JAMAICA'S PL480 SECTION 108 AUCTION PROGRAM: PAST SUCCESSES AND FUTURE DIRECTIONS

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EXECUTIVE SUMMARY

The PL480 Section 108 program, in effect from FY1985 to FY1990, allowed developing countries to pay part of their PL480 Title I commodity imports in local currency. The US Government agreed to keep these funds in the country for at least ten years and make most of them available for loans to productive private enterprises. Jamaica made extensive use of Section 108, channelling US$25 million in commodity sales to the program. This translated into J$321 million.

Congress's objective was to stimulate private sector investment in productive enterprises by making long term loan funds available through private financial institutions. Because the funds came from the PL480 program, agricultural investments were a high priority. Interest rates were to be at market rates. To comply with this objective, USAID Jamaica decided to auction the Section 108 funds to private intermediary financial institutions (IFIs). The highest bids would determine the interest rate. To date, USAID has held eight auctions, which will result in total lending over five years of J$357 million to qualified IFIs. Reflows of principal and interest to date amount to J$263 million, of which part has already been auctioned. J$136 million is available for future auctions.

The purpose of this program audit is to review Jamaica's Section 108 program to determine whether it is still meeting Congress's objectives and to assist USAID decide the future direction of the program. Because Congress stated that the real test of the program's success is in the quality of the subloans, the evaluation examines the developmental impact and the terms of the subloans. It also analyzes trends in the seven "first tier" auctions--to commercial and merchant banks--and looks at the success of the one "second tier" auction held to date--to development banks, private voluntary organizations and credit unions. Finally it looks to the future of the Section 108 program in its conclusions and recommendations.

To have a developmental impact on the country, a subloan project must have one or more of five developmental characteristics: 1) Potential to create employment; 2) potential to earn foreign exchange or to save foreign exchange; 3) bring new technology or processes to the country; 4) bring new entrepreneurs into the sector; and 5) contribute to implementation of sectoral or macroeconomic policy objectives. This evaluation found that all outstanding subloans have at least one of these characteristics; most have two or more. More funds are now flowing to the agricultural sector than in 1991. The bulk of current subloans are in the construction sector--housing and office buildings--whereas tourism received most of the funds in 1991.

The evaluation also found that IFIs are passing along the advantages of the long term fixed rate Section 108 funds much less than in 1991. A considerable number of the "first tier" subloans are now revolving credits rather than term loans, and with the exception of one subloan interest rates are variable and quite high. This is due to the Bank of Jamaica's tight monetary policies, which have pushed average lending rates to over 60 percent. Because Jamaica currently has an inverse yield curve, IFIs are treating Section 108 long term funds as they treat short term funding sources. When interest rates fall, they will repay the loans which carry rates above their marginal cost of funds.

USAID has held seven auctions for "first tier" IFIs, with a total of J$359.94 million auctioned, of which J$55 million was repaid early. Several trends have emerged from these auctions. First, the amount of Jamaican dollar funds has increased steadily, due to the steady depreciation of the Jamaican dollar vis-a-vis the US dollar. The US dollar equivalent remained at around US$25-29 million except in the eighth auction, when the amount demanded dropped sharply. Second, the spread in interest rates at the auctions has increased sharply, reflecting the differing marginal costs of funds between institutions. Third, the newer, smaller and more aggressive banks are willing to bid higher rates of interest and thus win all the funds. One banking group alone holds 68 percent of outstanding Section 108 loans.

The sixth auction to "second tier" institutions was intended to expand Section 108 subloans to the agricultural and rural sectors and pass on the advantages of the long term fixed interest rate money to the end borrowers. Development banks in Jamaica are the only institutions that typically will make long term fixed rate loans, and even they are moving to variable rates due to Jamaica's volatile interest rates. In general, the "second tier" auction was successful in fulfilling these objectives. Only J$3 million was auctioned because USAID wished to test the "second tier" institutions' absorptive capacity. One institution--Trafalgar Development Bank (TDB)--captured J$2.3 million. National Development Foundation won the rest.

Several issues arose from this auction. First, the "second tier" group includes fairly disparate institutions. TDB is by far the largest, and other institutions felt it dominated the auction. Credit unions themselves vary greatly in size and financial strength. The question is whether USAID should divide these institutions still further in future auctions. Because the Section 108 guidelines stress administrative simplicity, this is not advisable. Second, the borrower risk of "second tier" institutions is greater. Many credit unions and co-operative banks are financially weak. USAID should assure that auction participants are well vetted for financial viability. Third, in lending to small business, it is often advisable to lend on shorter terms to minimize default rates, but Section 108 objectives favor longer term lending. Thus some program contradictions may arise.

USAID must now decide whether to continue auctions of Section 108 reflows. The legislation stipulates that reflows may be used for 1) additional private sector lending to IFIs, 2) development of new markets for US agricultural commodities, 3) repayment of US obligations, or 4) conversion to dollars. Repatriation of principal may begin ten years after the last delivery of commodities from which the funds originated, but the legislation does not provide for repatriation of interest. USDA does not plan to use the reflows for market development activities until it has exhausted its current allocation of five percent of Section

108 principal, approximately J$20 million. Thus the two competing uses for reflows in the immediate future are relending to IFIs and payment of US obligations. Because the auction program has been successful in meeting program objectives, USAID should continue auctions for the foreseeable future.

The evaluation concluded that after five years and eight auctions, the management of the acution is proceeding smoothly. New issues are program monitoring and compliance, continuing the "second tier" auction, limits on USAID exposure as a lender, and the future of the program. Four recommendations resulted from this program audit:

- The next auction should be to "second tier" institutions, because they are more likely to meet program objectives given the Bank of Jamaica's policy of reducing commercial and merchant bank liquidity.

- Section 108 reflows should be auctioned to both "first tier" and "second tier" institutions in the future. Annual reflows of around J$100 million should permit one auction to each group.

- USAID should monitor IFI compliance with audit and reporting requirements and insist that IFIs submit required reports on subloans and their own financial viability.

- USAID should study the issue of a limit on its exposure to IFIs as a percentage of liabilities, in addition to its current limit of two and a half times shareholder equity. The purpose would be to prevent USAID Section 108 funds from becoming the major outside source of funds for any one IFI.

I. INTRODUCTION

1. Background on the PL 480 Section 108 Program in Jamaica

On December 23, 1985, President Ronald Reagan signed into law the Food Security Act of 1985. This act contained Section 108, an amendment to the PL 480 Title I "Food for Peace" program, which created an innovative US Government program to stimulate private sector investment in developing countries.[1] Title I funds flowed into the program for only five years because Congress did not renew the legislation in FY1990.

a. Legislation

Section 108 amended the existing PL 480 law to allow a developing country which purchased US commodities financed under the concessional terms of Title I to pay for part of its commodity imports in local currency. Recipient governments determined the amount of Title I funds to devote to this program, from 0% to 100%. The US Government in turn agreed to keep these funds in the country for at least ten years and make most of them available for loans to the private sector. Five percent of the money was reserved for US Department of Agriculture market development activities in the country. At the end of the ten year period, the US Government was entitled to convert the original amount of local currency principal--not interest--into US dollars over a period of up to twenty years at the exchange rate in effect at the time of conversion. The developing country benefitted in three ways: It saved scarce foreign exchange by paying for commodity imports in local currency; it shifted the exchange risk to the US Government when the funds were repatriated; and it gained the use of the funds for private sector investment for more than a decade.

Jamaica made extensive use of Section 108. From FY1987 through FY1990, when Jamaica's annual Title I commodity imports totaled around US$30-40 million, the Jamaican Government designated 25 percent of Title I commodity sales for the program. A total of J$321 million flowed into the lending program from these sales.[2] Because the Section 108

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[1]More details on the PL 480 Section 108 program, the origins of the Jamaican program and the first four auctions are contained in the two USAID occasional papers by Dorothy J. Black, *The First Auction of PL-480 Section 108 Funds: A Jamaican Experience*, March 1990 and *USAID Jamaica's PL-480 Section 108 Auction: A Contribution to Productive Private Sector Development*, July 1991.

[2]As of October 1994, the exchange rate between the US dollar and the Jamaican dollar was US$1=J$33. However, when the Section 108 program started in 1989, the exchange rate was

program was not renewed by Congress in the Agricultural Development and Trade Act of 1990, no additional funds from Title I commodity sales will be added to this amount. Nevertheless, the program will continue to be an important source of US development assistance and agricultural trade promotion for many years to come. Repatriation of the original funds is not permitted until the period 1999-2009 and, in the meantime, the reflows of principal and interest will be substantial.

b. Objectives of the Program

The main objective of the Section 108 program in developing countries was to stimulate private sector investment in productive enterprises by making long term loan funds available through private financial institutions. Section 108 thus required the US Government to loan the local currency generated from Title I sales to privately owned intermediary financial institutions (IFIs). The IFI was to use these funds for loans "to private individuals, cooperatives, corporations, or other entities...at reasonable rates of interest for the purpose of financing... productive private enterprise investment within such country," giving preference to the extent feasible to agricultural related enterprise. The law restricted eligible entities to those owned, directly or indirectly, by citizens of developing countries, except that up to 49 percent could be owned by United States citizens. No entities with any government ownership were eligible to participate in the program.

In a report on the Section 108 legislation, Congress said it would judge the program on the quality of investments made, not on the volume of funds directed to IFIs. The real test of the program's success is therefore in the developmental impact of the subloans. To be considered developmental, a project financed by Section 108 funds must have at least one of the following criteria:

- Potential to create employment.
- Potential to earn foreign exchange through exports or potential to save foreign exchange through import substitution.
- Brings new technology or processes to Jamaica.
- Brings new entrepreneurs into the sector, stimulating competition and efficiency.
- Contributes to implementation of sectoral or macroeconomic policy objectives.

US$1=J$5.55. Since PL 480 commodity sales in US dollars have been converted to Jamaican dollars at a variety of exchange rates, the discussion in this report will refer only to Jamaican dollars.

c. Jamaica's Auction Program

Because financial markets in developing countries can differ greatly, the Section 108 program was intended to be flexible. Section 108 guidelines gave US missions overseas broad authority to make decisions pertaining to implementation in their respective host countries. The decision making body in the mission was called the In-Country Policy Group (IPG), and included representatives from the US Agency for International Development (USAID), the State Department, and the US Department of Agriculture (USDA). Within the IPG, USAID was designated as the implementing agency for IFI loans.

The IPG in Jamaica had two key issues to resolve in implementing the program. First, how would USAID allocate Section 108 funds among eligible privately owned IFIs and, second, how would USAID determine what interest rate to charge the IFIs. Guidance from Washington said "the interest rate charged IFIs should normally approximate the cost of obtaining lendable resources of comparable maturities from the free private capital market in the individual cooperating country." The IPG's problem was how to determine a market interest rate for Section 108 funds which would carry the restrictions prescribed in the legislation in an environment where commercial lending rates were influenced by many non-market factors. The IPG decided to allocate funds and establish a market interest rate through an auction.

USAID hired the international management consultants Touche, Ross, Ogle & Co. (DTT)[3] to set up a two step process. First, IFIs were prequalified to assure that participants in the auction were financially viable privately owned institutions, as specified in the Section 108 guidance. Then USAID invited the prequalified IFIs to participate in an auction for the Section 108 funds. Each IFI submitted sealed bids specifying the amount of Jamaican dollars requested and the interest bid on that amount.

The following "Dutch Auction" principles govern the allocation of funds from the auction:

- Each successful bidder pays the interest rate he bid.
- The highest bidder gets first dip into the pool; if funds remain, the second highest bidder gets the next dip, continuing in this manner until the pool is dry. If two bidders are tied but remaining funds are insufficient to satisfy their demand, the pool is allocated proportionally.
- Each auction has a confidential minimum or floor rate to ensure the winning bid is not below the rate of inflation.

[3] Touche, Ross, Ogle & Co. has subsequently become Deloitte, Touche, Tohmatsu and will therefore be referred to as DTT in this report.

To date, USAID has held eight auctions, which will result in total lending over five years of J$357 million to qualified IFIs.[4] Reflows of interest and principal to date amount to around J$263 million, of which part has already been auctioned. J$136 million is available for future auctions. USAID, with the approval of the IPG, will determine the disposition of these funds as it reviews the Section 108 program's future.

2. Purpose of This Study

The purpose of this program audit is to review Jamaica's PL 480 Section 108 program to determine whether it is still meeting Congress's objectives and to assist USAID to decide the future direction of the program. Specifically, this study will 1) review the effects of current monetary policy and financial sector developments on the Section 108 program; 2) review the results of the "first tier" auctions held since July 1991, when the last audit was performed; 3) review and analyze the results of the "second tier" auction to development banks and credit unions held in 1992; 4) analyze the subloans currently outstanding for their developmental impact, comparing these results with the 1991 program audit; 5) review the auction's management process to determine whether program adjustments are necessary to meet Section 108 objectives; and 6) recommend a course of action for the Section 108 program once the final tranche of local currency payments has been auctioned, which is consistent with the legislation, Congressional objectives, and Jamaica's developmental needs.

II. EFFECT OF MONETARY POLICIES ON THE SECTION 108 PROGRAM

The results of the Section 108 auctions must be evaluated in the context of the Jamaican government's monetary policies, which determine the supply of and the demand for loan funds to financial institutions as well as prevailing interest rates. For this reason, USAID coordinates its program with the Bank of Jamaica on an ongoing basis.

Interest rate movements in Jamaica have been extremely volatile during the five year life of the Section 108 auction program. Treasury bill yields, for example, have fluctuated from a low of around 18 percent in June 1991 to a high of 51.98 percent in February 1994, a difference of 34 points. CD yields correlate closely with Treasury bills. The reason for the wide fluctuation is the Jamaican government's inconsistent use of monetary policies to offset the inflationary effects of large fiscal deficits, which cause price increases, currency depreciation, and economic instability.

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[4] USAID is still negotiating loan agreements with Horizon Merchant Bank and Century National Bank for a total of J$96.737. These banks won the funds in recent auctions.

Since August 1993, the Bank of Jamaica has maintained tight monetary policies. In an attempt to reduce inflation and stabilize the exchange rate, it is curtailing the rate of growth in the money supply. Because commercial bank cash reserve and liquid asset ratios have been at the statutory maximum of 25 percent and 50 percent respectively[5] since July 1992, the Bank of Jamaica's main discretionary tool is the sale of its own CDs and Treasury bills at interest rates high enough to crowd out private borrowing.

When the Bank of Jamaica started tightening monetary policies in mid-1993, the Treasury bill rate jumped from 27 percent to 41 percent and the CD rate rose to over 50 percent. The combination of the high cash reserve and liquid asset ratios and these competing instruments forced commercial banks to raise their lending rates to the 50-70 percent range, depending on the source of funds. CD and Treasury bill rates peaked in January 1994 at 52 percent, subsequently declining to around 37 percent by October.

Government monetary policies have had several effects on the Section 108 auction. First, they have caused an increase in both the bid rates and the spread between the high and the low bids at the auction. This is illustrated in the following table of auctions to "first tier" institutions (note that the sixth auction to "second tier" institutions will be discussed in Section IV):

[5]The liquid asset ratio of 50 per cent includes the 25 percent cash reserve ratio.

Table 1: "First Tier" Bid Rates Compared to CD and TBill Rates

Auction	Date	Winning Bids (%)	Bid Range (%)	Treasury Bill (%)	CD Rate (%)
1	Aug. 1989	19	14-19	19.72	20.13
2	Feb. 1990	28, 27	23.75-28	28.30	26.98
3	July 1990	31	24.5-31	30.10	29.12
4	May 1991	31.01, 30.01, 30	16- 31.01	33.40 (Mar.)	18.87
5	Sept 1992	35.0042 33.07 32.004	15-35.004	28.98	30.72
7	Mar. 1994	51.019-38.125	20-56	50.04	49.99
8	Aug. 1994	39.00-35.75	17-39	41.19	38.92

The winning interest rates bid at the auctions are closely correlated to Treasury bill and Bank of Jamaica CD rates (see Appendices 4 and 5), despite the fact that these monetary instruments are short term and Section 108 funds are long term. When monetary policies raise short term interest rates in Jamaica, the bid interest for the Section 108 funds rises. This is because all lending rates are variable and the interest rate volatility over the past decade has in general eliminated term lending outside of development bank funds. Jamaica has the phenomenon of a strongly inverse yield curve, where short term interest rates are higher than long term rates. Implications for the USAID program are that, despite their ten year term, IFIs now use Section 108 funds like short term sources of funds. If interest rates drop significantly, IFIs can repay the Section 108 funds without penalty by giving 60 days notice.

Second, monetary policies have caused USAID to auction smaller amounts of funds over a longer period than originally planned. The government used monetary policies during the past year to reduce liquidity in the economy. Section 108 provides another source of loan funds to commercial and merchant banks. Prior to the seventh auction, USAID discussed the implications of the program for monetary policies with the Bank of Jamaica. As a result of these discussions, the Bank of Jamaica requested that USAID split its Section 108 auction into three tranches of J$85 million over at least 18 months, fearing that the auction of several hundred million Jamaican dollars at one time would adversely impact the government's monetary targets.

Third, tight monetary policies have eliminated Section 108's exemption from cash reserve and liquid asset ratios. At the outset of the program, the Bank of Jamaica treated Section 108 funds like long term development bank loans, which are exempt from these ratios. Due to the extremely tight monetary policies in early 1994, USAID agreed that as of March 1994 Section 108 funds would be included in bank liabilities subject to cash reserve and liquid asset ratios. Commercial banks must now lend Section 108 funds at an interest rate at least 30 percent higher than the rate paid to USAID just to break even on the transaction. For example, if an IFI borrows J$10 million at 40 percent interest, it keeps J$2.5 million in cash at the Bank of Jamaica earning no interest. It must therefore loan the other J$7.5 million at 53 percent to earn enough to pay the interest to USAID. It holds another J$2.5 million in interest bearing government securities. The IFI must cover its costs and make its profit through the spread on the remaining J$5 million. Cash reserve and liquid asset ratios have forced real interest rates to high levels in Jamaica. In August 1994 the average lending rate was 63 percent. Inflation measured by the CPI was 38 percent, resulting in a positive real interest rate of around 25 percent. Now that Section 108 funds are subject to cash reserve and liquid asset ratios, they have become more expensive to productive enterprises.

Fourth, tight monetary policies have decreased the demand for and increased the supply of loan funds at prevailing interest rates. IFI participation in the eighth auction held in August 1994 reflected this reduced loan demand. Only four banks submitted bids and total demand dropped sharply.

In sum, the prevailing macroeconomic atmosphere in Jamaica, characterized by tight monetary policies and high real interest rates, makes it more difficult to realize the Section 108 objectives of increasing long term financing to productive private sector investments through "first tier" institutions in the medium term. Nevertheless, as will be detailed below, the program has had a commendable measure of success, given these difficult circumstances.

III. SUMMARY OF AUCTIONS TO "FIRST TIER" INSTITUTIONS

1. Overview of the Auctions

Between August 1989 and August 1994, USAID held eight auctions of Section 108 funds. Auctions one through five and seven through eight were to "first tier" institutions--institutions regulated by the Banking Act and the Financial Institutions Act. The sixth auction was to "second tier" institutions, mainly development banks and credit unions, which constitute a different market for loan funds. The "second tier" auction will be discussed separately.

In the seven auctions to "first tier" institutions, USAID has loaned a total of J$356.94 million to IFIs, of which J$55 million was repaid early. The current portfolio is therefore around J$300 million. The weighted average rate of return is now 37 percent, yielding approximately J$110 million annually. Based on exchange rates at the time of the auctions, USAID auctioned the equivalent of US$25.17 million. However, due to depreciation of the Jamaican dollar during the program period, the current US dollar value of the auctioned amount has shrunk to less than half and now totals US$10.8 million. The US Government bears the exchange loss.

The lowest winning bid was 19 percent in August 1989. The highest winning bid was 51.019 percent in March 1994. The range between winning bids was 32 percent. Nine IFIs have won funds in the auction and eight have outstanding Section 108 loans. One IFI, Century National Bank, has captured 62 percent of the outstanding loans and currently holds J$190 million. Century National's affiliated merchant bank, Century National Merchant, has won J$19 million. The Century National group thus holds J$209 million, or 68 percent, of outstanding Section 108 loans. The following table summarizes the results of the "first tier" auctions.

Table 2: Results of "First Tier" Auctions

No./Date	Amt. Offered (J$mil.)	Amt. Demanded (J$mil.)	Banks Bidding (No.)	Bid Range (%)	Winning Bids (%)
1/Aug. 1989	20.0	180.3	11	14-19	19
2/Feb. 1990	28.0	139.4	10	23.75-28	28,27
3/July 1990	47.0	219.0	13	24.5-31	31
4/May 1991	33.0	288.4	11	16-31.01	31.01, 30.01, 30
5/Sept. 1992	58.94	637.7	15	15-35.0042	35.0042,33.07, 32.004
7/Mar. 1994	85.0	798.25	16	20-56	51.019,50.296, 50, 49.996 49.99,38.125
8/Aug. 1994	85.0	220.0	4	17-39	39,38.6,38.5, 37.6, 36.5, 35.75

The table below shows the allocation of the Section 108 funds by financial institution:

Table 3: Allocation by Financial Institution

Auction/ Date	Bank	Amount J$mil.	Bid Rate %	Repaid
1/Aug'89	Eagle Merchant	10.0	19.0	
	Mutual Security	10.0	19.0	
	(US$3.10 million)	20.0		
2/Feb.'90	George & Branday	8.0	28.0	5/16/91
	Century National	9.4	27.0	
	Century National Merch.	7.6	27.0	
	Bank of Nova Scotia	3.0	27.0	
	(US$3.8 million)	28.0		
3/July'90	Eagle Merchant	47.0	31.0	4/25/91
	(US$5.5 million)	47.0		
4/May'91	Century National	11.0	31.01	
	Century National	11.0	30.01	
	Century National Merch.	11.0	30.0	
	(US$3.3 million)	33.0		
5/Sept'92	Corporate Merchant	20.0	33.07	
	Corporate Merchant	10.0	35.0042	
	Workers Bank	28.94	332.004	
	(US$2.66 million)	58.94		
7/Mar.'94	Century National	10.0	51.019	
	Century National	15.0	50.296	
	Century National	15.0	50.0	
	Century National	25.0	49.996	
	Century National	8.263	49.99	
	Horizon Merchant	11.737	39.0	
	(US$2.83 million)	85.00		
8/Aug.'94	Century National	10.0	39.0	
	Century National	15.0	38.6	
	Century National	25.0	38.5	
	Century National	15.0	37.6	
	Century National	10.0	36.5	
	Century National	10.0	35.75	
	(US$2.58 million)	85.0		

2. Discussion of Trends in the Auctions

a. Increase in the Amount of Funds Demanded

The first trend is a steady increase in the amount of Jamaican dollar funds demanded, up to the seventh auction. The most likely explanation for the rising demand for Jamaican dollars is the steady depreciation of the Jamaican dollar vis-a-vis the US dollar, which increased the cost of imports and added to inflationary forces during this period. When total auction demand is converted to US dollars at the prevailing exchange rate, demand remains in the range of US$25-29 million until the eighth auction, when it drops to US$6.6 million.

The eighth auction was a marked exception to this trend. Several reasons account for the precipitous drop in demand and number of bidders. First, tight monetary policies dampened loan demand, so bank liquidity was not a problem in August 1994. Second, because Section 108 funds are now subject to cash reserve and liquid asset ratios, banks must price these funds at higher rates and are thus more cautious in their bidding. Third, consistent aggressive bidding by some banks (see III.2.c. below) has discouraged other banks from submitting bids which they feel will be too low to win funds. Fourth, the imposition of a US$1,000 good faith bond eliminated some of the banks' speculative bids. It is too early to assess whether the good faith bond discouraged IFIs who have consistently bid lower rates from continuing to participate. None of the banks have mentioned this as a problem.

b. Increased Spreads Between High and Low Bids

The second trend, which becomes apparent in later auctions, is an increase in the spread between the high and the low interest rates bid. In the early auctions, the spread was only around five percent. It jumped to 15 percent in the fourth auction, 20 percent in the fifth, 36 percent in the seventh and 22 percent in the eighth. This trend can be attributed to the increased volatility of interest rates and differing plans by the banks as to where they would place these funds. As noted above, Jamaica's inverted yield curve, which gives short term funds a higher interest rate than long term funds, has adversely affected the value of Section 108's ten year term. Banks can bid at the higher short term rates, use the funds like a short term source, and repay USAID if interest rates fall. Those funds auctioned at higher rates of interest, for example the seventh and eighth auctions, are likely to be repaid before their ten year term. Funds from the first auction, which carry 19 percent interest, are unlikely to be repaid before term.

c. Most Aggressive IFIs Win Bulk of Funds

The third trend which is now discernible is that the newer, smaller and more aggressive banks are willing to bid higher rates of interest and thus tend to win the Section 108 funds. Auctions four, seven and eight were dominated by the Century National group (Century National Bank and Century National Merchant Bank), which now holds 68 percent of outstanding Section 108 loans. Auction five was dominated by Corporate Merchant and

Workers Bank, which are part of the same corporate family. These two institutions together hold 20 percent of the loans. Only one of the two dominant commercial banks, Bank of Nova Scotia (BNS), has won funds in the auction. BNS holds a loan of J$3 million from the second auction, less than one percent of total Section 108 loans outstanding.

The reason for this trend is that the newer, smaller banks, which have more limited sources of funds and higher marginal costs, bid more aggressively in the Section 108 auctions. Bank of Nova Scotia and National Commercial Bank, the two dominant commercial banks, have extensive branch networks which mobilize savings deposits at low rates of interest, currently around 18 percent. They are therefore unwilling to bid sufficiently high to win the Section 108 auctions. Newer commercial banks do not generate sufficient loan funds from deposits to meet loan demand; merchant banks, which do not take deposits, fund much of their lending with higher cost short term bank CDs.

This trend was underscored in the seventh auction when seven IFIs which won funds declined to accept them. Because there was no penalty for speculative bids in this auction, aggressive IFIs could bid at high rates and subsequently refuse funds when they realized they could win with lower bids. In addition, CD and Treasury bill rates began to drop shortly after the auction. Seven institutions which, in total, had bid between 39.5 and 56 percent for J$374.5 million in the seventh auction refused to sign loan contracts.

IV. SIXTH AUCTION TO "SECOND TIER" INSTITUTIONS

In September 1992, USAID held an auction for J$3 million of the Section 108 funds open only to "second tier" financial institutions, i.e. private development banks, credit unions and people's co-operative banks (PC banks). These institutions are privately owned but compete in a different market for funds. They are established under different laws than commercial and merchant banks and have different regulatory agencies, lower deposit and lending rates, and no reserve requirements. Most of the development banks' funding comes from concessionary loans, often from international lending agencies. The credit unions and PC banks raise funds from members' deposits but also have access to development funds.

USAID expected the "second tier" auction to meet Section 108 program objectives in two ways: expanding Section 108 subloans to the agricultural and rural sectors--a primary focus of Section 108--and passing on the advantages of the long term fixed interest rate funds to the end borrower. Some of the "second tier" institutions cater to the agricultural sector, and development bank loans generally have longer repayment periods and fewer interest rate adjustments than commercial and merchant bank loans. In addition, current US Government policy emphasizes the importance of "microenterprise and small business" in the development process. A number of the "second tier" financial institutions cater to clients which can be classified as small business.

1. Issues in Setting Up the "Second Tier" Auction

Several issues arose once USAID decided to hold a "second tier" auction. First, which of the many financial institutions outside the regulatory framework of the Banking Act and the Financial Institutions Act would USAID invite to participate in the auction. Potential participants were credit unions, PC banks, the National Development Foundation of Jamaica (NDF/J), Trafalgar Development Bank (TDB), the Jamaica Agricultural Development Foundation (JADF), and building societies. USAID decided to invite all these institutions provided they functioned as financial intermediaries and were able to prequalify as financially viable institutions.

A subsidiary issue was whether to divide the institutions even further, holding a "third tier" auction, given the disparate size and financial strength of this group. For example, TDB has three times the asset base of the largest credit union and six times that of NDF/J; JADF has one and a half times the asset base of the largest credit union and over twice that of NDF/J. Both these institutions would probably bid more aggressively for Section 108 funds. The different institutions also operate under a variety of lending restrictions, management structures and access to funding sources. Nevertheless, USAID determined that further bifurcation of the auction would not be consistent with the purpose and guidelines of the program which emphasize administrative simplicity.

The second issue was how to prequalify the institutions bidding in the "second tier" auction. Section 108 guidelines specify that IFIs must be sound, going financial concerns with a history of stability, financial strength and experience. In the "first tier" auction, USAID relied upon the Bank of Jamaica's certified list of financial institutions approved to transact business in Jamaica, supplemented by DTT's evaluation of the IFIs' audited and most recent unaudited financial statements. USAID chose a similar method for the "second tier" IFIs. Since the Credit Union League and the Agricultural Credit Bank regulate credit unions and PC banks, respectively, USAID asked these agencies to provide financial strength evaluations which it used to prequalify the credit unions and PC banks. The private development banks--TDB and JADF--and the non-government private voluntary agency NDF/J are not monitored or regulated by third parties. However, USAID was instrumental in establishing the first two and has provided extensive aid to the third under direct assistance projects since completed. Therefore, USAID was comfortable with DTT's own evaluation of these institutions' financial viability as prequalification for auction participation.

The third issue was the amount of funds to offer at the pilot "second tier" auction. The original proposal of J$10 million was reduced to J$3 million because of uncertainty regarding these institutions' absorptive capacity.

The fourth issue was how to set the floor rate for the "second tier" auction. USAID establishes a confidential floor rate for each auction which is used to reject unacceptably low bids. Section 108 guidelines state that interest rates should approximate the cost of obtaining lendable resources of comparable maturities from the local free private capital market and should be positive in relation to inflation. The legislation permits missions to charge a lower rate of interest on funds loaned to cooperatives or nonprofit voluntary agencies acting as financial intermediaries--and guidelines prefer grants to these institutions--but several of the "second tier" IFIs would not qualify under this provision. The question arose whether the same methodology used to set the floor rate for the "first tier" auctions was appropriate, or whether USAID should use another method, given the "second tier" institutions' different sources of loan capital. USAID decided that the same methodology for determining a floor rate was appropriate for both tiers because it conforms to Section 108 guidelines. The floor rate used for "first tier" auctions is intended only to prevent auctioning funds at interest rates which are negative in relation to long term inflation. The auction itself is expected to assure that Section 108 funds are loaned at rates comparable to IFIs' other sources of funds.

2. Overview of the Sixth Auction

Seven institutions submitted 12 bids for the J$3 million at the sixth auction: TDB, NDF/J, Churches Co-operative Credit Union, GSB Clerks' Co-operative Credit Union, Manchester Co-operative Credit Union, St. Elizabeth Co-operative Credit Union and Trelawny Co-operative Credit Union. Bid rates ranged from a low of 12 percent to a high of 24 percent. The J$3 million available met only 18 percent of the J$16.5 million in total demand.

The following table shows the results of the auction allocations:

Table 4: Results of the Second Tier Auction

Auction	IFI	Amount J$mil.	Bid Rate %
6/Oct. 1992	Trafalgar Development Bank	2.0	24.0
	Trafalgar Development Bank	0.333	22.0
	National Development Found.	0.667	22.0
	(US$140,000)	3.0	

3. Review of Auction Results

It is not surprising that TDB won 78 percent of the funds in the sixth auction. TDB has a much larger capital and asset base than either NDF or the credit unions. Its average loan is also larger, which permits it to cover costs with smaller spreads. Nevertheless, discussions with TDB personnel revealed that TDB's bids were the maximum it considered feasible at the time, given TDB's Jamaican dollar lending rate and its minimum spread. TDB currently lends primarily in foreign currency from foreign assistance funds. Its only Jamaican dollar funding sources are local borrowing, reflows from existing loans and share capital. Because lending rates on the local market are currently higher than TDB's interest rates, TDB lends in Jamaican dollars only from reflows and from share capital, provided shareholders' rate of return is competitive with alternative instruments. TDB is interested in participating in future Section 108 auctions.

TDB's only complaint about the sixth auction was the small amount of funds. TDB loaned the J$2.3 million it won in the auction to Nestle-JMP Jamaica Ltd. to finance new equipment for its condensed milk operation. The loan to Nestle was approved approximately one year before TDB won the Section 108 funds at auction. The total loan was J$5.6 million, given to Nestle in three disbursements. Section 108 funds covered the last disbursement, only half the total amount. TDB felt that at least J$20 million annually should be auctioned to "second tier" institutions.

NDF/J, the other winner at the sixth auction, agreed that the amount was too small. NDF/J representatives also felt smaller institutions had difficulties competing with TDB. Because TDB has larger clients and makes larger loans, it can live with smaller spreads and can therefore bid higher interest rates. NDF/J bid for J$5 million but won only J$667,000. NDF/J would like to see the next "second tier" auction offer as much as J$50 million.

NDF/J determined its maximum bid rate based on the cost of alternative funding sources, its minimum spread, and the prevailing rates it charges its customers. NDF/J retails loan funds from Jamaican government and foreign aid agencies to small business. Because its small business clientele tends to be high risk and its average loan size--J$76,000--high cost to service, it needs an average spread of around 15 percent. NDF/J's sources of funds at present are National Development Bank (NDB), currently at 18 percent; Micro Investment Development Agency (MIDA) at 18.5 percent; ACB, whose rate is tied to Treasury bills; Jamaica National Building Society at 24 percent; and credit lines from CIDA and GTZ, the Canadian and German aid agencies. NDF/J's lending rates are determined along sectoral lines, with current rates at 45 percent for services, 42 percent for manufacturing, and 39 percent for agriculture. In addition, NDF/J charges a ten percent fee up front. NDF/J's clientele reaches into all sectors of the economy. Half its loans are to the service sector, 26 percent to agriculture and 24 percent to the manufacturing sector.

Credit unions had another view of the auction. In general, they felt disadvantaged in competing against such "giants" as TDB. A representative of Churches Co-operative Credit Union, which bid for J$1.0 million in the sixth auction, pointed out that Churches' members have set a ceiling of 27 percent on credit union loans. This ceiling can only be increased by the members at the annual meeting. The credit union pays 18 percent on members' deposits. Churches' needs a spread of 8-10 percent to cover costs. Therefore it could not bid higher than 18 percent in the auction. This rate was too low to win, and in fact was below the floor rate for that auction. Since each credit union defines its own interest rate structure, these limits do not necessarily apply to other credit unions.

The Churches' representative also pointed out that it might be difficult for many credit unions to comply with the Section 108 requirement that funds be loaned to productive private enterprise. The bulk of Churches' loans are for consumer expenditures on homes, automobiles or other consumer financing. Only nine percent of Churches' total loan portfolio of J$37.6 million is for business loans, and two thirds of these are in the retail trade. One of the reasons for this concentration is that most credit unions cap the amount loaned to one member. Churches, for example, will not loan more than J$600,000. If a member has a growing business, he must establish a relationship with a bank to assure access to adequate working capital. For the above reasons, Churches would not expect to participate in future auctions unless its membership changes the credit union's interest rate structure.

Churches' problems are not necessarily representative of all credit unions. City of Kingston Credit Union (COK), the largest credit union in Jamaica with a membership of 58,000, has a much higher upper limit on interest rates, with some of its loans currently at around 50 percent. Unlike credit unions whose main source of loan funds is member deposits, COK has a Project Department which on-lends funds from donor agencies such as the NDB and the Government of the Netherlands (GON). The institutions which provide the loan capital set interest rate limits for the externally funded loans. Loans from the Project Department are for business development rather than consumer purchases. COK's clientele tends to be in distributive, service and manufacturing sectors, since membership is open to those who live or work in Kingston. Although COK did not participate in the sixth Section 108 auction, it would be interested in future "second tier" auctions. COK would expect to bid for around J$5 million.

JADF was invited to bid in the sixth auction but failed to make a timely bid submission. JADF is very interested in participating in future "second tier" auctions. JADF has a similar problem to TDB in accessing Jamaican dollar funds to loan to its clientele, which is agriculture and agribusiness. JADF currently sources its loan funds from the Agricultural Credit Bank (ACB) and reflows from its USAID trust fund. The trust fund, which was financed by Title II commodity sales, presently totals J$10 million. Some funds were used to purchase the Water Valley Estate which is used to grow fruit trees. Interest is used for research and commercial non-traditional export crops. The ACB is a wholesale development bank that lends Jamaican government and foreign aid funds to the agricultural sector through retail development institutions. Pursuant to an agreement with the World Bank, ACB now charges market rates of interest which are tied to the Treasury bill rate. JADF finds that its agricultural clientele is having problems paying the 41 percent it charges for ACB loans. JADF makes long term loans based on the payback period of the crop. JADF representatives felt that "second tier" institutions could absorb as much as J$100 million in a Section 108 auction.

If USAID continues the "second tier" auctions and includes the same universe of participants, it should be aware that the borrower risk will generally be greater than for the "first tier" institutions. An Inter-American Bank study of Jamaican financial intermediaries pointed out that many PC banks and credit unions are financially very weak. A number of them have a large percentage of uncollectible debts, inadequate loan loss provisions, and decapitalization through unrealistically low interest rate. Many have either failed to audit financial reports for at least two years, or have no financial reports at all. Operating costs are high, due to the small size of average loans and lack of management capability. USAID could mitigate this borrower risk by an effective prequalification process combined with periodic monitoring of audited and unaudited financial reports from IFIs with outstanding Section 108 loans.

In dealing with "second tier" institutions whose clientele is mainly in the small business field, USAID will find other donors' experiences relevant to the Section 108 program. Studies on term lending to small business have found that delinquency rates increase with the term of the loan, because many institutions are tempted to reschedule loans and capitalize delinquent interest payments when the repayment period is longer. Lenders find delinquencies in short term loans harder to hide and thus they deal with them in a more timely manner. The trend in small business lending is therefore towards shorter repayment periods, contrary to the program objectives of the Section 108 funds. USAID should consider this contradiction when assessing IFI subloans made to small business by "second tier" institutions.

Finally, although the larger development banks such as TDB and JADF have a shortage of Jamaican dollar loan funds, small business lending could be well funded in the future, given the absorptive capacity. For example, credit unions will have access to a Dutch US$7.7 million grant if administrative and logistical problems can be overcome. A European Union US$8 million loan for small business lending is also under consideration. The stronger credit unions may therefore reach their absorptive capacity for loan funds to small business without vying for Section 108 money, assuming these programs are realized.

4. Pros and Cons of "Second Tier" Auction

The pros of holding periodic auctions of Section 108 funds to "second tier" institutions can be summed up as follows:

- The "second tier" institutions have a better chance of channelling Section 108 funds to agricultural and rural sectors.

- Because "second tier" institutions' lending practices include fixed rate terms, they are more likely to pass on fixed interest rates to subborrowers.

- "Second tier" institutions are also more likely to pass on Section 108 term lending to subborrowers, for the same reason.

- The Bank of Jamaica does not require "second tier" institutions to hold liquid asset and cash reserve ratios against Section 108 funds. They can therefore price their loans at lower interest rates, using the funds to greater advantage of productive sectors.

- "Second tier" institutions are not awash in excess liquidity and thus have a greater need for Section 108 funds.

The cons of the "second tier" auctions are as follows:

- Borrower risk will be higher.

- The administrative burden on USAID could be higher because these institutions will tend to have more, smaller subloans and bid for smaller amounts of Section 108 funds, requiring greater monitoring and follow-up.

- "Second tier" institutions whose clientele is in the small business sector may prefer to lend for shorter terms to minimize the default risk, causing a potential conflict with Section 108's program objectives.

- Other foreign aid programs providing loan funds to credit unions for small business lending may stretch these institutions' absorptive capacity for productive loans.

USAID should also note that a floor rate consistent with Section 108 guidelines may reject more bids from these institutions.

V. ANALYSIS OF SUBLOANS

1. Summary of Subloans Outstanding

The following table summarizes the subloans currently outstanding:

Table 5: Subloans

IFI/Company	Sector	Amount (J$mil)	Interest	Term
Eagle Merchant Bank				
CCIAP, Ltd.	Manufacture	.512	50% var.	5 years
Hi-Mileage Retread	Transportation	2.295	50% var.	9 years
Total		2.807		

<u>Mutual Security Bank</u>				
Citrad Ltd.	Manufacture	.067	64% var.	4 years
St. Albion Estates	Agriculture	1.000	64% var.	5 years
Thermo-plastics Ja.	Manufacture	<u>.263</u>	64% var.	5 years
Total		1.330		
<u>Bank of Nova Scotia</u>				
L.A. Beadle	Agriculture	<u>2.506</u>	31.5% fixed	10 years
Total		2.506		
<u>Century National Bank</u>				
VGC Holdings Ltd.	Furniture	1.000	67% var.	2 years
VGC Holdings Ltd.	LPG cylinders	4.000	67% var.	10 years
Gibson Greve	Tourism	1.000	70% var.	Revolving
Three C's	Agriculture	14.203	69% var.	Revolving
Premium Finance	Tourism/Const.	credit	69% var.	Revolving
Eximpo	Bathroom fixt.	2.500	69% var.	Revolving
Aluminum Bldg. Prod.	Construction	3.624	69% var.	Revolving
Kingst.Arm.& Dynamo	Mining	.500	69% var.	Revolving
Global Construction	Construction	10.000	69% var.	Revolving
Central Rent-a-Car	Tourism	2.000	69% var.	Revolving
Community Televsn.	Motion Picture	2.600	69% var.	Revolving
Eurotrend Mfg. Co.	Kitch. cabs.	2.600	69% var.	Revolving
Alton Morgan & Co.	Airline	11.063	69% var.	Revolving
C.O. Jacks	Construction	<u>39.828</u>	69% var.	240 days
Total		94.918		
<u>Century National Merchant Bank</u>				
C.O. Jacks	Construction	7.576	70% var.	Revolving
Claudine Clusters	Construction	<u>9.261</u>	49% var.	4 years
Total		16.837		
<u>Trafalgar Development Bank</u>				
Nestle-JMP Ja. Ltd.	Agribusiness	<u>2.333</u>	34% var.	5 years
Total		2.333		
<u>National Development Foundation of Jamaica</u>				
Fitzroy Fagan	Refrig. repair	.290	30% fixed	3 years
Winsome Belnavis	Body care	.262	30% fixed	5 years
T. & I. Williams	Garment manuf.	.042	30% fixed	3 years
Pauline Housen	Grocery retail	<u>.027</u>	30% fixed	2 years
Total		.621		
Total Subloans		121.349		

Corporate Merchant Bank	Funds drawn but no subloans made.
Workers Bank	Funds drawn but no subloans made.
Horizon Merchant Bank	Loan agreement not signed, no funds drawn.

2. Description of Subloan Projects

The following section provides a brief description of some of the projects which currently benefit from Section 108 subloans. The dates the subloans were generated, if available, are in parentheses.

Caribbean Chalk Instruments & Art Products Ltd. (CCIAP Ltd.) (12/20/90) is a subsidiary of Intercorp Holdings Ltd. The associated companies include a stationery manufacturer which produces school supplies, ledgers and diaries; and a garment manufacturer that specializes in made-to-order uniforms. The chalk company makes school chalk and received a franchise from a British company to produce crayons. The loan was to assist the company in purchasing new premises and importing machinery and other capital goods necessary for the expansion. The project was intended to produce crayons for the Jamaican and CARICOM markets, which were dominated by Japanese and Taiwanese imports, producing foreign exchange and substituting for imports. This project has had management problems and principal and interest are overdue.

Hi Mileage Retread Ltd. (2/22/91) is a franchisee of the US company Oliver Rubber. It imports precured rubber tread for recapping of commercial vehicle tires. It began tire recapping operations in February 1990. Its only competitor in Jamaica is a franchisee of the US company Bandag. The Section 108 loan helped to finance start-up costs for acquisition of factory and office premises, machinery and raw materials. The project contributes to efficiency and productivity of commercial transport in Jamaica.

Citrad, Ltd. (2/28/90) produces ballast for fluorescent lights and lighting fixtures. Citrad evolved from a family-owned radio shop begun in the 1940's into a retailer of a broad line of domestic appliances. It now concentrates on electronics and electrical equipment. The Section 108 loan helped Citrad purchase a wire cutting machine to eliminate a bottleneck in its production line and to import new technology from Germany for a punch press which makes stainless steel bolts. Citrad exports to CARICOM countries.

St. Albion Estates (2/28/91) is a 300 acre farm on Jamaica's North Coast near Port Maria. The current owner rehabilitated a cocoa estate on the property and planted tomatoes, onions, beets, turnips, papaya, mango, and ugli fruit to sell to the tourist industry and local higglers. The Section 108 loan supported the expansion into tree crops. Principal and interest on this loan are overdue because the project had difficulties making a return high enough to cover the increased interest rates. The owner is clearing the arrears by selling part of the land.

Thermo-plastics (Ja.) Ltd. (5/9/90) has the largest and most modern plant in the Caribbean for production of plastics. It produces plastic packaging materials, housewares, fittings, and PVC pipes, which are sold in Jamaica and other CARICOM countries. The Section 108 loan was used to finance injection molding machines for soft drink crates.

L.A. Beadle (12/90) is the sole proprietor of the largest pig farm in Jamaica, which commands 20 percent of the local market. Because of strong demand for pork products, Mr. Beadle expanded his facilities and increased the number of sows on his farm. The Section 108 loan provided financing for the expansion. The project created new employment and increased the amount of locally produced pork products, which compete with imported meats and pork.

VGC Holdings Ltd. (7/31/91) has two divisions, an LPG cylinder plant and a school and office furniture plant. Both divisions received Section 108 loans for expansion. The furniture plant supplies most of Jamaica's school furniture. The Section 108 loan was used to refurbish the plant and expand production capacity, increasing employment from 20 to 30 workers. VGC hopes to export office furniture as well. The LPG cylinder plant is the sole producer of LPG cylinders in Jamaica. The expansion project financed by the Section 108 loan brought new technology to Jamaica in the form of presses, allowing VGC to fabricate the entire LPG cylinder locally. The project increased VGC's employment by around 20 workers. VGC's major competitor for cylinders is Trinidad and Tobago.

Gibson Greve (7/91) services pumps, air conditioners and generators islandwide through a radio despatch system. Major customers are airlines, hotels and office buildings. Increased power outages have greatly increased the firm's workload in generator servicing. The Section 108 loan was for working capital to purchase fittings and fixtures for pumps and service equipment. The firm emphasizes new energy efficient technologies for generators and air conditioners. The loan permitted Gibson Greve to increase its employment to meet the new demand for its services.

Three C's (12/91), one of the few agricultural projects benefitting from the Section 108 funds, is a farm near Ocho Rios which produces chickens, cattle and coffee. The owners have leased 16,000 acres of government-owned land which was at one time operated as Lydford Farms by Reynolds Aluminum Co. They operate 6,000 acres for their farm and sublease 10,000 acres to small farmers. Because the aluminum companies will mine the bauxite from the land at some time in the future, the government does not wish to sell it. Three C's used the Section 108 loan for diversification: to purchase houses for broilers and to plant papaya and coffee for export. The farm currently has facilities for 77,000 chickens, 1600 head of cattle, 15 acres of papaya and 60 acres of coffee. The papaya and coffee are exported, while the beef and chickens are sold locally. The farm employs about 110 persons, and this increases by about 50 when coffee is reaped. The chicken houses financed by the loan have an automatic feeding and drinking system which brings new technology to Jamaica.

Premium Finance (6/92) used the Section 108 loan to finance the construction of 112 rooms and ancillary structures for the exclusive resort called Enchanted Gardens. This all-inclusive luxury resort incorporates the Carinosa botanical gardens and aviary. Open for about three years, its main clientele comes from Canada, but Americans, Italians and to a lesser extent other Europeans are also frequent visitors. It employs around 250 persons and earns foreign exchange for the tourist industry. This project is in credit with its Century National Bank overdraft, but can draw on the funds at any time.

Eximpo Ltd. (12/91) supplies imported bathroom fixtures to the construction industry. The firm, which is owned by a woman entrepreneur, is new to the industry. It specializes in fixtures which conserve water. It employs 15 workers. The Section 108 loan was used for working capital to import supplies.

Aluminum Building Products Ltd. (6/92) is a subcontractor to the construction industry for installation of aluminum extrusion products, particularly window frames and door jambs which are designed to withstand the stress of a hurricane. It is a new, family owned company, which employs around 35 people. The Section 108 loan was for working capital to purchase materials.

Kingston Armature & Dynamo Works (11/91) supplies support services to the bauxite industry by servicing generators and pumps for heavy duty equipment. The bauxite companies used to provide these services themselves, but recently have begun contracting them out to local firms. The bauxite companies pay in foreign exchange. This firm employs around 35 workers. The Section 108 loan was used for working capital to purchase spare parts.

Global Construction Ltd. (9/94) is a well established real estate development firm which constructs office buildings. The Section 108 loan provided working capital which enabled the firm to increase its employment to the current 400 workers. This firm specializes in a new technology of metal casings for building columns which cuts construction costs by up to 20 percent.

Central Rent-a-Car (9/94) is a car rental firm based in Montego Bay which caters to the tourist industry. The firm is fairly new, employs about 35 people and earns foreign exchange. The Section 108 loan was to purchase spare parts and provide maintenance for the rental cars.

Community Television Systems (9/94) rents equipment and machinery to foreign film producers who make movies in Jamaica and films television ads. It earns foreign exchange and employs 25-30 people. CTS used the Section 108 loan to purchase cameras, lighting and fixtures which it will use in the business.

Eurotrend Manufacturing Company (9/94) makes kitchen cabinets and cupboards for middle and low income homes, as a supplier to the construction industry. The Section 108 loan was used for working capital to buy lumber and fixtures. EMC competes with imported cabinets, and is therefore an import substituting company. It employs around 30 workers.

Alton Morgan & Company (9/94) operates a small airline that flies to Miami. It is less than two years old and has had some start-up problems. The company used the Section 108 loan to purchase equipment for the airline, which expects to earn foreign exchange and generate employment in the future.

C.O. Jacks (7/90) constructs middle income townhouses and apartment buildings, concentrating on condominium developments. C.O. Jacks used the Section 108 loan as working capital for two developments, Gardens of Acadia and Townhomes of Manor Park. The first, which employed 300 workers at the peak of construction, has 72 apartments and 19 townhouses. The second employed 400 workers at the peak of construction and has 34 townhouses and 64 apartments. These two developments fill a growing need for housing for young professional Jamaicans.

Nestle-JMP Jamaica Ltd. (10/91) is a subsidiary of the Swiss firm Nestle. It produces condensed milk and other processed food products for local consumption and export. Nestle used the Section 108 loan to finance a new Rotomat rotary counter pressure retort, which sterilizes condensed milk and suppligen in the can.

Fitzroy Fagan took the Section 108 loan from NDF/J to purchase spare parts for repair and maintenance of refrigerators and air conditioners. He is the sole proprietor of a business which can save foreign exchange by substituting for service personnel from abroad. The project employs five persons.

Winsome Belnavis runs a health and body care business in Kingston. He used the Section 108 loan to purchase equipment and health skin care products for his company.

Tamika Williams/Ian Williams run a garment manufacturing business in Montego Bay which produces printed shirts and hand knitted garments. They used the Section 108 loan to purchase machines, install fixtures and purchase raw materials to expand their business. The project has export and employment creation potential and brings new entrepreneurs into the sector. It employs four persons.

Pauline Housen used the Section 108 loan to purchase stock for her grocery retail business. This loan brings a new entrepreneur into the sector, employs four persons and improves the distribution network for agricultural commodities.

The following projects have repaid their Section 108 subloans.

Elite Enterprises (11/91) manufactures aluminum extrusion products for the construction industry. Previously owned by the bauxite company Alcan, this firm was sold to new entrepreneurs a few years ago. It employs 300 workers and sells its aluminum products both in Jamaica and throughout the Caribbean, thus earning foreign exchange. Its only competitor is in Trinidad. The Section 108 loan was part of a larger package to finance start-up costs.

Montego Bay Investment Company used the Section 108 loan as part of a larger package to finance the renovation and expansion of an old Montego Bay hotel. The owner purchased the 40 room Beachview Hotel in 1988 and transformed it into a 100 room hotel, the Gloucestershire. The work force has doubled from 40 to 80 employees, and the hotel earns US dollars for Jamaica from its largely American clientele.

Caribspray Ltd. (5/90) makes paint, roof coatings, insulation, protective linings and waterproofing. It competes as a low price wholesaler and direct retailer against larger paint companies. The J$1.2 million Section 108 loan from George & Branday was to finance expansion and renovation. Caribspray purchased property that significantly expanded its warehousing and factory space. It can now double its production and increase employment.

Prudential Stockbrokers (5/90) is a brokerage firm which used the Section 108 loan for working capital to create a secondary market for Bank of Jamaica Treasury Bills. Widening and deepening financial markets in Jamaica and removing the Bank of Jamaica from its position as the sole purchaser of its own securities is an important macroeconomic policy goal. Previously this was an undeveloped area for brokerage firms. This loan brought a new financial service to Jamaica and helped to promote sectoral and macroeconomic policy goals.

Cabama Ltd. (5/90) is a joint venture between Grace Kennedy Properties and a construction company. The J$1.2 million Section 108 loan financed part of a J$9 million real estate development project to construct ten townhouses in Kingston. The project created employment for construction contractors building the townhouses.

General Merchandise (5/90) has been a wholesaler and distributor of Jamaican produced brand name consumer products since 1982. Because of its expanding volume of business, the owner decided to purchase a new site which would provide more warehouse and office space. The Section 108 loan financed the land and building purchase. Since the expansion, General Merchandise's sales have increased almost 40 percent, allowing it to expand employment. Since it sells Jamaican products, its ability to minimize distribution costs and compete with imports brings an import substitution component to the project.

Hescov Investments Ltd. (9/30/92) used the Section 108 loan as part of the surety to finance the US$7 million purchase of the Jack Tar Village Hotel and Property in Montego Bay. Since the sale of publicly owned hotels to the private sector was an important subset of the government divestment program, the project financed by this loan contributed to macroeconomic and sectoral policies.

Y.P. Seaton & Associates Ltd. (interim finance) has been in business for thirty-five years, most as consulting engineers. About ten years ago the company branched into construction. This project was a J$140 million 692 unit low income housing scheme in southern Jamaica. The primary financing came from the National Housing Trust, while the higher interest Section 108 loan provided short term working capital. The project employed 250-300 construction workers and contributed to the policy goal of alleviating the housing shortage, particularly for low income people.

Danscha Manufacturing Co. Ltd. (interim finance) operates a plant in Spanish Town producing women's undergarments. Danscha is a new company created to restart a closed brassiere factory in Trinity, a rural area of Jamaica. Both plants utilize the 807 program for exports to the United States. The Section 108 loan supplemented a long term fixed interest loan from the National Development Bank to finance the purchase and start-up of the factory. The closed factory offered an attractive investment prospect because the labor force was drawn from women living in the surrounding rural area. Thus most of the trained labor force was still available when the plant was reopened. Danscha's work force is expected to increase to a peak of 400. The project will also generate foreign exchange for the country, since 100 percent of production is exported under subcontracts to US firms.

Agape-Praise Holdings Ltd. (1/31/91) is a group of companies involved in spare parts distribution and automobile rental in the tourism sector. Since rental cars for visiting tourists are always in short supply, the project should generate foreign exchange earnings and alleviate the transportation bottleneck in the tourism industry. The Section 108 loan was used for working capital.

Ciboney Villas Ltd. (2/22/91), a subsidiary of Ciboney Holdings Ltd., is the second phase of a multi-faceted tourism project. The first phase is a 250 room all-inclusive hotel in Ocho Rios, completed and opened in 1989. The second phase includes seventy-five luxury villas, a country club/hotel complex, sports installations, several restaurants, and a convention center seating up to 450 people.

National Continental Corporation Ltd. (1/1/90) is a food products conglomerate. Among its subsidiaries are Caribbean Broilers, which supplies broiler meat for a third of the local market; Newport Mills, which produces animal feed; and National Continental Foods, a bakery for bread, biscuits and confectioneries. The Section 108 loan was part of a package to finance purchase of new facilities to consolidate warehouse and distribution operations, improving wholesale marketing and reducing the cost of distribution to retailers.

A.H. Building Ltd. (1/1/90) makes pre-fabricated concrete panels for low income houses. The Section 108 loan financed the purchase of a second 140 ton P&H model crane and a Manitowac 2900 ton 80 foot boom, which enabled the company to work at more than one site simultaneously. The bulk of the company's work is for government sponsored low income housing complexes.

Coffee Producers (6/30/91) owns 400 acres of land in the Blue Mountains. The coffee farm sustained extensive damage from hurricane Gilbert in 1988. The Section 108 loan financed a program of rehabilitation and maintenance to return the damaged trees to bearing. It included cutting back damaged trees; replacing those that were uprooted; controlling weeds, diseases and pests during the several years it takes plants to reach maturity; and fertilizing the trees.

Beachcomber Resorts involved the construction of a prestigious condominium complex on a beach front property in Negril. It contains four one-bedroom and eighteen two-bedroom units, with a restaurant, bar, swimming pool and other facilities.

3. Analysis of Subloans

Since the Section 108 guidelines stipulate that the quality of the subloans is the ultimate test of performance under Section 108, this section evaluates the subloans in light of the program's objectives. Because Congress intended that the Section 108 program would direct more foreign assistance to the private sector, the real test of the program's success is in the developmental impact of the subloans.

This evaluation assumes that a project must have one or more of the following five characteristics to have a developmental impact on a country:

1. Potential to create employment.

2. Potential to earn foreign exchange through export of goods or services or to save foreign exchange through import substitution.

3. Brings new technology or processes to Jamaica.

4. Brings new entrepreneurs into the sector, stimulating competition and efficiency.

5. Contributes to implementation of sectoral or macroeconomic policy objectives.

In addition, the evaluation assumes that the main advantage of Section 108 funds is the longer term maturity at a fixed interest rate, and therefore looks at interest rates and term structure of the subloans. Finally, since Congress expressed a preference for investment in the agricultural sector when possible, the evaluation considers the sectors to which investment was flowing.

a. Terms and Sectoral Distribution

The 1991 evaluation found that IFIs were usually passing on the longer term maturity of Section 108 funds to the borrowers. This is no longer the case. The bulk (14 out of 23) of "first tier" Section 108 subloans outstanding today are "revolving," which means they are essentially short term overdraft facilities, despite the precatory language in the loan agreement expressing preference for loans of three years or above. Section 108's fixed rate is also benefitting mainly the IFIs. Only one out of 22 "first tier" loans carries a fixed interest rate. Interest rates on all other subloans have increased considerably since the last evaluation along with the overall level of interest rates in the economy. IFIs make fixed rate business loans in Jamaica only when on-lending development bank funds, because other sources of funds carry variable interest rates. The "second tier" institutions have passed on the longer term and fixed interest rate charged by USAID to a greater extent than the "first tier" IFIs because they have different policies for setting rates.

Table 6: Terms of Subloans

Terms	Number of Subloans
First Tier IFIs (22 subloans)	
Fixed interest rate	1
Variable interest rate	21
Revolving	13
Two years	1
Between two and five years	5
Over five years	3
Second Tier IFIs (5 subloans)	
Fixed interest rate	4
Variable interest rate	1
Revolving	0
Two years	1
Between two and five years	4
Over five years	0

Section 108 guidelines state that the purpose of the subloans is "development of private enterprise institutions and infrastructure as the base for the expansion, promotion, and improvement of the production of food and other related goods and services within Jamaica." They also require that borrowers give preference, to the maximum extent feasible, to the financing of agricultural related enterprise.

Although the banks try to give priority to agricultural projects whenever possible, only four of the twenty-seven loans and 16.5 percent of the funds from the auction have gone to the agricultural sector. This is, however, a major improvement over the 1991 evaluation when only 8 percent of the funds went to agriculture. The main constraint on agricultural lending is high interest rates which result from macroeconomic policies. Because the rate of return in agriculture is generally lower than in other sectors, few agricultural projects can sustain the current high positive interest rates.

Table 7: Sectoral Distribution of Subloans (Numbers)

Sectoral Distribution	Number of Subloans
First Tier IFIs (22 subloans)	
Agriculture	3
Manufacturing	5
Tourism	3
Housing	2
Other construction	4
Transportation	2
Services	2
Trade	1
Second Tier IFIs (5 subloans)	
Agriculture	1
Manufacturing	1
Tourism	0
Housing	0
Other construction	0
Transportation	0
Services	2
Trade	1

IFIs have provided information on subloan distribution for about half the amount auctioned, because 1) Eagle Merchant and Mutual Security have not yet reloaned funds that were repaid, 2) Corporate Merchant and Workers Bank have not yet loaned their J$58.94 million, and 3) Horizon Merchant and Century National Banks have not yet signed loan agreements for J$96.737 million. Of the J$127.349 million in subloans reported to USAID by the IFIs, the following table shows the percentage distribution by sector. A marked shift in sectoral distribution has occurred since the last program audit. In 1991 the tourism sector received the bulk of funds; today, the construction industry, including housing, is the major recipient, with 60 percent of total subloans. The construction appears to be concentrated in housing and office buildings. The following table sets out the percentage of funds flowing to the sectors.

Table 8: Sectoral Distribution of Subloans (%)

Sector	Amount (J$'000)	% of Total
Agriculture	20,042	16.5%
Manufacturing	5,884	5%
Tourism	3,000	2.5%
Housing	47,404	39%
Other Construction	25,485	21%
Transportation	13,358	11%
Services	3,652	3%
Trade	2,527	2%

b. Developmental Impact

All subloans have at least one of the five developmental criteria, and most have two or more. Of the 22 "first tier" IFI subloans, three had only one development criterium, 13 had two, and six had three. Of the five "second tier" subloans, one had one developmental criterium, three had two, and one had three. The average for both "first tier" and "second tier" institutions is two developmental criteria per loan. The following table shows the number of subloans in each category of developmental criteria and by sector:

Table 9: Developmental Impact of Subloans

Developmental Criteria	Number of Subloans
First Tier IFIs	
Employment creation	15
Foreign exchange earning or import substituting	15
New technology or processes	6
New entrepreneurs	6
Contributes to macroeconomic or sectoral policies	3
Second Tier IFIs	
Employment creation	1
Foreign exchange earning or import substituting	3
New technology or processes	1
New entrepreneurs	4
Contributes to macroeconomic or sectoral policies	1

Employment creation and foreign exchange earning or import substituting are the most frequently found criteria in the "first tier" institution loans. The "second tier" institutions' most frequent criterium was bringing new entrepreneurs into the sector. This is primarily because NDF/J emphasizes helping new entrepreneurs in its loan programs.

VI. SECTION 108 MANAGEMENT

1. General Description of the Auction Procedures

The auction system is still operating much the way it did at the beginning.[6] DTT provides an information manual and a briefing for eligible IFIs before soliciting bids. IFIs interested in bidding must submit their most recent audited and latest in-house financial statements to DTT for prequalification evaluation. DTT then invites prequalified IFIs to submit bids, stating the amount of funds to be auctioned, the deadline for receiving bids, and the bid opening date. The limit on USAID's exposure to one IFI at any one time remains two and one half times the institution's equity, defined as share capital and reserves.

USAID establishes a confidential floor interest rate, which cannot be lower than the rate of inflation. This rate is used to reject unacceptably low bids.

On the designated day, DTT opens, reads and records each bid publicly. Thus the IFIs know immediately whether they have won funds in the auction.

2. Loan Agreements

After DTT determines the winning bids, USAID negotiates loan agreements with the IFIs. The loan agreement specifies a ten year repayment period at the bid interest rate, with two years grace for principal repayment. Borrowers agree to use the principal to make subloans for the purpose of financing productive private enterprise investment within Jamaica, which will have a developmental impact on the economy.

The loan agreement requires the borrower to submit quarterly statements listing subloans approved, the amount outstanding and the status of each subloan. In addition, the borrower agrees to an external annual audit of each subloan, the results of which are to be forwarded to USAID.

Borrowers are required to furnish USAID information as it may reasonably request on the outstanding Section 108 loans and on the financial viability of the borrower. Under

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[6]See Dorothy J. Black, *The First Auction of PL-480 Section 108 Funds: A Jamaican Experience*, March 1990, for further details.

Section 22 of the loan agreement, it is an "event of default" if the borrower fails to comply with any provision of the loan agreement.

Based on the results of the last program evaluation, USAID revised the terms of the loan agreement with IFIs in two areas. First, the loan agreement now contains a clause stating the borrower agrees, "to the maximum extent practical, to make subloans for periods of time that exceed three years." This is an attempt to ensure that IFIs pass on the advantage of longer term lending to the productive enterprises who take subloans. Second, the loan agreement now requires that funds be disbursed to IFIs within 12 rather than 18 months, and that 50 percent of the funds be disbursed within the first six months. IFIs were apparently slow to request the funds they had won at auction when interest rates swung below the rates they had bid. This problem stems from interest rate volatility during the period under discussion.

USAID also changed the auction procedures to require a US$1,000 good faith bond for each IFI participating in the auction. This was precipitated by the problems encountered in the seventh auction, when seven IFIs refused to accept funds they had won at the auction. Starting with the eighth auction, each IFI submitting bids must give USAID a check for US$1,000. USAID retains this bond without interest until all loan agreements are signed. Only if an IFI wins in the auction and subsequently fails to accept the funds does it forfeit its bond.

3. Compliance With Loan Agreements

In conducting this program audit, the author found that IFIs were in some instances failing to comply with loan agreement terms, primarily reporting and subloan audit requirements.

As of March 31, 1994, none of the nine IFIs with outstanding Section 108 loans had submitted the annual audit of each subloan as required in clause 11(D) of the loan agreement. Four IFIs had no financial statements available for periods ending after 1992.[7] As of the date of this report, two IFIs[8] have submitted no quarterly reports at all on subloans as required in clause 11(A), and three IFIs[9] have submitted no quarterly reports since December 1993.

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[7]Corporate Merchant Bank, Workers Bank, Trafalgar Development Bank and National Development Foundation.

[8]Corporate Merchant Bank and Workers Bank.

[9]Century National Bank, Century National Merchant Bank and Trafalgar Development Bank.

A potential problem also exists regarding "regeneration loans." Since USAID lends Section 108 funds to IFIs for ten years and the average subloan is for a shorter term, a large number of end-borrowers repay their subloans before the IFI repays USAID. When a borrower repays a subloan, the loan agreement terms require the IFI either to relend the Section 108 funds to productive enterprise according to the purposes of the program or repay the money to USAID. This requirement is not well understood or monitored by the IFIs. The problem tends to arise in regard to the older Section 108 loans, where subloans are more likely to be repaid. For example, Eagle Merchant Bank and Mutual Security Bank each won J$10 million in the first Section 108 auction. Each has a balance of J$6.875 million outstanding. Each loaned the entire J$10 million to productive enterprises at the outset. However, Eagle now has only J$2.8 million in outstanding subloans, and Mutual Security has only J$1.3 million. Neither reloaned the funds nor prepaid the money to USAID. Having been advised that they should relend these funds, both IFIs are confident they will find appropriate projects to benefit from the program. This aspect of the program clearly needs closer monitoring, to ensure that IFI personnel responsible for Section 108 loans are fully aware of the program's requirements.

VII. ISSUES

1. Issues From Prior Program Audits

This audit reviewed issues identified in prior program audits to determine whether they are still of concern. These issues are discussed below.

a. Should USAID Modify the Standard Loan Agreement to Address the Following?

Early repayment: The loan agreement permits IFIs to prepay without penalty provided they give 60 days notice. No IFI has prepaid Section 108 funds since 1991. Given the volatile interest rates in Jamaica, a prepayment penalty would be a significant deterrent for IFIs to bid market rates for Section 108 funds. The current loan agreement conforms to Section 108 legislation and guidelines and should not be modified on this point.

Fixed versus variable interest rates: All lending rates in Jamaica are variable. Thus a variable rate has the attraction of conforming to market conditions. The arguments against variable rates in the context of the existing Section 108 program are, however, overwhelming. First, a variable rate is incompatible with an auction-determined rate. If Section 108 rates were to be variable, USAID would have to set rates for all loans to IFIs at the same level and adjust them periodically according to a predetermined formula. This could be done, but it would require a fundamental change in the program. Second, a variable rate would require considerably more administrative monitoring. At this stage of the program, where IFIs and USAID are comfortable with the existing system, it is not advisable to change to a variable interest rate.

Failure of the winning bank to draw down funds: As noted above, USAID modified the standard loan agreement to require IFIs to draw funds within 12 months of signing the agreement rather than 18 months. Since the first auction, IFIs have not failed to draw funds in a timely manner after the loan agreement is signed. A different problem arose in the seventh auction. Seven IFIs failed to sign loan agreements for funds after submitting winning bids at the auction because interest rates dropped shortly after the auction. USAID now requires IFIs to submit a good faith deposit of US$1,000, which a winning IFI forfeits if it fails to sign a loan agreement. The US$1,000 bond will help USAID to cover its costs of running the auction if a similar situation arises again, but it will not prevent IFIs from refusing the funds if their bids are significantly above prevailing interest rates. Unless USAID can accurately predict the direction of interest rates, the problem is likely to arise again when interest rate volatility increases.

Use of funds for capital leases and insurance premiums: USAID's regional legal advisor resolved these two issues in 1991 when he concluded that both are eligible uses of Section 108 funds. Regarding capital leases, the regional legal advisor determined that a capital lease in Jamaica is in effect a loan and is therefore eligible for financing under Section 108 legislation. Regarding insurance premiums, he determined that as long as an insurance premium is attached to a productive investment that qualifies under the terms of the legislation, financing the insurance under Section 108 funds is permitted.

Monitoring the financial viability of IFIs: The Section 108 loan agreement has no provision requiring IFIs borrowing Section 108 funds to furnish USAID with annual audited financial statements to enable USAID or its agent to monitor the borrowers' financial viability. Clause 11(A) of the loan agreement does require the borrower to furnish the lender with such information and reports relating to activities under the agreement and under subloans as the lender may reasonably request. However, as noted above, four of nine institutions with Section 108 loans have to date failed to provide 1993 financial statements. DTT, USAID's consultant for the auctions, pointed out in the past that if IFIs continue to bid in subsequent auctions they will be required to furnish recent financial statements. This safeguard may not prove effective in the future, since auctions will be held less often, once the original PL 480 Section 108 funds have been exhausted.

Particularly if USAID auctions more funds to "second tier" institutions, which tend to be higher risk than "first tier" institutions, USAID or its agent should diligently insist that borrower IFIs provide annual financial statements sufficient to assess financial viability, as required by Section 108 legislation and guidelines. It is reasonable, pursuant to clause 11(A), to expect borrower IFIs to submit annual audited financial statements on their own operations. USAID should also insist that they provide the externally audited statements for subloans, which are explicitly required in clause 11(D) of the loan agreement. Bank auditors generally audit a certain percentage of outstanding loans on a random basis. IFIs should experience no difficulty in including the Section 108 subloans in this random sample.

b. Limits on IFI Spreads

Previous audits raised the question whether USAID should limit IFI spreads on funds won at Section 108 auctions. Only one "first tier" IFI--Bank of Nova Scotia--has seen fit to pass on the advantage of a fixed long term interest rate to the subborrower in the current high interest rate environment. In all other cases, IFI interest rates on Section 108 subloans have followed prevailing interest rates regardless of USAID's lending rate, resulting in spreads up to 45 percent on these funds. In these cases, it is hard to argue that anyone other than the IFIs are benefitting from the long term fixed interest rate loans.

Nevertheless, it is not clear that a limit on spreads is the answer to the problem. The problem arises from the volatility of interest rates and the general trend towards increased rates since 1989, the date of the first auction. Spreads on funds won in later auctions are lower, consistent with market trends. The previous program audit found that a limit on spreads for Section 108 funds would increase the program's administrative costs and reduce its simplicity and flexibility, two of its major attractions. A limit on IFI spreads is not recommended. Since "second tier" institutions appear to be passing on the benefits of the fixed rate long term funds offered by the Section 108 program to a greater extent than the "first tier," one solution to this issue is to auction more funds to "second tier" institutions.

c. Implementation Delays

IFIs experienced delays in disbursement of funds only in the first auction. Disbursements have proceeded smoothly in subsequent auctions, indicating this is no longer a problem.

d. Ministry of Finance Order of Exemption for Withholding Tax on Section 108 Interest

The Ministry of Finance has still not signed and gazetted the necessary order exempting USAID from withholding tax on interest payments for Section 108 funds, although USAID is tax exempt under its bilateral treaty with the Jamaican Government. In 1991, the Bank of Jamaica legal advisor undertook to see that the Ministry of Finance issued the necessary order to remove any uncertainty in the program, but apparently he failed to follow through. This issue is not of concern, however, because after five years of the program no IFIs have withheld taxes on interest payments.

2. New Issues

a. Computation of the Floor Rate for First and Second Tier Auction

Section 108 guidelines require that interest rates be positive, which means above the rate of inflation. The issue arises whether the floor rate should be computed differently for the first and second tier auctions, as the institutions compete in different markets for funds.

The floor rate is intended as a minimum rate, below which bids will be rejected. The auction procedure determines the "market" rate. In fact, "first tier" auctions have consistently seen bid rates considerably above the floor rate. Bids in the "second tier" auction came in both above and below the floor rate.

Since Section 108 guidelines are clear that funds should not be loaned at negative interest rates in this program, the floor rates should be computed in the same manner for all auctions.

b. Monitoring and Compliance

Section VI.3. above noted that compliance with reporting and subloan audit requirements of the loan agreements is in some instances lax. Because Section 108 is a long term program which extends up to 20 years, given the ten year loans and ten year repatriation period, it is not surprising that the some of the IFIs have lost sight of the program objectives and obligations. Therefore, USAID or its agent should review IFI compliance with their loan agreements at least once a year. This includes assuring that IFIs provide 1) quarterly statements on subloans, 2) external audits on subloans, and 3) sufficient financial information on their own operations for USAID to be satisfied with their financial viability; and assuring that IFIs whose subloans have been repaid either relend the funds to productive enterprises (regeneration loans) or repay the funds for USAID to reauction. USAID or a designated agent should also review the subloans from time to time to assure that the objectives of the program are being met.

c. Limiting USAID's Exposure

The limit on USAID's exposure to any one IFI is currently set at two and one half times an IFI's equity, defined as share capital plus reserves. These amounts are relatively large in relation to the program, and no IFI has come close to reaching this limit. USAID should consider setting a second limit to apply to future auctions which assures that Section 108 does not become a dominant source of loan funds for any one IFI. This limit should relate to IFI liabilities. For example, one possible limit for commercial banks would be a percentage of deposits, because their loan funds come largely from deposits. A different measure should be applied to merchant banks, who fund their loans from other sources. A final decision on the appropriate measure for first and second tier institutions should be based on a study of the IFIs' sources of funds and USAID's relative risk when Section 108 borrowing is compared with other sources of funds.

d. Should USAID Continue "Second Tier" Auctions?

USAID held the first "second tier" auction in October 1992, two years ago. Unlike the "first tier" institutions, which have sufficient liquidity to meet current demand, the development banks appear to have a shortage of Jamaican dollar loan funds. The pros and cons of "second tier" auctions are set out in Section IV.4. above. Because the "second tier" institutions have a greater likelihood of meeting the developmental objectives of the Section 108 program in the current macroeconomic climate, this evaluation recommends that USAID continue the "second tier" auctions. Given the increased risk in lending to these institutions, USAID should require a rigorous prequalification procedure and close monitoring of the IFIs' financial strength and subloans, as suggested in VII.2.b. above. USAID may also wish to limit the first amount auctioned to "second tier" institutions to J$50 million, to assure that absorptive capacity exists at net positive interest rates for these institutions.

VII. FUTURE OF PL 480 SECTION 108 PROGRAM

Congress did not renew the Section 108 legislation when it passed the 1990 Agricultural Development and Trade Act. No new funds have flowed into the program since the FY1990 PL 480 allocations. However, reflows from principal and interest repaid by IFIs totals J$263 million to date, of which J$136 million is still available for auction. This section discusses program options as provided in the legislation and suggests a course of action for the IPG.

1. Options Provided in the Legislation

The Section 108 legislation stipulates that reflows may be used for 1) additional private sector lending to IFIs, 2) development of new markets for US agricultural commodities, 3) repayment of US obligations, or 4) conversion to dollars. The Interagency Policy Group (IPG) decides on the use of reflows and allocates between competing demands. Principle repayments must be converted to US dollars at the prevailing exchange rate beginning ten years after the last delivery of commodities from which the funds originated and ending 30 years thereafter. There is no provision for repatriation of interest generated from the loans, although presumably these funds may be used to pay US in-country obligations, thereby substituting for US dollars which would otherwise be used for this purpose.

Five percent of Section 108 funds have been reserved for the US Department of Agriculture's market development programs in Jamaica. To date, USDA has used little of these funds. Thus it is unlikely--initially at least--that market development activities will use the reflows. Repatriation cannot start until 1999 because the PL 480 agreement with the Jamaican Government specifies that conversion to US dollars may begin ten years after the delivery of commodities. The two competing uses for reflows in the immediate future will therefore be relending to IFIs and payment of US obligations. Since the auction program has worked well, it should be a strong contender for reflows.

2. Discussion

Section 108 reflows from principal and interest currently amount to J$50 million. Based on a weighted average interest rate of 37 percent for the outstanding loan balance of J$305 million, interest reflows alone should total over J$100 million over the next few years, a substantial amount of funds to assist productive investment. "First tier" IFIs interviewed for this study suggest that future "first tier" auctions should offer between J$50 million and J$100 million to attract participation. "Second tier" institutions would like to see between J$10 million and J$50 million in an auction for their use. This suggests that reflows should be sufficient to support two auctions annually, one for each tier with approximately J$50 million offered.

USDA currently has almost J$20 million in Section 108 funds set aside for agricultural market development. The USDA representative said she would not ask for Section 108 reflows until this fund has been utilized. She has no objection to USAID continuing Section 108 auctions at this time.

USAID currently finances the auction process with private sector development funds. At approximately US$20,000 per auction, this is a small portion of USAID's development budget. Auction financing is therefore not an issue at this time.

VIII. CONCLUSIONS AND RECOMMENDATIONS

After five years and eight auctions, the management of the auction is proceeding smoothly. IFIs are comfortable with the process and most management issues identified in previous program audits have been resolved. As the program matures, the new issues are program monitoring and compliance, the "second tier" auction, limits on USAID exposure as a lender, and the future of the program.

In general, the auctions of Section 108 funds appear to be meeting the objectives of the legislation. Analysis of the subloans was hampered to some extent by incomplete information. Each of the subloans for which information was available are having some developmental impact on Jamaica. The bulk of subloans are now in the construction sector--housing and office buildings--compared with the tourism sector three years ago, reflecting the focus of economic activity today. More funds are now flowing into short term working capital, raising some concern that the IFIs are not making sufficient efforts to pass on the long term fixed rate nature of the Section 108 funds to encourage productive enterprises.

The following recommendations arise from this program audit:

- USAID should hold the next auction for "second tier" institutions in the second quarter of FY1995, offering approximately J$50 million. USAID should use the same methodology to calculate the floor rate for the "second tier" auction as for the "first tier" auction.

- USAID should continue auctions using the reflows. Assuming sufficient funds are available, USAID should hold another auction for "first tier" institutions in the third or fourth quarter of FY1995, offering between J$50-100 million. This pattern of approximately two auctions annually alternating between the two tiers could be continued for the foreseeable future, assuming sufficient reflows are available.

- USAID should increase its dialogue with the IFIs who have won funds in the auction to assure their continuing compliance with reporting and audit requirements as well as program objectives. USAID should require audited financial statements from these IFIs at least annually to review their financial viability. In particular, USAID should make sure the IFIs are aware that they are responsible for regeneration loans unless they repay their Section 108 loans.

- USAID should study the question of a second limit on its exposure to IFIs in the Section 108 program to assure that it does not become the major outside lender for any single institution. The study should examine balance sheets of commercial banks, merchant banks and "second tier" institutions to determine appropriate limitations for each type of institution. For instance, USAID may not wish Section 108 loans to any one institution to exceed 10 percent of that institution's liabilities. USAID should base its final decision on the results of a comprehensive analysis of IFIs funding sources and USAID's associated risks.

APPENDIX 1
LIST OF PERSONS INTERVIEWED

1. Jamaican Government

    Dr. Wesley Hughes, Deputy Governor, Bank of Jamaica

2. Jamaican Private Sector

    Mrs. Valerie M. Crawford, Assistant General Manager, Mutual Security Bank Limited

    Mr. Donovan Crawford, Chairman, Century National Bank Limited

    Mr. Lloyd A. Prince, Financial Consultant, Century National Bank Limited

    Ms. Grace J. Palmer, General Manager, Corporate Merchant Bank and Workers Bank

    Ms. Sheila Martin, Manager, Financial & Corporate Planning, Trafalgar Development Bank Ltd.

    Mr. Edgar Watson, Jamaica Agricultural Development Foundation

    Mr. Las Talbot, Eagle Merchant Bank

    Mr. Peter Moses, Citibank

    Mr. Ralvey Brian, Churches Co-operative Credit Union

    Mr. Kenarthur Mitchell, City of Kingston Credit Union

    Mr. W. Billy Heaven, Executive Director, National Development Foundation

    Mr. Waldon Wright, Manager, Banking Services, National Development Foundation

    Mr. Dixon, Production Manager, Three C's Ltd.

    Mr. Philmore Ogle, Partner, Deloitte Touche Tohmatsu

    Ms. Maureen Woodham, Deloitte Touche Tohmatsu

3. U.S. Government

Mr. William Craddock, USAID, Office of Private Enterprise

Mrs. Valerie Marshall, USAID, Office of Private Enterprise

Mr. John Owens, USAID, Office of Private Enterprise

Mr. Christopher Brown, USAID, Office of Natural Resources and Development

Ms. Susan Schayes, Agricultural Attache (resident in Dominican Republic)

Ms. Carol Miller, USDA

Ms. Mohini Kiswani, U.S. Embassy

Appendix 2
Summary of USAID PL480 Section 108 Auctions

Auction	Date	Bank	Amount	Winning Bid	Bid Range	No. of Bidders	Amount Repaid	Total Demand
			J$	%	%		J$	J$millions
1st	August 1989	Eagle Merchant	10,000,000	19.00	)		3,125,000	
		Mutual Security	10,000,000	19.00	) 14.00–19.00	11		180,300,000
2nd	Feb. 1990	George & Branday	8,000,000	28.00	)		8,000,000	
		Century National	9,393,939	27.00	)			
		Century Nat. Merchant	7,575,758	27.00	) 23.75–28.00	10		139,400,000
		Bank Nova Scotia	3,030,303	27.00	)			
3rd	July 1990	Eagle Merchant	47,000,000	31.00	) 24.5–31.00	13	47,000,000	219,000,000
4th	May 1991	Century National	11,000,000	31.01	)			
		Century National	11,000,000	30.01	) 16.00–31.01	11		288,400,000
		Century Nat. Merchant	11,000,000	30.00	)			
5th	Sept. 1992	Corporate Merchant	10,000,000	35.0042	)			
		Corporate Merchant	20,000,000	33.07	) 15.00–35.004	15		637,700,000
		Workers Bank	28,940,000	32.004	)			
6th	Oct. 1992	Trafalgar Dev. Bank	2,000,000	24.00	)			
		Trafalgar Dev. Bank	333,000	22.00	) 12.00–24.00	7		16,500,000
		National Dev. Found.	667,000	22.00	)			
7th	March 1994	Century National	10,000,000	51.019	)			
		Century National	15,000,000	50.296	)			
		Century National	15,000,000	50.00	)			
		Century National	25,000,000	49.996	) 20.00–56.00	16		798,250,000
		Century National	8,263,000	49.99	)			
		Horizon Merchant	11,737,000	38.125	)			
8th	August 1994	Century National	10,000,000	39.00	)			
		Century National	15,000,000	38.60	)			
		Century National	25,000,000	38.50	)			
		Century National	15,000,000	37.60	) 17.00–39.00	4		220,000,000
		Century National	10,000,000	36.50	)			
		Century National	10,000,000	35.75	)			
TOTAL TO DATE			359,940,000					2,499,550,000

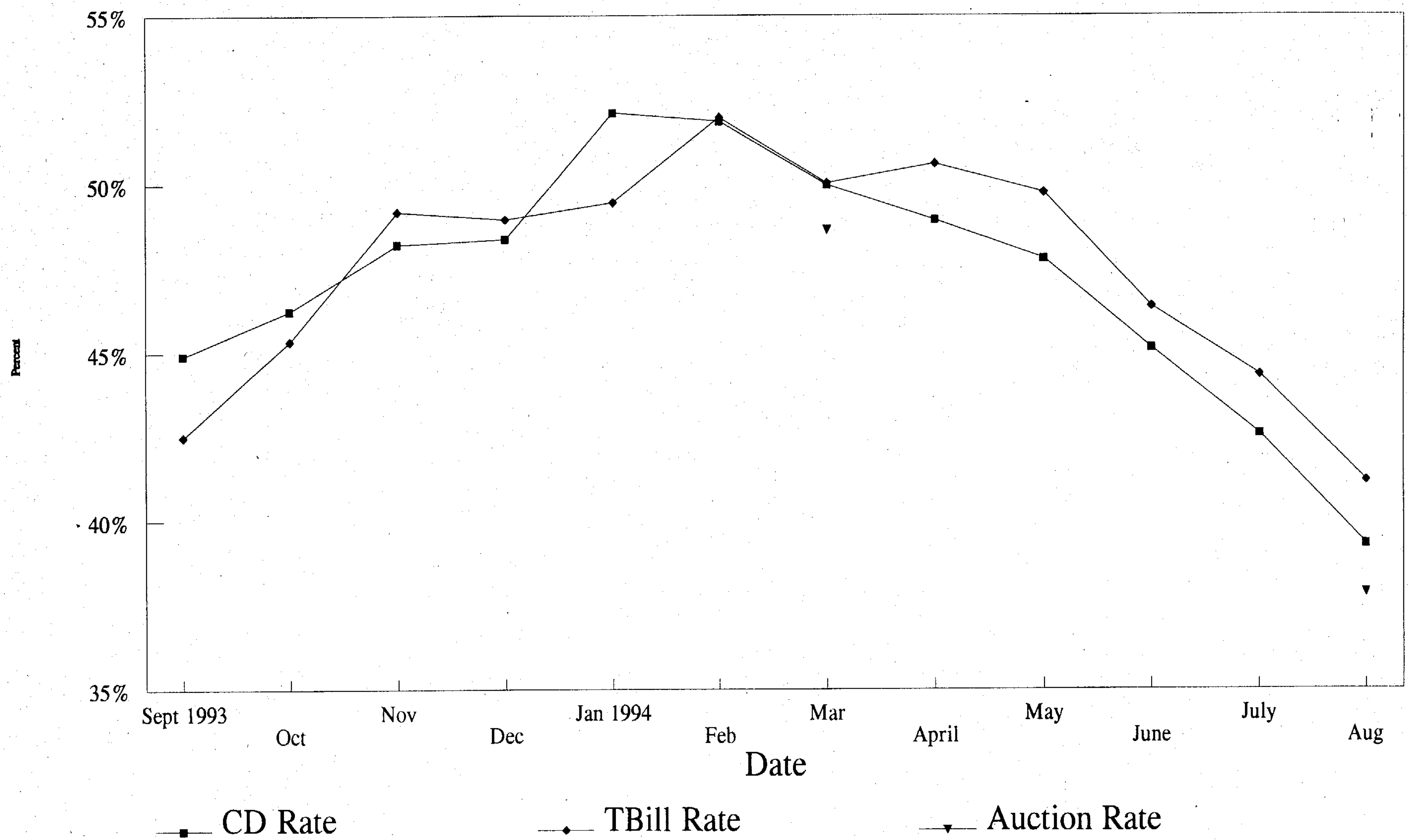
Appendix 3

Sub-Loans Outstanding as of October 1994

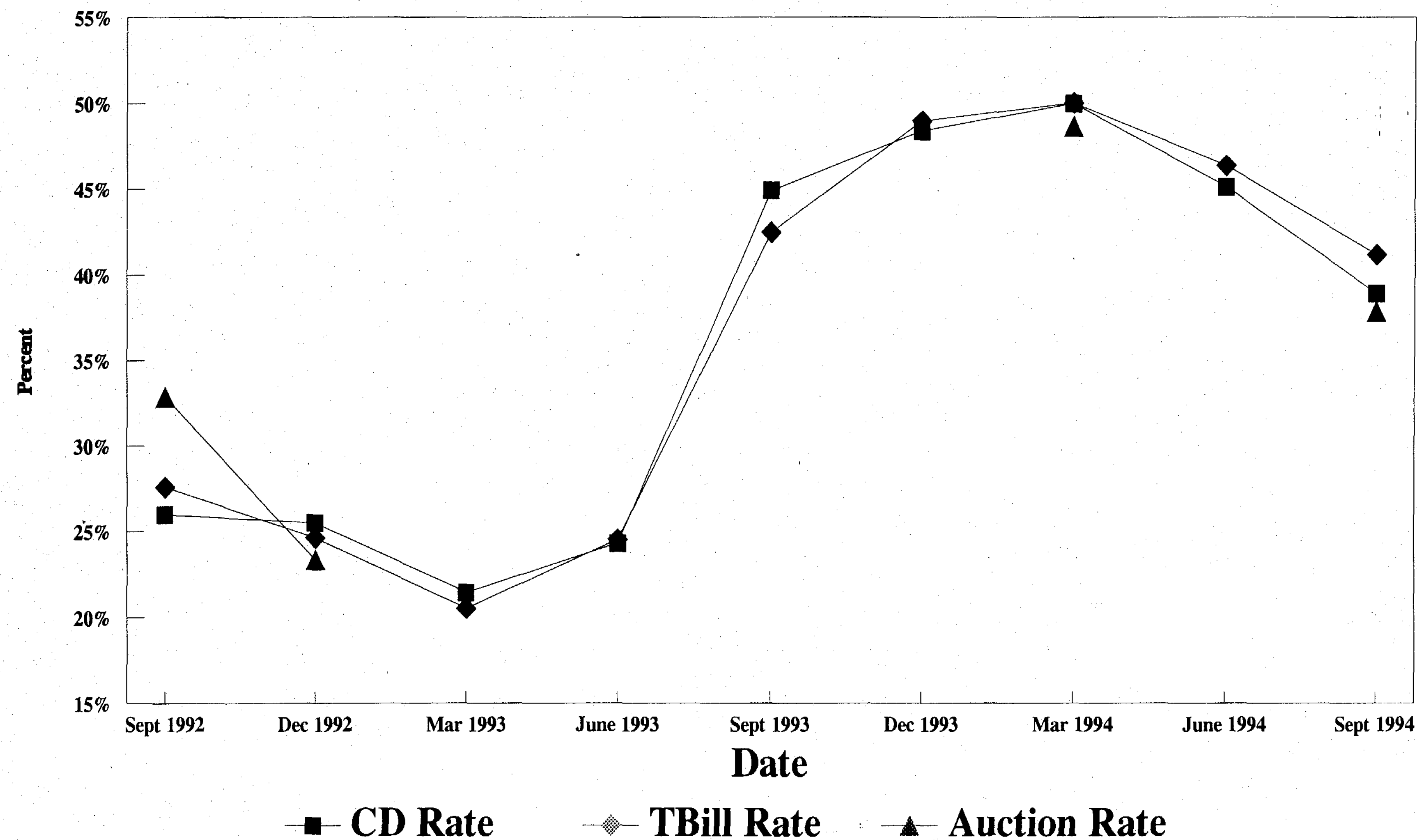
Borrower	Date of Loan	Loan Amount	Principal Balance	Interest Rate	Repayment Period	Sector	Purpose of Loan
		J$	J$	%	Years		
Eagle Merchant Bank							
CCIAP Ltd.*	12/90	511,506	511,506	50.0 var.	5	Manufacture	Acquire premises for expansion .
Hi Mileage Retread Ltd.	2/91	2,295,000	2,295,000	50.0 var.	9	Transportation	Acquire factory, office premises, vehicles.
Subloan Total			2,806,506				
Mutual Security Bank							
Albion Estates Ltd.*	2/91	1,000,000	1,000,000	64.0 var.	4	Agriculture	Finance expansion into tree crops.
Citrad Ltd.	2/90	1,000,000	66,666	64.0 var.	5	Manufacture	Purchase machinery to improve efficiency.
Thermo-Plastics Ja. Ltd.	5/90	2,000,000	262,959	64.0 var.	5	Manufacture	Finance machinery for soft drink crates.
Subloan Total			1,329,625				
Bank of Nova Scotia							
L.A. Beadle	12/90	3,030,303	2,505,527	31.5 fixed	10	Agriculture	Expand farm facilities, purchase sows.
Subloan Total			2,505,527				
Century National Bank							
V.G.C. Holdings*	7/91	5,000,000	5,000,000	67.0 var.	2 & 10	Manufacture	Refurbish plant, expand production facilities.
Gibson Greve*	7/91	1,000,000	1,000,000	70.0 var.	Revolving	Tourism	Support services for tourism trade.
Three Cs/Lydford Farm	12/91	14,202,926	14,202,926	69.0 var.	Revolving	Agriculture	Build chicken houses, plant papaya and coffee.
Premium Finance/Carinosa	6/92	credit	credit	69.0 var.	Revolving	Tourism	Construct 112 rooms for luxury resort.
Eximpo	12/91	2,500,000	2,500,000	69.0 var.	Revolving	Construction	Supply building supplies to tourism industry.
Aluminium Building Products	6/92	3,623,998	3,623,998	69.0 var.	Revolving	Construction	Construction.
Kingston Armature & Dynamo Works	11/91	500,000	500,000	69.0 var.	Revolving	Construction	Road construction and mining services for bauxite industry.
Global Construction Company	9/94	10,000,000	10,000,000	69.0 var.	Revolving	Construction	Working capital for office building construction.
Central Rent-a-Car	9/94	2,000,000	2,000,000	69.0 var.	Revolving	Tourism	Purchase spare parts and maintenance for rental cars.
Community TV Systems	9/94	2,600,000	2,600,000	69.0 var.	Revolving	Communications	Purchase cameras, lighting and fixtures to rent to film producers.
Eurotrend Manufacturing Company	9/94	2,600,000	2,600,000	69.0 var.	Revolving	Construction	Purchase lumber and fixtures for kitchen cabinet construction.
Alton Morgan Company	9/94	11,063,000	11,063,000	69.0 var.	Revolving	Airline	Finance for start-up airline.
C.O. Jacks	7/90	40,000,000	39,828,000	69.0 var.	240 days	Construction	Working capital to build apartments and townhouses.
Subloan Total			94,917,924				
Century National Merchant Bank							
C.O. Jacks	7/90	7,575,758	7,575,758	70.0 var.	Revolving	Construction	Build middle income apartments and townhouses.
Claudine Clusters	10/94	9,300,000	9,260,616	49.0 var.	4	Construction	Working capital for construction projects.
Subloan Total			16,836,374				
Trafalgar Development Bank							
Nestle-JMP Jamaica Ltd.	10/91	2,333,000	2,333,000	34.0 var.	5	Agriculture	Purchase new technology for milk sterilization.
Subloan Total			2,333,000				
National Development Foundation							
Fitzroy Fagan*	NA	290,000	290,000	30.0 fixed	3	Services	Spare parts for refrigerator and air conditioner repair and maintenance.
Winsome Belnavis	NA	290,000	261,940	30.0 fixed	5	Services	Purchase equipment for health and body care business.
T. Williams/I. Williams	NA	50,000	41,676	30.0 fixed	3	Manufacture	Purchase machinery and raw materials for garment manufacture.
Pauline Housen	NA	38,000	26,797	30.0 fixed	2	Trade	Purchase stock for grocery retail store.
Subloan Total			620,413				
Total			121,349,369				

*Principal and/or interest overdue.

Appendix 4
T-Bill, BOJ CD and Auction Interest Rates



Appendix 5
T-Bill, BOJ CD and Auction Interest Rates, 1992-1994



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