shall have their source and origin in the United States or countries of the Central American Common Market (CACM), except as AID may otherwise agree in writing. Ocean shipping financed by AID under the Grant shall be financed only on flag vessels of the United States, except as AID may otherwise agree in writing.

Daniel A. Chaij
Mission Director

Date: 8/27/86

Clearance:AST DIR:KKelly KK 8/22
RLA:GLecce (In draft)
OPS:RRosenberg RR 8/25
CONT:FLatham 8/27
DDIR:RArchi

Drafted by:LLucke:dm:8/20/86

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LIST OF ACRONYMS

ABC	Costa Rican Banking Association
AIR	Agricultural and Industrial Reactivation Project
BANEX	Agro-Industrial and Export Bank
BCCR	Costa Rica Central Bank
CAAP	Private Agricultural and Agroindustrial Council
CACM	Central American Common Market
CBI	Caribbean Basin Initiative
CINDE	Costa Rican Coalition for Development Initiatives
CODESA	Costa Rican Development Corporation
COFISA	Costa Rican Industrial Financing Corporation
DA	Development Assistance
ESF	Economic Support Funds
GOCR	Government of Costa Rica
ICI	Intermediate Credit Institution
LAAD	Latin American Agribusiness Development Corporation
LIBOR	London Inter-Bank Offer Rate
MINEX	Ministry of Exports and Investments
PACD	Project Assistance Completion Date
PIC	Private Investment Corporation
PIE	Investment Promotion Program (CINDE)
ROCAP	A.I.D.'s Regional Office for Central American Programs (Guatemala)

PROJECT DEVELOPMENT PARTICIPANTS

I. Mission Project Committee

Mr. Lewis Lucke, Project Development Officer
Ms. Maureen Dugan, Assistant Project Development Officer
Mr. Vinzenz Schmack, Office of the Private Sector

II. Mission Review Committe

Mr. Daniel A. Chaij, Mission Director
Mr. Richard Archi, Deputy Mission Director
Mr. Kevin Kelly, Assistant Director
Mr. Richard Rosenberg, Private Sector Office
Mr. Robert Adler, Economic Analysis Office
Mr. Frank Latham, Controller

III. Consultants

Mr. Juan Belt, LAC/DR - AID/W
Mr. Fernando Quirós, PSC
Mr. Alvaro Quirós, PSC

I. SUMMARY AND RECOMMENDATIONS

A. Recommendations

The Agricultural and Industrial Reactivation Project Committee recommends that a loan in the amount of $19.65 million and a grant of $0.35 million be made to the Costa Rica Central Bank (BCCR) to establish a dollar facility for term lending to the agricultural and industrial sectors.

B. Summary Project Description

The goal of the project is to stimulate growth in both the agricultural and industrial sectors of Costa Rica, resulting in increased levels of employment and foreign exchange earnings. The purposes of the Project are to (1) make long-term credit available through the BCCR for on-lending to private businesses seeking to expand or improve their facilities for the production of non-traditional exports and (2) capitalize the Agricultural and Industrial Reactivation (AIR) facility in the BCCR as a permanent source of long-term credit for this purpose. As such, the project flows directly from the Mission strategy of expanding and strengthening the role of the private sector in sustained economic development in Costa Rica.

The three-year, $19.65 million credit facility will be housed in the BCCR and will be open to all Costa Rican private banks meeting certain eligibility criteria, on a first-come-first-served basis, for on-lending to private businesses for fixed asset investment to increase non-traditional exports to non-CACM markets. 1/ Of the 16 private banks in Costa Rica, at least 10 are expected to participate in the project. Both new and existing companies planning non-traditional export projects will be eligible to borrow funds under the facility.2/

The facility will fill a gap in the country's capital market as term dollars are scarce. Previous AID-funded dollar credit projects are being, or have been, drawn down and no new resources from other donors with

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1/ Fixed assets is defined as tangible property used in the operations of an enterprise but not expected to be consumed or converted into liquid assets in the ordinary course of events. Examples include plant machinery and equipment and fixtures. Acquisition of land will not be financed with Project funds.

2/ For the purposes of this Project, non-traditional exports is defined as all exports except raw coffee, bananas, unrefined sugar, and beef.

a similar purpose are anticipated in the near future. The BANEX loan was fully disbursed in CY 1985. COFISA will have fully disbursed AID's loan by the end of CY 1986. The Private Investment Corporation (PIC) is an additional, albeit limited, source of dollars. The new ROCAP loan with the Latin American Agribusiness Development Corporation (LAAD) will provide another limited source of dollar financing. Analysis taking these and other resources into account has shown more than adequate demand for the proposed facility.

The advantages of housing the facility in the BCCR are several:

-- AID receives the guarantee of the BCCR to repay the loan.

-- The participating intermediate credit institutions (ICIs) and ultimate sub-borrowers achieve legal clarity as regards their dollar-denominated debt.

-- It builds upon the BCCR's experience with the "Special Credit Line", a colon rediscount facility funded by ESF local currency generations over the past three years. The Special Credit Line is generally considered one of the Mission's most successful endeavors in support of the private sector, and the BCCR has received high marks for its handling of the facility. (See Section II C.3.)

The concept of a lending facility has a number of additional features. It will not only foment healthy competition among the private banks, but will also enable the Mission to assist a number of banks with which it has not previously worked. Furthermore, it is hoped that the facility will spur inter-bank cooperation (e.g. loan syndication) as well as cooperation with the PIC and LAAD.

To ensure wide participation in the program, a maximum sub-loan amount of $350,000 has been established. Requests for funding in excess of this amount will require the Mission's written approval. The other terms planned for the subloans are: up to seven year tenor, a grace period according to the sub-project's cash flow, and an interest rate of LIBOR plus 3%. Within these basic guidelines, the specifics of any given sub-loan will be set by the participating ICI based upon the nature of the sub-project. All private Costa Rican banks will be eligible to participate in the facility if they meet the eligibility criteria established for the local currency Special Credit Line. Criteria are described in Section III.C.1.e.

In addition to the $19.65 million loan which will be used to capitalize the credit facility, $0.35 million in grant funds will be provided for training and technical assistance in development lending, technical assessment of sub-projects, and evaluation. The grantee will be the BCCR; however, a training contractor will be competitively selected to plan and administer all but the evaluation activities of this component of the Project. (See Section III.C.2.)

C. Summary Findings

The Project Committee has reviewed the technical, economic, financial, social, policy, and institutional soundness of the Project.

The Committee strongly believes the Project will make a significant contribution to ongoing GOCR and Mission efforts to revitalize the agricultural and industrial sectors via the promotion of non-traditional exports to extra-regional markets. The Project will provide support to and strengthen the private banks of Costa Rica by channeling the term credit through them and by providing them with needed technical assistance and training.

The private banking sector, albeit small, has grown rapidly over the past several years -- to the point where it now represents a viable alternative to the inefficient and cumbersome national banking system. Support of the private banks is consistent with Mission and AID policy on the private sector.

Support to non-traditional exporters is critical if Costa Rica is to succeed in diversifying the export sector, a sine qua non for sustainable economic growth. Given the structure of the Costa Rican economy, the country is reliant upon export earnings to maintain economic stability. Like many small and open economies, Costa Rica's development has historically been linked to its international trade performance. As such, Costa Rica has always been extremely vulnerable to external forces because the few traditional agricultural exports (coffee, bananas, sugar and cattle) on which it relies for the majority of its export earnings are subject to price fluctuations dictated by the international market. Recent external shocks such as fluctuations in petroleum prices, sharp rises and declines in demand for coffee, the weakening of the CACM, and the increase, and subsequent decline, in international bank credit have wreaked havoc on the Costa Rican economy, forcing it to look to new products to generate hard currency.

Based on their growth patterns over the last few years, non-traditional exports offer the potential needed to diversify Costa Rica's export base and, through increased domestic and foreign investment, to contribute to long-term growth in the economy. Resources made available by the Project will support the role which the non-traditional exports are being asked to fill.

D. Project Issues

The PID for the proposed project was approved by the DAEC in AID/Washington on 24 June 1986. The issues identified in the subsequent guidance cable, which is attached in Annex I, have been fully addressed in the text of this Project Paper. The issues are summarized below.

1. Government Bank Participation

The project's designers originally envisioned a lending facility in the BCCR which would be open to all eligible banks in Costa Rica. Participation by the state banks was included at the PID stage because the Central Bank, as a state institution itself, initially indicated that the state banks could not be precluded. At AID/W urging however, USAID/Costa Rica continued negotiations with the BCCR and reached agreement, formalized in a BCCR Executive Board meeting on 8/20/86, to exclude the four state banks. Thus the project is fully consistent with AID/W Policy Guidance on Public Sector Participation, and the original issue has been successfully addressed.

2. Evaluation

The LAC Bureau requested that the Mission conduct an impact evaluation of the project prior to completing the obligation of all project funds, originally planned to take place in FY 1987. An evaluation has been scheduled for FY 1987 and will focus on whether the Mission's strategy of passing resources through the Central Bank to the private banking system at large is achieving the project's objectives of quickly and efficiently delivering dollar investment financing to private enterprises. In that it now appears likely that, for programmatic reasons, the project will be fully funded in FY 1986, the evaluation will not be the basis for obligating additional funds; however, it will be used to make any necessary modifications to the design early on in the implementation process. See Section III.C. for a complete discussion.

3. Interest Rates

Concern was expressed at the DAEC that the interest rate to the final borrower be high enough to allow a sufficient spread to cover risks and transaction costs at the ICI level, as well as to allow for a reasonable profit for the participating banks (i.e., incentive to utilize project funds). The Mission has, with the assistance of economists and a financial analyst, carefully studied this issue and finds that the proposed structure is feasible from the financial standpoint of the private banks.

It must be recognized that the spread to the ICI is a function not only of the lending rate to the ultimate sub-borrower, but also of the cost of the funds to the ICI and the perceived risks involved. As currently designed and given the planned terms of the loan to the BCCR, the private banks will receive a spread of 4 1/2% on project resources on-lent. Should LIBOR rates fall below current levels, this spread would be reduced to a minimum of 3 1/2%. In addition, a one-time commission of 2% may be charged, raising the net spread to the banks. Representatives of the private banks who have been consulted throughout the development of this project have indicated this net spread is adequate in terms of covering their perceived risks, and they have indicated their intention of accessing the facility based on this spread.

4. Colon - Dollar Convertibility Risk

All sub-loans will be dollar denominated and will be registered by the ultimate sub-borrowers with the Central Bank upon receipt. As originally designed, at sub-loan repayment time, the sub-borrower would have had to return to the Central Bank to exchange colones for dollars, pass the dollars to the private bank making the loan, which would, in turn, pass the dollars back to the Central Bank. Subsequent to PID approval, the Mission successfully negotiated with the Central Bank to allow for sub-loan repayment in colones with a maintenance of U.S. dollar value clause. In other words, sub-loans can now be repaid in local currency at the prevailing exchange rate on the date of the repayment. This not only simplifies and expedites the repayment process, but ensures that the sub-borrowers as well as the participating banks will not bear any risk as regards the future availability of foreign exchange at the Central Bank. As a consequence, a major concern expressed by potential sub-borrowers queried about the Project has been successfully addressed.

5. Institutionalization of the Fund

The life of the facility will be twenty-five years. During this period, the Central Bank will make dollars available as requested by sub-borrowers. It is anticipated that loans from reflows will be relent in dollars but paid out in colones, except for cases involving direct importation where the borrower's requirement is for immediate access to foreign exchange. The cash flow analysis done on the facility indicates considerable positive benefits in project net cash generation with fund repayments of principal beginning in year eleven. Also reflected in the cash flow is the growth of a fund which will be available to the BCCR and ICIs as a reserve fund against bad loans, and additional capital for sub-loans consistent with the objectives of the project. See Section III.C.1.i. and Annex VIII for full details on the cash flow.

6. Sub-loan Size

Per discussions at the DAEC, the maximum size per sub-loan has been reduced from $500,000 to $350,000 to encourage broad

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participation in the facility. Any sub-loan request in excess of this amount will require written approval of the Mission prior to disbursement by the BCCR. It is the Mission's position that the foreign exchange and employment generation potential of a sub-project is more important than the size of the sub-loan, and previous experience with sub-loan limits in other Mission banking projects has shown a significant number of requests for approvals above $350,000. This will be reviewed as a part of the first year evaluation discussed above to ascertain if an upward adjustment is warranted.

II. Project Background

A. Background

Although Costa Rica has achieved some economic stability since the current crisis began in 1981, efforts to reorient the economy from an import-substitution industrialization model toward export-led growth remain a challenge. The Mission has assisted the GOCR in its stabilization endeavors through its ESF balance of payments assistance, the DA portfolio, P.L. 480 resources, local currency portfolio, and policy dialogue. A number of key successes have been achieved, including passage of the Monetary Law which clarified the obligations and ramifications of dollar denominated debt; the creation of a Ministry to focus on exports and investment; the Investment and Export Promotion (PIE) and Agricultural and Agroindustrial Council (CAAP) programs at CINDE; etc. However, much remains to be done if Costa Rica is to achieve sustainable economic growth.

Economic recovery in Costa Rica requires that the country move away from its present economic model that emphasizes import-substitution and parastatal enterprises, towards export-led growth in a more market oriented economy. It is AID's belief and policy that this can best be obtained by encouraging the revitalization of the more efficient private sector.

The principal constraints to a revitalization of the private sector include: the acute shortage of foreign exchange; a severe credit squeeze (local and external), aggravated by a cumbersome and ineffective nationalized banking system and the country's heavy external debt; many industries that are noncompetitive in world markets; limited technical and production management know-how for streamlining industry; the lack of expertise for penetrating foreign markets; and a relatively untested export promotion structure recently created by the GOCR.

From the perspective of the private sector, recovery and future growth will be facilitated by the following positive factors: an existing and underutilized industrial base (albeit somewhat inefficient); significant agricultural and agro-industrial potential; a skilled, competitive, productive labor force and enlightened human resources (largely the result of progressive social policies in education and health); a favorable geographic position that provides easy access to U.S. markets that are now open as never before due to the CBI initiative; and an increased recognition of the need to export.

The financial infrastructure in Costa Rica is also a constraint to economic recovery. The Costa Rican financial sector is dominated by four government owned commercial banks and one public investment/holding company (CODESA). Over 92 per cent of Costa Rican financial assets reside with these institutions, which tend to be extremely bureaucratic, inefficient and slow in the processing of loan applications. These

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institutions typically limit themselves to supplying secured and/or guaranteed short-term working capital loans to local borrowers. The balance of the credit available is supplied by about 20 small private financial institutions.

Although the nationalized financial institutions play an important role in the economy, their resource base and management style are not capable of meeting the economic challenge confronting Costa Rica (See Annex XI). As in most developing countries these institutions are characterized by having limited access to foreign exchange; being staffed with poorly trained personnel; using cumbersome lending procedures; emphasizing short-term commercial credit lines to the exclusion of capital investment loans; and being unable to consider large scale project investments or provide the packaging services required to make an investment project work. The private financial institutions by comparison are efficient and, though small, offer an alternative to the nationalized institutions.

Perhaps the greatest problem in the existing nationalized financial network is the general approach regarding guarantees. The public sector financial institutions, and to a lesser extent those in the private sector, demand excessive guarantees. This attitude serves as a disincentive to the further expansion of many companies and often leads to the granting of loans which are not matched to the cash flow of the borrower. The concept of project lending is rarely practiced, yet it is essential that this concept be adopted if large developmental projects are to be financed by the banking system.

Significant new investments in Costa Rica cannot be adequately developed through the existing nationalized financial institutions due to the inhererent limitations of the local banks. Existing banking legislation prohibits commercial banks, state-owned or private, from making equity investments; it further limits their response and flexibility by regulating debt/equity ceilings made even tighter by the devaluation of the currency (without offsetting new capitalization) and by the legal requirement that all loans must be "adequately" guaranteed.

A key determinant in a favorable investment decision by international companies is the availability of appropriate financial resources in Costa Rica. However, given the above constraints as well as Costa Rica's massive foreign debt which affects the ability to attract international financing, these companies are often unable to find the desired financing for their projects. The Manager of CINDE's Investment Promotion Program underscored this in a May 21, 1986 memorandum to the Mission in which he stated that one third of the companies visiting Costa Rica to study investment opportunities require dollar financing, the availability of which would be an additional incentive that Costa Rica could offer all prospective investors. Foreign companies are interested in dollar financing as opposed to local currency because they are accustomed to operating in dollars and current interest rates are low. (See Annex VI).

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The Mission's financial intermediation programs (See Section II. C. 3.) are designed to address the above constraints and directly support the improvement in the overall investment climate that is recommended by the National Bipartisan Commission on Central America (NBCCA). The proposed project is an integral part of the Mission's efforts to increase exports and foreign investment and to enhance the private sector's participation in economic growth. The shortage of dollars for term lending has been identified as a constraint to further investment and growth in exports. This is particularly critical in the case of non-traditional exports which are often considered more risky and, therefore, less attractive from a lender's perspective.

B. The Costa Rican Banking System

The four government owned commercial banks dominate the financial sector in Costa Rica, controlling approximately 92.3% of the total bank assets. The state banks also have a monopoly on demand deposits with the private banks being restricted to accepting time deposits (Investment Certificates) of six months minimum maturity. In that demand deposits represent the principal source of funds in the banking system, the ability of the private banks to capture resources is limited by this restriction. The immediate consequence is a smaller asset size which, in turn, limits the amount of resources the private banks can lend. However, while the nationalized banks will continue to dominate the local financial sector for the forseeable future, their resource base and management style will not be capable of meeting the economic challenge confronting Costa Rica.

As early as 1981, the Mission recognized the problem of the inefficient state-owned banks and began to support the private banking sector. At that time, AID provided support to BANEX via the $10 million Private Sector Productivity Project (515-0176). In late 1983, the Special Credit Line at the Central Bank was established to channel ESF local currency generations to the private sector. To date, the colon equivalent of $68 million (of a total of $95 million) has been made available through this facility to the private banks for on-lending to private industrial and agro-industrial enterprises (see Section II.C.4. for more detail).

In addition, AID has helped COFISA reestablish itself as a viable private financial institution with the $10 million Private Sector Export Credit Project (515-0187). More recently, AID supported the formation of the Private Investment Corporation (PIC) through a $20 million loan initiated in 1984. This direct support was complemented by AID assistance to the newly established private banking association (Asociación Bancaria Costarricense - ABC).

The growth in the private banking sector has been dramatic in recent years. Since 1982, the number of private banks has increased from 10 to 16. The following table shows the growth, from 1984 to 1985, in the financial strength of the private banks:

GROWTH IN THE PRIVATE BANKING SYSTEM
(Millions of dollars)

	1984	1985	Increase	% Increase
Total Assets	92.6	148.3	55	60%
Total Equity	20.5	26.5	6.0	29%
Number of Employees	458	582	124	27%

These are substantial increases, even after adjustment for devaluation; however, the private banks' total assets still represent only 7.7% of total bank assets.

Another indicator of the growing importance of the private banks in Costa Rica is the provision of banking services. The private banks have captured over 40% of the banking service business such as letters of credit, collections, and foreign exchange transactions. Annex VII provides comparative data on the commercial banks.

Through the Special Credit Line, the private banks have learned to make long-term loans based not only on guarantees but on cash-flow projections. Occasionally, new projects have been financed. An example is the $3 million syndicated loan arranged by PIC where Banco Interfin, providing a colon equivalent $500,000 loan, joined with BANEX and COFISA, each of which extended a $500,000 loan to the project. This demonstrates that, although the Special Credit Line was not set up specifically for project loans, private banks are venturing into this field. From this experience and discussions with several private bankers, the Mission believes that the private banks will take full advantage of funds made available under the proposed facility, especially the more aggressive among them. Because the general availability of loanable funds is extremely limited, the proposed facility will afford the private banks an opportunity to further expand their lending activities and thus strengthen their position vis-a-vis the state-owned banks.

This is an important step at this stage in the development of the private banking sector because the private banks are being criticized for focusing on the most attractive business and leaving the less attractive and marginal business to the state-owned banks. AID assisted the private banks in their initial growth stages and, through this project, intends to continue to support them in the second stage of consolidation which consists primarily of converting the private banks from strictly commercial lending, institutions to all service banks, including long-term project lending syndicate lending, co-financing arrangements with local and international lending institutions, and other new and innovative financial services.

C. Project Rationale

1. Project Strategy

The proposed project reflects the major objectives of USAID/Costa Rica and the GOCR regarding export-led economic growth. The genesis of the proposed credit facility was the Mission's ongoing analysis of constraints to export expansion and increased investment in Costa Rica. After first delineating the constraints, the Mission assessed which ones it could address, and with what resources. For example, the Mission helped secured passage of the Monetary Law (Ley de la Moneda) by addressing it at a policy dialogue level. Other constraints such as lack of factory space, unclear GOCR regulations regarding exports, and customs problems have been addressed via free zone legislation, the export contract and customs reform respectively. A remaining constraint, then, is the continuing lack of dollars for long-term lending.

Because of the inherent limitations of the national banking system discussed above, external resources are needed to foment term lending in dollars. The proposed lending facility is a simple mechanism that will make resources available to the private sector while also achieving the development objectives of strengthening the private banks and fomenting competition for resources among them. As described in Section III.C.1. the resource flow through the facility will parallel that of the Special Credit Line at the BCCR. That facility has established lending criteria and procedures which, after three years of experience, has resulted in smooth operations.

It is anticipated that the funds provided under the proposed project will serve as a catalyst to get more local commercial banks involved in development lending in Costa Rica. The infusion of project resources, albeit modest, can be an important factor in improving Costa Rica's investment environment.

2. Relationship to the CDSS and AID Private Sector Policies

USAID/Costa Rica's FY 1986 Country Development Strategy Statement (CDSS) proposes a multi-element assistance strategy to help stabilize and re-establish the bases for long-term, broadly-based dynamic growth in the Costa Rican economy. Achievement of this goal requires that the Mission take simultaneous action in a number of different areas which are responsive to the Mission's major strategic objectives. Those objectives include: (1) economic stabilization and recovery; (2) strengthening of the financial system; (3) promoting exports and investment; and (4) improving coordination between the public and private sectors.

Within the above context the Mission's private sector strategy was designed to provide resources to private institutions in order to: strengthen the private banking sector; expand exports, investments, and employment opportunities; and create a more favorable environment for private sector activity.

The proposed Project will be an efficient tool that is consistent with the overall Mission strategy and will contribute to the achievement of the Mission's private sector objectives. The direct effect of establishing the rediscount facility at the Central Bank will be to make term dollar credit available to the productive private sector. The private banking sector will be strengthened not only by increased loanable assets but also by providing incentives to expand their equity capital base to meet debt/equity requirements. The availability of dollar loans for the expansion and rehabilitation of agricultural and industrial production facilities will assist in the reconstitution of the manufacturing base for increased exports of non-traditional goods to extra-regional markets and will enhance investment opportunites.

The establishment of a dollar rediscount facility in Costa Rica is also consistent with AID's principal private sector development goals, as articulated in the Private Enterprise Policy Paper, which are:

- To assist in financing the establishment, improvement and expansion of productive, developmentally desirable private enterprises in priority sectors in developing countries in association with host country and U.S. private investors.

- To promote investment opportunities in developing countries by bringing together U.S. and host country capital and experienced management, thereby transferring technical, managerial and marketing expertise from the U.S. to the developing countries.

- To stimulate and help create conditions conducive to the flow of U.S. and host country private capital into productive investment in developing countries.

3. <u>Relationship to Current Mission Programs</u>

The Mission recently completed one credit project and now has three other active projects/programs aimed at strengthening the private banking sector.

a. BANEX

BANEX (Banco Agro-Industrial y de Exportaciones), initiated operations in 1980 as a small ($1.0 million equity) private export bank to provide an alternative to the state banking system as well as to provide financing for both traditional (particularly coffee) and non-traditional exports. The establishment of the bank unfortunately coincided with the onset of the major economic crisis in Costa Rica, which affected the bank's ability to grow and, until passage of the new Monetary Law, to place dollar loans in Costa Rica. In 1981, AID provided $10 million to BANEX to assist the bank in achieving a greater development impact and in providing a wide range of services to assist producers in the export process. The organization which emerged consisted of two principal components: BANEX, providing export credit and banking services, and BANEX Trading, providing export management services. BANEX Trading has not been very successful, and BANEX was initially very slow on project lending. BANEX did, however, fully disburse the AID loan prior to the December 1985 PACD. Since its creation in 1980, BANEX has developed into an efficiently operated private bank, has also begun to develop some project lending capability and has shown the potential to further improve this capability.

b. COFISA

COFISA was initiated with AID funding and has been in operation for 20 years. It was established originally to serve as a private development finance company, but evolved into a commercial lending institution. Due to the deterioration of the Costa Rican enonomy and the ensuing currency devaluation in the early 80's, it suffered large financial losses. In 1984, AID provided the institution a $10 million loan to help it regain a positive equity position and to help convert it into a development-oriented financial institution. In 1985, COFISA was able to settle all its foreign debt and regained a strong equity position. It also made substantial management changes and since the middle of 1985 has engaged actively in project lending. Based on current performance, the balance of the AID loan will be fully drawn by the December 31, 1986 PACD.

c. PIC (Private Investment Corporation)

In 1984, AID authorized a $21 million project to assist in the establishment of a private investment corporation (PIC) to provide investment packaging services, medium and long-term credit, and equity financing to investors for industrial projects in Costa Rica. The role of the PIC is unique in Central America as it was designed to act essentially as a merchant banking house, providing financial expertise in the marketplace and expanding the incipient stock exchange. In addition, the PIC was designed to mobilize resources and provide direct support to firms taking advantage of the CBI. As of July 15, 1986, the PIC had approved loans with a value amount of $6,987,000 and disbursed $4,707,792. Due to start-up and management problems it has concentrated primarily on the approval of project loans and has made only one direct investment of $300,000. It has not yet engaged in the other financial services contemplated under the Project, such as financial packaging and loan syndication.

d. Central Bank Rediscount Line (Special Credit Line)

Since 1983, a portion of the local currency generated by ESF cash transfers has been used to provide financial assistance to the private productive sector through a special rediscount facility at the BCCR. Since its establishment, the colon equivalent of $95 million has been channeled through private ($68 million) and state banks ($27 million) for loans to private industry. The reflows from these funds have also been made available through a revolving fund process.

As of December 31, 1985, local currency sub-loans have been made to approximately 200 firms. The funds channeled through the Special Credit Line finance working capital, the purchase of stock for new companies or new issues of stock from existing firms, debt restructuring or repayments of local companies, and capital equipment. The maximum amount of financing permitted for each company is ₡50 million, or approximately $1 million, unless otherwise agreed to in writing by the Mission and the BCCR. Even under these circumstances, a ₡75 million ceiling has been established.

The private banks have responded quickly and efficiently to disburse available funds to the private sector. To date, the entire $95 million equivalent has been fully disbursed, and demand is such that reflows are immediately relent to satisfy credit needs.

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III. PROJECT DESCRIPTION

To support the Mission's macro-objectives of strengthening the private financial system, increasing exports and investment and assisting in the reorientation of the industrial sector, this project will establish a dollar rediscount facility for term lending to the agricultural and industrial sectors. The $19.65 million facility will be housed in the Costa Rican Central Bank (BCCR) and will be open to all private Costa Rican banks, on a first-come-first-served basis, for on-lending to private businesses for fixed asset investment to increase exports to non-CACM markets. In addition to the $19.65 million which will be placed in the rediscount facility, $0.35 million will be provided as a grant to the BCCR to finance training in development banking and specialized project analysis. A contract will be competitively bid to plan and administer the services to be financed by the grant.

A. Goal and Purpose

The goal of the project is to stimulate growth in both the agricultural and industrial sectors of Costa Rica, resulting in increased levels of employment and foreign exchange earnings. The dual purpose is (1) to make long-term credit available through the BCCR for on-lending to private businesses seeking to expand or improve their facilites for the production of non-traditional exports to extra-regional markets and (2) to capitalize the Agricultural and Industrial Reactivation (AIR) facility in the BCCR as a permanent source of long-term credit for this purpose. Both new and existing firms planning non-traditional export projects will be eligible to participate in the facility.

B. Project Objectives

The objectives of the Project are:

- To deepen the Costa Rican financial market by increasing the availablity of dollars for term lending for production of non-traditional exports;

- To assist the Costa Rican private banks in improving their development lending capabilities;

- To strengthen the Costa Rican private banks by channeling project resources through them and creating competition among the banks by making the resources available on a first-come-first-served basis;

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- To increase employment opportunities through increased private sector productivity; and

- To increase Costa Rican foreign exchange earnings through increased export production.

C. Project Activities

1. Revolving Loan Facility

The Project will establish a $19.65 million facility in the Central Bank of Costa Rica open to all qualified Costa Rican private banks for on-lending at market rates to private businesses for fixed asset investment to increase non-traditional agricultural and industrial exports to non-CACM markets.1/ The credit will be available to both new and existing firms to finance fixed asset investment in non-traditional export projects whose output is destined for non-CACM markets.

An important element of the Project is that principal recuperations from sub-loan repayments will be available for relending. Loan reflows will capitalize a fund which will continue to fund projects with the same objectives as originally defined in the Project. Considerable turnover of funds will be achieved over the Project's twenty-five year life.

Counterpart financing will come from the ultimate sub-borrowers. Project funds will be used to cover a maximum of 70% of the total cost of each proposed investment. The ICIs, in effect, will also provide a non-quantifiable amount of in-kind counterpart by assuming the investment risks.

a. The Costa Rican Central Bank

The Financial Department of the BCCR, which is currently tasked with handling the Special Credit Line, will be responsible for overseeing the new facility. Disbursements to the facility will be made on a monthly basis over the three year life of the Project based on sub-loan approvals submitted to the Central Bank for the particular month.

The involvement of the Central Bank will be minimal. Participating ICIs will be responsible for project analysis, forwarding a request for funding to the Central Bank with a facesheet outlining the

1/ For the purposes of this Project, non-CACM and extra-regional markets are synonymous.

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basic characteristics of the proposed investment. The Central Bank will simply verify that the sub-project fits within the Project's general eligibility criteria and that the ICI is financially sound. Given the importance of timing in making investments in the export sector, procedures have been streamlined to the extent prudent. For this reason, the Central Bank will not duplicate the project analysis done by the ICIs. The Institutional Analysis (Annex VII) shows that the ICIs expected to participate in the Project have this capability.

Prior to the first disbursement of Project Loan funds, the BCCR will submit, in form and fashion satisfactory to AID, the following:

- an implementation plan for the project,

- a standard facesheet 1/ to be used by all participating ICIs when submitting funding requests to the Central Bank, and

b. Dollar and Colon Lending

The loan to the Central Bank, and the Central Bank's corresponding obligation to the U.S. Government, will be denominated in in U.S. dollars. The purpose of the Project, however, is to make credit available. Accordingly, disbursements, while denominated in dollars, will be in either dollars or in local currency in accordance with the needs of the sub-loan.

Operationally, the ICIs will make dollar sub-loans, receiving dollars from the facility in the Central Bank. Sub-borrowers, in turn, will receive dollar checks from the ICIs, which they will immediately take to the Central Bank for registration, and in many cases, for conversion into local currency. As a part of the registration process (required of all dollar denominated obligations in Costa Rica), the Central Bank will "tag" the dollar amount of the sub-loan to the sub-borrower's name. Agreement has been reached with the Central Bank that this will enable the sub-borrower to repay the sub-loan in local currency at the prevailing exchange rate on the date of repayment. This is an important and novel feature of the project and eliminates a commonly held perception that a big risk in taking dollar sub-loans is potential unavailability of dollars at the Central Bank to repay the sub-loan. This repayment mechanism also gives the Project a distinct advantage over other existing dollar facilities in Costa Rica.

1/ The facesheet will contain the following information: sub-project description, amount, terms, guarantees, repayment schedule, and estimations of foreign exchange earnings and employment generation.

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c. Reflows

Reflows will be placed in the lending facility for new lending and for a loan guarantee risk minimization fund. The Central Bank will covenant to make dollars available as requested under the facility even though the sub-loans may be repaid in local currency. Nonetheless, all sub-loans made with reflows will also be dollar denominated.

Cash flow tables in Section III.C.1.4 demonstrate the considerable potential for cash generation by the project, and the potential for building reflows under three scenarios: LIBOR at 7%, 10% and 15%. By year 10, cumulative reflows amount to $6.3, $7.7 and $9.3 million, respectively, under the three scenarios.

One of the dual purposes of this project is to capitalize the AIR credit facility in the BCCR as a permanent source of long-term credit for establishing or expanding facilities for the production of non-traditional exports. It is planned that at least two-thirds of project interest reflows will be devoted to capitalize the facility and, as shown in the cash flow analysis, this will provide at least $6.3 million by year ten for this purpose. As it is capitalized, the facility will become a new asset for the BCCR and, as such, will provide a new source of revenue which will help reduce Central Bank financial losses.

The remaining one-third of interest reflows will be earmarked as a loan guarantee/risk minimization fund. This will allow the BCCR to cover itself in event of an ICI default triggered by a potential non-payment of a loan by a sub-borrower.

d. Participation of Private Banks

The qualifying ICIs will be responsible for establishing their own internal procedures for promoting, analyzing, and approving the sub-loans. The burden of the investment analysis falls upon them. After approving loan requests, the ICIs will apply to the Central Bank for funding.

Because this type of lending is relatively new, the $350,000 grant has been included in the Project to finance technical assistance and training for the participating banks. While the assistance contemplated is not expected to convert commercial bankers into development bankers overnight, it will improve project analysis -- both technical and financial -- and provide assurance that the ICIs are funding sub-loans that will satisfy project objectives. (See Annex VII, Institutional Analysis.)

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e. Eligibility Criteria

1) Eligible Intermediate Credit Institutions

All private banks which operate as Costa Rican-registered entities will be eligible to participate in the facility if they meet the eligibility criteria established for the Special Credit Line. In addition, the Central Bank will assess the basic financial soundness of the lending institutions. At the present time there are 16 private banks which may satisfy these criteria and may be eligible to participate in the new credit facility. However, it is expected that only up to 10 of these will ultimately qualify for participation.

Under the Special Credit Line there are no specific limitations on private banks with more than ₡100 million (approximately $2 million) in capital other than the relevant banking laws and regulations. For those private banks with less than ₡100 million in capital the following conditions apply:

- During the second year of operations, private banks can access their credit line up to an amount equal to their capital and reserves.

- During the third year of loan operations, the private banks can access up to three times their capital and reserves.

- From the fourth operational year on, limits on the private banks access to the Special Credit Line is in accordance with the laws and regulations which govern banking activity.

2) Eligible Sub-Borrowers

Any new or existing private sector industrial or agricultural enterprise investing in fixed assets to increase production of non-traditional goods for export to non-CACM markets will be potentially eligible to participate in the facility. While it is presently contemplated that all credit will be channeled to non-traditional products, it is conceivable that a new export could be derived from one of the traditional export commodities (sugar, bananas, coffee, and beef). Therefore, the loan agreement with the Central Bank will stipulate that project financing will be available for non-traditional products, unless otherwise approved by the Mission.

Sub-loans will be extended by participating ICIs to private businesses desiring to expand or improve their facilities for the production of non-traditional exports 1/ to extra-regional markets. To

(1) Raw coffee, bananas, unrefined sugar, and beef would be ineligible for funding except as otherwise approved in writing by the Mission.

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increase the developmental impact of the Project, the facility will be open to new as well as existing companies to finance fixed asset investments in non-traditional export projects. Sub-borrowers will be required to present evidence of intent to make fixed asset investments. If the sub-borrower produces for the local market or the CACM as well, projected export sales outside the CACM will have to be sufficient to repay the principal and interest on the sub-loan.

After satisfying the basic project sub-lending criteria the following additional criteria will be applied by the ICIs in evaluating investment options:

- Does the proposed investment entail new, significantly labor intensive production methods? While minimum employment creation criteria have not been established because of the diversity in the non-traditional export sector, employment creation is an objective of the Project and each sub-borrower will be asked to demonstrate what impact can be expected from the Project.

- Does the proposed sub-project offer significant new net foreign exchange generations? As with employment, no minimum acceptable figure for foreign exchange generations has been established. This would be difficult to do because of the numerous types of sub-projects which will be financed. However, foreign exchange generation is an objective of the Project and, as with employment, the sub-borrowers' loan requests will include an estimation of the expected impact.

- Does the sub-project propose to utilize domestic raw material production? This is consistent with Mission's Agribusiness Strategy and the GOCR's efforts to maximize the utility of the country's agricultural resource base. The agricultural sector not only contributes significantly to GDP, but employs almost 1/3 of the labor force and offers substantial employment opportunities.

Does the proposed sub-project involve substantial growth in the productive capacity of the utilimate sub-borrower?

These four considerations, while not mandatory in terms of providing quantifiable responses, will be taken into account by the ICI in making investment decisions on proposed sub-projects. These are intended as further guidance on Project objectives and will be useful in the case of selecting among potential investments, particularly in border-line or questionable cases.

The loan applications filed by the ICIs with the BCCR will verify that the proposed sub-projects are non-traditional export projects whose output is destined for non-CACM markets and that Project resources will be used to finance fixed assets investments. The additional four considerations will also be addressed, but will not be subject to minimum quantifiable levels. The BCCR will not make evaluative judgements on the additional four considerations, but will ascertain whether the proposed sub-project is consistent with the Project's pre-requisites and that the ICI is financially sound.

f. Terms of Sub-Loans

The sub-loans will be extended for three to seven years with a grace period in accordance with the needs and cash flow projections of each sub-project. The interest rate to the ultimate sub-borrower will be the Costa Rican market rate, defined as the six-month LIBOR rate (London Inter-bank Offering Rate) plus a maximum of 3% p.a. This is the maximum rate that can be charged in Costa Rica for dollar-denominated obligations registered at the Central Bank. All dollar obligations must, by law, be registered with the Central Bank which also guarantees access to dollars at the Central Bank to cancel the obligation subject to the availability of foreign exchange. In effect, then, this is an administratively set cap on interest rates which the Central Bank uses in managing dollar credit made available in Costa Rica. Although this is an administratively established rate, it is tied to the principal international indicator of the market cost of funds, and, as the LIBOR rate changes, it does also.

Unless otherwise agreed to in writing by the Mission, the maximum amount of a sub-loan will be $350,000. This will ensure wide participation in the facility. In cases where sub-loans greater than $350,000 are requested, criteria described in Section III.C.1.e(2) shall be applied.

g. Spreads and Interest Rates

The AID loan to the Central Bank will establish a line of credit of $19.65 million with a tenor of twenty-five years including a ten-year grace period. During the first five years of the grace period, the interest rate will be 2% per annum, followed by 3% during the second five years of the grace period, and 5% during the final 15 years of the loan.

The interest rate applicable to the ultimate sub-borrower of the AIR facility is LIBOR plus 3%. This rate will be established at the time funds are disbursed for each sub-loan and will be adjusted semi-annually according to fluctuations in LIBOR. The distribution of interest spreads among the BCCR, AID and the private banks (ICIs) will be:

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- for the BCCR, 1% to 1.5%.
- for the ICIs, 3.5% to 4.5%.
- for AID, 2% p.a. interest in years 1 to 5
  3% p.a. interest in years 6 to 10.
  5% p.a. interest in years 11 to 25

The maximum spreads will be in effect for the BCCR and the ICIs as long as LIBOR plus 3% is sufficiently high to cover the maximum spreads plus the BCCR's cost of funds, i.e. AID's interest rate.

At today's rate in Costa Rica, LIBOR plus 3% is 9.5%, which is the end user rate. Therefore, if LIBOR remains at this rate during the first five years of the loan, the ICIs would receive funds from the Central Bank at 5% (9.5% - 4.5%). After applying the maximum BCCR spread of 1.5%, another 1.5% would remain which would be applied by the BCCR to capitalize the AIR credit facility on a permanent basis. (For a discussion of this proposal and its effects on the long-term capitalization of the fund, see Sections III.C.1.c and i). In other words, should LIBOR plus 3% be higher than the BCCR costs of funds plus 6% (the sum of the maximum BCCR and ICI interest spreads), two-thirds of difference will be used to create a reflow pool for new project lending. If, to make funds more attractive, the ICIs wish to reduce the interest rates to the ultimate sub-borrower from LIBOR Plus 3%, this may be accomplished with a corresponding reduction in the ICI spread.

If LIBOR plus 3% should fall to a point where the BCCR's cost of funds and maximum BCCR and ICI spreads cannot be covered, these spreads will be reduced to a level no lower than the minimum as shown above. A floor rate of the BCCR's cost of funds plus 4.5% (the sum of the minimum spreads for the BCCR and the commercial banks) will be set if LIBOR plus 3% goes so low that the minimum spreads plus the BCCR cost of funds cannot be accommodated. Spreads would be adjusted as follows:

- o First ICI spread is reduced from 4.5% maximum to 3.5% minimum, by the amount necessary to bring total interest changes to LIBOR plus 3%.

- o Next BCCR spread is reduced from 1.5% maximum to 1% minimum, by the amount necessary to bring total interest charges to LIBOR plus 3%.

- o The floor interest rate of the BCCR's cost of funds (2%, 3% or 5% depending on the year) plus 4.5% becomes the end user's interest rate.

In addition to the interest rates charged, the ICIs have some flexibility in charging a one time commission on the sub-loans. These vary from institution, averaging about 2%. Market forces come into play at this juncture, and competition among the private banks is expected to have an impact on the effective cost of the capital to the ultimate sub-borrowers. With the interest rate spread of 3.5% - 4.5% plus commissions, the ICIs will be receiving adequate renumeration for their participation in the facility.

h. Risk Assumption

The investment analysis, and concommitant sub-project risk will be the responsibility of the participating ICIs. The banks will evaluate the merits of various investments and, once satisfied that a sub-project is feasible, will apply to the Central Bank for funding. The Central Bank will assume only the institutional risk of the participating ICIs.

The foreign exchange risk will be passed on to the ultimate sub-borrowers. Since they will be exporting and earning foreign exchange, the ultimate sub-borrowers will have the capacity to repay the sub-loans in hard currency and, thus, will be in a position to assume the foreign exchange risk. Morevover, the Mission has negotiated with the Central Bank to allow repayment of the sub-loans in colones at the prevailing exchange rate of the day. While the ultimate sub-borrower will still be assuming the foreign exchange risk, the risk of unavailability at the Central Bank at the time of repayment is eliminated.

i. Cash Flow Analysis

The cash flow prepared for the 25 year life of the Project depicts the amounts to be recuperated from subloan placements, contrasted to outflows for repayment to AID, resulting in considerable positive benefits in terms of net cash generation of the project. The resulting cash buildups are more than enough to fund repayments of principal commencing in year 11. The cash flows also reflect the buildup of a loan guarantee fund. Three versions of the cash flow have been included to test the sensitivity of interest rates to this reserve fund buildup. (See Tables III.1, 2 and 3.)

A basic element of the Project is that all principal recuperation from sub-loan repayments will be available again for relending, thus achieving considerable turnover as the funds are reloaned several times during the 25 year life of the project. Additionally, two-thirds of the excess of interest paid by the private sector borrower to the ICI over amounts necessary to pay AID, BCCR's 1.5% spread, and the private bank's 4.5% spread are recaptured and contribute to the buildup in the reflow pool. This latter amount is included in the "interest reflow" line in the cash flow.

Under the three scenarios, the project achieves a turnover ranging from 5.5 (107.8 million in total principal plus interest

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Version 1: LIBOR held constant at 7.0%

MIR PROJECT CASH FLOW (in millions of dollars)

YEAR	1	2	3	4	5	6	7	8	9	10	11	12	13
BASIS													
Drawings + Reflows	7.0	10.1	4.5	4.5	5.7	6.8	6.3	5.5	6.0	6.3	6.3	4.7	4.7
Outstanding BCCR loan	7.0	17.0	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	18.2	16.9
Outstanding Subloans	7.0	15.3	17.3	20.7	25.2	25.4	22.4	23.0	24.3	24.8	24.4	22.8	22.2
LIBOR %	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
[illegible]													
Principal Reflow	0.0	1.0	4.3	5.4	6.5	6.2	5.4	5.8	6.1	6.2	6.0	6.0	5.8
Interest Reflow	0.1	0.2	0.2	0.3	0.3	0.2	0.1	0.2	0.2	0.2	0.0	0.0	0.0
MID Interest Collected	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9	0.8
Total Project Inflows	0.[illegible]	2.5	4.9	6.1	7.2	6.9	6.1	6.6	6.8	6.9	7.0	6.9	6.7
REPAYMENT TO MID													
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3	1.3	1.3
Interest	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9	0.8
Total	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	2.3	2.2	2.1
PROJECT CASH GENERATION													
Annual Totals	0.1	2.0	4.5	5.7	6.8	6.3	5.5	6.0	6.3	6.3	4.7	4.7	4.5
Cumulative	0.1	2.0	6.6	12.2	19.1	25.4	30.9	36.9	43.2	49.5	54.2	59.0	63.5
RESERVE FUND BUILDUP													
Annual Interest Reflow	.0	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Cumulative Buildup	.0	0.1	0.3	0.4	0.6	0.7	0.7	0.8	0.9	1.0	1.0	1.0	1.0

YEAR	14	15	16	17	18	19	20	21	22	23	24	25	TOTAL
BASIS													
Drawings + Reflows	4.5	4.2	3.8	3.3	3.0	2.6	2.3	1.9	1.5	1.1	0.8	0.4	107.9
Outstanding BCCR loan	15.6	14.3	13.0	11.7	10.4	9.1	7.8	6.5	5.2	3.9	2.6	1.3	
Outstanding Subloans	21.1	19.5	17.4	16.2	14.8	13.3	11.8	10.3	8.8	7.4	5.9	4.4	
LIBOR %	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	
[illegible]													
Principal Reflow	5.5	5.1	4.6	4.3	3.9	3.6	3.2	2.8	2.4	2.1	1.7	1.3	105.9
Interest Reflow	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.9
MID Interest Collected	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total Project Inflows	6.3	5.8	5.2	4.9	4.5	4.0	3.6	3.1	2.7	2.3	1.8	1.4	120.[illegible]
REPAYMENT TO MID													
Principal	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	19.5
Interest	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total	2.1	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	31.9
PROJECT CASH GENERATION													
Annual Totals	4.2	3.8	3.3	3.0	2.6	2.3	1.9	1.5	1.1	0.8	0.4	.0	88.4
Cumulative	67.7	71.5	74.8	77.8	80.4	82.7	84.5	86.0	87.2	88.0	88.4	88.4	
RESERVE FUND BUILDUP													
Annual Interest Reflow	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Cumulative Buildup	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	

ASSUMPTIONS:

- Loan for US$ 19.5 million available for drawing in three years
- Drawdowns of $ 7.0 million in year 1, $ 10.0 million in year 2, and $ 2.5 million in year 3
- Terms to BCCR of 25 years with 10 grace, straight line reduction commencing in year 11
- Cost to BCCR of 2% in years 1 to 5, 3% in years 6 to 10, 5% thereafter
- Spreads: 1.5% for BCCR, 4.5% for placing bank
- Subloan tenors of 5 years with 1 grace
- Semiannual payments on subloans
- LIBOR as above
- Cost to commercial borrower of LIBOR + 3%
- Reflows made in year subsequent to collection of subloan principal repayments
- Maximum amount of subloans taken down
- Two thirds of interest payments in excess of total spreads recaptured for lending reflow
- One third of interest payments in excess of total spreads recaptured for reserve fund buildup

Version 2: stepped LIBOR up to 10.0% and then held constant

AID PROJECT CASH FLOW (in millions of dollars)

YEAR	1	2	3	4	5	6	7	8	9	10	11	12
BASIS												
Drawings + Reflows	7.0	10.1	4.6	4.7	6.1	7.5	7.1	6.4	7.0	7.5	7.7	6.1
Outstanding BCCP loan	7.0	17.0	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	18.2
Outstanding Subloans	7.0	15.5	17.4	21.0	25.9	26.6	24.2	25.4	27.3	28.4	28.7	27.5
LIBOR %	7.0	8.0	9.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
SUBLOAN RECUPERATION												
Principal Reflow	0.0	1.8	4.3	5.4	6.6	6.4	5.7	6.3	6.8	7.0	7.0	7.2
Interest Reflow	0.1	0.3	0.5	0.7	0.9	0.7	0.6	0.7	0.7	0.8	0.4	0.4
AID Interest Collected	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9
Total Project Inflows	0.2	2.4	5.1	6.5	7.9	7.7	6.9	7.6	8.1	8.3	8.3	8.4
REPAYMENT TO AID												
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3	1.3
Interest	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9
Total	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	2.3	2.2
PROJECT CASH GENERATION												
Annual Totals	0.1	2.1	4.7	6.1	7.5	7.1	6.4	7.0	7.5	7.7	6.1	6.2
Cumulative	0.1	2.2	6.9	13.0	20.5	27.6	33.9	40.9	48.4	56.2	62.2	68.4
RESERVE FUND BUILDUP												
Annual Interest Reflow	.0	0.2	0.2	0.3	0.4	0.4	0.3	0.3	0.4	0.4	0.2	0.2
Cumulative Buildup	.0	0.2	0.4	0.8	1.2	1.6	1.9	2.2	2.6	3.0	3.2	3.3

YEAR	13	14	15	16	17	18	19	20	21	22	23	24	25	TOTAL
BASIS														
Drawings + Reflows	6.2	6.1	5.9	5.6	5.1	5.0	4.7	4.4	4.1	3.7	3.5	3.1	2.8	142.0
Outstanding BCCP loan	16.9	15.6	14.3	13.0	11.7	10.4	9.1	7.8	6.5	5.2	3.9	2.6	1.3	
Outstanding Subloans	27.5	26.8	25.6	23.9	23.0	22.1	20.9	19.7	18.4	17.3	16.1	14.8	13.6	
LIBOR %	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	
SUBLOAN RECUPERATION														
Principal Reflow	7.1	6.9	6.5	6.1	6.0	5.7	5.4	5.1	4.8	4.5	4.2	3.9	3.6	134.1
Interest Reflow	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	10.3
AID Interest Collected	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total Project Inflows	8.3	8.0	7.6	7.1	6.9	6.5	6.1	5.7	5.4	5.0	4.6	4.2	3.9	156.8
REPAYMENT TO AID														
Principal	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	19.5
Interest	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total	2.1	2.1	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	31.9
PROJECT CASH GENERATION														
Annual Totals	6.1	5.9	5.6	5.1	5.0	4.7	4.4	4.1	3.7	3.5	3.1	2.8	2.5	124.9
Cumulative	74.6	80.5	86.1	91.2	96.2	100.9	105.3	109.3	113.1	116.5	119.6	122.5	124.9	
RESERVE FUND BUILDUP														
Annual Interest Reflow	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	5.1
Cumulative Buildup	3.5	3.7	3.9	4.0	4.2	4.3	4.5	4.6	4.7	4.8	5.0	5.1	5.1	

ASSUMPTIONS:

- Loan for US$ 19.5 million available for drawing in three years
- Drawdowns of $ 7.0 million in year 1, $ 10.0 million in year 2, and $ 2.5 million in year 3
- Terms to BCCP of 25 years with 10 grace, straight line reduction commencing in year 11
- Cost to BCCP of 2% in years 1 to 5, 3% in years 6 to 10, 5% thereafter
- Spreads: 1.5% for BCCP, 4.5% for placing bank
- Subloan tenors of 5 years with 1 grace
- Semiannual payments on subloans
- LIBOR as above
- Cost to commercial borrower of LIBOR + 3%
- Reflows made in year subsequent to collection of subloan principal repayments
- Maximum amount of subloans taken down
- Two thirds of interest payments in excess of total spreads recaptured for lending reflow
- One third of interest payments in excess of total spreads recaptured for reserve fund buildup

Version 3: stepped LIBOR up to 15.0% and then held constant

AID PROJECT CASH FLOW (in millions of dollars)

YEAR	1	2	3	4	5	6	7	8	9	10	11
BASIS											
Drawings + Reflows	7.0	10.1	4.6	4.7	6.1	7.6	7.4	6.9	7.9	8.8	9.3
Outstanding BCCR loan	7.0	17.0	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5
Outstanding Subloans	7.0	15.3	17.4	21.0	25.9	26.8	24.7	26.4	29.0	31.2	32.6
LIBOR %	7.0	8.0	9.0	10.0	11.0	12.0	13.0	14.0	15.0	15.0	15.0
SUBLOAN RECUPERATION											
Principal Reflow	0.0	1.8	4.3	5.4	6.6	6.4	5.8	6.5	7.0	7.5	7.8
Interest Reflow	0.1	0.3	0.5	0.7	1.0	1.1	1.2	1.4	1.7	1.9	1.5
AID Interest Collected	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	..0
Total Project Inflows	0.2	2.4	5.1	6.5	8.0	8.0	7.5	8.5	9.3	9.9	10.2
REPAYMENT TO AID											
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3
Interest	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0
Total	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	2.3
PROJECT CASH GENERATION											
Annual Totals	0.1	2.1	4.7	6.1	7.6	7.4	6.9	7.9	8.8	9.3	8.0
Cumulative	0.1	2.2	6.9	13.0	20.6	28.1	35.0	42.9	51.6	61.0	69.0
RESERVE FUND BUILDUP											
Annual Interest Reflow	.0	0.2	0.2	0.3	0.5	0.5	0.6	0.7	0.9	0.9	0.8
Cumulative Buildup	.0	0.2	0.4	0.8	1.3	1.8	2.4	3.1	4.0	4.9	5.7

YEAR	12	13	14	15	16	17	18	19	20	21	22	23	24	25	TOTAL
BASIS															
Drawings + Reflows	8.0	8.4	8.8	8.9	9.0	8.9	9.1	9.3	9.4	9.5	9.6	9.7	9.9	10.0	208.8
Outstanding BCCR loan	19.2	16.9	15.6	14.3	13.0	11.7	10.4	9.1	7.8	6.5	5.2	3.9	2.6	1.3	
Outstanding Subloans	32.7	33.9	34.7	34.9	34.6	35.2	35.8	36.2	36.5	36.9	37.5	38.0	38.5	39.0	
LIBOR %	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	
SUBLOAN RECUPERATION															
Principal Reflow	8.2	8.5	8.6	8.6	8.5	8.8	8.9	9.0	9.0	9.1	9.3	9.4	9.5	9.7	184.1
Interest Reflow	1.5	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.7	1.8	1.8	1.8	34.[illegible]
AID Interest Collected	[illegible]	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total Project Inflows	[illegible]	[illegible]	11.0	11.0	[illegible]	11.0	11.1	11.1	11.1	[illegible]	11.3	11.4	11.5	11.5	[illegible]
REPAYMENT TO AID															
Principal	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	19.5
Interest	0.9	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total	2.2	2.1	2.1	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	31.9
PROJECT CASH GENERATION															
Annual Totals	8.4	8.8	8.9	9.0	8.9	9.1	9.3	9.4	9.5	9.6	9.7	9.9	10.0	10.2	199.5
Cumulative	77.4	86.2	95.1	104.1	112.9	122.1	131.3	140.7	150.1	159.7	169.4	179.3	189.3	199.5	
RESERVE FUND BUILDUP															
Annual Interest Reflow	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9	17.4
Cumulative Buildup	6.4	7.2	8.0	8.9	9.7	10.5	11.3	12.2	13.0	13.9	14.7	15.6	16.5	17.4	

ASSUMPTIONS:
- Loan for US$ 19.5 million available for drawing in three years
- Drawdowns of $ 7.0 million in year 1, $ 10.0 million in year 2, and $ 2.5 million in year 3
- Terms to BCCR of 25 years with 10 grace, straight line reduction commencing in year 11
- Cost to BCCR of 2% in years 1 to 5, 3% in years 6 to 10, 5% thereafter
- Spreads: 1.5% for BCCR, 4.5% for placing bank
- Subloan tenors of 5 years with 1 grace
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- Two thirds of interest payments in excess of total spreads recaptured for lending reflow
- One third of interest payments in excess of total spreads recaptured for reserve fund buildup

reflows/19.5 million amount of loan) to 11.2 (219.0/19.5).

On the cash flows, the line for principal reflows is the result of collecting 25% of each of the four previous years lending (since subloans are actually paid in four years because the first year is a grace period). For example, in Table III-1, the reflow amount of $5.4 million in year 7 is computed as follows:

25% of the year 3 lending of 4.5 = 1.13
25% of the year 4 lending of 4.5 = 1.13
25% of the year 5 lending of 5.7 = 1.43
25% of the year 6 lending of 6.8 = 1.70

principal collected in year 7: $ 5.39 million

The $5.4 million above, plus the amount of 0.1 million recaptured from excess interest, are then loaned out the following year, as depicted in year 8 of the "drawings + reflows" line of the table. In subsequent years when principal repayments to AID commence, the amount of reflows will be reduced accordingly. For the first three years, the "drawings + reflows" line of the cash flow also includes the drawings, arbitrarily assumed to be $7 million in year 1, $10 million in year 2, and $2.65 million in year 3.

The interest owed to AID under the AIR facility has been itemized separately. The interest collected is for the same amount as the interest paid by BCCR so that the numbers offset.

One third of the interest payments in excess of that needed to cover the interest paid to AID, the BCCR 1.5% spread, and the commercial bank's 4.5% spread will also be recaptured into a reserve pool. This means that in years 1 through 5, one third of amounts received in interest payments charged on sub-loans in excess of 8% p.a. will go into the reserve pool (excess of 9% in years 6 through 10, excess of 11% in years 11 through 25). The sensitivity of LIBOR interest rates for the buildup of this fund can be appreciated in the three versions of the cash flow, ranging from a ten year cumulative buildup of $1.0 million at a flat 7% LIBOR rate to $4.9 million at a stepped 15% assumption.

2. Grant Component

One of the principal findings of the May 1986 Booz Allen evaluation of the BANEX loan (515-0176) was that formal training for commercial bank personnel in development finance techniques was necessary for successful term lending. Development lending analysis varies significantly from traditional short-term commercial bank lending, and a substantial learning period is required to develop effective staff capable of performing this type of analysis. Accordingly, $350,000 in grant funds for such technical assistance have been included in the Project and will finance:

- Training in development (project) lending,
- Technical evaluation of sub-projects, and
- Project evaluation.

The grant agreement will be signed with the Central Bank, with a provision that the Mission will act as the contracting agent for all training and technical assistance. The Mission will then compete for the provision of required services in accordance with AID guidelines. To build the capacity of Costa Rican institutions, it is anticipated that a Costa Rican institution or individual will be selected to administer the training and technical assistance funds, although U.S. firms will be encouraged to compete. Several possible candidates have expressed interest in the activity, including the Central American Institute for Business Administration (INCAE), the Costa Rican Banking Association (ABC), and the training unit of CINDE (PROCAP). The contractor selected to administer the training will organize courses in cooperation with the participating banks and the Mission. The contractor, to be selected by December, 1986, will work closely with the Costa Rican Banking Association (ABC) in coordinating course development and trainee identification. Technical training plans developed by the contractor will be approved in advance by USAID project management after consultation with the ABC. AID will also have approval authority over sub-contractors selected to implement the courses as described in Section VI.E. The technical assistance will be available to all commercial banks participating in the facility. Participating banks will contribute one-third of the training and TA costs (see section IV. B).

a. <u>Training in Development Lending</u>

The Costa Rican banks have limited experience in project lending analysis techniques. One of the outputs of this project is improved project analysis and banking know-how. By offering the banks well designed training programs in all areas of project lending including cash flow analysis, loan documentation, disbursement procedures, and supervision, the Project will impact on the lending practices of commercial banks and facilitate the use of project loan funds. One third of the costs will be assumed by the participating banks. A total amount of $180,000 is budgeted over .hree year period, of which over $60,000 will be assumed by the participating ICIs. This figure is based upon an assumption that nine separate sessions in various aspects of project lending analysis will be offered during the life of the project. It is anticipated that a minimum of one hundred participants will receive training under this component of the project. As described above, the ICIs and the ABC will provide recommendations to the training contractor as to the content, orientation, and participants for each of the nine of the sessions in development lending. An additional $50,000 will be budgeted for overhead, contingencies and inflation.

b. Technical Project Evaluation

The participating banks will need technical experts in specialized areas of engineering, agriculture, marketing, manufacturing, food processing, etc. to properly evaluate new development and export-oriented projects. A total amount of $220,000 is budgeted, of which over one-third or $90,000 will be assumed by the participating banks. These short-term technical evaluation consultancies will be provided once at the beginning of a sub-project and a second time to provide follow-up technical advice during implementation of the activity. Assuming there will be forty-five sub-loans to ICIs requiring technical evaluation and two short-term consultancies per loan, about $2,500 per consultancy should be available for use by the ICIs. Past experience in the PIC Project has shown the utility of such specialized analysis in Costa Rica, not only for the technical expertise improving sub-loan and sub-project feasibility, but to aid both bankers and borrowers in technical evaluative techniques.

Selection and contracting of technical evaluation contractors will be the responsibility of the training contractor with approval authority residing with the USAID Project Manager. The training contractor must maintain close contact with both the ABC and ICIs in order to identify and process consultancies as the need for technical evaluation is identified.

D. Evaluation

Two comprehensive project evaluations will be carried out by independent consultants. The first will be an impact evaluation to be carried out in July 1987, and the second will be a final evaluation planned for August, 1989.

Guidance provided in the DAEC Review held at AID/Washington on June 24, 1986 (see PID Approval Cable, Annex 1), sets the focus and timing of the first impact evaluation. Given assumptions in the Project regarding the impact of loan terms and eligibility criteria on loan demand, this evaluation will provide answers as to the validity of the initial design features. The evaluation will also serve to determine whether rediscounting through the Central Bank is an effective mechanism for injecting dollar financing to Costa Rican private sector enterprises. Factors likely to be included for consideration in the first evaluation are disbursement rates at BCCR and private bank levels; size, type and purposes of approved sub-loans, repayment experience; types of export industries involved, demand for dollar versus colon loans, etc. The final evaluation will focus on lessons learned on feasibility of the Project design, experience in credit fund capitalization, increases achieved in foreign exchange and employment generation, types of sub-loans made, impact of technical training on the private banking sector, etc.

Contracting evaluation technical assistance will be the responsibility of USAID/Costa Rica acting in its capacity at the BCCR's (Grantee's) agent and as described in Section VI. D. Both interim and final evaluations as well as audits, will be financed from grant funds.

IV. COSTS ESTIMATES AND FINANCIAL PLAN

The total cost of the Project will be approximately $28 million including contributions from AID, the ICIs and ultimate sub-borrowers. AID's portion is $20 million of which $19.65 million will be long-term loan funds and an additional $.350 million will be in grant assistance. The AID funds will be fully obligated in FY 1986. Disbursements, however, will not begin until FY 1987. Ultimate sub-borrowers will contribute at least 30% of the total cost of each sub-project for a LOP contribution of approximately $8 million. The following table provides an estimate of counterpart contributions and a disbursement schedule over the life of the Project. As an indication of their interest in technical assistance, the Costa Rican private commercial banks will contribute one-third of the training and related technical assistance costs.

TABLE IV - 1

PROJECTED LOP DISBURSEMENTS BY FISCAL YEAR
($U.S. Millions)

	Component	FY 1987	FY 1988	FY 1989	Total
1.	Rediscount Facility				
	a. AID Funding (L)	$ 7.00	$10.00	$ 2.65	$19.65
	b. Sub-borrowers Counterpart	3.00	4.25	1.10	8.35
	Sub Total	$10.00	$14.25	$ 3.75	$28.00
2.	Technical Assistance				
	a. AID Funding (G)	$ .10	$ .15	$ .10	$ .35
	b. ICI Contribution	.05	.05	.05	.15
	Sub Total	$ .15	$ .20	$ .15	$ .50
	TOTAL	$10.15	$14.45	$ 3.90	$28.50

Disbursement of the training and technical assistance resources is broken down by fiscal year as follows:

TABLE IV - 3

PROJECTED TECHNICAL ASSISTANCE BUDGET
($000)

COMPONENT	87		88		89		TOTAL	
	AID	ICIs	AID	ICIs	AID	ICIs	AID	ICIs
Training	40	20	40	20	40	20	120	60
Technical Evaluations	44	30	43	30	43	30	130	90
Evaluation/Audit	25	-	-	-	25	-	50	-
Contingency/ Inflation	16	-	17	-	17	-	50	-
Sub Totals	125	50	100	50	125	50	350	150

V. PROJECT ANALYSES SUMMARIES

A. Demand Analysis Summary

Based on the current lending environment in Costa Rica and the increasing level of investment in non-traditional export projects, the Mission's analysis shows that there is more than sufficient demand for the project, and that the proposed facility will be fully drawn down over the planned three year life of the project. This conclusion is based on the most exhaustive demand analysis that has been done to date in Costa Rica. Since the development of the PID in August 1985, local bankers have been surveyed twice; potential end users several times; the disbursement rates and pipelines of existing dollar facilities were analyzed; and pipelines at private banks engaged in this type of lending were studied. In addition, the Mission has benefitted from the demand analysis undertaken in Costa Rica by ROCAP for recently approved projects with CABEI and LAAD. All of the above was matched against the likely supply of this type of financing over the life of this Project. Annex VI provides a complete discussion, with supporting figures, on the potential demand for project resources.

Before elaborating on the above, a caveat is in order. While the numerous aspects of the demand analysis have been thoroughly examined, the final demand figures for this type of resource in Costa Rica are, at best, a barometer of the potential market. In addition, demand is static at any given time. Moreover, the lending environment in Costa Rica in general, and the demand for the type of financing contemplated in particular, is very dynamic. The Project is aimed at assisting producers of non-traditional exports, an area which has shown tremendous growth in the past several years. Particularly noteworthy is the success of CINDE's efforts to attract foreign investors to Costa Rica, many of which require local financing for fixed asset investment.

The most basic characteristic of demand for term financing for export projects in Costa Rica is that it is divided into two components: 1) those investors who insist on borrowing in local currency so as to eliminate all foreign exchange risk, and 2) those who prefer dollar credit because of the lower interest rates. In today's market, the interest rate differential to the end user is over 100% - LIBOR plus 3% for a total of 9.5% in dollars, against approximately 23% for local currency term loans.

There are two components to foreign exchange risk: devaluation and currency inconvertibility.

The risk of devaluation comes into play when the proceeds of a loan in a hard currency must be paid back with earnings in a soft currency. Over time, as the soft currency devalues, more and more soft

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currency earnings will be required to make the payments on the hard currency loan. A structural solution to this problem is achieved with an export-oriented project. Since sales are generated in the hard currency (or in local currency pegged to the hard currency in a foreign exchange nationalization situation), revenues in local currency automatically increase to cover the devaluation over time. Currency inconvertibility risk is the risk that hard currency to repay the loan will not be available at repayment time. The borrower may have the local currency needed to make the payments even at a devalued exchange rate, but the Central Bank may be out of dollars. A lesser problem than total unavailability is a situation of chronic shortage of hard currency, resulting in an institutionalized temporary inconvertibility situation. Costa Rica went through an official total dollar unavailability situation in 1981-82, and has lived with a chronic dollar purchase pipeline ever since. The dollars are made available, but with a delay of up to several weeks. A permanent dollar request pipeline at the Central Bank accumulates (the "presa de divisas"), and extra interest expenses for dollar debt generated by presa processing time become a normal part of doing business.

A key feature of the Project is that investors are effectively protected from both the devaluation and currency inconvertibility components of foreign exchange risk. The first is covered by limiting the program to hard currency export oriented projects. The second, the special structuring of the exchange conversion process at the BCCR, will permit disbursal and repayment in local currency at the prevailing official exchange rate discharging obligations of the BCCR, the intermediary private banks, and the ultimate sub-borrower. This feature of the program, made possible by the BCCR's rules for application of the modified currency law (Ley de la Moneda), has made the concept of dollar term lending acceptable to the great majority of Costa Rican private banks. As a result, the question mark as to loan demand has effectively been transferred down from the level of the banking intermediaries to that of the ultimate sub-borrowers. This special foreign exchange processing feature is new and, as it becomes known among local potential export project investors, demand for loan funds is expected to increase significantly.

1) IRG Analysis

In August 1985, two consultants from the International Resources Group (IRG) assisted the Mission with preliminary analysis for the preparation of the PID. The consultants assessed demand for term dollars on the part of ICIs, and measured this against the available supply (from BANEX, COFISA, the PIC, etc.). From this, the net unmet demand for terms dollars was calculated. On the basis of their analysis, the IRG team determined that over a twelve to eighteen month period, the medium-term unfulfilled dollar demand in Costa Rica will range from $7 to $28 million before taking into account incremental demand that could be created by (1) any material improvement in the dollar lending climate and (2) the successful packaging efforts of entrepreneurs and institutions such as the PIC and CINDE/PIE. It should be noted that these figures were based on the existing pipeline at the ICIs, without taking into account new projects, and that projections were based on half of the proposed Project's life. Therefore, these figures can be considered conservative.

2) Mission's Demand Survey

To complement the IRG demand analysis, which was based on interviews and documents from ICIs, the Mission undertook an effort to survey the pool of potential ultimate beneficiaries of the proposed facility -- existing private enterprises. To reach this group, a demand questionnaire was prepared, tested, and sent to a stratified random sample of over 400 firms.

The response rate, (34%), was quite high for this type of survey. Some of the highlights of the analysis include:

- 80% of respondents were industrial firms, mainly producing for domestic markets.

- 21% met the minimum criteria (having investment plans, requiring more than just working capital financing, willing to borrow, and willing to consider dollar credit).

- 36% of the dollar financing required was by firms which exported more than half of their output.

- 77% of respondents with financing needs required more than just working capital credit.

- 60% of respondents stated they would consider dollar financing.

- 51% said they would borrow dollars rather than forego planned investments.

- The total financing required (and total possible demand) by respondents meeting the aforementioned minimum criteria is $29 million over the 1986 - 1988 period.

It should be noted that the questionnaire reached only existing firms. Therefore, the demand indicated by the survey can be considered conservative as it does not take into account new enterprises.

3) Estimates of ICIs

There are currently 16 private banks in Costa Rica, about half of which are strong and aggressive. In addition, there may be several new banks within the next years.

One of the new banks will be Banco de COFISA. COFISA has, as of July 1986, a pipeline of well developed projects of over $6 million, the great majority of which qualify under the Project's lending criteria. In addition, COFISA management indicated an additional $3 million of mature project proposals, of which approximately half will eventually be financed. COFISA, the financiera, has been in business for several decades and is the strongest and most active promoter of development financing in Costa Rica. As such, it is potentially the biggest user of the AIR facility. BANEX, Interfin, Banco de Fomento Agrícola, Banco Cooperativo, and the Banco BCT, collectively estimated current demand of $13 million. It should be noted that these figures represent current demand and can be expected to increase significantly over the three year life of the Project. (See Annex VI).

4) Recent Term lending for Export Projects

Another indicator of the market for the AIR facility is the recent experience for similar lending in Costa Rica. From 1984 to June 1986, a total of $33.3 million, in dollars, was on-lent for similar investments in export projects. In addition, the local currency equivalent of $27.5 million was on-lent for these purposes, for a total of $60.8 million. These figures are for BANEX, COFISA, the PIC, LAAD, and CABEI only. For further information, see Annex VI.

5) Supply

On the supply side, there is limited term financing for non-traditional export projects, whether in dollars or local currency. The principal source of local currency financing is the AID-funded Special Credit Line at the Central Bank. The Special Credit Line has been funded from ESF cash transfer local curreny generations over the last three years. Each funding tranche of the Special Credit Line has been rapidly exhausted to date. The local currency equivalent of over $95 million has been on-lent. While this facility is potentially competitive with the proposed Project, it must be noted that its uses and terms differ, thereby reducing its competitive impact. The Special Credit Line provides resources for project financing (up to five years), working capital, debt restructuring, and equity financing. To date only 10% has been used for project financing. In addition, the latest funding tranche (July 1986) carries the proviso that participating banks must increase their capital by an amount equal to 50% of the funds used. This may cause initial delays in bank requests for Special Credit Line funds, which should encourage both banks and sub-borrowers to look to other sources of financing.

FODEIN, the World Bank facility in the BCCR is, on paper, serious competition for the proposed facility. FODEIN's cumbersome and time consuming procedures, however, effectively reduce its competitive impact. The special department in the BCCR which handless the facility has taken an academic approach to sub-project analysis. The feasibility study preparations and processing in extremely comprehensive and often takes more than a year to complete.

On the dollar side, LAAD, with is new ROCAP Project, estimates lending $4.5 million in Costa Rica for agribusiness export projects. CABEI, also a recipient of recent ROCAP loan, has $15 million for private sector lending for all of Central America, a portion of which is expected to be disbursed in Costa Rica. The only other source of dollar term financing is the PIC, which lends to larger sub-projects than contemplated under this Project.

6) Summary

The Mission's position as regards demand for the proposed facility is based on a number of sources. Recent conversations with ICIs and the Costa Rican Banking Association confirm that significant demand exists and that the resources are needed in Costa Rica. Moreover, in view of the relative exchange rate stability Costa Rica has achieved and the large interest rate difference between dollar and colon loans, a greater disposition of even conservative local companies to borrow dollars has been noted.

B. Institutional Analysis Summary

1. The Central Bank

The loan will be placed with the BCCR through a special section of the Financial Department which will be in charge of disbursements, supervision and controls of the sub-loans to the ICIs. This department is fully computerized and has established a good track record through the AID Special Credit Line, demonstrating its capability to administratively handle the new facility in an efficient manner. This department will work closely with the Mission Project Officer. It is not expected that the Project will be an added burden on the BCCR.

2. The ICIs

By the end of 1986, Costa Rica will count about 20 private commercial banks of which between 8 to 10 will qualify to participate in the proposed project. These 10 banks have a sound financial structure and are well organized under experienced management. At least four of these banks, COFISA, BANEX, INTERFIN, and BANCOOP already have project financing experience. Other potential participating banks have expressed keen interest in acquiring this capability and actively participating in the program, especially given the proposed training and technical assistance which will be available under the Grant portion of the Project.

The acceptance of this program has been made much easier for the ICIs due to the fact that funds will be lent by the BCCR, thereby giving the ICIs and final sub-borrower clear protection under Costa Rican monetary law. This will also eliminate all transfer risk as the BCCR will accept repayment in local currency at the prevailing BCCR exchange at day of payment. This is a very attractive feature for sub-borrower since it will eliminate the "Presa" (waiting period to get the foreign exchange from the BCCR) which increases the cost of dollar lending. Presently, sub-borrowers have to pay interest on dollar loans from the time they deposit colones with the BCCR until the BCCR makes the dollars available which, under normal circumstances, can be weeks.

This feature also enhances the willingness of potential sub-borrowers to incur dollar liabilities and will further strengthen the demand for these funds. The complete Institutional Analysis is contained in Annex VII.

C. Financial/Economic Analysis

In carrying out the AIR economic analysis, three goals were paramount: establishing economic self sufficiency of the project, analysis of the returns to investors and to Costa Rica to be expected from projects financed, and estimation of wider economic-social benefits over time. These were seen as the necessary areas to be covered for a meaningful economic analysis covering both macro and micro economic aspects of the project. The first point was critical to see whether the project structure could be justified in a straight forward way, without resorting to difficult-to-quantify economic linkages and indirect benefits. Passing this initial test, an attempt at analyzing economic return and benefits to the private sector for the type of sub-projects to be financed was in order. This point was crucial in establishing an economic basis to confirm the positive conclusions on end user demand. Once sufficient returns at the sub-project level were established, economic-social benefits for Costa Rica as a whole were projected, based on parameters derived from experience of other Costa Rican institutions with similar types of loans.

The proposed project facility shows positive economic indicators from a project targeted at the most productive type of investment for Costa Rica: exports of non-traditional products to hard currency markets.

Examination of the portfolios and the applications for financing at two AID-related financial institutions in Costa Rica already operating in project financing, (COFISA and PIC), showed a bias towards agricultural and agroindustrial projects -- not surprising since this is the area where Costa Rica has a comparative economic advantage, and where value added is highest, contributing to the best returns.

On an individual project level, three agricultural projects showed internal rates of return (IRR) of 35.3%, 32.1% and 38.48%. Two manufacturing projects projected IRRs of 23.7% and 30.8%. Composite cashflows produced IRRs of 34.4% in agriculture and 26.1% in manufacturing. Given these very good returns, well above an opportunity cost of capital estimated at 10% to 12% p.a., it is not surprising that entrepreneurs have found these investments attractive so that three of them are actually being carried forward. (See Annex VIII.)

For the AIR Project as a whole, over the entire life of the project, cashflows with various assumptions as to the behavior of LIBOR over time show that the project will easily pay for itself directly for AID's borrower, the Central Bank of Costa Rica. Depending on a high or low LIBOR over time, the project has the capacity, assuming full utilization, to generate between $120 million and $231 million in principal plus reflow disbursals over its 25 year projected life.

Wider economic benefits were projected on the basis of factors applied to an actual investment project term lending portfolio, for total sales generation, foreign exchange generation, employment creation and people supported. They were projected as functions of loan principals outstanding over time, applied to the cashflow with the most conservative (lowest, for the purpose of this analysis) LIBOR projection.

The factors applied, based on a cross section of 27 projects presently being funded by the A.I.D.-supported COFISA porject in a similar target market, were:

Sales Generation	$ 7.12 per dollar loaned
Foreign Exchange Generation	$ 5.64 per dollar loaned
Employment Generation	3.68 jobs per $10,000 loaned
People Supported	18.4 per $10,000 loaned

These factors, impressive in themselves, highlight once again the productiveness of the target investment market. Over a ten year period, these factors applied to the most conservative cashflow yield the following results:

Sales Generation	$477 million
Foreign Exchange Generation	$354 million
Jobs Created	23,000
People Supported	115,552

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The complete Economic and Financial Analysis is contained in Annex VIII.

D. Social Soundness Analysis

1. Introduction

Until recently Costa Rica was considered a model of political and economic stability for a developing country. Following an import substitution strategy for two decades (1960-1978), Costa Rica sustained an average real GDP growth rate in excess of 6 percent per year. During this period, Costa Rica achieved one of the highest levels of per capita income in Latin America. Compared with other countries in the area, the benefits of growth in income were equitably distributed, health services became widely extended, infant mortality declined sharply, and the rates of population growth fell. In a political setting in which the democratic tradition has survived longer than any other in Central or South America, Costa Rica seemed well on its way toward eradicating poverty.

By 1979, the terms of trade turned against Costa Rica as coffee prices fell sharply from their 1977 high and the price of petroleum doubled. Trends in real growth of the GDP dropped sharply and fell to a negative rate of 9% in 1982. This economic crisis was characterized by double digit inflation, huge public sector deficits, sharp and adverse shifts in the terms of trade, the creation of an enormous external debt, rising unemployment, and the disappearance of commercial sources of credit.

By 1981, foreign exchange reserves were exhausted and the attempt to maintain real income collapsed with a de facto moratorium on servicing the foreign debt. GDP declined by 2.3 percent in 1981, and by 7.3 percent in 1982. Unemployment and underemployment rates rose by 1982 to 9 percent and 14 percent respectively. Inflation exceeded 100 percent by the end of 1981.

The economic crisis had a drastic impact on the standard of living of the average Costa Rican. Real wages declined strongly in 1981 and 1982; even after some recovery in 1983, they were at only 74% of the 1979 level.

Efforts by Costa Rica since the economic crisis, supported by AID, have focused not only upon stabilization of the economy but upon laying a basis for sustained economic growth by reforming the financial system to a more free-market orientation, decreasing public sector expenditures, removing disincentives to exports and production, etc. Since 1985 inflation has stabilized at about 10% and an improvement in external terms of trade (coffee and oil) and some increase in demand for Costa Rica's non-traditional exports will make possible a growth rate in GDP of some 3% in 1986, up from 1% in 1985.

The economic situation is, of course, detrimental to the poor. In addition to sharing inflation and other serious consequences of the crisis with the rest of the population, the poor suffer disproportionately from unemployment and shrinking social services budgets. By directing essential resources to the producers and manufacturers of non-traditional exports, this Project will generate greater production for export, contributing therefore to overall economic recovery. From that will follow more employment, higher real wages, and improved social services. In many lesser developed countries, the argument that general economic growth will be equitably distributed to all sectors of society (including the poor), might not be valid. Costa Rica, however, has long had a strong commitment to the equitable distribution of wealth. History has demonstrated this commitment transcends political shifts and other short-term conditions.

2. Impact on the Beneficiaries

The objective of this Project is to contribute to the growth of the Costa Rican economy by stimulating development and reactivation in the agricultural and industrial sectors. This new investment will generate substantial increases in employment and wages due to the financing of new or expanded agro-industrial projects.

The target population of the Project can be divided into three distinct categories of beneficiaries: (1) entrepreneur/investors, (2) unemployed or underemployed laborers and (3) farmers. Sub-project activities will benefit the target group either directly or indirectly. Jobs will be created for unskilled and semi-skilled labor in industrial enterprises and agro-industrial operations because these will require agricultural raw materials from farmers in rural areas. Expanded investment opportunities will be offered to both local and U.S. companies, to new entrepreneurs or young businessmen who do not readily have access to the capital or technology required for the consideration of export investment and who often can respond quickly to export opportunities.

The producers, processors, or manufacturers who will benefit from this Project will be those who can develop or have a comparative advantage for export marketing. By directing essential resources to the producers and manufacturers of exports, the project will generate greater production and thereby contribute to overall economic recovery. From that will derive more employment, higher real wages, tax revenue and better social services. Costa Rican's poor will be ultimate beneficiaries of the Project.

Sub-loans will support both labor intensive and capital intensive enterprises. It is estimated that the Project portfolio will create 23,000 permanent jobs over a ten year period, while generating over $475 million in sales over the same period.

3. Other Socio-Economic Benefits

It is anticipated that many sub-projects will involve new non-tradtional product lines with backward linkages to the rural population. Agriculture, agro-business, wood product industries, fisheries and leather product industries are heavily dependent on raw materials and other inputs from the rural sector. Rural employment and the quality of rural life are, therefore, linked to development of these potential sub-projects. On a parallel basis, direct feeder industries will expand, and related services industries such as transportation, warehousing, and others will be stimulated.

The Costa Rican society as a whole will also derive direct and indirect benefit from the Project due to the injection of an estimated $350 million in foreign exchange generated over the next ten years. The economy will be deepened; GDP will rise, especially in the agro-industrial sector; government tax receipts are likely to increase; foreign exchange earnings will rise substantially; and private resources, now idle, may be channeled into productive activities.

VI. PROJECT IMPLEMENTATION

A. Project Management

1. Role of USAID

The Mission will appoint a Project Manager from the Private Sector Office who will supervise the Project and will be responsible for its proper implementation on a day to day basis. The Project Manager will maintain direct contact with the respective officers of the BCCR and the ICIs and will be available for consultation as needed. The Project Manager will be supported by a Backstop Officer from the Project Development Division and will obtain guidance from Mission Management on key issues. The Project Manager will ensure that the AID procurement policies are respected, and will also review disbursement and reimbursement requests and recommend approval of disbursements to the Controller's Office.

2. Role of the BCCR

A division of the Finance Department of the BCCR will assume direct responsibility for the implementation of the Project. This division will request, through the AID Project Manager, disbursement from AID and will disburse the sub-loans to the ICIs according to disbursement procedures described below in Section C.

Loan disbursement requests from the ICIs will be reviewed by the Finance Department to determine qualification of the sub-project according to established guidelines. The review will not include an analysis of the economic and financial soundness of the sub-project, but will only determine if it falls in the authorized categories of financing eligibility.

The BCCR, through the Finance Department, will have the authority to exclude ICIs from the program if the financial soundness of the ICI becomes questionable based on a determination by the Auditoría General de Bancos. The Central Bank assumes the credit risk of the financial institutions but not of the ultimate sub-borrower.

3. Role of the ICIs

The ICIs will identify eligible sub-projects, analyze the sub-project for financial and economic feasibility, approve sub-loans, and assume the full credit risk of the sub-loan. The ICIs will be obliged to repay the sub-loans to the BCCR according to established maturities, independently of the repayment performance of the sub-borrower. However, the ICIs can negotiate with the BCCR restructuring of maturities if the ICI, in turn, restructured the sub-loan under justified circumstances. The ICI will also be responsible to ensure that the final sub-borrower complies with AID procurement policies.

B. Implementation Schedule

The following represents key implementation events:

	Event	Date
1.	Formal BCCR Executive Board approval of project	August, 1986
2.	Project Authorized	August, 1986
3.	Project Agreement Negotiated and signed	August, 1986
4.	CPs to disbursement of loan funds met	September, 1986
5.	AID-BCCR-ICI operating procedures formalized	September-October 1986
6.	RFP issued for training grant	October, 1986
7.	First disbursement at AID loan	November, 1986
8.	Training contractor selected, contract negotiate and signed	December, 1986
9.	Training, ST - technical assistance begins	March, 1987
10.	Interim project evaluation	July, 1987
11.	Final evaluation	July, 1989
12.	PACD	August, 1989

C. Disbursement Procedures

1. Sub-Project Disbursements

Disbursement by USAID to the BCCR for sub-project financing will be made through a special credit fund and through AID direct reimbursement procedures. The BCCR will create a credit fund through a dollar advance, the balance of which will equal the ICI's projected sub-project disbursements for not to exceed a thirty day period. The advance, to be held by the BCCR in a non-interest bearing account, will be replenished by the USAID upon the BCCR's submission of vouchers and supporting documentation to evidence ICI sub-project disbursements and a projection based on ICI sub-project disbursement needs for the coming thirty day period. Letters of commitment may also be used.

2. Grant Disbursements

USAID/Costa Rica will provide financing to the training contractor via direct reimbursements as will be specified in the contract. The contractor will submit a standard AID 1034 form for disbursement of funds.

D. Procurement Procedures

1. General Procurement Policies

Procurements by sub-borrowers with Project funds will be made in conformance with AID procurement policies as described in AID Handbook 1, Supplement B, Chapter 19, Intermediate Credit Institutions. The source and origin of all USAID funded procurements, with the exception of shelf items, are restricted to Geographic Code 941 and Central America.

As a practical matter, the degree of control which AID may exercise over this type of procurement is somewhat limited by the fact that the ultimate sub-borrower is separated from AID by two intermediaries, the BCCR and the ICIs. The Mission's recent experience with the PIC project, however, has demonstrated that it is possible for ICIs to effectively advise sub-borrowers of the restrictions on loan-financed dollar procurement and to monitor sub-borrower purchases.

USAID/Costa Rica will follow several approaches in establishing required AID procurement procedures. First, the BCCR shall provide copies of procurement regulations - supplied to them by AID - to each participating private bank as part of individual loan transactions. USAID using the ABC's and the training contractor's coordinative capacity with the ICIs, shall also undertake one or several seminars led by an AID procurement specialist with representation by each of the participating private banks to inform them of procurement requirements and monitoring mechanisms (as has been accomplished previously in the PIC project). Close relationships already established with many of the private Costa Rican banks will allow USAID project management to monitor ICI adherence to the regulations from the outset of the project and allow appropriate steps to be taken during project implementation.

The participating ICI's will be able to continue disbursements of sub-loans only if sub-borrower purchases of goods and services comply with AID procurement policy. The ICIs will be required to maintain a procurement record on each loan with USAID retaining the right to inspect these records and to recommend that the BCCR impose penalties if violations are detected and not corrected.

For each loan disbursement, the BCCR will provide USAID project management with a reimbursement request including copies of loan request of the ICI and indicating the purpose and conditions of the loan. Included in this package will be a procurement compliance checklist which will enable USAID project management to detect procurement violations and withhold disbursement. A.I.D. procurement regulations do not apply to procurement undertaken under financing by loan reflows.

2. Technical Assistance Contracting Plan

As discussed in Section III.C., technical assistance on development lending and technical project evaluation will be provided to the participating private Costa Rican banks through a training contractor to be selected through AID competitive procedures. Specialized consulting services shall be required either from international financial institutions such as the World Bank, specialized consulting firms, independent consultants or international banks. Further specialized technical assistance will be required from the two planned project evaluations (Section III.D.), planned for July, 1987 and July, 1989.

Subject to the approval of USAID, and in coordination with ABC, the training contractor will be responsible for the selection and contracting under the terms of AID Handbook 11 (Country Contracting). If an IQC route is pursued, Request for Proposals (RFPs) will be issued to identify and select the qualified firm. Otherwise, standard Handbook 11 competitive contracting guidelines would be followed.

In all cases the Mission will assist and encourage the training contractor to identify and utilize small, disadvantaged and women-owned enterprises possessing the requisite expertise to provide the required technical services.

VII. CONDITIONS, COVENANTS AND NEGOTIATING STATUS

A. Conditions Precedent to Disbursement

Prior to the first disbursement of Loan funds the BCCR shall submit in form and substance acceptable to AID:

1. An implementation plan for its portion of the Project.

2. A standard facesheet to be used by all participating private banks when submitting funding requests to the Central Bank.

B. Covenants

The Central Bank of Costa Rica shall covenant as follows:

1. That funds and reflows loaned to the BCCR under this project shall be made available exclusively to qualified private Costa Rican banks for the purposes and objectives of the Project.

2. That reflows from project funds will continue to be rediscounted in U.S. dollars for a period coinciding with the repayment schedule of the AID Loan.

3. That if LIBOR plus 3% should be higher than the BCCR cost of funds plus 6% (4 1/2% for ICIs and 1 1/2% for the BCCR), excess funds shall be deposited in the Project Loan Account to be established at the Central Bank for continued project lending and for use as a loan guarantee fund.

4. Loans between the BCCR and ICIs will be denominated and documented in dollars and payable in local currency at the Dollar/Colón exchange rate in force on the date of repayment..

5. To submit a report to AID each quarter for the life of the Project Agreement containing a break-down of sub-projects by type, commitments and disbursements, conditions of financing, and other information as AID may reasonably request.

The Central Bank of Costa Rica shall also agree to specify in loan agreements with borrowers that:

6. That mixed enterprises and parastatals will be ineligible ultimate sub-borrowers of funds rediscounted under this Loan.

7. No sub-loans shall be made for the development of agricultural exports that can be expected to cause substantial injury to U.S. exporters and whose production of agricultural export commodities could be deemed directly competitive with U.S. producers.

8. Applicable AID procurement practices shall be adhered to by ultimate sub-borrowers for loans made with the initial funds from the AID loan.

9. No more than 70% of ultimate sub-borrower financial requirements shall be provided from sub-loans made with project funds.

10. No loans shall be made for purposes that adversely affect the environment, harm endangered species or in any way involve the manufacture or sale of military, paramilitary or police equipment, or related activities.

C. Negotiating Status

USAID/Costa Rica has been discussing and negotiating development of all issues pertaining to the AIR facility with the BCCR and the Costa Rica private banks since August, 1985. Close working relationships between the private banks, the BCCR and AID have resulted in agreements as to the terms and conditions of the AID credit facility that, while adhering to AID private sector support and credit policies, have received the concurrence at the BCCR and the private banks. The Mission, throughout the design process, has consulted with working and managerial levels of the BCCR, and on August 13, 1986 received formal approval from the BCCR Board of Directors that project resources be channeled directly to the private Costa Rica banking sector. Unless there are major changes in terms, as outlined previously in this section, USAID/Costa Rica anticipates no problems during final negotiation of the Project Agreement.

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ACTION

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E.O. 12356: N/A
TAGS:
SUBJECT: AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT NO. 515-0223 - PID GUIDANCE CABLE

REF.: STATE 189806

1. THE SUBJECT PID WAS APPROVED BY THE DAEC ON JUNE 24. THE ISSUE OF PP SUBMISSION TO AID/W IS DISCUSSED AT THE END OF PARA 2, BELOW. THE FOLLOWING SECTIONS CONTAIN GUIDANCE TO THE MISSION FOR USE IN DEVELOPING THE PP.

2. GOVERNMENT BANK PARTICIPATION. PARA 3A REFTEL, PROVIDES GUIDANCE TO MISSION REGARDING THE PROVISION OF ASSISTANCE TO PARASTATAL FINANCIAL INSTITUTIONS THAT REQUIRES QUOTE PROJECTS (TO) SEEK TO EXTRACT GOVERNMENT MINISTRIES AND PARASTATALS FROM THE (ONLENDING APPROVAL) PROCESS IF THEY ARE NOW SO INVOLVED UNQUOTE. GIVEN THAT SUCH A SITUATION PRESENTLY EXISTS IN COSTA RICA, THE MISSION SHOULD NEGOTIATE IMPLEMENTATION OF THE SUBJECT PROJECT IN SUCH A WAY AS TO PASS ALL PROJECT RESOURCES TO AND THROUGH PRIVATE SECTOR FINANCIAL ENTITIES ONLY. ALTERNATIVELY, THE MISSION COULD SEEK TO JUSTIFY PARASTATAL PARTICIPATION (AT LEAST AT THE PROJECT'S OUTSET) ON THE BASIS OF GOCR COMMITMENT TO POLICY REFORM LEADING TO GREATER RELIANCE ON MARKET FORCES WITHIN THE FINANCIAL SECTOR. WE RECOGNIZE THAT THE ISSUE OF THE PUBLIC SECTOR DOMINATED BANKING SYSTEM IS COMPLEX AND POLITICALLY SENSITIVE IN COSTA RICA AND THAT NEGOTIATING ANY SIGNIFICANT PROGRESS IN REDUCING THE ROLE OF THE PUBLIC SECTOR AS PART OF THIS PROJECT MAY PROVE TO BE QUITE DIFFICULT. IF THE MISSION IS UNABLE TO COME UP WITH AN ARRANGEMENT THAT IS WORKABLE IN COSTA RICA AND AT THE SAME TIME IS IN LINE WITH POLICY GUIDELINES SET OUT ABOVE (NAMELY, THAT FINANCIAL ENTITIES BE DIVESTED AND/OR SIGNIFICANT POLICY REFORMS ON GOVERNMENT BANKS BE ENACTED), WE ASK THAT THE MISSION SUBMIT THE PP FOR BUREAU REVIEW UPON ITS COMPLETION. IF THE MISSION DOES SUCCEED IN ITS POLICY NEGOTIATIONS, WE WOULD NOT NEED TO SEE THE PP.

USAID/Costa Rica	Act.	Info
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3. EVALUATION. GIVEN THE ASSUMPTIONS IN THE PID DEALING WITH THE COST TO PRIVATE SECTOR BORROWERS AND THE PARTICIPATION OF THE COMMERCIAL BANKING SYSTEM, THE

BUREAU REQUESTS THAT AN IMPACT EVALUATION BE DONE ON THE PROJECT PRIOR TO THE MISSION'S OBLIGATING THE NEXT TRANCHE OF FUNDS FOR THE PROJECT IN FY 1987 (PRESUMABLY THIS WOULD BE DONE BY JUNE 1987). THE EVALUATION WOULD SERVE TO DETERMINE WHETHER MISSION'S STRATEGY OF REDISCOUNTING THROUGH THE CENTRAL BANK TO THE COMMERCIAL BANKING SYSTEM AT LARGE IS ACHIEVING THE PROJECT PURPOSE OF GETTING INVESTMENT DOLLAR FINANCING QUICKLY TO PRIVATE SECTOR ENTERPRISES. FACTORS WE BELIEVE WOULD MERIT EXAMINATION IN SUCH AN EVALUATION WOULD INCLUDE DISBURSEMENT RATES (AT THE CENTRAL BANK AND COMMERCIAL BANK LEVELS), DISCUSSION OF WHICH BANKS HAVE RECEIVED THE FUNDS, AND WHAT IS BEING FINANCED (TYPES OF EXPORT INDUSTRIES, SIZE OF LOAN, PURPOSE OF LOAN, AND REPAYMENT EXPERIENCE, IF ANY, ETC.). A SUMMARY OF THE EVALUATION SHOULD BE CABLED TO AID/W.

4. INTEREST RATES. THE BUREAU REQUESTS THAT THE ICIS BE ALLOWED TO SET INTEREST RATES TO THE FINAL BORROWERS AT LEVELS THAT WOULD ALLOW A SUFFICIENT SPREAD TO COVER TRANSACTION AND RISK COSTS (IN SOME CASES, PRESUMABLY, THESE WOULD BE HIGHER THAN 3.5 PERCENT), AS WELL AS PROFIT.

5. EXCHANGE RATE RISK. GIVEN CENTRAL BANK CONTROLS OVER FOREIGN EXCHANGE, THE MISSION SHOULD CONSIDER STRATEGIES WHICH ENSURE THAT THE FINAL BORROWER IS NOT HELD LIABLE FOR THE FOREIGN EXCHANGE CONVERTIBILITY RISK IF THE CENTRAL BANK IS UNABLE TO SELL DOLLARS TO EXPORTERS WHEN LOAN PAYMENTS FALL DUE, INCLUDING CONSIDERATION OF PAYMENT IN DOLLAR-EQUIVALENT LOCAL CURRENCY.

6. INSTITUTIONALISM OF FUND. THE PROJECT PURPOSE SHOULD BE CLARIFIED TO FOCUS THE PROJECT ON PROVIDING RESOURCES TO PRIVATE SECTOR INVESTORS ON AN EFFICIENT BASIS. IT WAS RECOGNIZED THAT SOME DECAPITALIZATION OF THE CENTRAL BANK FUND WILL OCCUR AS THE AID LOAN IS AMORTIZED. HOWEVER, THE CENTRAL BANK SHOULD COVENANT TO CONTINUE REDISCOUNTING LOANS IN U.S. DOLLARS EVEN IF IT ACCEPTS LOCAL CURRENCY REPAYMENTS FOR REASONS DISCUSSED IN PARAGRAPH 5.

7. LOAN SIZE. PER DISCUSSIONS IN THE DAEC, THE MAXIMUM SUB-LOAN SIZE FOR THE FIRST INCREMENT OF THE PROJECT SHOULD BE HELD TO DOLS 350 THOUSAND TO ENCOURAGE BROADEST DISTRIBUTION OF PROJECT FUNDS. THIS LIMITATION SHOULD BE REVIEWED DURING THE FIRST YEAR EVALUATION TO SEE WHETHER ANY ADJUSTMENT UPWARD IS WARRANTED.

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8. SUB-LOANS. SUB-LOANS SHOULD EXCLUDE MIXED ENTERPRISES OR PARASTATALS AS ELIGIBLE BORROWERS.

9. PAYMENT VERIFICATION. THE MISSION IS REMINDED THAT ALL PROJECT PAPERS MUST FOLLOW THE GUIDANCE PROVIDED ON PAYMENT VERIFICATION' BY AA/M TO MISSION DIRECTORS ON DECEMBER 30, 1983, PARTICULARLY PP 6-8, WHICH DEAL SPECIFICALLY WITH PPS.

10. GRAY AMENDMENT. GRAY AMENDMENT PRESCRIPTIONS AND PROSCRIPTIONS SHOULD BE CAREFULLY CONSIDERED DURING PP PREPARATION. A PLAN FOR THE UTILIZATION OF MINORITY - AND WOMEN - OWNED BUSINESSES SHOULD BE PRESENTED IN THE PP.

11. BUMPERS AMENDMENT. FYI, CONGRESS HAS RECENTLY PASSED THE URGENT SUPPLEMENTAL APPROPRIATIONS ACT, SECTION 209 OF WHICH IMPACTS ON D. A. ASSISTANCE TO AGRICULTURAL PROJECTS. SECTION 209 OF THE QUOTE BUMPERS AMENDMENT, UNQUOTE PROHIBITS THE USE OF APPROPRIATED FUNDS FOR TRAINING, TESTING, STUDIES, ETC. IN CONNECTION WITH THE GROWTH OR PRODUCTION IN A FOREIGN COUNTRY OF AN AGRICULTURAL COMMODITY FOR EXPORT THAT WOULD COMPETE WITH A SIMILAR COMMODITY GROWN OR PRODUCED IN THE U.S.. THE AMENDMENT IS NOT INTENDED TO PRECLUDE ACTIVITIES DESIGNED TO 1) INCREASE FOOD SECURITY IN DEVELOPING COUNTRIES WHERE SUCH ACTIVITIES WILL NOT HAVE A SIGNIFICANT IMPACT ON THE EXPORT OF AGRICULTURAL COMMODITIES OF THE U.S.; OR 2) RESEARCH ACTIVITIES INTENDED PRIMARILY TO BENEFIT AMERICAN PRODUCERS. THE CONFERENCE REPORT STATES THAT THE AMENDMENT IS INTENDED TO APPLY TO: A) PROJECT OR ACTIVITIES THAT ARE SPECIFICALLY AND PRINCIPALLY DESIGNED TO INCREASE AGRICULTURAL EXPORTS IN DEVELOPING COUNTRIES THAT CAN REASONABLY BE EXPECTED TO CAUSE SUBSTANTIAL INJURY TO U.S. EXPORTERS; B) THE PRODUCTION OF SUCH AGRICULTURAL COMMODITIES FOR EXPORT THAT ARE DEEMED TO BE IN DIRECT COMPETITION WITH U.S. AGRICULTURAL EXPORTS. WHILE GC/LEG WILL DRAFT SEPTEL WITH FORMAL GUIDANCE ON THE AMENDMENT LATER IN JULY, BUREAU FEELS IT IMPORTANT THAT THE MISSION BE AWARE OF THIS AMENDMENT AND THAT IT BE TAKEN INTO ACCOUNT IN DEVELOPING PP FOR SUBJECT PROJECT. END FYI.

12. STATUTORY CHECKLISTS. THE PROJECT PAPER SHOULD INCLUDE THE APPROPRIATE STATUTORY CHECKLISTS IN ACCORDANCE WITH GUIDANCE PROVIDED TO THE MISSION IN A MEMORANDUM FROM THE BUREAU ON THIS SUBJECT DATED DECEMBER 2, 1985. SHULTZ

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LOGICAL FRAMEWORK MATRIX

Narrative	Objectively Verifiable Indicators	Means of Verification	Assumptions
Goal: To stimulate growth in both the industrial and agricultural sectors of Costa Rica, resulting in increased levels of employment and foreign exchange earnings.	1. Increased exports. 2. Increased manufacturing productivity in Costa Rica by borrower enterprises.	1. GOCR statistics. 2. Borrowers financial statements 3. Project reports and evaluations.	1. Steady growth and recovery of Costa Rican economy. 2. No further deterioration in Central American business climate. 3. Maintenance of GOCR policy encouraging exports. 4. Maintenance of growth of market for Costa Rica exports.
Purpose: (1)To make credit available through the Costa Rica Central Bank (BCCR) to private banks for on-lending to private business seeking to expand or upgrade their facilities for the production of non-traditional exports to non-CACM markets; (2) to capitalize the Agricultural and Industrial Reactivation (AIR) facility in the BCCR as a permanent source of long-term credit for this purpose.	1. A functioning rediscount window at the BCCR with private banks effectively providing credit to private enterprises. 2. Effective development loan analysis capability existing within C.R. banking sector. 3. Co-financing arrangements utilized to provide additional capital to Costa Rican private sector.	1. Central Bank records 2. Loan portfolio analyses 3. Project reports, audit reports, project evaluations. 4. Bank records.	1.a Sufficient demand for dollar loans in Costa Rica. 1.b Adequate incentive exists for private banks to continue and increase development lending. 1.c Participating institutions make qualified personnel available. 1.d Guidance criteria for loans accepted by public/private banks. 2. Loans from private/public sector banks made upon adequate analysis of risk. 3. Other donors or financial institutions willing to enter co-financing arrangements.

Narrative	Objectively Verifiable Indicators	Means of Verification	Assumptions
Output Summary:			
1. Complete loan and equity portfolio at the end of each year ($000).	1. Year 3 - (cumulative) $19,650.	1. Bank records, project reports.	1. Sufficient demand for $ financing exists
2. Sub-loan identification, promotion, development.	2. Forty-five sub-loans identified analyzed and financed.	2. Bank records, project evaluations, project reports.	2. Economic factors indicate high likelihood of non-delinquet repayment.
3. Credit and project monitoring systems functioning efficiently to assure client success and loan repayment.	3. Interest/principal payments received on time.	3. Project reports, BCCR reports.	3. Administrative burden on BCCR will be negligible; on participating banks sufficient monitoring and management expertise exists.
4. Training completed in development lending; sub-project technical evaluations provided.	4. Nine training sessions completed in different aspects of development lending. One-hundred trainees working in ICI loan analysis sections. Sixty sub-loans will receive technical evaluation assistance.	4. Bank records, Contractor records.	4. Training contractor selected in FY 87 through AID competitive procedures; contractor/ABC/ICI coordination.
Inputs:	(LOP) (($000)		
1. AID loan (lending capital)	$19,650	1. AID reports	1. Funds available

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Narrative	Objectively Verifiable Indicators	Means of Verification	Assumptions
2. Sub-Borrower's Equity	8,350	2. Loan portfolio analysis bank reports.	2. Private banks have sufficie incentive to participate ir sub-project financing.
3. Technical Assistance			
AID (Grant)	350	3. Project reports, contractor reports, bank reports.	3. Funds made available from ICI's.
ICI's	150		

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5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. Procurement

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?	Yes
2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him?	Yes, and AID Geographic Code 941.
3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies, authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?	N/A
4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If offshore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)	N/A
5. FAA Sec. 604(g). Will construction or engineering services be procured from firms of countries which receive direct economic assistance under the FAA and which are otherwise eligible under Code 941, but which have attained a competitive capability in international markets in one of these areas? Do these	Yes, Yes

countries permit United States firms to compete for construction or engineering services financed from assistance programs of these countries?

6. FAA Sec. 603. Is the shipping excluded from compliance with requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?

No, waivers on a case by case basis if necessary.

7. FAA Sec. 621. If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? If the facilities of other Federal agencies will be utilized, are they particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?

Yes

8. International Air Transportation Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available?

Yes

9. FY 1986 Continuing Resolution Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States?

Yes

B. Construction

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services be used?

Yes

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable?

Yes

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP)? — Yes

C. Other Restrictions

1. FAA Sec. 122(b). If development loan, is interest rate at least 2% per annum during grace period and at least 3% per annum thereafter? — Yes

2. FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights? — N/A

3. FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries? — Yes

4. Will arrangements preclude use of financing:

   a. FAA Sec. 104(f); FY 1986 Continuing Resolution Sec. 526. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; (4) to lobby for abortion? — N/A

   b. FAA Sec. 488. To reimburse persons, in the form of cash payments, whose illicit drug crops are eradicated? — Yes

c. FAA Sec. 620(q). To compensate owners for expropriated nationalized property?	Yes
d. FAA Sec. 660. To provide training or advice or provide any financial support for police, prisons, or other law enforcement forces, except for narcotics programs?	Yes
e. FAA Sec. 662. For CIA activities?	Yes
f. FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained?	Yes
g. FY 1985 Continuing Resolution, Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for military personnel?	Yes
h. FY 1986 Continuing Resolution, Sec. 505. To pay U.N. Assessments, arrearages or dues?	Yes
i. FY 1986 Continuing Resolution Sec. 506. To carry out provisions of FAA section 209(d) (Transfer of FAA funds to multilateral organizations for lending.)?	Yes
j. FY 1986 Continuing Resolution Sec. 510. To finance the export of nuclear equipment, fuel, or technology?	Yes
k. FY 1986 Continuing Resolution Sec. 511. For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?	Yes
l. FY 1986 Continuing Resolution Sec. 516. To be used for publicity or propaganda purposes within U.S. not authorized by Congress?	Yes

ANNEX IV

BANCO CENTRAL DE COSTA RICA

Rodrigo Bolaños Z.
GERENTE GENERAL

G-259/86

26 de agosto de 1986.

Señor
Daniel A. Chaij, Director
A. I. D.
Presente

Estimado señor:

Me complace informarle que en Sesión 4155-86, Artículo 3, realizada el 13 de agosto de 1986, la Junta Directiva del Banco Central resolvió aprobar, en principio, el "Proyecto de Reactivación Agrícola e Industrial", basado en los términos de la carta enviada por el señor Richard Archie a la Presidencia Ejecutiva de esta Institución, fechada 12 de los corrientes. Según lo acordado, el Programa se financiará con $19,650.000 que serán prestados por la Agencia para el Desarrollo Internacional (A.I.D.) al Banco Central a un interés del (2%) anual durante los primeros cinco años, (3%) anual para los próximos cinco años y (5%) anual en los últimos quince años, que dan el plazo total de veinticinco años de la duración del préstamo. Estos fondos serán utilizados para que los bancos privados concedan créditos en moneda extranjera a empresas que aumenten la producción de bienes no tradicionales exportables.

Adicionalmente, se donarán $350.000 al Banco Central para cursos de entrenamiento a funcionarios de los bancos del Sistema Bancario Nacional sobre técnicas y procedimientos para analizar los proyectos del Programa y para financiar especialistas que evalúen su factibilidad técnica.

Por consiguiente, el Banco Central solicita formalmente que se comprometan los $20 millones con el propósito de que estén disponibles para el Proyecto de Reactivación Agrícola e Industrial. Asimismo, estamos a la disposición para proceder de inmediato a la firma del Convenio del Proyecto.

Augurando el mejor de los éxitos de este Programa, lo saluda

Atentamente,

Rodrigo Bolaños Z.

pm.

ANNEX V - THE COSTA RICAN BANKING SYSTEM

The Costa Rican Banking system consists of a Central Bank, four state owned commercial banks, 16 private banks, and 36 registered private finance companies. There are several more banks in formative stages, including Cofisa and Crediticia (well known financieras), of which Cofisa will purportedly be chartered this month (August 1986). Additionally, some foreign banks such as Citibank and First National Bank of Boston are actively negotiating with the Central Bank to become chartered as private commercial banks in Costa Rica (both presently maintain financieras in the country) by capitalizing existing Central Bank dollar debt under a new BCCR dollar to colon foreign debt conversion scheme.

The Public Banking System

The fundamental fact of banking in Costa Rica is the nationalization since 1948 of what are today the four state owned banks (Banco Nacional de Costa Rica, Banco de Costa Rica, Banco Anglo Costarricense, and Banco Credito Agricola de Cartago), of demand deposit accounts, and of all foreign exchange produced by Costa Rica's exports. Only the four state owned banks can open colon checking accounts, and all exporters must sell the foreign currency product of their exports to the Central Bank, which gives them colones at a Central Bank determined exchange rate.

The Costa Rican Central Bank (BCCR) is charged with the responsibility of emission and administration of the Costa Rican currency, denominated the colon, and with the administration of the country's foreign currency reserves. Additionally, the Central Bank acts as the government's investment banker, cooperating closely with the Treasury Ministry (Hacienda) for the placement and redemption of government bonds, both for the bank's own account and as an intermediary for the investing public. A third very important function is the direct regulation of all state banks and private financial entities, performing functions analogous to those of the Comptroller of the Currency in the United States.

The four Costa Rican state banks account for approximately 92% of consolidated Costa Rican banking assets, and function ostensibly as commercial banks. However, under the Bank Nationalization Act of 1948, which put these banks under state control, they were given an economic development orientation which has resulted in a rather unique mix of commercial and noncommercial lending objectives and policies.

Today, the primary role of the state commercial banks is to implement the Central Bank's annual Credit Plan, which basically consists of disbursing predetermined quantities of bank credit to specified economic sectors of the economy, with a specified mix between short term working capital credit and medium and long term investment credit. Loans under the National Credit Plan are funded from current account deposits, and from colon savings accounts and time deposits, as well as from any increases in money resulting from changes in reserve requirements or other activities of the Central Bank.

A second traditional function of the state banks, acting as recipients from the Central Bank, has been the disbursal of long term investment funds for the private sector from multinational development banks and other international, official credit institutions. This function has in the past been much more active than at the present time due to the existing external restrictions imposed on Costa Rican hard currency credits.

A third major function of the Costa Rican state banks has been the cooperation with the Central Bank in adjusting the money supply and in security exchange operations undertaken primarily to finance the government. Under the Monge administration, and the Arias administration so far, these activities have been fairly conventional and similar to the actions of U.S. banks in adjusting to changes in reserve requirements.

The Private Financial Sector

The private financial system in Costa Rica consists of private banks that cannot offer demand deposit services and a small number of important finance companies. This financial sector has undergone considerable growth and change in the last few years, while taking on a greater burden of non demand deposit related activities.

One of the major constraints for the private banks in functioning as such is the law under which they exist. The Ley Organica del Sistema Bancario Nacional sets forth the scheme under which the system operates, outlining among other things the sectoral portfolio allocations and controls on loan pricing for these various sectors which must be maintained by each bank. But the law itself primarily addresses the modus vivendi for the national banks.

In the past, Costa Rican private banks and the major financieras could be classified into two general categories: those owned by or associated closely with major international banks, and those owned by Costa Rican or foreign groups or individuals. The major change that has taken place in the financial sector in recent years has been the emergence of the latter type of private banks as the most dynamic factor in Costa Rican banking, as they have filled a vacuum caused by the elimination of eurodollar based lending in Costa Rica to which the banks or financieras associated with outside sources of funds were heavily committed for business. At the present time, the financieras owned by foreign banks are no longer a major force in the local financial market.

Because of difficulties in funding due to the constraints under which these private banks must work, activities have tended toward concentration in short term working capital lending, and especially towards import and export foreign exchange operations where rapid turnover of limited funds is possible, and where service is critical so that private banks can obtain a significant competitive edge over the state banks.

There are presently 36 financieras registered with the Central Bank, of which only a handful can be regarded as major. Of these several are owned by or associated with major foreign banks, such as Citibank, First National Bank of Boston, and Banque Nationale de Paris. As mentioned, some of these have been actively considering reincorporation as banks if something can be worked out under the Central Bank's debt/equity scheme.

The capital requirement for financieras has not been changed since the 1970's, and remains at only one million colones. The required capital for banks, on the other hand, has been increased from 5 million to 100 million colones. Despite this large capitalization discrepancy, financieras, at the discretion of the Central Bank, can be authorized to act as intermediaries in the foreign exchange market, giving them access to the relatively complex but potentially highly lucrative documentary import and export transactions (letters of credit and collections). Regulation requirements of the BCCR are also much less complex for financieras than for banks.

The combination of a low capitalization requirement, lesser Central Bank regulation, and access to foreign trade financing business was what attracted several international banks to set up operations in Costa Rica by means of financiera vehicles in the 1970's. But the banking groundrules have reversed today. The Central Bank has limited the export side of foreign trade (documentary collection) business to banks exclusively. Highly favorable international lines of credit from AID and other institutions are made available only to banks. And the foreign trade banking business that was the foreign banks' strong point is now hotly competitive, with certain aggressive private banks exploiting their ability to combine processing service with financing based on funding sources to which the financieras do not have access. As a result of this, the ranks of important financieras have become depleted because the powerful ones raise the capital to become banks as the only way to remain competitive.

The historical importance of financieras is considerable. This legal vehicle served, in the 1970's, to attract international banks that might not have come if incorporating as a bank would have been their only option to enter the market. These financieras operated in the local market and also served as representative offices for eurodollar lending activities through offshore affiliates. And, financieras provided an entry vehicle for several of today's important private banks, which started out as financieras. But, in Costa Rica today, those financieras not actively seeking to become banks are falling into an increasingly secondary market. Those affiliated with international banks are basically carrying out caretaker functions for past operations, while the local institutions concentrate on near usurious consumer financing.

State Bank Banking Practices and Their Effects

A major problem of the state banks is the lack of accounting standards. Up to this year, the state banks have not adhered to sound banking accounting practices of stopping the accumulation of interest on their income statement for loans that appear doubtful (thus inflating earnings), and of writing off loans from their balance sheets by means of charges to reserves or capital. Thus, by Costa Rican state bank accounting practice, the boards of directors do not make bad loans.

Under U.S. standards, any loan with principal or interest past due for 90 days or more, or any loan whose full collectibility is determined to be doubtful either by the National Bank Examiners or by the internal bank audit staff, must be classified separately on the balance sheet as non-performing. All accumulated and unpaid interest must then be immediately reversed against earnings, and automatic accrual of interest earnings is halted. The loan is put on "non accrual" status, so that interest income will only be booked for payments actually received.

But the state banks were not mandated by law or regulation to do this. Hence interest has kept accruing as accounts receivable on many past due loans, sometimes for years. And, making matters worse, nobody wants to take responsibility for writing off loans since this is a highly politicized decision.

State bank profits from year to year are grossly overstated because a very large proportion of the portfolio that, by prudent banking standards, should be classified as nonperforming, is kept accruing interest that is reported as (fictitious) revenue. The existence of a very large "frozen" (uncollectible) portfolio for the state banks, on the order of 25% of total loans (due to an accumulation of bad loans not written off over decades), has been mentioned in the local press by critics of Costa Rican nationalized banking. Such a large proportion of the portfolio, if written off, would wipe out all of the state banks' capital.

At the same time, annual disbursements of state bank paper profits, mandated by the banking law, are acting to decapitalize the system. The banking law requires state banks to disburse from profits 10% of the total yearly payroll to an employee pension fund, and there are other mandated disbursements as well. But since the profits are fictitious, these mandated contributions are in reality coming from capital. It is a difficult situation because all of the state banks have unionized employees, and the 10% of payroll pension contribution is politically untouchable. It has been remarked in the local press that the Costa Rican state banks are owned, not by the Costa Rican public, but by the state bank employees - as a priviliged class entitled to yearly

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dividends regardless of the banks' performance.

The Auditoria General de Bancos, an autonomously run department of the Central Bank, perhaps prodded by the necessity to apply realistic accounting standards to a growing private banking sector, has begun this year to enforce rating of loan assets for the quantification of eligibility for BCCR authorization to issue certificates of deposit. In calculating net banking assets, which are the basis of eligibility for these facilities, loans over 90 days past due are discounted on a stepped scale, increasing to 100% when the loan is a year overdue.

These standards, for the sake of consistency, are also applied to the State Banks. While this is a noteworthy beginning, there is still a long way to go. This new policy is only applied to new loans going on the books, so that the problem of rating the state banks' frozen portfolio is avoided. So far, the Auditoria has not yet demanded actual writing off of loans against capital and earnings. Given the dependence of state bank employees on reported income for their pension fund contributions, the Auditoria faces a considerable political problem if such measures are ever demanded of the state banks.

Some observers have mentioned that in the two decades subsequent to the bank nationalization of 1948, the system worked fairly well by previous standards. Although the political loans began almost immediately, the banks continued to function operationally because much of the management, especially the middle, unit managers, continued in their posts. But as these people rotated out of the system by natural attrition, there were no professional bankers to replace them and the system began to deprofessionalize itself and to deteriorate.

Now, after 38 years of government ownership, this process has accelerated considerably, and the gap with modern banking in view of the technological advances of recent years is enormous. The point has been reached where the lack of minimal operational competence in the state owned banks, especially in the critical foreign trade sector, has threatened to strangle the Costa Rican economy. This situation, more than anything else, has given successive Costa Rican governments, despite politically induced commitments to the state banking system, motivation to open the door to private banking as the only way to keep the economy producing.

AID and Private Banking

The deficiencies of Costa Rican state banking are apparent to all Costa Ricans. Because of the special interests in propagating it at many levels - the government, the bank employees, borrowers - progress in dealing with the problem is slow. But if an obstacle cannot be directly overcome, its effects can frequently be circumvented by providing an effective alternative. AID has made the development of viable private banking a principal element in its strategy for fortifying Costa Rica's economy.

In the aftermath of the crisis of the early 1980's, the urgent need was for stabilization of the economy and the private sector. AID directly helped two institutions, BANEX and COFISA, which were crucial institutions in the Costa Rican private sector. After a slow start, BANEX has emerged as one of the largest and most important Costa Rican private banks. COFISA's problems were much more serious, but today, thanks to AID funding and new management, COFISA is once again becoming a major financial force in Costa Rica, in the midst of what looks like a complete turnaround. In addition to specific help for these institutions, AID contributed to the development of the banking sector as a whole, and to businesses who became end users of the credits, with a Special Credit Line available for term financing and for restructuring of liabilities.

As Costa Rica and AID now seek to build on past accomplishments, this AIR line of credit is proposed. Based on its hard won stability, Costa Rica must now move on to restructuring its economy towards exports to hard currency markets. This line of credit is for that purpose. A noteworthy aspect of the proposed AIR line is that the Costa Rican Central Bank has acknowledged the preeminence of the private banks as development vehicles in Costa Rica, by allowing the facility to be channeled exclusively through the private banks.

ANNEX VI - THE MARKET FOR AIR PROJECT RESOURCES

Introduction

This section analyzes supply and demand for a very specific type of loan in accordance with the defined target market for the proposed loan - project loans for investment aimed at export production to hard currency markets. The specificity of the product hinders analysis based on aggregated data, because term lending in Costa Rica has historically encompassed a wider range of investment plans - import substitution, general fixed asset investment, and, more recently, debt restructuring and recapitalization by new stock purchases.

In addition, no centralized data is kept on flows of project credit over time: such data must be requested from the lending institutions themselves, with uneven results. Aggregated data generally must be extracted by subtracting balance figures on different dates, with the accompanying requirement that reports from several months or years ago are needed but are not always available. Finally, there is the difficulty of stale data, particularly for the Costa Rican banking sector as a whole. As of the date of this writing, the latest term loan balance breakdowns available for the Costa Rican banking system, obtained verbally at the initiative of a U.S. Embassy economist because published data was not available, were for December 1984.

Supply

Data obtained on project lending balances in Costa Rica and disbursals over the last thirty months is shown below. Please refer to the notes following the charts for specifics on the criteria used in their preparation. The entities listed are:

- BANEX - Banco Agro Industrial y de Exportaciones, is a private Costa Rican commercial bank founded in 1980 which has received a direct AID loan for $10 million and has developed a term lending capability as a result of collaboration with AID.

- COFISA - Corporacion Costarricense de Financiamiento Industrial, a private development oriented finance company which was particularly hard hit by the Costa Rican financial crisis of the early 1980's. COFISA has been the recipient of multiple AID loans, the last of which resulted in an impressive turnaround. COFISA is currently in the process of forming Banco de Cofisa, a Costa Rican bank, which, as a bank, will have certain advantages over COFISA, the financiera.

- FODEIN (Fondo de Desarollo Industrial) is a permanent term lending facility in the BCCR of $30 million, set up with a concessional World Bank loan for $15 million and a matching local currency equivalent from the BCCR. The fund is exclusively targeted at private sector project financing. Project eligibility guidelines require only that the project demonstrate a net foreign exchange gain over its projected life; as a result, import substitution and projects with indirect foreign exchange benefits are eligible for financing. FODEIN has existed since 1981, with access limited to the four Costa Rican State Banks as financial intermediaries. Impatient at the slow pace of disbursals, the BCCR/FODEIN Unit has recently (18 June 1986) received approval to channel loans through the private banks as well. FODEIN works in tandem with FOPEX (Fondo de Promocion de Exportaciones), a $70 million BCCR facility funded from credits from the World Bank, the International Development Bank, and a local currency contribution from BCCR. Up until now, FOPEX has been used only for short term import financing for exporting companies. However, the FOPEX charter allows term for lending, and the BCCR views it as a complement to FODEIN for term lending once FODEIN funds are all placed.

- PIC, the Costa Rican Private Investment Corporation, was founded in 1984 with $21 million in AID funds. The PIC has a flexible development financing charter, allowing the company to both make project investment loans and take equity positions in such projects. The PIC's charter is exclusively project lending oriented and does not include commercial banking services.

- LAAD, the Latin American Agribusiness Development Corporation, is a private institution with capital subscribed by several large U.S. corporations. LAAD has also received numerous AID loans over the years. LAAD's orientation is primarily agriculture or agribusiness project lending.

- CABEI, the Central American Bank for Economic Integration, is an interational lending institution with headquarters in Tegucigalpa, Honduras. CABEI lends to both the public and the private sector. The figure taken for investment financing from CABEI in this study is for the institution's private sector portfolio only.

In analyzing this data, the issue of comparability to the proposed project arises first. For aggregated data, it can be assumed that only a minor portion would meet the project's eligibility criteria. In terms of the different institutions, FODEIN, LAAD and CABEI all employ broader loan eligibility criteria. LAAD is especially flexible because it has a considerable amount of its own operating capital from reflows over the years, with which it finances projects with broader but indirect export benefits, such as farms using experimental techniques for agricultural technology improvement. The Banex colon facility and the COFISA and PIC dollar outstandings, on the other hand, all would have a very high correlation with AIR eligibility requirements.

PROJECT LENDING BALANCES IN COSTA RICA

In Millions

ENTITY	DATE	COLONES	DOLLARS OR DOLLAR EQUIVALENT
A. Colones			
BANEX	30/6/86	266.7	4.6
COFISA	30/6/86	136.7	2.3
FODEIN	30/6/86	1044.0	18.0
B. Dollars			
COFISA	31/7/86		9.0
PIC	31/7/86		4.7
LAAD	22/7/86		4.7
CABEI	30/4/86		27.2
TOTAL			70.5

For Reference Only:

Costa Rican Banking System
- State and Private Banks 1984 ₡18090.5 $376.9

Note on exchange rates used:
- all 30/6/86 conversions at 58:1
- 1984 Banking System conversion at 48:1

PROJECT LENDING DISBURSALS OVER TIME

Millions of Dollars

<table>
<tr><th></th><th colspan="2">1984</th><th colspan="2">1985</th><th>1986</th></tr>
<tr><th></th><th>Jan-Jun</th><th>Jul-Dec</th><th>Jan-Jun</th><th>Jul-Dec</th><th>Jan-Jun</th></tr>
<tr><td>Colones at 58:1</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>BANEX</td><td></td><td colspan="2">4.2</td><td colspan="2">5.6</td></tr>
<tr><td>COFISA</td><td></td><td colspan="2">1.6</td><td colspan="2">1.2</td></tr>
<tr><td>FODEIN</td><td></td><td colspan="2">9.7</td><td colspan="2">5.2</td></tr>
<tr><td>Annual Sub-totals</td><td></td><td colspan="2">15.5</td><td colspan="2">12.0</td></tr>
<tr><td>Dollars</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>BANEX</td><td>0.2</td><td>0.2</td><td>0.8</td><td>3.9</td><td>0.6</td></tr>
<tr><td>COFISA</td><td></td><td colspan="2">2.0</td><td colspan="2">9.6</td></tr>
<tr><td>PIC</td><td></td><td></td><td></td><td colspan="2">4.7</td></tr>
<tr><td>LAAD</td><td colspan="5">4.7</td></tr>
<tr><td>CABEI</td><td>1.1</td><td colspan="2">3.7</td><td colspan="2">1.8</td></tr>
<tr><td>Annual Sub-totals</td><td>2.2</td><td colspan="2">8.6</td><td colspan="2">22.5</td></tr>
<tr><td>ANNUAL TOTALS</td><td>2.2</td><td colspan="2">24.1</td><td colspan="2">34.5</td></tr>
</table>

NOTES TO TERM CREDIT BALANCES AND DISBURSAL DATA

1. The criterion for inclusion of balances is that these figures should encompass project term lending.

2. The division between colones and dollars was made according to the currency in which the end user must pay back the loan. Thus loans funded in dollars by multinational lending institutions, in which the BCCR takes the exchange risk, are considered colon loans.

3. An exchange rate of 58 colones to the dollar was used for current balances. The exception is the reference figure for total investment lending by the Costa Rican banking system. This data, although stale, is the latest available. The 31/12/84 exchange rate of 48 colones / dollar is used here.

4. When interpreting the banking system 12/31/84 investment lending figures, based overwhelmingly on state bank lending, two major factors which distort the dollar value in opposite directions should be kepc in mind. The relative weight of these two factors is highly subjective. The opinion of this analyst is that they offset to give a more or less accurate representation of total investment financing balances in Costa Rica. One, the total figure is overstated because Costa Rican State Banks never write down bad loans. Thus, this figure includes loans on which payments have not been received for years, that continue on the books without write-offs, as stated in the introductory section on Costa Rican banking. Two, the figure is understated for the older loans because the fixed assets financed have appreciated in colon terms as a result of the major devaluation of Costa Rica's currency in the early 1980's. Depreciation from the 1981 8.6 to 58 is a loss of value of 85% for the currency.

Demand

A dual market. The most basic characteristic of demand for export project investment term lending in Costa Rica is that it is divided into two components by currency. This dual demand arises only in the case of projects generating hard currency sales. The option to finance long-term in dollars is perhaps imprudent if the project financed will not generate dollar revenue to pay the loan, given the weakness of the colon vis a vis the dollar over time.

The demand for export project term credit loan demand in Costa Rica can be broken down as follows: 1) those investors who insist on borrowing in colones so as to totally eliminate all foreign exchange risk, and 2) those who prefer dollar credit because of the lower interest rates.

The BCCR has recently liberated colon deposit and lending rates for funds captured from depositors in the local financial market. However, funding for project lending outside of the state banks is based almost totally on long-term money from multilateral institutions, at interest rates unaffected by supply and demand forces in Costa Rica. So, interest rates for these credits should remain unchanged because they are generally fixed by the conditions of the international lenders who provide the funds. In today's market, the interest rate differential to the end user is over 100% - LIBOR plus 3% for a total of 9.5% in dollars, against aproximately 23% for colon term loans.

Within the dual market for term financing, borrowers are also separated, generally, into local and foreign. As is to be expected, locals generally prefer colones, and foreigners, dollars. And not only are people and outlooks different in the two groups. Projects are also different. Costa Rican businessmen, generally having farms or factories already producing but not for non-traditional export markets, lack the knowledge of and connections in those markets that give the confidence necessary to start an export project from scratch. So, the local investor's project is likely to involve a variation on a familiar activity, be it a new crop or a somewhat different product, aimed at a new market. The foreign investor, on the other hand, usually comes to Costa Rica looking for an economic comparative advantage, either to produce at less cost in a stable environment with good transportation connections, or to take advantage of natural conditions necessary for production of certain crops - to input into already well established marketing channels. The preference for each currency follows naturally from the two basically different situations. The Costa Rican knows that the banks will ask him to personally guaranty the credit, so he is leary of dollars. The foreign investor, on the other hand, generally has a difficult time accepting 23% credit in contrast to a 10% credit hard dollar economy.

Because currency preference for term financing is based on fundamental economic convictions, the decision of whether to finance in dollars or in colones is not highly sensitive to the interest rate differential. Given this situation, an interest rate differential that can compensate for the financing risks between the two currencies, a so called "indifference point" spread, is too much of an abstraction in the Costa Rican term financing market. For the two different types of investor, the availability of financing in the currency of choice at the prevailing rate would be the fundamental financial factor in the investment decision. There is more flexibility here on the part of the foreign investor. He could be coaxed into financing in colones if the interest differential dropped considerably, so that he would not have to pay such a high premium for the possibility of windfall profits should major devaluation of the colon occur. But for the local investor leary of borrowing dollars for the long term, something must be done structurally to reduce his risk.

<u>AIR - Reduced risk by means of special structuring</u>. There are two components to foreign exchange risk: devaluation, and currency inconvertibility.

The risk of devaluation comes into play when the proceeds of a loan in a hard currency must be paid back with earnings in a soft currency. Over time, as the soft currency devalues, more and more soft currency earnings will be required to make the payments on the hard currency loan. A structural solution to this problem is achieved with an export oriented project. Since sales are generated in the hard currency (or in local currency pegged to the hard currency in a foreign exchange nationalization situation), revenues in local currency automatically increase to cover the devaluation over time.

Currency inconvertibility risk is the risk that hard currency to repay the loan will not be available at repayment time. The borrower may have the local currency needed to make the payments even at a devalued exchange rate, but the Central Bank may be out of dollars. A lesser problem than total unavailability is a situation of chronic shortage of hard currency, resulting in an institutionalized temporary inconvertibility situation. Costa Rica went through a total official dollar unavailability situation in 1981-82, and has lived with a chronic dollar purchase pipeline ever since. The dollars are made available, but with a delay of up to several weeks. A permanent dollar request pipeline at the Central Bank accumulates (the "presa de divisas"), and extra interest expenses for dollar debt generated by "presa" processing time become a normal part of doing business since the foreign bank is not paid until BCCR provides the dollars.

A key feature of the AIR Project structuring is that investors are effectively protected from both the devaluation and currency inconvertibility components of foreign exchange risk. The first is covered by limiting the program to hard currency export oriented projects. The second, by special structuring of the exchange conversion process at the BCCR. A mechanism will be adopted that will permit disbursal and payment in colones at the prevailing BCCR exchange rate to discharge obligations of the BCCR, the intermediary private banks, and the ultimate borrower. This feature of the program, made possible by the BCCR's rules for application of the modified currency law (Ley de la Moneda), has made the concept of dollar term lending acceptable to the great majority of Costa Rican private banks. As a result, the question mark as to loan demand has effectively been transferred down from the level of the banking intermediaries to that of the ultimate sub-borrowers.

On the sub-borrower level, resistance to dollar financing of short term operations is rapidly diminishing, due to the orderliness of the Central Bank's gradualist mini devaluation policy and to the scarcity and high cost of colon financing. And, under the FOPEX line of credit used by BCCR to refinance documentary letter of credit and collection operations up to six months, the proposed AIR operational method of signing the promisory note in dollars and discharging the obligation with payment in colones at the BCCR rate is already in use. This new willingness to take on dollar credit by local businessmen is increasing to the point that some are even borrowing medium term funds in the United States to pay off colon loans, as reported to us by Intertfin, perhaps the most aggressive of the private banks. The structuring of term loans with payment in colones at the BCCR rate is new, but an important short term credit precedent exists. As this special feature of AIR term financing becomes known among local potential export project investors, the Costa Rican component of AIR loan demand may increase significantly.

A demand survey was carried out with the eight major banks that may be expected to participate in the proposed project. This survey consisted of visiting the various bank managers and asking their opinions on demand for project resources based on the defined target market and their contact with their clients. The results, detailed in the accompanying chart, were mixed but, on the whole, encouraging. The structuring with the ability to discharge the dollar obligations by payments in colones, thus eliminating the inconvenience and the currency unavailability risk inherent in "presas," was an especially attractive aspect of the facility. A very positive aspect was that all the banks questioned acknowledged that there is demand, with the principal differences being the different banks' willingness or lack thereof to take the time and effort to process this type of credit.

An indispensable element in the demand analysis for the AIR facility is a focus on foreign investment. This is, in many respects, the more natural demand component for AIR. Foreign corporate investors coming to Costa Rica generally have the marketing connections and the production know-how down pat; even non-corporate foreign investors are used to thinking in dollar terms and will not hesitate to take the lower interest rate on dollar loans in preference to possible windfalls in the event of

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	Term Lending Experience	037/040/043 Placement record/outstandings	Manifested Attidude	Existing Eligible Project Pipeline	Estimate of Client $ Borrowing Demand
BANEX	Has placed $5 MM in direct AID money	$16 MM since 1982	Want to use developed term loan capability	—	$2 MM
COFISA	$10 MM approved and $9 MM placed in the last year	Ineligible in the past but will become a bank in Aug/Sep 1986	Enthusiastic	$6.0 MM	$1.5 MM more
INTERFIN	LT Portion of 037/040 /043 including one shared loan with PIC	$16.5 Mh since 1982	Optimism that the market exists but need volume to make effort worthwhile	—	$3.5 MM
BANCO DE SAN JOSE	LT portion of 037/040/043 only	$4.8 MM only in last year	Want to get into project lending to diversify	—	—
BANCO DE FOMENTO AGRICOLA	A Small portion of total FOPEX use for $6 MM in last year	$1.3 MM outstanding	Knows demand exists, willing to work on it	—	$3 MM
EANCO DEL COMERCIO	--	$6.6 MM outstanding	Not interested in term facilities in dollars - would refer any request to PIC	--	--
BANCOOP	Considerable-concentrated in agricultural sector IDB Project Lending	$4.7 MM outstanding	Interested	--	$2 MM
BANCO BCT	—	$3.5 MM outstanding	Want the business	—	$2.5 MM
			TOTALS	$6.0 MM	$14.5 MM

significant devaluation of the colon.

In the area of foreign investment in Costa Rica, CINDE's Investment Promotion Program stands out. This program is modeled after the highly successful Irish program of aggressively promoting investment through offices in the target investment countries (the United States and France, in the case of CINDE). These offices are assigned specific quotas as to business calls in the target country and visits generated for investment candidate companies to the promoting country (Costa Rica). As of late July 1986, CINDE's results were:

Companies commited to invest in Costa Rica (evidenced by purchase of fixed assets)..............11

Total projected investment by the 11 companies....$13MM

Total projected investment for 1986...............$20MM

CINDE's management stated that, due to a lack of sufficient term financing sources in the country, it has thus far made it a policy to refrain from promoting the availability of local term credit as an incentive for investing in Costa Rica. CINDE would be glad to have a well founded term lending program as part of Costa Rica's package of investment benefits, and sees very good AIR term loan demand possibilities based solely on the investment it is generating. CINDE estimates that, conservatively speaking, term financing demand should be at a level of one-third of total investment generated by them. This comes out to $4.3MM for the investment already committed, and $6.7MM for projected 1986 CINDE generated foreign investment.

<u>The impact of competing funding</u>. With its special structuring whereby colon repayments at the BCCR dollar exchange rate discharge payment obligations, and competitive pricing at LIBOR plus 3%, AIR will have an advantage over all competing dollar funding sources for the end user. So, the true competition will come from colon sources, basically AID's own continuation of the Special Credit Line, and FODEIN-FOPEX, also at the BCCR.

Continuation of the Special Credit Line is potentially competitive with AIR, but this competition is diluted by the fact that there are funds available for many purposes other than project financing (working capital, debt restructuring, capitalization by financing of stock purchase), all of which are easier to structure and process than the project investment lending contemplated under AIR. Also, AID is structuring the new tranche of the Special Credit Line with new constraints, the principal being a requirement that the intermediary banks increase capital in an amount equal to 50% of funds used. Finally, the maximum five year tenor under this colon facility is a little short for many project loans. In view of these factors, the new funding tranche of the Special Credit Line should compete little with AIR.

This view is backed up by historical data. Of BANEX's approvals over the last two years utilizing the Special Credit Line (SCL), only two loans summing ₡30 million, out of a total of ₡310 million (a proportion of 9.7%) were for project investment. And, of Banco de San Jose's total term lending for ₡261 million, all with SCL funding, all the loans were to established companies without a single start-up project investment loan.

FODEIN-FOPEX is, on paper, potential serious competition for the AIR Project. As previously described, the program appears very attractive for the end user. However, FODEIN-FOPEX has a serious processing inefficiency problem. The program is set up and administered by a special department in the BCCR, which unfortunately has taken a completely academic approach to feasibility study preparation and processing requirements. The attitude is that they are there to make sure the investors and the banks do it right. Feasibility study requirements are so extensive and cumbersome that project preparation becomes a virtually endless data acumulation and number crunching exercise. An end user of a FODEIN loan stated that processing and approval took a year, and he was now six months into the disbursal program, with the assets financed already in production, without getting all of his loan money.

The planned analysis and disbursement procedures for the AIR Project should give it a distinct operational advantage over FODEIN. Basically, the participating private banks will structure and approve the loans "in house," with the Central Bank limited to confirming conformity as to activities financed, tenors, and interest rate, and revision of the loan documentation for consistency and legal correctness. The only time considerations in disbursement will be the requirement for a one month prior notification to the Central Bank for separation of funds, which should not cause any delay if well programmed, and a day or two for actual disbursal.

To be sure, at least half of FODEIN's poor performance to date has to be attributable to past limitation of the program to the State Banks as intermediate credit institutions. FODEIN's staff is trying to develop an interactive project feasibility study process, in which the end user, the intermediary bank, and FODEIN work together to ensure that the feasibility study is processed smoothly and that the approval is quick when it is finally completed and presented. It is feasible for private banks to do what the State Banks never did with FODEIN: assign credit staff full-time to the program and aggressively develop an effective working relationship with BCCR/FODEIN personnel, so that efficiency in processing is developed and processing times are reduced. But, human nature being what it is, the AIR Project will probably develop a significant working advantage over FODEIN with both intermediary banks and end users due to ease of processing.

FODEIN has another potential problem. With the current GOCR emphasis on Costa Rican public finance and the IMF negotiations currently focused on reducing deficits at BCCR, programs such as

FODEIN, in which BCCR assumes the full exchange risk, may be candidates for curtailment. FODEIN's administrators have stated that this won't happen because it would involve unilateral modification of signed agreements with the World Bank and other multilateral lenders. However, a simple slowdown or non-use of the program would involve no modification of agreements, and other sources within the BCCR have expressed doubts that FODEIN can continue indefinitely without reduction in view of the BCCR's need to cut its losses.

Conditions and constraints. The impact of competing fund sources upon the intermediate banks' use or non-use of AIR funds will be significantly affected by ease of use, profitability, and Central Bank regulatory constraint considerations. In ease of use, AIR should be a clear winner, with absence of project feasibility evaluation by BCCR and the very favorable mechanism for disbursal and payment in colones at the official exchange rate.

In matters of profitability, the AIR facility has advantages and disadvantages which should cancel out. AID SCL's 5.5% spread is a point above AIR's 4.5%. The FODEIN spread is 4.5%. AIR should be competitive in both cases due to the fact that, since AIR loans are denominated in dollars, the bank's spread will be pegged to the dollar and will not be subject to reduction over time due to devaluation of the colon.

Central Bank regulatory constraints will have a significant impact on intermediary banks' options to use AIR, AID's SCL or FODEIN-FOPEX. One constraint affects lending operations. Article 85 of the Central Bank's charter limits the size of loans by private banks to any one borrower to 15% of capital and reserves, with an increase up to 25% with specific authorization from the BCCR. Thus, a mature private bank with, say ₡120 million in capital and reserves (about the size of BANEX) can, at an exchange rate of 58, lend a maximum of $310 thousand to a single client without the waiver, and $517 thousand with the waiver. The bank with the largest capital is Banco Cooperativo at ₡234 million, giving that institution a single client limit of $605 thousand at 15% of capital and reserves, and $1 million at 25% These figures appear to be in a good development lending size range for the AIR Project.

The important BCCR limitation affecting private banks' access to AIR resources and other funding channelled through the Central Bank (AID's SCL and FODEIN), is the Central Bank's charter Article 63, which limits the BCCR's credit to any Costa Rican commercial bank to 50% of the borrowing bank's net banking assets. The definition of net banking assets is complicated. Basically, the idea is to arrive at a figure for a bank's sound loan and financial assets funded by the traditional banking sources of capital and reserves, deposits, and credit from other financial institutions, net of loans from the Central Bank, term debt on fixed assets, and specified proportions of past due operations.

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Private banks are authorized to leverage up to 10 to 1 in Costa Rica (leverage defined by BCCR as total liabilities / capital + reserves). The instrument for capturing time deposit funds is a "certificate of investment," so named to avoid any possible confusion under the banking law which prohibits private banks from receiving current account deposits. For the purposes of this study, these certificates will be referred to as CDs, based on the banking term, "certificate of deposit," by which they are commonly known. The BCCR must approve every application for issuance of CD's by private banks, and the Central Bank has used this power to effectively limit bank leverage. BCCR has established a tier rating system for private banks. The top rated banks are allowed full 10 to 1 leverage. The next tiers are allowed 7.5 to 1, 5.5 to 1 and 1 to 1 for the lowest rated banks. No members of the last group have been contacted for this study.

With the Central Bank dictating leverage levels for banks by restrictive use of its CD issuance approval power, only three major banks (BANEX, INTERFIN and Banco del Comercio) operate near the 10 to 1 level, with the rest between 3 and 6 to 1. Newer banks, which the Central Bank in practice limits severely for an unspecified trial period before substantial leverage levels are authorized, operate at less than 2 to 1 leverage.

Since issuance of CD's and BCCR discounts are the primary method of funding growth for Costa Rican private banks, the big banks by definition are the ones with heavy AID loan volumes already on their books. Thus, the historic major players for placement of the AID facilities are the very institutions constrained by Article 63. Given the relatively small size of the AIR facility, however, the problem is not lack of room under Article 63. It is that the AIR facility must compete with AID' SCL, FODEIN, and other BCCR discount facilities for what may be limited room on the intermediary banks' balance sheets.

The calculation of net banking assets is unique for every bank, and may vary over a wide range from month to month. Because of this, a quantification of the effect of Article 63 on the overall ability of the Costa Rican banking system to place project funds over time should not be based on any single month's balance sheet.

The question of the effect of Article 63 on perceived ability to use the AIR Facility was put to all banks interviewed for this study. Banex and Interfin, the biggest users of the Special Credit Line said that Article 63 would certainly be a factor to consider in their ability to disburse from the fund at a given moment, but that due to the longer lead times in processing these loans, disbursals can be accomodated and they do not anticipate that Article 63 limits would prevent them from doing a project loan. Banco del Commercio was basically not interested in AIR, stating that they would refer any requests for project loans to PIC. All the other banks were definitely interested and did not anticipate a significant Article 63 constraint on their ability to use the facility.

The different banks' availability for BCCR operations under Article 63 is indicated on the spread sheet in the bank financial analysis section. At the 30 June 1986 cutoff date for this financial analysis, Interfin was tightest of the major banks on Article 63 availability, at $1.3 million. Banex stood at $3.1 million in availability, and combined availability for the eleven banks analyzed was $18.2 million. In interpreting these figures it should be kept in mind that Article 63 availability may vary significantly from month to month.

Conclusions

The private banks estimates of client demand at this time total $14.5 million. With the exception of Cofisa, these banks have not been looking for project financing business.

CINDE estimates project financing demand for the foreign investment in Costa Rica that they will generate this year at $6.7 million.

Naturally there has to be overlap among the different banks' and CINDE's investment credit demand estimates, with more than one institution having the same project or projects in mind when making their projections. But even with some overlap, there is strong reason to believe that a good end user market exists. Cofisa, the only private bank-like institution in the project financing market, has a pipeline for 30% to 40% of the total AIR program, on top of $10 million in AID term lending funds to be completely disbursed within a fifteen month period ending (next month) in September, 1986.

The structuring of the AIR facility with payments in colones at the BCCR exchange rate discharging dollar obligations, thus completely avoiding "presa" problems, should significantly increase the Costa Rican portion of dollar term financing demand. There is already precedent for the use of this mechanism in short term operations, and the fact that some local companies are already refinancing medium term colon debt in dollars is an indication that Costa Rican businessmen are finally getting over the trauma of 1981 - 1982 and basing their planning on Costa Rica's newly established economic stability.

The principal pessimistic note is that FODEIN, on paper, beats AIR by being in colones and and with greater target market and loan structuring flexibility. But FODEIN's flaw of extremely difficult processing and disbursal procedures should act as a more than offsetting hindrance. Private banks will be able to have three or four sequentially processed AIR loans on their books in the time that it takes to process one FODEIN loan. Given the fact that learning to do term lending will require effort for these banks, it can be assumed that they will want to get maximum performance from the capabilities they develop.

BCCR Article 63 regulatory constraints will be a consideration for the major banks, including Cofisa, but should prove manageable if the bank is interested in the business. Its effect should be to slow the pace of use by the larger banks, but not to seriously limit it. This may not be a bad thing, as aggressiveness appropriate in commercial banking may go overboard if transerred to term lending without adequate study and structuring. And, the smaller banks will have more time to develop a term lending capability and compete with the major players.

The size of the AIR facility seems just right. Assuming even disbursal over three years, we are talking about $6.6 million per year. Assuming ten banks use the facility, this comes out to $660M, or about 3 or 4 modest sized projects, per bank per year. Since there are some institutions that can be expected to make much heavier use of the facility, as an average, $660M per bank per year is on target.

There is every reason to believe that the private banks, with their much closer client contact, can do better than the traditional term lending institutions (Cofisa excepted) that up to now have had a monopoly on the project lending market. As the Costa Rican private banking market matures, the days of easy growth by giving good service on foreign trade operations is drawing to a close.

Banks by their nature, and Costa Rican private banks in particular, are very growth oriented institutions. Up to now, project lending has not been a viable avenue of growth for the private banks, chiefly for lack of funding. But the demonstration effect of Cofisa, with ten million dollars virtually placed in a fifteen month period is strong. All but one of the commercial banks interviewed acknowledged that, in the future, a mix of other types of lending and services will be necessary to complement commercial operations for any banks that aspire to top positions in the market. With very good timing, the proposed AIR term lending facility is opening an important avenue towards necessary diversification for the Costa Rican private banks, in a market in which lending entrepreneurship has been as much of a missing ingredient as the term loan funds themselves.

Based on end user demand as evidenced by recent project lending disbursal levels in Costa Rica, and on what the banks and CINDE have to say, we are optimistic that AIR funds will be placed.

In the last two years, $24.1 million and $34.5 million in project loans have been disbursed in Costa Rica, with a significant portion by slow moving international lending institutions. It is reasonable to assume that this demand will not diminish, and its effective manifestation measured by project lending volume should increase if aggressive private banks, that have the client contacts, are given motivation under AIR to actively promote project investment financing.

ANNEX VII - INSTITUTIONAL ANALYSIS

A. The Private Banks

The following section attempts to categorize the private sector banks according to likely use of AIR, and to provide capsulized information on them.

Likely Major Users

This category of banks includes the largest private banks that manifested interest in AIR plus Cofisa under the assumption that the latter institution, once it obtains its bank charter, will quickly become a major user.

Interfin

This is the largest of the private banks in terms of assets and probably the best run. The Central Bank has recently approved a leverage level of 11 to 1 for Interfin, something that has not been done for any other bank. Interfin has, in general, the best earnings and efficiency indices.

It is probably the most entrepreneurial of the banks, flexible, and quick to take action. The bank is owned by a small and cohesive group of wealthy businessmen and has the best of both worlds in its top authority structure: an entrepreneurial minded board of directors that puts a premium on growth and efficiency, and strong, capable management with an unambiguous mandate and sufficient authority to get the job done. The general manager, Mr. Luis Liberman, has a Ph. D. in Economics from the University of Illinois and is an acknowledged leader in private banking circles.

If there are any negatives about Interfin, it is that their credit analysis may be somewhat undeveloped, due to the bank's concentration on documentary foreign trade transactions which generate their own collateral. Also, growth such as Interfin has experienced is always difficult to manage, and the bank is still at a stage where growth in itself can cover deficiencies that would come to the forefront in a slower paced business environment. Interfin maintains a Panama affiliate, and it is rumored that the volume of offshore business with this affiliate is substantial. If so, growth has been even faster than the impressive pace shown on Costa Rican books.

Banex

While second in assets, Banex has had an earnings performance that has lagged behind Interfin. This has probably been partially due to its more developmental portfolio booked as a result of its relationship with AID. This portfolio, with characteristically slower turnover, higher costs, and narrower spreads, can impact in lower earnings characteristics.

Ownership of the bank is widely disbursed, although board members together own about 50% of the stock. Most of the stockholders are not active in running the bank, depriving Banex of the close identity between management and stockholders which is the basis of Interfin's entrepreneurial aggressiveness. Although growth at Banex has also been impresive, this bank puts more emphasis on building relationships with clients than on growth per se. As a result, Banex is a much more consolidated institution than Interfin, with more management depth and broader capabilities.

Cooperativo
This is the most heavily capitalized of the private banks, and is well known to AID through previous grants. Ownership is by a coalition of the biggest cooperatives in the country. Cooperative laws in Costa Rica are very restrictive, and management of cooperatives is far less flexible than for regular sociedades anonomas. Also co-ops are vehicles for organizing workers and small farmers rather than entrepreneurs. This has worked to advantage with Bancoop's board of directors, which has opted to develop capable management and let it run the show to a greater extent than any of the banks not owned by a close and homogenous business group. Uncharacteristically for Costa Rica there is considerable delegation of credit approval decisions to the managers.

Due to these characteristics of ownership, development of the bank in its first two and a half years has not been as rapid as some of the other private banks. Bancoop's leverage is low, so Article 63 is a significant constraint. But firm groundwork has been laid, and momentum at Bancoop is building for a much stronger presence in the market. By its nature, the bank has a built in agricultural orientation, and has acquired term lending experience. If the Article 63 constraint can be well managed, Bancoop could become a quite significant user of AIR funds.

Banco BCT
BCT matches Interfin in aggressiveness, and has been limited up to now only by its smaller capital base, which stood at ₡ 30 million only a year ago. The bank maintains a fairly extensive network of affiliated companies dealing in several financial and business areas, including the Bolsa, fiscal warehousing (in partnership with Interfin and others), trade companies, information processing, travel, and agribusiness. The above includes a financial affiliate in Panama.

Ownership of BCT is more narrow than even Interfin. The principal shareholder is Leonel Baruch, who is also the general manager. Mr. Baruch, despite his relative youth, has politcal experience and was vice minister of Hacienda in the Carazo administration. Because of this ownership profile, management breaks with tradition in running the show. This management is sharp and capable.

As of 12 August 1986, BCT has negotiated a capital increase to 250 million colones under BCCR's dollar to colon debt conversion

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program. This is officially approved by BCCR, and the capital should be fully paid in within a month or two. This will give BCT the second largest capital of any Costa Rican private bank. Given BCT's past aggressiveness, it can be expected that its strategy will now be to use this as a leverage base to become the largest private bank in assets. In view of Mr. Baruch's manifested enthusiasm for AIR, and the greatly increased Article 63 placement limit which the capital increase and probable subsequent leveraging should bring, BCT should be one of the two or three top users of AIR funds.

Banco de San Jose
This bank bought out the Bank of America operation in San Jose as that major U.S. bank pulled out of Costa Rica and Central America earlier this year. The shareholders are prominent business people with investments primarily in finance and retailing: Inversiones Sama, a brokerage house; Credomatic, credit card; the Gurdian family, Crece finance company and fertilizers; Embotelladora Tica, Coca Cola bottler; Alonso family, Supermercados; Crespo Family, La Gloria department stores; Lachner family, Lachner & Saenz investments; Durman Esquivel, PVC pipes and related products.

The manager is experienced (Banque Nacionale de Paris local affiliate) and quite capable. Most of the rest of the staff is Bank of America personnel who stayed on with Banco de San Jose. They are well trained in Bank of America systems and operations, which is both an advantage and a disadvantage as BofA's lack of operational flexibility caused that bank, despite its size and resources, to lose considerable market share in financial services to the local private banks. As noted in the financial analysis the numbers are not good, indicating a very low return on loans. This could be indicative that the buy out of BofA was not such a good deal. Also, their expensive building, supposedly financed in dollars, is another financial burden for the bank.

Despite numbers that are not the best, and the most constrained Article 63 position of any bank examined, this bank deserves a vote of confidence due to the excellence of its ownership and top management, and strong manifested interest to use the AIR facility.

Cofisa
While not yet a bank, we have included Cofisa in the list of major players because we anticipate that they will have their banking charter by September, 1986, and because we also expect that they will play an important role in the AIR Project as a result of their development orientation and project lending capacity.

The numbers included in the financial analysis are for the Cofisa unconsolidated finance company at 6-30-86. When the bank charter is received, assets will be transferred to the new bank on a selective basis, so that the balance sheet will not automatically look like the one we have included. However, the listed numbers are indicative, especially because as many assets as possible will be needed in the new bank to increase the availability limit for AIR Project loans under the BCCR Article 63. Cofisa at the present time has a pipeline of well developed projects for over $6 million, the great majority of which qualify under AIR guidelines, with $3 million more of less mature projects of which management estimates about half will eventually be financed.

Other Eligible Banks

This category describes banks which are or should become eligible and which may or may not be significant users of the AIR facility. These include: Banco del Comercio, Fomento Agricola, Metropolitano, Industria, and Continental. Banks not listed in the financial analysis and which will be ineligible without significant increases in capitalization are: Cooperativo de Alajuela, Santander, and Lyon.

Banco del Comercio

This bank is third in size behind Interfin and Banex. The bank has full capability to be a major user of AIR but was not included in that list due to a manifested attitude of disinterest in dollar term lending.

Banco del Comercio was originally formed as a coalition of "comerciantes" to channel lucrative short term foreign trade business away from the State Banks and into their own bank. Ownership is diverse and this has contributed to the bank's success by tapping into a strong target market of the numerous successful businesses of its owners, including the Toyota and Datsun dealerships. As commerce in Costa Rica is heavily import dependent, this bank's strength is on the import side of trade financing.

The board of directors is considered to be fairly strong in credit analysis, and perhaps dominates management more than some of the other major banks, delegating less. There has been considerable top management turnover in the past couple of years, and a strong willed and experienced local manager was brought in within the past year. This bank probably has the highest level of operations in the offshore banking market in Panama, and probably takes a lot of its earnings outside. Therefore, published earnings are probably significantly understated.

Banco de Fomento Agricola

The development of this bank was promoted primarily by CAFESA, a very powerful, vertically integrated coffee growers'conglomerate. This group continues to be the strongest voice in management, although there are other important shareholders as well, including the Gonzalez family (Matra - Caterpillar) and Ernesto Rohrmoser, former Cofisa general manager. As expected the bank is primarily directed at the coffee sector.

The manager, Alberto Dent, is closely affiliated with coffee interests. Mr. Dent was the first president of Banex, so he has experience at high levels in Costa Rican private banking, although little previous work in actual line banking functions. However, he appears to be quite capable, and has put together a very good administrative team. Because of its agricultural orientation, this bank could conceivably be a strong candidate for AIR Project funds, and it has one of the largest availabilities under Article 63.

Banco de la Industria
This is a small (10 employee) "captive" bank established to complement the financial businesses of a small group of shareholders. However, capital is not so small (₡ 60 million) and the amount will purportedly rise to ₡ 100 million by January 1986. It is managed by one of the major shareholders, who has had extensive business experience. The group of companies provides financial and trade services and conceivably could place some AIR funds.

Banco Continental
This bank was established originally as Banco de San Jose and by the same shareholders. Later, when the opportunity to buy out Bank of America arose, the Banco de San Jose shareholders took over the B of A sub and changed its name to Banco de San Jose. They then changed the name of the former bank to Banco Continental.

Banco Continental is presently inoperative, but has recently been sold to Liga de la Caña, the powerful Costa Rican sugar marketing association. This group's resources and agricultural exporting focus could provide an outlet for AIR funds, by means of some variation on their traditional sugar exporting business compatible with AIR guidelines.

Banco Metropolitano
Metropolitano must be considered a viable potential user of AIR because it fulfills the basic requirements of capitalization and quality of ownership and management. It is the newest and also the smallest of the banks that can feasibly take on AIR debt.

The bank seems to be a copy of Interfin, owned by a tightly knit group of businessmen with a strong entrepreneurial bent and focused towards high turnover, short term business. The general manager is a career banker (from the State Banks) who appears to know what he is doing. However, the bank has been operating for such a short period of time that the numbers are not sufficient to draw any meaningful conclusions and are not yet indicative of how the bank will develop.

Other Banks
The following banks are not candidates for AIR Project funds, for one reason or another. **Banco Cooperativo de Alajuela** is very new and formed with only ₡ 5 million in capital under special rules for cooperatives. Due to its small size and consequent inability to take on AIR funds in any meaningful size, we have ignored it in our financial analysis.

Banco de Santander is the subsidiary of the Spanish bank of the same name. They have a capital of only ₡ 35 million, and they have expressed indifference to term lending and the AIR funds, and will probably not use the facility.

Banco Lyon provides an interesting footnote to private banking in the country. This family owned and run bank has been operating in Costa Rica for about fifty years, well before the bank nationalization of 1948. It captures no funds from the public and has never done so, concentrating on services such as selling bank drafts and travelers checks and providing letters of credit and collections services. Its capital is still only ₡ 1 million.

When commercial banks were nationalized in 1948, the rationale was (and still is) that public funds captured in the form of demand deposits should not be used for private profit. But Banco Lyon did not receive deposits, so the government could not nationalize it under its own motivating purposes for bank nationalization. Thus, the prior existence of Banco Lyon, coupled with the fact that its nationalization would have been perceived as an injustice, is probably the reason that the chapter allowing the existence of private banks, on which all private banking in Costa Rica is today based, was added to the Ley Bancaria.

Doubtful Banks

These are banks that, for one reason or another, will probably be denied access to AIR funds by the Central Bank.

Banco de la Construccion has had a checkered history. Abandoned by its founders, the bank was later bought out by its present owners, traditional Costa Rican businessmen with moral integrity but little knowledge of banking. The bank was brought low by the collapse of the colon in the early 1980's coupled with the then prevailing Ley de la Moneda, which allowed borrowers to pay off loans in colones at 6.6 and 20 to the dollar, for which Banco de la Construccion owed foreign banks in dollars, while the free market exchange rate was in the 40's. The bank, capitalized at only five million colones, has successfully renegotiated its debt. But it has not been able to attract capable management, nor fresh capital to restore its balance sheet, which will not support further credit.

Banco Weeden is an oddity. It loses money and nobody knows what it does. Its business dealings are also dubious, and its better to steer clear.

BIESA, Banco Internacional de Exportaciones, is owned and dominated by Mr. Hohabar Yazdani, an Iranian exile. Mr. Yazdani is a multimillionaire who supposedly was the richest banker in Iran before the revolution. He may be the biggest single coffee grower in Costa Rica. There is evidence that he uses his banking group principally to capture funds for his farming operations. BIESA has been in a running battle with BCCR and the Auditoria de Bancos due to illiquidity (failure to meet the 10% BCCR deposit reserve requirement for CD funds) and a poor financial condition, coupled with end runs around banking regulations to aggressively capture large amounts of CD funds from the public by use of an unregulated affiliate, IBESA. IBESA pays higher interest rates than any of the Costa Rican banking competition, while BIESA has no known local borrowing clients.

The Costa Rican Bankers Association (ABC)

The ABC is a non-profit professional association established to further the interests of professional banking in Costa Rica. Most of the private banks, and all of the major ones, are members, as are PIC, Cofisa, and most of the financieras associated with international banks. Banco de Costa Rica, a State Bank, is also a member.

The ABC has an able general manager and very few staffers. It is a small organization in terms of employees. Much of the association's business is conducted by committee, and about six committees have been established.

One of the committees relates to training. Its focus is to identify the private sector bank training needs and make appropriate recommendations. But because of the small size of its staff and the limited amount of time that bank members can devote to supervision and management, any program implementation (the design, packaging, delivery, and administration of the program) capacity is severely limited. In order to deliver a training program, ABC would either have to hire a full time staffer at an executive level, or contract the work.

A flaw of the ABC is the lack of centralized decision making capacity which can be binding, or at least carry clout with, the individual members. Power is diffused throughout the board and committees, with each member also being a boss of the organization as a whole. It must be considered that while the bankers have the same vested interests of furthering the professionalization of private banking in Costa Rica, they are also competitors in a small market. Fear of a tyranny of the majority disuades the members from giving the organization clear direction and powers. As a result, decision making may not always be clear cut.

An alternative is for CINDE to direct the training efforts as part of their ROCAP program. However, CINDE is a bureaucracy in itself, and great care must be taken to achieve close coordination with the ABC to assure that the appropriate course content and professionalism is obtained.

B. The Central Bank of Costa Rica (BCCR)

The Costa Rican Central Bank (BCCR) is charged with the responsibility of emission and administration of the Costa Rican currency, denominated the colon, and with the administration of the country's foreign currency reserves. Additionally, the Central Bank acts as the government's investment banker, cooperating closely with the Treasury Ministry (Hacienda) for the placement and redemption of government bonds, both for the bank's own account and as an intermediary for the investing public. A third very important function is the direct regulation of all state banks and private financial entities, performing functions analogous to those of the Comptroller of the Currency in the United States.

The AIR facility will be administered by the Financial Department (Departamento Financiero) of the Central Bank of Costa Rica. This department acts as BCCR's cashier, receiving both colón and dollar funds and disbursing by means of checks in either currency or credits to accounts in Costa Rica and abroad. The Departamento Financiero has four years of experience in successfully administering AID's 043 Special Credit Line. Departamento Financiero also administers BCCR's FOPEX line of credit, under which a payment mechanism utilizing colones paid at the BCCR exchange rate to discharge dollar denominated loans is already in effect.

Since no project evaluation role is envisioned for BCCR in the AIR facility, but only a review of documentation for conformity to target market, terms and conditions, internal consistency, and legal completeness, the BCCR Departamento Financiero should have no problem administering AIR. AID should work with Departamento Financiero and the BCCR accounting to make sure that adequate accounts are set up on BCCR's books for handling initial disbursals, reflows, and the loan loss reserve over the years.

ANNEX VIII - ECONOMIC AND FINANCIAL ANALYSIS

A. Private Bank Financial Analysis

The Business

Financially speaking, banking is a low turnover, high leverage business. This is because of the nature of the bank's assets. Unlike an industrial company that produces about the same level of yearly sales as assets, or a commercial enterprise that can turn over perhaps two to three times sales to assets, a bank's gross return on assets is in the range of about only 10% to 20% per annum. In order to obtain a fair market return to shareholders, leverage (liabilities/equity) must therefore be high.

In the U.S., the typical leverage for the 14,000 banks chartered in the country is about 14 to 1. This high leverage characteristic is also reflective of the extremely liquid nature of a bank's assets, which are normally about 30% in cash and marketable securities and 60% in loans out of the total assets on the balance sheet. The numbers analysis for a financial institution is therefore fundamentally different than for a commercial or industrial enterprise, because of the liquid nature of the bank's assets, and because of the bank's identity as a financial intermediary.

The banker's traditional job is to invest depositor's money productively and match these assets with an appropriate liability mix (thus maintaining adequate liquidity) and to make a profit while doing so. In more recent times, revenue generation from non loan sources has taken increased significance within this job definition as a means of diversifying revenue sources and competing with non bank financial institutions. The bank manager's job of financial intermediation is then different from a producer who manufactures goods, or from a merchant who buys at one price and sells at another to make a profit.

Financial Analysis

Comparative financial information for the Costa Rican private sector banks as of 6-30-86 is depicted on the following spreadsheets. It is interesting to note the relative size of the banks as well as their earnings characteristics and relative ratios. The clear leader is Interfin with the highest overall return indeces. The COFISA numbers are somewhat distorted in comparison to the banks because COFISA numbers are for their legal status as a financiera.

<u>Size</u>. Bank size is normally measured in terms of assets. The leaders among the private banks are Interfin and Banex, in the range of ₡ 1.6 billion (approximately US$ 27 million) followed by Cooperativo and Comercio at about 75% that size, and then by San

COMPARATIVE COSTA RICAN PRIVATE BANK FINANCIAL STATEMENTS AT 6-30-86

millions of colones	COOPER -ATIVO	COFISA	BANEX	INTER -FIN	COMER -CIO	BCT	SAN JOSE	METRO-POLI-TANO	FOMEN-TO AG-RICOLA	INDUS -TRIA	CONTI-NENTAL	COM-BINED
FINANCIAL SUMMARY												
Total Assets	1147	528	1543	1685	1257	739	860	119	489	94	242	8703
Quick Assets	90	47	399	472	366	360	203	26	112	42	39	2154
Total Loans	855	198	893	1032	786	266	479	33	352	35	42	4971
Total Liabilities	858	391	1366	1512	1109	626	741	87	377	33	185	7284
Total Borrowed Funds	384	298	591	722	443	320	343	2	184	12	150	3447
Total Certif de Inver	347	0	468	677	571	105	264	34	141	0	21	2627
Total Equity	289	137	177	173	147	113	119	33	112	61	57	1418
Total Net Revenues	43	49	48	68	47	N/A	26	N/A	30	5	N/A	316
Services Revenues	14	26	27	31	19	N/A	18	N/A	13	0	N/A	147
Net Income	19	15	16	27	12	20	11	N/A	10	1	N/A	112
ARTICLE 63 AVAILABILITY	82	200	180	75	107	55	6	0	243	29	115	1092
Headcount	45	60	84	85	75	48	50	15	52	10	10	534
RATIOS												
Earnings												
Return on Assets %	1.65	2.84	1.04	1.61	0.99	2.71	1.23	N/A	2.11	1.17	N/A	1.28
Return on Loans %	3.42	11.54	2.43	3.56	3.59	N/A	1.75	N/A	4.74	13.31	N/A	3.39
Return on Equity %	6.53	10.96	9.10	15.66	8.49	17.75	8.92	N/A	9.20	1.79	N/A	7.87
Services Rev/Tot Rev %	32	53	55	46	40	N/A	68	N/A	45	2	N/A	47
Efficiency												
Tot Rev/Staff Expense	3.00	1.79	2.81	3.25	N/A	N/A	2.27	N/A	N/A	2.18	N/A	N/A
Tot Rev/Operating Ex	1.78	1.09	1.57	1.75	1.55	N/A	1.03	N/A	1.67	1.30	N/A	1.47
Service Rev/Staff Ex	0.97	0.95	1.55	1.48	N/A	N/A	1.54	N/A	N/A	0.05	N/A	N/A
Liquidity												
Loans/Cert de Inver %	247	N/A	191	152	138	254	182	99	250	N/A	200	189
Loans/Borrowed Funds %	223	66	151	143	177	83	140	1665	192	289	28	144
Quick Asset/Tot Asset %	8	9	26	28	29	49	24	21	23	44	16	25
Loans/Total Assets %	75	37	58	61	63	36	56	28	72	37	17	57
Quick Assets/C.I. %	26	N/A	85	70	64	343	77	76	79	N/A	188	82
Funding												
C.I./Total Liab %	40	0	34	45	51	17	36	39	37	0	11	36
Borrow Fund/Tot Liab %	45	76	43	48	40	51	46	2	49	37	81	47
Capital												
Leverage (Liab/Equity)	2.97	2.85	7.72	8.74	7.54	5.56	6.23	2.63	3.37	0.54	3.26	5.14
BCCR Leverage	3.13	3.13	8.54	10.20	9.75	6.09	6.67	2.63	3.71	0.55	3.08	5.65
Equity/Total Assets %	25.22	26	11	10	12	15	14	28	23	65	23	16
Equity/Loans %	33.85	69	20	17	19	42	25	99	32	174	137	29

millions of colones	COOPER -ATIVO	COFISA	BANEX	INTER -FIN	COMER -CIO	BCT	SAN JOSE	METRO- POLI- TANO	FOMEN TO AG- RICOLA	INDUS -TRIA	CONTI- NENTAL	COM- BINED
BALANCE SHEET												
Cash + Banks	90	4	283	85	169	196	111	13	19	36	4	1009
Short Term Securities	0	43	117	387	197	163	92	12	93	6	36	1145
Quick Assets	90	47	399	472	366	360	203	26	112	42	39	2154
Net Loans	855	198	893	1032	786	266	479	33	352	35	42	4971
Receivables	0	40	89	101	31	0	53	51	0	0	0	364
Securities + Invest.	80	106	1	8	6	12	0	0	6	0	0	219
Premises + Equipment	30	60	91	30	48	21	113	4	17	1	7	420
Other Assets	93	78	71	43	20	80	13	5	2	17	155	577
Total Assets	1147	528	1543	1685	1257	739	860	119	489	94	242	8703
Short Term Payables	107	84	245	72	74	139	113	2	8	2	8	855
Due to Banco Central	328	0	547	499	318	207	262	2	163	12	2	2340
Due to Creditors	56	298	44	223	125	113	80	0	21	0	+8	1107
Certif. de Inversion	347	0	468	677	571	105	264	34	141	0	21	2627
Other Liabilities	21	9	62	42	21	62	22	49	44	18	6	356
Total Liabilities	858	391	1366	1512	1109	626	741	87	377	33	185	7284
Capital	238	97	151	135	100	100	93	30	100	60	60	1163
Reserves + Surpluses	36	28	9	13	14	3	18	3	2	0	0	126
Retained Earnings	15	12	17	25	33	10	8	0	10	1	-3	129
Total Equity	289	137	177	173	147	113	119	33	112	61	57	1418
Total Liab. + Equity	1148	528	1543	1685	1257	739	860	119	489	94	242	8702
INCOME STATEMENT												
Interest Revenue	102	37	129	160	126		63		46	5		669
Interest Expense	73	14	107	124	98		55		29	1		501
Net Interest Revenue	29	23	22	37	28	0	8	0	17	5	0	168
Services Revenue	14	26	27	31	19		18		13	0		147
Total Net Revenues	43	49	48	68	47	0	26	0	30	5	0	316
Salaries Expenses	14	27	17	21			12			2		93
Premises Expenses	1	3	3	3			2			0		12
Other Operating Exp.	9	15	11	15			12			1		62
Total Operating Exp.	24	44	31	39	30	0	26	0	18	4	0	215
Non Operating Exp.	0	-11	2	2	4		-10		2	0		-11
Net Income	19	15	16	27	12	20	11	N/A	10	1	N/A	112

Jose and BCT at about half the former two's size.

However, these public numbers understate the real dimensions of Costa Rican private banking because a significant amount of business is done offshore through the use of Panamanian affiliates. Most of the major private sector banks have established these affiliates, and they use them to book primarily dollar operations, although some book colon business as well. On the dollar side, they attract Costa Rican domiciled dollars and lend them out to Costa Rican companies, sometimes in back to back operations for tax purposes (deposit your own money, pledge it for a dollar loan, and pay tax deductible interest on the dollar loan).

The banks use this modus operandi to make greater profits at unregulated rates, untaxed in Panama, and to get around Central Bank legal lending limit and leverage restrictions. Some local bankers estimate that the size of this business is about 50% beyond aggregate declared assets as reported to the Auditoria General de Bancos.

<u>Earnings</u>. Net income for a bank, as with any other company, is important because it determines the capital formation rate (growth in equity) and provides the base from which the bank may grow. On an ongoing basis, the banks with the best earnings are usually the ones that are best managed.

Interfin posts the healthiest margins for return on assets (ROA) with 1.62% and return on equity (ROE) with 15.73%, which significantly outperforms Banex and the other major banks, although BCT profitability indeces are quite good. Because of the Interfin higher relative earnings, their ratios indicate better efficiency despite significantly higher operating costs than any of the others. However, some of these costs may be padding to limit tax exposure.

Some of the newer banks such as Metropolitano, Industria, and Continental do not yet have a sufficent operational history on which to base an accurate earnings potential figure.

<u>Asset Quality</u>. It is difficult to determine or compare asset quality between Costa Rican banks because of the general lack of accounting standards within local banking circles, because of the lack of internal credit audit departments, and because of the lack of a vigorous outside audit control (the Auditoria is a superintendency, not an audit office). But asset quality is of extreme importance, and in general reflects the quality of a bank's management, credit policies, and systems.

Banco de San Jose in particular, and to a lesser extent Banex, reflect a high dependency on services revenues in relation to total revenues. And, even with the higher services revenue, the ROA for these banks is not appreciably better than the competition, leading to the conclusion that their portfolio produces signicantly less in proportion to that of Interfin and the others.

This is confirmed by the return on loans, the net spread, which is lower for these two banks. This could mean a greater proportion of dollar loans with a lower spread than for local currency loans, or it could signal some weakness in the portfolio with higher levels of non performing loans. In the case of Banco de San Jose, which bought out the troubled Bank of America's local subsidiary, operations were close to break even, as 97% of the net income at 6-30-86 was due to extraordinary gains, primarily the non-recurring sale of fixed assets. However, much of this profit squeeze may be due to higher than normal costs for the semester in which the bank was purchased.

Liquidity. For private sector banks in Costa Rica, liquidity is not as crucial as it is to a normal bank with current account deposits. Banks funded by checking and saving account deposits have the legal obligation to pay all moneys so obtained "on demand," so that they could quickly become illiquid should too many depositors demand their money at the same time. This is the classic "run on deposits" which may lead to a bank failure in countries with normal private banking.

Since Costa Rican private banks cannot accept any form of demand deposit and are funded only with time deposits (Certificados de Inversion), loans, and capital, it is possible to program 100% of liability maturities. There is no question mark of how much money demand depositors may remove from a bank at a moment's notice. If there were a run on a Costa Rican private bank, it would have to follow the schedule of time deposit maturities. As an added measure of security, the Central Bank requires private banks to deposit 10% of all CD funding with BCCR as a reserve available for emergencies.

In addition to these built in liquidity enhancing features in their liability structures, Costa Rican banks maintain fairly strong liquidity on the asset side with prudent levels of cash and marketable securities (quick assets) to total assets and to Certificados de Inversion, similar to levels of average U.S. banks. An exception here is Banco Cooperativo which maintains a slim margin of only 8% of quick assets to total assets. Cofisa is also lower, but the Cofisa numbers are for their existing financiera legal vehicle which presents a different funding profile.

Funding. On the funding side, we can see that of the major banks Banex has the lowest proportion of Certificados de Inversion to total liabilities, perhaps indicating underutilization of this source of funds, at least as compared to the others. With respect to borrowed funds (BCCR and other creditor sourced), of the major private banks Interfin appears by far to be the most aggressive, with ₡ 131 million more than its nearest competitor (Banex). Interfin is also significantly higher in relative percentage terms than most of the private banks with 48% of total liabilities.

Capital. Leverage is the standard measure of capital adequacy, although when a bank is involved the equity/total assets ratio is often the norm used. The Costa Rican Central Bank measures leverage taking into consideration only capital and reserves, not retained earnings. For this reason their ratio will be reached sooner than if using the standard liabilities to equity measure.

Interfin has been the private bank most closely leveraging up to the 10 to 1 BCCR limit, surpassing 10 as of 6-30-86, although Banco del Comercio is right behind. The Central Bank has recently approved for Interfin to move up to 11. Because of the proximity to this limit, it is estimated that Interfin and Comercio are the most active in the Panama offshore market dealings.

The 10 to 1 leverage limit is typical for many countries in Latin America, but the figure is considerably below the average 14 or 15 to 1 for U.S. banks, and about half the leverage level of larger money center U.S. banks. As mentioned in other parts of this report, in practice the Central Bank manages how close the private banks can approach the 10 to 1 ratio through its control of authorizations for emission of Certificados de Inversion, having set up a tiering system to permit only the soundest banks to near the maximum leverage limits.

Comparison to State Commercial Banks. In contrast, the weighted average leverage for the Costa Rican public sector commercial banks is currently about 15.7 according to their balance sheets. But in reality the figure is enormous if normal banking standards were applied to their portfolios, which would result in massive write offs, most probably in amounts exceeding their existing capital bases.

The total combined assets of the Costa Rican private sector banks is close to ₡ 9 billion, which is about the size of the total assets of Banco Credito Agricola de Cartago (BCAC), the smallest of the state commercial banks, with ₡ 8.9 billion. The total assets of the national banks as of 3-31-86 are ₡ 91.7 billion, as listed on their balance sheets.

On the other hand, the ₡ 289 million equity figure for Banco Cooperativo, which has the highest capitalization of any of the private banks, is at 63% of the BCAC figure. If Banco Coop's (or any other private bank's) equity should ever exceed that of BCAC, the former's lending limit to any individual borrower would go down to the same 4% of equity as the national banks, compared to the present 15%, according to Article 85 of the Ley Organica of the BCCR.

In further comparing Costa Rica private bank results with the state commercial banks, it is noteworthy that the former's ₡ 107 million combined services revenue for six months is 39% of the full year 1985 figure for the latter. On a full year basis, this would mean an approximate 44% banking services market share for the private banks (since at the respective dates all banks charged the same rates), compared to only about a 7% share in terms of assets.

Conclusion. The Costa Rican private banks as a whole are in a good position to absorb the AIR credit risk, with present capitalization levels at US$ 23 million, to increase to US$ 25 million within a few months. Taking a pessimistic downside assumption of 10% writeoffs, which would be phased over several years and taken in succeeding years when individual capitalization levels will be even higher than the present, the system will be able to handle the credit risk easily.

As far as immediate balance sheet capacity to absorb the credit, Article 63 will be a consideration but not, over time, a significant hindrance (as covered in the market for AIR Project resources section). In analyzing the individual and collective figures for the Costa Rican private banks, we conclude that there is sufficient absorptive capacity for the US$ 19.5 million AIR facility on the basis of present Costa Rican consolidated private bank balance sheets. If we take into account a three year drawing period, Cofisa's entry into the market, BCT's probable drive for growth based on its increased capitalization, and the general dynamism that private Costa Rican banking has demonstrated up to now, we must conclude that the ICI vehicle for getting AID funds to end users is much more than equal to the task.

Private Bank Analytical Capacity

In the formative years of Costa Rican private banking, local lending practices have been characterized by balance sheet lending, perhaps as an outgrowth of nationalized banking. Credit would be based on who the borrower is, and then heavy collateralization would be required to stucture the loan, with only minimal attention paid to the cash generation capacity of the enterprise. This modus operandi, particularly applicable to lower risk short term lending, has been the norm because it is an easier way to operate and because of the lack of qualified and experienced bankers in the country. Consequently, there has been up to now relatively little project loan analysis in Costa Rican banking since this requires time consuming diagnosing and understanding of the client's business and risks by trained and experienced professionals.

However, in a banking environment of greater competitiveness and increasing sophistication, there will probably be a greater willingness to do project analysis. Some financial institutions in the market (Cofisa, PIC, Banex, Banco Cooperativo) are already doing some project analysis for term lending. Other banks will probably look at project analysis and term lending as another financial product to be offered to maintain market position and greater competitiveness, since other things being equal, many clients will prefer to steer their lucrative lower risk quick turnover business to the bank that can also provide developmental term financing.

With some training, some project lending capabilities will be developed, as some financial institutions, notably COFISA, have already been able to do. The banks have almost universally expressed interest in this and other types of training and would welcome any assistance in this area. For this reason, the training component of the AIR Project is highly complementary to the overall objectives of the program.

B. AIR Project Overall Economic and Financial Analysis

Economic Feasibility of AIR

The most basic evaluation of a loan program is simply if, as structured, it will generate sufficient revenue for its own repayment, under conservative assumptions for critical parameters applied over the life of the loan. This initial evaluation is easily passed by AIR, based on cashflow models incorporating all significant elements of the loan.

Based on the market analysis, initial placement of the funds over a three year period is assumed. Interest payments to AID and interest spreads for the participating private banks and BCCR are then built in. Loan recuperation and relending are programmed, taking into account interest reflows and the buildup of a loan loss reserve. Payment of principal starting in the eleventh year is then built in.

The principal sensitivity factor is LIBOR, the indicative interest rate to which AIR rates to sub-borrowers will be pegged. The effect of how big the reflow and reserve interest spread (above AID interests plus the spreads of BCCR and the private banks) is , compounded over 25 years, gives a considerable variance to cashflow projections. High LIBOR assumptions increase projected reflow and reserve interest generation. Three assumptions as to the behavior of LIBOR over time were projected:

A. LIBOR constant at 7% over the 25 year loan period.

B. LIBOR starts at 7% in year 1, increases to 10% in three years, and remains constant at 10% over years 4 to 25.

C. LIBOR starts at 7% in year 1, increases to 15% over eight years, and remains constant at 15% from years 9 to 25.

The results of projections can be summarized as follows:

Millions of Dollars over 25 Years

LIBOR Assumption	Repayment to AID	Total AIR Turnover	Total Loaned	Loan Loss Reserve Acum.
A	Yes	5.5	107.9	1.0
B	Yes	7.3	142.0	5.1
C	Yes	10.7	208.8	17.4

These results show more than adequate economic feasibility in the structuring of the AIR program. The cashflow models themselves and a detailed explanation of their elaboration follow:

Version 1: LIBOR held constant at 7.0%

MIR PROJECT CASH FLOW (in millions of dollars)

YEAR	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	TOTAL
LOANS																										
Drawings + Reflows	7.0	10.1	4.5	4.5	5.7	6.8	6.3	5.5	6.0	6.3	6.3	4.7	4.7	4.5	4.2	3.8	3.3	3.0	2.6	2.3	1.9	1.5	1.1	0.8	0.4	107.9
Outstanding BCCR loan	7.0	17.0	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	18.2	16.9	15.6	14.3	13.0	11.7	10.4	9.1	7.8	6.5	5.2	3.9	2.6	1.3	
Outstanding Subloans	7.0	15.3	17.5	20.7	25.2	25.4	22.4	23.0	24.5	24.8	24.4	22.0	22.2	21.1	19.5	17.4	16.2	14.8	13.3	11.8	10.3	8.8	7.4	5.9	4.4	
LIBOR %	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	
[illegible]																										
Principal Reflow	0.0	1.0	4.5	5.4	6.5	6.2	5.4	5.8	6.1	6.2	6.0	6.0	5.8	5.5	5.1	4.6	4.3	3.9	3.6	3.2	2.8	2.4	2.1	1.7	1.3	105.9
Interest Reflow	0.1	0.2	0.2	0.3	0.3	0.2	0.1	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.9
MID Interest Collected	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total Project Inflows	0.2	2.3	4.9	6.1	7.2	6.9	6.1	6.6	6.8	6.9	7.0	6.9	6.7	6.3	5.8	5.2	4.9	4.5	4.0	3.6	3.1	2.7	2.3	1.8	1.4	120.2
REPAYMENT TO MID																										
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	19.5
Interest	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	2.3	2.2	2.1	2.1	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	31.9
PROJECT CASH GENERATION																										
Annual Totals	0.1	2.0	4.5	5.7	6.8	6.3	5.5	6.0	6.3	6.3	4.7	4.7	4.5	4.2	3.8	3.3	3.0	2.6	2.3	1.9	1.5	1.1	0.8	0.4	.0	88.4
Cumulative	0.1	2.0	6.6	12.2	19.1	25.4	30.9	36.5	43.2	49.5	54.2	59.0	63.5	67.7	71.5	74.8	77.8	80.4	82.7	84.5	86.0	87.2	88.0	88.4	88.4	
RESERVE FUND BUILDUP																										
Annual Interest Reflow	.0	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Cumulative Buildup	.0	0.1	0.3	0.4	0.6	0.7	0.7	0.8	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	

ASSUMPTIONS:
- Loan for US$ 19.5 million available for drawing in three years
- Drawdowns of $ 7.0 million in year 1, $ 10.0 million in year 2, and $ 2.5 million in year 3
- Terms to BCCR of 25 years with 10 grace, straight line reduction commencing in year 11
- Cost to BCCR of 2% in years 1 to 5, 3% in years 6 to 10, 5% thereafter
- Spreads: 1.5% for BCCR, 4.5% for placing bank
- Subloan tenors of 5 years with 1 grace
- Semiannual payments on subloans
- LIBOR as above
- Cost to commercial borrower of LIBOR + 3%
- Reflows in year subsequent to collection of subloan principal repayments
- Maximum amount of subloans taken down
- Two thirds of interest payments in excess of total spreads recaptured for lending reflow
- One third of interest payments in excess of total spreads recaptured for reserve fund buildup

Version 2: stepped LIBOR up to 10.0% and then held constant

AID PROJECT CASH FLOW (in millions of dollars)

YEAR	1	2	3	4	5	6	7	8	9	10	11	12	13
BASIS													
Drawings + Reflows	7.0	10.1	4.6	4.7	6.1	7.5	7.1	6.4	7.0	7.5	7.7	6.1	6.2
Outstanding BCCP loan	7.0	17.0	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	18.2	16.9
Outstanding Subloans	7.0	15.5	17.4	21.0	25.9	26.6	24.2	25.4	27.3	28.4	28.7	27.5	27.5
LIBOR %	7.0	8.0	9.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
SUBLOAN RECUPERATION													
Principal Reflow	0.0	1.8	4.3	5.4	6.6	6.4	5.7	6.3	6.8	7.0	7.0	7.2	7.1
Interest Reflow	0.1	0.3	0.5	0.7	0.9	0.7	0.6	0.7	0.7	0.8	0.4	0.4	0.4
AID Interest Collected	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9	0.8
Total Project Inflows	0.2	2.4	5.1	6.5	7.9	7.7	[illegible]	7.6	8.1	[illegible]	[illegible]	8.4	8.3
REPAYMENT TO AID													
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3	1.3	1.3
Interest	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0	0.9	0.8
Total	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	2.3	2.2	2.1
PROJECT CASH GENERATION													
Annual Totals	0.1	2.1	4.7	6.1	7.5	7.1	6.4	7.0	7.5	7.7	6.1	6.2	6.1
Cumulative	0.1	2.2	6.9	13.0	20.5	27.5	33.9	40.9	48.4	56.2	62.2	68.4	74.6
RESERVE FUND BUILDUP													
Annual Interest Reflow	.0	0.2	0.2	0.3	0.4	0.4	0.3	0.3	0.4	0.4	0.2	0.2	0.2
Cumulative Buildup	.0	0.2	0.4	0.8	1.2	1.6	1.9	2.2	2.6	3.0	3.2	3.3	3.5

YEAR	14	15	16	17	18	19	20	21	22	23	24	25	TOTAL
BASIS													
Drawings + Reflows	6.1	5.9	5.6	5.1	5.0	4.7	4.4	4.1	3.7	3.5	3.1	2.8	142.0
Outstanding BCCP loan	15.6	14.3	13.0	11.7	10.4	9.1	7.8	6.5	5.2	3.9	2.6	1.3	
Outstanding Subloans	26.8	25.6	25.9	25.0	22.1	20.9	19.7	18.4	17.3	16.1	14.8	13.6	
LIBOR %	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	
SUBLOAN RECUPERATION													
Principal Reflow	6.9	6.5	6.1	6.0	5.7	5.4	5.1	4.8	4.5	4.2	3.9	3.6	[illegible]
Interest Reflow	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	10.3
AID Interest Collected	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total Project Inflows	8.0	7.6	[illegible]	[illegible]	6.5	[illegible]	5.7	5.4	5.0	4.6	[illegible]	[illegible]	[illegible]
REPAYMENT TO AID													
Principal	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	19.5
Interest	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total	2.1	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	31.9
PROJECT CASH GENERATION													
Annual Totals	5.9	5.6	5.1	5.0	4.7	4.4	4.1	3.7	3.5	3.1	2.8	2.5	124.9
Cumulative	80.5	86.1	91.2	96.2	100.9	105.3	109.3	113.1	116.5	119.6	122.5	124.9	
RESERVE FUND BUILDUP													
Annual Interest Reflow	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	5.1
Cumulative Buildup	3.7	3.9	4.0	4.2	4.3	4.5	4.6	4.7	4.8	5.0	5.1	5.1	

ASSUMPTIONS:

- Loan for US$ 19.5 million available for drawing in three years
- Drawdowns of $ 7.0 million in year 1, $ 10.0 million in year 2, and $ 2.5 million in year 3
- Terms to BCCP of 25 years with 10 grace, straight line reduction commencing in year 11
- Cost to BCCP of 2% in years 1 to 5, 3% in years 6 to 10, 5% thereafter
- Spreads: 1.5% for BCCP, 4.5% for placing bank
- Subloan tenors of 5 years with 1 grace
- Semiannual payments on subloans
- LIBOR as above
- Cost to commercial borrower of LIBOR + 3%
- Reflows made in year subsequent to collection of subloan principal repayments
- Maximum amount of subloans taken down
- Two thirds of interest payments in excess of total spreads recaptured for lending reflow
- One third of interest payments in excess of total spreads recaptured for reserve fund buildup

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[redacted]

Version 3: stepped LIBOR up to 15.0% and then held constant

AIR PROJECT CASH FLOW (in millions of dollars)

YEAR	1	2	3	4	5	6	7	8	9	10	11
BASIS											
Drawings + Reflows	7.0	10.1	4.6	4.7	6.1	7.6	7.4	6.9	7.9	8.8	9.3
Outstanding BCCP loan	7.0	17.0	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5	19.5
Outstanding Subloans	7.0	15.3	17.4	21.0	25.9	26.8	24.7	26.4	29.0	31.2	32.6
LIBOR %	7.0	8.0	9.0	10.0	11.0	12.0	13.0	14.0	15.0	15.0	15.0
SUBLOAN RECUPERATION											
Principal Reflow	0.0	1.8	4.3	5.4	6.6	6.4	5.8	6.5	7.0	7.5	7.8
Interest Reflow	0.1	0.3	0.5	0.7	1.0	1.1	1.2	1.4	1.7	1.9	1.5
MIO Interest Collected	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0
Total Project Inflows	0.2	2.4	5.1	6.5	8.0	8.0	7.5	8.5	9.3	9.9	10.2
REPAYMENT TO MIO											
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3
Interest	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	1.0
Total	0.1	0.3	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	2.3
PROJECT CASH GENERATION											
Annual Totals	0.1	2.1	4.7	6.1	7.6	7.4	6.9	7.9	8.8	9.3	8.0
Cumulative	0.1	2.2	6.9	13.0	20.6	28.1	35.0	42.9	51.6	61.0	69.0
RESERVE FUND BUILDUP											
Annual Interest Reflow	.0	0.2	0.2	0.3	0.5	0.5	0.6	0.7	0.9	0.9	0.8
Cumulative Buildup	.0	0.2	0.4	0.8	1.3	1.8	2.4	3.1	4.0	4.9	5.7

YEAR	12	13	14	15	16	17	18	19	20	21	22	23	24	25	TOTAL
BASIS															
Drawings + Reflows	8.0	8.4	8.8	8.9	9.0	8.9	9.1	9.3	9.4	9.5	9.6	9.7	9.9	10.0	208.8
Outstanding BCCP loan	18.2	16.9	15.6	14.3	13.0	11.7	10.4	9.1	7.8	6.5	5.2	3.9	2.6	1.3	
Outstanding Subloans	32.7	33.9	34.7	34.9	34.6	35.2	35.8	36.2	36.5	36.9	37.5	38.0	38.5	39.0	
LIBOR %	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	
SUBLOAN RECUPERATION															
Principal Reflow	8.2	8.5	8.6	8.6	8.5	8.8	8.9	9.0	9.0	9.1	9.3	9.4	9.5	9.7	184.1
Interest Reflow	1.5	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.7	1.8	1.8	1.8	34.9
MIO Interest Collected	0.9	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total Project Inflows	[illegible]	[illegible]	11.0	11.0	[illegible]	[illegible]	11.1	11.1	11.1	[illegible]	[illegible]	11.4	11.5	[illegible]	[illegible]
REPAYMENT TO MIO															
Principal	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	19.5
Interest	0.9	0.8	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	12.4
Total	2.2	2.1	2.1	2.0	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.5	1.4	1.4	31.9
PROJECT CASH GENERATION															
Annual Totals	8.4	8.8	8.9	9.0	8.9	9.1	9.3	9.4	9.5	9.6	9.7	9.9	10.0	10.2	199.5
Cumulative	77.4	86.2	95.1	104.1	112.9	122.1	131.3	140.7	150.1	159.7	169.4	179.3	189.3	199.5	
RESERVE FUND BUILDUP															
Annual Interest Reflow	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9	17.4
Cumulative Buildup	6.4	7.2	8.0	8.9	9.7	10.5	11.3	12.2	13.0	13.9	14.7	15.6	16.5	17.4	

ASSUMPTIONS:

- Loan for US$ 19.5 million available for drawing in three years
- Drawdowns of $ 7.0 million in year 1, $ 10.0 million in year 2, and $ 2.5 million in year 3
- Terms to OCCR of 25 years with 10 grace, straight line reduction commencing in year 11
- Cost to BCCR of 2% in years 1 to 5, 3% in years 6 to 10, 5% thereafter
- Spreads: 1.5% for BCCR, 4.5% for placing bank
- Subloan tenors of 5 years with 1 grace
- Semiannual payments on subloans
- LIBOR as above
- Cost to commercial borrower of LIBOR + 3%
- Reflows made in year subsequent to collection of subloan principal repayments
- Maximum amount of subloans taken down
- Two thirds of interest payments in excess of total spreads recaptured for funding reflow
- One third of interest payments in excess of total spreads recaptured for reserve fund buildup

Best Available Document

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The cash flow prepared for the 25 year life of the AIR project depicts the amounts to be recuperated from subloan placements, contrasted to outflows for repayment to AID, resulting in considerable positive benefits in terms of net cash generation of the project. The resulting cash buildups are more than enough to fund repayments of principal commencing in year 11. The cash flows also reflect the reserve fund buildup, which is sourced from interest reflows. Three versions of the cash flow have been prepared to test the sensitivity of interest rates, both to interest reflows and to the reserve fund accumulation.

A basic element of the AIR Project is that all principal recuperation from subloan repayments will be available again for relending, thus achieving considerable turnover as the funds are reloaned several times during the 25 year life of the project. Additionally, two thirds of the excess of interest paid by the private sector borrower to the ICI over amounts necessary to pay AID, BCCR's 1.5% spread, and the private bank's 4.5% spread are recaptured and contribute to the buildup in the reflow pool. This latter amount is included in the "interest reflow" line in the cash flow.

Under the three scenarios, the project achieves a turnover ranging from 5.5 (107.9 million in total principal plus interest reflows/19.5 million amount of loan) to 10.7 (208.8/19.5).

On the cash flows, the line for "principal reflow" is the result of collecting 25% (since subloans are actually paid in four years because the first year is a grace period) of each of the four previous years' lending. For example, in year 7 of version 1 of the cash flow, the principal reflow amount of $ 5.4 million is computed as follows:

25% of the year 3 lending of 4.5 = 1.13
25% of the year 4 lending of 4.5 = 1.13
25% of the year 5 lending of 5.7 = 1.43
25% of the year 6 lending of 6.8 = 1.70

principal collected in year 7: $ 5.39 million

The $ 5.4 million above, plus the amount of 0.1 million recaptured from excess interest, is then loaned out the following year, as depicted in year 8 of the "drawings + reflows" line. In subsequent years when principal repayments to AID commence, the amount of reflows will be reduced accordingly. For the first three years, the "drawings + reflows" line of the cash flow also includes the drawings, arbitrarily assumed to be $ 7 million in year 1, $ 10 million in year 2, and $ 2.5 million iyear 3.

The interest owed to AID under the AIR facility has been itemized separately. The interest collected is for the same amount as the interest paid by BCCR so that the numbers offset each other.

One third of the interest payments in excess of that needed to cover the interest paid to AID, the BCCR 1.5% spread, and the commercial bank's 4.5% spread will also be recaptured into a reserve pool. This means that in years 1 through 5, one third of amounts received in interest payments charged on subloans in excess of 8% p.a. will go into the reserve pool (excess of 9% in years 6 through 10, excess of 11% in years 11 through 25). The sensitivity of LIBOR interest rates for the buildup of this fund can be appreciated in the three versions of the cash flow, ranging from a ten year cumulative buildup of $1.0 million at a flat 7% LIBOR rate to $4.9 million at a stepped 15% assumption.

Expected Financial and Economic Return on AIR Projects

A point of major importance in evaluation of AIR is a study of costs and benefits for the Costa Rican economy. Since we are dealing with a financial project, the actual costs and benefits will be the sum of the costs and benefits of the various projects financed. Since these cannot be projected in advance, an initial analisis must focus on a more general economic criterion.

The economic concept applicable for setting cost and benefit standards is the opportunity cost of capital. A somewhat abstract economist's tool, this concept can be explained as the minimum return on capital of projects foregone by chanelling funds into a given investment. Since the concept focuses on projects foregone, we are therefore talking about a "second best" criterion. If an investor chooses between two or more investment projects, the return to be expected on the best projects <u>not</u> chosen sets the opportunity cost standard.

In Costa Rica, with the typical Third World weak currency problem, investments locked into production for the local market are especially problematic to analyze. The analysis is much simplified when dealing with projects structured along AIR's eligibility criteria, for export production to hard currency markets. The question then becomes, "What is the return to have been expected for Costa Rica from dollar generating investments not chosen because more profitable dollar generating projects were available?" Since Costa Rica has little experience in non-traditional export projects, there is not enough accumulated data on projects undertaken so as to judge what the second best projects would have been. Fortunately, the opportunity cost of capital is a subject of intensive research by the World Bank and similar institutions. For Costa Rica at this point in time, the World Bank opportunity cost of capital standard of between 10% and 12% per annum can be adopted as a point of departure.

<u>Costa Rican Project Analysis</u> Although very little information exists on "second best" projects in Costa Rica, there has been enough recent term lending and processing here in the last few years to form a criterion based on projects actually carried forward or studied by local term lending institutions. As a basis for analysis, five project presentations were selected. Three of the projects have been actually financed by Cofisa, a local

project lending oriented finance company on the verge of chartering as a Costa Rican private bank. Two of the projects have been studied by PIC, the Private Investment Corporation, an AID financed institution with a broad project oriented charter that allows taking of equity positions as well as financing. Highly summarized investment, loan amount, and cashflow information for the five projects are as follows:

PROJECT 1: TROPICAL PLANTS

Loan Amount: $235M - Total Investment: $325M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	0	180	319	369	418	418	418	418	418	418
Expenses	0	93	209	245	261	261	261	261	262	261
Cashflow	(325)	87	110	124	157	157	157	157	157	157

Leverage = 2.61:1
IRR = 35.27%

PROJECT 2: FLOWERS

Loan Amount: $250M - Total Investment: $412M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	169	461	612	612	612	612	612	612	612	612
Expenses	65	432	476	476	476	476	476	476	476	476
Cashflow	(308)	29	136	136	136	136	136	136	136	136

Leverage = 1.54:1
IRR = 32.11%

PROJECT 3: SPICES

Loan Amount: $100M - Total Investment: $198M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	97	203	213	225	237	251	251	251	251	251
Expenses	12	167	168	174	193	194	194	194	194	194
Cashflow	(113)	36	45	51	44	57	57	57	57	57

Leverage = 1.02:1
IRR = 38.48%

PROJECT 4: PLASTIC BAG MANUFACTURER

Loan Amount: $500M - Total Investment: $1380M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	746	2050	2460	2750	2880	2880	2880	2880	2880	2880
Expenses	690	1762	2100	2358	2476	2476	2476	2476	2476	2476
Cashflow	(1324)	288	360	392	404	404	404	404	404	404

Leverage = 0.57:1
IRR = 23.71%

PROJECT 5: FISHING GEAR MANUFACTURER

Loan Amount: $350M - Total Investment: $575M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	68	195	328	359	377	395	395	395	395	395
Expenses	25	175	131	129	129	134	134	134	134	134
Cashflow	(532)	20	197	230	248	261	261	261	261	261

Leverage = 1.56:1
IRR = 30.79%

The basic measure used for analysis of return on these projects will be the internal rate of return, abreviated to IRR. Internal rate of return is one of the principal economic and financial return measures used for project studies based on cashflows projected over time. The analysis takes place outside of an accounting environment - there are no assets and liabilities, only budgeted expenditures and projected revenues. Thus cashflow is negative during the investment stage, and positive when investment stops and revenues come in.

Since there is time preference in all investments, revenue in two, three, or more years must be greater than a given sum at the present time to justify an investment. In IRR analysis, a stream of future revenues must be discounted against a present investment to see if return is adequate. Discounting is compounded over time so that, the further in the future a given revenue is, the bigger it must be to balance a present investment. The internal rate of return is defined as that discount rate applied to a future stream of earnings, compounded over time, such that future earnings exactly balance present expenditures. It is a measure of how much return projected revenues will give over present investment, totally <u>within</u> a given project - thus, the <u>internal</u> rate of return.

The five projects for this analysis were grouped into agricultural and manufacturing. Each was analysed individually. Then the investments and cashflows were combined into composite projects for each grouping, and analyzed, and finally into a single overall composite cashflow for all five projects, and analyzed again. The results are shown as follows:

COMPOSITE PROJECTS: AGRICULTURE

Combined Loan Amount: $585M - Combined Investment: $935M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	266	844	1144	1206	1267	1281	1281	1281	1281	1281
Expenses	77	692	853	895	930	931	931	931	931	931
Cashflow	(746)	152	291	311	337	350	350	350	350	350

Leverage = 1.67:1
IRR = 34.41%

COMPOSITE PROJECTS: MANUFACTURING

Combined Loans Amounts: $850 M - Combined Investment: $1955M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	814	2245	2788	3109	3257	3275	3275	3275	3275	3275
Expenses	715	1937	2231	2487	2605	2610	2610	2610	2610	2610
Cashflow	(1856)	308	557	622	652	665	665	665	665	665

Leverage = 0.77:1
IRR = 26.07%

OVERALL COMPOSITE: AGRICULTURE AND MANUFACTURING

Total Loan Amounts: $1435M - Total Investment: $2890M

CASHFLOW

Year	0	1	2	3	4	5	6	7	8	9
Sales	1080	3089	3932	4315	4524	4556	4556	4556	4556	4556
Expenses	792	2629	3084	3382	3535	3541	3541	3541	3541	3541
Cashflow	(2602)	460	848	933	989	1015	1015	1015	1015	1015

Leverage = 0.99:1
IRR = 28.57%

INTERNAL RATE OF RETURN SUMMARY

Agriculture

Project 1 - 35.27% : Composite Cashflow - 34.41%
Project 2 - 32.11% : Unweighted Average - 35.29%
Project 3 - 38.48% :

Manufacturing

Project 4 - 23.71% : Composite Cashflow - 26.07%
Project 5 - 30.79% : Unweighted Average - 27.25%

Combined Total : Composite Cashflow - 28.57%
: Unweighted Average - 32.07%

Analysis of these results shows, first of all, that returns for nontraditional export projects in Costa Rica are very good.

Even the lowest IRR, 23.71% for Project 4 (the plastic bag manufacturer) is well above the opportunity cost of capital. This is in keeping with characteristics of private investment. The opportunity cost of capital is a macroeconomic concept. Analysis at that level generally doesn't take into account risk and uncertainty. Thus entrepreneurs, who weigh risk considerably before investing, require returns well above alternative risk free investments before going ahead with projects. The overall returns are very good, with composite projects in agriculture and manufacturing showing an IRR range of 26.6% to 34.4%, and average IRRs between 27.3% and 35.3%.

Based on these cashflows, the first criterion for project feasibility - private profitability - is met. The investments are attractive enough to entice private investors to carry them forward.

The second criterion for desirability of the investments is economic profitability, a measure of the benefits of the projects to the country as a whole. To make this type of analysis, corrective prices must be made to the various inputs and sometimes also to revenues, to adjust for distortions in the economy. In the case of these Costa Rican projects, which can be regarded as typical of future projects to be carried forward under AIR, all the adjustments are in favor of and not against economic profitability. Among the chief adjustments would be:

- Wage bills in Costa Rica are distorted by a minimum wage, contributing to unemployment, and by payroll taxes of over 40%. Thus salary related expenses, which are costs in the economic calculation of the private investor, carry an element of subsidy to the worker, in that he is being paid more than he is likely to get without a minimum wage structure, and to the state in the form of payroll taxes.

- Fuel bills are artificially high in Costa Rica, as the government uses its petroleum refining monopoly to charge fuel prices greatly in excess of world prices. The revenues extracted are used for a variety of subsidies in the economy.

- Due to IMF restrictions, Costa Rica has been forced to eliminate all subsidies on agricultural and industrial inputs, from fertilizers to electricity, so that all costs used in private financial calculation are at or above their true cost.

- Since these projects are aimed at hard currency markets and calculated in dollars, distortions due to overvaluation of the Costa Rican colon at any point in time are eliminated.

Based on all of these considerations, it can be concluded that, for non traditional export projects in Costa Rica aimed at hard currency markets, the financial calculation of the private investor will tend to show returns below the actual return for the country as a whole. Thus, if good private returns can be shown, the returns for the country will probably be even better.

Looking at the projects themselves also yields some interesting results. As logic dictates, the highest returns are in agriculture related projects, where value added is highest and where Costa Rica has a built in cost advantage over the advanced economies of the first world. A second thing that stands out is the generally small scale and quick return on the projects. This is the way Costa Rica must go, concentrating on smaller, manageable projects and avoiding very big investments that tie up too much capital and take too long to come on stream.

Wider Economic Benefits

In order to go beyond strictly financial return calculations and analyze wider benefits to the economy, it is best to look at actual projects. Fortunately, an institution exists in Costa Rica that has, in the last year, developed a portfolio very much along the lines of what AID is trying to accomplish on a wider scale through AIR. This institution is Cofisa, the project oriented financiera on the verge of chartering as a bank. The following Developmental Impact Spread Sheet is based on an examination of Cofisa's portfolio as of April 1986. This portfolio is loaned out totally in dollars, to be paid in real dollars and not in colones at the Central Bank's exchamge rate. A small minority of borrowers (coffee growers) would not be eligible for AIR. However, production financed, on a weighted average basis, is 79% export oriented. In generating this spreadsheet, certain assumptions were made in attempts to quantify key indicators of economic benefits:

> <u>Sales Generated</u>: Since all of the projects financed were new (although many were being carried out by established companies), annual sales were projected according to production expectations when the projects reached full output levels. Dividing projected annual total sales of ₡2.735 billion by the dollar loan total of $6,618,750, we get 413 colones in annual sales per dollar loaned, or $7.12 at an exchange rate of 58.
>
> <u>Foreign Exchange Generated</u>: Based on the 79.17% export weighted average for sales by Cofisa's project investing clients, applied to sales per dollar loaned, we get $5.64 in exports per loan dollar. For AIR, this figure is conservative as the more rigorous export orientation eligibility requirement will probably result in a higher percentage of export sales generation.

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DEVELOPMENTAL IMPACT SPREAD SHEET

COFISA DOLLAR PORTFOLIO - 4/86	APRVD $ AMT	% OF TOTAL	TENOR/ GRACE	SALES C. MM	XPRT %	ASSET C. MM	VAL AD%	CLIENT CATEGORY	INFLO C. MM	NO. EMP	WAGES C. MM	PEOPL SUPRT
Flowers/Plants			Yr - Mo									
Arbol Grande	235750	3.56	6 - 24	17	100	4	80	START UP	14	10	4	50
Bromelia	500000	7.55	5 - 12	85	100	30	80	START UP	68	45	21	225
Fincas Nabori	250000	3.78	5 - 12	36	100	25	80	START UP	29	55	9	275
Flores Intercont	300000	4.53	5 - 12	100	100	27	80	START UP	80	15	25	75
SUBTOTAL	1285750	19.43		238	100	86			190	125	60	625
Spices/Vegetables												
Agro Aromas	100000	1.51	5 - 12	10	100	5	90	SMALL FARM	9	22	4	110
Erkelens y Cia.	145000	2.19	3 - 0	8	100	8	90	SMALL FARM	7	20	3	100
Prod CR Aceit/Esp	56000	0.85	5 - 36	3	100	20	90	SMALL FARM	3	125	1	625
SUBTOTAL	301000	4.55		21		33			19	167	8	835
Coffee/Cacao												
Benef El General	250000	3.78	S T	300	100	200	90	COFFEE EXPORTER	270	60	75	300
Benef Montealegre	250000	3.78	S T	300	100	220	90	COFFEE EXPORTER	270	50	75	250
El Comendador	150000	2.27	5 - 12	60	100	33	90	REACTIVATION	54	100	15	500
El Dorado	250000	3.78	5 - 12	200	25	126	90	ESTAB INDUSTRY	45	57	50	285
SUBTOTAL	900000	13.60		860		579			639	267	215	1335
Fishing/Extractive												
Industrias Martec	25000	0.38	S T	33	80	16	90	START UP	24	37	17	185
Deriv Calcareo	110000	1.66	5 - 6	17	50	20	90	START UP	8	12	4	60
SUBTOTAL	135000	2.04		50		36			31	49	21	245
Industry/Construc												
Dise/Constr Naval	150000	2.27	S T	35	100	12	70	RECENT INDUSTRY	25	33	11	165
** Inversiones Zeta	500000	7.55	5 - 12	16	100	390 *	90	CONSTRUCTION	14	40	5	200
Portico	500000	7.55	5 - 12	81	100	135	95	TURNAROUND	77	165	24	825
SUBTOTAL	1150000	17.37		132		537			116	238	40	1190
Industry/Processing												
Gallito Indust	500000	7.55	2 - 12	231	30	302	90	ESTAB INDUSTRY	62	225	58	1125
** LAICA (Taboga)	500000	7.55	7 - 24	313	100	220	90	SUGAR COOPERATIVE	282	600	78	3000
Lordan	150000	2.27	S T	110	80	83	30	ESTAB INDUSTRY	26	96	28	480
Ser Gen Oeste	300000	4.53	5 - 12	200	100	85	40	RECENT INDUSTRY	80	124	50	620
Yanber	500000	7.55	S T	357	50	544	30	ESTAB INDUSTRY	54	190	89	950
SUBTOTAL	1950000	29.46		1211		1234			504	1235	303	6175
Textiles/Apparel												
Confec H y H	30000	0.45	3 - 4	12	100	11	90	DRAW BACK	11	110	10	550
Fuertejidos	440000	6.65	5 - 24	50	10	107	50	REACTIVATION	3	7	20	35
OS Textiles	265000	4.00	3 - 6	130	80	160	50	START UP	52	140	52	700
Textiles Flex	110000	1.66	5 - 12	10	60	16	50	TURNAROUND	3	72	4	360
SUBTOTAL	845000	12.77		202		294			68	329	86	1645
Tourism												
Bandana Republic	12000	0.18	3 - 0	1	50	0	90	START UP	0	2	1	10
CR Expeditions	40000	0.60	3 - 0	20	95	5	90	SERVICES	17	24	10	120
SUBTOTAL	52000	0.79		21		5			18	26	11	130
TOTAL PORTFOLIO	6618750	100.00		2735		2804			1585	2436	742	12180
PRORATED PORTFOLIO	19500000			8058		8261			4671	7177	2186	35884

* approximately 200 employees for 1 year divided by 5 year tenor

** figures for project financed only

Employment Generation: Total direct employment of the Cofisa dollar term loan clients, projected for mature sales levels, totaled 2436 employees. Again, dividing by loan totals, we get a factor of 3.68 jobs created per $10,000 loaned.

People Supported: Assuming that every worker supports himself plus four others, we have a factor of 18.4 people supported per $10,000 loaned.

It should be noted that the above figures only attempt to quantify direct sales, foreign exchange generation and employment effects. No multiplier effect for forward and backward linkages in the economy have been considered.

Since the preceding factors are all keyed to loan volume, their use in estimating and projecting the economic impacts they measure must be based on the lending volumes of the AIR project time.

Based on the most conservative of the cashflows generated for evaluation of AIR's basic economic feasibility (the one with the lowest LIBOR assumption), and on the previously derived factors, the following are AIR projections for sales generated, foreign exchange generated, employment generated, and people supported for the first ten years of the project.

As can be seen from the projections, AIR's sales, foreign exchange, employment generation and livelyhood provision for Costa Rica will be excellent. This is not surprising, as this AID credit facility is targetted on precisely the most productive type of project investment possible for Costa Rica.

AIR PROJECT ECONOMIC BENEFITS PROJECTION

YEAR	1	2	3	4	5	[illegible]	7	8	9	10	TOTAL
DISBURSEMENT SOURCES: ($ millions)											
Drawings	7.0	10.0	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	19.5
Reflows	0.0	0.1	2.0	4.5	5.7	6.8	6.4	5.5	6.0	6.3	43.3
Total	7.0	10.1	4.5	4.5	5.7	6.8	6.4	5.5	6.0	6.3	62.8
AIR ECONOMIC BENEFITS											
Sales Generation ($ millions)	49.8	71.9	32.0	32.0	40.6	48.4	45.6	39.2	42.7	44.9	447.1
For. Exch. Gener. ($ millions)	39.5	57.0	25.4	25.4	32.1	38.4	36.1	31.0	33.8	35.5	354.2
Employment Generated	2576	3717	1656	1656	2098	2502	2355	2024	2208	2318	23110
People Supported	12880	18584	8280	8280	10488	12512	11776	10120	11040	11592	115552

ANNEX IX - OUTLINE FOR LOAN AGREEMENT

AID - BCCR
AIR LOAN FACILITY

DESCRIPTION OF THE FACILITY: A revolving line of credit, with a tenor of twenty five years, with ten years grace, from the United States Agency for International Development to the Central Bank of Costa Rica. The line of credit will be for nineteen million six hundred fifty thousand United States dollars (US$ 19,650,000.oo).

USE OF THE FACILITY: The line of credit will be used for placements through the private banks of the Costa Rican National Banking System, to people or companies, exclusively for project investment. Only projects will be eligible for which the great majority of production is for exporting of non traditional products (that is, excluding coffee beans, bananas, unrefined sugar and beef) to markets outside Central America or for which payment will be in US dollars or other hard currency, defined as the currencies of any of the European Common Market countries or Japan. BCCR will continue to relend all principal reflows under this facility for the full twenty-five year tenor of the loan. BCCR's payments to AID will be in US dollars and sourced from BCCR's general funds.

ELIGIBLE BANKS: The banks responsible for the direct placement of these funds with end user clients will hereinafter be referred to as the Intermediate Credit Institutions (ICIs). Upon signing of the loan agreement, all Private Banks in the Costa Rican National Banking System that have a paid in capital of one hundred million colones and are in good standing with the BCCR Auditoria General de Bancos, and are approved by the BCCR for use of these facilities, will be eligible to act as ICIs under this facility.

INTEREST RATES, COMMISSIONS, AND THEIR DISTRIBUTION: The interest charged to the end user of this credit will be LIBOR plus 3%, fixed on the date of first disbursal for the full tenor of the loan. The distribution of interest spreads among BCCR, AID, and the commercial banks will be:

- for BCCR, 1% to 1.5%
- for the ICI, 3.5% to 4.5%
- for AID,
    - 2% p.a. interest in years 1 to 5
    - 3% p.a. interest in yeard 6 to 10
    - 5% p.a. interest in years 10 to 25

The maximum spreads will be applied for BCCR and the commercial banks as long as LIBOR + 3% is high enough to accomodate those maximum spreads plus BCCR's cost of funds (AID's interest rates). If LIBOR + 3% should fall to a point where BCCR's cost of funds and the maximum spreads for BCCR and the commercial banks cannot be accomodated, those institutions will reduce their spreads to

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points no lower than their respective minimums. A floor rate of BCCR's cost of funds plus 4.5% (the sum of the minimum spreads for BCCR and the commercial banks) will be set in case LIBOR + 3% goes so low that BCCR's cost of funds plus the minimum spreads can't be accomodated. The order of adjustment of spreads in case of a low LIBOR will be:

- First, BCCR will reduce its spread, from its maximum of 1.5% down to its minimum of 1.0%, by the amount necessary to bring total interest charges to LIBOR 3%.

- Second, the ICI will reduce its spread, from its maximum of 4.5% down to its minimum of 3.5%, by the ammount necessary to bring total interest charges to LIBOR + 3%.

- Third, the floor interest rate of BCCR cost of funds plus 4.5% will become applicable for the end user's loan.

If LIBOR plus 3% should be higher than BCCR cost of funds plus 6% (the sum of the maximum BCCR and commercial bank interest spreads), the difference will be used one third for the creation of a BCCR reserve fund for loan losses, and two thirds added to reflows for new lending to end users.

The ICI's are authorized to charge a negotiation comission of 2%, to be charged proportionally with each disbursal.

A graphic example of the application of interest rates as LIBOR drops and AID's floor interest rate varies, and of the distribution of interests charged among BCCR, the ICIs, AID and the reflow and reserve pool is the following:

AIR PROJECT APLICABLE INTEREST RATES AND SPREADS

EXAMPLE 1: Years 1 to 5, floor interest rate 2% + 4.5% = 6.5%

Interest Rates: * indicates rate to end user of credit

LIBOR	7.0	6.5	6.0	5.5	5.0	4.5	4.0	3.5	3.0
LIBOR+3	*10.0	*9.5	*9.0	*8.5	*8.0	*7.5	*7.0	*6.5	6.0
FLOOR RT.	6.5	6.5	6.5	6.5	6.5	6.5	6.5	*6.5	*6.5

Spreads: sum equals interest rate to end user

BCCR	1.5	1.5	1.5	1.5	1.5	1.0	1.0	1.0	1.0
ICI	4.5	4.5	4.5	4.5	4.5	4.5	4.0	3.5	3.5
AID	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
RES&REF	2.0	1.5	1.0	0.5	0.0	0.0	0.0	0.0	0.0
SUM	10.0	9.5	9.0	8.5	8.0	7.5	7.0	6.5	6.5

EXAMPLE 2: Years 6 to 10, floor interest rate 3% + 4.5% = 7.5%

Interest Rates: * indicates rate to end user of credit

LIBOR	7.0	6.5	6.0	5.5	5.0	4.5	4.0	3.5	3.0
LIBOR+3	*10.0	*9.5	*9.0	*8.5	*8.0	*7.5	7.0	6.5	6.0
FLOOR RT.	7.5	7.5	7.5	7.5	7.5	*7.5	*7.5	*7.5	*7.5

Spreads: sum equals interest rate to end user

BCCR	1.5	1.5	1.5	1.0	1.0	1.0	1.0	1.0	1.0
ICI	4.5	4.5	4.5	4.5	4.0	3.5	3.5	3.5	3.5
AID	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
RES&REF	1.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SUM	10.0	9.5	9.0	8.5	8.0	7.5	7.5	7.5	7.5

EXAMPLE 3: Years 11 to 25, floor interest rate 5% + 4.5% = 9.5%

Interest Rates: * indicates rate to end user of credit

LIBOR	7.0	6.5	6.0	5.5	5.0	4.5	4.0	3.5	3.0
LIBOR+3	*10.0	*9.5	9.0	8.5	8.0	7.5	7.0	6.5	6.0
FLOOR RT.	9.5	*9.5	*9.5	*9.5	*9.5	*9.5	*9.5	*9.5	*9.5

Spreads: sum equals interest rate to end user

BCCR	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
ICI	4.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
AID	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
RES&REFS	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SUM	10.0	9.5	9.5	9.5	9.5	9.5	9.5	9.5	9.5

THE AID - BCCR - ICI - CLIENT BORROWER RELATIONSHIP: DISBURSALS AND PAYMENTS.

BCCR sill sign a loan agreement in US dollars with AID. The loans between the ICIs and BCCR, and between the borrowing clients and the ICIs, will be documented by means of promisory notes in U.S. dollars, and will be disbursed and payed in colones at the official BCCR colon dollar exchange rate in force on the date of each transaction. Disbursals to ICIs may be in US dollars only in the case of payments abroad for goods to be imported to Costa Rica within a project investment plan. Both the promisory notes between the borrowing clients and the ICIs and the promisory notes between the ICIs and BCCR, under this mechanism, will be enforceable in dollars but payable in colones at the official BCCR colon dollar exchange rate on the date of payment.

Disbursals: AID to BCCR:

1. Through Commitment Letters: For payments abroad for goods to be imported into Costa Rica, BCCR will request that AID issue Letters of Commitment to one or more of BCCR's correspondent banks, satisfactory to AID, committing AID to reimburse such bank or banks for payments made by them to suppliers under letters of credit issued by ICIs under the AIR facility or in direct A.I.D. reimbursement.

2. Through a Dollar Advance Account: BCCR will request AID to make dollar advances into the AIR special account equal to BCCR's projected sub-project disbursements for a thirty day period. Advances will be replenished by AID upon BCCR's submission of AID vouchers and supporting documentation which gives evidence of sub-project disbursements.

3. Through Direct Reimbursement: In dollars, for advances by ICIs to clients, in dollars (for purchases abroad) or in colones at the BCCR rate, against vouchers and supporting documentation.

4 Other Forms of Disbursement may also be made by such means as AID and BCCR agree to in writing.

Disbursals: BCCR, ICIs and End Users:
For every disbursal, there must be exact correspondence between the principal amounts, tenors, grace periods and payment schedules, on the respective promisory notes between the borrower client and the ICI and the ICI and BCCR. Furthermore, interests and comissions should be in accordance with the aforementioned interest and commission structure. Against signature of the respective dollar denominated promisory notes between the final sub-borrowers and the ICIs and between the ICIs and BCCR, BCCR will disburse to the ICIs in colones or in dollars, in accordance with the procedures and mechanisms described below:

1. US Dollar Procurement:

   a. For imports against documentary letters of credit, ICIs will open the letters of credit through the BCCR foreign correspondent bank or banks to which AID has issued Letters of Commitment at the request of BCCR.

   b. For imports against documentary collections, against presentation of satisfactory import documents, BCCR will credit the account of the foreign correspondent bank in dollars.

2. Procurement in Costa Rican Colones:

   Against presentation of a list of items to be procured locally, the BCCR will reimburse the ICIs in colones for their disbursements to final subborrowers. The exchange rate applied for the colon disbursal under the dollar promisory note will be the official BCCR rate on the day of the ICI's disbursal to the sub-borrower.

3. Reflows:

   BCCR will create a second special account for all payment reflows on AIR credits. Upon receiving payment in colones, BCCR must credit this account with dollars calculated at the BCCR exchange rate on the date of payment, for later disbursals in colones calculated at the BCCR exchange rate on the day of disbursal. Two thirds of all interest payments from end users in excess of AID's interests, plus the maximum spreads for BCCR and the ICIs, must be credited to the reflow account. All payments into the reflow account will be available for relending under the AIR program.

4. ICI Loan Loss Reserve Account

   One third of any spread on interest payments from end users in excess of AID's interests, plus the sum of the maximum spreads for BCCR and the ICIs, must be credited to a loan loss reserve account.

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Payments: End Users, ICIs and BCCR:

In all of the above cases, the loans between BCCR and the ICI and between the ICI and the end user will be documented and signed in dollars. For payments, colones paid at the official BCCR exchange rate will constitute valid payment for both the end user's obligation with the ICI and for the ICI's obligation with BCCR. To avoid discrepancies, the exchange rate prevailing on the date of the client's payment to the commercial bank will also be valid for the commercial bank's payment to BCCR. In the event of default by the end user, BCCR will accept payment in colones by the ICI, at the exchange rate prevailing on the date of payment by the ICI to BCCR accompanied by a written statement from the ICI that the end user has defauulted on the payment in question.

AVAILABILITY OF FUNDS

The entire amount of the AIR facility will be immediately available for disbursal, subject to the above mechanisms, upon signature of the loan agreement between BCCR and AID. A three year limit will exist for initial disbursal of all the funds. In the event that all funds have not been disbursed after three years, AID will have no obligation for further disbursals, but BCCR must honor the terms of this loan agreement for all the funds that have been disbursed up to that time.

AID RULES AND PROCEDURES

The ICIs will be obliged to enforce the correct application of AID procurement policies. The ICIs will be instructed in this area by AID, and they and the end users of the AIR facility will be subject to audits and inspections by AID or AID's agents, for verification of compliance. Refusal to submit to audit or inspection by AID for these purposes, by either an ICI or an end user, or a confirmed violation of AID procurement rules and procedures, shall constitute sufficient grounds for barring the ICI involved in the credit from this program.

RELEVANT BANKING LAWS AND REGULATIONS
(Unofficial Translations)

1. Article 63 of the Organic Law of the Costa Rican Central Bank:

The Board shall establish, within the general limitations provided in this law, the regulative provisions and operational rules considered appropriate for the best implementation of the operations detailed in the preceding article. It shall possess full authority to restrain the maximum terms established in article 62 and to demand the security margins considered appropriate between the amount of the credits awarded and the real value of their guarantees according to the various types of operations which originated the credit. Likewise, it shall be able to fix maximum limits in the total of credit operations that the Central Bank can effectuate with the institutions authorized by this law to operate with the Bank, and request additional requirements as deemed necessary.

However, by no means could the total of the credit operations that the Central Bank may effectuate with the same commercial bank, as established in this law, exceed 50% of the liquid assets of such Bank as accepted and authorized by the Banks' General Auditor according to the last balance sheet submitted to that official. In determining the liquid assets, the credit operations effectuated with the Central Bank shall not be computed. In the case of inter-bank operations, its computation shall be subject to the approval of the Banks General Auditor.

In the emergency periods referred to in clause 6) of the preceding article, the Board shall be able to agree that the maximum limit be increased up to an 80% of the liquid assets, with the favorable vote of at least five of its members.

2. Title 1, Chapter 1, Article 4 of the Organic Law of the National Banking System:

Article 4 - The State Banks have the guarantee and the most complete cooperation from the Government and of all of its dependencies and institutions.

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9. Section VI.9, General Credit and Interest Rate Regulations

** 9. The private commercial banks shall be able to issue and offer to the public investment certificates, in minimum denominations of ₡5,000 at terms of not less than six months and at interest rates that conform with Chapter II of these regulations. For this purpose, the BCCR shall establish in its annual policy if its previous authorization is required or not. The authorized amount shall have a revolving character.

The issuance of said certificates and the public offerings thereof shall be conditioned upon, in the case of each private commercial bank, its indebtedness not exceeding 10 to 1, defined as the relation between the total liabilities, excluding resources obtained in the exterior and paid-in capital, and capital reserves. The BCCR shall be able to permit these entities to issue investment certificates which would raise the ratio above 10 to 1, when the additional captured resources are invested in the purchase of GOCR bonds.

The Authorizations issued for this purpose by the Issuance Institution shall be suspended, partially or totally, for the length of time deemed appropriate, when non-compliance with convenants, regulations or norms is proven, or when the financial situation of the bank in question indicates some danger for the investor/savor.

** Modified in Session No. 4114, Article II of 2/26/86. Subsequently modified in Session No. 4119, Article 8 of 12/3/86

ANNEX XI

AGENCIA PARA EL DESARROLLO INTERNACIONAL
MISION ECONOMICA DE LOS ESTADOS UNIDOS EN COSTA RICA

PROJECT DEVELOPMENT DIVISION
U.S.A.I.D./COSTA RICA

MAY 15 1 46 PM '86

Apartado Postal 10053
1000 San José, Costa Rica
Teléfono 33-11-55
Telex 3550 AIDCR KR

MEMORANDUM

May 15, 1986

TO: See Distribution

FROM: Vinzenz Schmack, OPS

SUBJECT: Comparative figures on Private and State-Owned Banks

The following are comparative consolidated balance sheet and profit and loss figures of the private and state-owned banks for the years ending in 1984 and 1985 as reflected on their local books.

As of 12/31/85 the National Banking System counted with 4 state-owned banks and 16 private banks. The Superintendant of Banks has 3 more requests for new banks under study: Banco COFISA, Banco Crédito de Inversion (CREDITICA), and Banco de Crédito Internacional, a subsidiary of Banco Internacional de Costa Rica, Panamá, which is in turn is a subsidiary of the 4 state-owned banks. Two additional "financieras", Financiera de Boston and Citicorp Financiera, are studying the possibility to change into a bank. So by the end of 1986 the number of private banks may increase to 21.

The private banks have shown an impressive increase not only in colones but also in dollar terms not only during last year, but especially if we look at the last three years as shown below:

	12/31/82	12/31/85	Increase	
Number of Banks	10	16	6	60%
Number of Employees	243	582	339	140%
Total Assets	¢1,651,561	¢7,929,859	¢6,278,298	380%
(In Thousands)	$36,701	$148,360	$111,659	304%
Total Equity	¢249,617	¢1,413,228	¢1,163,611	466%
(In Thousands)	$5,547	$26,440	$20,893	377%

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The growth of the private banking sector will continue not only in numbers but also in size. Of the present 16 private banks only 7 have the ₡100 million in equity required by law. The remaining 9 banks are still below the ₡100 million mark, and are not allowed to distribute any dividends till they reach the ₡100 million in equity. In total these nine banks have to increase the capital by ₡482,470,000 ($8 million) to reach the required minimum.

The seven largest private banks, Interfin, BANEX, Banco de Comercio, BANCOOP, Banco San Jose, Banco BCT and Banco Fomento Agricola, control 83% of the assets and 71% of the equity of the sixteen private banks.

The private banks are still rather small compared with the state-owned banks in relation to total assets (7.7% against 92.3%) and total equity (18.9% to 81.1%). However, in profitability the private banks have nearly made as much profit as the state-owned banks ₡210,428,000 against 213,774,000, and after compulsary deductions, the state-owned banks remained with a net profit of only 9,535,000 (down from 17,706,000 the previous year), while the private banks showed a net profit of ₡164,809,000 up from 113,352,000 (31%) the previous year. The most preoccupying matter is that the employee retirement fund obsorbs already 82% of the gross profit of the state-owned banks, and only 4.5% of gross profit remains available to strengthen equity. In 1982 the percentage of the retirement fund represented only 48% and net profit 36% of gross profit. According to law the state-owned banks take 10% of the payroll from gross profit to pay into the retirement fund. Private banks pay 10% of the gross profit into this fund. With the declining profit of the state-owned banks and the increase in salaries and employees very soon all profit will go to the employees, and the banks will in fact no longer belong to the state but to the employees. The efficiency of the private banks can also be measured by the commission income, which amounts already to 41.1% of total banks commission income. Commission income is attracted through efficient service and private banks definitely can prove with these figures their efficiency. The private banks have nearly doubled their loan portfolio over the last year and it amounts already to 12.7% of total bank loans. The amount ₡4,658,358,000 ($38,362,700) in total loans is substantial considering their limited access to loanable funds.

Distribution:

Mr. Chaij, MDIR
Mr. Archi, DDIR
Mr. Lucke, PDDC
Mr. Kelly, PDDE
Mr. Rosenberg, OPS
Mr. Adler, EA
Ms. Lincoln, ECON
Ms. Dugan, OPS

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COMPARATIVE BALANCE SHEET OF PRIVATE AND STATE-OWNED BANKS

(In thousands of Colones)

	Total Private Banks		Total State Banks		Percentage of Total			
					12-31-84		12-31-85	
	12-31-84	12-31-85	12-31-84	12-31-85	Private Banks	State Banks	Private Banks	State Banks
ASSETS								
Cash and Banks	578,240	1,192,041	19,266,623	28,301,811	2.9	97.1	4.0	96.0
Loans	2,564,411	4,658,358	27,923,650	32,083,959	8.4	91.6	12.7	87.3
Investments	617,250	996,489	11,186,506	12,644,505	5.2	94.8	7.3	92.7
Other Assets	338,521	592,108	16,011,001	18,150,276	2.0	98.0	3.2	96.8
Fixed Assets	324,632	490,863	1,040,097	1,215,178	23.7	76.3	28.8	71.2
Branches, Head Office	-0-	-0-	2,228,649	2,031,417	-0-	100.0	-0-	100.0
TOTAL ASSETS	¢4,423,054	¢7,929,859	¢77,656,526	¢94,427,146	5.3	94.7	7.7	92.3
	$93,117	$148,360	$1,634,874	$1,766,644				
LIABILITIES								
Deposits (Investment Bonds)	1,330,832	2,050,487	49,725,836	61,609,339	2.6	97.4	3.2	96.8
Due to BCCR	111,798	639,043	4,653,286	6,733,713	2.3	97.7	8.7	91.3
Loans from other Financial Institutions	1,239,585	2,603,246	1,097,943	2,183,238	53.0	47.0	54.4	45.6
Other Liabilities	765,436	1,223,855	17,214,884	17,827,472	4.2	95.8	8.6	91.4
TOTAL LIABILITIES	3,447,651	6,516,634	72,691,949	88,353,762	4.5	95.5	6.9	93.1
CAPITAL								
Capital - Stock	822,134	1,193,506	4,048,329	4,048,328	16.8	83.2	22.8	77.2
Reserves	153,269	219,722	916,248	2,025,056*	14.3	85.7	9.8	90.2
TOTAL CAPITAL AND RESERVES	¢975,403	¢1,413,228	¢4,964,577	¢6,073,384	16.4	83.6	18.9	81.1
	$20,535	$26,440	$104,517	$113,627				
TOTAL LIABILITIES AND CAPITAL	¢4,423,054	¢7,929,859	¢77,656,526	¢94,427,146	5.3	94.7	7.7	92.3
Debt to Equity Ratio:	3,5:1	4,6:1	14,6:1	14,5:1				

Exchange rate:
12-31-84 $1.00 = C47.50
12-31-85 $1.00 = C53.45

* The increase in reserves is due to the revaluation of assets and the revaluation of the investment in Banco Internacional de Costa Rica, Panamá, from C8.60 per dollar to C53.45

COMPARATIVE INCOME STATEMENTS OF PRIVATE AND STATE-OWNED BANKS

(In thousands of Colones)

	Total Private Banks		Total State Banks		Percentage of Total			
					12-31-84		12-31-85	
	12-31-84	12-31-85	12-31-84	12-31-85	Private Banks	State Banks	Private Banks	State Banks
INCOME								
Interest Income	534,150	1,053,565	6,288,027	7,829,927	7.5	92.5	11.8	88.2
Commission Income	203,693	273,418	517,408	391,811	28.2	71.8	41.1	58.9
Other Income	50,315	82,521	556,817	747,259	8.2	91.8	9.9	90.1
TOTAL INCOME	788,158	1,409,504	7,362,252	8,968,997	9.6	90.4	13.6	86.4
EXPENSES								
Interest (Other Financial Exp.)	339,379	787,083	3,869,410	4,730,326	8.0	92.0	14.3	85.7
Personnel Expenses	113,264	259,828	1,602,182	3,912,948	6.6	93.4	6.2	93.8
Other Operating Expenses	176,019	152,165	1,709,398	111,949	9.3	90.7	57.6	42.4
TOTAL EXPENSES	628,662	1,199,076	7,180,990	8,755,223	8.0	92.0	12.0	88.0
Income before Compulsory Deductions	159,496	210,428	181,262	213,774	46.8	53.2	49.8	50.2
Employee Retirement Fund	15,508	20,008	140,992	175,185	9.9	90.1	10.3	89.7
Education Fund	7,754	10,003	8,468	10,689	47.7	52.3	48.3	51.7
INFOCOOP	-0-	-0-	14,096	18,365	-0-	100.0	-0-	100.0
Income Taxes	22,882	15,608	-0-	-0-	100.0	-0-	100.0	-0-
NET INCOME	113,352	164,809	17,706	9,535	86.4	13.6	94.5	5.5
Return on Average Equity *	21,9	15,0	3,7	3,5				
Return on Average Assets *	4,5	2,7	0,2	0,2				
Number of Employees	458	582	7,079	7,249				

* Before Compulsory Deductions

ANNEX XII

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

LAC/DR-IEE-86-19

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Costa Rica
Project Title and Number	:	Agricultural and Industrial Recovery and Rehabilitation 515-0223
Funding	:	\$13,650,000 (L) \$350,000 (G)
Life of Project	:	3 years
IEE Prepared by	:	Heriberto Rodriguez USAID/San Jose
Recommended Threshold Decision	:	Negative Determination
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	Subject to incorporation of IEE recommendation into PP that the Bank of Costa Rica will adopt a policy of not funding projects whose establishment would result in an unacceptable environmental cost, with special emphasis on pesticides.
Copy to	:	Daniel Chaij, Director USAID/San Jose
Copy to	:	Heriberto Rodriguez USAID/San Jose
Copy to	:	Frank Zadroga, ROCAP/San Jose
Copy to	:	Lars Klassen, LAC/DR/CEN
Copy to	:	IEE File

Recd. 7-9	Act.	Info
MDIR		✓
DDIR		✓
MO		
PPDE		✓
PDD	X	
PRD		
TU		
EA		
GDD		
CONT		
RLA		
IAD		
OPS		
RDO		✓
CHRON		✓
RF		✓
ROCAP		✓
Due Date:		

James S. Hester

Date JUN 25 1986

James S. Hester
Chief Environmental Officer
Bureau for Latin America
and the Caribbean

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ANNEX XII

INITIAL ENVIRONMENTAL EXAMINATION

Project Location: Costa Rica

Project Title: Agricultural and Industrial Recovery and Rehabilitation

Funding: FY 1986, $14,000,000 Loan.

Life of Project: 3 years

Project Description: The Project will create a rediscount facility at the Central Bank of Costa Rica to provide credit through private and public sector banks to private businesses seeking to expand or upgrade their facilities for the production of non-traditional goods destined for extra-regional markets.

Action: The project contemplates support for the Costa Rican private sector which shall profit from greater availability of hard currency credit. This action does not have an effect on the natural or physical environment; AID, in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge or a control over, the details of the specific activities that have an effect on the physical and natural environment for which financing is provided by AID. The AID support is being made available through the Central Bank of Costa Rica and the Costa Rican banking sector which will adopt a policy of not funding projects whose establishment would result in an unacceptable increase in environmental cost to Costa Rica.

Based on 22 CFR216.2 (C), (1), (i), and (ii) and 22CFR216.2 (C), (X), the project would be exempt from an environmental analysis.

IEE prepared by: Heriberto Rodriguez
USAID/Environmental Officer

Concurrence: Daniel A. Chaij
Mission Director
USAID/Costa Rica

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LIST OF PEOPLE INTERVIEWED FOR ECONOMIC, FINANCIAL, AND DEMAND ANALYSIS

July 1986

Banco Central de Costa Rica and Auditoría:

Edwin Salas	Banco Central de Costa Rica
William Ulate	Banco Central de Costa Rica
Miguel Arias	Banco Central de Costa Rica
José Paniagua	FODEIN
Roberto Oreamuno	Auditoría

Private Banks:

William Rodríguez	Banco Banex
Jorge Dengo	Banco Banex
Leonel Baruch	Banco BCT
Oscar Gómez	Banco del Comercio
Luis Salazar	Banco Cooperativo
Alberto Dent	Banco de Fomento Agrícola
Alban Brenes	Banco de la Industria
Francisco Ruiz	Banco Interfin
Lemuel Byram	Banco Metropolitano
Mario Montealegre	Banco de San José
Guillermo Alvarez	Banco de San José

Other Private Financial Institutions:

Ernesto Solera	Citicorp
William Phelps	COFISA
Guillermo Serrano	COFISA
Héctor Wilkinson	LAAD
Jorge Morelos	Private Investment Corporation

Development Agencies and Other:

María Felicia Bolaños	CABEI
Carlos Torres	Investment Promotion Program, CINDE
Sergio Sepúlveda	Inter-American Development Bank
René Espinoza	Inter-American Development Bank
Fernando Caldas	Inter-American Development Bank

ASOCIACION BANCARIA COSTARRICENSE
Teléfono: 33-59-66 Apartado 7-0810
San José, Costa Rica

ANNEX XIV

REF: ABC-538-86

Junio 11, 1986

Señor
Daniel Chaij
Director
Agencia para el Desarrollo
Internacional AID.
EMBAJADA DE LOS ESTADOS UNIDOS DE AMERICA
Presente

Estimado señor:

Nos complace referirnos a la amable visita que los señores Rocherd Rosenberg, Lewis Lucke, Maureen Dugan y Vinzenz Schmak realizaran a nuestras oficinas el pasado 20 de mayo de 1986 con el propósito de comentarnos e informarnos sobre el proyecto que el AID está preparando sobre una nueva línea de crédito por US$15 millones para el financiamiento de proyectos de exportación de productos no tradicionales a largo plazo y en dólares.

Una vez más debemos agradecer no solo la asistencia continuada del AID al país sino la deferencia de habersenos tomado en cuenta en cuanto a los términos de referencia de dicho programa.

Es nuestra opinión que un programa como el presentado por ustedes podría ser de gran atractivo al sector exportador del país ya que el mismo constituiría una nueva alternativa de financiación que vendría a contribuir al desarrollo del esfuerzo de exportaciones no tradicionales.

Estamos seguros que los Bancos miembros de esta Asociación harían sus mejores esfuerzos por colocar estos fondos entre sus clientes exportadores en el menor tiempo posible.

..../2

ABC

Ref: ABC-538-86
Sr. Daniel Chaij
Página #2

Estamos a sus gratas órdenes y una vez más dejamos constancia de nuestro agradecimiento por la continuada asistencia a nuestro país.

Atentamente,

ASOCIACION BANCARIA COSTARRICENSE

Ing. Alberto Dent Z.
Presidente

ORIGINAL FIRMADO ING. ALBERTO DENT

C.C. Sr. Vinzenz Schmak, AID.
Archivo

jra*