

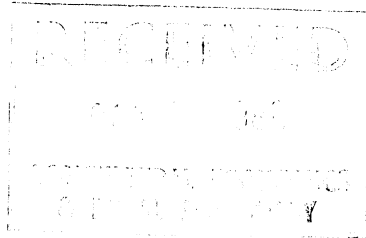
COSTA RICA  
POLICY TOOLS FOR RURAL FINANCE

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BANCO NACIONAL DE COSTA RICA:  
RISK AND PORTFOLIO MANAGEMENT

by

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Banco Nacional de Costa Rica:  
Risk and Portfolio Management

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I. Introduction

The following report summarizes observations and information obtained in Costa Rica from 15 to 23 January 1988, primarily from discussions with Banco Nacional (BNCR) officials and from internal BNCR guidelines and reports. The Purpose was: (a) to obtain an overview, per force preliminary in view of the time available, of portfolio management and treatment of risk by BNCR, and (b) to offer recommendations for improvement of relevant BNCR procedures. BNCR staff and managers were extremely accommodating, very alert and well-informed. My impression is that the quality of BNCR personnel provides great potential for constructive change. Indeed, major internal reforms and stunning increases in data management capacity are already being implemented.

II. Conclusions

The overwhelming impression is that BNCR has no focused, institutionalized capacity to deal with risk in agricultural credit decision-making or in structuring its loan portfolio:

a. Credit decisions for larger agricultural and agroindustrial loans are made through a series of clerical steps executed by different organizational units, none of which bears

overall responsibility for loan quality but rather only for completion of the step or steps it is required to execute (See Annex 1).

b. For smaller agricultural loans, including seasonal input credit, loan amounts are fixed according to representative farm models (avíos). Loans for most smallholder crops and livestock are sized to cover 100 percent of costs of production using recommended inputs and technology, including the cost of labor (much of it family labor) which amounted to between 40 to 60 percent of total costs on several farm models reviewed (See Annex 2).

The financing of 100 percent of the cost of ideal technical practices, rather than credit geared to actual expenses, and credit financing of family labor (a non-cash cost), means that credit is used as political patronage, broadly defined, and as a social-welfare device. This suggests profound political implications that constrain credit reform.

c. Loan interest rates are also standard, with agricultural lending at lower interest rates than charged on loans to industry and commerce, which are presumably less risky and less costly to administer. Managers interviewed were of the opinion that agricultural lending was unprofitable to BNCR, while industrial and commercial lending was profitable.

Maturities on agricultural loans are fixed with reference to harvest dates. The tenor of medium- and long-term loans is based on expected enterprise cash flow. Disbursement is related to

progress in using components of the recommended technical package (e.g., land preparation and planting, insecticide or weed killer, harvesting), or in construction, and can be suspended if loan supervision is effective and departures from recommended practice are discovered.

d. BNCR has no agricultural credit files. Loan documents and financial projections are kept together in envelopes that are stored securely. Once the loan is paid off, the corresponding envelope is removed from secured storage and eventually disposed of. There is no collected history of credit information on individual borrowers, or procedures for easy retrieval of past credit performance information. These procedures are consistent with the strategy of lending primarily for a project or purpose rather than to a borrower.

e. Portfolio composition is determined fundamentally by loan demand, as modified in the loan approval process. The approval process is not significantly oriented toward risk, with three expectations. The first is that present borrowers in arrears are subject to special scrutiny and can receive new credit only in conjunction with measures to bring the account current. The second is that nationalized banks and to some extent cooperative financial institutions exchange credit information in an effort to ensure that an applicant is not already indebted elsewhere in these two systems. However, information on credit history is not exchanged, and as noted, BNCR does not even keep credit history records for its internal

use. The third is that individual loan officers (delegados) may --but are not necessarily required to-- screen applications with an eye to risk.

f. Measures of loan recovery performance used by BNCR consist of the volume of arrears and of loans affected by arrears, the percentage of the portfolio in arrears and affected by arrears; and ageings of arrears. These are useful measures for valuation of a portfolio, but comparison of collections to amounts due, which is not calculated, is a better indicator of the effectiveness of collection procedures.

BNCR's loan collection procedures appear administratively coherent (See Annex 3). These have recently been tightened, by reducing the periods between follow-up measures, such as sending notices and taking legal action. However, collection procedures cannot fully correct for credit decisions that are not oriented toward risk, or for fragmentation of responsibilities regarding relationships with borrowers.

BNCR is in the midst of implementing a number of sweeping internal changes that will give it the capacity to improve risk management. However, risk does not appear to be a factor motivating change, and the improved form that is expected to result will need substance --an awareness of risk and incentives to manage it-- in order to respond rationally to risk:

a. Reorganization will create loan officer positions, with overall responsibility for credit decision procedures and loan supervision.

b. BNCR, with Central Bank prodding, has begun to implement procedures for tracking portfolio quality as a basis for establishing bad debt reserves. These procedures are well-founded. Appropriately expanded, they could permit better risk management and a strategic view of credit risk by BNCR managers (See Annex 3).

c. BNCR is rapidly computerizing its information systems, permitting better risk management if risk management is accorded priority (See Annex 4).

### III. Recommendations

Incorporate risk management as an objective of the reorganization of BNCR staff:

a. Ensure that loan officers have meaningful lending authority, supported by current information about the status of the accounts for which they are responsible. They should have information on repayment performance, deposit balances and related business, including fee-earning "collateral business" such as letters of credit and transfers, for each of their accounts.

b. Establish a system of credit files. Separate originals of loan documents, which require secure storage to protect BNCR's legal rights, from information related to credit decisions and loan quality.

Credit files should include data on the borrower and the principals where the borrower is not an individual; related

accounts; the borrower's legal status, productive activities, financial situation and business history; and a history of the relationship with BNCR. Financial statements, credit analysis worksheets and other materials used to support previous and current credit decisions should be kept in the file. Copies of correspondence belong in the credit file, along with BNCR officers' notes recording conversations with the client, calls and site visits, newspaper accounts (if any), records of irregularities in the relationship, and other relevant data on the borrower or principals and possibly on the industry or sector.

The first page of the file should be a form summarizing the account relationship, updated annually or more frequently as required by changes in status. BNCR already has a form of this type that accompanies credit analyses.

Establish a system regulating access to credit files, which contain a material that is confidential between BNCR and the borrower. The individual in charge of the system should know the location of all files at all times.

c. Improve credit analysis by incorporating risk adjustment. The first step is to identify the things most likely to go wrong with the proposed loan and loan purpose. The second is to provide some indication of the probabilities of their occurrence, and the third is to make adjustments for their expected impact.

Analysis should be directed to the substance of risk, i.e., what is likely to go wrong and what it will cost, rather than to

arbitrary adjustments of costs and benefits, e.g., a 10 percent increase in costs, a 10 percent decrease in revenues. Appraisal reports should become strategic plans designed to serve BNCR's interests rather than advocacy documents.

For corporate farming and agroindustrial lending, attention to risk would require adjusting projected financial statements (balance sheets, income statements, and sources and uses of funds statements) to reflect the impact of those things most likely to go wrong. Best-estimate or normal year projections should be supplemented by risk-adjusted projections that indicate repayment capacity under conditions of reasonably expected adversity.

Risk-adjustment for small-scale borrowers and for seasonal lending could be accomplished by modifying avíos to reflect assumptions of reduced harvests or prices, as the substance of risk dictates.

d. Increase attention to portfolio quality by portfolio review procedures. These can be developed by expanding the activities of the Riesgo de Cartera Unit and by refinements in information systems designed by the Estudios Económicos Department. Retain the measures already calculated. Also compare collections with "demand," defined as the sum of amounts overdue at the start of the reporting period plus amounts falling due during the period. Cross-tabulate arrears and collection performance data by branch, loan officer, sector or industry, crop, loan size, ostensible loan purpose, type of security, and any other variables that provide insights into portfolio risk.



e. Project BNCR income and loss by portfolio segment, to provide a basis for portfolio management. Portfolio management is greatly constrained by BNCR's agricultural lending mandate and fixed interest rates. However, patient collection and analysis of portfolio performance and cost and income data provides a basis for guiding policy-making and for capitalizing on any opportunities for flexibility that may develop.

Undertake research to address the firmly-held belief of many BNCR officers that 100 percent financing of crop production costs is essential to ensure that borrowers use "100 percent of the recommended technology." This presumption seems unlikely, in view of experience in other countries, and can be tested empirically.

Begin by ascertaining whether 100 percent financing results in 100 percent adoption. Ascertain whether lower levels of financing (perhaps by using samples of borrowers from other sources, or of non-borrowers) correlate closely with levels of technology use.

Determine whether the avíos are in fact optimal for farmers. Several avíos inspected were designed for country-wide application, which suggests considerable scope for misapplication in view of the heterogeneity of farms and farm households in Costa Rica. Test the validity of the avíos for application in risky agriculture with risk-adverse farmers. In many countries recommended packages are formulated solely on technical considerations, without regard to risk. Is this the case in Costa

Rica?

For activities covered by crop insurance, ascertain whether insurance changes farmer behavior. Cross-sectional analysis (with/without) and time series analysis (before/after) could be useful research techniques.

Ultimately, modify the role of avíos, using them as guides rather than as standards applied uniformly in all situations. Give incentives to delegados and other loan officers to tailor credit packages to specific borrowers. Completely customized lending is not economic where loans are small, but neither is complete reliance on avíos.

Complement the decentralization of loan decision-making (already accomplished in branches by the delegado-junta rural system) with responsibilities that give loan officers incentives to develop an acute awareness of risk in credit decisions. Borrower competence and commitment, affordability and technical risk, as well as productivity (the expected source of repayment) should govern access to credit and loan size.

Risk dictates reductions in loan size from the present high levels of financing. Smaller loans permit expansion of the number of borrowers, especially if interest rates are made flexible. Concern for risk would broaden the basis on which results are evaluated: the quality of lending would become more important relative to the quantity of lending. Growth in the number of clients could be an objective, but should be approached indirectly, through diversification targets or emphasis on

deposit market share, for example, so that expansion does not greatly increase BNCR's risk relative to its rewards.

NOTES:

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## Annex 1

## NOTES ON BNCR LOAN PROCESSING

BNCR processing of applications for loans for agricultural and agroindustrial activities follows procedures attributed to the Interamerican Development Bank. These consist of two categories: loans for more than 7 million colones, which are processed at Head Office, and loans for smaller amounts processed at branches.

I. Applications for relatively large loans --greater than 7 million colones-- for commercial agriculture and agroindustrial enterprises are analyzed at the Head Office in San Jose, as there is reportedly no formal analytical capacity at the branches. (This is expected to change with the staff reorganization). About 55 percent of BNCR's total loan portfolio is generated by the Head Office, 45 percent by branches. The analysis is qualitative and quantitative, and is the basis for credit decision-making.

Qualitative analysis conforms largely to standard financial practice. (Exceptions are discussed in parentheses). Items examined in the appraisal of a new venture or for a new activity by an established borrower are:

(a) Organizational structure of the firm, with attention to managerial capacity and ability, based on the experience and qualifications of the managers and/or principals.

(b) The chief executive officer (i.e., general

manager, managing director or president) is interviewed. The interview ascertains the manager's training, experience and background. If the manager has no business training, the BNCR officials responsible examine how the enterprise is managed. (Comment: performance should be the primary focus, rather than the paper qualifications of the manager). The information used by the manager in running the business is examined. The pattern of questions is designed to cross-check responses and to identify inconsistencies. Other key managers are also interviewed, using the same approach.

(c) Control systems for costs, inventories and management of the production cycle are examined. An evaluation is made of the extent to which controls are based on records, on estimates, or on "feel."

(d) The firm's history is reviewed, in order to identify problems and responses to problems.

(e) The firm's activities, classified by products or lines, are summarized.

(f) The firm's status with regard to licenses, subsidies, tax exemptions and similar factors is reviewed.

(g) The firm's credit standing is reviewed. Review includes an exchange of current credit information with other nationalized banks, which will report indebtedness, deposit accounts, and whether irregularities are currently present in the relationship. Historic data is not available for referents, either among the nationalized banks or within BNCR for its own

clients. Private banks will not exchange information of this type. If irregularities are reported, the application is rejected unless the account is brought current with the other bank.

In the common case where BNCR already has a relationship with the applicant, the credit recommendation will include provisions for bringing any arrears current. A novel analytical approach used by BNCR in some cases is to treat arrears as (part of) the applicant's equity in the proposed activity, on the grounds that these funds are already used in the business, but otherwise would have been repaid. One motive for not repaying is reportedly the length of time it may take to obtain a new loan, and the inconvenience of having to apply.

(Comments: treating arrears as "equity" has a certain logic if these funds are in fact retained in the business, as they are an indication of the applicant's commitment to the business. However, verifying their retention is complicated by fungibility. Arrears do not provide an equity cushion to the creditor, because they still have to be repaid. In addition, they may signify a lack of confidence --borrowers in arrears are presumably in general higher risk clients than those who are current. Overall, treating arrears as part of the owner's contribution to a new activity is a questionable analytical practice).

Credit review for renewal of a facility to an established client includes attention to changes in sales, production, various financial ratios, credit history and comparison of

performance with projections on which the previous credit decision was made.

An application for a loan in excess of 7 million colones goes through fourteen steps at BNCR's Head Office, as diagrammed in Appendix 1. Appendix 2 outlines the organizational structure of the analytical group. In fact, there are three Secciones Administrativas, one each for agricultural, industrial, and other loans. The reorganization of staff is expected greatly to alter the steps listed in Appendix 1, but details were not available at the time of the visit in mid-January.

II. Applications for medium- and long-term loans of less than 7 million Colones for agricultural investment purposes are processed at the branch level. The loan appraisal begins with a review of the situation of the farm, including its access to services and roads, its location in terms of climatic zone, its soils, topography and hydrologic resources, fragmentation of holding, legal limitations on use (if any, e.g., inclusion in forestry reserve zone), crops/enterprises, land tenure status, and experience of the operator with the activities for which financing is sought.

A land use plan is made, and budgets are constructed for each enterprise to be financed, and for those excluded from the credit-financed farm-level project. Livestock, machinery and infrastructure inventories are taken. The volume and value of production are estimated, including allowance for consumption of

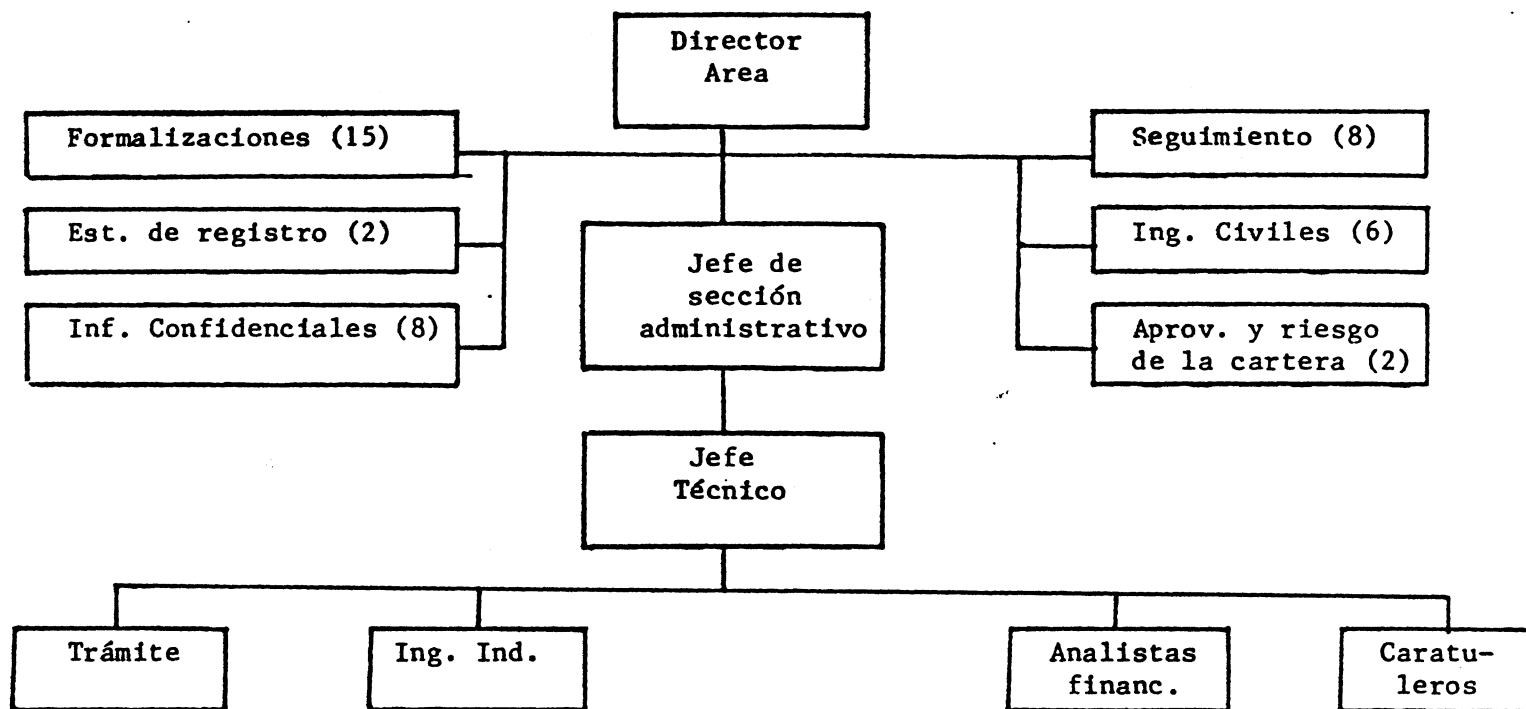
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Oficina

	Jefe de Sección	Trámite	Grupo de apoyo	Ingeniero Indust.	Jefe técnico	Analista de Proyectos	Nivel de aprobac.	Formaliz.	Cobro
1. Cliente presenta solicitud	1								
2. Se le da la orientación sobre recursos, indica sobre requisitos (internos, externos)	2								
3. Se invia a numerar (est. confidenciales, est. registro) y se encarga de recibir los requisitos solicitados al cliente		3							
4. Solicita estudios de apoyo necesarios (ingenieros civiles, agrónomos, abogados)			4						
5. Una vez completo el expediente trámite lo entregá al jefe técnico					5				
6. Jefe técnico revisa el exped. y entrega Ingeniero Indust.				6					
7. El jefe técnico revisa inf.					7				
8. Si el resultado el informe ind, es positivo se procede a enviarlo al analista						8			
9. Terminado → jefe técnico					9				
10. Si el inf. del analista es positivo, se confecciona una carátula (resumen) o si es negativo					10*				*caratuler
11. Se envía al nivel de aprobación correspondiente (jefe departamento, comité, comisión)							11		
12. La secretaría se encarga de comunicar al cliente el resultado del nivel de aprobación							12*		*secretarí.
13. El expediente se envía a formalizaciones si es aprobado (Si el crédito no es aprobado se archiva)								13	
14. Una vez formalizada se invía a cobro, que coordina la actividad									14

Appendix 1





Note: Figures in parentheses indicate staffing levels.

There are three jefes de secciones administrativos, one each for agriculture, industry and others (agropecuario, industria y diversificado), with a corresponding structure as shown above in the center and bottom portion of the organization chart. The total staffing of these three sections is 186.

The Informaciones Confidenciales section is responsible for the exchange of information with other nationalized banks and, where they participate in information exchange, with cooperative financial institutions.

produce on the farm. Non-agricultural income and costs are also ascertained. A summary of outstanding credit is also made.

From the basic data and with reference to the farmer's objectives, a projected farm plan is drawn up, again including land use and estimates of costs by input units, income from prices and volumes of output. These are summarized in a cash flow projection, from which the loan amount is derived and the amortization schedule is constructed. Standard farm budgets and loan schedules (avíos) are employed in most cases, unless the activity being financed is unusual (e.g., cut flowers for export).

III. Applications for seasonal input loans are processed along the same lines, but using simplified procedures directed primarily at the activity to be financed, with less emphasis on the whole-farm or farm-household situation. Standardized enterprise budgets (avíos) are used almost exclusively in these cases.

IV. Head Office credit analysis staff includes four financial analysts for industrial loan applications, three for agricultural loans, and one for other loans. Each of these analysts processes between six and eight applications per month, which is in line with industry standards elsewhere. However, this number of analysts seems small for a bank with 3,000 employees, even though they examine only those applicants that are relatively large.

## Annex 2

## NOTES ON BNCR LENDING NORMS

I. How Loan Size Is Determined

Agricultural lending norms used by BNCR are highly systematized, although the degree of consistency in their application was not verified. Loan amounts, specified as a percentage of costs of production, are listed for most crops grown in Costa Rica, for livestock, farm machinery and equipment, etc. These are organized into farm budgets (avíos). For each loan purpose there is a corresponding security requirement, but the valuation of security appears to receive relatively little attention. A group of 12 valuation specialists devised security valuation norms until a staff reorganization in the early 1980s, when their unit was effectively disbanded. This probably reflects relatively little reliance on security and a reluctance to foreclose on the part of BNCR.

Costs of production are defined to include labor, valued at the statutory minimum wage. On small farms and for many crops, a significant portion of this labor may be family labor, which is not strictly a cash cost. The portion of the financing provided by the agricultural borrower is between 0 and 20 percent for most purposes, while the level of loan financing is between 80 and 100 percent.

However, the borrower seldom has to put up 20 percent out-of-pocket towards the loan-financed activity. This occurs

because fixed investment on the farm is counted as part of the farmer's contribution. The value of fences, machinery and land improvements, that are sunk costs, are included in these calculations. The result is that virtually all incremental cash costs, plus the imputed costs of family labor, are covered by credit. Costs excluded from avíos consist of farm management, where this can be separated from the cost of field labor, and interest expense.

Disbursement is often made against receipts for inputs purchased, however, which may mean that the borrower puts up cash for the period between purchase and reimbursement, or that the borrower obtains credit from suppliers that is paid off when reimbursement is received from BNCR.

## II. Lending Authority

The system of lending limits at BNCR appears complex, with different limits for different types of loans, and is possibly in state of flux. Therefore, the following can be regarded as little more than indicative. However, one area in which there were no contradictory accounts is that all rejected loan applications must be forwarded to Head Office for review by senior management and the loan committee or Board. Accordingly, all applications tend to be processed, even if it is apparent they are not viable. With the forthcoming staff reorganization, more screening is expected to occur at lower levels. In fact, some may occur now, as delegados or others may advise clients infor-

mally that they are unlikely to obtain a loan, or could obtain one only after a lengthy delay, with the result that no applications is made.

BNCR's overall lending limit is 4 percent of its capital --no single borrower can be indebted to BNCR for an amount exceeding 4 percent of BNCR's capital, although this limit may be raised to 6 percent with Central Bank approval.

Several BNCR officials cited lower levels of limits of up to 7 million colones for branches, between branches' maximums and 11 million for individual managers at Head Office, and above 11 million for loan committees. An alternative categorization is that branches have limits of up to 7.5 million colones, while loans generated at Head Office can be approved administratively by single officers as follows: 700,000 for a section chief, one million for an assistant area director and deputy credit manager, which meets weekly. Amounts between 10 and 15 million colones are reviewed by a credit committee composed of an area director, an auditor, two deputy credit managers, and the credit manager (who is the General Manager of BNCR). Amounts in excess of 15 million colones are referred to the Junta Directiva. Yet another informant reported that a Comité Especial de Crédito has authority of up to 5 million colones for loans for coffee and rice.

An important question that could not be satisfactorily explored is whether loan authority limits are based on loan size (which appeared to be the case) or exposure. Basing decision authority on exposure would mean that even a relatively small

loan application, say for 100,000, colones, would have to be referred to the Junta Directiva if the borrower's total outstanding exceeded 15 million.

A related question that was not investigated is how exposure or "borrower" is defined. In many cases there may be clusters of related accounts --one client may have several businesses, or members of a family may have a number of interlocking interests. Because of the inter-related nature of risks from such clusters, many banks treat their exposure from such a cluster of accounts as a single relationship (the "one obligor concept"), with the result that any request for additional credit would receive higher level review than would be required based on the amount of the application standing alone. BNCR practices in this regard require further examination.

### III. Financial Information Requirements

BNCR is placing increased emphasis on obtaining financial statements from clients. These are required if the client's total debt exceeds 2 million colones, or if project cost exceeds 1.5 million. No information was obtained on the quality of this information.

### IV. Other Considerations

BNCR officials indicated that agricultural credit policy reflects the Government's objectives of self-sufficiency in six major crops: rice, corn, potatoes, belt peppers, tomatoes, and

beans. It is believed that credit is essential to adoption of new technologies and improved varieties, and that only with 100 percent financing will 100 percent adoption occur. Hence, high levels of financing predominate. Other sources suggest that livestock producers are especially powerful politically, with the result that avíos for livestock provide 100 percent financing (as opposed to 80 percent for arable crops). In view of the fact that 80 percent financing for arable crops is implemented in a way that covers more than the cash costs of production, it may be that livestock producers are being treated even more generously.

One strategy to manage arrears applied by some branches is to help borrowers get into tree crops with high value output, such as fruit. Arrears are combined with new money for the new activity, and the entire sum is expected to be repaid over a relatively long term, such as eight years.

Some flexibility in application of avíos was seen during a branch visit. Because disbursements are in tranches, activated by stages in crop production, approximately 70 percent of seasonal crop loans were expected to reach the limits specified in the avíos. The remaining 30 percent were expected to involve partial disbursement because of unsatisfactory input use or other inhibiting factors, such as poor germination. Branch officials assumed that crop sales income would amount to about 125 percent of costs as specified in avíos. When seasonal loans were repaid, a notation concerning loan performance was made in an index file: "A" for few or no problems, "B" for significant problems, and "C"

for blacklisting. A rule of thumb mentioned in discussion of a hypothetical small bakery loan was that the owner should have 30 percent of gross income free to service new debt, with 100 percent financing against pro-forma invoices for new equipment.



## Annex 3

**NOTES ON BNCR LOAN CLASSIFICATION AND MANAGEMENT OF ARREARS**

The purpose of loan classification is to identify accounts needing special attention in order to avoid bad debt loss, and to estimate adequate levels of bad debt provisions. BNCR ages arrears and calculates their amount and the portion of the portfolio affected by arrears, i.e., loans some portion of which are in arrears. Recently, under pressure from the Central Bank, BNCR has begun to use more complex procedures to indicate the quality of its loan portfolio. An indication of the magnitude or scope of portfolio management is suggested by 1984 data: BNCR had 85,000 loan accounts, 60,000 of which were agricultural, and 37,000 of which were under the jurisdiction of BNCR's Rural Credit Department. This Annex begins with a description of collection procedures, followed by a description of the loan classification system that is being introduced, and closes with a paragraph on loan rescheduling.

**I. Loan Recovery Procedures**

The Cobro section is responsible for loan recovery. Its procedures are described in the "Reglamento Sección Cobro de Préstamos, BNCR, Art. 8 Ses. No 9649 3-V-85," as amended in December 1987. The purpose of the recent changes is to speed up collections, by reducing the periods that elapse between increas-

ingly rigorous efforts by BNCR to obtain collection from borrowers in arrears. Uniform procedures are applied to all arrears, regardless of whether they are on agricultural, industrial, or other types of loans.

A client is sent a billing notice approximately 15 days before a loan or installment is due. If the payment is not received, a reminder is sent within 15 days of the due date. This letter may be sent through the mail, or delivered by hand by the delegado or other official most closely connected with the account. Between 15 and 30 days following the due date a letter is sent by a lawyer requesting immediate payment. This letter may be hand delivered or sent by registered mail. Between 30 and 60 days after the due day the loan is referred to a lawyer for collection. Both BNCR legal staff and outside lawyers are used for this purpose. A legal fee equal to 12 percent of the amount in arrears is added to the amount due at this stage. Payment must be made directly to the Bank, not through the lawyer. When the matter is referred to a lawyer, the loan status changes from cobro administrativo to cobro judicial. If foreclosure is undertaken, BNCR may proceed directly, based on registration of security or guarantees given at the time the loan was issued. It appears that recourse to foreclosure is infrequent.

The Cobro section prepares monthly information returns showing amounts collected. However, this report does not indicate the amount due for collection. This analysis is apparently not performed in BNCR, so Cobro staff and BNCR

management do not have a good view of collection performance. The volume of arrears outstanding is the most nearly relevant measure available to them.

Rice and sugar loan repayments are sometimes delayed because produce buyers are slow in paying farmers. In the case of sugar, the sugar authority, LAICA, borrowers from BNCR and on-lends to growers and is slow in repaying BNCR. In no other cases, except coffee, does BNCR seem to lend "wholesale." Agricultural lending has a seasonal pattern. Rice loans are disbursed in May/June, for payment in December. Sugar loans are collected during the cutting season, which begins in January. Coffee loans are apparently primarily for harvesting, with November/December disbursements for collection in January.

The role of crop insurance in loan recovery was not investigated in detail. Some sources reported that most loans are insured, while others indicated that the crop insurance program is moribund. Since the manager of the Cobro section and the Reglamento did not refer to insurance indemnities as part of the recovery mechanism, insurance probably does not materially diminish BNCR credit risk.

## II. Loan Classification

A system of loan classification was introduced in 1985 by BNCR at the instigation of inspectors from the Central Bank. The system covered 20 percent of new loans in 1985, 40 percent in 1986, etc., and should cover 100 percent of new loans by 1989.

Full portfolio coverage will be achieved by the mid-1990s when the last loans issued outside the system before 1989 are repaid or written off. The objective of the system is to improve portfolio quality, analysis and management, with emphasis on better credit decisions and loan administration.

Classification begins when a loan is considered for approval. A "risky point" (factores de riesgo) system is used to grade loan quality --the fewer the risk points the higher the quality, the greater the number of risk points the higher the risk, and the higher the level of bad debt reserve required to support the loan (see appendix 1).

Three categories of criteria are applied: past payment performance (comportamiento de pago), 0-20 risk points; estimated repayment capacity (capacidad de pago estimada) as indicated by analysis of financial data, 0-70 risk points; and the quality of security, usually a guarantee (calidad de las garantías), 0-10 risk points. The rating system gives great weight --50 risk points-- to obtaining borrowers' financial statements for their previous two years of operations, and to analyzing the data obtained. (Financial statements are not requested, however, from agricultural borrowers borrowing less than 1.5 million colones from BNCR or with less than 2 million in outstanding debt).

Loans going on the books are classified at "A" or high quality, with 20 or fewer risk points. For these loans, no loss reserve is required. For "B" loans, with from 21 to 50 risk points, a 1 percent loss reserve is required, and "C" loans,

having 51-100 risk points, require a 5 percent reserve.

A loan's initial classification can rarely be upgraded, and any reserve required initially must be maintained on any balance outstanding until the loan is paid off or written off. Rankings are reviewed every six months, however, and can be downgraded. (Before the present system was instituted, reserves were established only when a loan was the subject of judicial proceedings). Categories "D" or "E" are added to the ranking scale to accommodate downgrading. Falling into arrears on principal or on interest is cause for downgrading. Temporary problems relegate a loan to "C" category, serious problems rate a "D," and require a 15 percent loss reserve, and little hope of recovery merits an "E" and a 30 percent loss provision.

On-site inspections, visits to clients, must be conducted each six months for accounts constituting 25 percent of the balances outstanding in categories "C" through "E." This gives those responsible in the Seguimiento section an incentive to examine the largest problem accounts. Inspection usually results in downgrading. If performance improves, two inspections six months apart are required to upgrade the account rating, and the upgrading can virtually never exceed the original "A" through "C" classification issued at the time the loan was put on the books.

As of December 1987, 5.2 billion colones in loans were governed by the classification system. Of these, 2.6 billion (51 percent) were classified as "A," 1.2 billion (24 percent) as "B," 920 million (18 percent) as "C," 193 million (3 percent) as "D,"

and 211 million (4 percent) as "E." For the six month period concerned, the classification system resulted in an additional of 75 million colones to reserves.

An inconsistency, representing incomplete implementation of the portfolio quality grading system, is that BNCR continues to accrue interest on all loans regardless of the extent to which they are past due or of the prospects for their ultimate recovery. Standard banking practice is to cease accruing interest on doubtful accounts, so that interest income is not overstated. Write-offs follow failure to collect loans in non-accrual status. In standard banking practice, placing a loan in non-accrual or writing it off does not mean that collection efforts are abandoned. Non-accrual and writing off are accounting adjustments to keep reporting consistent with the facts. The decision to continue to press the borrower or guarantors or to foreclose is a separate decision, related to feasibility of recovery, the costs of recovery, and to the incentive effect on other borrowers who may be tempted to default.

If partial or full recovery is made of a doubtful loan, interest is first calculated for the non-accrual period, and the balance received is used to reduce the principal amount outstanding. If the loan has been written off against bad debt reserves, any payments in excess of interest due are credited to the bad debt loss reserve, reversing the loss previously taken. Introduction of non-accrual status should be relatively simple with the information system enhancements now underway in BNCR, and is

a logical extension of the decision to establish reserves against doubtful accounts.

III. Rescheduling and Renewals

Prorrogaciones involve bringing up to date the interest due on an account in arrears. This type of rescheduling is reportedly permitted only when justified by a feasibility study or technical analysis and when new and generally larger guarantees are obtained. Thus, new terms and conditions are usually --in about 85 percent of the cases according to one estimate-- accompanied by measures to improve the quality of the credit, not simply to make an account look healthier through a bookkeeping adjustment. Adecuaciones or renewals are reportedly almost never given on poor quality loans.

BANCO \_\_\_\_\_  
OFICINA \_\_\_\_\_

Determinación del riesgo estimado del crédito y asignación de la provisión correlativa, al formalizar el préstamo.

Fecha \_\_\_\_\_ Categoría de riesgo asignada \_\_\_\_\_

Operación No. \_\_\_\_\_ Nombre del deudor \_\_\_\_\_

Actividad económica financiada \_\_\_\_\_ Monto \_\_\_\_\_

FACTORES DE RIESGO	Valor	Valor por sumar
--------------------	-------	-----------------

I COMPORTAMIENTO DE PAGO (0-20)

1.1 <u>Tuvo operaciones con el Banco</u>		
SI	0	_____
NO.....Pase a Preg. 1.4	1	_____

1.2 <u>La (s) atendió con atraso en cuotas de capital y/o interés</u>		
SI	0	_____
NO.....Pase a preg. 1.4	0	_____

1.3 <u>Características del atraso</u>		
Hasta 60 días	4	_____
Más de 60 días	6	_____
<u>Nota: Si fueran varias operaciones marque sólo 1 respuesta, basándose en la operación - con mayor atraso.</u>		

1.4 <u>Tiene operaciones vigentes con el Banco</u>		
SI	0	_____
NO.....Pase a preg. 1.7	1	_____

1.5 <u>Muestran atraso con cuotas de interés y/o capital</u>		
SI	0	_____
NO.....Pase a la preg. 1.7	0	_____

1.6 <u>Características del atraso</u>		
Entre 1 y 29 días	1	_____
Entre 30 y 89 días	6	_____
Más de 90 días	10	_____

Información de otros Bancos

1.7 <u>Tiene operaciones vigentes</u>		
SI	0	_____
NO.....Pase a punto II	0	_____
NO HAY INFORMACION. Pase a punto II	4	_____

1.8 <u>Cómo se encuentra la atención de las operaciones</u>		
AL DIA	0	_____
ATRASADAS	4	_____
NO HAY INFORMACION	4	_____

Sub-Total I Comportamiento de pago.....

FACTORES DE RIESGO	Valor	Valor a sumar
--------------------	-------	---------------

II CAPACIDAD DE PAGO ESTIMADA (0-70)

1: <u>Actividad económica (1 a 20 puntos)</u>		
Agricultura	2	_____
Ganadería, Caza y Pesca	5	_____
Industria de manufactura y extracción	2	_____
Comercio	5	_____
Servicios	5	_____



2. Situación financiera (0 a 50 puntos)

2.1 Existe información financiera actualizada que respalde la capacidad de pago (al menos para dos períodos cuando corresponda).

SI.....Pase a preg. 2.2 0  
NO 50

2.2 Se concluye del análisis que el deudor cuenta con capacidad de pago para el cumplimiento oportuno de sus obligaciones con el Banco.

SI 0  
NO 50  
EXISTEN DUDAS...Pase a preg. 2.3 o 2.4 0

2.3 Se observan debilidades financieras que generen un cuadro de incertidumbre, no obstante se estima que de acuerdo al conocimiento actual de la situación, ellas no afectarían en forma importante la recuperación de lo adeudado.

SI 15

2.4 Se observan acentuadas debilidades financieras, - las que determinan que la utilidad operacional o los ingresos disponibles, son insuficientes para cubrir la carga financiera que genera el pago de intereses y el servicio del capital en los términos pactados, no existiendo mayores antecedentes que permitan inferir un fortalecimiento en su capacidad generadora de recursos. Por lo expuesto, se espera que exista una pérdida parcial de los recursos comprometidos. 35

Sub-Total II Capacidad de pago estimada.....

FACTORES DE RIESGO	Valor	Valor a sumar
--------------------	-------	---------------

III CALIDAD DE LAS GARANTIAS (0-10)

- 1. Hipotecarias
  - En primer grado a favor del Banco 1
  - En primer grado a favor de otros Bancos 8
- 2. Prendarias 6
- 3. Fianzas 9
- 4. Avales Bancarios 0
- 5. Avales casa matriz 1
- 6. Sin garantías 10

Sub-Total III Calidad de las garantías.....

TOTAL GENERAL I + II + III =.....

CATEGORIAS DE RIESGO	PUNTAJE	PROVISION %
A Calidad Alta	0-20	0%
B Calidad Media	21-50	1%
C Calidad Baja	51-100	5%

\*\*\*\*\*

Fórmula de acuerdo con resolución No. AG-5, formulario AG/RP 86-1, ambos de la Auditoría General de Bancos, en práctica a partir del 2 de enero de 1986.

Firma \_\_\_\_\_  
Jefe

Firma \_\_\_\_\_  
Analista de Crédito

Nombre \_\_\_\_\_

Nombre \_\_\_\_\_

## Annex 4

## BNCR Lending Priorities

An overall framework of BNCR lending priorities is specified in terms of the activity for which funds are requested. In descending order, these priorities are: crops, livestock, industry, housing, construction, and other purposes. These priorities are reflected in lending plans that are determined in consultation with the Ministry of Agriculture and the Central Bank. If more funds are required for high priority purposes, lending to lower priority areas is reduced accordingly.

These priorities are also reflected in BNCR's interest rate structure, with the lowest rates assigned to the highest priority loans. The convergence of interest rate preferences and credit allocation priorities results in reduced gross income for BNCR. Resources are channeled from high-interest low-priority loans or potential loans to low-interest high-priority loans.

The impact of these factors on BNCR earnings is not clear, because administrative costs by type of loan are not well defined, and bad debt losses for each category did not appear to be readily available. A general impression is that loans to the agricultural sector are the most risky, causing disproportionate bad debt losses. However, BNCR staff also remarked that the level of non-FODEA non-performing loans was higher than expected, a surprise that emerged when assets were reviewed to determine eligibility for FODEA relief.