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*Midterm Evaluation*

Costa Rica Financial  
Services Project

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# Glossary

ABC	Asociación Bancaria Costarricense
Academia	Academia de Centroamérica
ACORDE	Asociación Costarricense para Organizaciones de Desarrollo
AGEF	Auditoría General de Entidades Financieras
A.I.D.	United States Agency for International Development (see USAID)
Avance	Avance Microempresarial
BANHVI	Banco Hipotecario de Vivienda
CAP	Certificado de Aportación Patrimonial
CNV	Comisión Nacional de Valores
ESR	Economic Stabilization and Recovery (program)
<i>financieras</i>	finance companies
FINCA	Fundación Integral Campesina
FIRM	Financial Resources Management project
FSDP	Financial Sector Development Project
FSP	Financial Services Project
GOCR	Government of Costa Rica
IDB	Inter-American Development Bank
INCAE	Instituto Centroamericano de Administración de Empresas
MIS	management information system(s)
NGO	nongovernmental organization
OSU	Ohio State University
PVO	private voluntary organization
PACD	project assistance completion date
SDID	Société du développement international de Desjardins
WOCCU	World Council of Credit Unions
USAID	A.I.D. Mission

## Preface

This midterm evaluation of the Costa Rica Financial Services Project (number 515-0247) was prepared during a 2-week visit to Costa Rica and in the consultants' home offices during September and October 1994. The evaluation team, fielded by Nathan Associates Inc. and AG International Consulting Corporation under the Latin America and Caribbean (LAC) Trade and Investment Project, consisted of Phillip W. Rourk, economic policy analyst and team leader; Gustavo A. Gómez, credit union specialist; and Hilario A. Hooker, microenterprise specialist. The terms of reference for this evaluation are given in Appendix A, and a list of interviewees appears in Appendix B.

The team is grateful for the support received from USAID/Costa Rica project management, project implementing organizations, contractors, and counterparts, as well as other parties contacted during the course of the evaluation.

# Executive Summary

The Costa Rica Financial Services Project (FSP) was approved in June 1990 to "create an institutional environment that fosters secure, efficient financial intermediaries serving small- and medium-scale savers and borrowers, the project clientele." Project components included

- *Policy analysis and reform* at the macroeconomic level to ensure a policy environment favorable to the expansion of financial services
- *Prudential supervision* at the regulatory level to strengthen supervision of financial institutions
- *Financial management and innovation* at the level of individual intermediaries to demonstrate a range of financial innovations to improve services to project clientele.

The FSP was to be implemented over 5 years, building on private banking but including the integration of financial cooperatives (credit unions) into the mainstream of financial markets.

Delays in negotiating a workable grant agreement with the Government of Costa Rica (GOCR) caused the start of project implementation to be delayed until mid-1991 and a significant level of work output to be delayed until late 1991 and early 1992. For practical purposes, therefore, this midterm evaluation is being prepared at roughly the end of the third year of project implementation.

The main GOCR counterpart is the Central Bank of Costa Rica (BCCR), which chairs a Project Governing Committee that is the main executive body directing project implementation. Technical assistance contractors include Ohio State University's (OSU) Financial Resources Management (FIRM) Project and the Academia de Centroamérica (Academia), which have been responsible for the components on policy analysis and reform and financial management and innovation. The prudential supervision component, which was formally modified from the original project paper design to increase emphasis on the strengthening and supervision of credit unions, was implemented primarily through a technical assistance contract with the World Council of Credit Unions (WOCCU).

Principal findings, conclusions, and recommendations of the evaluation team are presented below for each of the FSP's major components.

## POLICY ANALYSIS AND REFORM

Outputs of this component have included directed research, technical assistance, policy advice, training, and dissemination through the publication of books, technical articles, and editorials as well as through seminars, conferences, and study tours.

Productivity has been high and outputs have been of a generally excellent professional quality. Subject matter of publications has been predominantly consistent with project objectives, and the technical complexity, format, and style of the publications have varied in accordance with the multiple target audiences selected. These publications have, in our view, been effective in reaching a wide range of audiences, including leaders in the executive and legislative branches of government, business and financial sector executives, policy analysts and researchers, and the public at large.

The bulk of advisory and technical assistance efforts to date have been directed at (1) supporting GOCR efforts at policy development and financial sector management and (2) supporting GOCR efforts in the area of legislative reform.

Substantial success was achieved in improving the policy and regulatory environment for financial sector performance during 1992 and 1993, primarily through assistance to the GOCR in developing policy and regulatory changes implemented through Central Bank administrative actions. Significant progress on the legislative front was also achieved. A new draft Central Bank Law was prepared with project assistance; however, although the draft law was reported out by a special legislative committee of the National Assembly, final passage of the new law was stymied by the electoral process and the change in administration in May 1994.

Contents of the draft Central Bank Law include important provisions for greater autonomy and stability in the Central Bank board, restrictions on the ability of the Central Bank to directly manage credit, and the long-awaited legal sanctioning of private banks' ability to offer demand deposits and checking to the public. In general, the draft law represents an important improvement over the current Central Bank Law, though certain provisions could, if adopted, potentially lead back to the same kind of distortions that legislative reformers started out to eliminate in the first place.<sup>1</sup> If the opportunity arises, FSP resources could be productively applied in assisting a future legislative commission to reexamine certain remaining deficiencies in the draft law such as these.

Prospects for passage of the draft Central Bank law by the new assembly without revisions are practically nil. Indeed, the new government has yet to make explicit a legislative or policy program for the financial sector, and it is difficult to predict how much priority will be given to these issues or how soon action will be taken. Several factors could make it necessary for the government to take prompt action on financial sector legislation, however. These include

- The bad press, public uncertainty, and potential political risks generated by the recent spectacular failure of the state-owned Banco Anglo-Costarricense
- The new government's possible interest in acting on financial sector reform in the context of finalizing negotiations with the World Bank and IDB for a third structural adjustment loan (PAE III)
- The opportunities for expedited action presented by the existence of two well-advanced financial sector legislative proposals.<sup>2</sup>

The FSP enjoys good relations with the new Central Bank leadership, which has expressed its interest in continuing FSP's involvement in supporting legislative reforms for the financial sector, including seeking passage of a new Central Bank law. This constructive relationship, added to the factors mentioned earlier, make it important for the FSP to maintain the capability to respond to the Central Bank's and a new legislative commission's possible urgent analytical needs if legislative reforms do, in fact, receive high priority from the new government in the near term. Much of the Academia's proposed activities for FSP Phase II, currently under discussion with Mission project management, is designed to position the Academia and the project in a way that will make possible a

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<sup>1</sup>For example, such provisions would permit the Central Bank to (1) directly fix intermediation margins as a new instrument to be used in lieu of fixing deposit or lending rates or (2) attempt to directly enforce a global ceiling on domestic credit, if only temporarily.

<sup>2</sup>These are (1) the already-mentioned draft Central Bank Law and (2) another important piece of draft legislation reported out by the Economic Affairs Commission of the last assembly dealing with complementary pension funds.

rapid response to GOCR legislative priorities. This capability should be maintained for the FSP, along the general lines proposed to the Mission by the Academia.

Additional resources should, in our view, be concentrated on an area where the project has had more limited success to date: public dissemination. The public at large, in addition to opinion-makers and decision-makers, needs to be better informed regarding the economic, financial, and technical dimensions of the debate surrounding financial sector reform. Better understanding of the long-term implications of financial sector efficiency for the country's internal stability and external competitiveness needs to be generated, and the extent to which such understanding is generated may, at a time when political leadership appears to be lacking a clear vision, heavily influence the legislative and policy directions that are ultimately chosen.

For these reasons, it is recommended that the FSP significantly strengthen its public dissemination program during the remaining life of the project. This evaluation contains an outline proposal recommending that the FSP devote a significant portion of resources remaining to supporting the establishment of a permanent "forum" for the promotion of financial sector development in Costa Rica. The main idea would be to mobilize the energies and resources of existing Costa Rican institutions that have a permanent interest in financial sector development, providing them with a vehicle for focusing attention and organizing regular and systematic analysis and dissemination efforts aimed at continually improving the capabilities of this central component of the Costa Rican economy.

### CREDIT UNION SUPERVISION AND SYSTEM DEVELOPMENT

The project has made reasonable progress in strengthening the institutional framework of the credit union movement, and important activities have been completed toward the achievement of the project objectives.

Fedecredito, the key implementing agency, is the parent company of a diverse group of financial services entities or subsidiaries made up of a bank, an off-shore bank, a brokerage agency, a fund management facility, and a housing finance company.

Fedecredito has demonstrated outstanding leadership in organizing and implementing new financial entities, and has been enhancing its capability to deliver useful technical assistance services for its member credit unions. Fedecredito's staff is composed of a highly committed group of young professionals with an average professional experience of between 4 and 7 years. We believe that monies spent on training these personnel to develop their potential and technical skills are a good investment.

Tangible project results on the credit unions' financial intermediation efficiency have not yet been demonstrated. However, there has been some progress in improving the financial solvency of credit unions. There is also a consensus that the project has helped to improve public confidence in the credit union system. Membership has increased and saving deposits have expanded in real terms.

The most important achievements generated with project support are as follows<sup>3</sup>:

- Enactment of the law that regulates financial intermediation activities
- Provision of useful training through study tours and courses implemented in Costa Rica
- Establishment and startup of the central liquidity facility
- Improvement in policies and managerial systems designed as a stepping stone in the process of ensuring the credit unions' solvency and long-term viability
- Improvement among credit unions facing extremely serious financial problems: out of 13, at least 8 have improved their situation and are now considered financially viable entities

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<sup>3</sup>The movementwide information system has not yet been designed.

- Development of standard norms for credit operations, including portfolio classification and provision for bad loans; these norms have been implemented in four credit unions.

The most important conclusions derived from our findings are summarized as follows:

- Fedecredito's concept of expanding the range of financial services available to credit unions is sound as long as the financial services established are really needed and the subsidiaries can operate profitably. Profits from the subsidiaries are the only certain source of funding to finance the credit unions' technical assistance needs.
- High-level decision-making authority and oversight functions are concentrated across the overall Fedecredito system. This situation might not be healthy for the system. We believe there is a need for at least some self-regulation to avoid the risks of concentration of authority.
- The credit unions' institutional debt over the loan portfolio of 40 percent is high under the current circumstances. There is a need to establish some guidelines and self-regulation regarding both debt in local Costa Rican currency and foreign currency.
- There is a need for prudential regulation and supervision measures aimed at reducing the potential risks derived from concentration of net debtors on the boards of credit unions. Innovative prudential regulation should also be established to ensure that credit unions function with an adequate base of permanent capital.
- Although the project's intended final outputs are far from being achieved, the implementation activities carried out so far are consistent with the objectives and outputs established in the project design and agreements. The overall implementation progress achieved so far is satisfactory, especially in management training.
- The partial outputs achieved so far in the area of prudential supervision should be useful for implementing AUDICOOP's prudential supervision mandate. AUDICOOP has already performed financial and operational auditing and inspections of a few credit unions. Intermediate project outputs have been generated toward the goal of financial stability and long-term viability of credit unions, particularly the implementation of the central liquidity facility. New methods and procedures have been designed to standardized financial planning, control, and reporting as well as some aspects of credit systems. WOCCU's technical assistance and training services have been useful in designing and developing these improvements.
- There is need to improve project planning and monitoring, as well as to monitor the credit unions' implementation of new or improved systems designed for their use. A computerized system should be used to monitor technical assistance for credit unions.

During the rest of the life of the project, the most important objectives for the credit unions are to (1) protect and strengthen the credit unions' financial solvency and (2) complete the implementation of standard policies, norms, and operating systems to improve management effectiveness and to control adherence to prudential regulation. Fedecredito's highest support priorities for the credit unions should include

- Developing innovative saving mobilization products and marketing strategies
- Improving financial and credit policies
- Implementing standard prudential norms and operational and internal control systems to strengthen managerial efficacy and improve accountability
- Developing coordination arrangements between AUDICOOP and AGEF.

In addition, the project should carry out several studies related to various important issues that demand attention in the short run.

The most important project objectives regarding Fedecredito's owned entities should be (1) to develop the Caja Central's technical capabilities to provide new saving mobilization services to credit unions and to manage funds established to meet various investor needs, such as special retirement accounts; and (2) to improve Fedecredito's technical assistance planning and monitoring and outreach capability to expedite the credit unions' implementation of standard management systems and prudential regulation norms.

In addition, Fedecredito's proposed electronic communication network is an important innovation that should receive project support even if it is not possible to complete its implementation during the rest of the life of the project.

Fedecredito's technical assistance approach for credit unions for the duration of the project should aim at maximizing the number of credit unions that achieve certain minimum financial and institutional capability standards and that adhere to prudential regulations established by AGEG and self-regulation norms. The first step is to determine what these standards should be and then to estimate how much technical assistance will be required. We believe that in a period of 1 year all of the credit unions should meet the institutional capability standards and at least 50 percent of them should meet the financial standards. It will be necessary to hire local consultants to increase the intensity and pace of technical assistance for credit unions.

Project assistance is necessary to strengthen the Caja Central and to design and implement the movementwide data system. Project assistance is also required for various special studies.

We recommend extending the project completion date through December 31, 1995. We believe that the amount of \$2.7 million of project funding programmed for Fedecredito should be sufficient to implement the technical support activities recommended in this evaluation. Much of the potential benefit of technical assistance activities carried out so far will not be realized without additional time and funding.

## FINANCIAL MANAGEMENT AND INNOVATION

The project design did not establish any specific sequence for the implementation of the two broad outputs of this component, namely, institutional strengthening and innovations. On the implementation phase, OSU, the project contractor, after evaluating the institutional weaknesses of the PVOs to be assisted, considered it essential to focus the initial efforts of the project on strengthening ACORDE, FINCA, and Avance in such areas as management capabilities, strategic plans, internal procedures and controls, and portfolio management, before concentrating on innovations.

As a consequence of this strategy, a significant amount of the outputs reported in this evaluation correspond to activities of technical assistance and training, with a lesser amount of results in innovation.

Technical assistance was provided to ACORDE, FINCA, Avance, Banco Nacional de Costa Rica, and Banco Popular. Significant achievements were noted at ACORDE and FINCA and encouraging findings at Banco Nacional and Banco Popular.

A project extension through December 31, 1995, for the microenterprise component is recommended. As activities for the second phase of this component, we suggest that ACORDE should limit its technical assistance to a reduced number of PVOs (i.e., three or four) that have shown willingness to follow ACORDE's technical recommendations and also have some possibility of becoming self-sufficient in the next 3 or 4 years. For that purpose ACORDE should increase its current staff with a supervisor who periodically would visit these organizations to provide guidance on these matters.

We recommend strengthening FINCA's management structure with a high-ranking professional to whom the executive director can delegate part of his considerable work load. We suggest financing such a professional with project resources for at least one year. It is also suggested that FINCA should initiate efforts to diversify its portfolio by opening urban village banks, which would allow income increases and operational costs reductions.

Because of Avance's poor results and lack of compliance to recommendations, we agree with the Academia that no further assistance should be provided to that organization.

In the case of Banco Nacional, we support the decision that the Academia should continue working with this institution on the design of a specialized branch for small businesses and farmers as a pilot project, applying innovative approaches to provide new financial services to small and microbusinesses. We also recommend investigations on the characteristics of small and microenterprise customers financed under the bank's personal loans and credit card programs, in order to determine (1) the degree of bank participation in the small business market through these programs and (2) the reasons why customers are willing to pay market interest rates instead of demanding loans through the institution-subsidized small business/farmers programs.

Assistance to create a second-story lending window for PVCs providing credits for small and microenterprises is recommended for Banco Popular. In addition, if the financial reforms presented to the Costa Rican Congress are approved, the bank would become a private institution subject to reserve requirements and taxes—in which case the bank would require certain assistance to determine its credit and interest rate policies. This task will probably require more time than available to the project, but the initial studies and design could be carried out.

In addition to the activities mentioned above, we recommend that the Academia should continue policy dialogue at the political level and with Banco Nacional and Banco Popular on the importance of eliminating subsidized interest rates in these institutions' small business programs. We also suggest that a wider dissemination of Academia and OSU research and findings on small and microenterprise services be provided to the Costa Rican public through five additional seminars.

# 1. Project Background

## ECONOMIC AND FINANCIAL SECTOR CONDITIONS IN 1990

The Financial Services Project (FSP) was developed in the context of a particular set of conditions—opportunities and constraints—that were perceived by the USAID Mission as key determinants of future financial sector development and of the likelihood of achieving the project's goal, defined as "access to a full range of financial services by Costa Rican households, small businesses, and farmers in order to stimulate savings, investment, and economic growth." As the project's developers state in the FSP project paper,

the key elements of a sound financial system are in place in Costa Rica, with a broad range of financial and supporting institutions. This system has the potential to meet the needs of large and small clients and provide financial intermediation for the growth of production and incomes, but it suffers from a range of difficulties.... Barriers to effective financial services for the project clientele exist within the macroeconomic and regulatory environment as well as at the level of individual institutions.

The macroeconomic environment, according to the FSP project paper, was "characterized by a large external debt and continuing uncertainty regarding inflation and exchange rates, leading to reduced investor and saver confidence." Further, "the capability of existing regulatory institutions has proven insufficient for prudential supervision of the expanding and diversifying banking sector." Four major policy areas were identified as affecting the continued liberalization of financial markets:

- Selection of instruments by the Central Bank for control of the money supply
- The high level of passive [deposit] interest rates, the result principally of financing of the GOCR budget deficit
- Access by regulated intermediaries to a lender of last resort
- Evenhanded prudential supervision for banks, finance companies, and financial cooperatives.

Costa Rica was able to reduce its total external debt by about 20 percent in 1990 as a result of a successful debt reduction agreement with commercial bank creditors. However, a growing public sector deficit and accelerating inflation were raising fears of a possible recurrence of the severe instability that had taken hold of the Costa Rican economy in 1981–1982 and again, somewhat less seriously, in 1987. Both prior instances of accelerating inflation and rapid depreciation of the colón had devastated the country's financial sector institutions—public and private—as interest rates lagged behind inflation and as reduced loan recovery, in real terms, eroded the sector's capital base.

A.I.D. played a key role during the 1980s in providing Costa Rica with the resources necessary to cushion the impacts of the stabilization programs required to keep Costa Rica from following the hyperinflationary course of other Latin American countries (Peru, Bolivia, Argentina, Brazil) during the decade. Between 1982 and 1990, A.I.D. had structured nine successive "Economic Stabilization and Recovery" (ESR) programs. Each was harmonized with the International Monetary Fund (IMF) and conditioned on continued GOCR commitment to a series of policy actions aimed, fundamentally, at improving fiscal performance, strengthening the economy's international competitiveness, reducing indirect subsidies and direct government control of key prices in the economy, and eliminating

distortions and restrictions constraining development of the private sector. Through these programs A.I.D. had already, between 1982 and 1990, provided over \$900 million in mostly grant funding to Costa Rica. During this period Costa Rica also embarked on a series of stand-by arrangements with the IMF and received from the World Bank two structural adjustment loans (SAL) totaling \$180 million.

In significant measure these programs helped to make it possible for Costa Rica to avoid the more catastrophic economic and political disruptions experienced elsewhere in the hemisphere during the 1980s. Financial collapse was averted; a functioning, relatively participatory and stable democracy was preserved; and the country was able to maintain both comparatively high living standards and a public services delivery system that is highly extended, effective, and justly renowned.

The achievement of the above-mentioned fundamental objectives undoubtedly signifies the overall success of public policy during the 1980s in Costa Rica, including the external development assistance policies that helped to make it possible. However, it is undoubtedly also true that overall success may, perversely, have retarded progress towards the implementation of reforms at the micro level. The very existence of (1) relatively abundant external resources to help cushion the impacts of earlier policy errors and (2) a participatory democratic framework for policy-making and policy implementation, undoubtedly made it easier for politically costly economic correctives to be deferred or avoided, and more difficult for profound structural changes to be implemented over the objections of those who would be hurt by such changes.

Thus, although financial sector initiatives were an important component of A.I.D.'s ESR programs during the 1980s, as will be briefly described later, the pace of change had been relatively slow and perhaps frustrating. The FSP project paper stated that "since 1982, A.I.D. [had] promoted private financial intermediaries for the efficient provision of financial services and to create a competitive alternative to the state-owned banks." However, as of mid-1989 the state banks continued to hold 79 percent of formal sector assets.

In something of a change of tactics, the FSP for the first time focused specific attention on the sector as a whole and shifted emphasis from credit and support to individual institutions, toward savings mobilization and intermediation, and to the policy and regulatory system that "underpins the health of the financial sector."

### STRUCTURE OF THE COSTA RICAN FINANCIAL SYSTEM

When the FSP was developed the Costa Rican financial system, in addition to the Central Bank,<sup>4</sup> consisted of five types of institutions:

- Four state-owned banks, holding 79 percent of formal financial sector assets in 1989
- Nineteen private banks (including two cooperative banks) and 50 finance companies (*financieras*)
- Financial cooperatives, including about 20 producer cooperatives with financial operations, 6 savings and loans (*mutualistas*), and 84 credit unions
- Other formal institutions, primarily state-owned, such as the Social Security Institute, the National Insurance Institute (a state-owned insurance monopoly), the housing bank (BANHVI), Banco Popular, and several governmental agricultural lenders
- Informal lenders, including PVOs, suppliers, and moneylenders.

Not mentioned in the FSP project paper are the offshore bank affiliates of Costa Rican private and public commercial banks, established beginning in the mid-1970s as a means of providing a broader

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<sup>4</sup>The Central Bank contained within it the semi-autonomous Auditor General for Financial Entities (AGEF).

range of international services to Costa Rican businesses, and already significant in size by the late 1980s despite being wholly unregulated and largely undocumented.

### LEGAL AND REGULATORY FRAMEWORK

As noted by the Inter-American Development Bank (IDB) in a document on its proposed investment sector and multisectoral credit loan, the Costa Rican financial system has been characterized by

the coexistence of an excess of regulations that 'protect' the state-owned banks with a series of practices that the market has developed that permit the relatively fluid operation of a very large informal system, used by the private sector to realize a wide range of financial activities, that for all practical purposes take place outside the control and supervision of the authorities.<sup>5</sup>

Under the direction of a central bank that is subject to an unusual degree of political control,<sup>6</sup> the financial sector legal and regulatory framework has until recently been slanted heavily in favor of the state-owned banks, created when the financial system as a whole was taken over by the government in 1948. Despite the authorization of private *financieras* and private banks in the late 1970s and early 1980s, state-owned banks maintained a legally sanctioned monopoly in their ability to offer demand deposits and checking services, and passbook savings. Only state-owned banks could obtain short-term liquidity through borrowing at the Central Bank's rediscount window. This was significant because of the practice of charging an interest rate on rediscounted funds that was lower than prevailing deposit rates. Minimum capital requirements—and, it was alleged, arbitrary leverage limits—also discriminated against private financial institutions.

Although the Central Bank's administrative practices had been considerably liberalized by the time the FSP was being developed in 1990, legally the Central Bank reserved the right to impose a number of quantitative restrictions ranging from direct fixing of deposit and lending rates to the establishment of sectoral credit ceilings. These restrictions severely distorted the operations of the financial system, abetted inefficiency and corrupt practices, and reduced the efficacy of monetary policies. FSP objectives included the elimination by new legislation of such direct controls and quantitative restrictions on banking operations.

Bank supervision had traditionally been conducted by the Audit Department of the Central Bank, which had defined its role primarily in terms of enforcing compliance with Central Bank quantitative restrictions and directives. While the Banking Sector Modernization Law of 1988 sought to increase the autonomy of bank supervisors by establishing the Auditoria General de Entidades Financieras<sup>7</sup> (AGEF) as a decentralized agency of the Central Bank, AGEF continued to report to the Central Bank board of directors and achieved little autonomy in practice. The above-mentioned modernization law had brought *financieras* under AGEF's purview, but failed to incorporate both financial cooperatives and an increasingly large number of sophisticated and unsophisticated "informal" operations. The maintenance of different regulatory powers and procedures for the intervention of state-owned banks as opposed to private banks and *financieras* has served to perpetuate a privileged position for the former.

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<sup>5</sup>Costa Rica: *Programas Sectorial de Inversiones y Crédito Multisectorial*, (CR-0032), Propuesta de Préstamo, Inter-American Development Bank, Washington, D.C., November 1992.

<sup>6</sup>Directors and management of the Central Bank continue to be named by each incoming administration, with no direct congressional review of nominees.

<sup>7</sup>Auditor General for Financial Entities.

## PRIOR A.I.D. ACTIVITIES IN THE FINANCIAL SECTOR

As mentioned earlier, financial sector policy reforms figured prominently in the objectives and conditionality of nine successive Economic Stabilization and Recovery (ESR) programs funded by A.I.D. between 1982 and 1990. Emphasis was placed on such areas as the maintenance of positive real rates of interest in the financial sector, the elimination of directed and subsidized lines of credit, the substitution of direct credit and monetary controls by indirect instruments (such as reserve requirements and open market operations), and the liberalization of the marketplace, ensuring equitable access and regulatory treatment for private sector financial institutions. Overall, considerable progress was achieved, though mostly via administrative measures rather than via new legislation that could provide more stability and permanence to the reforms adopted. In some areas, such as providing access to Central Bank rediscounts for private banks (a condition of ESR-II in 1982), no headway was made despite repeated efforts over a period of years, and A.I.D. ultimately had to itself fund a liquidity facility for private banks, operated in parallel to the Central Bank's rediscount window.

In addition, throughout the 1980s, A.I.D. made available significant amounts of local currency counterpart funds and local currency generations from the PL-480 programs for funding credit programs implemented primarily through private banks, *financieras*, and financial cooperatives. Areas of concentration included, among others, low-income housing, small enterprise, agriculture and agro-industry. An effort was made to ensure that credit was contracted and delivered at "market-compatible" interest rates.

Finally, A.I.D. had also been directly involved in supporting individual financial sector projects and institutions during the 1980s. These efforts included

- An early loan to a private bank, BANEX, to fund the development of nontraditional export projects (1982)
- Refinancing of COFISA, a *financiera* concentrated on industrial development finance (1983)
- Funding to establish the Private Investment Corporation (PIC) (1984)
- Funding of a long-term credit program, the Agricultural and Industrial Reactivation Project, to be distributed to borrowers exclusively through qualifying private banks (1987).

On the basis of experiences gathered over most of a decade, A.I.D. had by 1990 come to the realization that

an environment favorable to expansion of services to small-scale clients cannot exist unless the environment is favorable to overall development of financial institutions. Absent such circumstances, assistance to institutions serving small-scale clients is not a sufficient condition for achieving sustainable improvements in services. Reflecting this strategy, the FSP emphasizes policy reform and a supervisory structure which supports this reform.<sup>3</sup>

## OTHER DONOR INITIATIVES

In the policy arena, the principal actors other than A.I.D. during the 1980s were the IMF and the World Bank. IMF focuses primarily on short-term stabilization issues that are, nonetheless, crucial to the development and maintenance of a stable financial system. Thus, limitations on the growth of the public sector deficit and restrictions on its financing are crucial elements in maintaining price and interest rate stability, which are themselves fundamental to (1) the mobilization of deposits, (2) the maintenance of private sector demand for credit, and (3) the successful recovery of bank loans.

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<sup>3</sup>Project Paper, page 11.

Avoiding excessive public sector borrowing reduces the risks of inflation or increased real interest rates, or both, arising from increased competition for available funds. IMF conditionality, reinforced by the conditions imposed by A.I.D. in its various ESR programs, was crucial to maintaining the macroeconomic conditions that allowed the financial sector to continue to expand its services throughout the decade.

The World Bank's Second Structural Adjustment Loan (SAL-II) also included banking sector reform among its objectives, and supported the adoption of the 1988 Banking Sector Modernization Law. Specific financial sector conditionality contained in the World Bank's structural adjustment program for Costa Rica included

- Action to allow private commercial banks to accept short-term deposits (investment certificates) of any maturity
- Implementation of a scheme to allow private finance companies access to the Central Bank as lender of last resort
- Development of an action plan to strengthen prudential supervision, and continuation of AGEF's modernization program
- Enactment of a law establishing AGEF oversight of credit cooperatives
- Preparation of a law to recognize Banco Popular and Banco Hipotecario de Vivienda (BANHVI) as financial intermediaries
- Preparation of draft legislation to demonopolize the insurance sector
- Maintenance of limits on subsidized credit and maintenance of supportive monetary and financial policies.

These conditions in many cases echoed and reinforced A.I.D. policy initiatives of long standing, reflecting close coordination among donor agencies assisting the GOCR. Significant progress has been made on several fronts, although certain items continue to require additional action.

In the context of a variety of sectoral credit programs implemented through the Central Bank, both the World Bank and IDB were instrumental in addressing management problems and constraints of major institutions in the sector, particularly the state-owned commercial banks.

In the area of small-scale lending, A.I.D. programs implemented prior to 1990 with Fedecredito and Banco de Cooperativas (BANCOOP) were complemented by assistance from the West German Confederation of Cooperatives (CONCAF), and by the Canadian DesJardins Fund. Both sets of activities were scheduled to continue during the FSP period, and FSP project design aimed at maximizing complementarity among the various activities is being planned for this area.

## 2. Project Description

### OVERALL OBJECTIVES

The best overall summary of project objectives is can be found under "Summary Project Description" in the FSP project paper:

The purpose of the project is to create an institutional environment that fosters secure, efficient financial intermediaries serving small- and medium-scale savers and borrowers, the project clientele. Project components operate at the macroeconomic level to ensure a policy environment favorable to the expansion of financial services, at the regulatory level to strengthen supervision of financial institutions, and at the level of individual intermediaries to demonstrate a range of financial innovations to improve services to the project clientele.

### MAIN COMPONENTS

As originally designed, the 5-year FSP was to have had three principal components:

- *Policy analysis and reform* to promote dialogue among decision makers in the government and private sector on the interactions among macroeconomic policy, the financial sector, and the larger economy;
- *Prudential supervision* to strengthen the institutions responsible for supervising financial institutions, and to improve the support they provide; and
- *Financial management and innovation* to improve the management of financial institutions serving the project clientele and to test and demonstrate new approaches to savings mobilization, lending to small-scale clients, and other financial services.

The FSP was to have been implemented by a Costa Rican nongovernmental organization (NGO) through a local currency grant. The policy analysis and reform component was to have been implemented by the NGO with technical assistance from Ohio State University (OSU) through a USAID/Costa Rica contribution to the worldwide Financial Resources Management Project (FIRM). The prudential supervision component was to have been implemented by the NGO with technical assistance from Price Waterhouse, the A.I.D./Washington contractor for the worldwide Financial Sector Development Project (FSDP). The financial management and innovation component was to have been carried out by the NGO with short-term technical assistance procured through FSDP.

The original project cost estimate presented in the FSP project paper was \$8.4 million, of which A.I.D. was to contribute \$4.4 million as a grant to the GOCR, while the remaining \$4.0 million was to be provided by the GOCR from an ESF-generated local currency Special Account. Estimated life-of-project costs by component are given in the following table:

<u>Component</u>	<u>Cost (\$000)</u>
Policy Analysis and Reform	5,041
Prudential Supervision	1,990
Financial Innovation	1,219
Evaluation and Audits	150
Total	8,400

As discussed in further detail in Chapter 3, a number of significant events dictated changes in the original project conception and design.

First, project activation was delayed by grant negotiations with the GOCR and contracting requirements until the latter half of 1991.

Second, A.I.D. management has determined that, in recognition of Costa Rica's graduation to "advanced developing country" status and pressing budget constraints, the USAID Mission to Costa Rica will be closed in September 1996. Given the time required to close down projects in an orderly manner, this will make it impossible for the FSP to function as an A.I.D. project for the full five years originally intended. This, of course, needs to be considered in evaluating the project's potential to fully achieve all original project objectives.

Third, a significant design change was made for the second component of the project, prudential supervision, to take into account the GOCR's decision to undertake a long-term IDB-funded technical assistance project for the AGEF during the FSP project period. The prudential supervision component originally had two main emphases: (1) technical assistance and automation at the AGEF to enhance its supervision capabilities in general, and (2) the establishment of a formal supervision system at AGEF specifically for financial cooperatives. After the GOCR decision, the component was redesigned to focus almost exclusively on issues pertaining to strengthening the financial management and supervision of financial cooperatives. Startup of this component was delayed until July 1992. Rather than procuring technical assistance from the Washington-based Financial Sector Development Project, technical assistance for Fedecredito, its member cooperatives, and AGEF was contracted with the World Council of Credit Unions (WOCCU).

Finally, it should be noted that GOCR counterpart funds have not been available as planned, and that the USAID Mission has increased its obligations to a cumulative \$5.35 million as of the last grant agreement amendment, dated March 1994.<sup>9</sup> Overall funding for the project will be reduced, however, to an estimated \$6 million in total, rather than the \$8.4 million envisaged when the project was originally designed.

To reflect some of the above early-stage design changes, the Mission prepared an amended logframe, dated April 1991, for the FSP (see Appendix C). This reflects, primarily, the much increased emphasis being placed on the development of the credit unions and of a functioning credit union prudential supervision system. This amended logframe is the source of verifiable indicators that provide the principal framework for this evaluation.

## IMPLEMENTATION ARRANGEMENTS

### Policy Analysis and Reform Component

#### *Funding*

As noted above, the original project cost estimates allocated \$5.041 million—60 percent of a total \$8.4 million—to the policy analysis and reform component. An equivalent 60 percent of projected technical assistance person-months was also allocated to this component, corroborating the relative emphasis placed on it by project designers.

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<sup>9</sup>The original Project Grant Agreement was signed on May 31, 1991.

### ***Counterpart Roles***

The principal counterpart for the policy component of the FSP was envisaged to be the Central Bank. The 5-year component was to

- Assist the Central Bank in improving its capacity to inform decision makers about the impact of current and alternative policies and of macroeconomic conditions on financial intermediaries serving the project clientele
- Assist the Central Bank in formulating financial and economic policies buttressing the reforms sought by the IMF and the World Bank
- Form part of the Central Bank's drive to solidify the financial liberalization accomplished since 1985
- Promote a policy environment increasingly favorable to the expansion of private financial institutions.

The Central Bank, as the A.I.D. grantee, was to implement the project through a parallel Central Bank grant agreement with the Costa Rican management NGO, and was to supervise project activities through a project governing committee appointed by the Central Bank Executive President. The Central Bank Executive President was himself to serve as Counterpart to the Project Director hired by the NGO, while the project's Principal Investigator, also an NGO employee, was to maintain a counterpart relationship with the Chief of the Central Bank Economic Division. The Central Bank and USAID Mission were to jointly review proposals submitted by qualified NGOs interested in being considered for selection to manage the project.

### ***Contractor Roles***

As already noted, general project implementation responsibility was to be entrusted to a Costa Rican NGO, selected for award of a grant through a limited competition conducted jointly by USAID and the Central Bank. The NGO was to provide a project director, a principal investigator, a prudential supervision specialist, a financial services specialist, an administrator, and four office support staff.

In addition to the Costa Rican NGO, the policy analysis and reform component was to count on institutional support from OSU through the worldwide Financial Resources Management Project. OSU was originally to provide one resident Senior Policy Analyst, for 36 person-months, and an additional 39 person-months of short-term consultancies.

### ***A.I.D. Role***

A.I.D. project management responsibility was assigned to the Private Sector Office (OPS), with the active technical participation of the Economic Analysis Office also envisaged. Provisions were also made to enable A.I.D. to contract a full-time project manager.

### ***Planned Outputs and Verifiable Indicators***

The policy analysis and reform component was intended to contribute to a wide range of activities addressing a large number of financial sector policy issues. It necessarily established a rather flexible analytic agenda, as evolving conditions over the planned 5-year life of the project would require flexibility in project management. However, a few key areas were selected for early attention by the project, and others were indicated as having a high likelihood of being included among the project's outputs.

Specific attention was drawn in the FSP project paper to the following issues, with specific reforms identified and timetables established as indicated:

1. *Evenhanded prudential supervision for banks, finance companies, and financial cooperatives.* In this area the FSP was, by July 1991, to have helped AGEF reliably monitor the 24 banks and 50 finance companies chartered by the Central Bank. Also, a system for prudential supervision of financial cooperatives was to have been installed by September 1992.
2. *Access by all regulated intermediaries to a lender of last resort.* Legislation providing for the Central Bank to assume the position of lender of last resort for all regulated intermediaries (private banks and finance companies) was expected to be enacted by December 1992, allowing time for prudential supervision capability at AGEF to have been built up.
3. *Selection of instruments for control of the money supply.* The project was intended to assist the Central Bank in improving its utilization of a variety of instruments (e.g., open market operations, reserve requirements, foreign exchange interventions, setting the discount rate) to control the money supply indirectly, enabling it to eliminate use of traditional direct credit controls. An information system was to be established at the Central Bank to assist in monitoring indicators of monetary growth and managing monetary policy through indirect means.
4. *High levels of local interest rates.* As a counter to continued demands for the continuation of subsidized credit programs, the project aimed to provide the Central Bank with information systems and policy tools that would, through the prudent conduct of economic policy, reduce GOCCR borrowing requirements and enhance the efficiency of the financial system, thereby lowering real market rates to more acceptable levels.

Other issues identified for possible project attention included investigation of

- Policy bias against private financial intermediaries
- Impacts of policy reforms on the project clientele
- Weak contract enforcement and litigation practices as impeding access to credit for the project clientele
- The effect of payment delinquency and collections measures on the cost of credit
- Developmental impacts, costs, and benefits of subsidized agricultural credit programs.

Two additional outputs of the policy analysis and reform component, as identified in the FSP project paper, were dissemination and long-term training.

Dissemination of analytic findings was to take place through publications as well as through workshops and seminars involving both public and private sector decision-makers. Members of the legislature were specifically targeted for dissemination efforts in order to enhance their understanding of the functions of financial institutions, the impact of policies and economic conditions on their operation, and the relative roles and responsibilities of the various participants in the system.

To increase Costa Rican capabilities in policy formulation and financial management, long-term training resources were to provide for 5 doctoral and 14 master's degree students in economics, finance, and related disciplines. Thesis research by these students was to be conducted in Costa Rica, with 19 pertinent policy studies expected as immediate beneficial outputs of this subcomponent, and with continuing contributions to Costa Rican policy formulation expected over the long term.

Verifiable indicators of achievement of project objectives cited in the project's logical framework include:

- Better-informed decision-making on monetary and financial policies
- Increased deposit mobilization in the Costa Rican financial system
- Reduced transaction costs and reduced intermediation margins

- Greater financial deepening
- Wider public support for adequate financial policies
- Thirty-one studies completed, 25 of which have been published
- More effective prudential supervision of the financial system
- Increased financial viability of financial institutions.

Chapter 3 reviews outputs achieved to date and analyzes factors affecting the rate of output achievement.

## Credit Union Component

### *Funding and Institutions*

A total of \$3.2 million was budgeted for the credit union component in the grant agreement between Costa Rica and the United States. Fedecredito earmarked an amount of up to \$1,925,979 to finance a technical assistance agreement with the Credit Union National Association (CUNA). Technical assistance called for under the agreement with CUNA is provided through the World Council of Credit Unions (WOCCU). The rest of the project budget—\$1,274,021—was budgeted for expenditures on additional professional personnel, nonexpendable property, training, computerization, and various other items associated with technical assistance for credit unions. The amount of \$2.1 million has been obligated.

The group of project beneficiary institutions called for in the grant agreement is composed of Fedecredito, AGEF, and credit unions affiliated to Fedecredito. The Mission assigned management responsibility for the project to the private sector office and GOCR delegated in the Central Bank. The grant agreement also established an oversight committee for the overall project.

### *Planned Outputs*

The project design logical framework established the following outputs:

- Adequate regulation and supervision of credit unions, resulting in greater security and protection for savers.  
*Verifiable indicator:* law passed and systems established and implemented including reports from AGEF.
- An established credit union management training program.  
*Verifiable indicator:* 14 training sessions.
- A credit movement-wide information system.  
*Verifiable indicator:* system implemented as evidenced by management information systems (MIS) reports.
- Increased financial stability and long-term viability of credit unions.  
*Verifiable indicators:* acceptable financial ratios and ratings from AGEF.
- Improvement in the management of financial cooperatives.  
*Verifiable indicator:* AGEF reports and decrease in cost of financial intermediation.

In addition to these outputs, the grant agreement also calls for (1) strengthening Fedecredito's own internal supervisory unit, (2) restructuring Fedecredito's Central Liquidity facility as a decentralized

body, (3) establishing a stabilization program to determine the financial and institutional viability of credit unions and provide them with financial assistance if possible, and (4) establishing a savings protection program.

### **Microenterprise Component**

#### ***Funding***

A total of \$1.1 million of A.I.D. funds has been allocated to the Financial Innovations and Microenterprise component, although certain activities undertaken under the Policy Analysis and Reform component have also been aimed at supporting microenterprise finance objectives.

#### ***Contractor Roles***

OSU was selected as project contractor for the microenterprise component. OSU in turn subcontracted the Academia to provide local technical assistance to the project.

#### ***Planned Outputs and Verifiable Indicators***

Management of PVOs under the project will be improved through technical assistance and training, resulting in a higher quality of service. Six innovative approaches to improving services to the project clientele will be tested in cooperation with a range of financial institutions.

### 3. Midterm Evaluation Findings and Conclusions

#### POLICY ANALYSIS AND REFORM COMPONENT

##### Major Findings

##### Outputs Achieved

As Exhibit 3-1 shows, the productivity of the FSP's policy analysis and reform component has been prodigious. The level of activity and production achieved by participants in the component are all the more remarkable in view of the consistently high technical and professional quality of the component's work products.

**Exhibit 3-1. FSP Policy Component: Summary of Major Outputs, July 1991–August 1994**

Output Category	Output Description
Technical Papers	<ul style="list-style-type: none"> <li>Forty-three analytical papers produced and distributed as FSP "Occasional Papers"</li> <li>"An Assessment of the Costa Rican Financial Sector," contracted by A.I.D.</li> </ul>
Popular Articles	<ul style="list-style-type: none"> <li>Forty-five newspaper editorials and articles on financial sector issues published in the popular press</li> </ul>
Books	<ul style="list-style-type: none"> <li>Five full-length books published, total printing of 7,000 volumes</li> </ul>
Graduate Research	<ul style="list-style-type: none"> <li>Six doctoral dissertations and two master's theses completed on Costa Rican financial sector research topics</li> </ul>
Policy Advisory Services	<ul style="list-style-type: none"> <li>Presidency of the Republic</li> <li>Economic Cabinet</li> <li>Presidency of the Central Bank</li> <li>Minister of Finance</li> <li>Legislative Special Commission on Banking Reform</li> <li>World Bank Country Economic Memorandum team</li> </ul>
Focused Debate	<ul style="list-style-type: none"> <li>Comision <i>ad hoc</i> Reformas Financieras</li> </ul>
Seminars and Public Presentations	<ul style="list-style-type: none"> <li>Twenty-eight workshops: Foro, Academia de Centroamérica</li> <li>Thirty-one other conference presentations, press conferences, seminars, etc.</li> </ul>
Study Tours	<ul style="list-style-type: none"> <li>Eight study tours for public and private sector leaders organized by A.I.D.</li> </ul>

A sample of policy-oriented outputs of the FSP includes the following technical papers, popular articles, books, and dissertations published by the Academia.

##### Technical Papers

- "Eficiencia, Competencia y Economías de Escala: Las Reformas Financieras y el Futuro del Sistema Bancario Costarricense"

- "Sistema de Alerta Temprana para Identificar Bancos en Problemas: Aplicación al Caso Costarricense"
- "Eficiencia Relativa de los Bancos Estatales y Privados en Costa Rica"
- "Principios de Regulación y Supervisión Prudencial: Aplicabilidad a Organizaciones Financieras para Microempresas"
- "Importancia de la Capitalización en las Cooperativas de Ahorro y Crédito"
- "Impuesto a las Transacciones Financieras: Proyecto de Ley del Aporte Solidario Nacional"

#### *Popular Articles*

- "Reforma Financiera Costarricense: Hacia dónde ir Ahora?" *Actualidad Económica*
- "La Solidez de la Banca," *La Nación*
- "Sobre la Banca de Fomento," *La Nación*
- "Las Pérdidas del Banco Central," *La Nación*
- "El Margen de Intermediación del Sistema Financiero Costarricense: ¿Por Qué es Alto?" *Portafolio de Inversiones*
- "¿Saben los Bancos para Que Prestan?" *Perspectivas Financieras*

#### *Books*

Books have been written on the following subjects:

- *Financiamiento de la Microempresa Rural: FINCA - Costa Rica*
- *Reforma Financiera en Costa Rica: Perspectivas y Propuestas*
- *Regulación, Competencia y Eficiencia en la Banca Costarricense.*

#### *Dissertations*

- *Relative Efficiency in Banking: State-Owned and Private Banks in Costa Rica*
- *Interest Rate Behavior under Financial Liberalization in Costa Rica: Empirical Applications*
- *Pressure Group Influence on Policymaking: The Case of the Costa Rican Nationalized Banking System.*

As can be seen from the above sampling, the work product of the project has been diverse. Some of it—the last dissertation listed, for example—is primarily of broad, general, or "academic" interest. The books in particular are of practical interest, but more in the sense of providing a reference resource for specific topical analyses. Those items addressing a specific legislative proposal to tax financial sector transactions (such as the last technical paper cited above) are clearly focused on issues of immediate practical significance. Some of the work is directed at a generally sophisticated audience of decision-makers. Other items are intended to inform the public at large. A great deal of the work covers macroeconomic and financial sector policy issues, but some, as intended, is directly supportive of other components of the FSP—namely, those concerned with prudential supervision of credit unions, and microenterprise finance.

Among the other outputs listed above, special mention should be made of the advisory services provided, the focused debate sponsored, and study tours arranged through the project's policy component.

In the area of advisory services, three activities have been especially important. First, and perhaps most important in the long-run, was the permanent participation of an FSP adviser and short-term advisory support provided by the FSP to the work of the Special Legislative Committee on Banking Reform organized during the latter part of the last administration. This committee was able, with FSP

support, to report out a new draft central bank law, and to develop legislative proposals for reform in a wide range of other areas. While the proposed draft central bank law was not enacted for lack of time, it forms the principal starting point for consideration of financial sector legislative reforms in the new congress and will undoubtedly be influential in this regard.

Second, FSP advisers worked closely with the President of the Republic during the last administration, as well as with key members of the economic cabinet, especially the Minister of Finance. FSP advisers contributed to the analysis of monetary and exchange rate, fiscal, and structural adjustment policy options, as well as to the renegotiation of Paris Club debt and the development of terms for new policy-based loans from the World Bank and IDB. All such macroeconomic policy advice contributed directly to the maintenance of economic stability during the period, an essential precondition for financial sector development.

Third, the FSP team was directly and continuously involved in providing analytic support and advisory services to the two central bank presidents who served during the Calderón Administration. This advice was focused primarily on financial sector reforms, and was closely coordinated with the legislative efforts of the GOCR described above.

A second key area of activity, that of sponsoring focused debate on financial sector issues, is identified by FSP participants as one of the most productive and valuable of those undertaken by the project. In early 1992, the FSP took the initiative to organize an *ad hoc* commission to study financial reform in Costa Rica.<sup>10</sup> Its membership included the FSP project director, the FSP principal investigator, a former president of the Central Bank, the general manager of the Central Bank, the president of the National Securities Commission, the general manager of the Securities Exchange, private and public sector bankers, academicians, and lawyers. Over a 3-month period between May and July 1992, the commission met seven times to identify priority areas for financial sector reforms, generate consensus among the participants on the implementation of reforms, and prepare specific recommendations to be presented to the political leadership of the country. Issues discussed included

- The role of the Central Bank
- Appropriate monetary instruments for use by the Central Bank
- Approaches to prudential supervision of financial sector institutions
- The role of state-owned banks
- Tax policy impacts on the financial sector
- Operations of the securities market.

According to the participants—including specifically Mr. Jorge Guardia, then president of the Central Bank and chairman of the FSP steering committee—major strides were achieved through this commission in generating consensus on the issues discussed, and this was felt through the opinions expressed and influence exerted by members of the commission during subsequent periods.

In addition, several study tours were organized by A.I.D. in support of the FSP's policy component. These included visits to

- The United States, to permit government and financial sector leaders to observe supervision practices of the Federal Reserve Board and the Securities and Exchange Commission
- Mexico, to consult on supervision issues with the Comisión Nacional de Valores (CNV), the Comisión Nacional de Seguros, and the Ministerio de Hacienda
- Canada, to meet with staff of the the Société du développement international de Desjardins (SDID) credit union movement

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<sup>10</sup>Comisión *ad hoc* Sobre Reformas Financieras de Costa Rica.

- Indonesia, to observe that country's well-developed microenterprise finance programs
- Bolivia, to study credit union supervision, meet with the Bank Superintendency, and visit BancoSol, an innovative private microenterprise lender in that country.

Members of the FSP team participated in all such study tours to assist in focusing attention on key issues, help participants better assimilate their experiences, and document findings for broader dissemination in Costa Rica.

### *Variations from Implementation Plans*

Other than the delays in project startup alluded to earlier, the principal variation affecting implementation of the policy component concerned the mode of contracting used. Rather than implementing the component through a parallel grant to a Costa Rican NGO and a buy-in to OSU's FIRM Project, as originally contemplated, OSU subcontracted the services of a prominent Costa Rican NGO, the Academia de Centroamérica, thus reducing the number of contracts and simplifying A.I.D. contract administration. In practice, this had no deleterious impact on project implementation because OSU and the Academia have coordinated their work effectively.

In addition, the project was implemented with less permanent administrative staff than originally envisioned: the managers determined to focus more resources on short-term consultancies instead. This has undoubtedly been cost-effective, and has not interfered with the component's ability to deliver work products.

### **Conclusions**

#### *Retrospective Analysis*

The policy component's performance to date will be assessed retrospectively from five viewpoints:

1. Consistency of outputs with project objectives
2. Quantitative performance
3. Qualitative performance
4. Implementation efficiency
5. Progress towards achievement of project objectives

With regard to the first criterion, we find that the outputs realized by the FSP's policy component during Phase I are entirely consistent with the project objectives established in the FSP project paper and subsequent project documentation.

Likewise, we have already remarked on the impressive volume of output achieved to date, and on its consistently high quality. This large volume of high-quality work was performed for less money than originally contemplated, thereby attesting also to the high level of implementation efficiency that has been reached. This occurred despite two factors that worked against effective coordination during certain periods. First, strongly-held policy differences between top managements of the Central Bank and USAID/Costa Rica on the use of local currency funds led to an apparent distancing between the Central Bank president and the FSP for a period of time. According to this individual, however, such distancing was more apparent than real, and affected neither the relationship between the Central Bank and the FSP policy advisory team nor the quality and usefulness of the team's work.

In addition, the inclusion of very micro-level, institutional development activities aimed at strengthening credit unions in an otherwise very policy-oriented project may have led at times to the appearance of poor coordination among project components. Undoubtedly, Central Bank counterparts were of necessity focused primarily on issues pertaining to pressing macro-level policy decisions facing

the government at the time, and their interaction with people working on micro- and institutional development issues within the project was no doubt limited. The lack of interaction between components was attributable more to project design than to coordination deficiencies, and in any case does not appear to have had any serious negative consequences for implementation of the policy component or any other component of the FSP.

The activities undertaken with FSP support have significantly raised the level of debate on financial sector issues in Costa Rica, contributing to better decision-making in the short run. The research published by the project, and the training of Costa Rican financial sector policy analysts, constitute a longer-term legacy whose influence will continue to be felt for years to come.

When it comes to the achievement of specific measurable progress, however, it becomes more difficult to reach a definite conclusion regarding the project's performance to date.

The administrative reforms adopted by the Central Bank during the Arias and Calderón Administrations—relinquishment of direct controls on credit allocations, adoption of indirect means of monetary management, liberalization of the foreign exchange regime—have been maintained and perfected. Some additional measures have been taken to further liberalize the financial system, promote competition, and improve its efficiency; examples include gradual reduction in the minimum term of investment certificates that can be offered by private banks, reduction in reserve requirements on dollar deposits, and permitting of dollar-denominated loans.

Although difficult to prove, it is likely that, at least in a negative sense, the project contributed to the achievement of indicators such as increased deposit mobilization and reduced transaction costs in the Costa Rican financial system. Certainly, the FSP team responsible for carrying out the work of the policy component

- Established direct and continuous access to top-level decision-makers in the Costa Rican government
- Established credibility with the above-mentioned decision-makers
- Established a steady level of demand for policy advice on key financial sector issues
- Provided sound policy advice on a consistent basis, judging from the nature and quality of the project's published work.

Movement towards financial sector liberalization was initiated in the late 1980s, and significant progress had already been made in improving the quality of financial sector management by the Costa Rican authorities before the FSP began to function. The Central Bank, for example, had already by 1990 largely abandoned the practice of setting quantitative sectoral credit limits, allowing commercial banks, public and private, to be more responsive to demand and to their own internal credit policies. Presumably, this increased both efficiency in the allocation and recovery of loans and, in the aggregate, the efficiency of borrowers in the uses to which financial resources were put.

The Calderón Administration and the economic team that took office as the FSP was being launched also shared in the goals of the project with respect to improving the efficiency and the stability of the Costa Rican financial system. Thus, the project encountered fertile ground and an opportunity for close and continuous collaboration that was not wasted.

If not for the abundance, quality, and acceptance of the analytical and advisory work performed by the FSP, it is possible—and perhaps likely—that the management of financial and monetary problems during the last three years would have been less effective, and that a deterioration in the objective indicators of sectoral performance efficiency would have been observed.

Also, with support from the policy component of the FSP, a law was passed in April 1994 bringing credit unions under Central Bank authority and AGEF supervision.

However, the FSP was not able to achieve the passage of the proposed new central bank law, nor was a conclusion reached on other important legislation needed to permanently eliminate biases against the development of private financial institutions, while at the same time bringing more private financial sector activity into the formal sector and thus into the purview of the proper regulatory authorities.

Further, while the situation has not deteriorated, it is also true that there has been little visible structural change in the formal financial system of Costa Rica, while certain indicators point worrisomely to continued rapid expansion of offshore, undocumented financial sector activity.

Deposit rates at the end of 1993 remained extremely high in real terms (ranging roughly from 19 to 24 percent in nominal terms, with inflation during 1993 estimated at 9 percent), and intermediation margins extreme (nominal lending rates for industry, for example, ranged from 34 to 39 percent).

Deposit growth in real terms was only about 3 percent per annum between 1991 and 1993, significantly less than the growth of GDP. This performance reflects extremely poor performance by the state-owned banks (which only increased their deposits by about 0.5 percent per annum in real terms during this period), while private banks (whose deposits grew at a real rate of 22 percent) continued to represent a small portion of the banking system (only 15 percent of total deposits of the banking system at the end of 1993) and thus continue to have relatively little weight in the formal financial sector as a whole.

Financial deepening, measured as the ratio of M2 (*liquidez total*) to nominal GDP, fell significantly between 1991 and 1993 (from a level of 0.55 in 1991 to 0.48 in the latter year), which, coupled with the poor rate of overall deposit growth in the formal financial system, leads one to suspect increasing diversion of financial transactions to the undocumented offshore banking sector.

Finally, the spectacular and extremely costly failure of the state-owned Banco Anglo-Costarricense in 1994 points to continuing deficiencies in the management and supervision of state-owned financial institutions, while their lagging profitability in comparison to private banks brings to mind old but still unanswered questions as to their long-term viability in the absence of governmental subsidies.<sup>11</sup>

It is impossible to tell whether the FSP policy component could have achieved more during its first three years of operation. However, the FSP still has the potential to achieve tangible, permanent changes during its remaining life.

In sum, the effort should be continued. While unequivocal and visible results eluded the policy component of the project during Phase I, the investment was not wasted, and a substantial stock of intellectual and political capital has accumulated that could lead to significant results in a short period with little additional effort. The potential economic benefits to be gained from consolidating the progress made during Phase I are enormous and, in our view, fully justify the incremental investments that remain to be made.

### **Lessons Learned**

From the perspective of financial sector development strategy in general, the experience of Costa Rica in recent years will one day provide an unusually complete case study of the perverse effects of excessive government control in fostering the development of a parallel underground financial system. Such a parallel system, because it is not sufficiently recognized by law and institutional practice, poses a potentially greater threat to financial system stability, and is in fact less controllable, than a nominally

<sup>11</sup>An update of profitability calculations made for 1991 in the FSP-sponsored *Assessment of the Costa Rican Financial Sector* indicates that state-owned banks achieved only a 0.4 percent return on assets in 1993, compared to the private banks' 2.1 percent. In part this results from loans and investments (earning assets) representing only 32 percent of total public sector bank assets, compared to 80 percent for the private banks. Source: AGEF statistics.

freer, market-based system. While we can detect that numerous lessons will emerge from the Costa Rican experience, much "academic" work remains to be done to flesh out the details of this evolving case history. Once it is available, this work will, of course, be of immense practical importance, in Costa Rica as elsewhere where basic strategic debates on financial sector development remain to be concluded.

Another broad lesson that can be gleaned from FSP experiences during Phase I is that, sometimes, the pace of change that can be achieved in a democracy—absent a major crisis or collapse—is inversely proportional to the extent to which democratic processes have taken root. Costa Rica is an example of a developing country with highly-developed democratic institutions and traditions. The legislature has considerable say over the policy proposals of the executive branch of government, and the legislature is highly partisan. The judiciary is accessible to ordinary citizens and interest groups, and it is active in enforcing the limits of governmental authority. Interest groups themselves are well-organized, and well-versed in the exercise of power through organized action.

In such settings the pace of change can be excruciatingly slow, unless a crisis—or extended public debate—create the conditions where a genuine consensus can be achieved. In Costa Rica, that consensus has not yet been achieved on financial sector development policy. However, the public debate has been started, with active FSP participation and support. A prudent approach to furthering development—one that aims to avoid crises to the extent possible—must be patiently prepared to continue the debate until the requisite consensus has been brought about. The broader the extent of democratic participation, the broader must be the debate, to include not only decision-makers but those broad groups to whom decision-makers are ultimately beholden.

At the level of project design and implementation, two important lessons may also be drawn from the FSP experience to date. One is the need to avoid an overly long project development process and *ad hoc*, piecemeal modification during project development that can result in a loss of coherence among project components. In the case of the FSP, the Prudential Regulation and Financial Innovation components, originally conceived of as highly conceptual and sectorwide in scope, became rather narrowly redefined during an overly extended project development process towards technical assistance activities aimed at particular financial sector institutions. Although sector-wide efforts to improve prudential regulation and work in developing broadly accessible financial innovations can be compatible with macro-level policy development, this is not necessarily the case when assisting credit unions in improving self-regulatory capabilities or when providing direct technical assistance to PVO umbrella organizations. In the FSP, the narrowing of scope for these two components that took place between the Project Paper and Grant Agreement stages undoubtedly led to increased difficulties in project coordination during implementation, as implementors were faced with the problem of having to coordinate between two dissimilar project segments.

A further lesson that can be drawn from the FSP experience relates to the choice of the Central Bank executive president to chair the Project Coordinating Committee. Although the commitment of such a highly-placed government official undoubtedly serves to highlight the host country government's support of a project and provides access and high visibility for project implementors, in practice it is unrealistic to expect that a person with the time pressures and responsibilities of a central bank president will be able to devote the necessary time and attention to providing project leadership and continuity. This may cause disappointment or produce an impression of disinterest, or both, as was to some extent the case with the FSP. A more practical approach is to assign counterpart leadership and management responsibilities to a senior, but nonpolitical, government official from the relevant agency, enlisting the support of top political leadership only as needed to accomplish specific project objectives.

### *Considerations for Phase II*

The incoming Figueres Administration has a strong political commitment to the public sector banking system established by the current President's father and developed by the Liberación Nacional Party that this administration represents. The incoming administration also represents a new generation of Costa Rican leadership, one that is well-aware of the internationalization of global finance and the increasing predominance throughout the world of market-based approaches to financial sector development. However, the incoming administration has not yet committed itself to a particular policy framework or plan for its financial sector development program. Therefore, while it is clear that some of the policy issues decided by the previous administration will need to be reexamined, it is also apparent that an opportunity for participation in financial sector policy formulation continues to exist for the FSP.

Serious challenges exist that will force the pace of financial sector policy development. First is the laying bare of serious management and supervision deficiencies in the state-owned banking sector. The fiscal consequences of the failure of Banco Anglo-Costarricense are enormous (estimated at up to 2 or 3 percent of GDP) and will force political attention on measures to ensure that such a failure is not repeated.

Second, as has already been alluded to, the growth of the unregulated offshore banking sector has been such as to bring into serious question the government's ability to maintain control over credit or the money supply, or to maintain public confidence in the stability of the financial system as a whole. A sharp economic downturn could easily lay bare speculative practices in the increasingly important informal financial sector that could spread into the formal sector and, through it, to the economy as a whole. The GOCR would be well advised to take measures to enable these informal institutions to operate openly, under prudent regulatory and supervisory standards. The first step in achieving this, already begun in Costa Rica, must consist of freeing up the system to the extent necessary to allow formal sector financial institutions to be locally and internationally competitive, while maintaining those minimum safeguards necessary to protect the public interest. As a second step, legislation needs to be adopted or amended to require financial institutions to (1) comply with the modernized regulatory framework and (2) provide regulatory authorities with adequate information on any operations hitherto unrecorded or unregulated, or both, no matter where these are conducted.

Attempting to enforce compliance in an overly rigid regulatory environment will only result in the disappearance of what appear, after all, to be highly-demanded financial services, to the detriment of the domestic commercial and financial communities and, ultimately, of the economy as a whole. In acquiescing to the current state of affairs regarding offshore banking, the Costa Rican authorities appear to recognize the value of services provided by the unregulated offshore banking system. However, the prolongation of the offshore banks' informal status also poses serious risks for the stability of the affiliated formal banking system and erodes the authorities' ability to conduct an effective monetary policy. Now that significant liberalization is under way, the time is approaching for steps to be taken to require offshore operations to be consolidated with those of their domestic parents or affiliates, and for this growing segment of the Costa Rican financial system to be brought into compliance with the nation's prudential and monetary control systems.

Third, the opening of the Costa Rican economy through trade liberalization with Central America, Mexico, and, ultimately, the United States, poses a strong potential competitive risk to Costa Rican financial sector institutions. Their survival in the face of international competition will force an acceleration in the pace of financial sector modernization and development. This too should offer important opportunities for the FSP to consolidate its achievements and continue making a contribution during Phase II.

The USAID Mission and project management have not been oblivious to these opportunities, but have, on the contrary, advanced quickly in the formulation of FSP operating plans for Phase II. For the policy component, these plans comprise two main areas of concentration.

First, it has been decided to continue the project's ability to provide direct advisory support to the Central Bank of Costa Rica and, when and if such is reconvened, to the new Congressional Committee on Financial Sector Reforms.

Second, an analytical agenda has been established, identifying policy studies to be conducted by the Academia in such key areas as

- The size of the informal financial sector and its relationship to the formal financial sector
- The relationships between the banking system and the securities market
- Design of early warning systems for the supervision of financial institutions
- The development of public and private pension fund systems in Costa Rica.

Some provision—rather limited, in our opinion—has also been made for publication and dissemination of research findings.

In all, current plans call for an additional \$600 thousand to be authorized for the Policy Component of the FSP, which would bring total commitments to this activity to \$2,500 over the life of the project. In light of the Mission's plans to cease operations in Costa Rica in September 1996, it is currently envisioned that the FSP will terminate its activities by December 1995, almost a full year short of its originally intended life of 5 years. Due primarily to this unanticipated shortening of the project's expected life, it is currently anticipated that, overall, the FSP will only utilize \$5,800 out of the total obligated, which is itself significantly below the \$8.4 million originally contemplated by the project's designers.

## CREDIT UNION COMPONENT

### Major Findings

The project has made reasonable progress in (1) strengthening the institutional framework of the credit union movement and (2) completing important activities in support of project objectives. This section discusses this progress, as well as some important risk factors within the credit union movement.

### *Progress in Strengthening the Institutional Framework*

#### *Fedecredito*

Fedecredito, the federation of credit unions, is the parent company of a diverse group of financial service entities and subsidiaries. For the subsidiaries, Fedecredito oversees operations and provides administrative support. For member credit unions, Fedecredito provides technical assistance and training. AUDICOOP, an organizational unit providing auditing and prudential supervision services to member credit unions, also forms part of the Fedecredito office as a quasi-decentralized organizational unit with technical independence.

The main concept involved—expanding the range of financial services for credit unions through a network of subsidiaries and using part of the profits generated by subsidiaries to finance the cost of technical assistance for credit unions—is sound. The network of subsidiaries is composed of the following companies:

- Caja Central, which manages the credit unions' liquidity reserve fund and credit cards. Caja Central also plans to expand its services by managing supplementary retirement funds.

- Consorcio de Vivienda (Coovivienda), which runs a housing finance program and obtains funding from the GOOCR's housing program.
- Banco Federado, which provides banking services within the legal framework for private commercial banks. This bank was established with seed capital funding donated by the Mission through a previous project.
- Federated International Bank (Fedebank), an offshore bank established to receive deposits and grant loans in dollar currency. Fedecrédito has a 52 percent interest in the bank.
- Univalores, a securities market brokerage agency serving Caja Central. Fedecrédito has a 43 percent interest in Univalores.

Fedecrédito has demonstrated outstanding leadership in organizing and implementing new financial entities, and has been enhancing its capability to deliver useful technical assistance services for its member credit unions.

Fedecrédito is staffed by a highly committed, hard-working group of young professionals averaging between 4 and 7 years of experience. Both Fedecrédito and AUDICOOP personnel display a dedicated, professional, proactive approach toward their jobs. We believe that monies spent on training these personnel to develop their potential and technical skills are a good investment.

We are not in a position to comment objectively on Fedecrédito's solvency and especially its liquidity situation for lack of an in-depth analysis of the overall network of subsidiaries (a type of analysis not called for in the TOR for this evaluation). Fedecrédito's overall financial structure appears reasonable. The consolidated balance sheet as of July 31, 1994, lists Fedecrédito's assets and net worth as \$83 million and \$7.9 million<sup>12</sup>, respectively, for a ratio of net worth to assets of 10.5 percent.

However, Fedebank's lack of profitability will be cause for major concern if it is not reversed soon. During 1993, the profit generated by the overall operation represented only 2.1 percent of the average net worth for the year. This low return on net worth was caused by Fedebank's loss, which in 1993 was equivalent to approximately 4.4 percent of Fedebank's net worth. All of the other subsidiaries operated with high profitability ranging from about 13 percent for Banco Federado to 40 percent for Coovivienda. Fedecrédito's profitability is an important consideration not only from the viewpoint of financial solvency, but also because Fedecrédito's technical assistance and training services to credit unions are partly financed with the profits generated by some of the subsidiaries. An important concern is that profits from profitable subsidiaries might have to be diverted to capitalize unprofitable subsidiaries.

The network of subsidiaries functions under a decision-making authority concentrated in a few individuals. The persons that represent Fedecrédito in each of the subsidiaries' own administrative councils and oversight committees (*comités de vigilancia*) are also members of the Administrative Council and Oversight Committee of Fedecrédito itself. On the other hand, the Consultative Council, which is composed of members of the administrative councils of the individual credit unions, does not appear to play a significant role. This council held only two meetings in 1993: one to discuss the conclusions of a marketing study, the other to discuss possible reform of legislation on severance payments and new legislation on a complementary retirement fund system.

This concentration of authority possibly helps to maintain (1) common decision-making criteria among board members across the network of organizations and (2) good coordination among the subsidiaries. However, such concentration of authority could work against the Fedecrédito system because it weakens checks and balances throughout the system. For example, there is a higher possibility that the parent company could attempt to help one of the subsidiaries through the support of

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<sup>12</sup>Rate of exchange: US\$1.0 = 130.0 colones.

another subsidiary in a manner that could impose undue risk on the subsidiary giving the support. We believe there is a need for some self-regulation on this matter, and possibly some regulation by AGEF on transactions among subsidiaries belonging to the same holding company.

Fedecredito has established this network of subsidiaries under a dynamic and aggressive strategy aimed at providing all types of financial services. With good leadership and sound planning, this strategy may lead the credit union movement to become one of the most important financial sector groups in Costa Rica. The risk is that excessive enthusiasm for rapid growth and diversification of financial services could separate the system from its mission or lead to high risk undertakings, or both.

We heard that a number of leaders of individual credit unions have expressed strong disagreement with some of Fedecredito's undertakings. The most controversial example has probably been Fedecredito's acquisition of the offshore bank, Fedebank. This investment does not seem to have any direct link with Fedecredito's mission of "contributing to the economic and social wellbeing of persons belonging to credit unions." Moreover, the funding required for the service of the \$1.1 million long-term debt in dollars incurred by Fedecredito to finance this investment could reduce Fedecredito's resources to finance needed support programs for credit unions in the immediate future. Fedecredito could face this situation if Fedebank does not generate enough dividends in the short run for Fedecredito to pay for the service of the debt. Fedebank made a profit of \$25,000 in 1992 and incurred a loss of \$92,000 in 1993 equivalent to 4.4 percent of its equity. We did not analyze the impact of Fedebank's loans to Banco Federado on the profitability of Banco Federado because this kind of analysis is beyond the scope of this midterm project evaluation.

According to Fedecredito's management, the key objective of Fedecredito's investment in Fedebank was to create a source of foreign currency funding for Banco Federado. Fedebank is supposed to compete in Costa Rica for dollar deposits against other Costa Rican-owned offshore banks and to use these funds to finance loans in dollars for Banco Federado. Fedecredito has indicated that the purpose of the dollar loans received by Banco Federado is for deposit in overseas correspondent banks as collateral to guarantee the correspondent banks' exposure for international trade banking transactions performed on behalf of Banco Federado. Fedecredito has also informed us that Fedebank uses any dollar liquidity remaining after financing Banco Federado to provide dollar-denominated loans for cooperative organizations that generate exports, such as cooperatives of coffee and pineapple farmers.

Regardless of Fedecredito's mission and strategic objectives, the pace and timing of Fedecredito's investments and diversification into new financial business areas suggest that Fedecredito might be underestimating the risks associated with such business strategy. An adequate balance should be sought between quick-growth strategies and risk. Fedecredito's \$1.1 million investment in Fedebank does not look like a well-balanced decision considering Fedecredito's scarce financial resources and its limited chances of gaining a significant share of the dollar offshore business in a short period of time. The timing of the investment does not appear wise either, considering that the credit unions were still recovering from a financial crisis.

### *Credit Unions*

As of December 31, 1993, 51 credit unions were affiliated with Fedecredito out of a national total of approximately 110. The affiliated unions had approximately 200,000 members.<sup>13</sup> Assets of the affiliated unions totaled C15,312 million, or \$101 million. The ratio of net worth to assets was 6.9

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<sup>13</sup>*Estudio financiero de las Cooperativas*, AUDICOOP, 31 de diciembre, 1993.

percent<sup>14</sup>. The consolidated profits of the credit unions were equivalent to 24.7 percent and 1.7 percent of their net worth and assets, respectively. Fedecredito's annual report indicates that the credit unions' assets increased by 34 percent in 1993 (the inflation rate was 9.3 percent), adding that this increase in assets was largely financed by a 46 percent increase in institutional debt.<sup>15</sup>

We believe that, to protect their financial solvency, credit unions should follow a prudent policy regarding institutional borrowing. Although the credit unions are making profits, the use of more short-term loans to finance portfolio expansion might not be prudent for many of them under their current circumstances. Further, loans that must be repaid in dollars rather than colones should normally be avoided.

The reasons for such caution are as follows:

- The ratio of arrears to portfolio balance increased more than twofold between 1992 and 1993, according to an AUDICOOP survey that included all of the members of Fedecredito as well as eight nonmembers
- Provision for bad loans was significantly underestimated
- Debt to financial institutions was equivalent to more than 40 percent of the loan portfolio (largely financed by Fedecredito) and almost five times the "real capital"<sup>16</sup> base
- Approximately 72 percent of the loan portfolio is invested in personal loans
- The portfolio's environment risk will probably increase because of a foreseeable combination of higher inflation rates in 1994 than in 1993 and recessive economic policies in the short run
- The credit unions' capital base is weak, with reserves equivalent to around 5 percent of assets. The rest of the reported net worth is made up of certificates redeemable on demand if the owner cancels his or her membership in the credit union.

Costa Rican credit unions are vulnerable to the same major internal threats that have caused so much damage to the financial health and image of credit unions in many Latin American countries. Additional efforts must be made to foster savings mobilization and develop the saving habit among the members of the credit unions in order to increase the number of net savers. One of the more serious threats to the integrity of credit unions is the composition of their boards, which are frequently made up of net debtors because practically all of their members are net debtors. This situation can lead to many types of abuses, especially in credit unions that have incurred substantial institutional debt to finance loans for their members. Innovative prudential regulation and supervision measures should be studied to ameliorate this risk.

Another important threat to the solvency of credit unions is the vulnerability of their capital base and the lack of incentives to establish a solid capital base. With the capital base made up of reserves and the easily redeemed equity certificates, the credit unions are vulnerable to a run on their own so-called "capital" from those members who happen to be net savers if they perceive even a temporary weakness in the credit union. Because credit unions can not distribute dividends and each member represents only one vote in the general assembly of all members, there is not much incentive for the members to capitalize their credit unions with "real equity capital." Again, innovative prudential

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<sup>14</sup>Excluded from net worth calculations are investments by credit union members in "equity" certificates, which can be redeemed on demand if the holder cancels his or her membership in the credit union.

<sup>15</sup>Fedecredito. *Informe Anual*, 1993.

<sup>16</sup>"Real" capital does not include investments by credit union members in "equity" certificates, which can be redeemed on demand if the holder cancels his or her membership in the credit union.

regulatory and supervisory measures should be promulgated to ensure a strong capital base and encourage members of credit unions to care more about the financial health of their organizations.

### ***Outputs Achieved***

The projects outputs achieved so far are important stepping stones toward the project objectives of

- Improving the safety and soundness of credit unions as financial intermediaries
- Building public confidence in the credit union movement
- Strengthening the regulatory infrastructure to protect the savings of credit union members
- Creating model strategies for financial intermediaries to use to protect savings.

The overall progress of this project component is satisfactory considering the short period of time that has elapsed since implementation began. The Fedecredito-A.I.D. agreement was signed on July 22, 1992; the Fedecredito-WOCCU agreement, on November 24, 1992. Significant progress has been made in the institutional development of Fedecredito. The organizational framework is in place and basic policies, methods, and procedures have been designed.

Little tangible improvement has occurred in the efficiency of credit unions' financial intermediation and prudential supervision. However, there has been some progress in improving the financial solvency of credit unions. There is also a consensus that the project has helped to improve the public's confidence in the credit union system. Membership has increased and saving deposits have expanded in real terms.

The following discussion addresses achievements to date in the following project areas:

- Prudential regulation and supervision
- The management training program
- The movement-wide information system
- Financial stability and long-term viability.

### ***Prudential Regulation and Supervision***

The enactment of the law regulating the financial intermediation activities of credit unions was an important breakthrough for the future of the credit union movement.<sup>17</sup> The law was enacted in April 1994 and came into effect in November 1994. The law mandates that AGEF extend its prudential regulation and supervisory functions to financial intermediaries of the cooperative movement. The law provides AGEF with a maximum period of 5 years to extend its supervisory functions over all of the credit unions. Such a long period of time for full implementation will allow AGEF to do this gradually. The caveat is that some credit unions could remain without prudential supervision from AGEF for several years.

The development of prudential supervision coordination arrangements between AGEF and AUDICOOP should help AGEF to carry out its mandate more effectively. Under these arrangements, AUDICOOP would perform auxiliary supervisory functions in support of the AGEF's prudential regulation and supervisory mandate. Such coordination will be helpful in (1) establishing the managerial and financial management systems in the individual credit unions to ensure and supervise their adherence to prudential regulation norms, and (2) extending and expanding the supervisory outreach over credit unions. The law regulating the financial intermediation activities of credit unions provides flexibility by giving the credit unions' integration organizations the faculty to perform auxiliary

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<sup>17</sup>*Ley de Regulación de la Actividad de Intermediación Financiera de las Organizaciones Cooperativas*, abril 14, 1994.

supervisory activities (article 7). Federations of credit unions can supervise individual members (article 31).

The project, through both WOCCU as an institutional contractor and the Mission itself, organized tours to various countries to study prudential regulation and legislation on, and supervision of, credit unions. Participating in the tours were officials from AGEF and Fedecredito, as well as members of congress. Fedecredito officials participated in discussions with the Central Bank, AGEF, and members of congress during the preparation of the Costa Rican legislation.

Organization and staffing of AUDICOOP, along with definition of its functions as a semi-decentralized organizational unit within Fedecredito, were completed in July 1993. AUDICOOP has produced several manuals and procedures for standardizing the credit unions' financial systems and reporting. In addition, it has designed methodologies to carry out tasks related to financial and operational auditing and prudential supervision of credit unions. AUDICOOP has performed financial audits of five credit unions and operational audits of six.

Fedecredito produced a study on the financial situation of Costa Rica's credit union as of December 1993.<sup>18</sup> The original methodology and software for this study were provided by WOCCU, which carried out the study for year 1992. In addition to technical assistance from WOCCU, AUDICOOP has received technical support from the Federation of Credit Unions of Germany through an agreement not financed by the Mission.

The following are examples of WOCCU's technical assistance in this area:

- Preparing financial and economic performance indicators
- Evaluating the credit unions' provisions for bad loans
- Collaborating on the preparation of an accounting manual
- Preparing a prudential supervision inspection manual
- Inviting a member of the staff of the National Credit Union Administration to share with Fedecredito his experience on mergers of credit unions.

AGEF has initiated preparatory work to perform prudential regulation and supervision of credit unions. A new organizational unit has been put in place to perform this function. AGEF has completed a diagnosis of the credit union sector and has defined its computerization needs, including hardware requirements, with an estimated cost of \$166,000. The Mission informed us that funding for this purpose was eliminated from the revised project budget.

AUDICOOP has maintained communication with AGEF regarding AUDICOOP's support for prudential regulation activities. However, no concrete coordination arrangement has yet been established, possibly because AGEF is not yet ready to discuss this matter. In order to focus their support for the credit unions on those aspects that are more important for AGEF, AUDICOOP and Fedecredito must at least be informed of AGEF's priorities and basic approach regarding regulations and prudential supervision for credit unions. For now the most important priority for Fedecredito is to help the largest credit unions implement improved financial management systems and financial solvency protection policies.

### *Management Training Program*

In addition to 12 study tours with a total of 57 participants, between April 1993 and April 1994 WOCCU provided Fedecredito with 22 management courses totaling approximately 52,400 participant-hours, an average of 503 participant-days per month (assuming 8 hours of training per day).

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<sup>18</sup>*Estudio financiero de las Cooperativas, Audicoop, 31 de diciembre, 1993.*

The courses covered a wide range of managerial subjects such as organizational diagnosis, negotiation strategies, planning, credit, marketing, and bank management. In addition, one person received training in the auditing of computerized data processing systems and another 15 persons received training for 5 months in English as a second language.

Fedecredito personnel themselves have been providing credit unions with a significant amount of training financed by the credit union movement. For example, in 1993 Fedecredito delivered 26 courses totaling approximately 517,000 participant-hours of training, an average of 5,385 participant-days per month. These courses, attended by key personnel from the credit unions, covered a wide range of subjects. In addition, through the National University, Fedecredito provided an intermittent course on credit union management for 17 leaders of 15 credit unions.

There have been no surveys or interviews of past course participants to determine the extent to which the new knowledge gained through the courses has been applied (lack of follow-up is common in most training programs). However, we have reason to believe the training has been useful. Fedecredito personnel commented favorably on the courses delivered with project funds. In addition, all three credit union managers interviewed commented favorably on the usefulness of the courses that they either attended or oversaw.

#### *Movement-wide Information System*

A movement-wide information system has not yet been established. The design and implementation of this system involve three major steps:

- Standardizing an accounting system and statements of savings and loans for individual clients
- Allowing the electronic transfer of funds to allow credit unions to process basic financial intermediation transaction on behalf of other credit unions
- Establishing a system to access credit referral information about individual members of credit unions.

Implementation of the overall system will take time. AUDICOOP recently finished the design of the accounting system and Fedecredito just began providing support to a few selected credit unions for the implementation of the system. The electronic system has yet to be designed. Fedecredito also plans to integrate into the system credit card transactions and automatic teller machines. An assessment and recommendations regarding the planning framework for this project were prepared by consultant Alvaro Garcia.

Fedecredito should review the design or instructions for the computerization of the accounting system. One of the credit unions interviewed informed us that they had had difficulty implementing the computerized accounting system because of problems with the nomenclature of accounts. The general manager indicated that he will be able to solve the problem because he himself has substantial expertise in computerized data processing systems. Other credit unions that do not have such expertise will probably have trouble implementing this system.

#### *Financial Stability and Long-term Viability*

Significant progress has been made in putting in place the central liquidity facility and in designing improved policies and managerial systems as stepping stones in the process of ensuring the credit unions' solvency and long-term viability.

Key outputs achieved are as follows: (1) the central liquidity facility is functioning at the Caja Central; and (2) out of 13 credit unions facing extremely serious financial problems at the beginning of the project, at least 8 have improved their situation and are now considered financially viable entities.

Standard norms for credit operations, including portfolio classification and provision for bad loans, have been developed; so far, four credit unions have implemented them.

In addition to helping Caja Central design and implement its operating manuals, WOCCU has provided Fedecredito with support in technical assistance activities for the credit unions. The following are the main activities in which WOCCU was involved:

- Evaluation of the credit unions' credit systems and preparation of a credit manual and assistance for its implementation in 16 credit unions
- Updating of financial policies
- Planning and budgeting methodologies
- Advisory services on the management of credit cards, with emphasis on prevention measures against fraud
- Marketing studies for eight credit unions
- Credit analysis training to improve the analytical skills of managers and credit officers
- Preparation of manuals for cash management, financial planning, and management of assets and liabilities.

WOCCU also provided Fedecredito with technical assistance in the design of policies and the basic framework for establishing a stabilization fund. The objective of this fund is to rescue from bankruptcy those credit unions that may be affected by uncontrollable events such as natural catastrophes. However, Fedecredito has performed a diagnosis determining that implementation of the fund is not currently feasible.

Similarly, a WOCCU study recommended not implementing the savings protection program or insurance facility at this time because of the lack of prudential regulation and supervision and the need to improve the financial administration and financial discipline of the credit unions.

### *WOCCU's Technical Support*

Our opinion is that WOCCU's technical support services have been very useful. Study tours enhanced the knowledge of government authorities and credit union leaders on the need for and implementation of prudential regulation and supervision. Technical assistance for the Caja Central was helpful in strengthening the Caja Central's managerial and operational capability. In-country training and technical assistance in the design and implementation of standardized financial management and credit systems for the credit unions have improved Fedecredito's ability to deliver useful technical assistance services for credit unions. Fedecredito personnel interviewed consider that WOCCU's technical assistance and training services have been useful, but expensive.

Between November 24, 1992 and July 31, 1994, WOCCU provided approximately 794 person-days of technical services at a cost of \$987,454.<sup>19</sup> WOCCU's long-term consultant provided a level of effort of 462 person-days, equivalent to 58 percent of the total level of effort. The total cost includes \$75,000 for study tours and approximately \$44,000 paid to SDID. The average cost per person-month is about \$27,000.

Although the average cost per person-month of \$27,000 (as of August 31, 1994) appears high, it does not seem out of the usual cost range in comparison with similar projects when one takes into account the following factors, using accounting cost data provided by WOCCU.

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<sup>19</sup>Data from WOCCU.

### *Level of Effort*

The LOE used for computing the overall average cost of \$27,000 per person-month includes only the LOE provided directly by WOCCU through long-term personnel (21.5 person-months) and short-term consultants (15.1 person-months). It reflects neither the LOE provided by institutions contracted by WOCCU to deliver training nor the LOE provided by WOCCU's staff under the budget line item "technical support." The average cost per person-month falls to \$21,844 when the cost of technical services contracted by WOCCU is subtracted from the overall cost of \$987,454.

WOCCU delivered study tours and subcontracted with the Instituto Centroamericano de Administración de Empresas (INCAE) certain in-country training activities. The cost incurred for these activities is reflected in the statement of expenditures under the line item "training" and amounts to \$144,953, which is equivalent to \$3960 per person-month. The statement of expenditures shows an amount of \$43,791 paid to SDID for technical and training services subcontracted with this organization. This amount is equivalent to \$1,196 per person-month.

### *Home Office Technical Support*

The home office technical support provided by WOCCU amounts to \$114,730 and is equivalent to \$3,135 per person-month. The amount of \$114,730 is also equivalent to 45 percent of the total cost represented by the sum of the line items "salaries (long-term personnel)" plus "salaries (short-term consultants)" plus "fringe benefits." This percentage is high in comparison with most projects of a similar nature with which we are acquainted. However, WOCCU's technical support Fedecredito was conceived with a high dependence on home office technical support. This can be observed by analyzing the cost structure of the obligated budget. The line item "home office technical support" of the obligated budget amounts to \$177,181 and is equivalent to 106 percent of the total for salaries, consultants, and fringes of \$166,000. WOCCU informed the evaluator that the line item "home office technical support" includes not only salaries and fringes incurred in the provision of home office support, but also other direct cost items associated with the support provided—such as delivery, telecommunications, travel, and translations—which represent approximately 35 percent of the home office technical support cost.

Our opinion is that the overall cost of technical assistance and training services provided by WOCCU falls into the highest part of the cost range that could be expected from similar United States-based providers of similar services in Costa Rica.

### *Project Planning and Monitoring*

Both Fedecredito and AUDICOOP have documented project progress fairly well. At this stage of implementation, the general content of the studies performed and the methods and procedures designed can be classified as between good and very good from the point of view of their relevance and usefulness. A quick review of a sample of analytical documents did not reveal any technical errors.<sup>20</sup> However, some particular areas need a more in-depth analysis. For example,

- The baseline study on credit unions would have been more useful if it had provided a comparative analysis on members and nonmembers of Fedecredito
- Certain parts of some of the analysis performed should analyze data in real terms
- Borrowers' credit concentration aspects should be verified during inspections.

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<sup>20</sup>AUDICOOP, *Base Line Study*, 1994, and *Inspection Report of Coocique. R.L.*, September 12, 1994.

The project annual planning documents communicate well what Fedecredito and AUDICOOP want to achieve. However, the planning methodology needs to be improved to produce more realistic plans. Furthermore, some of the indicators used with regard to the implementation of new methods and manuals by the credit unions need clarification. For example, the accounting manual should not be considered fully implemented until the credit union is able to generate financial statements and supplementary reports in a timely manner and without errors. Before the manual is fully implemented, the implementation status could be expressed as, for example, a "new accounting manual in the process of implementation: basic training completed and on-the-job training through simulations in progress; 2 months away from full implementation." Work plans should spell out not only the time frame, but also the level of effort that Fedecredito will commit itself to providing during such a time frame. We can anticipate that the level of effort and time frame required from Fedecredito will vary among credit unions.

Fedecredito should develop technical support work plan models for various groups of credit unions classified according to the extent the credit unions' own institutional capability to implement the innovations that should be adopted. In this manner, Fedecredito's planning process would be more efficient.

A computerized system should be developed to monitor both the technical assistance work plans for credit unions and the implementation of new methods and technologies. The immediate objective of the technical assistance work plans is the credit unions' adoption of new methods and technologies. Reports from the system would facilitate the evaluation of the technical assistance efficacy and efficiency.

## Conclusions

Our most important conclusions may be summarized as follows:

- Fedecredito's concept to expand the range of financial services for credit unions is sound as long as the financial services established are really needed and the subsidiaries can operate profitably. Profits from the subsidiaries are the only certain source of funding to finance the credit unions' technical assistance needs.
- High-level decision-making authority and oversight functions across the overall Fedecredito system are concentrated to an extent that might not be healthy for the system. We believe there is a need for at least some regulation either limiting the concentration of authority or reducing the risks inherent in such a concentration.
- The credit unions' institutional debt over the loan portfolio of 40 percent is high under the current circumstances. Fedecredito and the credit unions should establish some guidelines and self-regulation regarding both debt in local Costa Rican currency and foreign currency.
- AGEF, in coordination with the Instituto de Fomento Cooperativo (INFOCOOP), should establish prudential regulation and supervision measures to reduce the potential risks derived from concentration of net debtors on the boards of credit unions. Innovative prudential regulation should also be enacted to ensure that credit unions function with an adequate capital base of permanent capital.
- Although the project's intended final outputs are far from being achieved, the implementation activities carried out so far are consistent with the objectives and outputs established in the project design and agreements. Overall progress so far is satisfactory, especially in management training.

- The partial outputs achieved so far in the area of prudential supervision should be useful for implementing AUDICOOP's prudential supervision mandate. AUDICOOP has already performed financial and operational inspections of a few credit unions. Intermediate project outputs have been generated toward the goals of financial stability and long-term viability of credit unions, especially the implementation of the central liquidity facility. New methods and procedures have been designed to standardized financial planning, control, and reporting, as well as some aspects of credit systems. WOCCU's technical assistance and training services have been useful in the design and development of these improvements.
- There is a need to improve project planning and monitoring, as well as to monitor the credit unions' implementation of new or improved systems designed for their use. A computerized system should be used to monitor technical assistance for credit unions.

### **Priorities for Phase II**

Project priorities for Phase II should address the need to adopt an improved project planning and monitoring methodology. Technical assistance to subsidiaries should concentrate on strengthening the credit unions' capacity for financial intermediation and Fedecredito's ability to deliver technical assistance. Technical assistance to credit unions should focus on ensuring financial viability and on adhering to prudential regulation.

### ***Technical Assistance to Fedecredito***

Although the project implementation plan proposed by Fedecredito for the period April 1994–June 1995 addresses important issues and modernization needs, more planning is necessary to ensure that the final plan is realistic considering the established time frame. The end-of-project status indicators (EOPS) should be defined in more concrete terms to ensure accountability and effective project monitoring. Also, the level of effort required should be estimated to ensure the timely availability of technical personnel. In addition, Fedecredito should

- Establish implementation priorities
- Review the tasks' implementation sequence
- Prepare a more detailed work plan that is easier to monitor.

There are some high priority tasks that are not included in Fedecredito's plan. These include determining (1) strategies or means to ensure that credit unions function with "real-capital" adequacy and (2) the legal and practical viability of establishing norms to ensure that administrative councils act as true leaders seeking to maintain and protect the financial solvency of the credit unions, rather than display a bias in favor of net debtors. Special studies will also be needed to supply AGEF with objective feedback on the pace, stages, and time frame for the implementation of prudential regulation norms. Fedecredito's competence in project management should be enhanced by establishing a computerized project monitoring system.

The most important project objective regarding the Fedecredito's owned entities should be to (1) develop the Caja Central's technical capabilities to provide new savings mobilization services to credit unions and to manage funds established to meet various investors' needs such as special retirement accounts, and (2) improve Fedecredito's technical assistance planning, monitoring, and outreach to expedite the credit unions' implementation of standard management systems and prudential regulation norms.

In addition, Fedecredito's proposed electronic communication network is an important innovation that should receive project support even if it is not possible to complete its implementation during the rest of the life of the project. We recommend that Fedecredito obtain the following technical support:

- WOCCU or an institutional contractor should perform a final review of Fedecredito's network needs and conceptualization of the system
- An institutional contractor should determine the basic system configuration and software requirements and prepare detailed TOR for the design of the overall system spelling out implementation priorities for the system applications
- Another institutional contractor should carry out the system design and implementation under a turnkey contract
- WOCCU, through its own personnel or through a subcontract with another organization of the credit union movement should help Fedecredito in the supervision of the institutional contractors mentioned above.

A final issue that should be studied is the high concentration of authority in Fedecredito's board and oversight committee for subsidiaries. This problem could be addressed by simply establishing in Fedecredito's bylaws that no individual can be a member of more than one oversight committee. In this manner, a better system of checks and balances can be achieved while at the same time retaining the administrative councils' current structure and establishing some norms of self-regulation.

### ***Credit Unions***

During the rest of the life of the project, the most important objectives for the credit unions are (1) to protect and strengthen their own financial solvency and (2) to complete the implementation of standard policies, norms, and operating systems in order to improve management effectiveness and to control adherence to prudential regulation. Fedecredito's highest support priorities for the credit unions should include

- Developing innovative saving mobilization products and marketing strategies
- Improving financial and credit policies
- Implementing standard prudential norms and operational and internal control systems to strengthen managerial efficacy and improve accountability
- Developing coordination arrangements between AUDICOOP and AGEF to ensure that AUDICOOP is able to provide useful support for AGEF.

In addition, the project should finance studies related to various important issues that should be addressed in the short run. One such study should explore ways to both foster saving habits and balance the influence of net debtors in the administrative councils. It might be feasible to require that administrative councils comprise a mix of net debtors and net savers to reduce the influence of net debtors, or that members of the administrative council keep a debt-to-savings ratio below a certain amount.

Similarly, a study should be carried out to determine and establish a strategy to increase the credit unions' permanent capital. Possible options include

- Establishing that capital contributions established on the amount of loans provided will not be repurchased by the credit union itself under any circumstance; rather, they would have to be sold to other members of the credit union at a price negotiated between the purchaser and buyer

- Earmarking a significant percentage of profits (*excedentes*) to go to increasing the permanent capital
- A combination of both of the above options.

A way must immediately be found to separate the financial intermediation services from "multiservice" credit unions. This study should include a legal analysis, as well as an examination of the financial implications of the divestiture.

Recommendations from these studies will have to be discussed at length with the credit unions in order to analyze possible impact on a case by case basis. Implementation of the recommendations will have to be carried out gradually.

## **MICROENTERPRISE COMPONENT**

### **Major Findings**

#### ***Strategy for Introducing Innovative Approaches to Client Service***

The purpose of the microenterprise component is to give expanding numbers of small and microentrepreneurs increased access to financial services. Funds will be locally generated, with as little external subsidy as possible.

According to the FSP project paper, this component will generate two outputs helping the financial sector to meet the need of project clientele for financial services:

1. Management of other financial intermediaries will be improved through technical assistance and training, resulting in a better quality of services.
2. Innovative approaches to improving services to the project clientele will be tested in cooperation with a range of financial institutions.

With technical assistance it is assumed that managers of PVOs serving the project clientele will strengthen their operating efficiency, planning, and financial controls. The assistance is intended to anticipate sector development, allowing these more efficient and aggressive institutions to be better positioned to attend increasing levels of services. Among the topics to be covered by such training are asset and liability management, financial control, data processing for portfolio control, staff incentives, and decentralized decision-making.

The FSP project paper provided a variety of examples of financial innovations that could be tested during project implementation by financial cooperatives and PVOs working in collaboration with private banks. For example, the document mentioned project assistance to facilitate the presentation of a financial PVO to a private bank. This might involve grouping PVO portfolios together to circumvent bank aversion to working with individual small-scale savers and borrowers that the banks might otherwise shun as unprofitable. Commercial banks would thus have the opportunity to develop relationships with small-scale entrepreneurs, and the entrepreneurs would gain a foothold in the formal financial system.

#### ***Outputs Achieved***

The project design did not establish any specific sequence for the implementation of the two broad outputs of this component. During the implementation phase, OSU, the project contractor, after evaluating the institutional weaknesses of the PVOs to be assisted, strongly recommended concentrating the project's initial efforts in strengthening the capabilities of ACORDE, FINCA, and

Avance in management, strategic planning, internal procedures and controls, portfolio management, and other areas before moving on to innovations.

As a consequence of this strategy, a significant amount of the outputs reported correspond to activity in technical assistance and training, whereas a lesser amount correspond to activity in innovation.

### ACORDE

The Asociación Costarricense para Organizaciones de Desarrollo (ACORDE) was established in 1987 as a nonprofit umbrella organization providing credit and technical assistance to PVOs. The PVOs, in turn, supplied credit, training, and technical assistance directly to small and microenterprises.

Until the beginning of the FSP, ACORDE, operating under its initial mission and strategy, provided PVOs with credit at subsidized interest rates. (This was in addition to subsidies to cover the PVOs' operating deficits.) As a matter of policy, neither ACORDE nor the PVOs had real concern for their self-sufficiency and long-term financial viability.

In June 1992 the Academia, as its initial approach for its technical assistance to ACORDE, evaluated ACORDE's financial position, policies, and administrative structure. The evaluation recommended a broad range of changes to the organization's mission, strategic planning, credit policy, technical assistance delivery strategy, and administrative structure. Among the most important were that ACORDE should

- Place as its most important goal its own self-sufficiency and long-term viability
- Commit the greater part of its resources to lending at market interest rates that would allow ACORDE to recover operational costs including loan losses, cost of funds, and inflation costs
- Reduce its general and administrative expenses as a percentage of loan portfolio
- Concentrate its lending efforts and technical assistance on those PVOs showing best clientele outreach and highest probability of achieving self-sufficiency.

In helping ACORDE implement these and related recommendations, the Academia's most important instrument consisted of an operating plan model against which monthly results may be compared, thus assuring senior management that financial and operational targets are being met. ACORDE's general manager gave high marks to the Academia's technical assistance, which he considered most beneficial for the organization.

Our evaluation of ACORDE's latest results shows improvements. ACORDE increased its average interest rates from 20.2 percent in December 1993 to 23.04 percent in August 1994. General and administrative expenses as a percentage of loan portfolio have decreased from 16.7 percent in 1992 to 7.1 percent in August 1994. In 1991 ACORDE provided financing to 40 PVOs; currently, 26 organizations are in its portfolio, of which six are cooperatives.

To improve its cost-effectiveness, ACORDE should eliminate from its technical assistance program those organizations that fail to (1) demonstrate a willingness to follow ACORDE's technical recommendations without good reason or (2) make adequate progress toward achieving financial self-sufficiency. We believe that ACORDE should establish institutional progress milestones for each of the organizations receiving its technical assistance and periodically review the progress made by the organizations. Those organizations unable to justify their failure to reach the milestones should be removed from the program.

Although technical assistance has so far been limited to subcontracting specific services needed, no follow-up is being done on the implementation of subcontractor recommendations. A reduced number of PVOs would permit ACORDE to effectively supervise the implementation of recommendations.

ACORDE should also increase its current staff with a supervisor who periodically would visit these organizations to provide supervision and guidance on these matters.

### *FINCA*

The Fundación Integral Campesina (FINCA) was founded in 1984 as a nonprofit organization working exclusively through rural village banks. Among Costa Rican PVOs, FINCA is considered to serve the greatest number of microenterprises, with more than 4,000 beneficiaries and 210 village banks at the end of 1993.

An analysis of the organization by the Academia at the beginning of the project revealed that, although FINCA has had relative success in providing credit and technical assistance to a substantial clientele, there was a need for significant adjustments to the organization's policy and management to secure its financial self-sufficiency and future growth. Based on those findings, the Academia has since the beginning of the project been providing institutional strengthening assistance to FINCA.

As part of that assistance, an organizational manual was prepared that emphasized the decentralization of FINCA's decision-making structure. Several efforts have been made toward this goal. However, as reported by the Academia and confirmed during this evaluation, most of FINCA's administrative decisions are still centered on its Executive Director. For this PVO to successfully grow from its current portfolio to 400-600 banks, as projected by the organization, it must decentralize its current organizational structure.

The Academia also provided financial assistance in the form of strategic financial projections for alternative means of attaining self-sufficiency. We found the document showing the projection to be of high quality, noting only that it should have been delivered to FINCA with adequate narrative implementation instructions to facilitate its understanding and execution, especially at the middle-management level. Even though FINCA has continued improving its financial position to the point at which it covered 96 percent of its operational costs in 1993, to reach the projected goal the organization needs to increase its portfolio.

For an institution of its size and operational complexity, FINCA must also have at its disposal an efficient mechanized management information system (MIS). Since 1991 FINCA has been struggling with the programming and installation of a system donated by the IDB that is still not functioning. The impact of this deficiency (currently being resolved) on FINCA's results is not easy to quantify, but has doubtless been substantial.

Considering future growth plans and current management weaknesses, it is recommended that FINCA strengthen its management structure with a high-ranking professional. This would permit the executive director to delegate a considerable amount of work in the areas of MIS and financial analysis and control. The hired professional will assume direct responsibility on certain specific operational activities. However, because FINCA is not yet financially self-sufficient, it would have to depend on a grant to finance the cost of a high-ranking professional.

### *Avance*

The grant agreement specifically designated Avance Microempresarial (Avance) as one of the PVOs receiving training and technical assistance in order to improve its institutional capability to serve its expanding clientele.

An institutional assessment of the organization carried out by the Academia revealed serious weaknesses in the organization's portfolio. These weaknesses included arrearages of over 40 percent as well as organizational deficiencies, operational deficits, and negative net worth. As technical assistance,

the Academia prepared an organizational manual, a portfolio collection manual, and strategic financial projections for alternative operational solutions to attain self-sufficiency.

However, because of Avance's poor compliance with Academia recommendations, the contractor suspended technical assistance to Avance in 1994. Some improvements in Avance's financial position were recently reported, such as a slight reduction in its portfolio arrearage from 40.0 percent to 32.6 percent—but also reported was a decrease in the number of customers from approximately 1,600 to 600. According to its general manager, the organization is not expected to break even with positive income monthly results until March or April of 1995, and its current negative net worth will not be overcome until 1998.

Considering those expectations, the project's limited time frame, and Avance's poor compliance with the Academia's recommendations, it is recommended that no further assistance be provided to Avance.

### *Banco Nacional de Costa Rica*

The FSP project paper stated that no financial or technical assistance should be provided to state-owned banks. However, considering the limited and uneven experience with the PVOs selected and the substantial amount of credit to small farmers disbursed by Banco Nacional, the Mission agreed that some assistance be given to such banks.

Banco Nacional performed an investigation on the Juntas Rurales de Crédito, which have existed as a mechanism to channel funds to small rural farmers since 1914. The study concluded that the number of small farmers served has declined in recent years from approximately 25,000 in the 1960s to 7,000 in 1992, but that Banco Nacional still constituted an important source of funding for small farmers. The study also reported that since August 1993 the bank has initiated a new small business loan program serving artisans, small industrial producers, and small business and commerce. The study recommended that in order to expand its customer base and attain branch self-sufficiency, the bank should adapt its previous experience to new lending technology and financial services at market interest rates and low transaction costs.

On the basis of these findings, we recommend that the Academia assist Banco Nacional in designing a specialized branch for small businesses and farmers as a pilot project, applying innovative approaches to providing new financial services to small and microbusinesses. We also recommend studies analyzing

- The characteristics of small and microenterprise customers financed under the bank's personal loans and credit card programs; this will determine bank participation in the small business market through these programs. (A bank officer interviewed estimates that much greater numbers of loans could be provided through these programs.)
- Why customers are willing to pay market interest rates instead of demanding loans through the institution-subsidized small farmer/business programs.

### *Banco Popular*

The Banco Popular also was not included in the original project design. As a result of its peculiar legal structure, this bank is considered neither a wholly owned state bank nor a private bank. Its strength in the Costa Rican financial system and the number of loans provided to small borrowers made advisable an assessment of its financial condition and credit policies.

The bank has 18 branches nationwide and is owned at least nominally by about 800,000 workers. Currently its portfolio includes approximately 100,000 loans, of which 4,000 are estimated by its

general manager to be small-producer loans. According to the Academia, the bank's exemption from both deposit reserve requirements and certain local taxes allows it to charge subsidized interest rates that distort the market and reduce the ability of other market players, including PVOs, to charge real interest rates. Approval of the financial reforms presented to the Costa Rican Congress would transform the institution into a private bank subject to reserve requirements and taxes.

The bank requires certain assistance to determine its credit and interest rate policies. Also, senior management personnel have expressed interest in assistance to create a second-story lending window for PVOs to provide credits for small and microenterprises in a fashion similar to the loan recently approved to FINCA for the amount of 41.0 million colones.

### *Innovations*

As mentioned previously, the change in strategy resulting from the PVOs' operational weaknesses delayed the research and implementation of project innovations. To date, reported innovations include

- The design of the Certificados de Aportación Patrimonial (CAP) implemented in approximately 20 FINCA community banks (*bancomunales*)
- The design of guidelines for implementing the securitization of mortgages and other types of loans
- The credit approved by Banco Popular to FINCA for 41.0 million colones, in which the Academia played an important role.

For the second phase of the project, the Academia estimates it will assist FINCA in increasing the number of village banks implementing CAPs from 20 to 100. Also, efforts will be made to implement credit securitization at Banco Hipotecario. The decision to initiate the testing of this innovation at a mortgage bank was based on the fact that this type of loan packaging is more easily adapted to portfolios that by nature are long-term and basically similar in terms and conditions. After this experiment has been completed, it will be simpler to package other types of loans, such as small business financing. Important innovative experiments can also be expected from the assistance to Banco Nacional and Banco Popular.

### *Research and Dissemination*

Outputs have consisted of direct research and dissemination on Costa Rica microenterprise financing, management training, and institutional strengthening.

Two books on the subject have been published, more than 40 technical articles and operational manuals have been written, and five seminars have been delivered to 359 participants. We have reviewed several chapters of the books published and a considerable amount of technical articles, all of generally excellent professional quality.

### *Other activities*

Two specific activities were funded directly with Mission resources:

- A trip in March 1992 to Indonesia with PVOs and local bankers to examine the microenterprise lending systems implemented in that country
- A trip in April 1994 to review the lending experience of BancoSol in Bolivia.

## Conclusions

### *Retrospective Analysis*

#### *Consistency of Realized Outputs with Original Project Objectives*

The FSP's goal is to increase access by Costa Rican households, small businesses, and farmers to a full range of financial services in order to stimulate, savings, investment, and economic growth.

The Costa Rican financial system has the potential to meet the needs of large and small clients through an improved financial intermediation system capable of growing and contributing to production and incomes. However, the system needs to overcome a range of deficiencies at all levels of the financial sector, including complicated procedures and rigidity, poor financial information, controls, and management weakness. All are being addressed by this project.

Efforts to solve these problems at the macroeconomic and political levels fall under the policy analysis and dissemination component of this project. The purpose of the microenterprise component was defined at the operational level as increasing institutional efficiency through technical assistance, training, and testing of innovations.

The approach of OSU and the Academia to achieving the goals of this component comprises three parts:

1. Research, and dissemination of findings, on the political and economic factors limiting the growth of financial services to small scale borrowers and savers
2. Technical assistance to the PVOs and banks already mentioned
3. Research and experimentation for the creation of innovative mechanism for financial service delivery.

The decision initially to place institutional strengthening before innovations was appropriate: it would not have made sense to concentrate on innovations in institutions burdened by questionable management and weak financial viability. However, this change in strategy delayed research and implementation of project innovations. It is expected that during implementation of the second phase of the project, the contractor will assign more resources to fulfilling project targets for innovation.

Research outputs have been substantial and of excellent quality. However, during the first three years only five seminars were given, with a total of 359 participants. Because education on market rigidities and imperfections is an important tool for change, we recommend that existing research publications be more widely disseminated.

#### *Quantitative Evaluation of Project Performance*

The FSP project paper logframe (see Appendix C) mentions only two specific activities related to the project purpose as verifiable indicators of this component: (1) improved management of institutions serving small savers and borrowers and (2) creation of six innovative mechanisms for financial service delivery.

As expressed in the Outputs Achieved section earlier in this chapter, institutional support was provided to ACORDE, FINCA, and Avance, resulting in substantial progress in cases of the first two organizations. Also, research was done at Banco Nacional de Costa Rica and Banco Popular. Except for the support to Avance, these efforts should continue in Phase II of the project.

Innovations have so far have been limited to the design of the CAPs implemented in approximately 20 FINCA *bancomunales*, and the design of guidelines for implementing securitization of mortgages and other types of loans. Even though not mentioned as such by the Academia, we could also consider

a successful innovation the disbursement of a loan for 41.0 million colones by Banco Popular to FINCA in which the Academia played an important intermediary role.

#### *Qualitative Evaluation of Project Performance*

All participants, including Banco Nacional and Banco Popular, have issued excellent reports on the quality and effectiveness of the technical assistance received. Implementation has in some cases been delayed or suspended, as was the case of the FINCA promoters incentive plan, which was discontinued for lack of lending resources. Avance gave the Academia's assistance high marks but was suspended from the program by the Academia because of poor compliance with technical assistance recommendations.

#### *Progress Toward Achievement of Project Objectives*

Although some progress has been made toward achieving project objectives, a great deal of targets remain to be met if project goals are to be reached.

Overall, the most significant achievements at the PVO level have been

- The recognition of the importance of lending at real interest rates
- The acceptance of the self-sufficiency concept
- The implementation of strategies to achieve such goals.

Only ACORDE and, perhaps, FINCA appear to be truly important PVOs in terms of financial viability and number of customers.

At the PVOs receiving technical assistance, the importance of lending at real interest has been understood. However, more work is needed for this concept to take hold as a matter of national policy, especially at Banco Nacional and Banco Popular. Banco Nacional's interest rate for its new small business program is priced at the market basic rate (*tasa básica pasiva*) with no additional points. Similarly, Banco Popular, because of its privileged market position, usually charges below market rates also. Unless a shift in policy occurs, the large size of these banks and the large number of smallscale loans they operate will eventually reduce the PVOs' ability to increase their market share.

According to ACORDE's general manager, the number of borrowers served by all PVOs under its umbrella was at the time of the evaluation approximately 6,300. He attributed 4,000 of these to FINCA, leaving only 2,300 borrowers attended by 19 organizations. This shows that, with the exception of FINCA, most of the PVOs are small and their market penetration has been relatively insignificant. Therefore, Banco Nacional and Banco Popular's participation in the project is important for reaching a larger number of small savers and borrowers.

#### *Project Component Considerations for Phase II*

##### *Project Support Limitations*

The grant agreement signed on May 31, 1991, specified a project assistance completion date (PACD) of June 30, 1995. An important factor in analyzing project support limitations is the fact that USAID's Costa Rica Mission will be closing in approximately June 1996, and that their expressed preference is to terminate the project by December 1995.

##### *Project Strategy and Priorities*

The limited amount of project output to date suggests that by the PACD (June 30, 1995) all services projected under the microenterprise component will not be completed, and that in normal conditions an

extension for at least 2 years would be needed. However, considering the time limitation already mentioned, in addition to the Mission concern for any extension later than December 1995, we sense that our recommendations should be restricted to the activities that (1) can be accomplished in the next 15 months and (2) are within budget and OSU and Academia technical capabilities.

## 4. Comments on Planned Phase II Design and Recommendations

### PROJECT IMPLEMENTATION ARRANGEMENTS

#### Policy Analysis and Reform Component

In general, the evaluation team concurs with the Phase II plans the USAID Mission and FSP management have already established for this component.<sup>21</sup> Our only major criticism of these plans is that insufficient provision is being made for public dissemination and for the contributions that the FSP is uniquely positioned to make toward ensuring the continuity and the quality of public debate on financial sector policy issues in Costa Rica.

As expressed earlier, we believe such public debate to be all-important in bringing about the consensus needed before decisive action can be taken on the fundamental policy issues that still need to be resolved in Costa Rica today. Until such consensus is created, whether by deliberate action or by the advent of crisis, the weight of inertia is likely to continue to burden the making of policy. In our view, the support of public debate should receive at least equal weight as the other two planned areas of activity for the FSP's policy component, namely, (1) advisory services to the Central Bank and the legislature and (2) issue-oriented policy analyses.

A major concern arises from the planned phaseout of the A.I.D. program in Costa Rica, which will significantly shorten the life of the FSP. As noted earlier, effecting legislative action as wide-sweeping as is needed to bring about permanent change in the structure of the Costa Rican financial system is always a slow process in a real democracy. Unfortunately—again, in part because of delays in getting the FSP started on schedule—some of the fundamental legislative proposals developed with project assistance during the previous administration did not come to a vote during the previous congress, despite having been reported out favorably by the special committee organized to study financial sector reforms. Inevitably, it will take several months before the new administration and congress, both recently installed in May 1994, can come to grips with these existing legislative proposals and have time to consider alternatives that they will undoubtedly want to review.

As things currently stand, much will have to happen within the 12 months making up the final year of the FSP. Otherwise, an inevitable risk exists that much of the ground that has been arduously gained over the last three years will again be lost. Some means to provide for the continuation of activity on financial sector development beyond 1995—particularly as pertains to stimulating public debate and maintaining the momentum for continuous improvement—would, in our view, be highly desirable.

One proposal that merits serious consideration by USAID/Costa Rica is the endowment of a specialized association that would bring together and provide a permanent forum for those already existing groups that are most interested in financial sector development. Such an association would

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<sup>21</sup>These plans are described briefly in Chapter 3 in the section Policy Analysis and Reform Component, Considerations for Phase II.

conduct a systematic debate aimed at highlighting key issues and bringing about the general consensus that is needed before such issues can be effectively addressed by the country's political leadership. Far from constituting a new institution in itself, the idea is to establish a forum within which existing institutions can bring their views and concerns to the attention of other interested parties in a systematic and serious way—and where the main elements under debate, and the rationale supporting the consensus that is achieved, can be effectively communicated to decision-makers, opinion-makers, and the public at large.

As summarized in Exhibit 4-1, the proposed Costa Rican Forum for Financial Sector Development would be dedicated to organizing research, dissemination, and promotional activities designed to support the expansion and continuous development of Costa Rican financial markets and institutions through

- Technical development and technology transfer
- Institutional development and strengthening of human resources, and
- The continuous modernization of the legal and regulatory framework governing the Costa Rican financial system, in order to ensure its ability to achieve and maintain adequate levels of service, measured in terms of coverage, efficiency, transparency and security.

Under the leadership of a core group that might include the Academia, a founding membership could be organized to include the institutions listed in Exhibit 4-1. These institutions include

- The key business and financial sector associations: Asociación Bancaria Costarricense (ABC), CANAFIC, and the Unión de Cámaras
- The key regulatory bodies responsible for financial sector policy-making and supervision, the Central Bank, the CNV, AGEF, and the Instituto Nacional de Seguros
- The securities exchange, BNV
- The country's leading research and policy institutions, the Academia de Centroamérica and the Asociación Nacional de Fomento Económico, and the economics and finance departments of the two leading Costa Rican universities.

Such a grouping would include the main parties that can contribute to a constructive debate on financial sector development. Although it would undoubtedly bring together groups with divergent views on certain issues, this should not be considered a liability. Rather, if properly managed so as to ensure that the range of opinions was always properly reflected in the forum's public communications, this should constitute a major asset. The objective is not to preordain the outcome but to sustain, elevate, and broaden a serious-minded debate on financial sector development that is, in our view, the only way that a stable consensus supporting change can be achieved.

It is strongly recommended that A.I.D. consider funding the establishment of the proposed forum, perhaps matching the commitments that could be generated from the proposed founding membership. This recommendation has been discussed with representatives of the Academia, who have expressed a strong interest and a willingness to assume a leadership position in helping A.I.D. further develop the concept and organize its implementation. A flexible approach will clearly be required to accommodate any institutional restrictions that may affect the participation of interested parties. Public sector organizations or ranking officials from such organizations, for example, might be granted the status of noncontributing members if, as has been suggested, existing government regulations would preclude their payment of membership dues or fees. As can usefully be determined through FSP-sponsored investigations, an appropriate legal and financial structure for the proposed Financial Sector Development Forum undoubtedly exists. The main thing is to ensure that the necessary dialogue is

### Exhibit 4-1. Description of Proposed Costa Rican Forum for Financial Sector Development

#### Foro Costarricense Para la Promoción del Desarrollo del Sistema Financiero

**Naturaleza:** asociación privada técnica, didáctica, proselitista y sin fines de lucro

**Objetivo:** realizar actividades de investigación, divulgación y promoción tendientes a fomentar la ampliación y el continuo perfeccionamiento de los mercados y de las instituciones financieras de Costa Rica, mediante:

- el desarrollo técnico y la transferencia tecnológica,
- el fortalecimiento de las instituciones y de los recursos humanos del sistema, y
- la continua modernización del régimen de políticas, leyes y reglamentos del sistema, en función de los requerimientos del mismo para alcanzar niveles adecuados de cobertura, eficiencia, transparencia y seguridad.

#### *Miembros Fundadores*

Academia de Centroamérica  
Asociación Bancaria Costarricense  
Banco Central de Costa Rica  
Comisión Nacional de Valores  
AGEF/SGEF  
CANAFIC  
Bolsa Nacional de Valores  
Instituto Nacional de Seguros  
Asociación Nacional de Fomento Económico  
Universidad Autónoma de Centro América  
Universidad de Costa Rica  
Unión de Cámaras de Costa Rica

**Directiva:** renovada anualmente con derecho a reelección entre profesionales, ejecutivos, empresarios y académicos de reconocido nivel escogidos por los propietarios entre ternas presentadas por cada institución afiliada

**Políticas:** promover el debate constructivo, divulgando siempre el contenido y la justificación de las diversas opiniones cuando sobre un tema no existe un consenso entre los miembros

operar como ente promotor y facilitador, manteniendo las inversiones y los gastos fijos en niveles mínimos para asegurar su buen funcionamiento

#### *Capitalización Inicial:*

donación de la Agencia Para el Desarrollo Internacional de fondos provenientes del Proyecto de Servicios Financieros

aportes de los miembros fundadores

established between the groups that have the capability and power to affect financial sector development in Costa Rica, and that this dialogue continues for as long as necessary to achieve the consensus and bring about the changes required to ensure that Costa Rica will enjoy the quality of financial services it will need to maintain a competitive and progressive position among Latin American countries well into the next century. Such an enduring institutional legacy—nonbureaucratic, participatory, and results-oriented—would also represent a fitting culmination of more than a decade of sustained work by USAID/Costa Rica on financial sector development in this model Central American democracy.

## **Credit Union Component**

### ***Technical Assistance Needs***

#### ***Credit Unions***

Fedecredito's technical assistance approach for credit unions during the rest of the life of the project should aim at maximizing the number of credit unions (1) meeting at least minimum standards of financial and institutional capability and (2) adhering to prudential regulations issued by AGEF, as well as to reasonable norms of prudential self-regulation. The first step is to determine what these standards should be and then to estimate how much technical assistance has to be delivered to help credit unions achieve these standards.

In the area of strengthening the credit unions' institutional capability, Fedecredito should be careful not to overburden the absorption capabilities of the credit unions. Rather, it should ensure that they implement the basic policies, management systems, and self-regulation norms that will allow them to maintain or achieve the minimum financial standards within a reasonable period of time. Much of the design work related to the strengthening of institutional capability has already been done and the credit unions' adoption of these policies and systems should be expedited. Specific strategies will have to be determined with each credit union for the achievement of financial standards and implementation of self-regulation norms. This assertive approach will put the credit unions in a better position to comply with AGEF's regulations as they are issued.

A technical assistance work plan should be developed with and for each credit union. The work plans should ensure that by the end of December 1995, all of the member credit unions have attained the institutional capability standards and that at least 50 percent of them have attained the financial standards and are adhering to AGEF regulations and self-regulation norms.

We recommend hiring a group of local consultants to increase the intensity and pace of technical assistance for credit unions. A substantial level of effort will be required to achieve these goals. For example, if each credit union requires an average level of effort of 4 persons-months of technical assistance and training to reach the established goal, Fedecredito would have to provide about 200 person-months, or 16 persons during each month. Under this illustration, two persons—a financial institutions management professional and a computer system technician—could assist three credit unions, working intermittently with each one of them during a period of 6 months.

Highest priority should be assigned to those credit unions best able to meet the designated standards quickly, as well as to the largest credit unions. The team of local consultants should work under the supervision of Fedecredito personnel. The services of computer system technicians will be needed to help credit unions implement computer systems for accounting, financial management, and management of statistical data. We recommend financing the cost of local consultants with project funds.

Assistance to credit unions should also include training for current and potential leaders of individual organizations. We believe it is healthy for the credit unions to develop more competition for leadership positions and to ensure some reasonable rotation in the membership of administrative councils, oversight committees, and advisory councils.

WOCCU's assistance should be sought to

- Define the self-regulation norms and minimum standards for financial and institutional capability for credit unions
- Advise in reviewing the methodology for preparing and implementing technical assistance and training work plans for credit unions
- Help enhance or update standard policies and financial and management systems.

### *Overall System and Subsidiaries*

Assistance from WOCCU would also be helpful in

- Analyzing the institutional strengthening needs of Caja Central and assisting accordingly, in areas determined by Fedecredito on the basis of the indicated analysis. It is especially important to strengthen the Caja's capability to manage funds established to meet the needs of various investors.
- Assisting in the preparation of a 3-year strategic plan for all credit unions as a group, and reviewing Fedecredito's strategic plan.
- Conceptualizing market strategies for credit unions and developing innovative savings mobilization products.
- Performing a final review of the credit unions' needs for a computerized network system and conceptualizing the system. WOCCU should also define the basic system configuration and software needs and prepare terms of reference for the overall design and implementation of the system. Another institutional contractor should carry out the system design and implementation according to the implementation stages defined in the terms of reference (see Appendix A). We suggest that the latter contractor carry out his job under a turn-key agreement with Fedecredito and that WOCCU provide assistance in the supervision of this contractor.
- Designing and implementing a computerized project management system to monitor the implementation of technical assistance work plans for the credit unions.

A diagnosis performed by Fedecredito determined that the stabilization fund is not currently viable. We recommend reviewing this diagnosis and determining whether it is necessary to perform an in-depth feasibility study of the stabilization fund project. If the project is not implemented, Fedecredito should recommend to the Mission alternative means of investing or using funding earmarked for the stabilization fund.

### *Special Studies*

We anticipate the need to carry out a few special studies throughout the rest of the life of the project. Some of the needs for special studies already identified in this report are related to issues such as

- Establishing a permanent capital base for the credit unions
- Reducing the influence of net debtors in the composition of the credit unions' administration councils or their possible bias in favor of net debtors.

AUDICOOP's collaboration with AGEF will be needed for studying the short- and medium-term implications of some of AGEF's future regulations on credit unions, as well as the possible strategies that credit unions should follow to adhere to these regulations.

Other studies will probably be needed as new legislation affecting the financial sector is enacted and the market for saving deposits becomes more competitive.

Other than AUDICOOP's studies on the implications of new regulations, we recommend that both AUDICOOP and Fedecredito concentrate their efforts on supplying auditing and technical assistance to the credit unions. Special studies requiring a level of effort longer than one week should be assigned to either WOCCU or local consultants. Studies of a more global nature, or those analyzing the financial sector as a whole, could be performed through the Academia.

### ***Funding and Time Frame***

We believe that the \$2.7 million in project funding programmed for Fedecredito should be sufficient to implement the technical support activities recommended in this evaluation. However, an extension of the project completion date from June 30, 1995, to December 31, 1995, will be necessary to allow the technical assistance program adequate time to strengthen as many credit unions as possible.

Our judgment is that the technical assistance's ratio of benefits to cost for the period January 1–December 31, 1995, should be much higher than in any previous year of the project. Much of the potential benefit of previous project activities will not be realized without the full implementation of the activities proposed in this evaluation.

### ***Microenterprise Component***

A project extension through December 31, 1995, for the microenterprise component is recommended. Although more time will be needed to meet the goals of this component, Mission constraints preclude recommending more time.

### ***Phase II Verifiable Indicators***

At the end of project completion date as recommended the contractor should have:

- Successfully developed and tested at least six innovative mechanisms for financial service delivery
- Improved management and financial services to four PVOs, of which two should be self-sufficient
- Conducted five additional seminars on small and microbusiness project research and findings.

### ***Key Activities***

Recommendations for this component's Phase II activities are as follows for ACORDE, FINCA, Avance, Banco Nacional, Banco Popular, and the Academia.

#### ***ACORDE***

ACORDE should limit its technical assistance to a reduced number of PVOs—perhaps three or four—that have shown willingness to follow ACORDE's technical recommendations and also have some possibility of becoming self-sufficient in the next three or four years. A reduced number of PVOs receiving assistance would permit ACORDE to effectively supervise implementation of recommendations. For that purpose ACORDE should increase its current staff with a supervisor who periodically would visit these organizations to provide guidance on these matters.

### *FINCA*

It is recommended that FINCA strengthen its management structure with a high-ranking professional. This would permit the executive director to delegate a considerable amount of work in the areas of MIS and financial analysis and control. The hired professional will assume direct responsibility on certain specific operational activities. Because FINCA is not yet self-sufficient, the financing of such additional staff with project resources for at least the first year is recommended.

In addition, FINCA should initiate efforts to diversify its portfolio by opening urban village banks, allow an increase in income and a reduction in operating costs.

### *Avance*

No further assistance should be provided to Avance.

### *Banco Nacional de Costa Rica*

The Academia should continue working with Banco Nacional to design a specialized branch for small businesses and farmers as a pilot project, applying innovative approaches to providing new financial services to small and microbusinesses. We also recommend studies analyzing

- The characteristics of small and microenterprise customers financed under the bank's personal loans and credit card programs; this will determine the bank participation in the small business market through these programs.
- Why customers are willing to pay market interest rates instead of demanding loans through the institution-subsidized programs targeting small farmers and businesses.

### *Banco Popular*

Assistance to create a second-story lending window for PVOs that provide credits for small and microenterprises is recommended. Also, if the financial reforms presented to the Costa Rican Congress are approved, this institution would become a private bank subject to reserve requirements and taxes and would require assistance in determining its credit and interest rate policies. This task will probably require more time than available, but the initial studies and design could be done.

### *Academia*

In addition to the activities mentioned above, we strongly recommend that the Academia continue policy dialogue—at the political level as well as with Banco Nacional and Banco Popular—on the importance of eliminating subsidized interest rates from their small business programs. The academia should also increase its efforts to disseminate the results of its project research.

*Appendix A*

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**TERMS OF REFERENCE**

## STATEMENT OF WORK

### FINANCIAL SERVICES PROJECT

#### MID-TERM EVALUATION

#### I. INTRODUCTION

This statement of work describes the key issues and concerns that will be addressed in a mid-term evaluation of the Financial Services Project (No. 515-0247). The project, implemented by Ohio State University (OSU) and FEDECREDITO, will be evaluated by a core team of three senior professionals. The team will assess OSU and FEDECREDITO performance to date in achieving the project's objectives and make recommendations for the implementation of the second phase of the project.

#### II. OBJECTIVES

The overall objective of this evaluation is to provide guidance for the future direction of the Financial Services Project.

The specific objectives are:

- a. examine the quality and relevance of the activities carried out and the progress obtained to date towards accomplishing expected project outputs and goals.
- b. make recommendations for overcoming constraints to achieving outputs.
- c. make recommendations on future research and field support activities with emphasis on the financial innovations and microenterprise programs.

#### III BACKGROUND

In 1991 USAID signed a grant agreement with the Government of Costa Rica (GOCR) to implement a Financial Services Project (No. 515-0247) intended to assist the GOCR in the modernization and improvement of the financial system. It was evident at that time that the Costa Rican financial system was in need of reforms in order for it to respond positively to the needs of the globalization of the economy. The project addresses three specific areas of intervention:

- 1) policy analysis and dissemination;
- 2) the improvement of the prudential regulation and supervision of

c) financial innovations that would provide access to credit to micro and small entrepreneurs and financial programs for microenterprises.

Ohio State University (OSU) was contracted to develop and implement areas a) and c) in close collaboration with the GOCR's Central Bank, the Legislative Assembly, the Ministry of Finance, the General Auditing Office of Financial Institutions (AGEF) and other interested parties. OSU, in turn, sub-contracted with Academia de Centroamérica, a Costa Rican NGO, to provide technical assistance for analysis, training and dissemination.

In the area of prudential supervision, a cooperative agreement was signed with the Federación Nacional de Cooperativas de Ahorro y Crédito y de Servicios Múltiples de Costa Rica (FEDECREDITO) to strengthen the supervision and regulation of member cooperatives. FEDECREDITO sub-contracted with the World Council of Credit Unions (WOCU) to provide technical assistance in the design and implementation of instruments for supervision and regulation of member cooperatives.

The projects' PACD is June 30, 1995, although the Mission expects to extend the project through the first quarter of 1996. This mid-term evaluation will allow a review of what has been so far accomplished against initial plans proposed in the project paper and to guide the direction of the next phase of the project, taking into account present needs and time constraints.

#### IV FOCUS OF THE EVALUATION

The evaluation will focus on the three broad areas described above and should address the following issues and questions:

##### 1. Applied Research

Examine the overall quality and quantity of work produced by OSU; its relevance and impact on the implementation of the project's objectives; and the dissemination efforts so far made.

Has the analysis focused sufficiently on identification and elaboration of specific policy interventions to improve sector performance, rather than on issues of academic or peripheral concern from a policy perspective?

What evidence exists that the analysis is being effectively disseminated to decision makers in government, the legislature and the private sector?

What policy changes have been made since project initiation and to what extent has the project contributed to these changes?

## 2. Project Implementation

Examine and judge the quality, quantity, timeliness and results of the technical assistance and training done so far by WOCCU under the FEDECREDITO cooperative agreement as well as the efforts of FEDECREDITO to advance the project's objectives.\

Has an adequate legal structure been put in place for supervision of the savings and loan cooperatives?

What actions are being taken by the project to improve the cooperatives' financial management and reporting systems?

What financial services innovations been designed to improve access of micro entrepreneurs to financial services?

## 3. Constraints to Achieving Project Outputs.

Examine and discuss the major constraints to obtaining the project's objectives.

Based on interviews to staff of the organizations involved in the project, indicate their level of satisfaction with the results so far obtained. Have OSU and WOCCU been able to respond effectively to host country organizations' needs?

What has been the impact of USAID management of the project? How is it perceived by the grantees?

## 4. Recommendations for Activities for the second phase of the project.

What, if any, substantive changes should be made in the theme areas of focus? What specific changes in the substantive direction of the project should be taken?

What are the priority issues that USAID should pursue in the field of financial services in the future?

What are the potential benefits and problems associated with the implementation of these recommendations?

## V. EVALUATION AND EVALUATION PLAN

The evaluation will be conducted by a team consisting of three senior individuals: one financial system specialist, one microenterprise specialist and a credit union specialist. The financial system specialist should have broad knowledge of monetary policy formulation and ample experience in evaluating financial sector reforms. The microenterprise specialist should have prior  
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financial organizations supporting the growth of the microenterprise sector. The credit unions specialist should have ample experience in evaluating programs which support the strengthening of supervision, and the organizational and financial development of cooperative credit unions. The financial system specialist should act as chief of party of the team.

The evaluation team will convene in San José, Costa Rica where it will review project documents, including the project agreement with the Government, the cooperative agreements, amendments, workplans, reports and other outputs. Prior to this activity, the team will meet with USAID/Costa Rica officers to discuss work schedule and methodology.

The team will interview the principal researcher of OSU and Academia staff involved in project implementation, FEDECREDITO and member cooperative staff as well as government and other public and private institutions related with project implementation.

Within 20 days after the start of evaluation activities, but not later than 30 days after the signing of the contract, the evaluation team will finalize the draft report and submit five copies of the draft report to the OPS office of USAID/Costa Rica. At this time the team leader will hold a briefing for relevant USAID Costa Rica staff in San Jose.

It is expected that USAID Costa Rica will submit comments to the draft report within 15 days after receipt of the report.

The chief of party will finalize the report, including comments received by the USAID Costa Rica project staff and submit five copies to USAID/Costa Rica 15 days after receipt of comments from USAID/Costa Rica. The final evaluation will be submitted to USAID/Costa Rica not later than 60 days after the signing of the contract.

#### VI LOGISTICAL SUPPORT.

The evaluation team members will be responsible for making their own travel and lodging arrangements to San Jose, Costa Rica. The team members will be responsible for providing transportation and their own word processing, copying and secretarial facilities, as needed.

The OPS/USAID project officer will make all pertinent documents available and will assist in arranging meetings with project related individuals and organizations.

VII LEVEL OF EFFORT OF EXPERTS

The following is an estimaste of the number of work-days that will be required to complete the evaluation. This estimate is subject to adjustments upon preparation of a detialed work program.

Financial Expert/Chief of Party.....	40 days
Savings and Loan Cooperative Expert.....	25 days
Microcenterprise Analyst.....	20 days

The evaluation will requiere a 10 day trip to Costa Rica for each of the experts and an additional one-week trip by the Chief of Party.

## **Appendix B**

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### **LIST OF INTERVIEWEES**

#### **USAID MISSION**

Stephen Wingert, Mission Director  
Richard Whelden, Director, Projects Group  
Mary Helen Vialas, Project Officer  
Rolando Quiroz, Project Officer  
Miguel Loria, Mission Economist  
Luis Solera, Chief, Private Sector Office

#### **CENTRAL BANK**

Olivier Castro, Vice President

#### **AGEF**

Rafael Díaz, Chief Auditor General  
Guillermo Bolaños, Credit Union Auditing Unit

#### **FEDECREDITO**

Mario Vargas, Chief Executive Officer  
Walter Mora, Manager, Caja Central  
José Luis Blanco, Planning, Marketing, and Project Manager  
Miguel Fiatt, Director, Technical Services  
Patricia Bravo, Planning Manager  
Laura Varela, Manager, AUDICOOP  
Loretta Ayala, Auditing Supervisor  
Mario Mora, Auditor  
Alfredo Barrantes, Technical Services Coordinator

#### **CREDIT UNIONS**

José E. Alvarado, General Manager, Cooperativa Nacional de Educadores, R.L. (COOPENAE)  
Gerardo Bonilla, General Manager, Servicios Cooperativos R. Ltda. (SERVICOOP)  
Maynor Sandoval, General Manager, Cooperativa Nacional de Ahorro y Crédito de los Empleados del Sector Salud, R.L. (COPEMEX)

#### **PROJECT PARTICIPANT PVOs**

Jorge Cespedes, President, Board of Directors, AVANCE  
Danilo Cola, Executive Director, AVANCE  
Bernardo Alfaro, General Manager, ACORDE  
Maria Martha Padilla, Executive Director, FINCA  
Iris Villalobos, Assistant Executive Director, FINCA

#### **INSTITUTIONAL CONTRACTORS**

Claudio González-Vega, FSDP Principal Adviser, Ohio State University

Ronulfo Jimenez, FSDP Project Director 1994, Academia de Centroamérica  
Thelmo Vargas, FSDP Project Director 1991-1993, Academia de Centroamérica  
Rocael Garcia, Regional Director, WOCCU

**CONFEDERACION DE COOPERATIVAS DE ALEMANIA FEDERAL (DGRV)**

Helmut Pabst  
Werner Schartel

**PRIVATE COMMERCIAL BANKS**

Oscar Rodriguez, Banco BANEX  
Luis Liberman, General Manager, INTERFIN; President, Banking Association

**PRESENT OR FORMER MEMBERS OF GOVERNMENT AND OTHER ORGANIZATIONS**

Eduardo Lizano, former president, Central Bank  
Jorge Guardia, former president, Central Bank  
Rodolfo Méndez, Minority Leader, National Congress of Costa Rica  
Luis Villalobos, former president, Congressional Committee on Financial Sector Reform  
Francisco Malavasi, Director, Asociación Nacional para el Desarrollo Económico (ANFE)

**OTHER INSTITUTIONS**

Miguel Campos, Economist, Banco Nacional de Costa Rica  
Max Alfaro, General Manager, Banco Popular  
Andrés Marchant, Deputy Representative, Inter-American Development Bank.

*Appendix C*

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**AMENDED LOGFRAME: FINANCIAL SERVICES,  
APRIL 1991**

**Amended Logframe  
Financial Services, 1991**

NARRATIVE	VERIFIABLE INDICATORS	MEANS OF MEASUREMENT	ASSUMPTIONS
<p><b>GOAL</b> Improve financial emedation in Costa Rica, Increase the mobilization of domestic resources, Improve their allocation to productive activities and expand the access to financial services to a wider segment of the population.</p>	<ol style="list-style-type: none"> <li>1. Growth of deposits held by cooperative credit Unions.</li> <li>2. Financial health of Coop. Credit Unions.</li> <li>3. Expansion in coop, credit union and other IFI services.</li> <li>4. Reduction in transaction and administrative cost for project clientele.</li> </ol>	<ol style="list-style-type: none"> <li>1. FEDECREDITO and BCCR reports.</li> <li>2. FEDECREDITO self-monitoring unit reports and AGEF records.</li> <li>3. FEDECREDITO reports and project evaluations.</li> <li>4. FEDECREDITO reports and project evaluations.</li> </ol>	<ol style="list-style-type: none"> <li>1. Macroeconomic conditions permit growth of financial sector.</li> <li>2. Entrepreneurs and community leaders able to take advantage of opportunities.</li> </ol>
<p><b>PURPOSE</b> contribute to the financial liberalization of recent years, promote the development of efficient financial market systems, in particular, cooperative credit unions, Improve the safety and soundness of credit unions as financial intermediaries, public confidence in the credit union movement, strengthen the regulatory infrastructure necessary to protect credit on members' savings, and</p>	<p><b>EOPS</b></p> <ol style="list-style-type: none"> <li>1. Establishment of a policy environment favoring the economically &amp; technically sound expansion of financial services.</li> <li>2. Existence of a regulatory and supervisory system for cooperative credit unions in Fedecredito and the BCCR's AGEF.</li> <li>3. Innovative mechanisms for financial service delivery developed and tested.</li> </ol>	<ol style="list-style-type: none"> <li>1. Reports to Oversight Committee and project evaluations.</li> <li>2. Project evaluations.</li> <li>3. Project evaluations.</li> </ol>	<ol style="list-style-type: none"> <li>1. Legislation establishing AGEF as regulatory body is passed.</li> <li>2. Technical assistance and training are sufficient to improve management.</li> <li>3. GOCR leadership continues to support reform of public and private financial institutions.</li> </ol>

NARRATIVE	VERIFIABLE INDICATORS	MEANS OF MEASUREMENT	ASSUMPTIONS
create models for savings protection strategies for financial intermediaries in Costa Rica.	4. Improved management of credit unions and other IFIs.	4. AGEF reports and project evaluations.	4. Substantial share of experimental techniques prove effective and economically attractive.

### OUTPUTS

1. Better informed decision-making with respect to monetary and financial policies.	1. Increase in deposit mobilization in the Costa Rican financial system.	1. BCCR reports and project evaluation.	1. GOCR participation and support.
2. Wider public support for adequate financial policies.	2. Thirty-one studies completed, twenty-five published.	2. Project records.	2. GOCR willing to support legislation.
3. Adequate regulation and supervision of credit unions, resulting in greater security and protection for savers.	3. Law passed and system established and implemented including reports from AGEF.	3. Legislation published and project records.	3. Credit unions and IFIs willing to participate in experiments.
4. An established credit union management training program.	4. Fourteen training sessions.	4. Project records.	
5. A credit union, movement-wide information system.	5. System implemented as evidenced by MIS reports.	5. Project records and evaluation reports.	
6. Increased financial stability and long-term viability of credit unions.	6. Acceptable financial ratios and ratings from AGEF.	6. FEDECREDITO and AGEF reports.	

NARRATIVE	VERIFIABLE INDICATORS	MEANS OF MEASUREMENT	ASSUMPTIONS
<p>Improvement in the management of financial cooperatives.</p> <p>Implementation of innovative approaches to improving services to project clientele.</p>	<p>7. AGEF reports and decrease in cost of financial intermediation.</p> <p>8. Six techniques proven effective.</p>	<p>7. Project evaluations.</p> <p>8. Project evaluations.</p>	