FINAL REPORT
"Expansion of Rural Finance Activity"

Cooperative Agreement (522-A-00-00-00205-00)

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I. BACKGROUND

The proposal subsequently funded for this post-Hurricane Mitch "Expansion of Rural Finance Activity" was submitted on July 20, 1999 and authorized for pre-award expenditures at ACDI/VOCA's risk on July 28, 1999. The Cooperative Agreement (522-A-00-00-00205-00) was signed by ACDI/VOCA on December 13, 1999.

The activity was designed as a mix of technical assistance to institutionally strengthen Financiera de Cooperativas Agropecuarias, Ltda. (FINACOOP) to improve its chances of business survival, and administer a pass-through to FINACOOP of a loan fund of $2,596,403 that it would lend to small farmers and cooperatives. This injection of loan capital to the rural areas was seen as important to post-Mitch recovery for a damaged and depressed small farming sector that had no other formal sources of agricultural credit.

The technical assistance component of the activity was aimed at strengthening FINACOOP to bring it from its 1999 status of technical insolvency to a financially viable entity employing modern operating systems and procedures that would enable it to achieve solvency while concurrently serving its small-farmer membership during trying times.

A key stipulation under the cooperative agreement required FINACOOP to be deemed sustainable by the end of this activity by USAID/Honduras and ACDI/VOCA in order that the ownership and administration of the loan fund be transferred to FINACOOP. An independent external evaluation providing an opinion on FINACOOP's prospects for sustainability was required as an input to USAID and ACDI/VOCA during the quarter immediately preceding end of project. A negative finding by the evaluation, USAID or ACDI/VOCA would result in the loan fund being transferred to Government of Honduras control.

The years 2000, 2001 and now 2002 have not been kind to Honduras, and FINACOOP did not escape from the overall negative picture. A catastrophic fall in coffee prices has taken place in the last three years, caused to a great extent by Vietnam flooding world markets with coffee produced, by some accounts, at a price of five cents per pound compared to Central and South American costs ranging to over 70 cents. This phenomenon had an immediate impact on FINACOOP's loan portfolio, over 80% of which had traditionally been small coffee growers and cooperatives marketing coffee. Many growers encountered severe problems repaying their loans, and FINACOOP undertook a major loan restructuring program to at least receive interest payments during a difficult period. Some cooperatives went into default and were brought into civil litigation by FINACOOP to recover all or part of the outstanding loan balances. These cooperatives were expelled from FINACOOP's board of directors. The loan recovery program was more successful than anticipated due to the introduction of an incentive program suggested by ACDI/VOCA volunteers that gave FINACOOP staff a percentage of recoveries of previously virtually uncollectible loans.

In addition, Honduras has recently been plagued by severe drought conditions and a highly depressed economy, situations that hurt production and limited non-farm income-generating activity that could have helped FINACOOP borrower families repay loans and/or request credit for micro-enterprise development. During this complicated period, FINACOOP did diversify its portfolio away from a coffee concentration and into other agricultural pursuits and micro- and small-business lending.

II. PROGRAM ACTIVITIES AND ACHIEVEMENTS

The top priority at the program start-up point was to quickly move loan fund capital into the FINACOOP system while modernizing that organization's culture, management and control systems and procedures, and data collection and reporting operations on a fast track. The cooperative agreement was signed just before Christmas 1999, so the program launching for all intents and purposes occurred in January 2000. In the January-March 2000 quarter, $497,576 of loan fund resources were transferred to FINACOOP, followed by another $1,018,649 in the next quarter, $530,314 in the next. Therefore, by September 19, 2000 $2,046,539 of the initial loan fund availability of $2,596,403 had been moved to FINACOOP. The last transfers took place at a slower pace during the second year of the activity. It should be noted that the total amount passed through to FINACOOP rose to $2,618,186 due to interest income on the loan fund account in dollars of $21,783 being incorporated into the loan fund, as stipulated in the CA..

All loan fund activity was verified as having been handled correctly by ACDI/VOCA and FINACOOP in various audits covering the period from activity start-up through December 31, 2001, the end of the provision of activity deliverables. Visiting GAO teams praised ACDI/VOCA's activity management and reporting, and numerous independent reviews of the ACDI/VOCA program gave it high marks for its management and record-keeping and its ability to implement efficient controls of large amounts of funds and numerous and multi-faceted technical assistance interventions at FINACOOP headquarters and rural branches.

While the tight administration of the loan fund under rapid disbursement marching orders was a crucial objective, USAID's and ACDI/VOCA's vision for a successful program converged on seeing a sustainable FINACOOP at end-of-project, and hopefully far beyond that. The ACDI/VOCA team implemented a comprehensive yet integrated program of volunteer and paid consultant technical assistance to FINACOOP that left few or no stones unturned in the areas of staff development, systems and procedures modernization, including a major MIS upgrade, cost-cutting measures, efficiency-enhancing initiatives, and a substantial turnaround in the business culture at FINACOOP. Gone was a fatalistic can't do atmosphere, which was transformed into a much more upbeat, take on the challenges and overcome them attitude. FINACOOP was on board, and made made necessary changes in staff, the board of directors, and in the way of doing business. Branches could be closed if necessary, staff levels reduced, headquarters moved to a much less expensive location.

The documents inserted and attached below provide a detailed picture of ACDI/VOCA's technical assistance efforts with FINACOOP. They are presented in a sequence that traces the documentation of the activity's efforts and the subsequent resultant opinions of external evaluations, interim and final progress and impact reports by ACDI/VOCA staff, and USAID Mission findings regarding the program. They have not been edited or modified in any way, thereby retaining their integrity as source documents for this report.

Insert #1. KPMG Consulting/Barents Group external evaluation: **"Viability and Sustainability, Financiera de Cooperativas Agropecuarias, Ltda. - FINACOOP",** December 5, 2001. This study represented the crucial first step toward USAID and ACDI/VOCA taking a position on the disposition of the loan fund at EOP.

VIABILITY AND SUSTAINABILITY EVALUATION
FINANCIERA DE COOPERATIVAS AGROPECUARIAS, LTDA.
FINACOOP

Introduction

This report reflects an external evaluation of the viability and sustainability of the Financiera de Cooperativas Agropecuarias, Ltda. (FINACOOP), as required by the Cooperative Agreement No. 522-A-00-00-00205-00 for $5,000,000.00 awarded by the United States Agency for International Development (USAID) to Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance (ACDI/VOCA) on October 29, 1999. Under this Cooperative Agreement, ACDI/VOCA's objectives are to expand access to financial services by small and medium-scale producers and rural entrepreneurs and to increase the sustainability of FINACOOP by strengthening its management and by helping it to improve the quality of its loan portfolio, develop new products and services, tap new markets, and regain profitability. The completion date to achieve the objectives and results of this activity is December 31, 2001.

Following the Terms of Reference provided by ACDI/VOCA Washington office, we conducted an evaluation of the institution's progress-to-date and future viability during November 12, 2001 through November 19, 2001. Our evaluation focused on measuring performance since the project inception with major emphasis on measuring current progress against the qualitative targets listed below:

- Financial management
- Organizational development
- Problem loan portfolio
- Ownership transition – government to private
- Loan underwriting techniques and Balance Sheet strengthening
- Branch operations financial feasibility
- Integration of automated Management Information Systems (MIS)
- Board of Directors oversight, education and training
- New product development

In conducting our evaluation, we concentrated our efforts in assessing the adequacy and effectiveness of policies, practices, procedures and internal control systems in place with limited evaluation of financial information.

In relation to the USAID loan funds, we evaluated ACDI/VOCA's processes and controls in place in the following areas:

- Funds distribution and use
- Record keeping
- Audits
- Loan underwriting

Acknowledging that FINACOOP's board of directors is ultimately responsible for the safety and soundness of the institution, we conducted several meetings and interviewed members of the board of directors (Junta Directiva) and oversight board (Junta de Vigilancia) in order to understand and adequately evaluate their effectiveness in managing the institution and strengthening its financial condition.

SUMMARY OF CONCLUSIONS:

As of the evaluation date, FINACOOP remains a viable institution for both, the Government of Honduras and the market it serves. However, as many financial institutions in Honduras, FINACOOP faces two major challenges: liquidity and asset quality. Since June 2001, Board and management have been aggressively managing all sources and uses of liquidity to provide for operations and runoffs. As of the evaluation date, liquidity was sufficient for daily operations and was mostly provided by fees generated from administration of third party funds, loan repayments and the investment portfolio. In addition to the liquidity sources previously mentioned, funding for lending area has also been provided by the USAID funds managed by ACDI/VOCA.

The second challenge, asset quality, remains an area of concern for FINACOOP. However, it is important to note that the majority of troubled assets in the loan portfolio were generated by 12 cooperatives that were later incorporated into FINACOOP. Some of these cooperative are currently in litigation and the outcome will be decided by the legal system in the future.

Since 2000, FINACOOP's board of directors and senior management have been able to improve the overall operations and financial performance of the institution. This is evidenced by reflecting positive earnings at the end of the year, despite significant loan provisions, compared to substantial losses in prior periods; the implementation of a new computer system; and updating of policies, procedures and internal controls systems. In addition, management has been able to cut operational, occupancy, and personnel expenses while maintaining positive earnings.

FINACOOP is one of the few institutions in Honduras that has an established branch network throughout the country. For many years the Government of Honduras and several donor agencies have used FINACOOP as the intermediary to deliver the necessary financial assistance and products to those enterprises and individuals involved in the agricultural sector that were affected by Hurricane Mitch. Without this infrastructure, the GOV is not able to deliver the financial means that are required to maintain the agricultural sector operating. Therefore, FINACOOP plays an important role as a non-bank financial intermediary in Honduras.

Based on the improved financial condition of FINACOOP, compliance with the Memorandum of Understanding, board of directors and senior management commitment to further strengthen the institution, we recommend that the funds provided under the ACDI/VOCA and USAID cooperative agreement remain at FINACOOP.

Financial Management

FINACOOP's financial management processes and systems in place are considered Satisfactory. As of the evaluation date, FINACOOP was transitioning from a manual accounting to an automated system. The implementation of this new system is scheduled to be completed by year-end. When fully implemented, the system will provide senior management and the Board with real-time MIS reports necessary in the managing of the institution.

In reviewing this area, we started our evaluation by obtaining copies of current management information system reports generated by the Finance and Operations department and provided to the Board of Directors. Our main goal was to assess the adequacy of the information provided and the Board's effectiveness in using these reports to effectively manage the institution. Some of the reports obtained included the following:

- Financial statements for the month
- Sale of Other Real Estate Owned and status of other properties
- Internal audit reports
- External audit report FYE 2000
- Past due reports, including member cooperatives and directors
- Variance analysis

Although moving in the right direction, additional assistance and oversight is needed in the financial reports generation function. For example, subsidiary balances on manual reports reflecting total loan portfolio and past due and non-accrual loans as of September 30, 2001 did not reconcile to the institution's internal financial statements totals for the same period. Management is presently researching and confident that once all the modules of the new accounting system are integrated, operational and tested all differences will be properly identified and timely corrected.

It should be noted that the integration of the new system has caused several delays in the following areas as of the evaluation date:

- Internal financial statements for the month of October 2001 were not yet completed.
- Quarterly analysis at 9/30/01, of the adequacy of the Allowance for Loan and Lease Losses was not yet performed.

On the positive side and reflecting significant progress and initiative on management is the fact that they are already working on the development of the Year 2002 business and operating plan for presentation and approval at the December 2001 board meeting. This planning process was strengthened by the technical assistance provided through an ACDI/VOCA advisor during in the area of business and strategic planning.

Recommendations:

1. Take the necessary steps to ensure that the new system integration takes place before the end of the year and that a process is in place to ensure that financial reports generated are accurate and properly reconcile to the subsidiary records.

2. Finalize the preparation of internal financial statements for the month ended October 31, 2001 and perform the ALLL analysis for the quarter ended September 30, 2001. Management needs to ensure that monthly financial statements and ALLL analyses are prepared in a timely manner.

Organizational Development

FINACOOP' management and directors, in conjunction with technical advisors provided by ACDI/VOCA, have evaluated the organizational structure of FINACOOP and taken the necessary actions to develop a more efficient structure that supports the current needs of the institution. The new structure, takes into consideration the integration of the automated system, personnel skills and capabilities, and duties and responsibilities at the exempt and non-exempt level.

ACDI/VOCA advisors provided management with the methodology and necessary tools to evaluate existing personnel to determine their strengths and weakness in order to re-define their duties and responsibilities within their functional areas. As of the evaluation date, management had accomplished the following:

- Developed new organizational structure.
- Developed and implemented new job/function descriptions for all personnel.
- Decreased number of employees from 63 at the end of 1999 (beginning of the program) to 35 employees.
- Converted 4 of its 7 branches from full service locations to 1 agency and 3 "payment only windows". This was the direct result of the feasibility study performed by FINACOOP's consultant.
- Reassigned duties and responsibilities within the main office.
- Implemented the new computer system in five out of seven branches.

Currently, management and the internal consultant are updating FINACOOP's operating and internal control practices and procedures manuals to conform to the new structure and personnel changes, integration of the new system and implementation of new job descriptions. When properly adhered to, the revised operating procedures will ensure that all activities are performed in an accurate and consistent manner.

Recommendation:

1. Finalize the revision of FINACOOP's operating procedures before year-end and designate an individual at each branch location to ensure that procedures are properly presented and communicated to all personnel. Once implemented,

compliance with operating procedures should be reviewed by the internal auditor and deficiencies communicated to the board for prompt corrective action.

2. Incorporate into the existing personnel manual the new job descriptions and ensure that all employees fully understand their duties and responsibilities and how their performance will be measured. Incorporate quantitative factors, when applicable.

Problem Loan Portfolio

The level of problem loans (past due and non-performing) within FINACOOP's loan portfolio remains a concern. On its surface, problem loans at 9/30/01 accounted for 43% of total gross loans. However, further review of this figure revealed that approximately 28% was related to 12 FINACOOP's cooperative members whose portfolio of loans had been non-performing prior to being incorporated into FINACOOP. Therefore, adjusting for those cooperative member problem loan portfolios, adjusted past due and non-performing loans at 9/30/01 are approximately less than 10%.

Since 1999, management has recognized the negative impact of these troubled cooperatives on FINACOOP's performance and liquidity. Despite this financial burden, management has been able make provisions to the Allowance for Lease and Loan Losses to provide adequate coverage on the level of risk identified in the portfolio while maintaining compliance with capital requirements. On 12/31/99, and following the guidance of ACDI/VOCA advisors, management wrote off approximately Lps. 22 million with the goal of strengthening the loan portfolio by removing non-performing loans[1]. As a result, 1999 financial performance was poor. Following the same strategy, at the end of December 2000, a similar transaction took place and approximately an additional Lps 5 million were removed from the books and are currently under litigation proceedings[2]. Despite loan write offs and the additional provisions made to maintain an adequate allowance, FINACOOP reflected positive earnings for the year ended 12/31/00.

Although written off from the books, management is aggressively pursuing collection on these loans through legal proceedings and the sale of these repossessed assets. As of the evaluation date, management had sold one of these properties and had a second property under contract for sale.

In regards to the portfolio of loans accounting for less than 10% past due loans shown above, management has implemented new collection practices and is currently revising the institution's procedures to aggressively collect on these loans and reduce delinquency. In adopting these practices and procedures, FINACOOP's management has shown the ability to closely manage the level of past due and non-performing loans despite being affected by the Honduran economy as the result of Hurricane Mitch and most recently the deterioration of the coffee prices considering that the majority of FINACOOP's borrowers are farmers and coffee producers with limited or non-existing cash flow to service their debts.

[1] Exchange rate at 12/31/99 – US$1 = 14.6215 Honduran Lempiras.
[2] Exchange rate at 12/31/00 – US$1 = 15.1015 Honduran Lempiras.

Of equal importance, the president of the board of directors has also demonstrated the ability and commitment to strengthen FINACOOP's financial condition and public perception by actively participating in the loan collection process, supporting management in all decisions, removing board members with delinquent loans, and starting legal proceedings on problem loans.

Although significant progress-to-date has been achieved by management and the board, substantial work remains ahead as management continues to address the level of problem loans in the institution and restructure the balance sheet while maintaining sufficient liquidity to provide for additional loans and cover operations. However, any adverse trend in the local economy could be detrimental to FINACOOP's condition as well as to any financial institution in Honduras.

Recommendations:

1. Continue aggressive collection practices on repossessed assets and delinquent loans, including director loans, in order to improve delinquency levels and augment liquidity.
2. Perform internal evaluations of Other Real Estate Owned properties in order to maintain adequate values on the books.
3. Continue efforts of writing off problem loans from the books by making the necessary provision to the Allowance.

Ownership Transition – Government to Private

The transitioning of the current government majority ownership structure to private ownership is dependent on a number of conditions to be met by FINACOOP followed by effective and timely decisions made by the Government of Honduras (GOH). Some of these conditions are to be effective by 12/31/01, while some will take place by 12/31/03.

As stated on the Memorandum of Understanding (MOU), the GOH acting through its Secretary of Finance (SEFIN) is committed to gradually turn over its ownership on FINACOOP back to its members once all MOU conditions are met. However, the MOU is silent as to how it is going to take place or what ownership percentage will be transferred.

Conversations with board members and the General Manager revealed that the transfer of ownership from the GOH-SEFIN to the private sector, FINACOOP, will not take place as stated on the MOU because it will require an action from Congress acknowledging and approving the transfer. Given the fact that Honduras is currently under elections, FINACOOP's ownership issue will not be solved in the near future. Conversations with board members and general manager revealed that the transfer of ownership from the GOH-SEFIN to the private sector, FINACOOP, will not take place as stated on the MOU because it will require an action from Congress acknowledging and approving the transfer. Given the fact that Honduras is currently under elections, FINACOOP's ownership issue will not be solved in the near future.

Currently, FINACOOP'S Board of Directors includes three non-voting members appointed by SEFIN. These three board members act as the government representatives with no voting authority on the day-to-day decisions of the Board. Their responsibility is to act as the "eyes and ears" of SEFIN. As of the evaluation date, one of SEFIN's representative had defaulted on a loan that matured on May 5, 2000 and was significantly in non-compliance with his/her duties and responsibilities as a board member.

Loan Underwriting Techniques, Balance Sheet Strengthening and New Products

Loan underwriting and approval processes in place appear Adequate. Management, assisted by ACDI/VOCA advisors, has concentrated its efforts in managing the loan portfolio problems as mentioned earlier. The lending function remains as one of FINACOOP's biggest challenges going forward, specifically those loans in the agricultural sector. Since the implementation of the new lending policies in 2000, management introduced two new products in order to diversify the portfolio: small- and medium-enterprises (PYMES (Pequeñas y Medianas Empresas-in Spanish) and consumer lending.

Loan underwriting techniques for these new products are included in the lending policies. The lending policies are currently under review by ACDI/VOCA's consultant to ensure consistency during the underwriting process.

Given the branch structure, line of business, and products and services offered by FINACOOP, concentrations are evident, mainly in the agricultural sector.

Since 2000 it has been management's goal to diversify and specifically to reduce the volume of loans to the agriculture sector from almost 100% down to approximately 70% at the end of September 2001. The major contributor has been the PYMES product. This product provides FINACOOP with continuous cash flow as these businesses generate tremendous cash flows on a daily basis and provide for the orderly repayment of debts as scheduled. Diversification through introduction of consumer products has been slow, as borrowers have been affected by recent negative trends in the Honduran economy. As of 9/30/01, this product accounts for less that 1% of total gross loans.

Although FINACOOP's directors and management continue to try to diversify the institutions' loan portfolio, FINACOOP remains as the number one institution responsible for servicing the financing needs of the farmers throughout the country. FINACOOP is also the only institution with an established branch infrastructure capable of disbursing funds to its members in a timely manner. Ultimately, the GOH looks at FINACOOP as the financing vehicle to support agriculture sector activities. Therefore, diversification from its major activities will be a challenge for FINACOOP given the market its serves.

We used the internal and external auditors reports to validate the underwriting techniques utilized on those loans granted, since our scope did not provide for underwriting testing. The scope of these audit reports was comprehensive and validated compliance with lending policies and operating procedures in place. Deficiencies identified by the auditors were addressed by senior management at the main office and by managers at the branch level. Corrective actions were taken and follow up was adequate.

As envisioned by management, balance sheet strengthening will be achieved through the following strategies:

- Aggressive collection practices on delinquent loans.
- Increase volume of PYMES to further diversify portfolio and improve liquidity.
- Dispose of Other Real Estate Owned in a timely manner to minimize potential losses.
- Provide for adequate Allowance for Lease and Loan Losses to cover risk in the loan portfolio and unanticipated losses.

Branch Operations Financial Feasibility

The branch feasibility study performed by ACDI/VOCA's Consultant, Mr. Marcelo Subia dated July 16, 2001 appears Satisfactory and provides sufficient information for the directors to make a decision on the future of the branches. Our review focused on the methodology utilized for measuring efficiency, growth in the areas of loans and deposits, past due levels, management skills and capabilities, and operating expenses. The study included all the branches plus the main office.

The results of this feasibility study revealed that three out of the seven branches needed to be converted into "payment only windows" given the limited activity, financial performance, high operating expenses and weak management. There was also one other branch that based on the study needed to be converted into an agency. This agency branch will provide limited services, capture deposits from its members and the public, and grant loans on a limited basis. The "payment only windows" will only process loan payments and recoveries. As of the evaluation date, all recommendations to convert branches were already implemented.

In addition to the feasibility study, ACDI/VOCA's Consultant conducted an evaluation of individual personnel at every branch focusing on identifying strengths, weakness, opportunities, and threats. Using this evaluation, the directors and management have replaced and terminated personnel in those branches that now provide limited services and at those other full service branches where management was found to be the part of the problem.

Integration of automated Management Information Systems (MIS)

As of the evaluation date, management and ACDI/VOCA's consultant were involved in the implementation and integration of the new automated management information system at the main office and at the branch level.

The new system when fully operational will include the following modules:

- Cash
- Banks
- Loans
- Deposits
- Risk Center
- Micro-credit

- ♦ Accounting
- ♦ Information Center

Data Sistemas Internacional (DIS), a local computer company, is implementing the new system, NetBanking. To date, the system is operational at the main office and at five other branches, including the "payment only windows". Another branch will be incorporated by November 23, 2001 and the last office will be incorporated early December 2001.

Although the modules are operational at the branches mentioned above, the information is not yet consolidated into the main office system due to poor communication connections between the branches and the main office. The main impediment is the fact that the telephone infrastructure in Honduras cannot support the volume of information that will be required from these branches on a daily basis. Considering all the alternatives, management decided to consolidate the information from each branch via disk backup. In order to perform these backups, management is procuring the purchase of five disk burners/cloners to copy the information on a daily basis and forward it to the main office.

Recommendations:

1. Management should ensure that the new system in fully incorporated, operational and fully tested before year-end to ensure accurate information is obtained when preparing reports for the end of the year.

2. Ensure that effective internal controls are developed in to the system to provide for adequate system security, safeguarding of information and assets, and accountability.

Board of Directors Oversight, Education and Training

Under the program, ACDI/VOCA has provided the directors, management and staff with numerous training seminars, courses, country trips in the areas of: micro-finance, administration of small and medium businesses, property appraisals, accounting, computer courses, marketing and sales, and many other courses focusing on professional and personal development.

In addition to the courses, directors and management received other training in the area of micro-enterprises and micro-credit when visiting Bolivia, Guatemala, Mexico, and Washington.

Since 2000, FINACOOP directors and institution personnel have received technical assistance and guidance from a number of ACDI/VOCA advisors in the following areas:

- ♦ Budget Planning and Forecasting
- ♦ Management Development
- ♦ Viability Studies
- ♦ MIS Board Financial Reports
- ♦ Loan Workouts

- Loan Collections, Recoveries and Incentives
- Marketing & Sales – Market Segmentation
- Accounting and MIS
- Human Resources & Organizational Structure
- Liquidity and Funds Management
- Gap Analysis
- Net Interest Margin

Recommendation:

Continue providing training and education to all personnel to strengthen skills and capabilities. The training component should be an integral part of the business strategic plan.

USAID LOAN FUND

In relation to the USAID loan fund, we evaluated the following areas:

- Funds Distribution, Use and Record Keeping
- Audits
- Loan Underwriting

Overall policies, practices, procedures, internal controls, audits and loan underwriting appear Adequate. Deficiencies noted during the internal and external audits were reviewed by management and timely corrected. Funds distribution and use are adequate and provide for the safeguarding of assets and documentation.

Funds Distribution, Use and Record Keeping

We evaluated the practices and processes in place surrounding the distribution, use and record keeping of funds provided by the USAID loan since the inception of the project.

All fund distribution transactions were properly recorded. A typical fund distribution request consisted of the following documentation:

- funds request letter from FINACOOP's Finance Manager specifying amount requested.
- summary listing of loans to be funded under the USAID loan funds indicating borrower, loan amount and purpose (based on individual branch listings).
- withdrawal slip properly signed ACDI/VOCA's authorized signers requesting withdrawal of US dollars from bank account at BAMER (Banco Mercantil, S. A.).
- bank receipt for exchanging US dollars to Honduran Lempiras.
- copy of the check issued by BAMER in Lempiras payable to FINACOOP.
- promissory notes (English & Spanish) signed by FINACOOP's General Manager acknowledging receipt of USAID loan funds.

Although our review of internal controls and segregation of duties revealed that because of its ACDI/VOCA's size and personnel structure, one individual is responsible for many administrative duties in the office, there are compensating controls in place to provide for checks and balances. This was evidenced by different levels of review performed by individuals not involved in the function. Another controls include independent audits performed ACDI/VOCA internal and external auditors and USAID Regional Inspector General auditors. The auditors identified no weaknesses in the internal control system or practices.

As of 9/30/01, ACDI/VOCA had provided FINACOOP with approximately US$2,517,839 or Lps. 37,537,364 in USAID funds used to finance approximately 928 loans granted since beginning of 2000. These loans were distributed among the following sectors:

Sector	% of Loans
Coffee	52%
Grains	7%
Ganado	10%
Business/PYMEs (SME)	26%
Other	5%
Total:	100%

Audits & Loan Underwriting

The ACDI/VOCA program undergoes a series of audit reviews throughout the year. Internally, ACDI/VOCA's internal auditor is responsible for auditing the program and personnel adherence with policies, procedures, controls, disbursement and use of loan funds, loan underwriting and loan documentation requirements. Since 1999, the internal auditor and the Regional Inspector General auditors have audited the program activities on a quarterly basis. We reviewed all audit reports issued by the internal auditor to ensure deficiencies identified were timely and deficiencies properly corrected. As of our evaluation date, management was in the process of correcting deficiencies noted during the last review performed as of 6/30/01 and presented to management during this evaluation.

ACDI/VOCA's external auditor, Morales Group, performs the next level of audit reviews representatives of Arthur Andersen. Since 1999, Morales Group has been auditing the financial statements of FINACOOP under Honduras' generally accepted auditing standards.

In addition, to the internal auditor reviews and the external auditor's certification of the FINACOOP's financial statements, USAID contracted the services of Grant Thornton to perform an independent review of ACDI/VOCA's activities under the Inspector General guidelines. Their review includes all of loans funded with USAID funds, internal controls and disbursement practices and procedures. As of our review date, Grant Thornton auditors were conducting a review of activity for the period of August through September 2001. They anticipate starting their 4th quarter 2001 review sometime during December 2001.

EVALUATION
FINANCIERA DE COOPERATIVAS AGROPECUARIAS, LTDA.
FINACOOP
COMPLIANCE WITH MEMORANDUM OF UNDERSTANDING

MEMORANDUM OF UNDERSTANDING (CARTA DE ENTENDIMIENTO)

Although not part of the Scope of Work provided by ACDI/VOCA, the USAID-Honduras Mission requested the Analyst to prepare an evaluation of FINACOOP's compliance with the MOU. Therefore, we evaluated the institution's compliance with Sections 6 and 7 of MOU as of our evaluation date.

Based on our evaluation, we concluded that FINACOOP was in "Full Compliance" with the majority of the articles of the MOU, except for articles listed below which are considered to be in "Substantial Compliance" and expected to be in "Full Compliance by the end of the year.

Art. 6 Terms and Conditions for transferring of ownership

Art. 6.5.2 **<u>Past due loans should be less than 10% of total gross loans.</u>** As stated earlier, a portfolio of problem cooperatives affects FINACOOP's loan portfolio. If adjusting for these cooperatives, FINACOOP's past due percentage as of the evaluation date is less that 10% and in full compliance with this article. However, until these problem assets are removed from the portfolio, we recommend measuring this ratio taking into consideration those loans granted prior to the ACDI/VOCA program and those granted after the program.

Art. 6.5.5 **<u>Total deposits should increase by 10% per year for the next three years.</u>** Given the current economic conditions in Honduras, the entire banking system has been affected by deposit runoffs. Therefore, FINACOOP has been concentrating its efforts in strengthening its financial condition and capturing funds when available and at a reasonable cost.

Art. 7 Strategic actions for the strengthening of FINACOOP

Art. 7.4.2 **<u>Update and implement an effective operating procedures and internal control manual.</u>** Management and the ACDI/VOCA consultant are currently finalizing the manual. However, its completion is dependent on the full implementation of the new control and automated systems in order to develop operating procedures that provide for effective controls.

Art. 7.5.2 **<u>Implement the new system at the main office level not later than the end of 2000 and at the branch level by June 2000.</u>** The new system is already operational at the main office level; however, due to the existing telecommunications network in Honduras, the implementation at two of the branches has experienced some delays. Management expects full implementation by the end of this year.

Art. 8 Monitoring and Control – SEFIN and USAID

Art. 8.1 **Monitoring Committee.** Although not directly affecting FINACOOP's compliance with the MOU, we noted that a monitoring committee composed of two representatives from USAID and two from SEFIN was not created and performing its responsibilities as required by the MOU. Further conversations with USAID representatives revealed that there was an "informal committee" composed of one representative from each group. However, monitoring meetings were not conducted on a monthly basis, and minutes were not taken to evidence compliance with the MOU. On the other hand, ongoing monitoring was performed by FINACOOP in conjunction with ACDI/VOCA personnel in country.

It is important to mention that although the purpose of this MOU was to strengthen the systems and processes at FINACOOP, in addition to its financial condition, this MOU was drafted for a three-year period. However, it fails to indicate who will be responsible for and how performance/compliance will be measured after the end of the ACDI/VOCA Program.

Insert #2. "CAMEL Evaluation of FINACOOP", prepared by expert consultant Monnie Markel Biety, December 7, 2001. This study was programmed by Chief-of-Party Kendall Mau for two principal reasons: To secure a second opinion on FINACOOP's projected sustainability before EOP, and to lock FINACOOP into the habit of having annual CAMEL evaluations so they will continue to strive toward overall financial institution excellence.

CAMEL Explanation

The CAMEL rating system used is based upon an evaluation of five critical elements of the credit union: capital adequacy, asset quality, management, earnings and liquidity. This rating system is designed to take into account and reflect significant financial and operational factors that examiners assess in their evaluation of credit union performance. Credit unions are rated using a combination of financial ratios and examiner judgement.

Although the composite CAMEL rating normally bears a close relationship to the component ratings, circumstances beyond the ratios were considered such as pending donations, the adequacy of internal controls, the usefulness of the annual budget, the quality of the written policies and procedures, the method and timeliness of funding the provisions for asset loss accounts, the level of active participation by the officials, management and members and the level of service provided to membership and the community. The following are the general guidelines used to assign the CAMEL composite rating:

Rating 1 – This is the highest rating that can be assigned. It indicates strong performance that consistently provides for safe and sound operations. The historical trend and projections for key performance measures are consistently positive. Credit unions in this group are resistant to external economic and financial disturbances and are capable of withstanding the unexpected actions of business conditions more so than credit unions with a lower composite rating.

Rating 2 – Reflects satisfactory performance that consistently provides for safe and sound operations. Both historical and projected key performance measures should generally be positive with any exceptions being those that do not directly affect safe and sound operations. Credit unions in this group are stable and able to withstand business fluctuations quite well; however, areas of weakness can be seen which could develop into conditions of greater concern. Any operational concerns should be resolvable in the normal course of business without effecting operations and member service.

Rating 3 – Represents performance that is flawed to some degree and is of concern. Financial and operational performance is marginal. Both historical and projected key performance measures may show little progress or negative results to the extent that safe and sound operations may be adversely effected. Credit unions in this group are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting certain identifiable areas of weakness. Overall strength and financial capacity is present so as to make failure only a remote probability.

Rating 4 – Refers to poor performance that is of serious concern. Key performance measures are likely to be negative. Such performance if not corrected would lead to conditions that could threaten the viability of the credit union. A high potential for failure is present but is not yet imminent or pronounced. If a credit union has one individual rating of a 4, the highest the composite rating could be is a 3.

Rating 5 – Considered unsatisfactory performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, directly impairs the viability of the credit union. Credit unions in this group have a very high probability of failure in the near future and will likely require liquidation, merger or some other form of assistance. If a credit union has one individual rating of a 5, the highest composite rating that could be assigned is a 4.

The evaluation system used had to be changed to reflect the Honduran market, laws and economic situation. Two ratios were added to the CAMEL ratios currently used by credit union regulators in the United States, Provision for Loan Loss for loans greater than 12 months and Provision for Uncollectible Loans / Delinquent Loans between 1 – 12 months. These two ratios are part of the PEARLS system developed by World Council of Credit Unions (WOCCU). They were necessary because the CAMEL system assumes that the provision for loan loss account is adequately funded at all times. This is not the case in credit unions outside of the United States. The CAMEL ratio ranges were adapted to the financial situation outside of the United States so as to judge FINACOOP on the level of other developing countries. Due to these changes, the rating given is somewhat more subjective and based on personal experience as compared to a CAMEL rating in the United States. An internationally accepted rating system has yet to be developed that can determine the financial soundness of a credit union outside of the United States.

CAMEL Analysis

Capital Adequacy

FINACOOP at 1st glance appears to have a tenuous capital position. But upon further analysis it is really quite strong due almost entirely to outside donations. FINACOOP has 65,456,433 lempiras in member shares. Normally this number is not considered a part of capital because the members may withdraw should they decide to terminate their relationship with the credit union. However in this case, the government owns 93% of these shares. The government is to donate its shares to the institution per the “Carta de Entendimiento”, but there is no written schedule or date that states when this has to be done. When the government donates these shares they will be considered capital. The credit union also has several other sources of capital that most credit unions do not enjoy. They are to receive:

- a donation of $250,000 from FONDESA (European Union),
- PROREMI (USDA) loan proceeds (USDA has communicated with the credit union that they may take to the capital accounts all of the PROREMI loan proceeds that they collect; this is a potential increase of $800,000 to $1.2 million), and
- all USAID loan proceeds that are collected (potentially between $800,000 to $900,000). The availability of this donation is based on the evaluation received by the two independent evaluators.

The credit union has a capital to assets ratio of 27.01% (of the above only the government shares are included in capital). Under normal circumstances this appears to be sufficient. However there is no deposit insurance in Honduras, so the capital must be greater than in other countries where deposit insurance is provided and the loans granted are much higher risk due to loan type and the borrower's ability to repay. The government of Honduras has established a capital to assets goal ratio of 20-30%.

The provision for loan loss account is not adequately funded for delinquent loans and current loans that management know are uncollectible. Honduras does not have a rule or regulation that states that the provision for loan loss account must be adequately funded for all known losses (including the delinquent and current loan portfolios) at all times. Delinquent loans greater than 12 months must be funded 100% through the balance of the provision for loan loss account and 33% of total capital. Loans between 1 and 12 months are classified using 6 percentages (2%, 10%, 25%, 50%, 75% and 100%) depending on loan delinquency, ability of the borrower to repay, the value of the collateral, etc. For sake of simplicity when calculating the ratios, it was decided that FINACOOP should have between 35% - 50% of the total loan balance delinquent between 1-12 months in the provision for loan loss account. As of the CAMEL examination date of September 30, 2001, the provision for loan loss account and 33% of the capital accounts was adequate to cover all delinquent loans greater than 12 months delinquent and it covered 33.19% of loans between 1 and 12 months delinquent.

FINACOOP also has several other reserve accounts "Reserva para Cobrar Sobre Prestamos, Reserva Para Amortizaciones Activos Eventuales y Reserva para Depreciacion de Activos Fijos". All are considered to be adequately funded.

The overall capital and provision for loan loss accounts are considered to be adequate. However they are only considered adequate because of the government shares that are to be donated to capital. In the future, capital will increase only because of the amount of donations from FONDESA and PROREMI. FINACOOP is in a unique and enviable position. Few, if any, credit unions receive the amount in donations that have been received. FONDESA and PROREMI donations will only become reality if the credit union can improve its collections. As previously stated, FINACOOP will receive as a donation only those funds they can collect from the loans that were granted under the two programs. To maintain and improve capital, management must focus on collecting the outstanding and delinquent loans. They have everything to gain from collecting these loans because they are not carried on their books. They were administrators of these loan programs only. So everything they collect will go directly to capital.

In the area of Capital Adequacy, FINACOOP receives a CAMEL 2 rating.

Asset Quality

The credit union was chartered to grant agricultural loans in the rural areas of Honduras. Most loans have a maturity between 12 and 18 months. Very few loan payments (interest or principal) are made until the loan matures. The loans were made in a variety of agricultural sectors collateralized by mortgages, collateral liens and personal guarantees. PYMES, loans to small and medium sized businesses, are also granted. In 2001, management started to grant more PYMES in order to diversify the risk present in the loan portfolio and to improve liquidity through monthly loan repayments.

In the past, quality loan underwriting and collections were not emphasized and this represents a real problem. Economic problems (such as the decrease in coffee prices) have only exacerbated the problem. The asset quality ratios clearly indicate that asset quality is seriously lacking. Delinquent loans greater than 1 month are 36.34% of total loans. The stated goal for this ratio (both in the "Carta de Entendimiento" and the CAMEL matrix) is less than 10%. The net charge offs (loan charge offs during the last 9 months less any recoveries made on all charged off loans) to average loans ratio is 29.85%. The goal ratio is no more than 2.0% annually. It is important that management always analyze these ratios simultaneously. A credit union can reduce delinquency by charging loans off quickly, extending and/or refinancing loans, and through loan payments.

If FINACOOP were not receiving the large amounts of donations, it would not exist. No financial institution can exist:

- with delinquency greater than 36%,
- in which the majority of loan payments are received no more frequently than annually, and
- with charges off in excess of 29% of its loan portfolio.

To improve these ratios management must change the focus of the institution. Quality loan underwriting must be based on the borrower's cash flow and their ability to repay the loan. Collateral does not repay a loan. Loans are not donations. Loans should only be granted to those members who can demonstrate their ability and desire to repay the loan. Loan underwriting procedures must be standardized amongst the branches and placed in writing.

Members must be educated, so that they know a loan is to be repaid by its stated maturity. Only in very extreme and unforeseen circumstances should loans be extended or refinanced. Extensions or refinances should only occur if the borrower is able to demonstrate that they will be able to repay after the extension or will be able to meet the new terms of the refinancing agreement. If this is not the case then FINACOOP is understating delinquency and is only avoiding the inevitable, the loan charge off.

Loan collections must become the FOCUS of the institution. The credit union should establish a collections department, headed by an individual who is a proven "hands on" expert in collections. Everyone possible should be involved in loan collections. Management should receive a weekly report on the actions of the department and the officials should be informed of all material collection activities at each meeting.

To provide the necessary incentive it is suggested that everyone involved in collections receive a commission based on their collections or their salary should be based on performance. FINACOOP should use whatever methods they can to give the necessary incentive needed so that employees dramatically improve delinquent loan collections. All FINACOOP employees and members should be educated in the importance of loan repayment. The culture of the institution must be changed from one of non-repayment to one of timely repayment if it is to remain a going concern.

In the area of asset quality FINACOOP receives a 5 under the CAMEL rating system.

Management

Management should have as its main objective to plan, direct and control the financial future of FINACOOP. Over the past 14 months, management has made numerous improvements in operations and they are commended for them.

A sample of the accounting records was reviewed. The accounts reviewed were in balance, supported by subsidiary ledgers and reconciliations were present when necessary. Immaterial accounting findings were noted in the form “Examiner Findings”.

The 2001 annual budget and the supporting assumptions were reviewed. Future budgets should start with a projected balance sheet and once these numbers are established the statement of income should flow from the budgeted balance sheet.

The policies and procedures are currently being rewritten. Only the credit policies and procedures were reviewed. In the draft, both policies and procedures were mixed in one document along with a lot of unnecessary information. Policies are to be written with board of director guidance and approved by the board upon completion. Procedures state “how” daily functions are to be accomplished. The employees establish and review the procedures. The board of directors is not involved with daily operations or the procedures. In order to improve the consistency of operations among branches and deliver quality member service, all policies and procedures should be placed in writing and reviewed no less than annually.

Board minutes for the last 9 months were reviewed. During the meetings, management and the board should spend more time analyzing the current financial situation, the relationship between the numbers and ratios, and developing plans to correct current deficiencies before they detrimentally affect the financial health of the credit union.

Collections remains THE area in which very little has been accomplished and this is the area that will determine if this institution will remain a going concern in the future. In the past, management was totally dependent on outside donations to fund loans and provide liquidity. The donations that remain are all based on the collections of loans. This institutional culture must change. If this institution is to survive, collections must be a priority. Borrowers should realize that a loan is not a donation; it is to be repaid as stated in the contract. FINACOOP loans and services must be something of value in the “eyes” of its members. Members interpret loan products as valuable when:

- they can not get a loan for their needs at another institution,
- loans are granted quickly upon applying,
- the requirements (collateral, insurance, fiduciary guarantees, etc.) to obtain a loan are not overly burdensome,

- loan fees and interest rates are not excessive (greater than the local market),
- a financial institution has enough liquidity to satisfy the loan demand, and
- the borrower realizes that if they do not repay they will not receive another loan at FINACOOP or other financial institutions.

In the area of Management FINACOOP receives a 4 under the CAMEL rating system.

Earnings

Earnings at FINACOOP appear to be adequate. Using generally accepted accounting procedures, this would not be the case. Earnings are only adequate because under Honduran law the provision for loan loss does not have to be adequately funded at all times and they are allowed to use 33% of reserves to cover delinquent loans in which the recovery is doubtful.

The net income (annualized) / average assets ratio as of September 30, 2001 is 1.69%. The goal ratio is greater than 2.00%. This ratio has increased since December 2000. It was .752% for the previous 12 months. Management has made a concentrated effort to reduce operating expenses and they are commended for their efforts. Operating expenses for the 1st quarter of 2001 were 2,941,103 lempiras, for the 2nd quarter were 5,473,154 lempiras (of the total 3,285,890 lempiras represents depreciation expense) and for the 3rd quarter were 2,641,630 lempiras. Management is encouraged to continue to reduce or eliminate all unnecessary expenses. In addition to reducing expenses, management is encouraged to increase net income by:

- periodically (quarterly) determining that the loan interest rates are no less than the local competition,
- granting loans that have monthly repayments or at the very least monthly interest payments,
- disbursing loans only to borrowers who have the ability to repay,
- collecting delinquent loan interest,
- charging fees that are adequate to cover the cost of providing the service,
- periodically determining that the interest paid on shares and deposits is no greater than the competition's, and
- discontinuing the practice of paying above market rates on deposits unless the credit union has a plan in which they will use the deposits in a way that allows the credit union to realize a profit even after the above market rate has been paid.

In the area of Earnings FINACOOP receives a 2 under the CAMEL rating system.

Liquidity

FINACOOP suffers from a severe liquidity shortfall. This is due to high loan delinquency and the concentration of outstanding loans that pay on an annual basis. The liquid assets (cash and investments with a maturity of less than 30 days less payables due in 30 days or less) to total assets ratio has fallen from 13.84% as of December 2000 to –.39% as of September 2001. The goal for this ratio is not less than 15% or more than 20%. With such a lack of liquidity it makes it very difficult to meet operating expenses, loan demand and member share and deposit withdrawals. However, FINACOOP does have less pressure than most credit unions because the amount in deposits that have no stated maturity is relatively small, 8,176,277 lempiras or 8.3% of assets. The majority of member funds are in share accounts. These funds can only be accessed when the member terminates their relationship with FINACOOP. The government owns 93% of the member shares and intends to donate these shares to the credit union.

The loan to assets ratio is 76.80%. The goal for this ratio is between 75-80%. FINACOOP has a solid loans to assets ratio which would indicate that liquidity should be sufficient assuming that the fixed assets to total assets does not exceed 5% and long term investments (maturity greater than 1 year) are less than 2-3%. FINACOOP's fixed assets to total assets is 2.4% and investments with a maturity of more than 1 year are 1.76% of total assets. The liquidity problem lies in the doubtful collectibility of the loans.

The majority of liabilities that are used to fund long-term assets are considered non-rate sensitive. The majority of funds are in shares that are owned by the government. These funds are only withdrawable if the member terminates their relationship with FINACOOP. The remainder of liabilities is made up of the USAID loan that will become a part of capital upon the termination of the evaluations and project. There is a small amount of rate sensitive liabilities made up of term deposits and savings deposits. These accounts total 19,285,672 or 20% of assets. The accounts earn interest between 7.0% and 15.0% depending on the account balance.

All loans are fixed rate. The loan portfolio currently turns over every 33 months. Due to the delinquency problem the portfolio turns over very slowly considering that the majority of loans have maturities between 12 and 18 months.

FINACOOP currently has external credit totaling 8,911,717 lempiras. They have access to credit should they need to borrow to meet liquidity needs. However this is not the suggested method to improve liquidity. Management must concentrate on collecting delinquent loans and granting more loans with monthly payments.

In the area of Liquidity FINACOOP receives a 5 under the CAMEL rating system.

Composite Rating

The composite ratio is arrived at by calculating a simple arithmetic average of the 5 individual CAMEL ratings and following the CAMEL requirement stated above "that no credit union receiving an individual rating of a 5 may have a composite rating of anything but a 4".

FINACOOP receives a composite rating of a 4 under the CAMEL rating system.

Insert #3. **"Final FINACOOP MIS Report**", prepared by ACDI/VOCA MIS Senior Director Dale Key, December 14, 2001.

FINACOOP Trip Dec. 10-14, 2001
FINAL MIS Report
Dale J. Key

Background

FINACOOP has been involved in an MIS system upgrade project for over two years. The initial studies were done in the fall of 1999, the system and vendor selection occurred in the Spring of 2000 and implementation started in the Summer of 2000. Additional staff hired in 2000 to carry out this project were Franklin Gomez, project director, and Alberto Colindres, project assistant in addition to Sonia Flores, FINACOOP's MIS director. In the Fall of 2000 two accounting students, Magda Duron and Carla Videa, were hired for a short term assignment to correct FINACOOP loan data deficiencies. The vendor/software selected was Data Sistemas Internacional (DSI)/Net*Banking.

DSI was selected based on the applicability of Net*Banking to FINACOOP, price, eagerness to cooperate and the availability of local technical support. MS SQL Server was purchased for the database engine. Eight file servers and workstations, laser printers with upgrades to Windows 98 were also purchased.

This trip was undertaken to make an end of project assessment of the MIS effort before the official closeout of A/V's project on 12/31/01. A/V's closeout was well underway when I arrived. Project staff had been reduced to Kendall Mau, chief of party, Marcelo Subia, technical advisor, Luisa Lucker, administrative assistant, and Franklin Gomez, MIS project director. Franklin Gomez and Sonia Flores, FINACOOP MIS director are the two remaining members of the MIS team. Ms Flores will take over the entire project when Mr. Gomez leaves on December 31.

MIS Project Implementation

Listed below were the major steps for each phase of the FINACOOP MIS project. At the time of this visit, the project was finishing Phase III.

Phase I

- Install Net*Banking on a file server at the central office and test thoroughly.
- Install Net*Banking on a second file server and test communications between servers.
- Enter central and branch accounting data into Net*Banking from original documents and clean up data and program errors.
- Install cabling and related network hardware in two selected pilot branches, Danli and Marcala.
- Send accounting students to pilot branches to clean up and standardize loan data.
- Train branch personnel in Net*Banking.

- Install file server and Net*Banking (with cleaned accounting data) in pilot branches.
- Enter loan data at branches.
- Link loan data to the general ledger module.
- Activate and enter branch data in other relevant Net*Banking modules: Banks, Teller, Membership and Savings

Phase II

- Send accounting students to two more branches to clean up loan data and prepare them for Net*Banking implementation.
- Repeat process of installing network hardware and Net*Banking at the two branches, Santa Barbara and La Entrada.
- Establish communications between branches and HQ for daily transmission all Net*Banking data.
- Follow up as needed.

Phase III

- Send accounting students to last three branches: Juticalpa, Siguatepeque and Yoro.
- Repeat process of installation at these branches.
- Establish communications.
- Follow up as needed.

Progress to Date

Since my last visit in June 2001, the FINACOOP central office has moved to smaller quarters and reduced its staff by half. Two of the seven branches, Juticalpa and Yoro, have been reduced to collecting existing loans and will close down once this function has been completed. The other five branches are concentrating on collecting existing agricultural loans and granting new commercial business loans, the future direction of FINACOOP. Net*Banking is installed and functioning in all seven branches. Franklin Gomez and myself visited the five branches open for new business: Danli, Marcala, Siguatepeque, Santa Barbara and La Entrada.

Each of these five branches has a small local area network consisting of a file server and at least two new or fairly new workstations and a laser printer. These installations were cleanly and professionally done. The file servers have a modem and a CD RW drive for backup purposes. Each branch has an HP 2100 laser printer. All staff except one have received formal Net*Banking training in Tegucigalpa, the Net*Banking operator in Siguatepeque was trained by Franklin Gomez.

A final push was made in the last six months to complete this project. Marcelo Subia was enlisted to assist the MIS team with the integration of Net*Banking to FINACOOP's business practices and to make sure that all necessary information and support activities were accomplished. When I visited in June, Net*Banking was installed and being tested in the two pilot branches, Marcala and Danli. There were still many issues to iron out with the program, including interest calculation and the interface between the General Ledger and Loan modules. Other modules in use are Bank Accounts, Teller, Savings and Membership.

Before we went to visit the branches, I was briefed on the progress of the project from Franklin Gomez. A three year maintenance contract was recently signed with DSI to support Net*Banking. All branches currently use Net*Banking for daily activities and are run the manual card system in parallel. It appears that a few programming problems were still not resolved by DSI due to the delay in finally signing the service contract.

Franklin stated that the major problems yet to be resolved are:

- Interest calculation errors of some loans that are not paid on a regular monthly basis.
- Data transmission via modem between the branches and the central office.
- Equipment damage due to electrical fluctuations. One server is currently in the shop being fixed because of this problem.

Franklin and I agreed meet with Mr. Guillermo Carcamo, president of DSI after our first branch visit to Danli to discuss the system issues. We also determined that the data transmission problem was due to the length of time it took to send the data over poor phone lines. Franklin agreed that the he could reduce the time dramatically by only transmitting changes in a few significant tables and therefore ensure that the data would be transmitted daily. This would be a significant improvement as currently the data is sent once a month to FINACOOP, depriving the central office of daily updates from field operations.

Danli presented us with considerable feedback. This branch has the longest experience with Net*Banking and the branch person most knowledgeable about the program, Karen Melo. Danli began using Net*Banking for its daily operations in September, 2001. Ms Melo proved to be a fast learner and was used to train the Marcala Net*Banking operator.

Ms Melo stated that two main problems were interest calculation errors for 8-10% of the loans. Additionally, the program did not globally calculate interest correctly causing her to calculate each loan individually. We spent some time comparing manual interest calculations with Net*Banking. Franklin determined that the problem lay with past due loans that had “pending interest payments” where the capitalization flag after closing was not properly set. He felt that this was not a particularly difficult programming issue and probably would have been fixed some time ago had it not been for the delay in signing the maintenance contract with DSI.

Another main area of complaint from Ms Melo was the lack of customized reports. Although Net*Banking has many reports, it seems FINACOOP’s requirements were not properly stated to DSI, resulting in inadequate reports. The delay in not producing the reports seems to be also due to the delay in signing the maintenance contract. I explained to Ms Melo that report creation is an ongoing process and that DSI will do some of the reports and Sonia Flores will do others. FINACOOP purchased a powerful report generation tool with Net*Banking, Crystal Reports. This tool should allow the rapid creation of needed reports.

Upon returning to the central office, Franklin, Marcelo Subia and myself met with Mr. Carcamo from DSI to discuss pending issues. Although apparently weary of all the work DSI had done for FINACOOP, he seemed willing to resolve the following issues: interest calculation for pending payments, global interest calculation and creating several critical reports. A detailed meeting was set for 12/18/01 between Franklin, Marcelo and one of the DSI programmers to discuss the details.

The next day Franklin and I visited Marcala and Siguatepeque. Marcala, the other pilot branch, has the second longest experience with Net*Banking. Once the branch with the largest loan portfolio, it has fallen on hard times. Marcala relies almost totally on coffee production and has seen their economy collapse with the sharp fall of coffee prices. It remains to be seen if this branch can diversify and remain viable with commercial business loans.

Marcala started using Net*Banking for daily operations in October, 2001. Rosaura, the Net*Banking operator, had the same complaints as Karen Melo, the interest calculation errors in a certain percentage of its loans, global interest calculations and the lack of adequate reports. They desperately need reports that among other things classify loans according to fund source, type of guarantee, past due and current status. Another error they have uncovered is that although some loans show 0 days past due they have delinquent interest.

The MIS project staff put in long hours implementing Net*Banking in Marcala and Danli and should be commended for the hard work. Significant changes were made to address FINACOOP's non-traditional payments and disbursements for agricultural loans. Most of these issues have now been addressed except for those mentioned above. The good news is that Net*Banking was designed for the traditional commercial business loans up which FINACOOP is now focusing.

The visits to the remaining three branches, Siguatepeque, La Entrada and Santa Barbara did not uncover significant complaints with Net*Banking other than the lack of adequate reports. Franklin seems to think that the reason they are not having interest calculation problems is that they have a slightly earlier version of Net*Banking, that perhaps the latest version is causing these problems. These three branches had been using Net*Banking for approximately six weeks (starting in November) and were still becoming accustomed to the system. All were running the manual card systems in parallel and indicated they would do so for at least another two months.

Observations

The FINACOOP Net*Banking installation and implementation has met its major goals for this project. It is being used for daily operations in all the branches and at the central office. All branches have a professionally installed network and trained staff capable of using the system. All major problems have been addressed. The three-year maintenance contract signed with DSI should provide the professional support needed. The problems that still need to be addressed such as interest calculation errors should and can be corrected quickly. DSI and FINACOOP can rapidly address the reports issue.

All branch staff need follow up training. Net*Banking is extensive and most staff only use a small portion of its capabilities. They are not aware, for example, that there are codes that classify loans according to type such as agricultural or commercial. The relative newness of the Net*Banking installation still leaves it in a fragile state, it needs close supervision over the next several months until everyone is more comfortable with the system and all outstanding issues have been satisfactorily resolved.

The data transmission issue needs to be resolved before Franklin leaves at the end of December. The main problem is the length of time it takes to transfer the data from the branch offices to the central office over the phone. Franklin states that he can significantly reduce this transmission time by only focusing on the tables that have daily changes. This problem must be fixed because FINACOOP needs branch data on a daily basis, they can also provide extra backup protection on the central file server.

Daily backups must be taken more seriously. Currently the backup system consists of backing up Net*Banking data to the hard disk. Monthly backups are made to a read-write CD.

The lack of adequate reports must be addressed immediately. A system such as Net*Banking is only as good as the information it supplies.

Recommendations

Franklin Gomez should dedicate his remaining time at FINACOOP to the following major issues:

- Correct the interest calculation problem for pending payments and global calcuation.
- Direct DSI to create the most urgently needed reports.
- Reduce the data transmission time between the branches and successfully transmit data between the branches and the central office.
- Complete any pending procurement issues with project funds such as the purchase of UPS's and spare parts.
- Make sure Sonia Flores has the information she needs, as she will take over all duties as of January 1.

Sonia Flores needs to make sure she has all the information necessary to administer Net*Banking. She should go over outstanding issues with Franklin and bring up any questions she may have before he leaves. She also needs to begin to immediately address the reporting issues. DSI can provide some to the reports, but she can do much of this herself using the Crystal Reports tool that comes with Net*Banking. She should also schedule 1-2 days with each branch in January, going over in detail all aspects of their day to day operations in Net*Banking, addressing outstanding issues and providing hands-on training at the same time.

Sonia also needs to set a deadline for the termination of the parallel manual system. This will help her focus on resolving any outstanding issues and adequately training the staff to handle more advanced aspects of Net*Banking. I propose that she set the end of February 2002 as the day the manual system is discarded. If not, the branches will continue running this time consuming system in parallel as a "security blanket" when what they need to do is to devote their time to extracting valuable information from Net*Banking. If this is not done, then one of the major reasons for implementing this system is lost.

Daily backups of Net*Banking data **must** be made to CD. Additionally, the entire hard disk must be backed up on tape on a daily basis. This is especially crucial due to voltage fluctuation and outages in the branches that can permanently damage the server's hard disk. This has already happened with one server and it will most probably happen again. The current system of only daily backing up internally to the hard disk offers no protection for a hard disk failure. In sum, FINACOOP should implement a four tiered backup system:

1. Internal hard disk backup of Net*Banking data.
2. Transfer of Net*Banking backup to CD.
3. Transmit Net*Banking data to central office (where it will also be backed up).
4. Daily backup of entire hard disk to tape.

Failure to implement this backup scheme leaves FINACOOP extremely vulnerable to catastrophic data loss and will seriously set back the entire project.

Insert #4. Introduction of ACDI/VOCA Quarterly Report to USAID covering the last program quarter of the activity (excluding the administrative wrap-up period ending March 31, 2002), prepared by Kendall Mau and Luisa Lucker, February 27, 2002.

Expansion of Rural Finance Activity Project
QUARTERLY REPORT

October 1 – December 31, 2001

Introduction

On December 13, 1999, USAID/Honduras and ACDI/VOCA entered into Cooperative Agreement 522-A-00-00205-00, the Expansion of Rural Finance Activity project, scheduled to end in December 2001. This report covers the principal activities during the 4th and final quarter of 2001 of the project.

As of December 31, 2001, the remaining part of the $2,596,403, plus the interest earned (US$ 21,782.86) totaling US$ 2,618,185.86 loan fund was dispersed. The loan fund reached 1,006 borrowers in the rural sector divided between agriculture production and small and medium enterprise loans. US$ 273,806.33 was placed during the quarter in additional small and medium rural sector enterprise loans.

The following major items on the agenda were completed during the quarter:

- Completion of the new computer system installation linking the main office with branch offices for a fully integrated accounting and loan system.
- Installation and implementation of the new accounting and management reporting system.
- Creation of a new organization structure.
- Relocation of FINACOOP's headquarters to new installations to lower monthly expenditures by 57%.
- Independent program evaluator to verify the progress and future sustainability of FINACOOP.
- A CAMEL analysis of FINACOOP's financial and managerial systems to provide management with a blueprint for financial and organizational refinement during the next 3 years.

Operations

At the end of November 2001, the new computer system was up and running in the main office and branch offices. All information is now directly posted to the central system from the branch offices. One major modification to the original design of the system was required. Because of heavy static in transmission lines, we had to make a concession to batching the information on a diskette instead of a more automated telephone transmission. New CD burners have been installed in all branches and the main office to assure backup facility each evening; and the creation of a new security matrix was developed and installed into the system. The main office was fully in operation in its new location by the beginning of November.

Loans

As mentioned above, (US$ 273,806.33) in new small and medium rural sector enterprise loans were placed during the quarter. These loans were placed in La Entrada, Santa Bárbara, Danlí, and Siguatepeque where there are markets for this type of loan. (See Annex I for Loan Fund Summary Information)

ACDI/VOCA volunteer experts and advisors to FINACOOP's Board of Directors, Mr. Randy Frescoln and Ken Hennings from the USDA, spent a week in October working with FINACOOP senior managers to design an incentive program for loan recoveries. With PROREMI, FONDESA, and USAID funds to be donated, there will probably be a pool of close to $5.0M to recover over the next 3 years. The deeper the penetration of recovery of these loans, the more can be added to FINACOOP's capital. The principal usage of recovered funds will be: 1) to build liquidity (in the form of cash and investments) to about 20% of assets to provide adequate cash flows for operations during the year to compensate for a large percentage of agriculture-related loans that produce no cash flows until maturity; and 2) to augment FINACOOP's capacity to write-off the bulk of bad loans that originated pre-1998. Overall delinquency for FINACOOP's pre-1998 loan portfolio is about 32.0% while post-1998 is running sub-10% per stipulation of the MOU.

Also, USAID had recommended that FINACOOP apply for entry into the MSED loan guarantee program. Indirect benefits such as partial loan guarantees and the possibility of leveraging the guarantee for increased bank lines-of-credit made the program attractive to Finacoop. However, upon evaluation by Ms. Kathleen Wu and her team from MSED, it was found that the MSED program was not a good fit for Finacoop. The principal problems were: 1) no agriculture-related loans were permitted; 2) any small and medium enterprise loans where loan capital originated from donated funds from USAID, USDA, or the European Union would be excluded – 100% of FINACOOP's MSED loans fell into this category; and 3) any financial institution where the majority of shares were held by the government would not be covered – 90% of FINACOOP's shares were government owned. No further action was taken.

Accounting

FINACOOP continues to refine its accounting system as it moves to more fully use all features of the Net*Banking software. A 3-year software legal maintenance and updates-contract was signed between FINACOOP and DSI. In case of DSI not being able to fulfill a 3-year contract, the root program password has been given to FINACOOP so it can hire its own programmer.

Auditing

RIG auditors from the Honduras office performed their Quarter 3, 2001-audit of ACDI/VOCA-Honduras' financials. The Quarter 4, 2001-audit is expected to be initiated in January-February 2002.

External auditors from the Morales Group, began a pre-2001 audit of FINACOOP's FY2001 books, and will complete the full audit in the March-April 2002.

External Program Evaluation
Final program evaluation began on November 14, 2001. The purpose of the final evaluation was to see if ACDI/VOCA-Honduras had helped FINACOOP reach a level of self-sustainability as an institution through the strengthening of the accounting, MIS, operating, management, and human resources functions. Positive program evaluation would result in the $2.6M USAID loan fund recoveries being donated to FINACOOP.

The evaluation was undertaken by Mr. Francisco Figueroa of KPMG who was recommended by USAID. His evaluation (Annex II) yielded a positive opinion and the recommendation of donating the loan recoveries of the $2.6M USAID fund to FINACOOP. USAID had asked that Mr. Figueroa include an evaluation of the MOU signed between the Government of Honduras and Finacoop. His findings showed that FINACOOP had complied with all requirements of the MOU and achieved 90% of the goals while USAID and the Government of Honduras failed to comply with the terms of the MOU agreement. They were to have established a commission consisting of four (4) representatives (2 from each entity) to undertake monthly monitoring of FINACOOP's progress. That was not done.

CAMEL Evaluation
Ms. Monnie Biety, a ten-year veteran as a senior examiner for the National Credit Union Administration of the United States, was contracted in December 2001 to undertake a CAMEL evaluation of FINACOOP. The purpose of the evaluation was to: 1) provide FINACOOP with a progress report as to where it stood in comparison to world standards; and 2) to provide FINACOOP management with financial and managerial refining tasks to follow after the exit of ACDI/VOCA. (See Annex III for a copy of her Evaluation)

CAMEL stands for: 1) C-Capital; 2) A-Assets; 3) M-Management; 4) E-Earnings; and 5) L-Liquidity. A rating of 1-5 is used with 1 being excellent, and 5 being poor or critical.

C – Rating of 1: This excellent rating is based upon FINACOOP having close to 30% in capital. Following the GOH guidelines of provisions for delinquent loans and write-offs, FINACOOP has sufficient capital and provisions to cover potential loan losses.

A – Rating of 5: This critical rating is caused by the amount of write-off each year that FINACOOP is taking to clear off pre-1998 bad loans. The guideline is less than 10% of the loan portfolio, whereas FINACOOP' write-offs are approaching 30%. This rating will remain a 5 for another 3 years as FINACOOP continues to clean its books. Once the pre-1998 debt disappears from FINACOOP's books, the rating will climb to the 3-level.

M – Rating of 4: Ms. Biety wanted management to focus the majority of its attention on loan recoveries that are so necessary to building working capital and writing-off pre- 1998 bad loans. She left management with the task of converting the culture of FINACOOP from a passive loan recovery mentality to an aggressive collection culture. She believes that this

change, to be undertaken during 2002, will result in the strengthening of FINACOOP's financials. Once accomplished, the rating can be changed to a 3.
She also noted that the new Board of Director's President, Mr. Franklin Osorio, took a significant step in discharging five directors and one supervisory committee member from their positions. These officials had been delinquent in their loans for many years and refused to pay.

She also left management with a list of 50 financial and organization refinements to accomplish during the next 3 years to keep FINACOOP on track after the departure of ACDI/VOCA.

E – Rating of 2: Earnings were deemed good due to FINACOOP having lowered its operating expenses by 25% during 2001 and maintaining the costs at less than 10% of average assets. Ms. Biety noted that any net income in excess of 2.0% of assets is being used to write-off pre-1998 bad loans.

L – Rating of 5: Liquidity has been a critical problem for FINACOOP for many years. The basic reason for the problem was management's belief that FINACOOP would be more profitable if all available cash was placed in the loan portfolio. FINACOOP being an agriculture-related cooperative with the majority of its loans repaying at maturity, requires a very high liquidity (20% of Assets) to cover its operating expenses and bank payments for co-signed members' bad loans during the year when no cash flow is being generated from loan recoveries. Management now understands that it must build its liquidity from its current 5.0%-level to 20.0% to avoid running in crisis mode. This will be done through loan recoveries and members'savings. This problem should be rectified during 2002 and improve the rating to 3.

Human Resources
FINACOOP's executive assistant, MaryElena Ramirez, has also assumed the role of human resources generalist. She is a recent university graduate in business administration and will complete a certificate in HR management in March 2002. She worked with Ms. Mona Melanson, a volunteer HR management expert: 1) to design new job descriptions with built-in performance standards; 2) to create a new compensation system based upon banding; and 3) to put the final touches on FINACOOP's new organizational chart.

During the quarter, several training sessions were completed:

- Liquidity and Net Interest Margin for Senior Management.
- PYMES underwriting for branch managers and loan officers.
- MIS – systems' training for two (2) computer operators.
- Presentation Skills, Dale Carnegie, for Senior Management.
- English – ongoing daily lessons for FINACOOP managers.
- Participation in the World Micro-credit Summit in Puebla, Mexico – Senior and branch managers.

Insert # 5. **"FINACOOP Wrap-up Observations and Recommendations**", prepared by Chief-of-Party Kendall Mau, March 25, 2002.

FINACOOP PROJECT WRAP-UP OBSERVATIONS & RECOMMENDATIONS:

By

Dr. Kendall Mau
Chief-of-Party
ACDI/VOCA – FINACOOP PROJECT

March 25, 2002

This is a summary of the actions taken during the project to strengthen the management and financial positions of FINACOOP.

ACCOUNTING:

Start: Accounting was in complete disarray with no monthly financials produced for over 14 months.

Actions: 1) An accounting reconstruction consultant was hired to reestablished the financials; 2) completed 2 third-party certified audits with the 2001 audit currently being performed; 3) complete migration to a new computerized accounting system with up-to-date financials; and 4) the hiring of a highly qualified senior accountant with 20 years of industry experience.

Close: The accounting department is completely staffed and working with the latest accounting software. All branch offices are fully using the new accounting software. Monthly financials are completely up-to-date.

Observation: The goal to revamp the accounting department systems was 100% met.

FINANCE/BUDGETING:

Start: The annual business plan was non-quantifiable and usually presented to the Board 3 to 4 months after the new fiscal year began. There was no analysis of the Balance Sheet as a basis for strategic planning.

Actions: 1) Senior staff completed two budget cycles with financial consultant; 2) the second budget cycle entirely done by the senior staff; and 3) taught senior staff how to restructure the Balance Sheet according to an ideal financial model for savings and loan cooperatives.

Close: The FY 2002 budget was completed on time and presented to the Board on time. The budget concentrates on loan recoveries and liquidity. The Balance Sheet has been restructured to follow the following general guidelines – cash and investments to be 15 to 20% of total assets, loan portfolio up to 75%, and fixed assets up to 5%. Capital to be in the 20-30% of assets range.

Accounting department is completely staffed and working with the latest accounting software. All branch offices are fully using the new accounting software. Monthly financials are completely up-to-date.

Observation: Management can now produce a quantifiable budget as well as follow the Balance Sheet targets. Liquidity (15% of assets) and capital (20-30% of assets) targets have already been met. Increased loan volume and reducing fixed assets to under 5% will be accomplished in 2002.

The goals for finance and budgeting have been completely met.

COMPUTER:

Start: FINACOOP was using a semi-mechanized system that had been not been upgraded since its initiation over 7 years ago. Data was corrupt and no credible financial reports were being issued.

Actions: 1) A new computer system was purchased; 2) an installation team was formed; 3) installation of hardware and software were completed by December 2001.

Close: 1) The new system was fully integrated; 2) a senior programmer from the computer vendor was hired by FINACOOPO; 3) a 3-year software upgrade contract was purchased; and 4) all FINACOOP branch and main office personnel have been trained in usage of pertinent modules.

Observation: The goal to install and integrate usage of new computer system was 100% met.

AUDIT:

Start: A certified audit by 3rd party independent external auditors had not been performed for 1999.

Actions: 1) Along with the accounting reconstruction consultant, ACDI/VOCA supplied the services of 2 internal auditors to analyze and correct procedural weaknesses and errors; 2) after reconstruction of 1999 books, a certified audit by independent external auditors was completed with an unqualified opinion; 3) an external certified audit was completed for 2000 with an unqualified opinion.

Close: 1) An external certified audit is currently being performed for 2001;

Observation: The goal to have yearly 3rd party external certified audits has been 100% met.

LOANS:

Start: High delinquencies and an overabundance of coffee-sector loans were found.

Actions: 1) Restriction of new coffee-sector loans; 2) an increase in SMED loans to provide more monthly cash flows of interest payments; and 3) making delinquent loan collections the number one priority of FINACOOP.

Close: 1) Coffee-sector loans had dropped by half; 2) SMED loans had increased to 25% of assets with the ultimate goal of 50%; 3) a new full-time loan collector was hired; and 4) a new incentive program was put in place for branch managers to sell foreclosed real estate.

Observation: Loan portfolio risk has dropped with the advent of a full-time collections agent, 2) incentives to branch managers to sell foreclosed property; and 3) the ever increasing volume of new SMED loans. This will be an on-going task that FINACOOP has embraced with new personnel, procedures, and incentives. From a training point of view, management has been thoroughly trained in collections.

OPERATIONS:

Start: FINACOOP was overstaffed with 63 employees and 7 branch offices that had been opened without any market and financial feasibility analyses.

Actions: 1) Staff was cut by 33 people, 50+% cut; 2) the branch network was completely reorganized with 4 branch offices and 3 collection windows with a savings of 3 branch managers; 3) the head office was moved to new facilities thereby cutting costs by two thirds; 4) overhead was cut by 50% - costs approached an unfavorable 20% of assets - to below 10%, ideal for a cooperative of this size; 5) board meetings were reduced to 6 times per year to saving costs; and 6) high insurance costs for board members and family were reduced by limiting coverage to only board members.

Close: 1) overhead costs were reduced to an ideal sub-10% of assets; and 2) the branch system was completely revamped.

Observation: The goals to lower overhead costs and restructure the branch system were 100% met.

HUMAN RESOURCES:

Start: FINACOOP was overstaffed with 63 employees with no updated job descriptions, annual performance review criteria, and organizational chart.

Actions: 1) staff was cut by 33 people, 50+% cut; and 2) three American consultants were brought in to train staff in modern HR management, training, employee development, and organization development techniques.

Close: 1) a Honduran HR firm has been hired to install new HR software and update organization chart, job descriptions, and performance evaluation criteria.

Observation: The goals to overhaul HR practices and organization development were 100% met.

LETTER OF AGREEMENT:

Start: FINACOOP signed and agreement with the Ministry of Finance agreeing to specific financial goals and management issues over a 3-year period. Principal among the requirements were the reduction in delinquency; the quality of the loan portfolio; levels of savings; profitability; and a reorganization of FINACOOP's staff. The results of completing 80%+ of the requirements would be the donation of the government shares (about 90% of FINCAOOP) to FINACOOP.

Actions: 1) FINACOOP worked diligently on all requirements throughout 2000 and 2001; 2) all goals were met in one year instead of three with one exception – savings; 3) the Honduran economy experienced a huge downturn in the coffee market that increasing savings of its members proved to be an uncontrollable factor for FINACOOP.

Close: 1) with all requirements but savings met, FINACOOP will be putting forth new plans for increasing members'savings; and 2) FINACOOP awaits word from the government as to the passing of its shares to FINACOOP.

Observation: FINACOOP achieved all requirements of the LOA except raising savings level. This was an uncontrollable for FINACOOP. An 80% achievement of goals was called for in the LOA. FINACOOP achieved a greater that 90% compliance.

3RD PARTY PROGRAM EVALUATION:

Start: Two independent program evaluations were specified in the agreement signed between ACDI/VOCA and USAID.

Actions: 1) the first was performed by Mr. Francisco Figueroa in November 2001. His report is attached; and 2) the second, a CAMEL evaluation was performed in November 2001 by Ms. Monnie Biety. Her report is attached.

Close: 1) Mr. Figueroa presented his findings in person to USAID and FINACOOP, and the final report was sent to ACDI/VOCA headquarters with copies to USAID; and 2) Ms Biety's report was presented to FINACOOP and the final report sent to ACDI/VOCA headquarters with copies to USAID.

Observation: Mr. Figueroa deemed that FINACOOP had achieved a 90%-level of compliance with the LOA against an 80%-level requirements. Along with the strengthening of accounting, MIS, management and operations, he recommended that the government of Honduras cede its shares to FINACOOP.

Ms. Biety's CAMEL analysis gave FINACOOP an idea of where it stood after one year of profound changes in comparison to US-regulated cooperatives. A CAMEL rating assesses the quality of Capital, Assets, Management, Earnings, and Liquidity. On a scale of 1-5, with 1 being the highest, and anything above 3 being positive, FINACOOP scored the following:

Capital - #1: the primary check is the ability to cover all bad loans with sufficient reserves. FINACOOP could use up to 33% of its capital to cover delinquencies. At the time of the test, it was fully covered at 31%. At the end of the 1st quarter 2002, it had strengthened its position and needed only 28%.

Assets - #5: this low score is due to the high rate at which FINACOOP is writing off pre-1998 bad loans. The #5 rating will continue for another 3 to 5 years as FINACOOP writes off these bad loans from current income. The GOH helped capitalize FINACOOP in 1992 with a 54.0M Lempira loan portfolio. However, said loan portfolio was not cleaned out before the transaction. Subsequent to the transfer of the portfolio, almost 90% of the portfolio proved to be uncollectable. Although the 5-rating is horrible, it is looked upon as a positive step to clean up the books of FINACOOP. Using only post-1998 write-offs, the rating would be an acceptable #3.

Management - #4: Ms Biety noted that there was a lack of priority by senior management as to loan collections. She left a list of 50 procedural and financial adjustments to be made before the end of 2002. Once these adjustments are made, the rating will be changed to an acceptable #3.

Earnings - #2: FINACOOP has the ability to earn a ROA of close to 8-9%. It currently limits the ROA to 2% and uses the rest to write-off pre-1998 bad debts.

Liquidity - #5: FINACOOP should have enough current assets to cover current liabilities. At the time of the exam, it was in a severe cash shortage and rated this low #5. At the end of 1st Quarter 2002, the problem has been entirely fixed through higher loan recoveries and a restructuring of the Balance sheet. It would now rate a #1.

Overall, FINACOOP shows exceptional progress in one year. At the start of the project, it would have rated #5 in all categories. It now has reached world-class level of 3 or above in 4 categories.

RECOMMENDATIONS:

FINACOOP has made a remarkable turnaround in only one year. Management knows where it is headed, and has implemented all the right procedures to accomplish its goals. I would highly recommend that the $2.6M loan fund be donated to FINACOOP.

However, to help maintain the integrity and momentum of the positive changes accomplished by senior staff, I would also recommend the following three actions:

- Continue certified annual audits by third party external auditors.

- Continue certified annual CAMEL analysis to maintain high standards of operations.
- The services of a qualified consultant to check FINACOOP's strategic planning direction for the 2003 budget preparation.

Insert #6. Letter from ACDI/VOCA to USAID CTO Dennis Sharma expressing ACDI/VOCA's opinion that, given the positive findings of the external evaluation, the CAMEL study, and of Chief-of-Party Kendall Mau, the ownership and administration of the loan fund be transferred to FINACOOP, March 28, 2002.

March 28, 2002

Dennis Sharma
Office of Agriculture and Natural Resources
USAID/Honduras

Dear Dennis,

Pursuant to our discussions and agreements reached at the Mission last week, we are communicating our opinion that the stewardship of the FINACOOP project loan fund exercised by ACDI/VOCA should be transferred to FINACOOP. ACDI/VOCA's funds-transfer obligations under the project's cooperative agreement breaks down as follows:

CA Loan Fund Amount to Be Transferred to FINACOOP:	$2,596,403
Interest Earned in Loan Fund Dollar Account:	$ 21,783
Total:	$2,618,186

We have reached this decision to recommend the transfer of the loan fund to FINACOOP ownership for a variety of reasons. First, as per the cooperative agreement stipulation, an external evaluation of FINACOOP's institutional sustainability was to be conducted shortly before end of project. The evaluation findings would assist USAID and ACDI/VOCA reach a determination on the disposition of the fund. If the evaluation's findings were positive, and USAID and ACDI/VOCA concurred with them, ownership of the fund would be transferred from ACDI/VOCA to FINACOOP. An adverse finding by the evaluation, coupled with similar opinions by USAID and ACDI/VOCA, would lead to the recommendation that ownership of the fund be transferred to the Government of Honduras. The KPMG/Barents external evaluation concluded that FINACOOP was a viable lending institution, that its financial management processes and systems were satisfactory, and that its loan underwriting and approval processes in place were adequate. FINACOOP had no identifiable weaknesses in their internal control system or practices. The main challenges identified by the evaluator were liquidity and asset quality. Liquidity was seen to be sufficient to cover daily operations, however, while a substantial part of the problem assets were related to cooperatives that were defaulting on large loans, many or most of which pre-dated the ACDI/VOCA project. The evaluator noted that FINACOOP had initiated litigation against some of those cooperatives to force repayment of their delinquent loans. Finally, the evaluator noted that FINACOOP was in full or substantial compliance with all terms of FINACOOP's MOU with the Ministry of Finance, and that full compliance on all provisions was anticipated by the end of 2001.

We present a short list of findings regarding improvements in FINACOOP's operations and financial position during our technical assistance presence over the last few years:

- Accounting: Monthly financial statements went from 14 months overdue to completely up to date, with previous-month transaction reports available during the first week of the following month.
- Finance/Budgeting: Annual business plans went from being non-quantifable and not prepared for the board of directors until 90 to 120 days after the new fiscal year began to having the 2002 budget and balance sheet analysis on hand for the board meeting.
- MIS: FINACOOP went from a semi-mechanized system that had never been upgraded, which resulted in unreliable data and financial reports lacking credibility, to the full integration of a new computer system, accompanied by intensive staff training at headquarters and the branches, that has led to smooth and modern MIS operations.
- Audit: A certified external audit for 1999 was long overdue. Now external audits are up to date, and no serious findings occurred for 2001. FINACOOP will engage the services of external auditors every year.
- Loan portfolio: High delinquency rates and overexposure in the coffee sector were dealt with by aggessively pursuing collections (a full-time collections officer is now on staff), by providing financial incentives for branch managers to sell foreclosed properties, by reducing the coffee-sector loans by 50%, and by diversifying into small- and medium-business lending.
- Operations: Total staff was cut from 63 employees to 33, seven branches were reduced to four branches and three collection windows (thereby reducing the number of branch managers by three), the head office moved to quarters rented at one-third of the previous rental cost. Overhead costs were cut in half by these and related measures.
- An external CAMEL (Capital, Assets, Management, Earnings, Liquidity) analysis of FINACOOP completed last December found the organization to be strong in capital and earnings, moving toward a good rating of management (especially if they become more aggressive on collections, which they are), and weak in assets (due to the burden of writing off old loans to cooperatives) and liquidity (which is also linked to delinquent loans, but improving.) The outside expert was positive regarding FINACOOP's prospects, anticipating good to excellent ratings in all categories by the close of this business year.

Finally, related to the last point above, FINACOOP has declared its intention to have the CAMEL analysis performed annually to ensure that they achieve and then remain in compliance with worldwide rating standards. They also intend to contract for the services of an external consultant to advise them on strategic planning direction and budget preparation for 2003 (Dr. Kendall Mau has already been invited to perform this task.) FINACOOP will contract for these services and pay for them with their own resources.

This fax message will be followed by a FedEx delivery to you of the hard copy. We await your response to our recommendation regarding the disposition of the loan fund. If your are in agreement, we will proceed to return the promissory notes signed by FINACOOP for each transfer of loanable funds to them.

As usual, we thank you for your assistance.

Sincerely,

Charles C. Cox
Regional Vice President
Latin America and Caribbean Programs

cc: Mr. Joseph Lombardo
Mr. Armando Busmail
CA File

Insert #7. Letter from ACDI/VOCA to FINACOOP returning the loan fund promissory notes, thus officially transferring the loan fund to FINACOOP ownership, July 9, 2002.

9 de julio de 2002

Lic. Marco Tulio Fonseca
Gerente General
FINACOOP
Tegucigalpa, Honduras
América Central

Estimado Sr. Gerente:

Nos place informarlo que hemos recibido la aprobación de la Oficina Regional de Contratos, ubicada en USAID/Honduras, para transferir la administración del fondo de préstamos del Programa "Expansión de Finanzas Rurales" de ACDI/VOCA a FINACOOP.

Tal aprobación de la transferencia fue concedida, segun la carta de aprobación (copia adjunta), bajo "el entendimiento que el fondo será utilizado exclusivamente para lograr los objetivos del Programa."

La carta cierra con el hallazgo que la aprobación fue baseada en los resultados positivos de la evaluación externa, los cuales determinaron que FINACOOP habia demostrado sostenibilidad institucional con su desempeño operacional en relación con los indicadores de buenas prácticas y resultados en la Descripción de Programa en nuestra propuesta a USAID en el año 1999.

La citada Descripción estipula la aprobación de ACDI/VOCA y USAID para la transferencia de los pagarés. Nosotros ya habíamos comunicado nuestra aprobación a USAID después de mi visita a Honduras en marzo (ver carta a USAID adjunta.). Entonces, ahora declaramos oficialmente que transferemos la administración del fondo de préstamos del arriba citado Programa en su totalidad a FINACOOP, cediendo el título de los pagarés en nuestra posesión completamente y sin condiciones. Adjuntamos todos los pagarés, y a partir de esta fecha los consideramos cancelados.

El valor de los pagarés es L. 39,147,341, monto que corresponde a $US 2,618,186, resultado de las tasas de cambio segun la época de ejecución de los pagarés correspondientes. El total de $2,618,186 representa nuestro compromiso inicial con USAID de repasar $2,596,403, mas el interés ganado por el fondo (e incorporado en el fondo) de $21,783.

Pues, Sr. Gerente, felicitaciones para ustedes. Se trabajó bastante, y FINACOOP ha ido bien adelante a pesar de la crisis del cafe, inundaciones, sequias, recesiones económicas,
y tantas otras calamidades. La pregunta seria si ustedes podrian funcionar tan bien bajo condiciones económicas y climáticas ideales. Quisieramos ver tal situación como algun
tipo de laboratorio o estudio de caso. Quisieramos igualmente ver eso para nuestro querido Honduras.

Con el deseo de ver sus éxitos (y reservas!) crecer, y de tener el placer de revernos algun dia no lejano, los enviamos nuestros saludos mas cordiales a Ud., Dr. Omar Osorio y nuestros demas estimados amigos y colegas en FINACOOP.

Atentamente,

Charles C. Cox
Vicepresidente Regional para América Latina y Caribe

Anexos: Carta de aprobación de USAID.
Carta de aprobación de ACDI/VOCA a USAID.
Los 38 pagarés firmados por FINACOOP.

III. CONCLUSION

ACDI/VOCA concludes, based on the observations, findings and approvals found in all the documentation here that the FINACOOP activity was successful. In 1999, that institution was saddled with a large portfolio of bad and delinquent loans, had just removed the general manager responsible for most of their problems, and was technically insolvent. The USAID Mission responded with trepidation to ACDI/VOCA's proposal to turn FINACOOP around, judging the proposed activity to be extremely challenging. It could be said that the factor that clinched the Mission's decision to move forward was the fact that FINACOOP was the only viable lending facility available to small farmers at that point in time (and at the present time.)

ACDI/VOCA was also encouraged to see FINACOOP chosen in February 2000 by USDA for a PL 416-funded project to move a significant amount of loan funds ($4.8 million in the first phase, to be followed by additional loan capital in 2001) out to lending programs directed at small farmers that had suffered severe structural damages to their farms and facilities during the hurricane. This "Programa de Rehabilitacion de las Unidades de Produccion Afectadas por el Huracan Mitch - PROREMI" entrusted substantial resources to FINACOOP. ACDI/VOCA was informed that its presence in the form of its expert team housed in FINACOOP headquarters and an ongoing loan program that was in the process of placing $1.5 million in USAID-provided loanable funds gave the U.S. Government and the Government of Honduras confidence that PROREMI would be conducted efficiently and correctly by FINACOOP.

In what ACDI/VOCA saw as the final action to close out this activity on a high note, the promissory notes were dispatched to FINACOOP last month, as documented in Insert #7. above. They will be pleased to have earned this great improvement in their balance sheet, and ACDI/VOCA is happy for them. It is noted that the referenced letter asks that FINACOOP continue to use the loan funds for their originally-intended purpose. Finally, it is noted that FINACOOP has committed to annual CAMEL ratings and annual technical advisory visits by Dr. Mau for the next few years so as to not lose momentum. Dr. Mau and ACDI/VOCA will remind FINACOOP of this commitment from time to time in a collegial manner.

Attachment #1. Response to letter cited above to ACDI/VOCA from CTO Dennis Sharma, stating the Mission's intent to approve the transfer of the loan fund to FINACOOP, and the imminent resolution of two FINACOOP audit recommendations to complete "project closeout matters", April 3, 2002.

Attachment #2. Letter from Regional Contracting Officer Annette Tuebner to ACDI/VOCA confirming the Mission's approval of the loan fund transfer to FINACOOP, July 1, 2002.