5960030 (4) C & IR

5960030001801

PD-~~AAB-489~~-A1

38p.

AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

OFFICE OF THE AUDITOR GENERAL

AREA AUDITOR GENERAL - LATIN AMERICA

REPORT OF AUDIT

CONCERNING OPERATIONS OF

THE CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION (CABEI)

Period Covered: 11/1/71 thru 12/31/74
Audit Report No. 1-596-75-80
Date Report Issued: June 5, 1975

TABLE OF CONTENTS

I INTRODUCTION

The Central American Bank for Economic Integration (CABEI), hereinafter referred to as the Bank, was established in May 1961 to assist in the development of the economies of the five Central American countries. We previously made a comprehensive management review of the activities of the Bank, the results of which are recorded in our Audit Report No. 1-596-72-57 dated January 13, 1972. The primary purposes of our current audit are to (1) make a selective fiscal examination of the Bank's accounts, records and reports, (2) determine whether the 19 recommendations of the prior report have in fact been properly implemented or considered, and (3) evaluate the ability of the Bank to undertake additional agricultural initiatives. The latter area of coverage was specifically included because of ROCAP's interest in the agricultural sector as expressed in its revised DAP.

This report also contains other matters worthy of management's attention that were disclosed during the course of our examination.

II SUMMARY

The Bank provided us every consideration and courtesy in the conduct of our examination of its financial affairs. This involved not only good working facilities and speedy access to officials of the Bank, but also all of its records and reports -- including the minutes of its meetings.

The Bank is a viable organization which is performing a valuable service to the five Central American countries.

Its operations are conducted in an orderly manner. However, the Bank's accounting statements do not adequately disclose its financial condition, and its actual net worth is less than reported as the reserve for bad debts is considerably understated. The Bank's earnings are adversely affected because resources derived from lenders are not utilized immediately, collateral for sub-loans is occasionally inadequate, and sub-borrowers do not always comply with the terms and conditions of sub-loans.

The liability of the members of the Bank is limited to the amount of their capital subscriptions. Also some of the Bank's more recent sub-loans are directed toward larger and foreign-owned firms ~~rather than medium-sized~~ locally-owned industries.

Thirteen of the 19 recommendations of the prior audit report have been fully implemented or duly considered by ROCAP. The six open items are repeated as recommendations of this report.

New initiatives in the agricultural sector cannot be undertaken unless the Bank increases its Agriculture Department staff.

With the fine attitude that exists at the Bank, and the good relationship that ROCAP has developed with the Bank over a number of years, it can be expected that the Bank would react favorably to ROCAP's efforts to improve those conditions which are susceptible to correction.

III STATEMENT OF FINDINGS AND RECOMMENDATIONS

A. General Observations

1. Government Guarantees

According to the Agreement Establishing the Central American Bank for Economic Integration, as ratified by all five member countries, the liability of the members of the Bank is limited to the amount of their capital subscriptions, which currently is $12 millions each. Substantial increases in the capital subscriptions over the coming years are being considered by the member countries. This means that the obligations of the Bank are not now supported by the full faith and credit of the respective Central American governments.

Although the same agreement also authorized the Bank to obtain guarantees from member governments for loans or credits from other institutions, the Bank has not obtained such guarantees. This condition has precluded ~~the Bank from obtaining~~ loans from the World Bank, because the World Bank's charter requires host country guarantees for its loans.

ROCAP Comments

It should be noted that the limit of liability of the members of CABEI to the amount of their capital subscription and the statement that the obligations of the Bank are not supported by the full faith and credit of the respective Central American governments is not unique to CABEI as the same condition prevails in the Inter-American Development Bank and the World Bank.

2. Relativity of Other Than AID-Financed Transactions

no country guarantee for AID loan

Some of the comments of our report pertain to general operations of the Bank, rather than to specific transactions identified to A.I.D. This is because the prospect for repayment of A.I.D. loans is contingent on the financial well-being of the entire Bank. Expressed another way, it is necessary to review the Bank's entire operation to determine how well A.I.D. funds have been managed and safeguarded.

3. Bank's Instrumentality in the Integration Process

The Bank is one of several institutions that were created to become instrumental in the process of Central American integration. Its activities are financed through (1) its Integration, (2) Housing, and (3) Ordinary Funds. (The Integration Fund finances sub-loans for infrastructure projects for the public sector, the Housing Fund finances housing mortgages, and the Ordinary Fund finances regionally oriented industries in the private sector.) Within the limitations imposed upon the integration movement by the member countries' unwillingness to give up their own priviledged positions, the inequality of their economies, and finally the 1969 war between Honduras and El Salvador which at the time of our audit had not yet been concluded with a peace treaty, the Bank has achieved noticeable progress towards its intended role as a Regional Development Bank.

However, there are shortcomings in two areas that are worthy of mention:

One of ROCAP's goals is to have the Bank become a "Banker's Bank" instead of dealing directly with the final users of loan funds. A review of the Bank's present policies, its financing plans for the remainder of this decade, and the actual composition of its portfolio indicate that this goal, as it applies to the Ordinary Fund, has not yet been actively implemented. Out of 124 active loans amounting to $62.6 million that are wholly or partially financed by A.I.D. in the Ordinary Fund, only $6 million have been made to ten intermediate credit institutions. (This comment is not applicable to the Integration and Housing Funds as they involve sub-loans to governments and intermediate credit institutions, respectively.)

The other important area is the mobilization of financial resources from within the Central American region. Here, the Bank is facing competition from other financial institutions which are in a position to offer higher returns to potential investors. The Bank has been able to place, in part, only one series of bonds within Central America (6-1/2% Managua Emergency Bonds), and these were placed not with private institutions, but with the Central Banks of the member countries.

4. Impact of Bank's Operations

Six percent of the cumulative amount of all sub-loans authorized by the Bank since its inception were allocated to the agricultural sector -- which comprises 60% of the total labor force. Within the Ordinary Fund, 17% of the sub-loans were for agriculture.

The development of the region is at present jeopardized by balance of payment difficulties of all five countries. The gap between the more and the lesser developed economies within the region is also increasing.

Originally, the system for Central American integration industries provided for allocation of certain new vital industries to individual countries; however, the system did not work very well because of the inherent danger of creating industrial monopolies, and the participating countries' fear of having to accept such eventual monopolies.

5. Future Expansion Plans

The Bank's projection of loan activity in the magnitude of $1,376 million by 1980 is not supported by a thorough study of the absorptive capacity of the region. In this connection, we note ROCAP's assessment that the 16 million inhabitants of the CACM area have a total purchasing power equal to a U.S. city of about 1.1 million people.

In our opinion, any expansion of the Bank's operations of this magnitude should be contingent upon studies of the capability of the Central American market to absorb additional financial resources. Applications for loans are not good measurements for such needs, especially if the number of failed projects are taken into account. One should also not lose sight of the fact that the Bank's operations supplement certain financial assistance received by the five member countries individually.

Apparently the Bank's Board of Directors took cognizance of this need as they ordered (on November 28, 1974) an in-depth study of the five member countries' economic situation with special emphasis on their capacity to absorb more foreign capital, their money market, and fiscal policies. The study is being carried out by the Economic Research Department of the Bank. This study, however, had not been completed as of April 22, 1975 - the final date of our audit visit.

B. Financial Management

1. Inadequate Disclosure of Bank's Financial Condition

Although we consider the Bank's accounting system generally acceptable, the financial statements, in our opinion, lack adequate disclosure in several respects:

a. Cash

All Central American countries, except Costa Rica, had stable currencies during the period covered by our report. The Bank's statements are prepared, as are in fact all the accounting records, in Central American Pesos ($CA), a hypothetical currency equal in value to the U.S. Dollar. The Costa Rican currency (COLON = ¢) had an exchange rate of ¢6.62 to 1 $CA until April 1974 when it was devalued to a new parity of ¢8.54 to 1 $CA.

During the month of December 1974, the Bank's current account with the Central Bank of Costa Rica contains transactions at different rates resulting in an understatement of the final balance by 105,000 $CA.

At present, not only Costa Rica, but all the other member countries are under heavy balance of payment pressures, and it is, therefore, possible that the value of their currencies may fluctuate. The Bank already adjusts periodically the balances of its accounts with lenders outside the CACM area. Generally these fluctuations will be charged or credited to the corresponding sub-loan accounts. To avoid distortions, we believe it would be desirable for the Bank to adopt an acceptable system of accounting for exchange fluctuations for all of its accounts.

b. Accounts Receivable

The main account in this category is Outstanding Sub-Loans which comprises almost 80% of all assets. Nevertheless, this substantial amount is shown in the Balance Sheet as only a single line item representing the net amount of sub-loans disbursed and outstanding after deduction of bad debts allowances.

One of the schedules that accompany the statements shows the sub-loan portfolio divided by loans approved, signed, disbursed, and repaid. The portion of sub-loans signed but not disbursed is quite substantial; as of December 31, 1974, it amounted to approximately $150 million. This is a contingent liability of the Bank and should be identified as such in the body of the statements.

It is the Bank's policy to maintain unsettled balances of the defaulted sub-loans in its active portfolio until the accounts have been definitely liquidated and closed into profit or loss. Our test of sub-loans indicate that there are at least eleven* seriously delinquent sub-loans with a total of $1.6 million outstanding still shown in the Bank's portfolio. An amount of $266,583 corresponding to interest, credit fee and other charges due on these loans is also contained in the Interest Receivable account. These amounts belong to sub-loans where the borrowers have ceased operations and/or where the Bank has initiated legal proceedings. Another $495,000 represent the book value of assets of defaulted sub-borrowers that were put up for auction, but because of the lack of bidders were passed to the Bank. These assets consist of real estate, and machinery and equipment, and the possibility of converting them into cash is remote. They are listed in the Balance Sheet under Other Assets.

The above indicates that the Bank's net worth was overstated on December 31, 1974. It also means that the reserve for bad debts of $450,000 is inadequate and should be increased substantially. By these facts, we take exception to the Bank's assertion, as confirmed by its external auditors, that the bad debt reserve is considered adequate.

In establishing a reasonable bad debt reserve so as to more fairly reflect the value of its subloan portfolio, the Bank should also consider the substantial amount of unrepaid principal and interest and other charges ($3,358,000) now delinquent 180 days or more.

*3-0267, 3-0355, 3-0358, 1-0167, 3-0107, 3-0253, 3-0346, 1-0283, 4-0110, 4-0301, and 3-0339

c. Accounts Payable

This account shows loan~~s~~ repayments due to lenders divided between portions due within one year as short-term, and the remainder as long-term liability. These loans are recorded only to the degree that they are drawn down. There is only a quick reference to the total amount of resources available in the Bank's Annual Report; neither the financial statements not the related schedules and footnotes mention this situation at all. Nevertheless, there are $171 million available to the Bank in loans from lending agencies and banks that have not been drawn down for different reasons. It seems that loans signed with foreign lenders are not recorded in the Bank's accounting system at all, prior to disbursements. We believe that an official accounting of loans, signed but not drawn down should be shown in the statements.

d. Bank's Guarantees

In October 1972, the Bank entered into a guarantee on behalf of one of its sub-borrowers (3-0344) in the amount of $150,000. In November 1973, it made a guarantee of $750,000 on behalf of another sub-borrower (3-0153). The latter guarantee was reduced to $500,000 in April 1974. These transactions, which constitute contingent liabilities, are not reflected in the Bank's statements or its annual report. We were assured by officials of the Bank that these are the only cases in which the Bank guaranteed loans of third parties on behalf of its sub-borrowers.

e. Confirmations

At our suggestion, the Bank prepared requests for written confirmations to a total of 70 cash depositaries, security custodians, lenders, and sub-borrowers. We mailed the requests to the addressees who were asked to return their replies to us. The following table indicates the relevance of the replies received, and the extent that we were able to obtain replies to those requests:

Addressees	No. Requested	Replies Received: Tallied with Bank's Records	Did not So Tally	Not Responsive	Replies Not Received
Written to					
Depositaries	20	18	-0-	-0-	2
Temporary Investments	11	6	2	-0-	3
Lenders	18	10	-0-	2	6
Sub-borrowers	21	7	3	-0-	11
Sub-totals	70	41	5	2	22
Visited	No.	Accounts Observed			
Sub-borrowers	46	43	3	NA	NA
Totals	116	84	8	2	22

We do not rule out the possibility that certain confirmation responses may be in error. But there is also the possibility the replies that are not responsive to the request, or are not received, may hide activities that the addressee does not wish to bring to our attention. So we believe that there should be further follow up until all the replies have been received, compared with the Bank's records and any differences appropriately accounted for.

As indicated above, we also visited 46 sub-borrowers located throughout the five countries, and confirmed that the accounts of 43 of these sub-borrowers tallied with the records of the Bank with respect to amount currently due on all of their sub-loans.

these ?

With respect to the eight instances where records did not tally, the Bank's records reflect assets that are $547,966, in net, more than that reported by the two temporary depositaries and six sub-borrowers. In each instance, we reviewed the Bank's records and found that it had support for the transactions posted to its accounts. Conversely, the accounts of certain sub-borrowers that we visited were not up-to-date or were maintained poorly. At this point, further correspondence or visits will be required.

Because of the possibility that the Bank's assets may be overstated and its liabilities understated, we intend to make a follow-up examination of the 32 unresolved matters. The relevant findings will be shown as an addendum to this report.

Recommendation No. 1

ROCAP should request the Bank to (a) adopt an acceptable system of accounting for exchange fluctuations for all of its accounts; (b) improve its financial statement presentation by (1) including in the body of the Balance Sheet the amount of bad debt reserve, (2) specifically identifying as contingent liabilities sub-loans signed but not disbursed and guarantees of behalf of sub-borrowers and (3) including loans not drawn down by the Bank; and (c) review its policy and procedures relative to its reserve for bad debts.

2. Utilization of Resources

One of the major preoccupations of the Bank's officials is obtaining new financial resources. Nevertheless, the resources already available are not used in their entirety. As of December 31, 1974, the Bank had available resources of over $415 million, most of which were from foreign sources, but had drawn down only $244 million; i.e. 59%. committed ?

not drawn down

In ageing the foreign loan accounts, we found that $103 million had been at the Bank's disposal from two to five years, and $21 million over six years. Since the older loans were obtained at interest rates generally much lower than the later ones, it would presumably follow that to make first full use of the former is in the best interest of the Bank. This, however, is not feasible as most of the foreign loans are tied for various reasons and, therefore, are not freely available. The Bank should profit by this experience by making certain that there are no insurmountable impediments to the utilization of any future foreign loans.

With regard to A.I.D. loans which are less restrictive, the Bank still has $25.4 million undisbursed from these loans that were signed more than four years ago. Viewed from another angle, almost $20 million of A.I.D. funds are committed to sub-loans which have no disbursements so far, although they have been on the Bank's books for over a year.

Most of the fluid resources are placed in short-term interest-bearing accounts, known as temporary investments. These sums have been steadily increasing and as at

December 31, 1974 totaled $34.4 million. Temporary investments of A.I.D. funds are all derived from reflows; i.e. no portion is derived from A.I.D. loans. This distinction, however, does not apply to funds derived from other sources.

On January 15, 1974, the Bank borrowed and drew down $10 million at 9-1/8% from the Equitable Life Assurance Society of the U.S.A. As these funds were received, they were merged with other funds on deposit and lost their identity. In essence, the $10 million were used for normal banking operations as it was not until November 1974 that $6 million of this amount was placed in an interest-bearing account in London, drawing 9-5/16% interest. But $1.6 million had been placed in sub-loan projects yielding only 8% per annum, and $2.25 million were allocated to projects at 9-1/4%. The balance, some $150,000 were still on deposit in bank accounts drawing no interest. Because of the slow placement of these funds, the Bank has sustained an accumulated loss of $713,000 as of December 31, 1974 from this loan; under present conditions, it will continue to lose $8,800 every six months. This calculation does not consider asministrative costs of the Bank allocable to this loan.

At the time of the $10 million drawdown, the Bank had $8.6 million in temporary investments drawing interest at varying rates but all less than 9-1/8%. When we questioned whether it would have been in the Bank's interest to withdraw these funds from temporary investments rather than borrow such sum at the 9-1/8% interest charge without having an immediate use for them, the Bank responded that they could not do so, as all of the amounts in the temporary investment accounts were earmarked for specific pending sub-loans. This results from the Bank's policy of having such monies physically on deposit before approving individual sub-loans. The Bank's policy in this regard is costly because it (1) incurs interest charges on funds borrowed before they are actually needed, and (2) does not provide any flexibility in the use of funds already in the Bank's possession. The Bank's Financial Manager informed us that the condition had also occured to him and that he is proposing to the Board of Directors of the Bank that this policy be revised.

Recommendation No. 2

ROCAP should confer with the Bank to revise its cash management policy with the aim of better utilizing resources and thereby reducing costs and increasing profits of the Bank.

3. Sources of Profit

After having sustained losses in consecutive years through 1966, the Bank has since been operating with an apparently ever-increasing profit.

During fiscal year 1974, net profit was reported to be $5.3 million, bringing the total general reserve, donated surplus, and retained earnings to $23.4 million. By December 31, 1974, the Bank's net worth had increased to $69.2 million.

Since interest charges on A.I.D. loans are considerably more favorable than that charged by other sponsoring agencies or lender banks, it follows that these concessionary terms are the principal reason for the Bank's profits.

In fact, during the last complete fiscal year 1973-74 the gross profit derived for the Bank from A.I.D. funds was $3.6 million, whereas the result of all other loans from foreign sources, inclusive of the IDB, was an overall loss of $560,000. It then follows, assuming that all other circumstances remain equal, that as the concessionary A.I.D. loans expire in the distant future and are presumably replaced by loans at higher interest rates, the Bank's profit will gradually decrease and may eventually disappear. We believe that this future situation ought to be visualized by the Bank's management when planning expansion of its portfolio and sub-loan operations. This should be taken into account especially in planning new agricultural development activities which traditionally bear a higher risk.

4. Expenses

Since 1969, the Administrative Expenses of the Bank (its largest expense category) have increased at an average rate of 18% p.a., which is comparable to the increase in the size of the loan portfolio. General Expenses and Miscellaneous Expenses, however, have increased at a faster pace percentage-wise. During the past fiscal year, $96,000 were provided for personal representation allowances of the Board of Governors and the Directors. Also during the past fiscal year, travel costs increased almost 20%, but these should lessen now that the Bank has reduced the per diem rates to between $35 and $75 for travel outside the country of assignment.

We did not audit these expenditures to see whether they conformed with any applicable Bank regulation. Our purpose in mentioning this subject is informational, and to show an area where some belt-tightening could be made.

C. Sub-Loan Activity

1. Category of Sub-Borrowers

The Bank's lending practice favors large firms as well as foreign firms, or their local subsidiaries or affiliates.

As of December 31, 1974, 431 sub-loans had been approved from the Ordinary Fund in a cumulative amount of $199 million. Over 50% of this amount had been granted to 46 borrowers with individual sub-loans of $1.0 million or more. These sub-loans are often allocated to borrowers who by background and credit standing could very well obtain financial support from other sources. Sub-loans to larger firms, although they sometimes help the Bank to make a faster drawdown of its foreign loan resources, have the general disadvantage in that the Bank normally is not the sole creditor. In case of default, the Bank has to share with other creditors its lien on the sub-borrower's assets. (An outstanding example is active sub-loan 4-0172 to a Nicaraguan firm which also obtained eight loans from other sources. The Bank's sub-loan to this firm was recently refinanced to enable the firm to pay interest charges to the Bank.)

We were informed by ROCAP that it intends to encourage the Bank to further assist small and medium-sized locally-owned industries through sub-loans to intermediate credit institutions.

2. Handling of Sub-Loan Applications

From a review of the Bank's file, it is our impression that the quality of the Bank's pre-loan review is not adequate. This view is shared by the Bank's internal audit staff.

not analysis

When an application for a sub-loan is received by the Bank and has been found eligible in line with current loan policies, the application is forwarded to the Board of Directors together with an opinion of the inspector of the respective department. We noticed that this opinion generally reflects the information contained in the application in much the same words, and does not show evidence that the prospective sub-borrower's assertions have been independently confirmed, although indeed this might have occurred at the time of the Bank's review. In one case (3-0365), the Bank decided to obtain a credit rating of the sub-borrower's stockholders and representatives four years after the first contact, which was over one year after the loan was signed.

check!

Any over-optimistic estimates related to production and sales made by the prospective sub-borrower and contained in its application, if such did occur, could be conveyed into the Bank's opinion and thus serve as a base for the Board's favorable decision.

One of the basic reasons for the Bank's existence is to attend to those projects that are not bankable in the common sense of the word, meaning that many of the projects presented to the Bank are, almost by antonomasia, bad risks. This should be an additional reason for a very thorough inspection of projects, their sponsors, and their prospects for success.

Recommendation No. 3

ROCAP should request the Bank to document its verification of data during the course of its reviews of a sub-loan application, and on a test-basis confirm that this is being done.

3. Site Inspection

Subsequent to the sub-loan approval, the Bank's Industrial Department makes additional site inspections. At this point, the inspectors detected and reported many sub-borrower problems (several of which are continuing) not acted on in time by higher Bank authority. Stated another way, the Bank does not use the talent available in this department to full advantage.

Required inspections are not made at regular intervals; and even though a report rightfully concludes in a recommendation to repeat the inspection, this is not being done. The files are silent about the reason for this neglect.

Recommendation No. 4

ROCAP should encourage the Bank to better put to use the reports of the Inspection Division of its Industrial Department.

(Editor's note: Some of these comments might also apply to the Inspection Division of the Infrastructure and Housing Departments - operations that are beyond the scope of this audit.)

4. Misrepresentation by Sub-Borrower

In one notorious situation (3-0365), an applicant grossly misrepresented himself in meeting conditions precedent; but for unknown reasons, the Operations Division reversed a firm decision of the Board of Directors and extended the terminal date for compliance with conditions precedent. The circumstances surrounding this sub-loan clearly indicate that it should be cancelled forthwith.

Recommendation No. 5

> ROCAP should review sub-loan 3-0365 with the Bank and suggest cancellation of the sub-loan if possible.

5. Collateral for Sub-Loans

For various reasons, the Bank has experienced unexpected losses in the liquidation of collateral as a result of foreclosure.

(unpledged?)

To become eligible for a Bank loan, a prospective sub-borrower must be able to pledge collateral in an amount of at least 150% of the requested sub-loan. Collateral consists mainly of mortgages on real estate, chattel mortgages on equipment and/or bank guarantees. Losses occur in the liquidation of mortgages as estimates provided by the sub-borrower, or sales offers tend to overstate the real value of the Bank's lien; i.e. the actual value of real estate cannot be determined with reasonable accuracy until the time of sale. Losses also occur in the liquidation of chattel mortgages on equipment whenever insufficient allowances have been made for obsolescence. Particularly risky are liens on intangibles.

also sharing with other creditors,

The following weaknesses in the Bank's practice of accepting collateral were noted in the 49 files which we examined:

(1) Two liens on land that are not the prop-

erty of the sub-borrowers, but are leased from a private landlord or a Honduran Government Agency. (3-0365, 3-0255)

(2) A lien on leased land that is not demarcated (3-0365).

(3) A lien on improvements (three buildings and a pier) on Government land that may not be saleable (3-0255), and

(4) A lien on a fishing concession granted by the Government which subsequently expired (3-0255).

The following are examples of actions which subsequently lessened the value of the collateral:

(1) Three liens on which contractors and/or labor subsequently filed suit against the sub-borrower, (3-0258, 1-0283, 3-0339) and

(2) A lien on finished goods which at the time of default had diminished in quantity by at least 50% (3-0267).

For these reasons, it should come as no surprise that the Bank has sustained substantial losses in cases of foreclosure and subsequent sale of assets to third parties. A detailed count on all expenditures defrayed by the Bank shows a net loss on one transaction alone of $138,527. In another individual transaction, the loss might approximate $135,000. Under present practice, it follows that such types of losses will continue.

Based on another recent case in which the Bank has also accepted guarantees on intangibles and faces a loss of about $30,000, the Board of Directors ordered on January 28, 1975 a general review of the policy governing collateral with special emphasis on intangibles. Since this is an important matter that affects the profits of the Bank, we suggest ROCAP's involvement.

Recommendation No. 6

ROCAP should confer with the Bank about the results of the study in-process, and suggest the adoption of more realistic practices regarding collateral.

6. Lag in Disbursement of Sub-Loans

There is a considerable lag between the time sub-loans are authorized and disbursements begin. To illustrate, no disbursements had been made on seven sub-loans totalling $7.8 million that were financed by the Ordinary Fund and signed over one year ago. It seems that terminal dates for compliance with Conditions Precedent are extended practically at the will of the sub-borrower.

We believe that the lag in disbursing sub-loans would improve if the Bank is required to focus on the matter.

Recommendation No. 7

ROCAP should periodically review the reports received from the Bank to identify sub-loans on which disbursements have not started within established time limits, and prevail on the Bank not to extend terminal dates unless there are valid reasons.

7. Lack of Action in Cases of Non-Compliance

The Bank has been lenient in requiring certain sub-borrowers to comply with the terms and conditions of their sub-loans.

We noted one case (1-0283), in which the sub-borrower was committed to increase his paid-in capital from $10,000 to $200,000 before disbursements could be initiated. When the loan defaulted, the Bank already had disbursed over $150,000 but the borrower's paid-in capital was still $10,000. In another case (3-0322), disbursements were suspended on account of apparent mismanagement of the sub-borrower's operations. One of the conditions for the resumption of disbursements was the replacement of the manager; nevertheless, the Bank resumed disbursements although the manager is still acting.

We saw several cases (2-0096, 3-0267, 5-0178, 3-0258), where financial statements, which are to be audited by Public Accounting firms acceptable to the Bank, had not been submitted at all, or they were presented unaudited or incomplete, without corrective action being taken by the Bank.

In yet another case (4-0382), the Board of Directors authorized the first disbursement before the loan was even signed.

Also, the Bank is rather lenient in the continuous enforcement of loan terms once they initially have been complied with and disbursements have started (2-0096).

We suggest that ROCAP call these matters to the attention of the Bank so that it can strengthen its procedures to preclude recurrences.

Recommendation No. 8

> ROCAP should suggest that the Bank strengthen its procedures to obtain compliance from sub-borrowers with the terms and conditions of sub-loans.

8. Other Sub-Loan Policies

We noted certain other policies and/or practices that warrant consideration:

a. Purchase of Stock

It is an established Bank policy to loan funds for the purpose of purchasing stock in companies which would be eligible for Bank financing. While we have no objection to such policy when such borrowing is intended to increase the capital of an otherwise ongoing company, we believe it is not wise to lend money for the purchase of stock in any company that is already delinquent in its own sub-loan from the Bank. In the two cases noted (4-0218, 4-0313), the companies as well as the new stockholders (4-0291, 4-0382), were delinquent in repaying their sub-loans.

b. Refinancing

The Bank is now in the process of making a $2 million sub-loan to an ICI which in turn will provide the sub-borrower with funds to liquidate his debt to the Bank (2-0096). The Agreement creating the Bank prohibits refinancing, and the Bank has interpreted this to mean that they will not lend money to a firm whose purpose is to pay off its debt to a third party but they will do so with respect to debts owed to itself. We suggest that this transaction (2-0096), be reviewed for legality. If it is concluded that the transaction is in violation of the Agreement, a decision should be reached to desist from this practice, or amend the Agreement to permit the practice.

Recommendation No. 9

ROCAP should confer with the Bank on its sub-loan policies for stock purchases and debt financing.

9. General Comment

When the sub-borrower runs into financial difficulties, the Bank can drive him into bankruptcy and thereby most certainly sustain a loss, or see to it that he obtains more funds so that he possibly could become solvent again. There is no doubt that the latter course is risky at times but can be justified to a certain extent for a development bank. Nevertheless, the risk should be held to a minimum by careful inspection of the projects and their sponsors before approval of the sub-loans, as mentioned elsewhere in this report.

D. Follow-Up on Recommendations of Prior Audit Report

Thirteen of the 19 recommendations of the prior audit report have been fully implemented or duly considered by ROCAP. The six recommendations not properly or fully implemented or considered are included in this report for appropriate reconsideration and action:

1. Revolving Fund

Recommendation No. 1 (c) requested ROCAP to negotiate with the Bank to substitute Bank funds for the $1.5 million of A.I.D. funds used to establish a revolving fund under Loan No. 596-L-010.

ROCAP informed us that the Bank does not intend to pay needless interest charges on the Revolving Fund, and therefore will definitely substitute its funds if the results of its short-term cash forecast show that this is feasible.

This recommendation was only partially implemented, as $318,371 of the Revolving Fund remained unreplenished as of December 31, 1974. (At the exit conference, ROCAP informed us that the amount of the Revolving Fund had been reduced to $259,649 as of April 14, 1975.)

Recommendation No. 10

> ROCAP should substitute Bank funds for all of the A.I.D. funds used to finance the operations of the Revolving Fund under Loan No. 010.

2. Recommendations of Bank's Internal Audit Staff

Recommendation No. 2 encouraged the Bank to expand its internal audit function to perform more management type audits. This they have done.

In this regard, the Bank's internal audit staff does not always receive replies to its findings and recommendations from the Bank office that it has audited.

(A case in point is the unanswered recommendation that sub-loan applications be better screened in order to improve chances of repayment by sub-borrowers). Under these circumstances, the audit staff is not in a position to know whether all of its recommendations have been implemented or not. In our opinion, the audited offices should be required to respond to the recommendations of the Bank's internal audit staff that are addressed to it for action. Also, the Board of Directors of the Bank should be periodically informed by the internal audit staff of the status of overage outstanding recommendations so that it can take action to assure their implementation.

Recommendation No. 11

ROCAP should suggest that the Bank establish better procedures to assure that appropriate consideration is given to all of the recommendations of its internal audit staff.

3. Delinquency Rates

Recommendation No. 6 called attention to the need for the Bank to intensify its efforts with mortgage institutions to reduce the delinquency rate of home loan mortgages and suggested that a report of delinquencies be required from all mortgage institutions as a means of detecting potential problems.

The Bank has been requiring and is receiving the delinquency reports from all affected institutions, but apparently is not taking any action on these reports. The Bank ~~is~~ apparently cognizant of the general situation as it now intends to follow-up on those institutions which show a high delinquency rate and try to assist them to solve their collection problems.

ROCAP's reply to this recommendation stated in part that "Delinquency rates are not the serious problem
7 for the Bank that is implied. The Bank requires substitution of any mortgages more than 90 days delinquent. Primary risk is assumed by the originating institution, second-

ary risk by the national housing bank or FHA system involved."

We do not share this view as the security of the Bank's investment is dependent on the continued solvency of the mortgage institutions, as well as the primary mortgages purchased by the Bank. Our concern has in no way diminished as delinquency rates have deteriorated further.

Recommendation No. 12

ROCAP should follow up to assure that the Bank is obtaining the substitution of any mortgages more than 90 days delinquent, and assisting the institutions to solve their collection problems.

4. Amortization Period of Sub-Loans

Recommendation No. 12 pointed out the variances in the Bank's interest rate structure and amortization periods and asked that they be reviewed by the Bank.

In responding to this recommendation, ROCAP informed us that the Bank had made its review and concluded that its interest rate structure should be simplified. No mention was made of the variance in amortization periods.

We found that the rate structure had been simplified, although there continue to be some variances. However, we also found that no noticeable change had been made in amortization periods. We believe that the latter warrants equal consideration; accordingly, that portion of the prior recommendation is repeated.

Recommendation No. 13

ROCAP should request the Bank to review its policy with respect to the amortization period of sub-loans.

5. Contract Provisions

Recommendation No. 18 suggested that sub-borrowers incorporate into their contracts a standard set of cost principles, a recovery clause for defective pricing data, and the use of provisional overhead rates where applicable.

ROCAP agreed to this recommendation and informed us that it is encouraging the Bank to make a broader use of these cost principles in cost reimbursement contracts. ROCAP explained further that as the Bank's audit capacity is augmented, additional action will be taken with respect to the use of actual overhead as distinguished from fixed overhead on cost reimbursement contracts.

We found that the Bank had not required its sub-borrowers to incorporate in their contracts a standard set of cost principles for direct and indirect charges. Also, a fixed overhead rate is still being used by the sub-borrowers. Though the Bank is currently auditing the direct costs of contracts, no work has been performed in determining the reasonableness of indirect costs. Accordingly, the recommendation is repeated.

Recommendation No. 14

ROCAP should request the Bank to require the sub-borrowers to incorporate into their contracts a standard set of cost principles, a recovery clause for defective pricing data, and the use of provisional overhead rates where appropriate.

6. Training Program

Recommendation No. 19 requested ROCAP to encourage the Bank to provide a training program, including an appropriate manual, for appropriate personnel within the Bank and the CACM countries on the techniques of performing cost and price analysis of contractor bid proposals.

ROCAP and the Bank agreed with the recommendation and arranged for two programs to be conducted in the United States to which members of the staff of the infrastructure department of the Bank would be assigned. It was expected that the persons receiving this training would return to the Bank, would hold seminars and prepare written material in Spanish to be distributed throughout Central America in an effort to spread this particular highly technical type of knowledge to those needing additional skills in the field.

In reality, one program was conducted to which one Bank employee, an engineer, attended. Upon his return to the Bank (he is currently employed by the Bank), he did not hold seminars and prepare the prementioned written material.

Recommendation No. 15

> ROCAP should encourage the Bank to impart the training received on the techniques of performing cost and price analysis of contractor bid proposals to appropriate personnel within the Bank and the CACM countries.

E. Operations of the Bank's Agriculture Department

The Department's present complement of seven professional employees is engaged in making studies to implement the Board of Director's approved agricultural projects which were established on the basis of recommendations of SIECA -- the organization which serves as the secretariat of the integration movement and coordinates policy development in areas of common interest to the five countries. As indicated in Exhibit A of this report, the Department thus far has completed studies on eight of the approved projects, has partially completed five others, and has not yet begun studies on the remaining eight projects. In its opinion, it has sufficient work lined up to keep the Department busy for the next five years. This means that the Department will not be able to engage in any new initiatives, unless, of course, the Board of Directors increases the staff.

In reviewing those studies already completed, we noted that the Department does not make any effort to compare its products with any similar studies made by the respective cooperating government or USAID. This is probably due to lack of foresight. We suggest that this be done to assure that the quality of the Department work is satisfactory.

IV BACKGROUND AND SCOPE

The Central American Bank for Economic Integration, (CABEI) is a Regional Development Bank for the Central American Common Market (CACM) countries whose objectives are to promote balanced economic development within each CACM country and to promote Central American economic integration.

A.I.D., through its Regional Office for Central American Programs (ROCAP), has actively supported both the CACM as a concept and the Bank as an institution. On June 22, 1961, A.I.D. made available to the Bank $2 million in the form of a grant to assist the Bank to begin operations. Since 1962, A.I.D. has made direct loans to the Bank totalling $182.5 million, and has made available $39 million in loans under the Housing Investment Guaranty Program. Since 1963, the Inter-American Development Bank (IDB) has been the second largest source of financing to the Bank. IDB has made loans totalling $72.1 million. Beginning in 1966, the Bank's source of financing has expanded and it has loans or lines of credit from ten different countries. As of December 31, 1974, available resources to the Bank from subscribed capital stock from CACM countries, accumulated net earnings, and external resources (loans, lines of credit, etc.) totalled $502 million.

Our audit covered the period November 1, 1971 through December 31, 1974, and was conducted in the Spring of 1975. In conjunction with our overview of the Bank's entire operation, we selectively examined disbursements of $11,387,000 from the Ordinary Fund as financed by A.I.D. Loan 596-L-010, under A.I.D. Project No. 596-22-995-032. (grant?)

The purposes of our audit were accomplished by discussions with Bank officials and an examination of their supporting records and files. The first purpose of our audit involved an analysis of the Bank's chart of Accounts, and a comparative analysis of selected accounts to determine financial trends. We verified the accuracy of the Cash, Temporary Investments, and Accounts Payable accounts primarily by obtaining written confirmations. We verified the accuracy of Accounts Receivable primarily by visiting certain sub-borrowers. These accounts were selected because of their relative materiality. We also reviewed the CPA reports for the years ended June 30, 1973 and 1974, of the latter we reviewed both English and Spanish versions and compared the respective texts.

We examined the Bank's basic statistical data on sub-loans, their distribution by country, and historical data on the same subject. We reviewed the reports prepared by the Bank's Internal Auditor on handling and monitoring these sub-loans, as well as the operations of the Inspection Division of the Bank's Industrial Department. In view of the limited scope of this audit, we generally excluded from our review the sub-loans made from the Integration and Housing Funds. From the sub-loans under the Ordinary Fund, we identified 124 sub-loans granted to 88 borrowers which were on the books as of December 31, 1974 and wholly or partially financed with A.I.D. loans. From this universe, we visited 46 sub-borrowers holding 65 sub-loans. We purposefully selected those in remote areas, and those who did not respond to previous requests for confirmation from the Bank's internal auditors. Additionally, we scanned another 49 sub-loans to evaluate the Bank's compliance with A.I.D. loan requirements.

We also utilized to good advantage the audit techniques of reading minutes of recent Board of Director meetings, and examining endorsements on redeemed checks.

An exit conference was held with ROCAP on April 24-25, 1975, to review the findings of our audit. Comments of ROCAP, as expressed at this exit conference, were duly considered and reflected in this report as appropriate.

BANK'S AGRICULTURAL FEASIBILITY STUDIES AS AT DECEMBER 31, 1974

PROJECT	COMPLETED	STARTED	NOT STARTED
Cultivation of Cashew Nuts	x		
Cultivation of Rubber		x	
Cultivation of Cacao		x	
Cultivation of African Palm		x	
Training of Agricultural Labor			x
Construction and Equipment for the Agriculture Faculty of the University of San Carlos			x
Agricultural Education in San Salvador			x
Regional Forestry School			x
Warehouse Facilities for Central America	x		
Regional Fund for Basic Grains	x		
Wholesale Market for Guatemala	x		
Wholesale Market for Costa Rica		x	
Retail Market for Nicaragua	x		
Storage Facilities for Basic Grains	x		
Central America Irrigation, Drainage and Land Conservation		x	
Irrigation Facilities-Costa Rica	x		
Irrigation Facilities-Nicaragua	x		
Irrigation Facilities-Honduras			x

BANK'S AGRICULTURAL FEASIBILITY STUDIES AS AT DECEMBER 31, 1974

PROJECT	COMPLETED	STARTED	NOT STARTED
Procurement of Agricultural Equipment			x
Food Production			x
Farm Animal Disease Plan			x
TOTALS	8	5	8

LISTING OF RECOMMENDATIONS

Recommendation No. 1

ROCAP should request the Bank to (a) adopt an acceptable system of accounting for exchange fluctuations for all of its accounts; (b) improve its financial statement presentation by (1) including in the body of the Balance Sheet the amount of bad debt reserve, (2) specifically identifying as contingent liabilities sub-loans signed but not disbursed and guarantees on behalf of sub-borrowers and (3) including loans not drawn down by the Bank; and (c) review its policy and procedures relative to its reserve for bad debts.

Recommendation No. 2

ROCAP should confer with the Bank to revise its cash management policy with the aim of better utilizing resources and thereby reducing costs and increasing profits of the Bank.

Recommendation No. 3

ROCAP should request the Bank to document its verification of data during the course of its reviews of a sub-loan application, and on a test-basis confirm that this is being done.

Recommendation No. 4

ROCAP should encourage the Bank to better put to use the reports of the Inspection Division of its Industrial Department.

(Editor's note: Some of these comments might also apply to the inspection Division of the Infrastructure and Housing Departments - operations that are beyond the scope of this audit.)

Recommendation No. 5

ROCAP should review sub-loan 3-0365 with the Bank and suggest cancellation of the sub-loan if possible.

Recommendation No. 6

ROCAP should confer with the Bank about the results of the study in-process, and suggest the adoption of more realistic practices regarding collateral.

Recommendation No. 7

ROCAP should periodically review the reports received from the Bank to identify sub-loans on which disbursements have not started within established time limits, and prevail on the Bank not to extend terminal dates unless there are valid reasons.

Recommendation No. 8

ROCAP should suggest that the Bank strengthen its procedures to obtain compliance from sub-borrowers with the terms and conditions of sub-loans.

Recommendation No. 9

ROCAP should confer with the Bank on its sub-loan policies for stock purchases and debt financing.

Recommendation No. 10

ROCAP should substitute Bank funds for all of the A.I.D. funds used to finance the operations of the Revolving Fund under Loan No. 010.

Recommendation No. 11

ROCAP should suggest that the Bank establish better procedures to assure that appropriate consideration is given to all of the recommendations of its internal audit staff.

Recommendation No. 12

ROCAP should follow up to assure that the Bank is obtaining the substitution of any mortgages more than 90 days delinquent, and assisting the institutions to solve their collection problems.

Recommendation No. 13

ROCAP should request the Bank to review its policy with respect to the amortization period of sub-loans.

Recommendation No. 14

ROCAP should request the Bank to require the sub-borrowers to incorporate into their contracts a standard set of cost principles, a recovery clause for defective pricing data, and the use of provisional overhead rates where appropriate.

Recommendation No. 15

ROCAP should encourage the Bank to impart the training received on the techniques of performing cost and price analysis of contractor bid proposals to appropriate personnel within the Bank and the CACM countries.

DISTRIBUTION OF AUDIT REPORT

	Copies
Assistant Administrator, Bureau for Latin America, AID/W	1
Mission Director, ROCAP	10
Director, ARA-LA/CEN, AID/W	1
Director, Program Operations Staff, LA/OPNS, AID/W	1
Director, Office of Public Affairs, OPA, AID/W	1
Inspector General of Foreign Assistance, IGA/W	1
Director, AG/AUD, AID/W	13
Director, AG/IIS, AID/W	1
Director, Operations Appraisal Staff, AG/OAS, AID/W	1
AG/GAO-IGA Liaison Officer, AID/W	1