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Report to the Chairman, Subcommittee on Foreign Operations, Committee on Appropriations, U.S. Senate

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FOREIGN AID

Issues Concerning AID's Private-Sector Revolving Fund

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National Security and
International Affairs Division

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The Honorable Daniel K. Inouye
Chairman, Subcommittee on
Foreign Operations
Committee on Appropriations
United States Senate

Dear Mr. Chairman:

This report responds to your requests for our analysis of the operations of the Agency for International Development's (AID) Private-Sector Revolving Fund. The report discusses a number of financial, management, and policy issues concerning Fund operations, both at its Washington, D.C., headquarters and in its field projects in developing countries.

We will send copies of this report to the Administrator of AID and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

Frank C Conahan

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

The Agency for International Development (AID) has increased its emphasis on providing U.S. foreign assistance through private-sector channels. In 1983, a Private-Sector Revolving Fund was established to provide loans to small businesses and cooperatives in developing countries.

GAO was requested by the Chairman of the Senate Appropriations Subcommittee on Foreign Operations, to review the operations of AID's Revolving Fund. GAO's review addressed issues concerning financial management, funding levels, and management/ monitoring of field projects.

Background

The Revolving Fund was authorized by the International Security and Development Assistance Authorizations Act of 1983, which added Section 108 to the Foreign Assistance Act of 1961, as amended. AID initiated its first Fund project in April 1984; at the end of fiscal year 1987, AID had 30 approved loans valued at approximately $60 million in 14 countries. The Fund has received $61 million for operations through fiscal year 1987.

Appropriations for fiscal year 1988 are authorized by the Congress not to exceed $9 million, to be derived by transfer from funds appropriated under the Foreign Assistance Act for development assistance. In response to a draft of GAO's report, AID indicated that in view of the funds projected to be available from all sources, it will transfer no more than $4.5 million to the Fund in fiscal year 1988. As of May 3, 1988, $3 million had been transferred.

Fund projects include direct loans to private businesses and indirect (collateral) loan guarantees through intermediate financial institutions, such as commercial banks. AID has requested congressional authority for direct guarantees which would enable the Fund to operate at approximately four times its current size.

Results in Brief

GAO found weaknesses in Fund financial management and AID took several steps to address the financial deficiencies. GAO's analyses of AID's cash flow projections indicate that nearly $16 million will be available for the Fund in fiscal year 1988, which is sufficient for operations since the Congress has limited obligations to $12 million. GAO's analyses indicate that appropriations of $8.5 million requested by AID for fiscal year 1989 would exceed Fund requirements.

There are serious questions as to whether the Fund can effectively operate a larger program. Staff limitations have affected the quality of project management/monitoring and questions have been raised within AID as to whether its field missions should assume management responsibilities for Fund projects. In addition, GAO found that the Fund does not have a risk policy that defines the balance that should be sought between the credit worthiness of projects and AID's developmental goals.

Principal Findings

Weaknesses in Financial Management

GAO identified several financial management weaknesses including (1) a data base that did not accurately project cash flows or appropriations requirements; (2) a lack of complete and audited financial statements; (3) the lack of a loss reserve account; and (4) inadequate procedures for converting loan reflows of principal, interest, and fees into U.S. securities.

As a result of GAO's findings, AID took several actions, which included revising cash flow projections; preparing financial statements as of September 30, 1987, which included establishing a loss reserve account at 2 percent; strengthening procedures for reflow investments, including the automatic investment of cash balances reaching $10,000; and hiring a financial consultant to survey the adequacy of overall financial management.

Funds Available May Exceed Requirements for Fiscal Year 1989

AID has requested $8.5 million in fiscal year 1989 appropriations for loans and direct guarantee reserves. Based on AID's reflow projections, revised deobligation plans, and its decision to transfer no more than $4.5 million in fiscal year 1988 appropriations, approximately $13 million would be available for operations in fiscal year 1989 without additional appropriations. Over $21 million would be available if AID receives its $8.5 million appropriations request—about $9 million more than the current obligation authority.

To date, AID has not demonstrated that it can effectively use more funds than the levels authorized for obligation in fiscal year 1988. GAO noted that loan disbursements totaled only about $20 million at the end of fiscal year 1987, whereas obligations totaled $60 million.

Management and Policy Improvements Needed

Local bank officials in Thailand, Indonesia, and the Philippines said that the Fund had encouraged lending to small businesses, often in rural areas. However, the banks required small businesses to provide collateral often in excess of 150 percent of the loan, even though AID guarantees up to 50 percent of the risk. GAO concluded that such requirements seemed inconsistent with Fund objectives of reaching higher risk markets.

GAO also noted significant limitations in AID monitoring of the projects. For example, GAO found a lack of project files or records in the Philippines mission, inadequate oversight and knowledge of project beneficiaries in the Indonesia mission, and inadequate oversight in Thailand. AID officials said that (1) the Fund has had significant difficulty in managing and monitoring overseas projects with only three U.S.-based program officers and (2) additional staff and resources would be needed to effectively manage a direct guarantee program.

Recommendations

GAO recommends that the AID Administrator:

- Provide sufficient resources for strengthening the administration and monitoring of Fund projects by adding Fund staff and/or increasing the direct involvement of its field missions in project management.
- Establish a policy on maximum collateral requirements of local banks. The policy should (1) establish a ceiling on banks' collateral requirements as a condition for Fund loans/guarantees; (2) identify options for encouraging bank lending based on project performance and cash flow, instead of collateral-based lending; and (3) define, as part of an overall policy of what constitutes acceptable risk, the loss-rates necessary and/or acceptable for balancing developmental goals and the objective of ensuring that revenue exceeds losses to retain Revolving Fund capital.
- Provide for annual audited Revolving Fund financial statements.

Agency Comments

AID stated that:

- It believed GAO's estimates of annual fund availability were overstated because GAO included $8.4 million in reflows that AID has projected will be paid to the Fund in fiscal year 1989. AID stated it has adopted a policy of not considering loan reflows as funds available until the fiscal year after receipt. While GAO recognizes that funds must be received to be available for obligation, it is not necessary to wait until the fiscal year after receipt. By ignoring the reflows projected to be available in fiscal year 1989, AID's policy results in an understatement of funds available for that year.

- It plans to strengthen project management by more closely linking the Fund to mission programming and by increasing the use of contract support staff in selected missions. AID stated it recognizes additional resources would be required to operate a direct guarantee program.
- It agrees that the time frame for disbursing obligated funds needs to be reduced. AID also agreed that a risk policy is needed, noting that it will address local bank collateral requirements along with other elements of risk.

Contents

Abbreviations

AID	Agency for International Development
IFI	Intermediate financial institutions
PRE	Bureau for Private Enterprise
SMSE	Small- and medium-sized enterprises

Chapter 1

The Private-Sector Revolving Fund

The International Security and Development Assistance Authorizations Act of 1983, which added Section 108 to the Foreign Assistance Act of 1961, as amended, established AID's Private-Sector Revolving Fund to promote private-sector development in developing countries. Provisions of the legislation include that Fund loans should

- support enterprises which will maximize the development impact appropriate to the host country, particularly in employment and the use of appropriate technology;
- provide, primarily to small-business enterprises and cooperatives, necessary support and services not otherwise generally available;
- provide capital which is at or near the interest rate generally available in that country's market;
- not provide any more than $3 million for any one project; and
- not use any more than 20 percent of the Revolving Fund's assets in any one country.

Most of the Fund's loans are provided through intermediate financial institutions (IFI) in developing countries. In initial congressional hearings on the program, AID stated it would encourage the channeling of loan funds through such institutions. These organizations were believed to be best suited for reaching small- and medium-sized enterprises (SMSE), particularly in rural areas. The House Committee on Foreign Affairs also advocated such use in its consideration of the authorizing legislation, which states that in order to maximize institution building, loans should be made primarily to intermediate entities which provide necessary support and services for private-sector activities. The January 1984 report of the National Bipartisan Commission on Central America also encouraged loans through intermediary private-sector institutions, including venture capital firms, to help address that region's development problems.

Two general types of loans have been used by the Revolving Fund: loans made to developing country IFIs and loans made directly to private developing country businesses or to joint ventures between developing country and U.S. businesses. The IFI mode normally takes one of two forms. The first is a Revolving Fund loan made directly to the IFI, which in turn, matches the AID loan in local currency, forming a pool of funds for subsequent lending to local private enterprises. The second form of a Revolving Fund loan serves as collateral to guarantee a portion of the risk of subloans made by the IFI with its own funds. In both cases the IFI provides administrative support, including subloan application review and approval, implementation, and monitoring.

Income from fees and repayments of loan principal and interest are redeposited in the Fund account and invested in U.S. securities. The funds are available for further lending. Of the Fund's 30 active loans at the end of fiscal year 1987, 25 were implemented through intermediate institutions, such as local banks and venture capital firms, and 5 were direct loans to business enterprises in developing countries. A general description of the purpose and status of the Fund's projects is provided in appendix I.

AID's fiscal year 1989 Congressional Presentation includes a proposal for $100 million in direct guarantee authority. AID has proposed changes to Section 108 to provide for direct guarantee authority which, among other things, would require AID to establish a separate reserve account to cover not less than 25 percent of the contingent liability on guaranteed loans. AID believes that most of the projects now financed by direct dollar loans can be supported instead by guarantees because (1) small businesses often need only local currency (not dollars) and (2) local financial institutions are willing to provide local currency if they receive some form of guarantee.

Organizational Structure and Staffing

AID's Bureau for Private Enterprise (PRE) manages the Revolving Fund. The Fund's staff manage the program, identify projects and potential investment opportunities, develop projects, and monitor project performance. At the time of our review, the Fund's staff included a director and deputy director, a program assistant, and three program officers. Program officer responsibilities include most aspects of project management, including the monitoring of ongoing projects. In addition, three groups—the Revolving Fund Portfolio Review Committee, the PRE Advisory Committee, and the Private-Sector Loan Review Board—assist in screening project proposals and monitoring key issues affecting program performance.

Funding

According to AID data, the Fund had received a total of $61 million in funds through fiscal year 1987. The following table provides data on funds received and loan obligations and disbursements.

Table 1.1: Funds Received, Obligations, and Disbursements

Dollars in millions

Fiscal year	Funds received[a]	Loan obligations	Loan disbursements
1984	$14.5	$12.00	$0
1985	16.0	18.50	3.11
1986	15.0	15.40	8.24
1987	15.5	15.15	8.83
1988	9.0[b]	0[c]	.50[c]
Total	**$70.0**	**$61.05**	**$20.68**

[a]Funds received through fiscal year 1987 represent appropriations and deobligations transferred from other AID accounts.

[b]Represents maximum transfer authority; AID has indicated that actual levels transferred will not exceed $4.5 million.

[c]As of November 30, 1987.

According to AID data, $3.5 million deobligated from non-Revolving Fund programs was made available by AID for Fund operations—$1 million in fiscal year 1986 and $2.5 million in fiscal year 1987. In fiscal year 1986, the Fund also deobligated $1 million of its funds, which became available for new loan commitments.

Disbursements have lagged obligations due to a number of factors. The Fund's collateral guarantee arrangements, while representing an innovative scheme designed to minimize the foreign exchange risk to the IFI—typically a local lending bank—have, in some cases, required considerable time to complete all arrangements. Collateral guarantees typically involve providing IFIs with guarantees for up to 50 percent of loans targeted at specified sub-groups, based on (1) a "three-party agreement" between AID, the IFI, and a U.S. depository bank; (2) a collateral account in the IFI's name established at the depository bank; and (3) upon request of the IFI, an AID disbursement to the collateral account, to cover a letter of credit from the U.S. depository bank to the IFI guaranteeing an extension of local currency credit. In other cases, projects have encountered delays in implementation due to changes in management of key implementing institutions (e.g., Caribbean Basin Corporation project) and problems in local management and shareholder disputes (e.g., Thailand Livestock Meat Processing project).

Objectives, Scope, and Methodology

Our objectives for this review were to determine

- whether AID was taking sufficient steps to improve financial management of the Revolving Fund (e.g., preparing accurate balance sheets and reliable reflow projections);
- given the funds currently available to the Revolving Fund, what level of funds would be annually available for lending and whether these levels would be sufficient for the Fund to operate effectively;
- whether there is an adequate policy basis for the size of the Fund and the future demand for its services;
- whether the present orientation of the Fund, which emphasizes lending through IFIs, is consistent with the initial objectives of the Fund; and
- whether small businesses and cooperatives in developing countries were receiving from Revolving Fund projects necessary support and services which are not otherwise generally available.

We conducted our review from May 1987 to January 1988. We reviewed files and interviewed officials of AID in Washington, D.C., and in the Philippines, Thailand, and Indonesia. Our analysis of financial management issues focused only on selected areas of internal control and did not include a comprehensive review of all Fund controls. During our Asian fieldwork, performed in October and November 1987, we met with officials of local banks and other organizations participating in the Revolving Fund program. Except for one direct loan project in Thailand, the projects we reviewed in Asia were implemented through IFIs. Loan values of the projects represented about one-half of total obligations and disbursements through IFIs as of November 30, 1987.

Our review was performed in accordance with generally accepted government auditing standards.

Budget and Cash-Flow Issues

Our analysis of AID budget requests and Revolving Fund cash-flow projections indicated that the data base was inadequate for accurately projecting the requirements for additional appropriations, as transferred from AID's development assistance accounts. We found that (1) AID's budget requests did not contain complete data on sources of funds available for Revolving Fund operations and (2) Fund cash-flow projections indicated that less money would be needed than AID asked for in its budget requests.

Budget Estimates

According to AID's fiscal year 1988 Congressional Presentation, additional appropriations are needed for the Fund in the near term because (1) the Fund lost $10.5 million in potential earnings as a result of a Treasury Department determination that appropriations, prior to being obligated as loans, could not be invested in U.S. securities and (2) disbursements of Fund loans have lagged obligations, which in effect reduced reflows and funds available for new lending. AID stated in the Congressional Presentation that an annual lending program of $15 to $20 million is necessary to achieve the Fund's goals.

Our analyses of AID's budget requests raised several questions about the accuracy and completeness of the budget data. For example, the fiscal year 1988 Congressional Presentation estimate of $10.5 million in lost potential earnings lacked supporting analysis or justification, and our subsequent discussions with Fund staff indicated that this estimate may have been overstated by as much as $4 million. Also, the Congressional Presentation did not identify all actual/potential sources of funds available for Revolving Fund operations, such as non-Revolving Fund program deobligations. AID documents indicate that the Revolving Fund received $3.5 million in such funds through fiscal year 1987, and Fund cash-flow projections available when we began our review indicated that an additional $2.5 million in non-Fund deobligations would be available in fiscal year 1988.

Our comparison of Fund cash-flow projections with AID's budget requests raised additional questions about whether the data used was adequate for estimating the Fund's needs for additional appropriations. For example, projections available in July 1987 indicated that, excluding additional transfers of new funds, as much as $14 million would be available from prior year appropriations and other sources for operations in fiscal year 1988. Those estimates indicated that only $1 to $6 million in additional funds would be needed for new loan obligations of $15 to $20 million, instead of the $12 million AID had requested for fiscal year 1988. Fund staff said, however, that the July 1987 projections should be considered as only preliminary. They said that revised cash-flow projections would be developed based on updated project information and an improved methodology.

Revised Cash-Flow Projections

Projections made available to us in late September 1987, indicated that, excluding any additional transfer of new funds, approximately $12.275 million in total funds would be available in fiscal year 1988. This estimated amount was approximately $4 million short of the Fund's target of $16 million in fiscal year 1988 obligations.

While the projections indicated that additional appropriations might be needed for fiscal year 1989 and beyond, the levels were uncertain because of several apparent flaws in projection methodology. The flaws included (1) carrying forward negative cash balances (the differences between funds available and desired levels of new obligations), which we felt significantly distorted estimates of funds available annually, and (2) projecting interest and fee reflows at the same general level each year. With increases in loans outstanding, there should be a concomitant increase in repayments.

In early December 1987, AID provided us with revised cash-flow projections which eliminated the apparent flaws in methodology for fiscal year 1989 and beyond estimates. Those projections are shown in table 2.1.

Table 2.1: Cash-Flow Projections Assuming No Additional Transfer of New Funds in Fiscal Year 1988 and Beyond

Dollars in thousands

	Fiscal year							
	1984	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**
Balance carried forward	0	$2,500	$89	$917	$4,154	$95	$69	$168
Reflows:								
Principal	0	0	27	1,919	1,823	6,562	10,436	15,423
Interest	0	56	279	1,205	1,141	1,736	1,969	1,764
Fees	0	33	76	72	100	100	100	100
Subtotal of reflows	**0**	**89**	**382**	**3,196**	**3,064**	**8,399**	**12,505**	**17,287**
New funds transferred	14,500	16,000	14,000	13,000	0	0	0	0
Interest from invested funds	0	0	1	53	318	228	300	414
Deobligations:								
Revolving funds	0	0	1,000	0	2,000	1,000	1,000	1,000
Non-revolving funds	0	0	1,000	2,500	0	0	0	0
Total inflows	**14,500**	**18,589**	**16,472**	**19,666**	**9,537**	**9,722**	**13,874**	**18,869**
Write-offs[a]	0	0	155	412	441	652	706	343
Net available funds	**14,500**	**18,589**	**16,317**	**19,254**	**9,095**	**9,069**	**13,168**	**18,526**
New obligations:								
Prior year funds	0	0	2,000	2,500	2,000	1,000	1,000	1,000
Current year funds	12,000	18,500	13,400	12,600	7,000	8,000	12,000	17,500
Ending balance	$2,500	$89	$917	$4,154	$95	$69	$168	$26

[a]At a 5-percent level.

Source: AID Revolving Fund—some numbers do not total due to computer rounding.

The projections in table 2.1 indicated that, excluding the additional transfer of new funds, approximately $9 million in funds will be available for operations in fiscal year 1988. The funds projected to be available in fiscal years 1989 and 1990, without additional transfers, total about $9 million and $13 million, respectively. AID's projections also indicate that in fiscal year 1990, reflows of loan principal and interest are expected to reach $12.4 million. AID's fiscal year 1988 Congressional Presentation stated reflow levels in the $10 to $20 million range would permit a meaningful scale of operation on a self-sustaining basis.

Appropriations Received in Fiscal Year 1988

For fiscal year 1988, the Congress authorized (1) appropriations not to exceed $9 million, as transferred from AID development assistance accounts, and (2) obligations for new lending not to exceed $12 million. In its comments on a draft of this report, AID stated it plans to transfer no more than $4.5 million in fiscal year 1988 funds to the Revolving Fund, and as of May 3, 1988, had transferred $3 million. AID has also revised its deobligation plans which indicate $4 million instead of $2 million will be deobligated in fiscal year 1988.

Table 2.2 indicates the amount of funds that would be available for lending through fiscal year 1989, assuming that (1) no more than $4.5 million is transferred by AID to the Fund in fiscal year 1988 and (2) an option based on no additional transfers for fiscal year 1989 and an option based on AID's request for fiscal year 1989 appropriations ($8.5 million for loans and direct guarantee reserves and $500,000 for investment studies and grants to strengthen borrowers institutional capabilities).

Table 2.2: Estimated Funds Available Through Fiscal Year 1989 Including the Transfer of New Funds Authorized in Fiscal Year 1988

Dollars in millions

Fiscal Year 1988		Funds
Balance carried forward from prior year		$4.15
Reflows of principal, interest, and fees		3.06
Interest from invested funds		.32
New funds transferred		4.50
Deobligations (Revolving Fund projects)		4.00
Subtotal:		**$16.03**
Less: writeoffs[a]		.25
Net available funds		**$15.78**
Obligation authority		$12.00
Fiscal Year 1989	**No additional appropriation**	**Appropriation request**
Balance to carry forward from fiscal year 1988	$3.78	$3.78
Reflows of principal, interest, and fees	8.40	8.40
Interest from invested funds	.23	.23
Deobligations (Revolving Fund projects)	1.00	1.00
Subtotal:	**$13.41**	**$13.41**
Less: writeoffs[a]	.30	.30
Subtotal:	**$13.11**	**$13.11**
New funds transferred (loan and guarantee)	0	8.50
Net available funds	**$13.11**	**$21.61**

[a]At 2 percent.

The appropriation request for fiscal year 1989 also includes justification for initiating a direct loan guarantee program. Under either scenario for fiscal year 1989, the Revolving Fund would have between $1.1 million and $9.6 million more available than the fiscal year 1988 obligation authority of $12 million authorized by the Congress.

Conclusions

Our analysis indicates that (1) the Revolving Fund will have sufficient funds for operations in fiscal year 1988 and (2) AID's estimates of its appropriations requirements for fiscal year 1989 may be overstated by as much as $9.6 million, assuming the Fund operates with a $12 million obligation authority.

Agency Comments and Our Evaluation

AID believed that our initial estimates of fund availability for fiscal years 1988 and 1989, which assumed the full appropriation of $9 million would be transferred in fiscal year 1988, were overstated. AID told us that to date it had transferred $3 million to the Fund and subsequent to our review, decided to provide no more than $4.5 million for Fund operations in fiscal year 1988. AID also said that it has revised its plans, which now call for the deobligation of $4 million in projects instead of $2 million in fiscal year 1988, and has adopted a policy of not considering reflows as funds available until the fiscal year following receipt. We changed our estimates of funds available based on AID's latest revision to its data.

AID believed its policy on annual reflows, which it stated was made in view of the uncertainty of reflows and Anti-Deficiency Act concerns, clearly demonstrated the need for a fiscal year 1989 appropriation of $8.5 million. We disagree because AID's reflow policy ignores the $8.4 million in reflows projected to be received in fiscal year 1989. We believe that to the extent reflows are actually received, they should be made available at that time for obligation. AID needs to adopt a more flexible policy over reflow use—one that avoids any legal concerns raised by the Anti-Deficiency Act, which prohibits the overobligation of funds, and at the same time minimizes the need for additional appropriations.

Financial Management and Monitoring Issues

Our review indicated that improvements were needed in Fund financial management and that there are limitations in Fund project management and monitoring capability. AID has taken steps to improve its financial controls and is currently considering options for strengthening management and monitoring capacity. An April 1988 internal AID assessment has suggested that a substantial reorganization of the Fund is needed, with greater responsibilities for operations to be placed in the Agency's regional bureaus and overseas missions.

Financial Statements

We found that AID had not prepared complete annual financial statements on Fund operations. The Fund was using copies of Treasury reports (e.g., form 220s) as its annual financial statements for the Revolving Fund. However, the forms did not fully meet the reporting standards prescribed in the Fund's Operational Procedures, and the data had not been audited to verify its accuracy. After we briefed Fund management, they hired a consultant to develop financial statements on Fund operations as of September 30, 1987.

The statements reflect Agency records of actual cash receipts and disbursements and are designed to convey the annual financial status of the Fund in a traditional, commercial-type presentation. In preparing the annual reports, AID's consultant found that the Treasury forms contained approximately $2.245 million in key punch errors, which affected the Fund's cash balance, investment, and total asset accounts. These errors have since been corrected on the financial statements, and AID believes that the statements represent an accurate financial picture of the Fund's operations at the end of fiscal year 1987.

Reflow Investments

The reflow of principal, interest, and fees from Revolving Fund loans are invested in U.S. government securities and are available for further lending. We found that (1) reflow log-in procedures used by AID's Office of Financial Management had delayed the Fund's purchase of government securities and (2) reflow cash-balance criteria had not been established to trigger the purchase of securities. This practice resulted in lost earnings.

Revolving Fund management has worked with AID's Office of Financial Management to address these problems, and has made improvements such as (1) requiring all reflow payments to be electronically transferred directly into Treasury accounts and (2) automatically investing cash balances reaching a level of $10,000. Through fiscal year 1987, the Fund had approximately $3.6 million in reflows invested.

Loan Disbursements

As of September 30, 1987, Fund loan obligations totaled approximately $60 million, compared to disbursements of about $20 million, or a disbursement/obligation ratio of about 34 percent. According to analysis by the Fund's financial consultant, the delay in loan drawdown appears to be largely due to (1) the complexity of the Fund's loan procedures and (2) the fact that some of the project agreements are not signed until much later than the bank loan agreements. Loan agreements typically set forth, among other matters, obligations and understandings between AID and a U.S. bank concerning the issuance of letters of credit to the participating local bank. The project agreement covers, among other matters, the circumstances under which the local bank may apply for a letter of credit.

We noted in our review that the complexities of the loan guarantee procedure appear to contribute to delays in disbursements. However, numerous other factors unique to each project (e.g., local management capability) appeared to have a critical impact on the rate of loan drawdowns. The delays in disbursement have reduced the levels of loan reflows, increasing the need for additional appropriations in the initial years of Fund operations.

AID's consultant believed the Fund could improve drawdown performance if more emphasis were placed on expediting the project agreement process. The consultant also suggested that the program officers be required to prepare periodic reports on their respective loans to explain, among other things, the delays in loan drawdown and planned/actual actions to expedite drawdowns.

Project Oversight

We found AID has limited oversight of Revolving Fund projects due to (1) the physical difficulties of effectively monitoring projects in developing countries using U.S.-based staff and (2) the reluctance of certain field missions to assume responsibilities for programs funded with other than mission funds (centrally funded). The limitations in monitoring appeared to be part of a problem within AID of coordinating centrally funded programs with mission activities.

Because of these limitations, AID could not effectively oversee project implementation to determine whether local IFIs were properly managing

Fund-supported loans or whether the loans are being made to recipients who might otherwise obtain comparable financing from commercial sources. In some cases, we identified lending activity and decisions by local project investors which appeared contrary to project objectives.

The AID mission in the Philippines had little role in monitoring Fund projects, and no project files or records were maintained. As a result, mission staff responsible for private-sector programs were unable to fully respond to questions concerning the impact of Fund projects. We believe that this limited knowledge was inconsistent with the mission's responsibilities for (1) maintaining a continuous dialogue with the host government on development issues and (2) being informed on all U.S. foreign assistance activities. An October 1987 internal assessment of mission controls showed that the problem is not unique to the Revolving Fund, noting that over 100 centrally funded projects were operating in the Philippines. The assessment indicated that (1) many of the centrally funded projects were not adequately coordinated with the mission by AID/Washington and (2) some centrally funded projects were probably operating in the country without the mission's knowledge.

Also in the Philippines, AID had agreed with one of the local banks not to let sub-borrowers know that the U.S. government was backing a portion of the loan against default. This arrangement, although primarily designed to reduce the likelihood of sub-borrower default, also precluded follow-up with sub-borrowers to accurately determine (1) why the services of the Fund-sponsored program were financially attractive and (2) whether the Fund provided a service not otherwise readily available. We also found that because the Revolving Fund program is centrally funded, the AID mission in Indonesia had only limited knowledge of a Fund bank project.

In Thailand, we also found evidence of monitoring limitations. For example, a shareholder in a $21.5 million meat processing plant—which includes a direct Fund loan, not to exceed $2.5 million, to encourage the procurement of cattle and other animals from SMSE suppliers—had imported several hundred breeding bulls without the knowledge of either the AID mission or Fund management. The import of the cattle appeared to contradict a major project goal of encouraging procurement from Thai SMSE suppliers. AID officials, while agreeing that such activities indicated limitations in Fund monitoring capability, noted that the imports may eventually be sold to other breeders or cross bred to produce high-quality beef. They stated that a contract employee was recently hired to help monitor Fund programs and coordinate activities with mission private-sector projects.

Although AID-contracted evaluations have not specifically focused on the issue of project monitoring, recent evaluations of Fund projects have identified some program monitoring issues. For example, a November 1987 draft evaluation report noted that in Ecuador some of the operational details of the projects were not sufficiently monitored, contributing to underutilization of the loan guarantee. Evaluation officials said that they have been contracted by AID to develop a standardized project monitoring system for the Fund which will (1) improve control over key project financial activities, such as loan fee billings and payments, and (2) provide more comprehensive data on project beneficiaries. They also said that although such systems will represent improvement, the physical demands for monitoring/managing projects have increased significantly for Fund program staff. They believe the need for more effective monitoring has become apparent as the Fund's program changed from its initial emphasis on designing projects and obligating funds to ensuring that projects are successfully implemented.

Staff Limitations

AID has three program officers based in Washington, D.C., to manage and monitor Fund field projects. Each program officer is responsible for one of three geographic regions—Asia/Near East, Latin America/the Caribbean, and Africa. The Fund's projects have had a geographic concentration in Asia, and at the end of fiscal year 1987, the program officer responsible for that region had management responsibilities for over 10 active projects. AID officials told us that the Fund staff have had great difficulty in managing/monitoring the existing Fund portfolio. They believed that additional staff resources would be needed to effectively manage a direct guarantee program.

Although Fund program officers have received requests for projects from several overseas missions, the demand for Fund services has not been clearly established because the Fund has not systematically (1) notified AID's overseas missions of the services available or (2) obtained feedback on the program areas which the missions have an interest in. Fund staff said that they have not conducted a comprehensive survey of the missions because of concerns that the Fund could not meet significantly larger demands with its current resources.

Conclusions

AID has improved the financial management of Revolving Fund operations by preparing annual financial statements and by strengthening the procedures for investment of loan reflows. We believe, however, that because significant data errors were found in preparing the financial statements as of September 30, 1987, audited financial statements will be necessary to ensure the integrity of future annual reports. Also, in order for the Fund to operate more effectively, AID needs to plan Fund operations with an objective of improving its loan disbursement/obligation ratio, which was only about one-third at the end of fiscal year 1987.

We believe that AID should not significantly expand Fund operations until the Agency's capacity to monitor and manage field-projects is strengthened. Basic issues need to be addressed by AID concerning the level of staff required to manage and monitor Fund projects. If additional Fund staff is not a practical option, monitoring policy should require the direct involvement and support of AID's field missions in project oversight and management.

Recommendations

We recommend that the AID Administrator provide sufficient resources for strengthening the management and monitoring of Revolving Fund projects by adding Fund staff and/or increasing the direct involvement of its field missions in project management. We also recommend that the AID Administrator provide for annual audited Revolving Fund financial statements.

Agency Comments and Our Evaluation

AID believed that the Fund's disbursement/obligation ratio at the end of fiscal year 1987 inaccurately portrayed the magnitude of the problem because the Fund's entire 1987 portfolio had been obligated on that date, with relatively few disbursements taking place. AID agreed, however, that the time frame for disbursing obligated funds needs to be reduced. AID said it had assembled an implementation team to accelerate the process of readying projects for disbursements and is exploring ways to shorten this time lag.

AID said it plans to strengthen the Fund's capacity to manage and monitor projects by more closely linking the Fund to overseas mission programming and by increasing the use of contract support staff in selected missions. AID also stated that it recognizes additional resources would be required for the operation of the proposed direct guarantee program.

During the time a draft of this report was with AID for comment, AID completed an internal management assessment of the Bureau for Private Enterprise (PRE), which is responsible for Fund operations. The assessment raised concerns similar to ours about the capability of the Fund to manage and monitor an expanded program of direct guarantees, concluding that PRE will not be in a position to develop and monitor an expanded Fund program principally because of limitations in program staff and the lack of participation by AID's regional bureaus and missions in Fund activities. The assessment report suggested that (1) the Fund's operations be placed under the direction of a board comprised of the Assistant Administrators of AID's regional bureaus and PRE, (2) the board determine the annual allocations required for the Fund, and (3) AID's missions assume primary responsibility for day-to-day implementation of Fund projects. As of May 3, 1988, AID had not decided what actions, if any, it would take on the suggestions.

Risk and Collateral Policy Issues

AID has designed its loan guarantees to encourage banks and other financial institutions in developing countries to lend to small businesses and cooperatives in what are considered higher-risk markets. Our analysis of Fund projects in Indonesia, Thailand, and the Philippines indicated, however, that the level of risk taking by local banks was low even with AID guaranteeing up to 50 percent of the risk of loan default. We believe this occurred primarily because the Fund project agreements did not require that participating banks change their policies of requiring that small businesses have substantial collateral to cover the risk of loan default. Fund project designs in the Asian countries we visited typically defined risk in terms of potential losses; at the time of our fieldwork, the banks in Thailand and Indonesia had no losses. Losses in the Philippines' project having significant levels of sub-loan activity were about 4 percent; however, these losses were associated with only one sub-borrower.

We recognize that a risk-averse posture that was silent on such fundamental issues as sub-borrower collateral may have been prudent in beginning the program in order to build the Fund with cash inflows. However, if the Fund is to achieve its goal of promoting innovative programs, higher risk efforts may be required, to include (1) placing a ceiling on participating banks' collateral requirements as a condition for an AID guarantee against losses; (2) encouraging local bank lending based on projected project performance and cash flows, instead of collateral-based lending; and (3) defining, as part of an overall risk policy, what loss rates are necessary and/or acceptable for achieving Fund goals. We recognize, however, that if the Fund is to become self-sufficient, the risk of losses cannot exceed interest and other revenues.

It is important that as a part of an overall risk policy, AID establish creditable loss reserve accounts for the Fund. At the time of our review, risk had been addressed only on a project-by-project basis and we found that the Fund had not followed its operational procedures, which call for classifying projects into categories of risk and establishing a reserve based on that classification. Although AID recently established a 2-percent reserve for losses based on the Fund's limited loss experience to date, it is unclear whether that level will be sufficient to cover future losses, particularly if AID decides to pursue a more aggressive risk posture as part of its innovative programming.

Collateral Requirements of Local Banks

In Thailand, Indonesia, and the Philippines, we found that the local banks' collateral requirements were often in excess of 150 percent of the sub-loan value, in addition to the Fund guaranteeing up to 50 percent of the loan principal in the event of a sub-loan default. For example, the collateral requirements for 30 sub-borrowers in one of the Fund's Indonesian projects ranged from a low of 31 percent of the subloan to a high of 1,129 percent, with an average value of 164 percent of the sub-loan. The median collateral requirement for the 30 sub-loans was 200 percent.

The significant collateral requirements have adversely affected the Indonesian project's achievement of the Fund's stated goal of encouraging substantial risk-taking by the participating bank. The difficulties in encouraging risk-taking were noted in a 1987 mission analysis of the initial sub-borrowers participating in the Indonesian project. That analysis concluded that the typical lending officer at the participating bank, or any other strong commercial bank, is reluctant to make a marginal loan, even with a 50-percent guarantee of the risk. Any loss/default would be considered a discredit to the loan officer's professional capability.

In our follow-up discussions with officers of the Indonesian bank, they indicated that the Fund encouraged them to take somewhat greater risks by (1) lowering their collateral requirements for certain loans, enabling borrowers to obtain larger loans; (2) providing loans for longer periods; and (3) assuming the higher operational costs associated with screening numerous SMSE loans. Although such changes in bank lending practices are important and a direct benefit of the Fund program, the maintenance of high collateral requirements for sub-loans made it difficult for other than established businesses to acquire credit. For example, the mission analysis of initial bank loans concluded that the Indonesian bank had simply attracted or drawn clients from another bank. Our analysis of the complete loan portfolio indicated that over 80 percent of the clients had a prior credit history with banks.

Thailand Project

The Fund's bank project in Thailand has helped the participating bank to accelerate its branch expansion program into rural areas, with a concurrent focus on providing loans to small businesses. However, we found that the Thailand project resulted in low risk-taking because the participating bank continued the general Thai banking policy of requiring substantial collateral for loans. Loan and collateral information was made available to us on 53 sub-loans. Collateral requirements ranged from a low of 27 percent of the loan to a high of 1,028 percent. The average collateral provided by borrowers was 123 percent and the median was

168 percent. About one-third of the sub-borrowers provided collateral in excess of 200 percent of the value of the loan, a level that a draft AID-contracted evaluation report has suggested would have been eligible for a loan from the bank without a guarantee. In our discussions with Thai bank officials, they did not give a specific collateral/loan ratio that triggered the need for a guarantee; but they indicated that the lower the ratio, the greater the need for a loan guarantee program.

Collateral Issue Addressed in Thailand Mission Follow-On Project

An additional benefit of the Revolving Fund bank project in Thailand has been to encourage the AID mission to use a guarantee instrument in designing its rural industries and employment project. Mission documents indicate that a key element of the project's design will be to encourage a reduction in participating bank collateral requirements, which would presumably encourage the participating banks to adopt some form of project cash-flow and operating income lending criteria as an alternative to the traditional collateral-based lending. Mission officials believe that if lower collateral policies are adopted by participating Thai banks, the access to credit of small businesses would be significantly increased, particularly in the rural sectors of Thailand.

The major component of the project will be a credit guarantee fund managed by the Industrial Finance Corporation of Thailand. Project documents indicate the mission will provide $8.3 million for the guarantee program and the Corporation will be encouraged to adopt policies requiring that participating banks will have to limit the collateral coverage for loans to one-half of what is typically required. The mission also predicts that a new customer base will be reached through such collateral policies, noting that while the Fund's project achieved success by moving one Thai bank into a new area of lending, the type of businesses reached were already served by larger Thai banks under the same terms. The mission also predicts higher risk of losses than the current Revolving Fund loss reserve of 2 percent; a minimum loan default rate of 4 percent is predicted as businesses without strong collateral positions receive loans.

In addressing collateral requirements and the experiences of other guarantee credit programs, the mission project design noted that inadequate collateral among borrowers is one of the most frequently cited barriers to small business credit in developing countries. The project design observed that even though most guarantee programs recognize lack of collateral as the principal rationale for the partial assumption of risk, such programs, including the Revolving Fund, generally have not imposed a ceiling on the borrower collateral required as a condition of eligibility. We believe that the Revolving Fund should consider the options for such ceilings in its program as part of an overall strategy to encourage lending that will reach small businesses without strong collateral positions.

Other Analyses of Collateral and Risk Issues

AID-contracted evaluations of Revolving Fund projects have not focused on the collateral and risk issues; however, the issues have surfaced in certain project evaluations. For example, an April 1987 draft report noted the apparent disadvantages of using local banks as intermediate institutions because of their collateral policies. The draft report also stated that while there is no simple answer to the issue of risk, a key policy decision is to define the amount of risk and failures that are acceptable from an operational perspective. We discussed the risk and collateral issues with the AID contractors. They added that the Revolving Fund not only needs to define risk in terms of what losses are operationally acceptable, but also in terms of what losses may be necessary to obtain development objectives.

AID officials also provided us a recent World Bank technical paper which, based on assessments of programs in 27 developed and developing countries, concluded that loan guarantees tend to work best when they support loans given to creditworthy clients unable to obtain loans because of the lenders' requirements for collateral. The paper noted that in developing countries, a major problem faced by guarantee schemes is how to encourage commercial banks to participate in the program and to be less risk-averse in lending to small businesses. In discussing loan loss rates, the technical paper indicates that losses should be, to some degree, a function of guarantee program policy—namely, how far to extend the risk frontier to achieve desired goals. The Revolving Fund has not addressed the issue of risk from this perspective.

Project Impact and Additionality

In our analyses of projects in Thailand, Indonesia, and the Philippines, we found several positive indicators of the program's impact. For example, it appears that Fund projects had encouraged local banks to expand lending to small businesses, often in rural areas, and to extend credit, in some instances, for longer terms than usual.

Despite these positive indications, we were unable to determine conclusively how much support and services the Revolving Fund provided that would not otherwise be available. In addition to the issue of local bank collateral requirements, information available on the results of projects in those three countries raised some questions about the extent to which bank loans were reaching small businesses that did not already have access to commercial credit. For example, an AID mission analysis of the initial beneficiaries in a Fund bank project in Indonesia concluded that the participating bank probably would have extended some of the loans in the absence of the Fund program, because many of the recipients were, or were subsidiaries of, well-established companies which had been doing business with other banks. A mission analysis in Thailand concluded that while the Fund's bank project achieved success by moving one bank into a new area of lending, the type of businesses served by the project were already serviced by larger Thai banks under the same loan terms.

Conclusions

AID needs to establish an overall risk policy for the Fund that defines the balance sought between the credit worthiness of individual projects and AID's developmental goals. As part of the policy, AID needs to address the collateral requirements placed on sub-borrowers by local banks in developing countries—maximum collateral ceilings should be adopted as a condition for Fund loans/guarantees. We believe collateral ceilings would help encourage local lending to small business enterprises that do not have strong collateral positions or easy access to commercial credit.

Recommendations

We recommend that the AID Administrator establish a Fund policy on maximum collateral requirements of local banks. The policy should (1) establish a ceiling on banks' collateral requirements as a condition for Fund loans/guarantees; (2) identify options for encouraging bank lending based on project performance and cash flow, instead of collateral-based lending; and (3) define, as part of an overall policy of what constitutes acceptable risk, the loss-rates necessary and/or acceptable for balancing developmental goals and objectives of ensuring that revenue exceeds losses to retain Revolving Fund capital.

Agency Comments and Our Evaluation

AID agreed that a Fund risk policy is needed to clarify the balance needed between creditworthiness and development impact. AID believed that although risk has been assessed to date on a project-by-project basis, it now has the experience to codify an overall risk policy for the Revolving Fund. AID stated that collateral requirements will be one of the elements of its policy. AID said it will consider collateral requirements along with other elements of local bank risk, with an emphasis on encouraging banks to lend to a new class of creditworthy customers and to offer term-lending and cash-flow lending, thereby reducing collateral requirements.

Revolving Fund Projects

At the end of fiscal year 1987, AID had 30 Fund loan projects in 14 countries located in Asia/Near East, Latin America/the Caribbean, and Africa. The following is a general description of the purpose and status of these projects.

Asia/Near East

Regional

- Healthlink/PATH—A $2.5 million loan to create a credit pool through a private voluntary organization to encourage Thai and Indonesian investments in new or less expensive health products. The loan agreement was signed August 1984. As of January 1988, four sub-projects had been initiated; the Fund had disbursed $314,000 and planned to deobligate $2.186 million because of problems in identifying commercially viable health technologies.
- NovaGene Group Limited—A $2 million direct loan to a U.S.-based biotechnology research company for development of vaccines to control fatal swine diseases to be marketed in Asia. The loan agreement was signed September 1987; no disbursements had taken place as of January 1988.
- South Pacific Loan Guarantee Facility—A $1.75 million collateral loan guarantee through a U.S. bank, with a South Pacific branch, to encourage lending by affiliated local banks to SMSEs in 10 South Pacific countries. The bank is in the initial stages of preparing one sub-project and identifying additional sub-projects. The loan agreement was signed January 1988; no disbursement was made as of that date.

India

- Serum Institute of India—A $3 million direct loan project designed to help the Institute finance vaccine production. The loan agreement was signed September 1986; however, in October 1987, the government of India granted approval for only $1 million of the $3 million loan. The Fund plans to deobligate the remaining $2 million. As of February 1988, the loan was not disbursed.

Indonesia

- Bank Niaga—A $2 million collateral loan guarantee to encourage local bank lending to SMSE exporters. The loan agreement was signed August 1985 with a U.S. bank, and as of October 1987, the loan was fully disbursed. AID documents indicated the local bank had made 34 sub-loans t(small businesses.

- Overseas Express Bank—A $2.85 million loan guarantee to encourage lending to SMSEs in rural Indonesia. The loan agreement was signed August 1985. Because of management changes, the local bank has made no sub-loans. No disbursements were outstanding as of September 1987.

The Philippines

- Bank of Philippine Islands—A $2.4 million collateral loan guarantee to encourage local bank lending to SMSE agribusinesses. The loan agreement with a U.S. bank was signed September 1986. No disbursements were made as of January 1988. Delays in this project and the Metrobank and Philippine Commercial International Bank project were largely due to difficulties in obtaining approval of the Central Bank of the Philippines.
- Far East Bank and Trust—A $2 million collateral loan guarantee to encourage SMSE exports. The loan agreement was signed August 1985. As of March 1987, the loan was fully disbursed, and as of September 1987, the local bank had 35 active sub-loans. Over 100 sub-loans have been made since the start of the program.
- Metrobank—A $2.1 million collateral loan guarantee to encourage lending to rural SMSE agribusinesses. The loan agreement was signed September 1986. As of October 1987, the bank had identified seven potential sub-loans. The Fund disbursed $500,000 during November 1987.
- Philippine Commercial International Bank—A $2.4 million collateral loan guarantee to encourage local bank lending to rural SMSE agribusinesses. The loan agreement was signed September 1986, and as of October 1987, the bank had identified 18 potential sub-projects. During December 1987, the Fund disbursed $1 million.

Thailand

- Thai Danu Bank—A $2.35 million collateral loan guarantee to encourage local bank lending to small rural export businesses. The loan agreement was signed August 1985. The loan was fully disbursed as of September 1987, and the bank had made 76 sub-loans.
- Thai Venture Capital—A $3 million direct loan to establish a venture capital fund (Business Venture Promotion, LTD.) to encourage investments in projects utilizing U.S. agribusiness technology. The loan agreement was signed March 1987. As of November 1987, the loan was not disbursed. However, the Thai partners had made one investment from their own funds and were considering six additional investments.
- Thailand Livestock Meat Processing Company—A $2.5 million direct loan to co-finance a $21.5 million livestock meat processing facility to encourage procurement of beef and other meats from as many as 2,000 small-scale suppliers. The loan agreement was signed September 1984.

No disbursements were made as of November 1987, due largely to management problems that resulted in the re-execution of loan agreements to accommodate a change in plant investors/ownership.

Turkey

- Securitized Trade—A $2.4 million loan guarantee to a Turkish holding company to encourage lending to SMSE exporters. The loan agreement was signed January 1987, and by July 1987, Securitized Trade had made six sub-loans and was identifying additional projects. The loan is fully disbursed.

Latin America/ Caribbean

Regional

- Accion—A $1 million collateral loan guarantee to encourage local bank lending to micro-lending enterprises in Latin America and the Caribbean. The loan agreement was signed September 1985. As of November 1987, $400,000 had been disbursed for the project.
- Agribusiness Investment Corporation—A $2.5 million direct loan to provide venture capital for small agribusiness start-ups, to encourage small satellite farming investments in Latin America, the Caribbean, and Africa. The loan agreement was signed August 1985. Between October 1985 and February 1986, $146,000 was disbursed to the project. In February 1987, Agribusiness went into technical and financial default and remained in default, as of December 1987.
- Caribbean Basin Corporation—A $1.2 million direct loan to establish a venture capital fund to finance Caribbean SMSEs, predominately satellite farming. The loan agreement was signed September 1984. As of November 1987, the Fund had disbursed $261,250. A Corporation management reorganization delayed project implementation.

Antigua

- Antigua Shrimpery II—A $100,000 direct loan supplementing a previous non-Revolving Fund loan to a local bank financing construction of shrimp ponds. The loan agreement was signed September 1985, but the project is inactive. The Fund made no disbursements and planned to deobligate the loan at the time of our review.

Bolivia

- Union of Bolivian Banks—A $2 million collateral loan guarantee to encourage lending to SMSES producing or distributing agricultural or artisan products. The loan agreement was signed September 1986. Although there were no disbursements as of November 1987, the signing of the project agreement in October 1987 suggests that disbursements will occur in the near future.

Dominican Republic

- FINADE Development Bank—A $2 million collateral loan guarantee to encourage investment in nontraditional exports by SMSE growers/manufacturers. The loan agreement was signed April 1984. As of December 1987, the loan was fully disbursed and the bank had made 10 sub-loans.
- International Multifoods Revolving Credit Facility—A $1.2 million loan for an agribusiness sub-project. The loan agreement was signed September 1985. The sub-project failed, and as of December 1987, the Fund had a potential loss of $480,514. Documents indicate the Fund may deobligate $200,000.

Ecuador

- FINGUASA—A $1.4 million loan to form a pool of funds to encourage local bank lines of credit for small- and medium-sized agro-industrial businesses, including livestock and fisheries. The loan agreement was signed September 1984 and was fully disbursed as of September 1987. Finguasa has issued two letters of credit totaling $188,189, as of November 1987.
- FINIBER I—A $1.4 million collateral loan to form a pool of funds to encourage local bank lines of credit for small- and medium-sized agro-industrial businesses. The loan agreement was signed September 1984 and the loan was fully disbursed as of September 1987. As of August 1987, 42 letters of credit had been issued to 18 sub-borrowers.
- FINIBER II—A $1.5 million deposit/bond guarantee to encourage local bank lending to small- and medium-sized agricultural enterprises. The loan agreement was signed September 1986. As of January 1988, the Fund had made no disbursements because the depository bank had not yet been selected.

Guatemala

- Guatemala LGF—A $3 million collateral loan guarantee to encourage three Guatemalan banks to lend to SMSE artisans, farmers, agribusinesses, and industrial sectors engaged in nontraditional exports. The loan agreement was signed September 1987. The Fund had made no disbursements as of January 1988.

Africa

Regional

- EDESA, S.A. Holding—A $2 million collateral loan guarantee to encourage local bank lending to African SMSEs, with emphasis in agribusiness. The loan agreement was signed September 1986. As of November 1987, $1.5 million was disbursed. As of August 1987, EDESA had funded two sub-projects and was considering five additional sub-projects.
- Trident Foods Limited—A $2 million direct loan to Trident to establish a commercial fishing and tuna processing operation in Mauritius, using U.S. technology, for export products to Europe. The loan agreement was signed September 1987 and funds had not been disbursed as of January 1988.

Kenya

- Diamond Trust of Kenya—A $1 million collateral loan guarantee to encourage lending by a non-bank financial institution to SMSEs. The loan agreement was signed September 1987. No disbursements were made as of January 1988.

Morocco

- Societe Marocaine—A $2 million collateral loan guarantee to encourage lending to SMSE exporters. The loan agreement was signed September 1985. Because the guarantee proved to be too complicated, a redesign of the loan guarantee was completed January 1988. The Fund expected a signed project agreement by March 1988.
- Wafabank—A $2.5 million, short-term inventory credit facility to encourage local bank lending to SMSE exporters. The loan agreement was signed December 1984. As of September 1987, the loan had been fully disbursed. Wafabank had made 177 sub-loans to 54 businesses as of December 1987.

Comments From the Agency for International Development

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

ASSISTANT
ADMINISTRATOR

May 3, 1988

Mr. Frank C. Conahan
Assistant Comptroller General
United States General Accounting Office
441 G Street, N. W.
Room 4804
Washington, D. C. 20548

Dear Mr. Conahan:

Thank you for the opportunity to comment on the GAO's draft report entitled, "A.I.D.'s Private Sector Program: Issues Concerning Performance of Its Revolving Fund." I appreciate the time and attention the GAO staff spent reviewing the Revolving Fund. We found the report on the whole thorough, well-written and fair. The audit report reflected an appreciation of what the Revolving Fund is attempting to accomplish and also of the difficulties inherent in establishing a market-driven investment fund. We also appreciate the fact that the positive indicators of the program's impact were set forth in the report.

Our comments, attached as an annex to this letter, therefore, will be limited to four areas of concern discussed in the report: (1) funds available for operations; (2) the Agency's capacity to monitor and manage projects; (3) the pipeline of obligated but undisbursed loan funds; and (4) policy issues, particularly with respect to risk undertaken in the Revolving Fund.

Thank you again for this opportunity.

Sincerely,

Neal Peden
Assistant Administrator
Bureau for Private Enterprise

Clearance:
DAA/PRE:CRussell______
PRE/PR:MUnger_________
PRE/PD:RAnderson_______
GC/PRE:MKitay___________
AA/PPC:RBissell_______
PPC/PDPR:NZank _______
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Drafter:PRE/I:JHardy:gjw:647-9842:0020h

ANNEX

FUNDS AVAILABLE FOR OPERATIONS

The GAO finding that $18 million will be available for Revolving Fund operations in FY 1988 is inaccurate because it is based upon incomplete information. Since the auditor's review, new information about appropriation and deobligation levels has become available. Furthermore, this figure is inaccurate because of a risky and inappropriate treatment of current year reflows. First of all, as the auditor indicated in the report, the GAO arrived at the $18 million figure on the assumption that the maximum level of appropriations which were authorized by Congress for the Revolving Fund in FY 1988 would indeed be transferred in the the account. This, however, is not the case. Although Congress appropriated "not to exceed" $9 million in transfer authority for the Revolving Fund, A.I.D. to date has transferred $3 million and will in fact transfer no more than $4.5 million into the account. Finally, the project deobligations which also affect funds available for FY 1988 have also been revised from $2 to 4 million.

In addition to the above modifications, we believe that "current year reflows" should not be considered "net available funds" until the fiscal year following that in which they are received. This argument is made on advice of counsel in light of the uncertainty of reflows and consequential Anti-Deficiency Act problems. From a management prospective, this approach is also the most prudent as it enables Fund staff to know the resources actually available for investment rather than being forced to rely on projected reflows.

Based on the above adjustments, AID has reconstructed the estimated Funds Available as follows:

Fiscal Year 1988	($ Millions)	
	GAO	A.I.D.
Balance carried forward	$4.15	$4.15
Current reflows	3.06	--
Interest on inv. funds	.32	.32
Appropriation	9.00	3.00
Deobligations	2.00	4.00
	$18.53	$11.47
Less: writeoffs	(.25)	(.25)
Net available funds	18.28	11.22
Obligation authority	12.00	12.00
Ending balance	$6.28	0

-2-

Fiscal Year 1989

	GAO	AID
Balance forward	$6.28	$3.06*
Current reflows	8.40	--
Interest from Inv. funds	.23	.23
Deobligations	1.00	1.00
Subtotal	15.91	4.29
Appropriation	8.50	8.50
Net available funds	24.41	12.79
Obligated Authority**	12.00	12.00
Ending balance	$12.41	$ .79

* Current year reflows from prior year

** Assume straight-line from FY 1988

We, therefore, are convinced that considering the funds that will be actualized by the Revolving Fund in FY 1989, and the legally appropriate way to handle current reflows, there is a clear need for an FY 1989 appropriation of the $8.5 million requested.

THE AGENCY'S CAPACITY TO MONITOR AND MANAGE PROJECT

In addition to management improvements already undertaken and noted in the audit report, PRE is considering how Fund operations can be further refined in light of receiving the proposed guarantee authority. The guarantee authority would enable the Fund to operate at approximately four times its present size. This program expansion would, of course, require an increase in internal and/or external staff. Senior agency management has assured the Revolving Fund managers that it supports the larger guarantee program and that the necessary steps will be taken to ensure that PRE has the resources with which to manage and monitor projects in a prudent, professional manner. Thus, while detailed decisions regarding additional program staff and contract support have not yet been made, the Agency is committed to supporting this enhanced authority.

-3-

A second means by which PRE seeks to strengthen its capacity to monitor and manage projects is by linking Revolving Fund projects more closely to Mission financial markets strategies. Building upon the increased coordination that Fund management has initiated with the field Missions (with the result that of the seven Revolving Fund projects developed in FY 1987, five were co-designed and three co-financed with the Missions), PRE now proposes to even more closely link the Fund to the Missions by recasting the Fund as a source of both expertise and resources for the Missions. Under this new approach, Fund management would utilize the Fund as a mechanism and resource to assist the Missions in developing and implementing financial markets strategies. In so doing, the Fund will garner support now lacking from some Missions and will more readily enlist Mission participation in managing and monitoring Fund projects in the field.

To further assist Missions in monitoring Fund projects, PRE is also proposing to increase the level of contract support in selected Missions. The Fund has two Personal Service Contractors in place in Asia and we anticipate expanding that number to five to better assist the Missions with local implementation of Revolving Fund projects.

PIPELINE OF OBLIGATED BUT UNDISBURSED LOANS

The GAO auditor relied upon a disbursement/obligation level which inaccurately portrays the magnitude of obligated but undisbursed loans for the Revolving Fund except on the date chosen (September 30, 1987). This is a result of the fact that on that date, the year end for the Revolving Fund, 100% of the 1987 portfolio had been obligated but very few disbursements under those loans had been made. The actual disbursement figures are substantially better at this time. The overall portfolio will be 43% disbursed by the end of April and A.I.D. expects the portfolio to be 50% disbursed by the end of May.

Nevertheless, we agree with the auditor that the time frame for disbursing obligated funds needs to be reduced. We have assembled an implementation team to accelerate the process of readying projects for disbursement and are exploring ways of shortening this time lag.

POLICY ISSUES, PARTICULARLY WITH RESPECT TO RISK

In light of the auditor's recommendations, Fund management has determined that an explicit overall policy on risk for the Revolving Fund will be helpful and is in the process of developing such a policy. Until now, risk has been assessed on a project-by-project basis. At this point, with a four year old fund, management believes that it now has an experience

-4-

base with which to codify an overall risk policy for the Revolving Fund. The Agency's soon-to-be issued Policy Paper on Financial Markets Development will be the basis for an internal Revolving Fund policy.

Collateral requirements are one of the elements that will be addressed in this policy. However, in our continuing effort for fund projects to have an institutional impact on local financing institutions, we realize that collateral is but one of the elements in the way a bank does business that we are trying to affect. The Fund must first encourage a local bank to consider entering developmentally desirable markets which will prove to be profitable. Secondly, we encourage banks to offer term lending and cash-flow lending, thereby reducing collateral requirements.

In a discussion of risk and collateral requirements, we think that it is important to point out that even a bank in the sophisticated United States financial environment does not consider a fully collateralized loan risk-free and this is certainly the case in the developing world. Banks are not in the business of collecting loans against collateral and in fact consider that a loan has "gone bad" that has reached that point.

Lending institutions are interested in making credit available to enterprises which will repay on a timely basis. We believe our role is to expand the horizons of these lending institutions and demonstrate to them that new classes of borrowers are creditworthy. Additionally, missions will not seek to replicate a "failed" process; thus the Revolving Fund mandate would be diminished. If we force banks into unprofitable lending, we will have failed in our mission. Nevertheless, we agree that a formal risk policy will clarify the balance to be struck between credit worthiness and development impact.

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