PN-ABW-263

Consultancy Report

Review of Internal Policies and Procedures

AGROCAPITAL
Cochabamba, Bolivia
Financial Resources Component of CORDEP
Project Code: 138

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I. EXECUTIVE SUMMARY

Mission Statement: (ACDI) Improve reliability of data and reduce processing time and costs

Mission Statement: (EXPANDED) Improve efficiency of credit and operations departments to provide better customer service, reduce processing costs, increase credit official effectiveness, and assure adequate internal controls to allow Agrocapital to develop into a stand-alone financial institution.

Summary

The Management has been very successful to date in developing Agrocapital. The accounting records have been corrected, new agencies have been strategically opened, and a basic credit process is in place. More importantly, they can point to the success of their lending activities in dramatically changing the lives of many of their borrowers.

Management recognizes they have arrived to a critical juncture and that evolution into a stand-alone financial institution requires a focus on common goals and efficient operations.

Based on established goals for 1995 and projections for 1996, Agrocapital will achieve self-sufficiency in 1996. In other words, they will not need to rely on an operating subsidy from PL-480 to generate a profit. By 1997, earnings should also cover costs of technical assistance for credit operations now provided by ACDI.

These goals are achievable, but require that the following critical activities be completed on schedule:

Critical Activities

1. Decision/Modification/Implementation-new software package

2. Implementation of decentralized procedure-microloans

3. Hiring of Internal Auditor

4. Hiring of Economic Advisor

5. Streamlining/Standardization-credit process-regular loans

6. Implementation of monthly budget review process

7. Achieve loan placement goals

8. Obtain additional funding
   1995- US$2,200M
   1996- US$5,300M

9. Implementation of savings product-"Caja de Ahorros"

The Institutional goals for the next two years are very clear. Management is very grateful for the support of its staff and the individual donors to date. They look forward with great enthusiasm to the challenges ahead. I am confident they will meet these goals and that the development of Agrocapital will stand out as a major accomplishment for its management and sponsors.

II. BACKGROUND

Agrocapital was founded in 1992 as a non-profit foundation to assume collection activities for a PL-480 loan portfolio. Proceeds of the collections were to be re-lent into certain rural development areas.

Subsequently, additional donor funds and portfolios were received with a variety of different operating requirements. More staff and rural lending agencies were contracted/opened in line with the new collection/lending requirements. It was not initially contemplated that Agrocapital would develop into a self-sustaining institution.

1. Bank expansion was not due to growth in volume of the existing "product line", but by the addition of new products in new geographical areas. Often these products, although all considered loans/collections, required completely different accounting treatment, credit/collection policies, revenue recognition, revenue-sharing (with the donor), and reporting requirements.

2. The letters of understanding governing the management of these funds have often been unclear from initiation or modified after implementation due to changes in donor requirements, e.g., revenue sharing, capitalizsation of collections, payment of legal collection fees, interest waivers (ordinary and penalty), and currency conversion, etc. Some of these changes have been unilaterally mandated after the fact.

3. Portfolios received were often in disarray due to mismanagement by other institutions. The customer information was incorrect or incomplete, payment histories were wrong, credit files were non- existent, loan documentation was missing, and accounting information was inaccurate.

4. The accounting/operational systems inherited by Agrocapital were inadequate for managing its own portfolio and even less appropriate for the additional portfolios. Complete account reconstructions were required to correctly state Agrocapital's initial statements of account.

5. Other "Investments" were also unloaded on Agrocapital due to pressure from other government entities. These were problematic from the start and now require a considerable of management time. There were no operating/accounting/credit policies or procedures for these investments when inherited, and the accounting has consequently been mixed-up with the Bank's normal accounts.

6. Due to the preceding, the internal automated processing system is basically a complicated patch-work of independent programs that were developed quickly to cope with the incremental accounting and reporting requirements. Attempts were made to develop a new integrated system locally, but the developer failed in the project and left the user in a worse situation than before. The automated system in use now consists basically of two independent systems (accounting and loans) that are written in different languages that allows use by only one person at a time.

It should be apparent from the above, that building Agrocapital into the institution it is today must have been like constructing a building on quicksand.

Bank management has been well aware of the need for an integrated processing system. They requested the advice of outside consultants who made a review of the existing alternatives in September 1994.

A number of systems were reviewed including those available locally and packages from the U.S. Their final recommendation was to focus on two suppliers: Alpha package/NCR platform, and Proceda/Sobolcom/IBM platform. A final decision was deferred pending final cost proposals from these suppliers and the analysis of "broader data processing implications and potential opportunities for regional systems development". Concurrently, applicable software packages available from other international vendors were to be reviewed. The IBM proposal was rejected due to cost and the Alpha alternative was not pursued due to perceived limitations in their ability to deliver what was promised.

Subsequently, information packages and proposals were received from Axon (based in Santa Cruz) and Microbanker (an internationally used package). The above packages are being reviewed by Mr. Mark Jones (Denver, Colorado) and local staff.

Modification of the existing programs by local or foreign programmers is also being considered. While this may be cheaper in the short term, inclusion of new product modules (savings, drafts/transfers, foreign exchange) may make this uneconomical in the medium term.

It is still recommended that the final software decision take into consideration the needs of other ACDI operations. There are many similarities between the institutions and installation of the same basic software package should result in considerable savings on an individual basis. This same situation applies to the other internally developed (manual) procedures. Systems developed in Agrocapital could be easily adapted for implementation in newer institutions and vice-versa. There is no need to develop these procedures "from scratch" in each institution as is presently being done.

III. FINDINGS, RECOMMENDATIONS, CONCLUSIONS

Credit/Marketing

The review focus in this area was on streamlining procedures and maximizing credit officer productivity. A basic distinction should be made between credit and marketing.

The credit function is to determine and document which lending activities and related risks/returns are acceptable to the institution. This includes products, volumes, concentrations, pricing, guarantees, approval levels, and maintenance requirements, etc. The Credit Manager is responsible for developing this criteria and presenting it to the General Manager for his approval. Once approved, the Credit Manager is responsible for establishing the corresponding individual lending goals for each credit officer. These goals should also include the acceptable level of past due obligations.

The marketing function pertains to the delivery or "sale" of these products to institutional clients and the required customer relations and periodic follow-up. The credit officers are responsible for finding qualified clients and developing/maintaining their individual loan portfolios in accordance with approved policies.

This distinction (credit vs. marketing), although very common now in the banking environment, is even more desirous in the case of Agrocapital due to the small average loan size. Credit officers should visit the borrowers with a clear, documented product description in hand. They should immediately express our credit requirements to the client. If the borrower meets these hurdles (minimum income, minimum equity investment, guarantee and cash flow coverage ratios, etc.), and if his character is satisfactory, the credit officer should be reasonably assured the credit will be approved. This approach does not require the credit officer to be an expert in credit. He becomes an expert in marketing his products.

The following are the results/recommendations of this review:

1. Together with the Economic Advisor (already budgeted and soon to be contracted), the Credit Manager should develop lending/portfolio guidelines for the different economic sectors in the rural markets. In the agropecuario area, goals/limits should be established for credit extensions related to rice production, bean production, and other crops on a percentage of portfolio and geographic basis. This should limit concentration risks related to crop disease, droughts, etc. These guidelines should also consider anticipated local market demand, import competition, export potential, and other general country and international economic factors.

Agroindustrial loan products should be similarly analyzed to avoid undue concentration in crops or geographic areas.

Commercial/service industry loans should also be spread out geographically.

2. Detailed approval (credit) requirements for each credit prodcut should be developed in advance by the Credit Manager. The credit officials should use this criteria (checklist) for screening their clients.

3. It is recommended that credit presentation requirements for loan approvals be differentiated based on the amount of credit being extended. The amount of US$20,000.00 could be used as a starting point for later adjustment based on experience. At present, extensive credit and financial analysis is completed for all loans with the exception of microloans (which will be treated later). The depth of credit analysis and size of the proposal should be in direct relation to the amount of the credit. These analyses currently take 3-5 days to complete and the subsequent review by members of the credit committee are similarly time consuming.

Additionally, the forms utilized by the credit officials for basic client and project information should be consolidated into one form, as much of the information is redundant. A sample, combined form was presented to the Credit Manager for his review and modification. It is suggested that this be completed and implemented as soon as possible.

4. Credit approval presentation formats vary with each credit official. Standard formats should be designed for use by all credit officers. This will save preparation time by the credit officias (who won't need to continue tinkering with the layout), review time by the credit committee (which will know in advance which part of the report contains the relevant information), and in the training of new credit officers. The size of the document should be limited to a more manageable size.

It is suggested that the credit approval process be changed as it relates to the credit committee. Presently it is understood that a separate committee composed of the General Manager, Credit Manager, and Operations Manager must meet together to approve certain credits. Photocopies of the credit package are supplied to the members in advance of the meeting. The concept "credit committee" implies only that three different individuals approve the credit. It does not require that they meet jointly to make a decision. In the future, it will be more efficient to have the credit initiator, the Credit Manager, and the General Manager sign off on the credit without necessarily meeting together. Only the original credit request document needs to be circulated up through the credit levels. It is not necessary to make photocopies.

It is suggested that Management consider designating a Financial Analyst to prepare all financial analysis packages for loans over us$20,000.00. An experienced analyst will be able to prepare these packages faster, and the credit officers will have more time available for marketing.

6. It is advisable that credit officers attend all clients near
their own agencies whenever possible. There will always be exceptions, but it is more efficient and less costly. When there are multiple credit officers in one agency, it is suggested that they be assigned specific market sectors to avoid overlap. This will also allow more specialization and will not require all officials to be "experts" in all types of credits.

7. Microloans-. The processing of these small (normally signature) loans has imposed a major burden on both the credit and operations departments. These loans are initiated in the field offices and then forwarded to the main office for review, approval, and check preparation. The loans are normally sent in weekly batches and the corresponding disbursement checks are returned by courier or bus.

After initial field office approval, the loan will be rejected in the central office if it appears in the Bank's internal "central de riesgos". This consists of an old PL-480 information (1989) listing showing past due names and a file-by-file review of Agrocapital's own outstandings.

This process results in wasted time since the credit officer spends time on a client that may be automatically rejected. A client who is now in good standing may also be unfairly rejected.

Copies of all loan documentation are maintained in the field offices and originals are maintained in the central office. Copies of all payment receipts are forwarded to the central office, and an original (and copy) of the customer's most recent loan history update are returned to the office for filing and future distribution to the client by hand. This process of paper shuffling is extremely time-consuming.

In order to rectify this situation the following procedural changes have been made:

A. The automation department is designing a routine to integrate the seven data files so they can be accessed once by entering the customer's name or identification number.

B. The old PL-480 information will not be used in the future, (It should be noted that PL-480 no longer maintains a "central de riesgos". We have contacted them on several occasions and they have not shown interest in updating their infomation. If Management determines this information to be essential, PL-480 must be convinced to update and maintain the information.)

C. Updated customer loan history information will be made avaiable on diskette for the agencies. This will be provided to the agencies on a weekly basis together with the "central de riesgos" discussed in (A) above.

D. A new loan application/approval format was developed to consolidate the "consulta preliminar" with the "solicitude de credito" since much of the information is redundant. This new form was developed into a computer screen to allow direct data input. After filling-out this computer screen, the contract can be immediately printed. (This step also eliminates the need to print blank loan contracts for distribution to the agencies.) The disbursement receipt form was also eliminated by providing space for this information in the new contract form.

8. A fax-based reporting system was established to provide more prompt and efficient reporting of agency loan activity for disbursements and approvals. Each day summaries of collections and disbursements are faxed to the main office for processing. All original documentation will be maintained in the agencies. (See comments in Premises section of report) Periodic interim reviews

by the Internal Auditor or other designated staff should ensure that documentation is complete and properly filed/stored.

9. The goals programs for the individual account officers should include a minimum number of "customer call reports" per week. These reports would include information concerning new and existing customers who the officers have met with personally.

10. A schedule of standardized training courses should be established for the account officers. Advancement to higher approval/responsibility levels should be based on a minimum standard of formal training.

Operations

The focus in this area is to reduce costs, assure adequacy of internal controls, and provide accurate and timely presentation of management and other reports.

Some of the internal control problems, many of the timing problems, and many of the efficiency problems will be improved with the implementation of an integrated, multi-user software program which should be implemented by no later than June of this year.

It would be possible to eliminate all control and separation of function weaknesses immediately through contracting more employees. This staff would then be redundant after software implementation. Consequently, it seems more reasonable to rotate the staff in certain (2) key positions in the interim. This would apply to the positions of bank account reconcilements and to loan/accounting input/output clerk. This rotation should occur for at least one full monthly accounting cycle. In the future, the system input and output functions should be separated and the reconcilement clerk should be replaced for a minimum one-month cycle each year.

The following are the more detailed results/recommendations of this review:

1. A supplementary hand-written book ledger maintained by the bank account reconcilement clerk was eliminated. It was inaccurate and was not used for anything other than back-up information.

2. A system of fax reporting was instituted in the two main agencies for daily report submission to the main office. Summaries of collections and disbursements by loan category are included in the reports. Instead of sending copies of all receipt and disbursement documentation, only bank account deposit slips and copies of the loan agreements (micro's only as regular credit forms are still being redesigned) are transmitted to the main office. (This system will be modified with the implementation of the automated processing system.)

3. A recommendation was made to change the loan numbering system. A new loan number is presently assigned for every new loan, even if the borrower is an existing (or previous client). This results in a plethora of files with duplicate customer information and a large incremental expense for file preparation, maintenance, and storage. It has been recommended that the customer's national identification number (carnet de identidad, ruc, run, etc.) be used as the basic number for all customer loans. Additional loans to the same borrower would be identified by letters A-Z and so on. Management should decided whether this should be done retroactively.

4. Basically duplicate credit files are maintained in the agencies and the main office. The cost in time and money of shipping and controlling these files is exorbitant. It is suggested that the main customer files be maintained in the agencies only. Information required by the main office for loan/accounting update will be supplied on a summary basis only to the loan/accounting department.

5. One of the main projects currently underway will provide customer/loan status information to the agencies by diskette. An updated diskette will be provided to the agencies on a weekly basis to allow the agency staff to calculate payment applications and to print out customer loan statements without

having to wait for the hardcopy information to be received from the main office. All of the basic form design and automation work has been completed, pending a test/review to be completed by the Assistant to the Credit Manager. (This is a temporary process to be used pending installation of the new software which should allow on-line or batch processing on a daily basis.)

6. Credit checkings for new customers are currently made against an outdated PL-480 report, Agrocapital's own client base, and through an expensive independent credit-checking agency for larger credits. Reasonably priced credit-checking services are not available locally, possibly because the Central Bank maintains an extensive data base covering all clients in the banking system.

Recognized members of the banking system receive monthly reports indicating information on their own portfolio and outstandings of these same borrowers with other members of the system. These members can also receive this same information for a potential client by requesting directly to the Central Bank. The Central Bank normally responds the next business day.

Agrocapital does not presently have access to this information since it is not a member of the banking community as defined by the Central Bank. We can (and have) "borrowed" information from affiliated institutions, but this only includes information on customers who are classified as "collection and/or write-offs". It it would be extremely useful and cost-effective for us to have access to all the Central Bank information.

It is possible for us to have access to this information by being "approved" by the Central Bank. This will require submission of our data to them on a monthly basis. This is already contemplated as a requirement of the Central Bank should they approve our plan to accept deposits from the public.

There is also the outside chance that they provide us the information based on some pressure from US-AID. The central bank restricts lending to banking system clients who are in arrears or that have other credit problems. By restricting our lending to these same clients, we would in effect help by enforcing their policies. (It doesn't hurt to ask in any case.) When, and if available, this information would also be made available to the agencies on either a weekly or direct consultation basis.

7. The Assistant to the Credit Manager spends a considerable amount of time at the beginning of each month preparing an analysis of the portfolio, specifically the past due loan accounts. He prepares adjustments based on prepayments, insignificant amounts due, and other obvious errors in payment application. It is suggested that his review take place before the end of the month, since this process delays substantially the monthly closing.

8. The officer mentioned in point 7. above also prepares a report reflecting the classification of the portfolio according to Central Bank standards. To ensure independence in report preparation and to save this official time, it is recommended that this report be prepared by operations. The operations area has sufficient information to prepare this report based on the number of days past due and its legal status. Additional more severe classification based on other factors can be supplied in advance to operations on an individual credit basis.

9. Management should define and document which reports are needed, to whom they should be issued, and when they are issued. Additions and exceptions to these policies should be approved by senior management. Considerable time is lost in the data processing department due to many individual requests for additional copies of existing reports or for special reports. Many important projects currently underway require assistance from the data processing area and these unscheduled requests seriously disturb their progress.

10. As indicated in the Background section of this report, the Institution participates in private investments in the agricultural sector. Agrocapital normally has the majority investment which would require consolidation of financial statements for accounting purposes. These companies have not produced current financials and consequently our accounting for them is inaccurate. This will probably generate criticism from our external auditors. In the interim, the operations department should continue to pressure management of these companies to provide updated financials.

Agrocapital's 1995 Operating Plan includes the objective of clarifying the role that direct investment could have in developing the rural markets. This will require definition and documentation of policies and procedures related to the analysis, acceptability, and accounting for these investments. In accordance with Central Bank regulations, these investments can not be held directly by Agrocapital. It is recommended that a complete, detailed study be completed to determine the correct legal vehicle for these investments. This study will be relatively complex requiring analysis of all the appropriate legal and tax implications and should be initiated in the very new future. Subsequently, the existing investments should be transferred to this vehicle.

Administration

Budget Process

A rudimentary budget process was implemented for 1995 based on profit and cost centers. Credit officer goals in line with this budget were developed on a monthly basis. An agency profitability analysis including 100% allocation of centralized operating costs and overhead expenses was also developed.

Monthly comparisons should be made between actual and budget, and differences should be analyzed in detail. These variations and refinements in the cost allocation methodology should be used as a basis for developing/integrating an automated budget procedure for the 1996 budget cycle.

It appears that 1995 will be profitable for Agrocapital after receiving reimbursement from PL-480 for certain staff expenses.

A forecast of 1996 activities was also made based on the goal of achieving self-sustaining status by year-end. It is anticipated that PL-480 will not provide a subsidy in 1996. The Institution should record a profit without the subsidy if projected goals are met.

A rough forecast made for 1997 indicates that all subsidies can be eliminated including that currently provided by ACDI for technical assistance.

The 1996 budget process should be completed by November 15, 1995 at the latest. It should be based on a bottom's-up system starting with the credit officials, agencies, and operating departments.

The importance of a good budget process can not be emphasized enough. It provides essential information for the ongoing management of the institution as well as the future requirements for funding, staffing, and new products. Good customer service requires that we maintain our services at a consistent level without any breakdowns due to lack of funds, operations overloads, or credit approval bottlenecks.

Internal Auditor

The need for this position was identified in the previous consultancy report (Lee Cecere-September 1994). In addition to providing the necessary independent verifications of bank procedures, this person will participate in the implementation of the new software package.

It is important to emphasize that filling this position should result in an overall cost reduction to the Institution. At present, transactions are often over-controlled at initiation as many signatures are required for loan approval and loan disbursement. The internal audit function provides a review "after the fact" based on "audit trails" and sample testing. Some of the up-front reviews and signatures will no longer be needed.

Management is currently interviewing candidates for this position.

Treasury Function

As the bank acquires more external funding in line with its 1995 goals and 1996 projections, it becomes more important that this function be implemented. The responsibilities include management of the Bank's liquidity position (deposit and loan disbursement and runoff) to ensure that credit and depositor commitments can be made on a timely basis. He will also be responsible for investing excess cash and obtaining the best mix of risk/return. Specific attention must also be given to the foreign currency position to ensure that sudden fluctuations do not jeopardize the Bank's capital.

Hopefully, the Economic Advisor will be able to provide assistance in evaluating these risks. If not, it is suggested that the employee attend related training courses or seminars.

Economic Advisor

This person will provide essential information to the Credit Manager, the Investment Advisor, and general management. He will be responsible for keeping management informed of relevant general economic factors in addition to specific factors such as (bank) competitive analysis, new banking regulations, legislative changes and international development policies.

He will also participate in developing analyses of the different market sectors and the inherent risk components. This information will form a critical part of the credit process and is currently a "bottleneck" restricting growth in product marketing.

Much of this same information must be made available to the Investment Advisor who will use it in preparing information packages for interested investors as well as in analyzing the different investment alternatives.

Management is aware of the need for this person and is actively searching to fill the position.

Documentation and Storage

As has been noted in the Credit/Marketing section of the report, efficiency requires that much documentation be stored in the agencies rather that shipped to the main office. This will require fire resistent or fireproof storage which is not currently available in the agencies or Cochabamba. This should be resolved through construction of vaults or purchase of fireproof safes.

A program should be developed immediately to maintain off-site storage of automated data files. This can be based on complete daily back-up of information, or a complete weekly backup with daily backup of new transactions.

Premises

Management should consider changing the locks on the entry doors to both floors occupied by Agrocapital. These doors currently require key access from both sides. In case of emergency, these doors could slam shut and trap those inside without a key.

Fire extinguishers should be installed on both floors of the main office and in all the agencies. This is especially important considering that storage containers for prime documents are located in these areas.

Emergency evacuation procedures (fire, earthquake, civil disturbance) should be developed for the main office at a minimum. Although the direct risk has not yet become apparent in Cochabamba, the usefulness of these procedures has been demonstrated in many countries over the years.

Agrocapital should consider transferring its operations to a new location in the future. It is anticipated that many additional microloan borrowers will be coming to the office to receive their disbursements. The present location is difficult to locate for these borrowers and well away from the major bus routes which they utilize. (The four floor walk-up doesn't help!) When changing locations, Management should consider a first floor location with open seating for staff. This will allow better communication between staff and easier supervision.

Miscellaneous

Specialized Products

Agrocapital needs to develop a model agency that can be opened in areas where the initial volume does not justify more than one employee. The Bank needs to minimize its fixed overhead while at the same time maintaining satisfactory controls over disbursements and collections. Use of franchises and/or commission agents should be studied, but extra care should be taken to minimize the risk of fraud. One method of entering these markets is as follows:

Electrical service has recently become available to Mizque and funds (NRECA and Agrocapital) are available for microloans which are not being disbursed as fast as desired. The following new loan product is suggested for consideration:

Mizque is a small town of approximately 5,000 inhabitants located about 3 hours by bus from Cochabamba. There are very few commercial businesses in the town and the vast majority of purchases are made on visits to Cochabamba.

It is suggested that we contact wholesalers of electrical appliances, water pumps, and other electrical goods to put samples of their products in our Mizque office. (There is ample space to display products and related catalogs.) Agrocapital (or its independent agent) would "sell" the goods and provide financing of the purchase.

Disbursement of funds would be directly to the wholesaler after the goods are delivered to the customer in Mizque. The pricing to the buyer would be at the equivalent Cochabamba resale (or slightly lower) price. The profit (resale minus wholesale) would be divided between Agrocapital and the agent on a basis to be agreed upon after a review of the initial results of the program. If volume and margins allow, the agent could become completely independent thus relieving Agrocapital of his salary and office expenses.

A reserve would be retained from the initial sales to cover the risk of the agent approving unqualified credits and theft of samples. This reserve would be based on the value of the merchandise on consignment and the past due history. It is anticipated that the microloan application/contract would be received and analyzed in Cochabamba before the merchandise is shipped.

It should be noted that other related products could be handled by
this office/store in the future. Electrical products (wiring, lamps, bulbs, switches, ceiling lamp/fans, irons, etc.) Are not available locally. Even though these products would not qualify for financing, it would add value and traffic to the store.

Similar "agencies" could be established in the future as the electification project is expanded.