PD-ABE-012

A.I.D. EVALUATION SUMMARY - PART I

1. BEFORE FILLING OUT THIS FORM, READ THE ATTACHED INSTRUCTIONS.
2. USE LETTER QUALITY TYPE, NOT "DOT MATRIX" TYPE.

IDENTIFICATION DATA

A. Reporting A.I.D. Unit:

Mission or AID/W Office USAID/El Salvador
(ES# ____________) PRE Office

B. Was Evaluation Scheduled In Current FY Annual Evaluation Plan?

Yes [ ] Slipped [ ] Ad Hoc [X]

Evaluation Plan Submission Date: FY 92 Q 2

C. Evaluation Timing

Interim [ ] Final [XX] Ex Post [ ] Other [ ]

D. Activity or Activities Evaluated (List the following information for project(s) or program(s) evaluated; if not applicable, list title and date of the evaluation report.)

Project No.	Project /Program Title	First PROAG or Equivalent (FY)	Most Recent PACD (Mo/Yr)	Planned LOP Cost (000)	Amount Obligated to Date (000)
519-LC-19	Investment Promotion Insurance System	1986 ESF/MOU	1/12/97	N/A	₡302.0 Mill. (US$ 37.75M)

ACTIONS

E. Action Decisions Approved By Mission or AID/W Office Director

Action(s) Required	Name of Officer Responsible for Action	Date Action to be Completed
1. Undertake an external audit as soon as auditors with expertise in insurance and reinsurance can be contracted. Contract a financial, administrative and "due diligence" audit. Task the auditors to develop a comprehensive financial reporting system based upon 100% of premiums.	CONT	07/31/92
2. Notify the BCR and the Consortium that the Mission does not agree to use PROINVER funds for fire and transport insurance unless and until the terms of this coverage are negotiated with the Mission and ratified in a PIL. Advise both that the Mission does not accept the unilateral modification of the deductible.	PRE	02/28/92
3. Negotiate an increase in the leverage of PROINVER to 6 to 1. Leverage PROINVER at 8 to 1, if the BCR agrees to stop loss reinsurance coverage to protect against unespectedly high losses. If PROINVER is further leveraged, negotiate a commission rate cap on total commissions with the Consortium of insurers.	PRE	06/30/92
(Continued .....)		

(Attach extra sheet if necessary)

APPROVALS

F. Date Of Mission Or AID/W Office Review Of Evaluation: (Month) February (Day) 11, (Year) 1992

G. Approvals of Evaluation Summary And Action Decisions:

	Project/Program Officer	Representative of Borrower/Grantee	Evaluation Officer	Mission or AID/W Office Director
Name (Typed)	James Stephenson	Lic. Mirna Liévano ~~de Marques~~		
Signature	Patricia Bojórquez	Minister of Planning	Karen Freeman	John A. Sanbrailo
Date				

ACTION DECISIONS (Continued)

4. Negotiate as expeditiously as possible the monetization of the reserves to prevent them from being destroyed by inflation and devaluation. Once monetized, reduce the PROINVER reserves to ¢150 million and reprogram remaining funds.	PRE PBojórquez	06/30/92
5. The PRE Project Manager periodically should review the lines of communication between the Project and the Mission to insure that the Mission continues to receive a full, complete and timely flow of information about the development of the Project. The PRE Project Manager should review the minutes of the meetings of both the Comité de Aceptación and the Junta Supervisores and review the "Reglamento" (with the assistance of the Project Implementation Committee as applicable) to make changes as necessary. It should review the newly established accounting on a quarterly basis.	PRE PBojórquez	N/A
6. Anticipate the continuation of PROINVER during the Peace Process and in the immediate years following a successful conclusion to the negotiations. The Program should be reevaluated in one year to decide on further actions and/or closing schedule.	PRE PBojórquez	01/31/93

ABSTRACT

H. Evaluation Abstract (Do not exceed the space provided)

The PROINVER program was established in 1986 to protect and promote private sector investment in El Salvador by providing insurance against politically motivated destruction of economic assets after the private reinsurance industry withdrew from El Salvador. At present, it provides about ₡1.2 billion of coverage on productive assets including agroindustrial and industrial risks, coffee and sugar stocks, and public transport buses. Major findings of the evaluation include:

- The program has realized its goals at essentially no cost to the Mission or to the local currency reserves. In fact, when the investment earnings are included, the financial results are positive.

- The present leverage ratio is 4 to 1. Given the present rate of losses, this ratio can be increased to 6 to 1. If stop loss reinsurance is used, the leverage can safely be increased to 8 to 1.

- The reserves of ₡287 million is held by the BCR in non-interest bearing accounts. Inflation is rapidly eroding the real value of this reserve and depriving the Mission of the ability to undertake other development activities. Monetizing the reserve would avoid this heavy opportunity cost.

- Once the reserve is held at interest, the PROINVER reserve should be reduced to about ₡150 million, with the remaining funds used to pursue other development activities.

- The PROINVER program should be continued through the Peace Process and during the immediate post-peace years, as it is possible that the rate of politically motivated economic damage may not decline. PROINVER would also be an incentive to new investment to establish in El Salvador following the peace agreements.

The PROINVER program is the first USAID program to work with an insurance industry. While the insurance industry investments are one of the largest sources of long term development capital, its capacity has yet to be utilized to execute and participate in development projects. Until the PROINVER program, USAID has worked with banks and other financial intermediaries, but had not incorporated the insurance industry into its activities. The relationship established through the PROINVER program can be very useful in initiating new development projects, in El Salvador as well as other countries.

COSTS

I. Evaluation Costs

1. Evaluation Team

Name	Affiliation	Contract Number OR TDY Person Days	Contract Cost OR TDY Cost (U.S. $)	Source of Funds
Dr. William Michael Gudger	N/A	519-0177-0-00-1193-00	$23,652.00	Project 519-0177

2. Mission/Office Professional Staff Person-Days (Estimate) 18 person/days

3. Borrower/Grantee Professional Staff Person-Days (Estimate)

A.I.D. EVALUATION SUMMARY - PART II

SUMMARY

J. Summary of Evaluation Findings, Conclusions and Recommendations (Try not to exceed the three (3) pages provided)
Address the following items:

- Purpose of evaluation and methodology used
- Purpose of activity(ies) evaluated
- Findings and conclusions (relate to questions)
- Principal recommendations
- Lessons learned

Mission or Office:	Date This Summary Prepared:	Title And Date Of Full Evaluation Report:
Private Enterprise	February 14, 1992	An assessment of the Investment Promotion Insurance Program (PROINVER) October, 1991.

ADMINISTRATION AND FINANCE: The PROINVER program was established in 1986 to protect and promote private sector investment in El Salvador by providing insurance against politically motivated destruction of economic assets after the private reinsurance industry withdrew from El Salvador. It is operated by a pool of 13 Salvadoran insurance companies. The reserves (FOINVER), currently about ¢287 million, to back claims are held in the Central Reserve Bank. Currently, these funds are leveraged at a 4 to 1 ratio and about ¢1.4 billion are insured by PROINVER. Of the ¢1.4 billion in coverage, FOINVER is responsible for about ¢902 million, with the remainder borne 10% by the pool of companies and 15% by the insured via a deductible. Agroindustrial and industrial risks comprise about ¢620 million (of which ¢475 million is the responsibility of FOINVER), coffee and sugar stocks which are insured for about ¢677 million (with ¢377 million is FOINVER), and ¢90 million in buses (where FOINVER's responsibility if about ¢57 million). The treatment of buses is somewhat different in that the majority of the companies take no risk and the deductible is 30%. The insurance companies receive a commission of 20% for producing and managing the business.

LEVERAGE AND RESERVE SIZE: This highly innovative program has been essentially cost free. Premiums and interest income on ¢15 million held in commercial banks have more than offset the indemnities since the program's launch. The leverage can safely be increased to 6 to 1 without reinsurance and 8 to 1 with reinsurance. The size of the reserve can be reduced to about ¢150 million, freeing about ¢150 million for development activities if monetization and reinsurance purchase take place.

MONETIZATION: The reserve is being eroded by inflation. At the presente rate of inflation the opportunity cost this year alone will be about ¢40 million, if inflation continues at about 15% per year, the constant dollar value of about US$34 million (at current exchange rates) will decline to $10 million in 1996 and to $4 million in 2000. The reserve should be moved to interest bearing accounts in order both to protect it and to enable it to sponsor additional development activities.

COORDINATION: The pool of insurers and the BCR apparently made significant modifications to include fire coverage on coffee, sugar and cotton and a reduction of the deductible to 1% (with a ¢50,000 maximum) the latter without consultation of and agreement of the Mission. The Mission needs to strengthen its oversight of the two bodies that set policy and make insurance decisions.

AUDIT: An audit by experienced insurance and reinsurance auditors should be conducted as soon as possible. They should establish a more complete accounting system to include 100% of all premiums.

PROGRAM CONTINUATION: The on-going Peace process has not undermined the need for the program. Politically motivated attacks continue to occur, especially in the highly exposed coffee and sugar industries. The Mission should plan to continue the program for two to three more years until the shape of the post conflict era is clear.

LESSONS LEARNED: This is the first USAID program to work with the insurance industry to carry out development activities. Insurance companies are usually the second largest source of long term capital, but have yet to be brought into the development process in the same way that USAID has involved banking and financial institutions. There are significant development opportunities that should be explored both in El Salvador and in other developing countries in general to involve the industry in innovative financial sector programs.

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ATTACHMENTS

K. Attachments (List attachments submitted with this Evaluation Summary; always attach copy of full evaluation report, even if one was submitted earlier; attach studies, surveys, etc., from "on-going" evaluation, if relevant to the evaluation report.)

1. Final Evaluation Report.

COMMENTS

L. Comments By Mission, AID/W Office and Borrower/Grantee On Full Report

The Evaluation of PROINVER presented the Mission with two major project management issues to resolve and several technical issues. It was also a timely evaluation given the end of the armed conflict in El Salvador.

The evaluation disclosed that the grantee had changed, without prior consultation with the Mission, the terms and scope of available insurance. The Mission, as detailed in the "AID Actions" section, has moved quickly to curtail this practice until it can be adequately justified and considered. The Mission has also contracted an external audit in order to assure that there are no other irregularities, improve accounting and financial controls and strengthen the program's management. Finally, we have adjusted reporting requirements to ensure closer monitoring of PROINVER actions in the future.

The second issue was the excess in the reserves of 150 million colones. The Mission will move quickly to negotiate the reprogramming of these funds to other developmental activities.

The Mission concurred with the finding of the evaluator on continuing this program until the post war situation solidifies. We will, however, reevaluate this decision in one year to determine if it is still needed.

AN ASSESSMENT

OF THE INVESTMENT PROMOTION INSURANCE PROGRAM (PROINVER)

CARRIED UNDER THE TERMS

OF PURCHASE ORDER 519-0177-0-00-1193-00

CONDUCTED BY

W. MICHAEL GUDGER

OCTOBER 1991

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EXECUTIVE SUMMARY

ADMINISTRATION AND FINANCE: The PROINVER program was established in 1986 to protect and promote private sector investment in El Salvador by providing insurance against politically motivated destruction of economic assets after the private reinsurance industry withdrew from El Salvador. It is operated by a pool of 13 Salvadoran insurance companies. The reserves, currently about C.287 million, to back claims are held in the Central Reserve Bank. Currently, these funds are leveraged at a 4 to 1 ratio and about C.1.4 billion are insured by PROINVER. Of the C.1.4 billion in coverage, PROINVER is responsible for about C.902 million, with the remainder borne 10% by the pool of companies and 15% by the insured via a deductible. Agroindustrial and industrial risks comprise about C.620 million (of which C.475 million is the responsibility of PROINVER), coffee and sugar stocks which are insured for about C.677 million (with C.377 million in PROINVER), and C.90 million in buses (where PROINVER's responsibility if about C.57 million). The treatment of buses is somewhat different in that the majority of the companies take no risk and the deductible is 30%. The insurance companies receive a commission of 20% for producing and managing the business.

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AN ASSESSMENT
OF THE INVESTMENT PROMOTION INSURANCE PROGRAM (PROINVER)
CARRIED UNDER THE TERMS
OF PURCHASE ORDER 519-0177-0-00-1193-00[1]

BACKGROUND:

PROINVER was initially established under the 1986 Memorandum of Understanding for Local Currency Activities. Its purposes are:

1. To help to meet a temporary need for reinsurance for the productive industries of the country when the commercial reinsurance market had withdrawn due to heavy losses arising from the campaign of destruction waged by the left

2. To help create a more favorable climate for existing investment

3. To help stimulate new investment, especially in the non-traditional export sector and

4. To help slow capital flight by offering protection that could not be obtained in commercial markets against politically motivated violence.

The program was designed to protect productive investment against politically motivated destruction and enable it to reconstruct following a loss.

THE FINANCIAL SYSTEM, called FOINVER, consisted of a local currency reserve held in the Banco Central. Initially C.220 million were placed in the original fund; an additional C.90 million was placed in the fund for the Eastern Region (Fondo Oriente). A smaller amount of local currency (initially C.15 million) was placed in the commercial banking system at interest to meet part of the expected indemnities while funds were disbursed from the BCR, as well as to generate interest income to allow the program to meet administrative costs without drawdown of the reserves.

THE ADMINISTRATIVE SYSTEM was based upon the formation of a "pool" or a consortium of all of the insurance companies in El Salvador to write the terrorist coverage jointly as an annex to the existing fire business for those categories of risks that PROINVER would accept. Both the fire and the terrorist coverages had to be written at replacement value, implying significant increases in the sums insured in almost all cases.[2]

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1 All of the data contained in this draft report is taken from PROINVER reports and not derived from audited data. Many of the premium estimates are derived by deduction, as the present accounting system does not account for total premiums, only those ceded to PROINVER.

2 It is usual in Latin America for companies to "underinsure," that is, to insure for less than replacement value. In some cases, this is so because the local insurance industry cannot obtain enough reinsurance to meet the demand. More commonly, however, the insurance on a "first loss" basis arises from the assumption that there is very little likelihood of the complete destruction of the insured good. Partial damage is far more probable, thus money can be saved by insuring less than the replacement value of the good. The

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For all risks except buses, the pool of insurance companies sold and managed the business but retained only 10% of the risks, which was divided between all the participating companies. They were allowed a 20% commission for this service. A Stop Loss protection of 100% of the losses in excess of 150% of the premium retained by the system was also included to protect the companies against catastrophic losses. When buses were approved for coverage, the pool of insurance companies wrote all of the bus insurance for PROINVER's account (except for two member companies). They retained no risk.

The pool or consortium's activities are managed on a day to day basis by an administrator hired by the pool. Its management is governed by the Junta de Supervisores. An Acceptance Committee (Comite de Aceptacion), made up of members from both the consortium's member companies and from the Central Bank, is responsible for reviewing and accepting or denying coverage for the risks laid before them by the participating companies. The Acceptance Committee, and in fact, the PROINVER system, is overseen by the Junta de Supervisores. Under the terms of the MOU, when required, changes can be requested to the Central Bank by this Junta and USAID can concur via an exchange of letters, which then become an integral part of the basic operating agreement.

UNDERWRITING PERFORMANCE OF PROINVER:

The underwriting of insurance has been in effect for approximately four years. On 31 December, 1990, PROINVER's insurance covered just over C.750 million of productive assets. With deductibles and the participation of the companies, this amount was increased to slightly under C.1.2 billion. On 31 August, these figures had risen to C.902 million and approximately C.1.4 billion respectively.

The division of insured productive resources as of August 31, 1991 covered by PROINVER is as follows:

1. Agroindustrial and industrial risks (terrorism only)
   C.620 million, of which C.475 million were in FOINVER

2. Coffee, (including fire, transport and allied risks)
   C.419 million, of which FOINVER insured C.226 million

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economic logic is false, as insurers calculate premiums in a manner to compensate for this by making each dollar of coverage proportionally less expensive, but it is appealing to budget-minded insurance buyers. Indeed, during the negotiations, this became one of the more difficult issues. The industry was quite willing to write full value replacement coverage on the fire policies, as this generated additional premium and profit. These increased sums insured in fire business were one of the principle reasons that they agreed to the pool. However, they feared correctly that it would be difficult to sell the new higher value policies and, incorrectly as it turned out, that the losses would be very heavy due to insures arranging attacks to obtain replacement value indemnities on depreciated plants.

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3. Sugar (including fire, transport, and allied risks)
   C.258 million, of which FOINVER covered C.145 million

4. Buses (terrorism and in some cases fire too)
   C.90 million, of which FOINVER insured C.57 million.

In categories 2 and 3 above, it appears that the industry and the BCR have modified both the coverage to allow PROINVER to cover fire and allied lines, as well as transport, and have modified the deductible from 15% to 1%, with a maximum deductible of C.50,000, without the Mission's prior knowledge or agreement. The minutes of the meeting of the Board of Directors in which these changes were approved were not available, but should be reviewed by the auditors as part of their audit.

These changes were, according to verbal accounts, made about 2 years ago. This is borne out by the further information from the PROINVER office that this agreement is to be renewed for year three in October of 1991. Furthermore, the premiums and losses from PROINVER's office shows that both the 1989/1990 and 1990/1991 crops of sugar and coffee were covered. It appears that this business may have generated losses over the two years, although these losses are not desegregated by cause. Thus, it is not clear which were fire losses and which were caused by terrorist attacks. Of the C.3 million in losses paid, there is one recent large loss of about C.1.2 million reported to be due to fire.

There is no basis in the agreements and PIL's for the modification of the deductibles. In a single loss, the application of this deductible has cost the PROINVER program about C.250,000. There may be other cases in the current and past policies where the PROINVER funds have been used to pay fire losses with this insignificant deductible applied to the indemnity. Only the contemplated external audit will be able to clarify whether and to what extent these funds have been used in ways not contemplated by the agreement.

The initial agreement did permit the issuance of fire insurance in cases where no company was prepared to issue fire coverages, but this was contemplated as a special case and not designed to cover an entire class of business. There is no basis for insuring transport risks in PROINVER.

The documentation in the Mission's files indicates that a request was made to include these products (coffee, sugar and cotton) but did not mention the changes in the terms and conditions. There is no communication from the PROINVER office informing the Mission that these changes had been made and put were effect.

The proposed coverages for the October 31, 1991 renewal would expand the coverage of coffee from C.226 million to in excess of C.620 million. In a 30 September 1991 letter from PROINVER to the BCR, PROINVER proposes a continuation of the fire and transport coverages, a 1% deductible with a maximum deductible of C.50,000, and a premium rate of 5.25/mil. This rate is below the rate of the preceding year, not withstanding the losses in excess of premiums, and marginally lower than the rate set in the agreements. Bear in mind that this rate appears to be for: fire, allied lines, transport, and terrorist coverage. Fire coverage in the Salvadoran market is usually around 3 per mil.

The modification of the deductible is especially serious, as the coverage is on agricultural commodities which have very volatile prices. The modification of the deductible introduces an element of moral hazard. In the case of a sharp decline in the price of the sugar or coffee, due to price fluctuations in world markets, the insured goods, in some cases, can more profitably be "sold" to the insurer through a fire loss rather than in the marketplace. The insured collects the full insured value, irrespective of the market value, minus only an insignificant C.50,000 deductible.

The issuance of fire and transport insurance has fortunately had only a modestly adverse impact on the overall financial results of PROINVER over the past two years. If this business is sold on a commercial, not a concessional, basis, there are sound reasons that the Mission may want to consider allowing it to continue. In fact, as a commercial decision, the inclusion of fire insurance has several important aspects to recommend it. First, fire and transport insurance and reinsurance is generally quite good business. Second, it should generate additional premium, as the terrorism insurance is sold as a rider with additional premium added to underlying fire or transport business.

Third, it is apparently the situation that the industry could not obtain fire insurance on coffee and sugar warehoused in and transported from the eastern part of the country in 1989, thus the companies of the Consortium ceded 100% of the risks to PROINVER. The following year, the commercial industry began to reenter the market, based in part on the favorable results of 1989-1990, and the pool ceded 52% of coffee and sugar risks. In 1990-1991, the cession is about 55%. The use of PROINVER to meet a temporary withdraw of the commercial market is in the spirit of the initial agreement. However, the method used to do so clearly violates the spirit of the agreements.

LEVERAGE RATIO OF THE RESERVES:

The current leverage factor is 4 to 1. At present, PROINVER can accept risks up to C.1.2 billion. Given current total PROINVER liability of C.900 million, it can still write an additional C.305 million without modifying either the leverage ratio or the amount of funds in the reserves.

It is doubtful that there are many additional industrial risks that can be covered. The market for terrorist cover in this segment of the portfolio seems to be largely saturated. Until there is a significant increase of investment in the industrial sector, or until the items that can be insured is modified, the demand for terrorist cover is unlikely to grow rapidly.

There is however a very substantial demand for insurance on the newly privatized agroindustries inventories, especially coffee and sugar. As noted above, the proposed coffee coverages would increase to excess of C.600 million and more than absorb the remaining C.305 million of coverage that can be written at the present 4 to 1 leverage ratio. If the value of the coffee and sugar is to be covered, and additional coverages on other exports, such as sesame and honey are to be issued, the leverage ratio must be expanded.

Expanding the coverage to these more exposed areas and items is likely to increase the rate of losses. If C.600 million of coffee is covered, this is a massive concentration of risk. This is especially so if PROINVER also covers some portion of the fire and transport risks. A concerted effort to destroy the coffee as a means of applying economic pressure to the government could result in a major loss to PROINVER.

Not withstanding this concentration, if the historical record is the basis upon which a judgement is made, the leverage can be expanded significantly without endangering the fund. While recognizing that the recommendation to increase exposure in coffee and sugar in the eastern zone is not one that a prudent commercial insurer would likely take, the developmental nature of PROINVER and the efforts made by the Mission to reactivate the Salvadoran economy would justify taking somewhat more risk than would be commercially acceptable.

From a commercial point of view, no prudent insurer or reinsurer would take such a concentration of risk without reinsurance to spread it and protect against a "worst case" event. In the past, reinsurance has been proposed to protect the PROINVER reserves. At that time the Banco Central opposed it. The present position of the BCR could not be ascertained at my meeting with the Bank President's Assistant.

UNDERWRITING RESULTS:

The cumulative underwriting results have been mildly negative. As of 31 December 1990, PROINVER had collected a total of C.6 million in premiums since initiating operations in 1987 and paid C.11.1 million in indemnities for a net loss of C.5.1 million in four years of operation. The pure loss ratio (indemnities/premiums) was 185%, or 85% more than the PROINVER's premiums.

The premiums paid to PROINVER in the first 9 months of 1991 are almost C.3 million. Losses, including loss adjustment and settlement expenses are about C.2.4 million. The underwriting profit for PROINVER was slightly in excess of C.500,000 before PROINVER's administrative expenses of just over C.300,000.

Over the life of the project, premiums paid to PROINVER are about C.9 million (out of a total of roughly C.12.5 million collected by the Consortium) and losses paid are about C.13.5 million. The net losses are therefore about C.4.5 million in excess of premiums collected (C.13.5 - C.9 million) in four years of operation. The losses have averaged only about C.1.25 million a year, a sum far lower than the expected damage rate at the outset of the program and quite modest indeed given the circumstances in El Salvador over the past five years. Indeed, such losses appear to be remarkably low.

Even bus losses have been lower than expected. To date, losses on buses have totaled about C.3.8 million on a premium of about C.1 million for a net loss of about C.2.8 million. Here, moral hazard continues to be a significant factor.

ADMINISTRATIVE EXPENSES:

The cumulative administrative expenses incurred by the program, including equipment, was about C.392,000 through the end of 1990, or about 6.5% of premium income to PROINVER over the same period. In the first 9 months of 1991, the expenses rose to just over C.300,000, due primarily to the establishment of a full time office staffed by four people. As a percentage of PROINVER's premium, it represented about 10%.

In addition to the above administrative cost of C.692,000, PROINVER paid commissions to the insurance companies. One can estimate the amount of these commissions based on the premium income of PROINVER. PROINVER received premiums of about C.9 million. Total premiums over the life of the project before commissions should be about C.12.5 million (PROINVER's C.9 million divided by 72%). Of these C.12.5 million, PROINVER recognized a commission of 20%, or C.2.5 million, to the companies. If this amount is added to the C.692,000 administrative expenses, total administrative costs sum to about C.3.2 million, or about 26% of total premiums.

These expenses are not in excess of those that characterize most commercial lines of business. A "load" of 30% (including agents' commissions) is considered as an industry standard in property insurance business. On balance, PROINVER has been run efficiently and has incurred reasonable administrative expenses.

In fact, the 20% commission paid by PROINVER (actually 22% on ceded premium) is about 10 points lower than that paid by commercial reinsurer to acquire fire business. This is the category in which "riot, strike, and civil commotion" coverage is usually written. The commission structure was designed to provide an incentive to the companies to move their insurance to private reinsurance markets as soon as they could obtain the coverage in order to increase their commissions.

It should be pointed out that the program's original design was to utilize the insurance industry as a largely fee-for-service delivery vehicle for the terrorist insurance coverage that they could not obtain because the commercial markets had withdrawn from El Salvador. While they have clearly generated a considerable cash from PROINVER activities, as these are only a marginal cost added to their normal operations, the profit appears to be relatively moderate and not out of proportion to the administrative and managerial time dedicated to the project.

The C.2.5 million or so of commissions paid to the companies are divided between a fluctuating number of companies (between 8 and 13 at different times) represent about C.625,000 per year in the four years of the project. The amounts were not equally divided, but instead are based upon the amount of business that each company wrote. Thus, several of the larger companies realized most of the commissions.

In the first 9 months of 1991, the level of commission payments have accelerated due to the sale of fire and terrorism business in coffee and sugar and the increased number of buses insured. As of 31 August, PROINVER's premiums had reached almost C.3 million. This implies that total premiums were around C.4.2 million, with about C.840,000 being paid in commission to the industry. A projection of the total commissions for the year would be in the range of about C.1 million.

It should be noted that I do not yet know with certainty whether the new fire business has been treated in the same manner as the terrorism business. That is, one cannot yet ascertain whether fire business has been reinsured by PROINVER at a 20% commission on the percentage ceded to it or whether the industry has subtracted a 20% commission on the total premium while ceding a lesser portion.

INVESTMENT INCOME OF PROINVER:

Interest incomes of C.7.4 million on the funds held at interest in the commercial banking system more than offset the underwriting losses and administrative expenses and produced a modest profit of C.1 million through the end of 1990. In the first three months of 1991, investment income derived from C.14.5 million held at 19% interest added C.1.8 million to the underwriting profit. All of these assets are currently held in commercial banks at the interest rate paid on time deposits.

RESERVE MAINTENANCE AND PROTECTION:

In real terms the reserve has been and continues to be decapitalized by inflation. The decapitalization is especially notable if the value of the reserve is stated in constant dollars. The long term ability of PROINVER to sponsor and promote development through insurance and other financial activities is severely imperiled by holding the reserve, currently C.287 million, in non-interest bearing accounts.

Table One below contains a calculation of the constant Colon value of the reserve with rates of inflation ranging from 10% to 30%.

> The 10% rate would represent a modestly optimistic scenario of a moderate paced recovery without inflationary price pressures and in which capital continues to be repatriated either for investment or to enjoy the currently available positive interest rate spread between the passive rates and the underlying inflation rate.
>
> The 30% inflation rate represents a scenario in which the recovery stagnates, capital again flows out of the country, liquidity dries up and the cost of capital rises significantly.
>
> In either case, or any of the intermediate cases, inflation's impact on the PROINVER reserve is a severe erosion of its value and a loss on the part of the Mission to utilize these funds for further development activities.

TABLE ONE
IMPACT OF INFLATION ON THE
PROINVER RESERVES
(287 MILLION 1991 COLONES)

CONSTANT 1991 COLON YEAR END
RESERVE VALUE WITH
INFLATION RATE
(Rounded to the nearest million)

YEAR	10%	15%	20%	25%	30%
1991	258	244	230	215	201
1992	232	207	184	161	141
1993	209	176	147	121	98
1994	188	150	118	91	69
1995	169	127	94	68	48
1996	153	108	75	51	34
1997	137	92	60	38	24
1998	124	78	48	29	17
1999	111	66	39	22	12
2000	100	57	31	16	8

Given that inflation for the current year is around 14%, the erosion of the real value of the reserve of C.287 million held in the BCR is a loss of value of over C.40 million between January and December of 1991. This is far more severe than the relatively moderate underwriting losses, which are largely offset by interest earnings on the small amount of funds held at interest.

TABLE TWO
IMPACT OF INFLATION AND DEVALUATION ON THE PROINVER RESERVES
(287 MILLION 1991 COLONES= $34.17 MILLION)
AT A 5% ANNUAL EXCHANGE RATE DEVALUATION

DOLLAR VALUE AT YEAR END
(Rounded to the nearest million)

YEAR	EXCHANGE RATE	INFLATION RATE 10% C.	10% $	15% C.	15% $	20% C.	20% $	25% C.	25% $	30% C.	30% $
1991	8.4	258	31	244	29	230	27	215	26	201	24
1992	8.8	232	26	207	23	184	21	161	18	141	16
1993	9.3	209	22	176	19	147	16	121	13	98	11
1994	9.7	188	19	150	15	118	12	91	9	69	7
1995	10.2	169	17	127	12	94	9	68	7	48	4
1996	10.7	153	14	108	10	75	7	51	5	34	3
1997	11.3	137	12	92	8	60	5	38	3	24	2
1998	11.8	124	11	78	7	48	4	29	2	17	1
1999	12.4	111	9	66	5	39	3	22	2	12	<1
2000	13.0	100	8	57	4	31	2	16	1	8	<1

The erosion of the value of the reserve may in fact be more rapid than shown in Table One if the Colon is devalued against the dollar in future years. If one was to suppose that over the forthcoming decade, the Colon be devalued against the dollar at an average rate of 5% per year, Table Two illustrates the combined impact of inflation and devaluation when the value of the PROINVER reserve is stated in dollars. Even a reasonably optimistic scenario of 10% inflation and a 5% per year slide in the exchange rate, reduces the dollar value of the reserve by nearly one half in 5 years. It is halved again by the year 2000.

The Colon has already declined from 5 to 1 to the present 8 to 1, reducing by almost 40%, or $22 million, of the dollar value of the PROINVER reserves. Furthermore, the current inflation rate of 14% is quite low compared to most of Latin America. Thus, these assumptions seem conservative in the current situation. Unless action is taken to protect the reserves, they will be destroyed by a combination of inflation and devaluation.

MONETIZATION AND MAINTENANCE OF AN ADEQUATE RESERVE:

From a technical point of view, there is no justification for retaining the present level of reserves to support the terrorist insurance program. Unless one postulates a massive increase in the level of economic damage caused to the insured goods by terrorist attacks, the reserve is far larger than it need be to support the current amount of coverage issued by PROINVER.

In the 4 years that the program has been in effect, the total amount of indemnities in excess of premiums is about C.5 million, or about C.1.25 million per year. Even if one postulates a ten fold increase in the level of losses, the reserve would appear to be far too large for the level of damage caused by insured perils.

The reserve can only be protected by a monetization and by investing the reserve in financial assets that pay a real rate of interest or in investments that appreciate at least as rapidly as inflation. Traditionally, insurance companies are one of the major sources of long term capital. In the case of PROINVER, the Mission may not wish to undertake the oversight of the management of a substantial investment portfolio and will choose the route of investing in interest bearing accounts of different maturities.

Protecting the reserve against the effects of inflation, and partially against the effects of devaluation, by monetization will have the result of generating cash inflows far larger than are needed by PROINVER. In fact, C.287 million invested at 19% would generate over C.54 million in the first year. The reserve, if held at this interest rate, would be valued at over C.1.7 billion in a decade (although the value in 1991 Colones would depend upon whether real interest rates were positive or negative over the period).

Should the entire reserve be monetized, under current circumstances only about C.150 million are needed to support PROINVER activities, even at the new 6 to 1 leverage ratio. This would produce an interest income of about C.28.5 million (in addition to the interest on funds currently held in commercial banks) at the current 19% interest rate in the first year. At the present real interest rates, the interest income on C.150 million would be sufficient to cover both the effects of inflation and substantially higher loss ratios arising from insuring larger volumes of coffee and sugar in the eastern zones. Leveraging this amount at a 8 to 1 rate with a stop loss reinsurance would also be reasonable.

ALTERNATIVE USES FOR PROINVER FUNDS:

The monetization would free up over C.150 million that could be used for other economic reactivation programs. Concretely, the Mission could undertake further insurance and guarantee programs to leverage additional investment and help foster economic growth by using these funds in new and innovative programs.

The use of financial guarantees and insurance for the timely payment of principle and interest of some financial instruments appears conceptually to be worthy of exploration and development. Using funds freed up by monetizing the PROINVER reserve to guarantee payment of principle and interest on various classes of long term debt would help create and develop a long term capital market. Financial strengthening of the debt market could be fostered by developing a small agency which established "conforming loan" criteria and buys from financial institutions whose loans are made in compliance with these guidelines.

The long term debt market could be further deepened by repackaging these debts in the form of collateralized obligations and placing them with long term investors either through direct placements and/or through the use of the new stock market as a sales and pricing mechanism. Investors would be encouraged to make longer term investments in return for rates in excess of what they could earn by depositing funds in the banks. They would still enjoy reasonable liquidity via the stock market should they want to sell the obligations before maturity.

Furthermore, if the agency could "rate" the debt according to the borrower's credit worthiness and charge a premium that reflected the risk of default, it would be possible both to create a service much like Moody's or Standard and Poor's bond and debt rating services. Investors would know the riskiness of the debt they are buying and could agree to take a somewhat lower yield by in effect purchasing insurance against default.

Some portion of the funds backing these loans placed in dollar denominated assets (see Recommendation Five), would permit hard currency operations, offering the opportunity to individual and institutional Salvadoran investor the opportunity to purchase long term debt without the devaluation risk. At the same time, it would enable local enterprises to borrow in dollars for activities that require hard currency (for example, acquisition of capital goods). The new stock market could make a market in these collateralized and guaranteed obligations. Such a system would not only help reliquidify the financial institutions originating loans, but would also help establish a secondary market, which is essential to building a long term capital market.

These types of activities provide attractive investment opportunities that would help anchor Salvadoran capital and would be an inducement to return to El Salvador some of the expatriated capital. If the rates paid by these instruments were sufficiently attractive and the guarantees offered by the agency deemed acceptable, capital could be attracted from outside of El Salvador. This would especially be true if some or all of the repackaged paper could be dollar denominated.

As these types of financial instruments generally pay several points more than the deposit rate at banks (currently around 19% with about 14% inflation, or a 5% positive real interest rate), they would prove very attractive to investors prepared to make longer term commitments in return for a higher yield, but would still retain reasonable liquidity.

The prefeasibility study of utilizing some of PROINVER's investment product, once it is monetized, could be carried out with about 8 person months of effort and should cost about $150,000 to $250,000, principally in consulting expertise and in travel costs. Following this prefeasibility study, the Mission would be in a position both to make a decision and to determine the most appropriate institutional structure for the new guarantee agency (or agencies). The prefeasibility study would also address the creation of a secondary market, utilizing the stock market as a pricing mechanism and the guarantee agency's repackaging some of the loans in dollar denominated instruments.

<u>IMPACT OF PROINVER ON INVESTMENT:</u>

The question of the impact of PROINVER on investment in El Salvador is a difficult one indeed to answer. Insurance by its very nature seldom impacts directly on the rate of investment. It is but a single factor in making an investment decision. I know of no single case where insurance is the single factor that can be said to have produced a specific investment. Its availability will make a given investment alternative more attractive; conversely, its absence will make it a less attractive option. Only in rather rare cases when the risk is perceived as very high is insurance a decisive factor that will sway an investment decision.

Unfortunately the reputation of El Salvador is far worse than its reality. Recently, <u>Fortune</u> Magazine rated El Salvador as the second most dangerous place in the world (after Peru) for executives, not withstanding that in recent years not a single one has been kidnapped or killed. Investors also pay close attention to rankings of riskiness developed by organizations such as <u>The Economist</u> (London) Intelligence Unit. Recently the Intelligence Unit gave El Salvador a composite (composed of political, financial and economic risks) below countries such as North Korea, Mali, Nicaragua, and Vietnam and only marginally above India, Mozambique, Yemen, Cuba, Bangladesh and Lebanon.

One cannot point to investment that has been attracted to El Salvador as a result of PROINVER. However, it is clear that the PROINVER program, combined with other initiatives, has helped keep the existing investment from fleeing during the worst years of the conflict. It has been an important element in sustaining critical sectors which have been the target of the FMLN.

The public transport system was especially hard hit by constant attacks. These public buses are especially critical to maintaining communications with the provinces and to low income people who use it to get to and from work. Despite constant attacks and burning, the insurance has been there to help the owners replace their buses and keep operating.

In the coffee and sugar industries, which employ large numbers of rural workers and were prime targets of attacks seeking to destroy employment and exports, thus creating unrest and loss of export earnings, the insurance program appears to have been successful in helping to maintain investment and restore job creating investment at a surprisingly low cost.

In conversations with all parties, the most repeated comment on PROINVER is that it provided a guarantee that those who chose to remain at their industries during the crisis years have the support and backing of the program in case anything happened. The effect of PROINVER was rather like that of life insurance on our daily lives. One does not buy it in the expectation that our heirs will collect, but instead to enable us to plan for an unexpected event. The impact of PROINVER has been the alteration of perceptions--that economic life can go on in very difficult times without undue concern about guerilla attacks

ACCOUNTING AND AUDITING:

The PROINVER accounting system is presently deficient. First, no external audit has been carried out. Second, all insurance and reinsurance accounting should be done on the basis of 100% of total premium. At present, one can only deduce mathematically what the total premium and commissions are. PROINVER has no accounting for the total premium generated by the program or of the commissions deducted by the consortium before forwarding the balances to PROINVER. Currently, the accounting system does not distinguish the fire and transport insurance premium from the terrorist premium.

The accounting should be changed to show the entire amount of premium collected, the 20% commission and 90/10% sharing of the remaining premium. This amount should, of course, be congruent with the amount remitted. At present, one can only estimate the approximate amount of premium collected and the commissions paid.

The stop loss reinsurance of 150% of the system's premium should be accounted for separately and by category. Accounts need to be stated at 100% of premium to determine the "entry point" for the stop loss reinsurance indemnity. Any stop loss indemnities paid needs to be accounted for separately, not included in the general indemnity accounting.

The fire and transport insurance may also have come under the stop loss protection. As the stop loss is 150% of premium of the system, the likelihood of loss is significantly increased as the protection is for BOTH fire and terrorist losses. If the stop loss protection has been used to indemnify the Consortium for fire and transport losses, it needs to be desegregated from other indemnities. The auditors should establish an accounting system for the stop-loss provision.

In the present circumstances, it is pressing that the audit be carried out as soon as possible. This audit should be carried out by a firm with expertise in insurance and reinsurance auditing and should focus not only on source and use of funds but also on compliance with agreements. The auditors should conduct a due diligence audit that reviews all the documentation of the Acceptance Committee, the Junta de Supervisores, and any relevant decisions made by the Board of Directors of the BCR.

Without complete accounting, there is no way of knowing whether the consortium's companies have calculated correctly their commissions and have, in fact, ceded the stipulated portion of business and the corresponding premiums.

The timing of the payment of the premiums due to PROINVER should also be reviewed. In periods of high interest rates, holding funds is a source of additional profits.

In reinsurance, insurers generally submit a premium and loss bordereaux which contains on a policy by policy basis the total premium and its application to different account. The auditors should be tasked to develop and implement such a system.

While no irregularities have been noted in the documentation, given that the consortium has modified the system without the Mission's knowledge, a more complete and sophisticated accounting system should be implemented as soon as possible to account for all funds in the system, however used, not just the balances forwarded to PROINVER. Unless this is done, USAID cannot determine precisely the total premium collected for PROINVER's terrorist (and now fire) insurance, nor the exact amount of commission paid to the companies.

<u>MISSION COORDINATION WITH THE COMITE DE ACEPTACION AND THE JUNTA DE SUPERVISORES:</u>

The Acceptance Committee has for all practical purposes ceased to be an instrument which monitors compliance with the basic agreement. The same must be said of the Junta de Supervisores. Likewise, both seem to have forgotten their responsibility to coordinate the utilization of PROINVER resources with the Mission. The management of PROINVER of late seems to have made little or no effort to inform and involve the Mission in the program.

One clear example that has come to light is that the Comite de Aceptacion and, apparently the Banco Central, permitted acceptances not contemplated by the basic agreements, as modified, and significantly altered the term, conditions, and premiums. According to the available documentation, it would appear that the leverage was to be increased for the 1991-92 crop to permit even more coffee and sugar to be insured under both the fire and terrorist cover without Mission involvement.

Apparently, what happened was that as these industries moved back to private hands, the commercial reinsurer were reticent to enter this market. PROINVER's acceptance the first year of 100% of the risk gave the commercial market an opportunity to see what the results would be. When the results were good, they began to enter the market and continue to do so. PROINVER, in effect, became through the decision of the acceptance committee a substandard risk pool, until such time as commercial fire reinsurers are prepared to enter the Salvadoran market.

In one particular case, the acceptance committee has clearly abused PROINVER. This is the case of a coffee "beneficio", which suffered a large loss. In this particular case, the reinsurance was shared with the private reinsurance market. However, when the private market was not prepared to write additional coverage on increasing inventories of coffee, the percentage participation of PROINVER was steadily increased from 60% to excess of 75% on an increasing sum insured (as would be expected in a coffee beneficio which accepted coffee for processing). In fact, the acceptance committee increased the sum insured and the percentage of the cession to PROINVER the day after notification of a large loss. While the insurer notes that loss was adjusted at the former sum insured, this argument does not address the basic issue of the authority to write and to continue to increase the sum insured after a loss.

The amount of coffee burned was multiplied by its market price and an indemnity was paid. The deductible was applied on the sum insured at the time of loss, but it was only 1%, with a maximum of C.50,000. As the sum insured was C.37 million, the deductible was a slight .135% of the sum insured. This, in turn, implies that PROINVER lost a very substantial sum of money by not applying a deductible of 15% on the former sum insured at the time of loss, but instead subtracting only C.50,000. How the loss settlement costs were allocated between PROINVER and the commercial market, is not known at present.

PROGRAM CONTINUATION:

It is not yet the case that PROINVER has outlived its usefulness as a mechanism to help protect existing investment and to permit it to recover after a terrorist attack, as well as helping to sustain vital transportation and exports.

The Peace Process probably does not imply that politically motivated attacks will disappear. In fact, they may not even decline. One could envision a scenario in which the military units on both sides are demobilized and cannot be immediately reincorporated into the economy. As a result, they may turn to illegal activities.

Likewise, the peace could help speed the rate of investment in El Salvador. This new investment would likely create a demand for new PROINVER coverage.

The PROINVER program is self regulating. It is based on voluntarily purchased insurance. If and when business no longer feel that political violence is a threat, they will be unlikely to continue buying it. When coverage begins to decline sharply the Mission will know that the insures do not think that the cover is necessary. Likewise, given that commercial market commissions are higher than those of PROINVER, the insurance industry will move the "riot, strike, and civil commotion" cover to commercial reinsurance markets as soon as those markets are again prepared to write it.

On balance, it would seem prudent to continue the PROINVER program until the peace process is completed and one can determine what the post war situation will be. Clearly, there is a strong and growing demand in coffee, sugar and other agricultural commodities for the PROINVER cover. The coverage in other sectors, such as industry has not yet begun to decline. The commercial reinsurance market is not yet prepared to write this cover. Thus, there is a strong reason to continue the program.

SUCCESS OF PROINVER: THE LESSONS LEARNED

PROINVER has been on balance a highly successful program. One must go back to the rather grim days of 1985-1986 to put this success in context. The Mission was able, despite the prevailing chaos of those days, to contact and negotiate with an industry under threat of nationalization a program to protect productive assets by providing a guarantee when international reinsurers had effectively withdrawn from the country.

This is the first time that USAID has been able to work with the insurance industry and the first program that has used a private sector approach to confront a crisis provoked by a systematic program of economic sabotage. Both are very important milestones in developing a new USAID strategy in El Salvador and in other developing countries.

Although USAID has traditionally worked with banking, and to a lesser degree, other financial intermediaries, this is the first program with the insurance industry. Insurance, typically, is the second largest source of capital (after banks), especially long term investment capital. Despite the importance of insurance in the capital markets of developing countries, USAID has not traditionally worked with the industry to assist in channeling this capital to development oriented projects.

Furthermore, the PROINVER program has been remarkable in that it was able to persuade the insurance industry to participate in the risk sharing arrangements for the terrorist coverage and was able to carry out the program at virtually no cost. That is, the premiums and the interest earnings more than offset the losses incurred under the program.

The local currency funds held in a "sterilized" Central Banks account to prevent them from entering the economy and producing inflationary pressures, were still used for development purposes. These funds are use as the backing for the terrorist insurance. This is a quite innovative way to permit funds held in sterile accounts to do double duty.

Perhaps the most impressive result to arise from the PROINVER project is that USAID has had the opportunity to appreciate first hand that the insurance industry can be a vehicle of development when it is approached with innovative insurance and guarantee programs that make business sense to the industry. When USAID can develop innovative programs of insurance and guarantees, the local insurance industry can be involved in a management and risk taking capacity. This in effect opens the door to a substantial source of capital that has not been tapped to date.

As suggested above, there are a wide range of insurance and guarantee activities that can be undertaken jointly by USAID and the insurance industries to jointly promote development. In fact, the range of activities in which USAID protects private capital against the unknown risks of a new venture are more limited by imagination than they are by financial constraints. One could imagine for example the utilization of local currency and dollar funds to provide financial guarantees for a broad range of development activities. This use of insurance and guarantees serves to leverage substantially larger injections of private sector funds than would direct financial activities, such as supplying capital for loans or grant funds. What has happened with PROINVER is that USAID has had an opportunity to appreciate that insurance is, in effect, banking under in a different guise and that there are a wide range of development opportunities arising from a collaboration with the industry.

RECOMMENDATIONS:

RECOMMENDATION ONE:

a) An external audit should be carried out as soon as it is possible to contract auditors who have expertise in insurance and reinsurance. This audit should consider financial, administrative and "due diligence" aspects to clarify exactly what has happened in the case of the inclusion of fire and transport insurance and the modification of the deductible.

b) The Mission should move expeditiously to halt the issuance of fire and transport insurance until the situation surrounding the inclusion of this coverage are clarified to the satisfaction of the Mission.

c) The Mission should notify the Banco Central and the Junta de Supervisores of PROINVER that neither the inclusion of fire and transport insurance, nor a modification of the deductible to 1% with a maximum deductible of C.50,000, have been approved by the Mission, as stipulated in the agreements. Likewise, the expansion to include up to C.620 million of cover for coffee during the 1991-92 renewal should not proceed until the Mission is involved in the process of review and approval through the issuance of a PIL.

d) The profit and loss generated by fire and transport insurance should be researched during the audit and any unauthorized losses produced by undertaking this business should be repaid to PROINVER.

e) There is, in my view, an argument for providing temporary fire coverage on coffee, sugar and other agricultural commodities in the Eastern zone of the country, if it cannot be obtained in commercial reinsurance markets in adequate volumes to cover these crops in storage and transport. That decision, however, should be made in conjunction with the Mission.

f) I would recommend that a temporary authorization for covering a portion of these fire and transport risks on a co-reinsurance basis with the commercial market be considered by the Mission. The authorization should be temporary, as this business can now be partially reinsured in commercial markets and in all likelihood, if losses remain modest, can be moved completely to the private market. An authorization for not more than 3 years, with a declining percentage of the fire and transport ceded to PROINVER would be appropriate. For the 1991-92 renewal, the portion should not exceed 50% and should decline by 15% per year for the next two years.

If PROINVER is to co-reinsure, the reinsurance agreements must be made available to PROINVER and should be presented to the

Comite de Aceptacion at the time that cover is requested. The business must be carried out on an open basis, instead of as in the past, with all reinsurance documentation made available to PROINVER and the Mission.

The proposed expansion to include over C.600 million of coffee, sugar, and cotton stock should be considered together with the leverage issue (see below).

g) I see no reason to modify either the terms or conditions of the PROINVER program. PROINVER was not designed to offer commercial coverages but instead to provide protection of highly exposed risks that were not acceptable to the commercial market. The terrorist premium should be retained and the deductible should be kept at 15%.

h) The stop loss protection should not apply to the fire and transport insurance. As the companies' retention are quite small, usually in the range of C.150,000 per risk, there is no reason for a stop loss protection. If they wish to stop loss their net retained lines, they should be able to do so in commercial markets.

RECOMMENDATION TWO:

PROINVER can be safely leveraged further. When the results of the program are reviewed, it is apparent that the net underwriting losses (indemnities less premiums) have been remarkably small. The present rate of underwriting losses is not seriously decapitalizing the fund. A leverage of 6 to 1 would seem to be indicated in the present circumstances.

It is not a commercially prudent decision to accept a massive exposure in coffee and sugar, especially in the eastern part of the country without a catastrophic reinsurance protection for a worst case scenario. It is strongly recommended that the Mission determine if the Banco Central's view on reinsurance has changed, and if it is prepared to authorize disbursements for reinsurance premium.

If reinsurance protection, probably on an stop-loss basis, can be placed in commercial markets to protect the fund against losses excess of about C.5 million per year, the leverage can be increased to 8 to 1.

RECOMMENDATION THREE:

The underwriting results have been negative, but have not produced unacceptably high losses. There is at present no reason to modify either the original premium rates or the policy terms. The losses should be carefully monitored by the Mission. Should they begin to rise, it may be necessary to intervene to protect the fund.

Buses are a special case where it is clear that moral hazard is a significant problem. The reported bus burnings by the left are apparently declining; so too should the losses. If this is not the case, further action, such as increasing deductibles and premiums will be required. The program should be subjected to a periodic independent verification that the inspection and adjustment system remains effective in reducing fraud losses. A specialized loss adjusting firm could carry out this responsibility quickly and at a low cost.

RECOMMENDATION FOUR:

a) One of the audit's tasks should be to determine exactly how much commission, especially on the unauthorized fire and transport insurance, has been paid to the consortium. It is important to determine if commission last year was paid at the 20% of total premium allowed by PROINVER for terrorism coverage or if it was paid at the rate of 20% of the premium ceded to PROINVER. Should the former be the case, the companies have been overpaid, as they would also have received commission on the premium ceded to commercial reinsurer.

b) If the Mission opts to permit the temporary insurance of fire business on coffee and sugar, most of which will probably be located in the eastern part of the country, the commission scale should be the same 20%. However, the commission is payable only on the portion of business ceded to PROINVER, not on total premium, as other reinsurer will pay commission on the premium ceded to them.

c) Commission levels have now reached a level where they are a source of profit to some of the insurance companies that write substantial volumes of PROINVER cover. PROINVER was intended as a stop-gap program to meet a temporary withdrawal by the private reinsurance market, not as a commercial venture, and the commission was intended to meet administrative costs, not provide profits.

The Mission should negotiate a cap on the consortium's commissions before authorizing a massive expansion in coffee and sugar sums insured. An inverted sliding scale is one option. For each additional C.10 million of coverage written in excess of the present limits, the commission will decline by 1% until it reaches 10%. At this level, the commissions should cover administrative costs without providing much profit.

RECOMMENDATION FIVE:

a) PROINVER's reserves should be monetized in order to protect them against the steady erosion arising from inflation.

Once they are monetized, assuming that a positive spread over the inflation rate can be achieved by investing them in time deposits, the amount of funds backing the PROINVER insurance obligations should be reduced to C.150 million.

The monetized reserves, to the degree possible, should be used to acquire dollar denominated assets, such as U.S. Treasuries, to offset the impact of future currency devaluations on the value of the reserves.

b) Should the funds currently held in the BCR not be monetized, no drawdown of the reserve should be contemplated. Likewise, if reinsurance is not in place to protect against unexpectedly heavy losses, a leverage ratio of 8 to 1 is inadvisable.

RECOMMENDATION SIX:

The Mission should undertake a prefeasibility study of additional financial insurance and guarantee activities that would utilize the C.150 million not required to back PROINVER activities. The activities that appear to hold substantial promise to use C.150 million are:

a) To establish a system to purchase, repackage and sell through direct placements and/or the stock market "conforming" long term debt obligations and loans.

b) To use the same system to also issue guarantees on loans made to small and medium enterprises, among others, by financial institutions that originated such loans in conformity with the guarantee agency's guidelines.

c) To establish dollar denominated activities which permit local enterprises to borrow internally in hard currency for dollar denominated activities such as the import of capital goods. The purpose of these activities would be to broaden, strengthen and deepen the Salvadoran capital market by offering local investors the opportunity to earn dollar denominated assets without having to send their capital abroad.

RECOMMENDATION SEVEN:

An external audit should be conducted as soon as feasible.

a) Among other tasks, the auditors should establish an accounting and auditing system for PROINVER that accounts for 100% of the premium and any deductions therefrom, such as commissions. The external auditors should verify that the balances paid to PROINVER are in agreement with the stipulated terms.

b) The Mission should have PROINVER forward an audited statement with the auditing notes on a quarterly basis and should review this statement for compliance and completeness.

RECOMMENDATION EIGHT:

a) The Mission should reestablish an active role by strengthening its oversight of the Comite de Aceptacion and the Junta de Supervisores activities. The minutes of their meetings should be sent to PRE Project Manager.

b) The Mission should also review the existing "Reglamento", in order to include all administrative details, and to define the PROINVER Office staff's responsibilities and reporting requirements. This will help in a better understanding of all parties attributions and responsibilities, as well as provide the Mission with better control of implementation details.

c) A healthy measure to be negotiated with the Central Bank and to be included in the new Reglamento, would be to ask the BCR to name different representatives to the Comite de Aceptacion yearly, or not to renew their appointments for more than two consecutive periods.

RECOMMENDATION NINE:

The PROINVER program should continue to provide protection against politically motivated activities for the present. This should continue until it is clear that the danger of a resurgence of politically motivated destruction of economic asset has passed.

The program should be reviewed in about 2 years time to determine if its continuation is still required by the circumstances in El Salvador.

The experience of the PROINVER project has much to recommend that other Missions study the experience gained. It has demonstrated several lessons that can be applied in other developing countries.

First, this is the first project in which USAID has worked closely with the insurance industry. That close collaboration had demonstrated that there is a significant development opportunity to be realized through collaborative ventures with the insurance industry.

Second, this collaboration has enable the USAID to carry out a project (a) while keeping the guarantee fund intact and (b) at essentially no cost. Working closely with the insurance industry can be a very inexpensive way of achieving substantial developmental impact.

Third, working with the insurance industry appears to hold substantial promise for broadening and deepening financial markets, as well as mobilizing long term investment capital by using the leverage implicit in insurance instead of making direct commitments of capital.

Fourth, in these type of projects the insurance industry can be induced to accept a share of the risk, and unlike other types of guarantee funds, can be used to insure that the project is run on a commercial, bottom line oriented basis.

Finally, it is clear that when USAID works with commercial entities that seek to make and maximize profits, a well designed system of continuous supervision should be reviewed periodically.

USAID EVALUATION SUMMARY

PART I: ACTIONS

E.

Actions Required

1. Undertake an external audit as soon as auditors with expertise in insurance and reinsurance can be contracted. Contract a financial, administrative and "due diligence" audit. Task the auditors to develop a comprehensive financial reporting system based upon 100% of premiums.

2. Notify the BCR and the Consortium that the Mission does not agree to use PROINVER funds for fire and transport insurance unless and until the terms of this coverage are negotiated with the Mission and ratified in a PIL. Advise both that the Mission does not accept the unilateral modification of the deductible.

3. Negotiate and increase in the leverage of PROINVER to 6 to 1. Leverage PROINVER at 8 to 1, if the BCR agrees to stop loss reinsurance coverage to protect against unexpectedly high losses. If PROINVER is further leveraged, negotiate a commission rate cap on total commissions with the Consortium of insurers.

4. Negotiate as expeditiously as possible the monetization of the reserves to prevent them from being destroyed by inflation and devaluation. Once monetized, reduce the PROINVER reserves to C.150 million and reprogram remaining funds.

5. The PRE Project Manager periodically should review the lines of communication between the Project and the Mission to insure that the Mission continues to receive a full, complete and timely flow of information about the development of the Project. The PRE Project Manager should review the minutes of the meetings of both the Comité de Aceptación and the Junta Supervisores and review the "Reglamento" (with the assistance of the respective project implementation committee as applicable) to make changes as necessary. It should review the newly established accounting on a quarterly basis.

6. Anticipate the continuation of PROINVER during the Peace Process and in the immediate years following a successful conclusion to the negotiations. The Program should be reevaluated in one year to decide on further actions and/or closing schedule.

H. ABSTRACT

PROINVER was established to enable the Salvadoran insurance industry to meet the demand for politically motivated destruction of economic assets when the international reinsurers withdrew due to heavy losses. The program has been successful. At present, it provides about C.1.2 billion of coverage on productive assets including agroindustrial and industrial risks, coffee and sugar stocks, and public transport buses.

The program has realized its goals at essentially no cost to the Mission or to the local currency reserves. In fact, when the investment earnings are included, the financial results are positive.

The present leverage ratio is 4 to 1. Given the present rate of losses, this ratio can be increased to 6 to 1. If stop loss reinsurance is used, the leverage can safely be increased to 8 to 1.

The reserves of C.287 million is held by the BCR in non-interest bearing accounts. Inflation is rapidly eroding the real value of this reserve and depriving the Mission of the ability to undertake other development activities. Monetizing the reserve would avoid this heavy opportunity cost.

Once the reserve is held at interest, the PROINVER reserve should be reduced to about C.150 million, with the remaining funds used to pursue other development activities, including establishing an agency to issue guarantees on small and medium business loan, repackaging them, and on selling them via the new stock market to create a secondary long term financial market.

The PROINVER program should be continued through the Peace Process and during the immediate post-peace years, as it is possible that the rate of politically motivated economic damage may not decline. PROINVER would also be an incentive to new investment to establish in El Salvador following the peace agreements.

The PROINVER program is the first USAID program to work with an insurance industry. While the insurance industry investments are one of the largest sources of long term development capital, its capacity has yet to be utilized to execute and participate in development projects. Until the PROINVER program, USAID had worked with banks and other financial intermediaries, but had not incorporated the insurance industry into its activities. The relationship established through the PROINVER program can be very useful in initiating new development projects, in El Salvador as well as other countries.