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AUDIT OF
USAID/COSTA RICA'S
PRIVATE SECTOR PRODUCTIVITY
PROJECT NO. 515-0176

Audit Report No. 1-515-87-18
March 17, 1987

AGENCY FOR INTERNATIONAL DEVELOPMENT

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March 17, 1987

MEMORANDUM

TO: USAID/Costa Rica, Director, Daniel Chaij

FROM: RIG/A/T, Coinage N. Gothard

SUBJECT: Audit of USAID/Costa Rica's Private Sector Productivity Project No. 515-0176, Report No. 1-515-87-18

This report presents the results of audit of the Costa Rica Private Sector Productivity Project No. 515-0176. The Office of the Regional Inspector General for Audit/Tegucigalpa made a program results audit of the project. The audit objective was to determine if project objectives were achieved. Specifically, the audit evaluated the performance of the Agricultural Industrial Export Bank (BANEX) in implementing the project and whether project resources were effectively used.

The audit found that two of the three project components had had some degree of success, while the third, export management, had been unsuccessful. Effectiveness of project operations was limited . The two audit findings concern limitations in the risk minimization fund and the reserve for bad debt. The report recommends improvements in the terms and operations of BANEX's risk minimization fund, as well as increasing the size of the reserve for bad debts to an annual provision of two percent of the outstanding portfolio. This reserve, it is understood, would be capped at some appropriate level in the future based on loan portfolio assessments.

You generally agreed with our recommendations concerning the risk minimization fund, but did not agree with our recommendation concerning an increase in the reserves for bad debt. We continue to believe this recommendation is warranted and designed to strengthen and benefit primarily the bank, not AID.

Please advise us within 30 days of any additional information relating to actions taken or planned to implement the audit recommendations.

We appreciate the Mission's cooperation and courtesy to our staff during the audit.

EXECUTIVE SUMMARY

On September 25, 1981 AID loaned the Agricultural Industrial Export Bank, a private sector bank, $10 million. The overall objective of this AID loan was to expand the production and export of non-traditional Costa Rican products to world markets by establishing an integrated program of credit, export-oriented banking services and export management assistance for the producers, manufacturers, brokers and other expediters of such exports. The total estimated cost of the project was $12 million, of which the Agricultural Industrial Export Bank raised $2 million in equity capital as its contribution to the project. The uses of the funds were to include capital investments in plant and equipment, the purchase of raw materials, and working capital. The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of USAID/Costa Rica's Private Sector Productivity project from its inception on September 25, 1981 to November 13, 1986. The audit covered $10 million in AID expenditures as of August 31, 1986.

Audit objectives were to determine success in achieving planned results, efficiency of project operations, compliance with AID and project requirements, and the adequacy of administrative internal controls.

As of June 30, 1986 the project had been only partially successful in achieving planned results. The financial performance (as measured by cumulative income before taxes) of the Agricultural Industrial Export Bank had fallen 59 percent short of projections in the project paper, six months after the expiration of the extended project completion date. Also the majority of the loans did not further the overall objective of the project to expand the production and export of non-traditional products. The effectiveness of project operations was limited by the poor performance of the Agricultural Industrial Export Bank Trading Company, slowness in disbursements caused in part by uncertainities generated by local legislation, and lower than predicted interest earnings received by the bank for its subloans. One condition precedent and one special covenant relating to the establishment and maintenance of a risk minimization fund were found not to have been complied with for 26-months. Also, improvements in internal controls over "insider" lending practices by the Agricultural Industrial Export Bank were needed.

Two of the three project components had had some degree of success, while the third, export management, had been unsuccessful. The credit component had successfully placed a number of loans (generating some foreign exchange earnings and new jobs) but had been less profitable than predicted because of the slowness in disbursements of loans and a lower-than-anticipated rate of interest on sub-loans made. As noted in the final project evaluation, the majority of loans to date had not furthered the objectives of the project to expand the production and export of non-traditional products to world markets. AID and the bank recognized this and accepted a project evaluation recommendation to use all loan reflows for this purpose. The banking services component had been fairly successful as earnings on fee income of the bank were higher

than projected. Finally, the export management component, executed by the newly created Agricultural Industrial Export Bank Trading Company (formed April 1982) had not been successful as this entity had failed to develop required expertise, had too high an overhead, and had failed to generate sufficient income. In accordance with a recommendation in the final project evaluation, this component is being abolished.

Improvements are needed in the risk minimization fund. The loan agreement required the Agricultural Industrial Export Bank to establish and make semiannual payments into such a fund. These funds were to be used to acquire financial instruments acceptable to AID. Payments into the fund and earnings thereon were to pass to AID should the bank default on the AID loan. The risk minimization fund, as currently managed, was not providing AID with adequate security against loan default. The value of the fund as of August 31, 1986 was at least $89,257 less than required. The fund was not providing adequate security because: 1) the bank invested in high-risk Government of Costa Rica bonds that had significantly decreased in value; 2) the bank undercalculated the amount that should be in the fund and overcalculated the value of assets held with fund monies; 3) the bank did not retain the interest earned in the fund as required; and, 4) USAID/Costa Rica did not follow required procedures to semiannually revalue the investment instruments in the fund. The risk minimization fund has, therefore, not fully accomplished its intended purpose to furnish additional protection to AID in case of loan default by this bank. We have recommended some improvements in the terms and operations of this fund. While not agreeing with all aspects of the finding, the Mission agreed to implement the recommendations subject to an independent audit calculation of the dollar requirements of the risk minimization fund.

The Agricultural Industrial Export Bank's reserve for bad debts may not be sufficient for future losses. Consistent application of prudent reserve policies regarding developmental loans (two years or longer), such as those in this bank's portfolio, would require an annual increase in the reserve for bad debts of at least two percent of the annual average outstanding loan and investment portfolio. This is consistent with the reserve for bad debt policies recommended by USAID/Costa Rica to this bank as well as those currently established for the Private Investment Corporation (a separate AID project). This reserve, it is understood, would be capped at some appropriate level in the future based on loan portfolio assessments. The Private Investment Corporation has some of the same clients as this bank and undertakes projects with similar risk-taking. The reserve policies of the AID loan agreement and this bank require the establishment of a reserve for bad debts that would be less than that required by an annual provision of two percent of the average annual outstanding portfolio. We were told that this loan agreement was the first of its type since the expansion of the AID Costa Rica program in 1981, and that subsequent AID loan agreements with other banks had placed more conservative bad debt reserve requirements on the borrower. As a result of this less stringent reserve for bad debts, the bank's reserve for medium-term development loans may not be sufficient to cover probable loan losses. We have recommended increasing the size of

the reserve for bad debts to an annual provision of two percent of the outstanding loan portfolio or requiring formal periodic loan portfolio assessments. The Mission did not agree to implement this recommendation but promised to discuss the matter further with the Agricultural Industrial Export Bank.

Office of the Inspector General

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PRIVATE SECTOR PRODUCTIVITY
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PART I - INTRODUCTION

A. Background

On September 25, 1981 AID loaned the Agricultural Industrial Export Bank (BANEX), a private sector bank, $10 million. The bank agreed to repay the principal of this loan in 20 years, with an interest rate of two percent per annum for the first 10 years and three percent for the remaining life of the loan. BANEX obtained its initial capital subscription in January 1981 and officially began operations on July 1, 1981.

The overall objective of the project was expansion of the production and export of non-traditional Costa Rican products to world markets. The purpose of the project was to establish an integrated program of credit, export-oriented banking services and export management assistance for Costa Rican producers, manufacturers, brokers and other expediters of non-traditional exports to world markets.

Under the credit component of the project, BANEX was to undertake financing of sub-borrower projects which would contribute to the development or improvement of non-traditional export production and marketing systems, and contribute to export sales, profits and foreign market penetration by Costa Rican sub-borrowers. Under the export management component of the project, BANEX was to develop and manage the BANEX Trading Company, which was to provide producers and manufacturers with basic export management services, information about the marketplace, information on and knowledge of the export process, etc. Under the banking services component of the project, BANEX was to develop an in-house capacity to deliver a range of banking services for sub-borrowers including: export collection services and bonds; currency management; documentary services; and new market development.

The total estimated cost of the project was $12 million. BANEX contributed $2 million in equity capital in addition to AID's $10 million loan. The project was to be completed by September 30, 1984 but it was extended 15 months to December 31, 1985.

AID loan funds of $9.3 million were to be used to make sub-loans to eligible producers, manufacturers, brokers and other expediters of non-traditional exports to world markets. The BANEX Trading Company was to be established using $700,000 from the same loan. Uses of the funds included capital investments in plant and equipment, purchase of raw materials, and working capital.

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit USAID/Costa Rica's Private Sector Productivity project from its inception on September 25, 1981 to November 13, 1986. The audit covered $10 million in AID expenditures as of August 31, 1986. Audit field work was conducted from September 2 to November 13, 1986.

The objectives of our audit were to determine BANEX's success in achieving planned results, the efficiency of project operations, compliance with AID and project requirements, and the adequacy of administrative internal controls.

To accomplish these objectives, we reviewed project files and interviewed project officials at USAID/Costa Rica, BANEX, the Costa Rican Stock Exchange, the Private Investment Corporation, and the Panamanian subsidiary of Bankers Trust. We visited four different types of businesses that received sub-loans and observed a wide range of project activities. We examined documentation supporting expenditures of $10 million in AID funds. The audit was performed in accordance with generally accepted government auditing standards.

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PART II - RESULTS OF AUDIT

As of June 30, 1986 the project had not been fully successful in achieving planned results. Six months after the expiration of the extended project completion date, cumulative income before taxes of the Agricultural Industrial Export Bank (BANEX) had fallen 59 percent short of the expectations set forth in the project paper. A majority of the loans had not furthered the overall project objective of expanding the production and export of non-traditional products. The effectiveness of project operations was limited by the poor performance of the BANEX Trading Company, slowness in disbursements caused in part by uncertainities surrounding local legislation, and lower-than-anticipated interest earnings received by BANEX on its sub-loans (see Exhibits 1, 2 and 3). One condition precedent and one special covenant relating to the establishment and maintenance of a risk minimization fund had not been complied with for 26 months. Also, improvements in BANEX internal controls over "insider" lending practices were needed.

Two of the three project components had achieved some degree of success, while the third, export management, had been unsuccessful. The credit component had successfully placed a number of loans (generating foreign exchange earnings and new jobs) but had been less profitable than hoped because of slowness in loan disbursements and lower-than-anticipated interest earnings on loans made. As noted in the final project evaluation, the majority of loans made to date had not furthered the objectives of expanding the production and export of non-traditional products to world markets. AID and BANEX recognized this and accepted the project evaluation recommendation to use all loan reflows for this purpose. The banking services component had been fairly successful as earnings on fee income of the bank had been higher than projected.

The export management component, executed by the Agricultural Industrial Export Bank Trading Company (formed April 1982) had been a failure. This subsidiary did not develop the necessary expertise, had had excessive overhead, and did not generate sufficient income. In accordance with recommendations in the final project evaluation, USAID representatives stated this component was being abolished.

A BANEX quarterly project report for the period ending September 30, 1986 indicated that a total of 73 dollar-denominated loans had been made, of which 20 were for non-traditional export-oriented activities (per loan amendment No. 1 at least 50 percent of the loans were to be used for these purposes; the final project evaluation concluded that 30 percent of the loans had been used for developmental purposes). The other 53 loans were for such activities as working capital, suppliers debt payments, debt rescheduling, and equity financing. The report indicated that 3,474 jobs and $4.9 million in foreign exchange earnings had been generated as

a result of these loans. Also, the report predicted that foreign exchange earnings would eventually total $39.6 million. These figures, if accurate, would seem to compare favorably with project paper predictions regarding employment impact and potential net foreign exchange earnings.

The audit identified several specific problem areas. Improvements were needed in the risk minimization fund to comply with the terms of the loan agreement and to provide AID with adequate security against loan default. Also, BANEX needed to increase its reserve for bad debts under its medium-term development loans to ensure that the reserve is sufficient to cover probable write-offs and to secure the future financial condition of the institution. AID/Washington needs to establish an Agency policy regarding "insider" lending in intermediate credit institutions.

We have recommended to USAID/Costa Rica that: BANEX increase its risk minimization fund; all future payments into the fund be made in dollars and invested in relatively risk-free investments; the pledge agreement be revised so that all future payments into the fund correspond to the dates when interest becomes due on the AID loan; all future interest earned on investments of the fund be retained in the fund; Government of Costa Rica (GOCR) bonds held by the fund be revalued semiannually in accordance with the terms of the pledge agreement; and, BANEX make an annual provision for bad debts of at least two percent of its average outstanding development loan and investment portfolio.

A. Findings and Recommendations

1. Risk Minimization Fund Needed Strengthening

The loan agreement required the Agricultural Industrial Export Bank (BANEX) to establish and make semiannual payments into a risk minimization fund. Monies deposited into the fund were to be used to acquire financial instruments acceptable to AID. Payments into the fund and earnings thereon were to pass to AID should BANEX default on its AID loan. The risk minimization fund, as currently managed, was not providing AID with adequate security against loan default. The value of the fund as of August 31, 1986 was about $89,257 less than required. The fund was not providing adequate security because: 1) BANEX invested in high-risk GOCR "Presa" bonds that had significantly decreased in value; 2) BANEX undercalculated the amount that should be in the fund and overcalculated the value of assets held with fund monies; 3) BANEX did not retain the interest earned in the fund as required; and, 4) USAID/Costa Rica did not follow required procedures to revalue the investment instruments in the fund semiannually. The risk minimization fund had, therefore, not fully accomplished its intended purpose of furnishing sufficient protection to AID in case of default by BANEX.

Recommendation No. 1

We recommend that USAID/Costa Rica, in consultation with the Agricultural Industrial Export Bank, revise the terms and operations of BANEX's risk minimization fund as follows:

a) obtain evidence that the Agricultural Industrial Export Bank has deposited not less than $89,257 into the fund to make up the shortfall;

b) cause the Agricultural Industrial Export Bank to make all future payments into the fund in dollars to be invested in relatively risk-free investment instruments as described in the pledge agreement at sections 3A1 through 3A6;

c) amend the pledge agreement so that all future payments into the fund correspond to the dates when interest becomes due on the AID loan and make such payments in amounts one-third larger than the corresponding interest payment;

d) obtain formal BANEX acknowledgement that all future interest earned be retained in the risk minimization fund as required by the loan agreement; and

e) revalue the current Government of Costa Rica bonds in the risk minimization fund semiannually in accordance with the terms of the pledge agreement and ensure a certificate is issued by the Mission Director attesting to the U.S. dollar value which has been assigned to such certificates.

Discussion

A risk minimization fund was established under this project because the Government of Costa Rica did not guarantee the AID loan in case of default by the borrower. The purpose of the fund was to provide AID with additional security against default and to provide additional longevity to the credit program.

The loan agreement required BANEX to establish and make semiannual payments into a risk minimization fund equal to three percent of the average outstanding balance of the AID loan during the first 10 years and two percent thereafter.

These funds were to be used to acquire financial instruments acceptable to AID. Payments into the fund and earnings thereon were to pass to AID should BANEX default on its AID loan. Payments into the fund were to continue until the balance of the fund, including accumulated interest, equaled the outstanding principal of the AID loan.

In order to implement the risk minimization fund, an escrow account was established and a pledge agreement signed on April 12, 1984 by BANEX (the pledgor), USAID/Costa Rica, and Bankers Trust of New York (custodian or pledge agent). The Mission approved a condition precedent to initial disbursement [5.1(j)] that required "evidence from the Borrower that it has entered into an escrow (pledge) agreement for the establishment of a risk minimization fund." Even though the Mission approved this condition precedent on December 17, 1981 the pledge agreement was not actually executed with Bankers Trust until April 12, 1984, after more than $3.3 million in loan funds had been disbursed. The Mission issued instructions for the fulfillment of this condition precedent in PIL No. 1 and BANEX sent a telex to Bank of America, the then prospective pledge agent, outlining the escrow agreement. Although the Mission accepted this as fulfillment of the condition precedent by issuing PIL No. 2, the telexed offer was not accepted by the prospective pledge agent.

The risk minimization fund, as currently managed, is not providing AID with adequate security against loan default. For example, the value of the fund as of August 31, 1986 was about $89,257 less than required. The fund is not providing adequate security because: 1) BANEX invested in high risk GOCR "Presa" bonds that have significantly decreased in value; 2) BANEX undercalculated the amount that should be in the fund and overcalculated the value of the assets in the fund; 3) BANEX did not retain the interest earned in the fund as required; and, 4) USAID/Costa Rica did not follow required procedures to revalue the investment instruments in the fund semiannually. The risk minimization fund has, therefore, not fully accomplished its intended purpose to furnish sufficient protection to AID in case of default by the borrower. Below follows our detailed analysis of the four problems which limited the effectiveness of the fund.

Selection of Inappropriate Investment for the Fund - The pledge agreement governing the operation of the risk minimization fund stated that assets delivered by the pledgor (BANEX) to the pledge agent (Bankers Trust)

should consist solely of (i) cash, in U.S. dollars, and (ii) certificates (dollar denominated not to be in excess of U.S.$1,000,000). The pledge agreement listed the following seven categories of authorized investments:

1. Certificates of deposit issued by large New York commercial banks;

2. Highest rated commercial paper (six months or less) of leading U.S. bank holding companies, sales finance companies or industrial firms;

3. Banker's acceptances of large New York commercial banks;

4. Repurchase agreements for U.S. Government securities;

5. U.S. Treasury Bills maturing in less than six months;

6. U.S. state and local government tax exempt obligations of highest rating; and

7. Other readily marketable obligations jointly agreed to by AID and the pledgor.

We believe the clear intent of the pledge agreement was that the risk minimization fund hold only low-risk, highly secure financial instruments which would serve as a substitute for the lack of a sovereign guaranty by the Government of Costa Rica.

In contrast, BANEX selected a high-risk financial instrument that had significantly decreased in value. The type of instrument chosen by BANEX and subsequently approved by AID was Government of Costa Rica "Presa" dollar-denominated bonds. BANEX purchased $1,029,000 of these bonds in May 1983 at a cost of $753,273 (purchased at 73.2 percent of face value). AID's project manager stated BANEX chose these instruments because they could be purchased with colones 1/ and that BANEX had very few dollars to purchase the other types of instruments. AID's approval of these bonds was based on BANEX's shortage of dollars and a desire to help the bank comply with the terms of the loan agreement. As of September 10, 1986, 70 such bonds with a face value of about $829,000 were in the fund. These bonds were valued in the Costa Rican Stock Exchange at 51 percent of face value on August 31, 1986. A New York bond broker we contacted estimated the bonds were worth only 35 to 48 percent of face value there, but were not traded frequently. As a result, BANEX added $300,000 in cash to the fund on July 9, 1986 to partially compensate for the estimated 50 percent drop in value of these bonds. Since the value of these bonds has dropped steadily, neither AID nor BANEX officials can be assured that AID's interests are adequately protected. The choice of these financial instruments to constitute the fund has led to poor financial performance by this fund and forced BANEX to add $300,000 to keep the fund at the required minimum level.

1/ The unit of currency in Costa Rica is the colon. At the time of the audit, the colon was valued at about 57 to 1 US dollar.

In order to provide AID with better security, we concluded that BANEX should make all future payments into the fund in dollars to be invested in relatively risk-free investment instruments as described in the pledge agreement in sections 3A1 through 3A6.

Undercalculation of the Amount that Should Be in the Fund - The pledge agreement for the risk minimization fund stated that semiannual payments (February and August 15th) were to be made totaling three percent of the average outstanding principal balance of the AID loan during the initial ten-year grace period and two percent thereafter. These payments were to be made until the total value of the pledge assets held in the account equaled the outstanding principal balance of the loan.

As shown below, BANEX calculated that it had a surplus of $44,775 in the fund, while we calculated that the fund had a deficit of at least $89,257. The major reason for this difference was that the auditors estimated the value of the GOCR "Presa bonds" at 40 percent of face value while BANEX used 51 percent of face value. The auditors used a market value of these bonds in New York as reported by a local banker. BANEX used the market value of the bonds as reported on the local stock exchange. Another reason is that the auditors calculated the amount of interest that should have been earned on the bonds whereas BANEX omitted doing this.

AID AUDITORS' AND BANEX'S CALCULATIONS OF THE SURPLUS OR DEFICIT CONDITION OF THE RISK MINIMIZATION FUND

	BANEX AS OF 12/31/86	AUDITOR'S AS OF 8/31/86
CALCULATED REQUIRED VALUE		
Principal required	$678,000	$637,227
Interest required	---	83,619
TOTAL	$678,000	$720,846
LESS: CALCULATED VALUE OF FUND		
Cash (U.S. Treasury Bills)	$300,000	$300,000
GOCR "Presa" Bonds (face value of $828,971.54 x 51%)	422,775	---
GOCR "Presa" Bonds (face value of $828,971.54 x 40%)	---	331,589
TOTAL	$722,775	$631,589
SURPLUS OR (DEFICIT)	$ 44,775	$(89,257)

To simplify calculating the amount of payments due to the fund, we have recommended revising the pledge agreement so that all future payments into the fund correspond to the dates when interest becomes due on the AID loan and making such payments in amounts one-third larger than the corresponding interest payment on the loan. Additionally, we have

recommended that not less than $89,457 be added to the fund to cover the estimated deficit as of August 31, 1986.

Interest Earned on GOCR "Presa" Bonds Was Not Retained in the Fund - BANEX payments into the fund and earnings thereon less escrow fees, if any, were to pass to AID, should AID communicate to the escrow agent that the loan is in default.

Contrary to this requirement, BANEX did not retain the interest earned on the GOCR "Presa" bonds in the fund. BANEX had redeemed 57 interest coupons totaling $71,089.81; none of this interest was subsequently deposited in the fund 2/. As a result, the risk minimization fund had fallen short of its required level at the time of our audit. In order to avoid this in the future, we have recommended that all future earnings be retained in the fund.

Required Procedures to Revalue the Fund Were Not Followed - The value of any certificates delivered by BANEX to the pledge agent was to be determined by the AID Mission Director as of the delivery dates (February and August 15th annually) of the certificates. The Mission Director was also to issue to BANEX and the pledge agent a written certificate attesting to the U.S. dollar value assigned to these certificates.

USAID/Costa Rica did not follow the above procedures to revalue the investment instruments in the fund semiannually. Instead, USAID/Costa Rica relied on BANEX to value the bonds. In our opinion, BANEX overvalued the bonds. BANEX valued the bonds at 51 percent of face value in August 1986, when the value of such bonds was fluctuating between 35 to 48 percent in the New York bond market. Therefore, we concluded that USAID/Costa Rica should revalue the GOCR "Presa" bonds in the fund in accordance with the pledge agreement.

Management Comments

USAID/Costa Rica, while not completely agreeing with the wording and detail of the finding, nevertheless agreed to implement the five-part recommendation subject to independent auditor verification of the exact funding shortfall of the risk minimization fund.

USAID/Costa Rica considers it inappropriate to comment on what AID/W ought to do in a report on a specific project in Costa Rica unless flagrant abuses were found. Such is not the case here. Inclusion of comments as to AID/W responsibilities in the report tends to decrease the clarity of the report and should be eliminated.

Inspector General Comments

The Mission's comments on appropriateness of bringing problems to AID/W attention reflect a lack of full awareness of the role of the Inspector General in identifying policy deficiencies and recommending corrections.

2/ The GOCR is not honoring the principal on these bonds and is extending the date by which the principal must be paid.

2. Reserve for Bad Debts May Be Inadequate to Offset Future Losses

Consistent application of prudent reserve policies regarding developmental loans (two years or longer), such as those in BANEX's portfolio, would require an annual increase in the reserve for bad debts of at least two percent of the average outstanding loan and investment portfolio. This reserve, it is understood, would be capped at some appropriate level in the future based on loan portfolio assessments. This is consistent with the reserve for bad debt policies recommended by USAID/Costa Rica to BANEX as well as those currently established by AID under a similar loan project with the Private Investment Corporation (PIC). The latter bank has some of the same clients as BANEX and finances projects of similar risk. The reserve policies of the AID loan agreement and BANEX require the establishment of a reserve for bad debts that would be less than that required by an annual provision of two percent of the average annual outstanding portfolio. We were told that the BANEX loan agreement was the first of this type since the expansion of the Mission program in 1981, and that subsequent AID loan agreements with other banks placed more conservative bad debt reserve requirements on the borrower. As a result, the BANEX reserve for bad debts for medium-term development loans may not be sufficient to cover probable loan losses.

Recommendation No. 2

We recommend that USAID/Costa Rica, in consultation with the Agricultural Industrial Export Bank, amend the AID loan agreement to provide that:

a) the Agricultural Industrial Export Bank make provision for bad debts of at least two percent of its annual average outstanding development loan and investment portfolios (colon and dollar denominated), and revise its written policies accordingly; or

b) a formal, periodic portfolio loan risk assessment be made to justify the provision for bad debts applied.

Discussion

AID has financed three private sector banking projects in Costa Rica. The three banks (Agricultural Industrial Export Bank [BANEX], Industrial Finance Corporation of Costa Rica [COFISA] and Private Investment Corporation [PIC]) are exposed to similar risk-taking and participate in some joint development lending activities.

In our opinion, developmental loans (two years or longer), such as the type in BANEX's portfolio, require an increase in the reserve for bad debts of at least two percent of the annual average outstanding loan and investment portfolio. This reserve, it is understood, would be capped at some appropriate level in the future based on loan portfolio assessments. Our opinion is consistent with the reserve for bad debt policies recommended by USAID/Costa Rica to BANEX and to those followed by the PIC. On August 30, 1985 a USAID/Costa Rica memorandum to BANEX stated that, in view of the risk it expected BANEX to take in its

developmental lending activities, a two percent reserve for possible loan losses would be needed. This reserve should enable BANEX to withstand annual loan losses of two percent on its average outstanding portfolio. Also, a covenant in the PIC loan agreement stated that for the life of loan, the PIC will make an annual provision for bad debts of at least two percent of its annual average outstanding loan and investment portfolios.

The reserve policies established by the AID loan agreement and BANEX only require that the reserve be equal to a fixed percentage of the outstanding portfolio rather than increased by a fixed percentage of the portfolio each year. As a result, these reserves were significantly less than what they would have been had an annual two percent provision been added to the reserve. The AID loan agreement requires BANEX to maintain bad debt reserve requirements of at least one percent of all outstanding loans. Also, BANEX's written loan policies require a bad debt reserve which is 2.5 percent of the balance of the development loan portfolio. Actual BANEX reserves as of June 30, 1986 were C.11,673,000 of the outstanding colon loan portfolio of C.995,414,000 or 1.17 percent; and $332,000 of the outstanding dollar loan and equity portfolio of $14,004,000, or 2.37 percent.

BANEX and AID officials told us that the BANEX loan agreement was the first of its type authorized by AID in Costa Rica and that subsequent private sector banking loan agreements placed more stringent bad debt reserve requirements on the borrower. These more stringent reserves were created, we were told because of experiences learned from the BANEX and COFISA projects.

We concluded that the reserves for the BANEX development loan and investment portfolios may not be sufficient to cover possible loan losses, thus resulting in the overstatement of net income. BANEX's General Manager stated that, although it is difficult to assess the potential risk of each project at an early stage (most loans are still in their principal and grace periods), problems had already arisen resulting in the rescheduling of two loans. A BANEX quarterly report for the period ending September 30, 1986 indicated that 10.6 percent in interest outstanding ($992,400) on $9.95 million in outstanding loans was overdue. The report also indicated that 22 of the 73 dollar-denominated loans had had repayment terms extended.

Management Comments

USAID/Costa Rica did not agree that current reserves are inadequate, nor did they agree with the recommendations as written but agreed to discuss reserves in greater detail with BANEX.

They also stated they considered our recommendations "unethical" and a breach of contract for AID to attempt to renegotiate or amend loan agreements solely for its own benefit where the borrower has complied with loan covenants.

Inspector General Comments

Recommendations in the audit report dealing with increasing the reserve for bad debt are not solely for the benefit of AID, but rather are intended to increase the financial soundness of the institution itself thereby chiefly benefiting the bank not AID. We, therefore, do not consider this recommendation to be "unethical," especially since it also reaffirms earlier Mission advice to BANEX.

In the event USAID/Costa Rica does not believe that the reserve requirement should be changed, then that decision should be formally supported by appropriate periodic loan portfolio risk assessments. Such assessments were not contained in the project paper for this or the other two private sector credit projects (COFISA and PIC). All three projects have different bad debt reserve requirements even though the activities financed are closely allied. The amount of the bad debt reserve requirement should relate to the risk assumed by the lender, that is the greater the risk, the larger the reserve. According to our reading of accounting texts on this subject, lender risk assessments should be a function of several factors, such as the merits of the project itself, the borrower's equity in the project, and the realizable value of the borrower's collateral.

B. Compliance and Internal Controls

Compliance

Our audit disclosed five compliance exceptions:

-- $3.3 million in AID loan funds were disbursed despite the fact that BANEX, for 26 months, did not enter into a pledge agreement as required by condition precedent 5.1(j) to initial disbursement of AID loan funds.

-- BANEX, for 14 months, did not comply with debt to equity ratio requirements established in special covenant 6.1 (y) of the loan agreement.

-- BANEX had not deposited interest earned on escrow account certificates into the risk minimization fund as required by Amplified Project Description Section IV, Part D of the AID loan agreement.

-- The Mission Director had not issued a written certificate establishing the dollar value assigned certificates in the risk minimization fund, as required by the pledge agreement.

-- The majority of loan funds given out to date did not contribute to the developmental lending objectives of the project (see Other Pertinent Matters).

Other than the conditions cited above, nothing came to our attention that would indicate that untested items were not in compliance with applicable laws and regulations.

Internal Controls

The loan agreement provision to avoid conflict-of-interest situations arising from "insider" lending practices needed improvement (see following report section: "Other Pertinent Matters").

C. Other Pertinent Matters

Another issue identified during the audit dealt with internal control weaknesses in monitoring the conflict-of-interest covenant of the loan agreement. No formal recommendation has been made because of Mission objections to tighter conflict-of-interest requirements and the lack of an AID/Washington policy on conflict of interest with respect to "insider" lending in AID projects of this sort.

The AID loan agreement with BANEX was entered into on September 25, 1981 and was the first private sector banking project in Costa Rica since the expansion of the AID program that same year. Subsequent to this agreement, two other AID loan agreements have been entered into with the Private Investment Corporation (PIC) and the Industrial Finance Corporation of Costa Rica (COFISA).

Prudent loan management practices require effective loan provisions and monitoring thereof to avoid conflict-of-interest situations.

The BANEX loan agreement stated "The Borrower and the Guarantor covenant ...that, unless AID otherwise agrees in writing, they will... not make subloans to, or equity investments in, business or other activities in which the President, Vice-President, auditors, managers, or employees [or the immediate family of any of the foregoing] 3/ of the Borrower, the Guarantor, or any of its subsidiaries has a controlling financial interest, using AID funds."

In comparison with the conflict-of-interest provisions of the AID loan agreement with the PIC, the BANEX loan agreement provisions need strengthening and their monitoring should be improved in order to meet prudent loan management standards. Special covenant 6:(o) of the PIC loan agreement stated that "The PIC agrees that it will for the life of the loan, unless AID otherwise agrees in writing... not make, without prior AID approval, an equity investment in or a subloan to, any business or other activity in which any PIC officer, director, employee, or their immediate families has a financial interest." Also, the project officer stated that current PIC disbursement procedures require the PIC to submit a stockholder list for all companies receiving PIC loans for which AID reimbursement is sought. Contrary to these requirements, the current BANEX special covenants allow the President and Vice-President of BANEX's Board of Directors, auditors, employees, or their immediate families to receive AID loan monies or the reflows therefrom as long as they do not have controlling interest in such company. Additionally, other board members may have 100 percent interest in companies and still receive AID loan monies because they are not covered by the covenant. Furthermore, when BANEX sought reimbursement for the loans it made with AID funds, it was not required to submit a list of stockholders in these companies (necessary for monitoring purposes).

3/ Bracketed statement added in Amendment Number One of the Loan Agreement.

As of June 30, 1986, BANEX had made 20 long-term loans, 3 equity investments, and 36 short-term loans with AID funds. In the past, BANEX had voluntarily brought to AID's attention and subsequently sought approval for one loan and one equity investment application involving companies whose ownership included the President of BANEX's Board of Directors. The loan application was rejected by AID while the equity application was accepted. Thus, of the 59 loans for which AID reimbursed BANEX, AID had received no positive assurance for any that conflict of interest had been avoided.

We reviewed a list of 54 companies that had received AID loan monies from BANEX. 4/ We noted that 10 of the loans had been approved for companies in which former or present BANEX board members (or members of their immediate family) had a financial interest. In these 10 loans we found no evidence that BANEX was in non-compliance with this special covenant. In four of these loans the President and Vice-President of the BANEX Board of Directors did not have controlling interest. In the other six loans, directors or family members (other than the President and Vice-President) who did have a controlling interest were not covered by the special covenant. We believe the special covenant is ineffective because the Board of Directors approves loans and most of the Directors (17 of 20) are excluded from requirements of the conflict-of-interest covenant.

Currently, effective controls are not in place. There is a need for an improved special covenant on conflict of interest and for better monitoring procedures for detecting this (i.e. require BANEX to periodically submit a list of stockholders for those companies receiving loans from AID loan reflows). We believe that prudent loan management practices dictate that effective controls over "insider" lending need to be in place for the remainder of the loan. Without amendment of the conflict of interest covenant, and periodic reporting from BANEX on the use of reflow funds, this situation will continue.

Mission management stated that the auditors assume it is bad business practice for a Costa Rican bank to extend loans to businesses in which a bank officer or director has even a minority interest. BANEX Board members have interests in many important local companies. To exclude all these companies from doing business with BANEX would be an unnecessary and unreasonable millstone around the neck of any Costa Rican commercial bank, according to the comments we received from USAID/Costa Rica.

The majority of the loans made by BANEX from project inception until September 30, 1986 did not contribute to the project's development strategy. This condition was noted in BANEX's final evaluation report where the evaluators concluded that only 30 percent of these loan funds to date had contributed to the project's development strategy (i.e.

4/ BANEX did not provide stockholder lists for two companies receiving loans; three other companies had received both short and medium-term loans.

medium and long-term loans for non-traditional export-oriented activities). This finding is supported by BANEX's quarterly project report for the period ending September 30, 1986 where it lists the details of the 73 loans given to date. Exhibit No. 3 of this report shows that only 20 medium and long-term loans have been given out for non-traditional export-oriented activities. The other 53 loans are separately listed in another exhibit and are shown as loans for working capital, suppliers' debt payments, debt rescheduling, and equity financing.

The original purpose of the $10 million dollar loan as stated in the Amplified Project Description to the loan agreement was to make loans at or near market rates to eligible producers, manufacturers, brokers and other expediters of non-traditional exports to world markets. This loan purpose was late amended by AID, at the request of BANEX, in Loan Amendment Number One dated February 13, 1984. This loan amendment Amplified Project Description was revised to read "at least 50 percent of the longer term AID funds would be used for long-term sublending," (i.e. long-term loans for non-traditional exports to world markets).

BANEX had requested this change in loan purpose because of the difficulties they were having in placing non-traditional loans and due to uncertainties and ambiguities in the nation's monetary laws which put the lender at some risk on dollar loans (i.e. the law contained a provision that the borrowers could, under certain condition, repay dollar-denominated loans at the highly inflated official rate of exchange of the colon, thus causing a large loss for the lender).

We have not made a recommendation in this area as the loan has been fully disbursed and the Mission is aware of this problem through the project's final evaluation report. At the time of the audit, the Mission was conducting discussions with BANEX on this and other issues raised by the evaluation. The Mission has concurred with the evaluation's recommendation that all future loan reflows should be used for longer term developmental purposes as originally contemplated. Also, BANEX representatives have not objected to this recommendation.

AUDIT OF
USAID/COSTA RICA'S
PRIVATE SECTOR PRODUCTIVITY
PROJECT NO. 515-0176

PART III - EXHIBITS AND APPENDICES

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ANALYSIS OF FINANCIAL PERFORMANCE OF THE AGRICULTURAL INDUSTRIAL EXPORT BANK

The financial performance of the Agricultural Industrial Export Bank had fallen short of projections in the project paper. After four and one-half years of project activity, the actual financial performance of the Agricultural Industrial Export Bank (BANEX Consolidated) was considerably lower than expected. For example, the project paper had predicted cumulative "Income before Taxes" after four and one-half years to be $3,730,500. Actual cumulative "Income before Taxes", was $1,546,220 1/. This was only 41 percent of what was predicted after the loan funds were fully disbursed. The reasons for this underperformance were the poor results of the BANEX Trading Company, slowness in disbursements, and lower-than-predicted interest earnings received by the bank for its subloans.

The BANEX Trading Company had projected cumulative losses after four and one-half years of $353,000 and was to start breaking even in year five of the project loan and grant agreement. In contrast, actual losses were $1,093,263, or about $740,263 more than predicted. The final BANEX evaluation noted that the poor performance of the Trading Company was related to high overhead, failure to gain sufficient expertise to subsequently generate revenues, starting the Trading Company at too large a size, etc. We have no recommendation in this area as the Mission has decided to accept the recommendation of the final project evaluation to abolish this project component.

Another factor affecting the performance of BANEX Consolidated was the slowness of disbursements of the AID loan. Mission and BANEX officials attributed this to uncertainties in controversial Costa Rican banking legislation "Ley de la Moneda" (Currency Law), first passed in February 1983 and later revised in September 1984. These officials noted that this law permitted "dollar-denominated loans" to be repaid in colones at the official rate of exchange which at times had been about five times less than the free-market rate of exchange. BANEX officials were reluctant to sub-loan money until the law and its actual application was clarified because of the potential for huge losses if a debtor paid back a dollar-denominated loan at the official rate of exchange. This had happened to the Industrial Finance Corporation of Costa Rica (COFISA), another private sector borrower under a similar project.

1/ Using varying colon rates in effect at year end for each profit and loss statement, and without considering AID funds granted to BANEX Trading Company.

Whereas the project paper projected that the loan would be completely disbursed by the end of year three (September 30, 1984), the original project completion date, only 39.6 percent of the $10 million loan had actually been disbursed on that date. Therefore, over 60 percent of AID loan monies were disbursed late and little if any interest had been earned on this portion of the portfolio by June 30, 1986.

Actual interest rates on subloans were much lower than predicted. The project paper predicted London InterBank Interest Rates (LIBOR) to be an average of 36.5 percent higher than they actually were, as illustrated by the following chart:

Year	Predicted Interest Rate	Actual Interest Rate
Year 1	16%	9.81%
Year 2	15%	10.37%
Year 3	14%	9.18%
Year 4	13%	8.12%
Year 5	12%	7.00%

This chart illustrates that the average predicted interest rate of 14 percent was 5.104 percentage points higher than the actual average of 8.896 percent charged by BANEX on subloans, (the rate of interest BANEX can charge on its subloans is controlled by the Costa Rican Central Bank and is related to LIBOR). This reduced BANEX's operating margins and profits accordingly.

Therefore, the weak performance of BANEX Trading Company accounts for about 34 percent of the $2,184,280 shortfall in profits before taxes, while slowness in disbursements and the lower than predicted LIBOR rates for subloans accounts for the remaining 66 percent. We noted that profits before taxes of BANEX Consolidated would likely have been lower had additional AID generated local currency lines of credit not been made available through the Central Bank. These lines of credit may have contributed to BANEX's decision not to use AID loans as intended, thus reducing project accomplishments in relation to employment generation and foreign exchange earnings (i.e. since BANEX had an alternative source of revenue from these less risky local currency loans, there was less incentive for BANEX to make more risky dollar-denominated loans). The lines of credit provided by the Central Bank were for colon denominated loans and were used by traditional Costa Rican businesses for such activities as working capital, suppliers' debt payments, equity financing, and debt rescheduling. These loans were for relatively risk-free ventures and did not contribute to such project objectives as new employment generation and non-traditional exports.

Additionally, as shown in the BANEX quarterly project for the period ending September 30, 1986, 73 loans had been made of which only 20 were listed in Exhibit No. 3 of the report which listed loans for non-traditional export-oriented activities and their employment generation and foreign exchange earnings to date and those predicted for the future. This data supports the final evaluation of the project which concluded that only 30 percent of the loan funds to date had contributed to the project's development lending strategy. Thus, much of the initial $10,000,000 disbursement did not contribute to the goals and objectives of the project. Since BANEX has apparently agreed that all reflow funds will be made for non-traditional development lending projects, we have made no recommendation.

EXHIBIT 2

AGRICULTURAL INDUSTRIAL EXPORT BANK (BANEX)

PROJECTED BALANCE SHEET AT END OF FIRST 60 MONTHS OF THE PROJECT COMPARED WITH ACTUAL FINANCIAL POSITION AFTER 57 MONTHS OF OPERATIONS (JUNE 30, 1986)

	ACTUAL 1/ AS OF 6/30/86	PROJECTION AT END OF FIFTH YEAR
ASSETS		
Cash	$ 8,614,301	$ 328,000
Negotiable Securities	4,793,675	25,000
Loans Receivable	27,399,645	32,361,000
Fixed Assets	2,443,773	---
Interest & Commissions earned but not received	672,286	---
Other Accounts Receivable	5,019,391	---
Inventory	533,531	---
Other Assets	457,604	---
Traco Equity	---	1,300,000
TOTAL ASSETS	$49,934,206	$34,014,000
LIABILITIES		
Loans Payable in BCCR	$10,408,946	$20,000,000
Loans Payable in AID	10,137,184	9,524,000
Customer Time Deposits	16,794,088	---
Other Liabilities	8,935,414	---
TOTAL LIABILITIES	$46,275,632	$29,524,000
NET WORTH		
Paid-in Capital	$ 2,777,306	$ 2,000,000
Legal Reserve	186,591	418,000
Retained Earnings	694,677	2,072,000
TOTAL NET WORTH	$ 3,658,574	$ 4,490,000
TOTAL LIABILITIES & NET WORTH	$49,934,206	$34,014,000

1/ Based on unaudited consolidated financial statements of June 30, 1986.

EXHIBIT 3

AGRICULTURAL INDUSTRIAL EXPORT BANK (BANEX)

PROJECTED INCOME AND EXPENSE STATEMENT FOR THE FIRST 54 MONTHS COMPARED TO ACTUAL RESULTS FOR THE 57-MONTH PERIOD ENDING JUNE 30, 1986

	PROJECTED RESULTS		ACTUAL RESULTS 2/	
	WITH TRACO 1/	WITHOUT TRACO	USING DIFFERENT COLON RATES WITH TRACO	USING FIXED COLON RATE OF C.55.70 WITH TRACO
INCOME				
Interest Income	$ 9,616,500	$ 9,616,500	$13,382,467	$12,195,662
Fee Income	1,796,500	1,796,500	2,353,219	2,149,412
Other Income	2,712,500	322,500	1,161,041	1,086,525
TOTAL INCOME	$14,125,500	$11,735,500	$16,896,727	$15,431,599
LESS: EXPENSES				
Interest Expense on Loans	$ 4,798,500	$ 4,798,500	$ 9,332,771	$ 8,590,541
General and Admin. Exp.	5,082,500	2,339,500	4,761,411	4,254,069
Other Expenses	---	---	407,144	381,262
Bad Debt Expense	---	---	499,960	471,639
5% CONAPE 3/	$ 172,000	$ 172,000	$ 46,805	$ 39,926
10% Employee Fund	342,000	342,000	93,609	79,851
TOTAL EXPENSES	$10,395,000	$ 7,652,000	$15,141,700	$13,817,288
INCOME BEFORE TAXES	$ 3,730,500	$ 4,083,500	$1,755,027 4/	$ 1,614,311 5/
Less: Income Tax	1,213,481	1,454,000	37,740	30,490
NET INCOME AFTER TAXES	$ 2,517,019	$ 2,629,500	$ 1,717,287	$ 1,583,821
Less: Dividends	$ 562,847	$ 588,000	$ 171,594	$ 157,531
NET INCOME AFTER DIVIDENDS	$ 1,954,172	$ 2,041,500	$ 1,545,693	$ 1,426,290

1/ BANEX Trading Company.

2/ Includes audited financial statements for the 48-month period ending December 31, 1985 only.

3/ National Commission for Education Loans, a student loan program financed from profits of financial institutions.

4/ This figure includes ESF grant 515-0186 of $208,807 ($136,314 in 1984, $72,493 in 1985). Income before taxes would be $1,546,220 using varying colon rates if this grant were excluded.

5/ This figure also includes the ESF grant. Income before taxes would be $1,427,562 using constant colon rate of C.55.70 if this grant is excluded. In both cases, income was increased by 12 percent by the grant.

AGENCY FOR INTERNATIONAL DEVELOPMENT
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February 5, 1987

MEMORANDUM

TO: Mr. Coinage Gothard, RIG/A/T

THRU: Mr. Daniel A. Chaij, MDIR

FROM: Mr. G. Franklin Latham, Audit Liaison Officer

SUBJECT: USAID/CR Response to RIG Draft Audit Report on Project No. 515-0176 (BANEX)

The AID/CR Controllers Office has reviewed the abovementioned report for the purpose of assisting the Mission in drafting its response to the RIG. We have met with the project officer and other appropriate individuals and have incorporated their comments. The responsibility of the Controller's Office with respect to the draft audit report is to coordinate the Mission's formal response contained herein. The observations made are in the same format as that of the auditors draft report.

"EXECUTIVE SUMMARY" SECTION

Unethical Recommendations

USAID/CR considers it unethical and a breach of contract to attempt to renegotiate or amend loan agreements solely for its own benefit where the borrower has complied with loan covenants. To do so would damage AID's credibility and in turn its effectiveness. The Executive Summary makes no reference to the fact that the RIG recommendations include renegotiation and amendments. The auditors recommendations on renegotiating or amending loan agreements would not be legally enforceable and USAID/CR has no technical, ethical nor legal basis to do so. USAID/CR requests that its point of view be stated in the Executive Summary Section of the final report.

Insider Lending

The Executive Summary is incomplete stating that "... improvements on internal controls over insider lending practices ... were needed." After reviewing loans on a case by case basis, the auditors were unable to find a single case of non-compliance with the loan agreement nor special treatment of insiders regarding, terms of payment, interest rates, collection,

collateralization, nor did they find any lack of good faith. Such facts, and the USAID/CR's strong disagreement with the auditors on this point, should be included in the Executive Summary to keep it from being misleading and USAID/CR strongly suggests that no reference at all be made to insider lending.

Risk Minimization Fund

- Value of the Fund

That the "value of the fund ... was about $89,257 less than required" is primarily the result of a difference of opinion between the auditors and USAID/CR on the fair market value of investments in the fund. USAID/CR believes that the Costa Rican open market, which deals regularly with these investments and which is intimately familiar with the issuing entity's financial capacity, is more capable of determining the fair market value of the investments than the New York market prices used by the auditors. It is much more likely that the local market could sell the investments than could New York. Since there is a difference of opinion regarding the best source of market information and a discrepancy between the fair market value as quoted by two knowledgable sources, USAID/CR requests that, (1) all reference to a shortfall be eliminated from the Executive Summary and that (2) a clarification that the "shortfall" is a matter of opinion be included in Part II A.1.b. of the RIG's report.

Similarly, the wording that "the bank undercalculated the amount that should be in the fund and overcalculated the value of the assets in the fund" is inappropriate in that it leaves the reader with the idea of foul play or incompetence on the part of BANEX when neither is the case.

- Interest Earned by the Fund

The comment that "the bank did not retain the interest earned in the fund as required" is correct in form but not in substance, in light of the bureaucratic nature of the Costa Rican banking environment. While it is true that BANEX did not leave the interest coupons in the fund (which have a collection period of up to three or four months), BANEX did put an equivalent amount of new certificates in the fund. This did not diminish the total amount which AID could lay claim to in the event of default on the loan. Since BANEX technically complied with the requirement, USAID/CR believes it is not appropriate to point out the issue in the Executive Summary and believes that the above discussion should be included in Part II A.1. of the RIG report. The wording as presently contained in the Executive Summary section of the report is misleading.

Further, effective at Dec. 31, 1986, BANEX has agreed to a new system for cashing of the coupons. BANEX will withdraw the coupons and cash them at the Central Bank (about 90 days lag time) and once cashed, deposit the amount into the fund. See discussion of Part II A.1. Recommendation 1.d) below.

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- Semi-Annual Valuation of Fund

The auditors' comment that "USAID/CR did not follow required procedures to semiannually revalue the investment instruments in the fund" is correct. No additional clarification is required.

- Auditors Conclusion That Fund Not Accomplishing Intended Purpose

The auditors conclusion that "the Risk Minimization Fund has, therefore, not fully accomplished its intended purpose to furnish additional protection to AID in the case of loan default by this bank" is not correct. The fund does offer "additional" (but not absolute) protection against default. The fund was established ONLY because no GOCR guarantee was available.

Given this rationale; it is somewhat anomalous to tell BANEX that direct obligations of the GOCR are unacceptable investment instruments for the fund. Further, USAID/CR believes that BANEX net worth of about $3 million is a more substantial assurance of the repayment of the AID loan than is the risk minimization fund. Any additional amounts put into the fund would be unavailable for the projects fundamental purpose - developmental lending.

The above issues support that the risk minimization fund is in fact accomplishing its intended purpose and that the auditors conclusion is not correct. USAID/CR requests that all reference to the fund in the Executive Summary, be eliminated from the auditors final report.

- Non-Compliance with Condition Precedent Regarding Establishment of Fund

The RIG observation is correct that "establishment ... of a Risk Minimization Fund" was not complied with on a timely basis.

- Non-Compliance with Special Covenant Regarding Maintenance of Fund

It is not correct however that "maintenance of a Risk Minimization Fund" was "not...complied with...". This special covenant was fully complied with once the fund was finally established. As stated above, reference to the maintenance of this fund should be eliminated from the Executive Summary. It was the "establishment" of the fund, not the "maintenance" of the fund which was not complied with on a timely basis.

Bad Debt Reserve

The underlying assumption of the auditors appears to be that BANEX, COFISA and PIC are homogeneous institutions which is not the case. For example, COFISA was an insolvent institution when AID agreed to make a loan; PIC also makes equity investments and is restricted to long-term loans; and BANEX is a strong, high net worth institution having both short and long-term loans as well as banking services. Consequently, it is not correct to assume that what is appropriate for one institution is appropriate for the other.

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The auditors' comments totally ignore the issue of collateral as a factor in the ultimate collectibility of a loan and USAID/CR recommends that the auditors re-evaluate their observations and recommendations taking into account the issue of collateral.

The auditors' draft report is silent with regard to the fact that BANEX has totally complied with the loan covenant regarding bad debt reserve. In fact, at September 30, 1986, BANEX had a reserve for its development loans of 2.5% which is actually in excess of that required by the loan agreement.

The exposure to AID in collecting its loan from BANEX is not only related to the bank's ability to absorb bad debt losses but to other factors as well such as the risk minimization fund, collateralization, net worth, dividend restrictions, etc.

Conceptually, if BANEX were to reserve 2% of its average annual loan and investment portfolio over 20 years that would be 40%. If there were any reasonable probability of the bank losing 40% of its entire portfolio, neither BANEX nor AID would have entered into a loan agreement. Although loan collections must be watched continuously, USAID/CR believes that increasing the bad debt reserve during the life of the loan from 2% to 40% (conceptually) is without merit and should be eliminated from the Executive Summary and discussed only in Parts II and III of the report. (See discussion below under Part II A.2.).

Significant Accomplishments

The Executive Summary fails to mention significant accomplishments of the project even though the data necessary to do so is included in EXHIBIT 2 to the auditors' draft report. USAID/CR recommends that the following accomplishments be included in the Executive Summary:

1. The project had projected total assets after five years to be $34 million while, with three months remaining to complete that period, total assets were almost $50 million - nearly a 50% increase.

2. Based on the same time period as 1. above, BANEX had only $10.5 million payable to the Central Bank, nearly 50% less than the $20 million originally projected making BANEX less dependent on the bureaucratic state-owned banking system.

3. BANEX had acquired $16.8 million in customer time deposits even though none was originally projected. Time deposits are a significant source of capital.

4. BANEX had increased its paid-in capital by $777,000 which is about 30% in excess of the projected paid-in capital.

USAID/CR believes these significant achievements should be included in both the Executive Summary and other appropriate sections of the auditors final report.

****

This concludes USAID/CR's comments on the Executive Summary section of the RIG's draft audit report for Project No. 515-0176. See USAID/CR's comments on Parts I through III of the RIG draft audit report below.

"PART I - INTRODUCTION" SECTION

USAID/CR has no comments on this section of the report.

"PART II - RESULTS OF AUDIT" SECTION

There is some misunderstanding of facts in pages 4 and 5 of this section of the report. The wording that "the majority of the loans had not furthered the overall project objective of expanding the production and export of non-traditional products" is misleading. The overall objective of the project was to create an efficient private commercial bank with development loan capacity. (Note: COFISA and PIC, on the other hand, were always development oriented and are not private commercial banks).

The auditors have an error in facts that 20 loans were for non-traditional export activities. The correct data is that 53 out of 73 loans (i.e. the majority) were for non-traditional export oriented activities (a major project purpose).

While 20 out of 73 loans would imply that 27% of the loans were not in accordance with the project purpose, those 20 loans represent only aproximately $800,000, or 7% of the total estimated project cost of $12,000,000.

The auditors also fail to note that the abovementioned 20 loans were specific exceptions authorized by USAID/CR as a temporary measure to help BANEX earnings. Further, these loans are short-term which is allowable under the loan agreement.

A. Findings and Recommendations

USAID/CR considers it inappropriate to comment on what AID/W ought to do in a report on a specific project in Costa Rica unless flagrant abuses were found. Such is not the case here. Inclusion of comments as to AID/W responsibilities in the report tends to decrease the clarity of the report and should be eliminated.

1. Risk Minimization Fund Needed Strengthening

The wording and details under this subheading should be modified to incorporate the comments provided in this Memorandum above regarding the Executive Summary.

Recommendation No.1

a. Recommendation to make up the shortfall in the risk minimization fund is accepted subject to independent auditors verifying that a shortfall does in fact, exist.

b. Recommendation that BANEX be limited to investing in instruments outlined in pledge agreement sections 3A1 through 3A6 would totally nullify the possibility of investing in "other readily marketable obligations jointly agreed to by AID and the pledgor" which is also permitted by the loan agreement (section 3A7). USAID/CR finds no justification for tying the hands of both AID and BANEX with regard to suitable investment instruments. Note that the underlying element in the loan agreement is marketability of fund investment instruments and not the risk of the instruments. (See also USAID/CR comments included herein under the Executive Summary Section above).

c. Recommendation accepted as stated. It will help in the administrative aspects of the loan.

d. Recommendation that all future interest earned be retained in the risk minimization fund is accepted utilizing the mechanics outlined herein under the Executive Summary section above.

e. Recommendation to revalue GOCR bonds in the risk minimization fund semiannually in accordance with the terms of the pledge agreement, accepted as stated.

Discussion

Page 10 of the Discussion does not consider that BANEX $3.6 million net worth also provides security against loan default in addition to the risk minimization fund as does the 18% dividend rate limit which forces the stockholders to keep over 80% of BANEX' earnings reinvested until the loan is repaid. Further, it should be clearly pointed out that there was no instance of non-compliance except for the untimely establishment of the risk minimization fund. The Discussion detailed in page 10 should include these important facts.

-Selection of Inappropriate Investment for the Fund

The Risk Minimization Fund was established because a GOCR guarantee was not available. Logically the fund, once established, invested in GOCR bonds (i.e. essentially a GOCR guarantee) which the auditors now claim is not

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sufficient. These observations, as well as USAID/CR comments on this issue included above in the Executive Summary section should be included in this part of the auditors' final report.

2. Reserve for Bad Debts May be Inadequate to Offset Future Losses

The auditors completely failed to demonstrate the inadequacy of reserves. The wording of the auditors comments on this issue leaves the impression that USAID/CR is in agreement with the auditors' opinion, which is not the case. The auditors final report should be clear in that USAID/CR does not agree with the auditors on the issue of bad debt reserves.

This section of the report should incorporate the USAID/CR observations included herein under the Executive Summary section above.

Recommendation No. 2

USAID/CR does not agree with this recommendation as written but agrees to discuss reserves in greater detail with BANEX.

Discussion

Page 20 of the Discussion states that "all loans are still in their principal and grace periods" which is not correct. Nearly one third of BANEX long term loans have already initiated the repayment period. USAID/CR's letter of August 30, 1985, is not correctly interpreted. It is in reply to a specific question of BANEX and does not comment on the specific issue of adequate loan loss reserve. Also, the amount of 2% mentioned in the letter is wrong, it should read 1%.

Although COFISA and PIC sub-projects may have some similarities to those financed by BANEX (re: page 21), BANEX has not had the same delinquency rate in as these institutions. These three institutions are not sufficiently similar to justify applying the same requirements to all three; COFISA was insolvent at the time the loan was made, PIC is an investment institution, whereas BANEX is a high net worthy company.

E. Compliance and Internal Controls

- Compliance

USAID/CR accepts the compliance exception that $3.3 million in loan funds was disbursed despite non-compliance with condition precedent to initial disbursement.

While USAID/CR agrees that BANEX was out of compliance with debt-to-equity ratios under special covenant 6.1(y) of the loan agreement, the auditors' final report should clarify that USAID/CR believes that the ratio should be calculated on a consolidated basis. Since quarterly consolidated financial

statements are not prepared, there is no basis on which to make the calculation. Further, USAID/CR considers the audited combined financial statements to be the only reliable source of data for the calculation. The auditors final report should include the clarification that 1985 was the first time BANEX went out of compliance.

A number of changes were requested by BANEX on Sept. 22, 1986, to the loan agreement which include a request to increase the allowed debt-to-equity ratio. Both the BANEX letter of Sept. 22, 1986, and USAID/CR internal reponse dated Oct. 30, 1986, were available to RIG auditors. Nevertheless, the draft audit report fails to mention USAID/CR's comments. The auditors' final report should include a reference that:

1. There are no clear guidelines as to the maximum debt-to-equity ratio of a financial institution.

2. Financial institutions are judged more by profitability and the soundness of their loan portfolio than by their debt-to-equity ratio.

3. Financial institutions are essentially debt (both receivable and payable) institutions and are most commonly compared on the basis of total assets rather than debt to equity.

4. The average debt-to-equity ratio of U.S. banks is about 15:1 while Japanese and European banks go even higher. Even Costa Rican state-owned banks are nearly 15:1.

5. USAID/CR Office of the Private Sector endorses BANEX proposal of a more liberal debt-to-equity ratio.

USAID/CR does not accept the finding that BANEX "did not deposit interest earned on escrow account certificates into the risk minimization fund ...". While this is true in form, it is not true in substance. On the contrary, BANEX has complied with this provision to the full satisfaction of AID. USAID/CR comments contained herein under the Executive Summary Section - Risk Minimization Fund, should be included in the auditors' final report and the auditors' conclusions on compliance with this covenant should be reassessed.

USAID/CR accepts the observation that the Mission Director "did not issue a written certificate establishing the dollar value assigned to certificates...".

Internal Controls

USAID/CR does not agree with the finding that "insider lending practices needed improvement." USAID/CR comments on this issue included herein in the Executive Summary Section should be considered and the auditors observation reassessed.

C. Other Pertinent Matters

USAID/CR objects to such extensive treatment of the conflict of interest issue in light of the fact that no AID/Washington policy exists, that the auditors case by case review of loan portfolios failed to disclose a single case of inappropriate action, and that "insiders" were involved in only a small minority of BANEX loans and that, "outsiders" were hardly denied access. USAID/CR considers the issue irrelevant and does not consider the criteria applied by the auditors appropriate in the circumstances.

Although USAID/CR is opposed to a prohibition of insider lending, it is willing to discuss formalization of conflicts of interest policies with BANEX. There are, however, two important issues which USAID/CR requests be included in the auditors final report:

1. BANEX was in total compliance with the loan agreement at all times with regard to insider lending (see USAID/CR comments herein under the Executive Summary Section), and

2. Since no special or preferential treatment of insiders was found, loan management was in fact "prudent", it was in fact "effective" and in fact "monitored." The existing wording leaves the impression that the loan agreement and loan management were imprudent, ineffective and not monitored. The Mission requests that the auditors clarify these facts further or eliminate the comment altogether in the final report.

"PART III - EXHIBITS AND APPENDICES" SECTION

Exhibit 1

The comparative interest rate chart is misleading. It depicts projected versus actual interest rates which, to be comparable, must first be applied to the amount of money lent at each rate. This will in turn affect the overall portfolio interest rate. The auditors' final report should clarify exactly what is being compared in this chart. Is it the overall rate, individual loan rate or what?

Exhibit 2

This exhibit should clarify whether or not it is consolidated, combined, or individual. (See also comments on Exhibit 3 below).

Exhibit 3

Generally accepted accounting principles do not permit the use of a single fixed exchange rate for the translation of financial statements although such practice is common in Costa Rica for internally prepared unaudited financial

statements. When generally accepted accounting principles are applied in the translation of standard financial statements to another currency, an unrealized gain or loss is generated affecting the income statement and indirectly the financial position. Any gain or loss on the translation of non-current assets and liabilities is normally deferred and not taken into the income statement.

The lack of the use of generally accepted accounting principles in these internally prepared financial statements could cause major financial distortions in their interpretation and makes there usefulness in the RIG audit report highly questionable. USAID/CR requests that their inclusion in the auditors' final report be reconsidered.

CONCLUSION

The only issue of relative significance in the auditors report is the compliance exception of not having semi-annually valued the investment certificates in the risk minimization fund. This condition is easily rectifiable. By way of perspective, it should be pointed out that none of the subjects on which the auditors made recommendations have had any substantial impact on the success or failure of the project to date.

LIST OF RECOMMENDATIONS

Recommendation No. 1

We recommend that USAID/Costa Rica, in consultation with the Agricultural Industrial Export Bank, revise the terms and operations of BANEX's risk minimization fund as follows:

a) obtain evidence that the Agricultural Industrial Export Bank has deposited not less than $89,257 into the fund to make up the shortfall;

b) cause the Agricultural Industrial Export Bank to make all future payments into the fund in dollars to be invested in relatively risk-free investment instruments as described in the pledge agreement at sections 3A1 through 3A6;

c) amend the pledge agreement so that all future payments into the fund correspond to the dates when interest becomes due on the AID loan and make such payments in amounts one-third larger than the corresponding interest payment;

d) obtain formal BANEX acknowledgement that all future interest earned be retained in the risk minimization fund as required by the loan agreement; and

e) revalue the current Government of Costa Rica bonds in the risk minimization fund semiannually in accordance with the terms of the pledge agreement and ensure a certificate is issued by the Mission Director attesting to the U.S. dollar value which has been assigned to such certificates.

Recommendation No. 2

We recommend that USAID/Costa Rica, in consultation with the Agricultural Industrial Export Bank, amend the AID loan agreement to provide that:

a) the Agricultural Industrial Export Bank make provision for bad debts of at least two percent of its annual average outstanding development loan and investment portfolios (colones and dollar denominated), and revise its written policies accordingly; or

b) a formal, periodic portfolio loan risk assessment be made to justify the provision for bad debts applied.

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