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KENYA PROGRAM GRANT COULD HAVE BEEN MORE EFFECTIVE

Audit Report No. 3-615-85-1
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EXECUTIVE SUMMARY

Introduction

In August 1982 the Government of Kenya (GOK) requested $11 million in emergency balance of payments assistance to partially meet additional import requirements totalling $131 million. Assistance was also requested of other donors. The request cited substantial damage to property associated with an attempted coup d'etat on August 1, 1982 and other economic difficulties as justification for the special request.

A $10.7 million program grant agreement was signed on September 29, 1982. The purposes of the grant were to help the GOK to meet immediate balance of payments requirements and to support its economic adjustment program. The equivalent of Kenya shillings $5.6 million was to be deposited in a special account with the pay master general to be used for development programs. The remaining funds, the Kenya shillings equivalent of $5.1 million were to be used for a discount facility within the Central Bank of Kenya to make funds available to commercial banks for short-term loans to businesses which suffered losses during the looting of August 1, 1982.

Purpose

The purposes of our audit were to determine whether (a) AID-provided resources were used in accordance with agreements, applicable laws and AID regulations; (b) the program was meeting its objectives as stated in program documentation; and (c) USAID/Kenya was adequately monitoring the project.

Findings, Conclusions and Recommendations

While the dollars provided balance of payment support, the use of local currency funds programmed for establishment of a discount facility to provide short-term loans to businesses which suffered losses as a result of the attempted coup d'etat has not been satisfactory. After approximately two years, only 25 percent of the funds allocated for the discount facility have been loaned to affected businesses. This has resulted, in large part, because commercial banks were unwilling to take 100 percent of the risk when making loans to the affected businesses which they considered either to be a credit risk or to lack sufficient collateral. Also the grant agreement is silent on what to do with the unused funds as well as the principal and interest on loans which have been repaid and returned to the Central Bank.

At this late stage in the program, the funds are no longer needed for the original purpose. Most of the businesses have recovered through other sources of financial assistance or are no longer in business. Accordingly, we believe that USAID/Kenya should develop alternative uses for the unutilized funds as well as for those funds which will be returned to the Central Bank when loans are repaid.

Audit findings were discussed with USAID/Kenya, and a draft audit report was provided for their written comments. We have included their comments in the report as considered necessary.

BACKGROUND

In August 1982 the GOK requested $10 million in emergency balance of payments assistance to partially meet additional import requirements totalling $130 million. Assistance was also requested from other donors. The request cited substantial damage to property associated with an attempted coup d'etat (coup) on August 1, 1982 and other economic difficulties as justification for the special request. A total of 800 businesses suffered losses from looting valued at over $30 million.

A $10.7 million program grant agreement was signed on September 29, 1982. The purposes of the grant were to assist the GOK to meet immediate balance of payments requirements and to support its economic adjustment program. Within 60 days from the date of disbursement, the Kenya shilling equivalent of the dollars generated by the grant were to be placed in a special account. These funds were to be used to finance the local currency cost of the GOK's development programs and to provide local businesses assistance to recover from the losses suffered in the disturbances of August 1, 1982.

Specifically, the GOK was to provide the USAID within 60 days from date of disbursement a list of development programs which it proposed to support. Amendment No. 1 revised this date to July 1, 1983. Also, not less than the equivalent of about $5.1 million of local currencies deposited in the special account were to be made available to the Central Bank of Kenya for a discount facility for local commercial banks. The banks were to provide short-term loans to businesses which were looted during the August 1, 1982 coup attempt. The GOK and USAID/Kenya were to agree to specific conditions before the funds would be made available. All funds from the special account were to be disbursed within 14 months from the date of the grant disbursement unless otherwise agreed. This date was subsequently revised to June 30, 1985.

OBJECTIVES, SCOPE, AND METHODOLOGY

Audit objectives were to determine whether (a) AID-provided resources were used in accordance with program agreements, applicable laws and AID regulations; (b) the project was meeting its objectives as stated in program documentation; and (c) USAID/Kenya was adequately monitoring the project. Except as noted in this report we found no exceptions in our review of these areas.

Audit work was performed from March to August 1984 and covered project activities from September 1982 through August 1984. Delays were encountered during the audit because meetings with responsible GOK officials could not be arranged and access to records was initially denied.

Our audit included a review of records and files at USAID/Kenya, the Central Bank of Kenya and at selected commercial banks. We held discussions with USAID/Kenya, GOK, Central Bank of Kenya and commercial bank officials and loan recipients.

The major focus of our audit was on the utilization of local currency to assist businesses suffering losses as a result of the attempted coup d'etat. We did not specifically look at the procedures to control use of local currency generations for development purposes under this agreement because we looked at and will report on these procedures under our review of a structural adjustment grant done in conjunction with this audit.

Our review was made in accordance with the Comptroller General standards for audit of governmental programs and accordingly included such tests of the program, records, and internal control procedures as we considered necessary in the circumstances.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

The purposes of the grant were to assist the GOK to meet immediate balance of payments requirements and to support its economic adjustment program. On December 30, 1982, USAID disbursed $10,714,000 to the Central Bank of Kenya account at the Federal Reserve Bank of New York. The grant proceeds were converted into Kenya shillings (Kshs) at the rate of Ksh 12.7058 per dollar; and accordingly, Ksh 136,129,941.20 was deposited in a special account with the Central Bank of Kenya. On March 30, 1983, the Ksh equivalent of $5.6 million were withdrawn from the special account and deposited in a pay master general account to be used for development programs agreed to between the GOK and USAID. The Ksh equivalent of $5.1 million were left in the Central Bank of Kenya to establish a discount facility for commercial banks to make short-term loans to businesses which suffered losses on August 1, 1982.

As part of its economic adjustment program, the GOK was to take steps to restore the confidence of the business community by reinstituting elements of an export compensation plan and assurances that further export incentives would be introduced in the near future. In response to this requirement, the President of Kenya in his September 21, 1982 Statement on the Current Economic Situation in Kenya announced reintroduction of the export compensation scheme which had been previously cancelled. The Finance Act of 1982 with a date of assent of December 16, 1982 provided the legal authority to carry out the directives made in the President's speech. The Finance Act also proposed an additional incentive for exporters whereby they would be able to obtain a 15 percent bonus on selected export products. Also, export promotion was encouraged by devaluing the shilling, simplifying export procedures and lowering tariffs.

While most of the purposes of the grant have been met, the special discount facility to provide short-term loans to businesses has not been satisfactory as detailed in the following section of the report.

Discount Facility For Providing Short-Term Loans To Businesses Has Been Ineffective

The special discount facility established under the terms of the grant, to provide resources on a loan basis to businesses affected by the coup, has been ineffective. After approximately two years, 25 percent of the funds have been loaned. Of the 364 business loans approved by the Rehabilitation Committee, 94 were granted by the commercial banks. Also, 27 percent of the funds received by the commercial banks from the Central Bank of Kenya discount facility were never used for their intended purpose. We were unable to determine what use, if any, the commercial banks made of these funds because the funds were commingled with other bank cash. The funds could have been used for any purpose.

The program's limited success in assisting those businesses which suffered losses was largely caused by the reluctance of the commercial banks to take 100 percent of the risk.

The grant agreement is silent on what is to be done with the unused funds as well as the principal and interest on loan repayments that have been or will be returned to the Central Bank. According to USAID officials, this matter remains unresolved. Once a decision is made, an Implementation Letter will be issued.

In accordance with the grant, not less than the equivalent of $5,114,000 (Ksh 64,977,461) was to be deposited in a special account at the Central Bank of Kenya. As of July 31, 1984, Ksh 21,960,000 had been disbursed to the commercial banks (Exhibit I). Of this amount, Ksh 16,005,000 had been loaned to affected businesses. A total of Ksh 48,972,461 made available under the grant remained unutilized. The specific conditions under which the funds were to be made available through the discount facility as mutually developed and agreed upon by the grantee and AID is contained in Exhibit II.

Furthermore, funds provided to the commercial banks were not all lent. A total of Ksh 5,955,000 remained with the commercial banks. Of the nine commercial banks involved in the program, two of the banks (Habib Bank Ltd. and National Bank of Kenya) accounted for Ksh 4,830,000 of the funds disbursed but not loaned out. Both banks have held the money since October 1983 even though the guidelines on the rehabilitation loan scheme require that they be disbursed or committed within 90 days. Although these financial institutions were charged 10 percent interest on the money by the Central Bank of Kenya, the funds were not used for the intended purpose. When we brought this to the attention of the Central Bank of Kenya, they had the unused funds recalled.

Under the operating guidelines of the plan to lend these funds, the commercial banks were required to take 100 percent of the risk. Officials of the Central Bank of Kenya, the commercial banks, the Rehabilitation Committee, and the Ministry of Finance all told us that normal banking practice requires adequate collateral to cover the amount of the loan. Thus, few loans were made. We confirmed this point during our review of those loan applications which were refused. We found that in most instances loans were refused because of lack of collateral.

As early as December 1983, USAID/Kenya recognized that the original plan was not working. A memo from the USAID Director to the American Ambassador in Nairobi, dated December 29, 1983, summarized the chronology of events concerning the rehabilitation fund. The USAID Director concluded:

> "Overall, the above described chain of events does not present a particularly illustrious example of AID or GOK responsiveness to a rehabilitation need. Presumably most businesses have now either gone out of business or have managed through other means to rebuild their businesses.
>
> "However, it remains important to pursue the program for the following reasons:
>
> "(1) There are still at least some affected businesses which remain in a precarious state following events of August 1, which can still be helped by this program;
>
> "(2) USAID had made a commitment to assist these businesses. To fail to provide that assistance, even belatedly, would not only mean a fair amount of bad publicity for the U.S. Government, but would also adversely affect our ability to work with the private sector (an area of increasing U.S. interest) in the future;
>
> "(3) Government agreed to make these counterpart Kenya shillings available to assist the private sector. To allow Government to let the program fail and thereby retain the Kenya shillings for their own use would be an unfortunate precedent for future efforts to program counterpart funds meaningfully and effectively."

The Director further proposed the following course of action for USAID:

"(1) Push the Rehabilitation Committee to engage in jawboning efforts with reluctant commercial banks to prompt further utilization of the fund, even at the expense of bending some collateral rules. The Chairman of the Committee has already been charged with pursuing the matter with Barclays and Standard banks.

"(2) If necessary, once again modify the terms of the program to extend the period of time during which the funds may be used and to make it more attractive to participating banks. This could be done either by lowering the interest rate which banks are charged (currently 10% which leaves them with less than the margin between the minimum saving and maximum lending rates) or by agreeing that bank repayment will be forgiven up to say 25% for loans which go bad. The former would be much simpler to administer and much less subject to manipulation and fraud."

In a letter dated February 14, 1984, USAID wrote to the GOK expressing concern about the slow rate of disbursements from the rehabilitation fund through commercial banks to businesses qualifying for assistance. However, it was not until the signing of Implementation Letter 1/ No. 3 on July 18, 1984 that USAID was able to reach agreement with the GOK on changes that attempt to improve the situation. Implementation Letter No. 3 extended the completion date for the fund to June 30, 1985 and the terminal date for redemption of loans financed by the program to December 31, 1987. It also lowered the interest rate from 13 to 12 percent and that chargeable to commercial banks from 8 to 7 percent.

1/ Project Implementation Letters are to be used to furnish additional information about matters stated in the project agreement and to confirm and record mutual understandings on various aspects of project implementation.

Two commercial banks (Standard and Barclay's) which we visited reacted unfavorably to the July 18, 1984 modifications which were intended to allow full and effective utilization of the remaining funds. Both banks felt that lowering the interest rates to allow for a greater profit margin for the commercial banks would have no effect on their willingness to lend the money. The problems regarding collateral and the requirement that the commercial bank take 100 percent of the risk remained. Also, both banks expressed skepticism that loans were still needed by affected businesses.

At this late stage of the program, it appears unlikely that the funds will now be used for the intended purpose. Most of the affected businesses have either recovered through other sources of financial assistance or are no longer in business.

Conclusions and Recommendations

The special discount facility established under the terms of the grant agreement to provide financial assistance to businesses affected by the attempted coup has been ineffective. Primarily, this is because the commercial banks were and are unwilling to take 100 percent of the risk on loans to borrowers who they consider a credit risk or who lack sufficient collateral. It appears that most of the businesses which required help have either gone out of business or have arranged, through other means, to rebuild their businesses. Accordingly, we believe that USAID/Kenya, in conjunction with the GOK, should develop alternative uses for the unutilized funds. For example, these funds might be used as part of an AID financed Rural Private Enterprise project, reducing the $24 million in local currency funds needed for subloans under that project. This would free dollars for other development purposes. Also, a provision should be made for the use of principal and interest on loan repayments that have been or will be returned to the Central Bank.

RECOMMENDATION NO. 1

USAID/Kenya should, in conjunction with the GOK, develop alternative uses for the funds remaining in the discount facility and program the local currency funds accordingly.

RECOMMENDATION NO. 2

USAID/Kenya should issue an implementation letter making provision for the use of principal and interest on loan repayments that have been or will be returned to the Central Bank.

EXHIBIT I

KENYA PROGRAM GRANT
FINANCIAL ANALYSIS OF REHABILITATION LOAN FUND
AS OF JULY 31, 1984
(KSH 000)

Name	Amount Received From Central Bank	No. of Loans	Amount of Loans	Unused by Commercial Banks
Standard Bank	5,640	36	8,095	
Bank of India	3,580	17	3,180	400
Bank of Boroda	2,090	9	1,765	325
Pan African Bank Ltd.	1,060	6	1,060	
Commercial Bank of Africa		1	200	
Habib Bank Ltd.	3,905	3	575	3,330
Nat'l Bank of Kenya	2,110	4	610	1,500
Barclay's Bank of Kenya	3,575	18	3,175	400
Subtotal	21,960	94	18,660	5,955
Loans made to businesses but funds not received from CBK			2,655	
	21,960	94	16,005	5,955

EXHIBIT II

KENYA PROGRAM GRANT

GUIDELINES ON REHABILITATION LOAN FUND SCHEME

1. The affected businesses will first obtain a certificate from the Business Rehabilitation Committee indicating the amount of assistance required and the bank through which such assistance is being sought.

2. Once the Business Rehabilitation Committee has issued a certificate as in (1) above, the holders will then make applications for loans under this facility to their respective bankers.

3. If the applications satisfy all the normal criteria under which the named commercial bank approves normal loans, the loans will then be approved. Any loan approved under the rehabilitation grant will be additional to any other facility the customer enjoys with the named commercial bank at the date of application of the facility. Adequate security must exist or be offered to cover this additional facility.

4. On September 1, 1983, or immediately thereafter, the Central Bank will disburse the amounts recommended by the Business Rehabilitation Committee to the respective commercial banks specified by the committee against the security of promissory notes maturing within six months; the notes being automatically eligible for roll over on maturity, for a total period not exceeding 30 months from the original date of issue and provided that all notes must be redeemed on or before May 31, 1986[1/].

5. An interest rate of 10 percent[1/] per annum will be charged on the loans from the Central Bank from the date of disbursement, and will be payable every six months, upon roll over of the securing promissory note.

6. Each commercial bank will provide the loan facility to the affected businesses in the form of a loan at 30 months carrying a maximum interest rate of 13 percent[1/] per annum for the time being, or at such other rates as may be determined by the Central Bank from time to time.

1/ Implementation letter No. 3 extended the terminal date for redemption of loan to December 31, 1987. It also lowered the interest rate from 13 to 12 percent and that chargeable to commercial banks from 8 to 7 percent.

7. Each commercial bank should endeavor to disburse the funds provided by the Central Bank under (1) above by November 30, 1983. Any funds that have not been disbursed or committed for whatever reason, by November 30, 1983, will be returned to the Central Bank for re-allocation.

8. Any funds re-allocated by the Business Rehabilitation Committee to a commercial bank after November 30, 1983 must be disbursed within 90 days. Any funds not disbursed or committed within that period must be surrendered to the Central Bank for further re-allocation.

9. The loan facility will initially be restricted to a maximum of Kshs 200,000/- per customer. If all applicants are accommodated and the loan facility is not exhausted, the Business Rehabilitation Committee may, at its discretion, authorize a specified commercial bank to raise a term-loan of a particular customer from Kshs 200,000/- to a sum not exceeding Kshs 400,000/-, provided the customer satisfies all the normal lending requirements of the named commercial bank.

10. The special loan facility will be in operation for 30 months from December 1, 1983. In this regard, the entire facility must be repaid to the Central Bank by the bank concerned together with interest by May 31, 1986[1/]. The period September 1 to November 30, 1983 is being provided to enable commercial banks to complete documentation, and is thus over and above the 30 months specified above.

11. The commercial banks participating in this loan facility must appraise the merits of the proposals to be financed as they will be required to accept full responsibility for ensuring payment of principal and payment of interest to the Central Bank. That is, any losses which may arise in the course of the lending will entirely be for their account.

12. The commercial banks will be required to submit quarterly returns to the Central Bank commencing December 31, 1983. The returns should reach the Central Bank within thirty days after the end of the quarter.

1/ Implementation Letter No. 3 extended the date to December 31, 1987.

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APPENDIX A

List of Report Recipients

	No. of Copies
Field Offices	
USAID/Kenya	5
REDSO/ESA	2
AID/Washington	
AA/M	1
AA/AFR	5
AA/PPC	1
LEG	1
GC	1
AA/XA	1
IG	1
AFR/EA	2
M/SER/COM	2
M/FM/ASD	2
PPC/E	1
PPC/E/DIU	4