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LESSONS FROM EXPERIENCE: THE DESIGN AND IMPLEMENTATION OF COMMERCIAL LENDING PROJECTS BY A.I.D.'S BUREAU FOR PRIVATE ENTERPRISE

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FOREWORD

A.I.D.'s Bureau for Private Enterprise is a creation of the 1980s. It reflects A.I.D.'s growing emphasis on the private sector as the primary engine of growth in the developing world -- an emphasis which is increasingly shared by the governments and people of the developing world.

With A.I.D.'s desire to focus increased attention and resources on stimulating private sector activities came two unsettling realizations. Comparatively little was known about how best to use publicly funded programs to fuel the private sector; and even when we felt we knew what to do, A.I.D.'s procedures were frequently ill-suited to the task.

In an effort to address these problems, the Agency charged the Bureau for Private Enterprise with helping to identify, test and disseminate effective approaches for promoting and improving the performance of the private sector in developing countries. As part of this effort, the Revolving Fund was established on November 14, 1983 with the explicit mandate to develop approaches to direct investment by A.I.D. to the private sector in developing countries and to disseminate the results of this experience throughout the Agency.

The initial experience of the Bureau concentrated on testing and refining two basic "models" or approaches for direct investments -- direct loans to facilitate the establishment of industries, and loans or loan guarantees to private intermediate financial institutions (usually banks) in developing countries for on-lending to small and medium sized businesses.

This report analyzes the Bureau's initial experience to date in both its direct loan program and its loans to intermediate financial institutions. It is based primarily on field assessments of four projects:

Leather Industries of Kenya (direct loan)
Antigua Shrimpery Ltd. (direct loan)
Kenya Commercial Finance Company (government intermediate financial institution)
WAFABANK [Morocco] (private intermediate financial institution)

The report also draws on experience gained from other comparable projects in the portfolios of PRE's Investment Office, various USAIDs, the World Bank and the International Finance Corporation.

The intent of this document is to assist in the dissemination of lessons learned -- both positive and negative -- from PRE's initial experience. As such, the primary intended audience for the document is field practitioners charged with designing and implementing private sector activities. The document should also be of considerable interest to researchers and policy makers concerned with planning or assessing efforts to promote the private sector.

As with all lessons derived from experience, the conclusions and recommendations of this document are necessarily tentative having been drawn from relatively few cases each of which began implementation less than five years ago. It is our intention to continue to monitor these projects and to collect comparable data on additional projects in an effort to enrich our understanding of what works and why.

Neal Peden
Assistant Administrator,
Bureau for Private Enterprise

I. INTRODUCTION

A. Background

A.I.D.'s Bureau for Private Enterprise (PRE) was created in July, 1981 and charged, among other things, with developing, testing and disseminating effective means for increasing investment in developmentally desirable private sector projects. The Bureau's Investment Office (PRE/I) was created in that same year and charged with achieving this mandate.

PRE made its first loan in January of 1983 to Kenya Commercial Finance Company for $2.5 million and by the end of FY 86 had approved 31 investments totaling $65.5 million. In November of 1983 Congress specifically authorized the establishment of a $100 million Revolving Fund to be administered by PRE, and charged it to promote private sector development. Revolving Fund projects must:

* have a demonstration effect (i.e., can be replicated by A.I.D. field missions, financial institutions and others);

* be innovative and demonstrate financial viability;

* maximize development impact appropriate to the host country, particularly in employment and use of technology; and

* be directed primarily to provide support and services not otherwise available to small business enterprises.

Since the creation of the Revolving Fund, all new PRE activities have been financed under that fund. Through FY 86, 23 projects (of the 31 noted above) totaling $44.9 million had been implemented through the Revolving Fund.

PRE activities to date have focused on developing, refining and implementing two types of projects -- direct loans for the support of agribusinesses and loans through local intermediate financial institutions (IFIs) for on-lending to small and medium sized private businesses. Within each of these two broad "models" or approaches, several variations have been tried. Some of these variations were responses to the differing objectives and circumstances characterizing each project and others reflected the experience gained from the first projects.

The majority of projects implemented to date, and most of the recent projects, have been loans through IFIs. Including those outstanding loans which pre-date the Revolving Fund as well as those made by the Fund, the current portfolio includes seven direct loans and 24 loans to IFIs. The full list of projects undertaken to date includes the following:

LOAN PORTFOLIO

IFI PROJECT	LOAN AMOUNTS ($)	GRANT AMOUNTS	WHERE
1. KCFC	2,500,000	250,000	Kenya
2. Women's World Bank	150,000 200,000		Worldwide
3. Bolivia Water & Sanitation	2,000,000	250,000	Bolivia
4. American Express Agribusiness Pool	2,500,000		South East Asia
5. Banco de Desarrollo Finade, S.A.	2,000,000	50,000	Dominican Republic
6. Healthlink Credit	2,500,000		Thailand/Indonesia
7. National Development Leasing Corp.	2,500,000		Pakistan
8. WAFABANK	2,500,000	50,000	Morocco
9. Financiera De Guayquil	1,400,000		Ecuador
10. Caribbean Basin Corporation	1,200,000		Caribbean
11. Accion Micro Lending Pool	1,000,000	100,000	Latin America/ Caribbean
12. Agri-business Investment Corp.	2,500,000		Latin America/ Africa
13. Bank Niaga	2,000,000	50,000	Indonesia
14. Overseas Express Bank	2,850,000	50,000	Indonesia
15. Thai Danu Bank	2,350,000		Thailand
16. Far East Bank & Trust	2,000,000		Philippines
17. Societe Marocaine de Depot et Credit	2,000,000		Morocco
18. International Multifoods Revolving Credit Facility	1,200,000		Latin America/ Caribbean
19. Union of Bolivian Banks	2,000,000		Bolivia
20. Financiera Ibero-Americana, S.A.	1,500,000		Ecuador
21. EDESA	2,000,000		Sub-Sahara Africa
22. Metropolitan Bank & Trust	2,100,000		Philippines
23. Philippines Commercial International Bank	2,400,000		Philippines
24. Bank of the Philippine Islands	2,400,000		Philippines

DIRECT LOANS	LOAN AMOUNTS ($)	GRANT AMOUNTS	WHERE
1. Antiqua Shrimpery	150,000 100,000		Antiqua
2. Thailand Livestock Meat Processing	2,500,000	70,000	Thailand
3. Malawi Bridge Financing Loan	2,000,000		Malawi
4. Subproductss de Cafe	2,500,000	50,000	Central America
5. Leather Industries of Kenya	1,400,000		Kenya
6. Sayyed Machinery, Ltd.	800,000	200,000	Pakistan
7. Serum Institute of India Pvt., Ltd	3,000,000		India

New projects under consideration by the Investment Office include additional IFI loans and various alternative financing arrangements or "models" such as venture capital development, loan guarantee facilities, support for creation of venture capital companies, and bond guarantee by private IFI's for local capital market placement.

B. PRE Monitoring and Evaluation System

As an experimental program intended to perform a catalytic role with the Agency, PRE collects, analyzes and disseminates systematic information on the impact and cost-effectiveness of its efforts. A recent report to PRE proposed that these needs be met by implementing a monitoring and evaluation system with three basic components:

* to provide basic management information, an automated monitoring system with information on key financial and development indicators and suitable for production of real time, monthly and quarterly portfolio analyses; action alerts on missing documentation; and detailed project status reports on an "as needed" basis. These reports would be primarily for the use of PRE personnel.

* to provide for accountability and overall assessment of program impact, an Annual Report modeled on corporate annual reports and directed to Agency Management and Congress. This Annual Report should include:

    - a letter from the A.I.D. Administrator presenting the rationale and accomplishments of the program to date, discussing current program emphases, and projecting future activities;

    - a "year in review" text presenting a more specific discussion of PRE Revolving Fund activities in the past fiscal year;

    - financial reports (balance sheet, income statement, and statement of change in financial position) for the Revolving Fund portfolio.

* to provide a vehicle for disseminating lessons learned, a series of periodic assessments of the "models" developed and/or tested by PRE. These assessments would be based on the evaluation of selected field projects. While using individual projects as the primary source of data for these assessments, the "model", and not the individual project, should be the unit of analysis in these reports to maximize the transferability of lessons learned. These assessments would be intended principally for use by A.I.D. personnel and officials of other development agencies.

A fuller description of this monitoring and evaluation system can be obtained from PRE/PR. This report represents a first attempt to perform the type of periodic assessment of financing models called for as the third element of the PRE's new monitoring and evaluation system.

C. Description of Models

Unavoidably, any discussion of development in terms of models or categories is somewhat arbitrary. Each situation is unique in significant respects. Successful projects normally reflect this uniqueness in the idiosyncrasies of their design and implementation. This diversity is particularly true in programs as manifestly experimental as PRE's, and it could be plausibly argued that each of PRE's 31 projects represents a separate "model".

There are, however, two basic strategies which underlie most of the projects undertaken by PRE. The majority of these projects entail the guaranty or lending of funds to IFI's in order to encourage or otherwise facilitate lending by these institutions to small and medium sized businesses. In some cases, A.I.D.'s funds have been provided in the form of a direct loan to the IFI, and in other cases as a guaranty; in some cases the purpose of the sub-loans was short-term credit to facilitate exports and/or imports by local producers, while in other cases the objective was to encourage provision of long-term investment capital by IFIs; in some cases predating the establishment of the revolving fund the IFI was owned by the government, while in other cases funds were channeled through private commercial banks. In each case, however, these programs were:

* providing funds at commercial rates of interest for a fixed period (normally 3-7 years) through normal commercial channels;

* designated for specific target groups and specific development objectives not adequately served by existing financial mechanisms;

* provided in the form of relatively small (normally $1-3 million) centrally-funded projects;

* matched at least 1 to 1 by funds from the IFI; and

* intended to be sustained and possibly replicated without further need for A.I.D. financial support.

These features constitute the key elements of the IFI model discussed in this report.

The second model discussed in this document involves direct loans by PRE to private businesses in developing countries. Again, these projects differ from one another in several important respects including the size of the investment, the nature of the equity participants in the project, the extent of earmarking of the A.I.D. funds, and the proportion of project capitalization represented by the A.I.D. loan. There are, however, several significant common features of these projects as well which are used herein as defining features of the direct loan "model". These features include:

* providing term loans at commercial rates of interest to private businesses registered and operating in developing countries;

* financing the start up of new businesses and/or new products;

* emphasizing agribusiness activities; and

* specifically encouraging the transfer of technology, backward and forward linkages, foreign exchange savings and employment creation.

As illustrated below, differences in the approaches used in various projects to implement these general models serve principally to clarify available options and suggest possible lessons rather than to undermine the analytical usefulness of the basic models.

II. METHODOLOGY

The research that forms the basis of this report was carried out by MSI over a five month period from October, 1986 through February, 1987 (see Annex 1 for team composition). Included in this research were the following tasks:

* review of available documentation on relevant projects in the PRE portfolio and interviews with Investment Officers;

* identification and review of relevant experiences of other donors;

* conduct of site visits to four projects to review recipient organization records; hold discussions with borrowers, their competitors and collateral institutions; visit representative sample of sub-borrowers; prepare report and conduct debriefing for local USAID Mission staff; and

* preparation of final document and case studies for submission to PRE.

Each of the four case studies was carried out by a two person team that spent from one to three weeks investigating the case in detail to derive evaluative information and lessons learned concerning operational issues, development and institutional impact, sustainability and replicability of the strategies employed in each project.

The specific indicators selected for investigation were linked directly to those enumerated in the Congressional mandate and policy directives establishing A.I.D.'s Bureau for Private Enterprise and its Revolving Fund and included:

* sustained project activities after withdrawal of A.I.D. funding;

* changes in loan appraisal terms and criteria (for IFIs only);

* changes in portfolio composition (for IFIs only);

* sub-project disbursement and repayment rates (for IFIs only);

* replication in other host country institutions of approaches tried in target institution;

* improved capability to identify, process, monitor and recover relevant loans (for IFIs only);

* money invested by other sources in PRE assisted projects;

* jobs created;

* increased sales.

In each of the four field cases, review of documents and records was supplemented by 20-50 personal interviews with a range of actors involved in, or knowledgeable about, the project. Those interviewed included:

For Direct Loan Projects

PRE personnel
USAID personnel
Senior managers of the enterprise
Officials of co-financing institutions
Officials financing and/or implementing comparable projects
Project designers and feasibility analysts
Operators of horizontally or vertically linked enterprises

For IFI Projects

PRE personnel
USAID personnel
Senior managers of the IFI and those responsible for management of the project
Officials of other comparable banking institutions
Officials of the Central Bank
Officials of correspondent banks (if appropriate)
Representative sample of sub-borrowers (i.e. those receiving loans under the project)

Although many of the interviews conducted were, of necessity, conducted in an informal manner, standardized interview guides were used to orient these interviews and to record responses in order to ensure that the information collected was complete and consistent. Illustrative of these instruments are the IFI and sub-borrower questionnaires included as Annex 2 of this document.

Following each field investigation, a preliminary case study was prepared and discussed with the local USAID Mission prior to the team's departure from the country. These case study reports, and the associated debriefings, were tailored wherever possible to incorporate the special information needs and interests of Mission personnel while continuing to serve the primary purpose of case studies examining basic PRE models of assistance. These case studies are presented separately and provide the primary evidence on which this report's lessons learned are based.

Following the completion of the four case studies, interviews were conducted with officials in A.I.D., the World Bank and IFC who had been involved in carrying out or evaluating similar projects; and a variety of previous reports on the subject were reviewed. (A bibliography listing the documents reviewed is included.) The results of these interviews and documentary reviews were used to supplement, or in some cases modify, the lessons learned from the four case studies. Where such additions or changes were introduced, they are explicitly acknowledged.

For reasons discussed at length in Chapter I, all of the evidence collected was analyzed in terms of two basic models and the lessons to be learned from each. A decision was subsequently made, however, to further synthesize these lessons into a single report. This final synthesis had two objectives. First, it was observed that significant parallels existed between several of the key conclusions reached independently by the teams studying the two models. Presenting these conclusions in a single report greatly strengthened their power and credibility. Secondly, several interesting contrasts were noted between the two models, and it was felt that these contrasts contributed important insights to the report's final conclusions.

III. CASE DESCRIPTIONS

As noted above, the lessons from experience presented in this document are drawn, in large measure, from the four projects that were intensively surveyed in the field. Full reports of these field investigations are presented as separate documents. This Chapter briefly summarizes those reports.

A. Direct Loans

1. Leather Industries of Kenya

PRE's investment in Leather Industries of Kenya (LIK), which was made before the establishment of the Revolving Fund, took the form of a $1.4 million direct loan for ten years at 12% interest. The loan was channeled through an international commercial bank and was part of a $9 million investment by a number of Kenyan and international institutions in a processing plant for manufacturing finished leather for export.

At the time the project was being formulated, Kenya was one of the few countries that was still exporting most of its hides and skins in raw hide or semi-finished form. At full production, the tannery is expected to process approximately 13 percent of Kenya's production of hides, employ 400 Kenyans, and generate $60 million in foreign exchange earnings over a period of 10 years.

The LIK venture was organized, "packaged" and managed by Investment Promotion Services (IPS), an arm of the Aga Khan Foundation for Economic Development. IPS was recognized as a major player in Kenyan commercial circles, and had been the recipient of previous investment financing support from the International Finance Corporation of the World Bank and other international investment institutions.

PRE's investment, and that of the other organizations, provided long term credit which was not available through the Kenyan commercial banking system. It also filled a widening gap in the overall flow of commercial credit from international banks to ventures in Kenya. While there is no evidence to indicate that the PRE participation directly leveraged investments by other institutions, it was a major component of the capitalization of the venture.

A crucial element of the LIK venture was the transfer of leather processing technology of a sophisticated nature to be used in exploiting a resource with high export market potential. The technology transfer process has been thoroughly integrated into the structure of the enterprise through equity and management participation on the part of the technical collaborator, a well established Belgian tannery.

The operation is unique in Kenya as it aims specifically at the export market for high quality finished leather. While targeting this high-risk, high return market, however, LIK has already begun to tap alternative markets both in Kenya and internationally.

In addition to the direct transfer of a relatively sophisticated manufacturing technology, the drive for quality is also aimed at improving the backward linkages to raw hide suppliers thereby resulting in increased income for livestock raisers. This is taking place through the provision of improved equipment for use in the flaying process, and through a premium incentive payment of 40 percent to suppliers of higher quality hides.

Another important impact of PRE's involvement in this venture was the transfer of environmental protection technology. A.I.D.'s participation was conditional upon strict environmental requirements and fulfillment of these requirements resulted in the construction of a "state of the art" effluent treatment facility at the tannery.

While newly opened and operating at only 30 percent capacity at the time of the study, the tannery appeared well on the way to establishing its niche in the export market, and was having no trouble marketing its product internationally or domestically.

The LIK project has served to create a strong connection between the USAID Mission and IPS, an important private sector institution in Kenya. It is generally regarded as "successful" by all involved, and other efforts to stimulate development through the local private sector are already being designed by USAID/Kenya in cooperation with IPS.

2. Antigua Shrimpery Limited

The Antigua Shrimpery Limited (ASL) project, whose initial loan was also made before the establishment of the Revolving Fund, was originally developed and appraised by the World Bank's Caribbean Project Development Fund. As finally implemented by PRE, the project involved a co- financing pass-through loan for the installation of a commercial shrimp production facility on the island of Antigua in the English-speaking eastern Caribbean. A financing procedure was arranged through which a local banking institution, Bank of Antigua (B of A), made a long term (7 year) loan totaling $270,000 to the company, and sold to A.I.D. a portion ($150,000) of the loan. This procedure was used to establish a buffer between A.I.D. and the company, and to help ensure direct involvement by B of A in monitoring and supervision of the financial management of the enterprise. The bank was also expected to provide short term financing in the form of overdraft facilities to ASL.

The purpose of the loan was to finance construction and start-up of a modern commercial shrimp production installation composed of a nursery/quarantine building and 12 two-acre grow-out ponds. Full production was expected to reach a level of 65,000 lbs. of heads-on shrimp per year for sale to local tourist-oriented businesses, replacing dependency on imported shrimp.

The B of A and A.I.D. were the only debt participants in the financing, and equity was supplied by several private investors, most notably the young American entrepreneurs who also served as the company's

Chief Executive Officer and principal technician. A.I.D.'s participation was the major factor in leveraging the involvement of B of A. ASL became that bank's largest loan, representing approximately 10 percent of its entire loan portfolio.

The venture was plagued with difficulties from the beginning. With the withdrawal of one of the technically qualified partners before the operation went into the construction phase, technical management of the enterprise was very thin. Subsequently, major additional costs arose due to the collapse of a government-maintained dam near site, closure of the company which was to provide growing stock for the operation, and the necessity to install electrical power facilities when the Antiguan Electricity Authority disclaimed responsibility for extending power lines to the farm.

B of A continued to provide overdraft credit to the enterprise up to $150,000, three times what was originally anticipated. At the time of the study, the farm had produced a total of approximately $13,000 in revenues after one year of operation, had ceased operation, and was essentially bankrupt. A corporate restructuring was taking place, and in January of 1987 a new company was created with ownership passing into the hands of a major international corporation with substantial holdings in the Caribbean.

There was little, if any, involvement of regional USAID officials in designing, monitoring or supervising this activity. The B of A which itself had limited financial or managerial resources, overextended itself in providing support to the venture to the point that failure of the operation would likely have a major impact on the future of the bank itself.

* * * * *

The two cases of direct loans to new ventures, LIK and ASL, share several features in common. Although the loan amounts were substantially different in absolute amounts, both were relatively small projects and each represented approximately 25 percent of the total capitalization necessary for the venture and approximately half of the debt portion of that capitalization.

Both ventures were aimed at the introduction of relatively sophisticated technology designed to make better use of unexploited existing natural resources for export generation or import substitution. In both cases, market studies indicated that the enterprises could be very profitable if and when production goals were met, and the anticipated income from both enterprises was seen as having beneficial effects on foreign trade balances of the respective countries.

The role of other international investment organizations, most specifically the IFC, was important in both cases. In the case of LIK, IFC participated in the feasibility study and became both a debt and equity participant in the venture. In the case of ASL, the Caribbean Project Development Fund, a branch of IFC, was largely responsible for preliminary feasibility analysis and brought the venture to PRE's attention.

In both instances, a close supervisory role was assumed by a commercial entity in the country in which the project existed, and neither PRE nor the USAID Mission played a major part in monitoring the activity once the conditions precedent were fulfilled and the loan was disbursed. The role of the institutions closest to each project was of a different nature, but in both cases the direct involvement of those institutions in the capitalization of the venture was sufficient to stimulate a vested interest in monitoring of project progress.

In a macroeconomic sense, both investments were in response to similar conditions in terms of local and international financial markets. The banking systems in both Kenya and Antigua were not disposed to make long term credit available for new enterprises, and flows from international banks were at a low ebb at the time. These factors made interventions from non-traditional sources of financing such as PRE an important element in getting the venture under way.

The two cases begin to diverge in areas of technical and managerial backup. The larger investment in LIK was backed up by a major local institution with substantial human and financial resources, and long experience in Kenyan commercial circles. In the ASL case, on the other hand, technical and managerial support was divided between the principal project organizer (a relatively inexperienced entrepreneur) and the major debt participant, B of A, which was itself relatively small and able to handle only matters of financial management. ASL was, in many instances, managed in a relatively unprofessional manner while the LIK venture was carried out with a high degree of professionalism on all sides. The fact that operations of the failing ASL venture have been taken over by a major international company provides additional evidence that management and financial backstopping may indeed be major factors accounting for the enterprise's relative lack of success to date.

The general USAID climate in which the two ventures were proposed and implemented was also different. The Kenya situation exhibited a substantial amount of PRE/USAID interaction. The Antigua project, on the other hand, evidenced little, if any, direct involvement or monitoring by regional USAID personnel.

B. IFI Loans

1. Kenya Commercial Finance Corporation (KCFC)

This loan of $2.5 million, made before the establishment of the Revolving Fund, was intended for on-lending to Kenyan-owned or controlled SMSE's, particularly agribusinesses located in rural areas. In addition, a grant of $250,000 was given to Kenya Commercial Bank (KCB), the parent corporation of KCFC, to strengthen its Business Advisory Service. The PRE loan was for 12 years at a 10.5 percent interest rate. KCFC committed an equal amount of its own resources to the program.

KCFC is a non-bank financial institution (NBFI) and a subsidiary of KCB, a government owned commercial bank with branches throughout Kenya. KCFC had administered similar on-lending programs in the past, supported by the International Finance Corporation (IFC) of the World Bank and the Organization of Petroleum Exporting Countries (OPEC).

The project was an attempt to provide long term credit to enterprises which were unable to obtain such credit in the Kenya commercial banking sector. At the time of the loan, Kenya was in a reduced liquidity situation which further restricted the traditionally conservative lending practices of commercial banks in the country.

Subloans under the project were made at the prevailing interest rate for NBFI in short term loans (19 percent). These loans were made, however, primarily to finance long-term capital investment and typically had terms of 6 to 8 years. The operation is managed by KCFC "Schemes", a division established specifically for administering special projects. Reflows from subloan payments become part of KCFC's normal loan pool, and are not specifically designated for re-lending under the program.

At the time of this study, the program was fully committed, with a total of approximately 74 million Kenya shillings pledged to 95 sub-borrowers. Most sub-borrowers had regular savings accounts at KCB and learned of the program from the bank. Sub-borrowers demonstrated a broad range of characteristics in terms of size of enterprise, business knowledge and management experience. Forty-four percent were small scale cereal millers, although these millers accounted for only 8.6 percent of the funds lent. Larger enterprises in manufacturing and distribution received 9 percent of the loans but accounted for almost 40 percent of the funds. Enterprises in the transport sector accounted for an additional 23 percent of the funds lent. Approximately 75 percent of the loans were used to start new enterprises or activities.

The loan fund appears to have had a substantial impact on the operations of a number of the businesses surveyed, with many of those businesses reporting significant sales increases over the period of the loan.

Strict collateral and legal requirements imposed by KCFC reflect traditional conservative banking practices which were adhered to in administration of the project. While a significant portion of sub-loans are currently in arrears, experience with the IFC and OPEC programs has indicated that these loans can probably be expected to be serviced over time, particularly when the threat of legal action is applied.

The PRE input to KCFC, along with the schemes financed by IFC and OPEC, appears to have been generally profitable for the bank, and to have resulted in some change in the institution's perception of the risks involved in term lending to small scale enterprises. There is also evidence of some impact on the commercial banking system as a whole in that other private commercial banks have now agreed to participate in a similar program planned by USAID/Kenya.

2. WAFABANK

A loan of $2.5 million from PRE's Revolving Loan Fund was matched by WAFABANK, Morocco's second largest privately owned bank, to create a loan fund in foreign currencies for small and medium-sized enterprises. The loan from PRE was actually deposited in a collateral account[1] in the New York branch of the French bank Credit du Nord, WAFABANK's main correspondent bank. The funds were immediately invested in Treasury Bills and used as a guarantee mechanism to support expansion of WAFABANK lending to Moroccan SMSEs that required foreign currency to import raw materials, finished goods and equipment.

In order to respond to the credit ceilings imposed by the Central Bank of Morocco on all local banking institutions, the original structure of this project was modified such that Credit du Nord, a foreign bank, became the lender of record for the loans to Moroccan enterprises. In addition to increasing WAFABANK's effective foreign currency credit ceiling by $5 million, this change had the additional benefits to sub-borrowers of reducing real rates of interest and permitting them to make prompt payment for imported supplies in a number of foreign currencies.

The loan program was managed for the most part by WAFABANK's Small and Medium Scale Business Division, which oversees approximately 2,600 clients. The bank's standard oversight process which was used for this project is rigorous, requiring a thorough analysis of a company's financial health as well as the viability of its proposed marketing plans.

Loans made under the project were for short-term financing, and none of the credits taken up to the time of the study had exceeded a six month term. A total of 177 loans totaling $9.7 million to 54 different SMSE's had been made, and the absence of payback delinquencies had enabled the fund to "revolve" twice in less than two years of operation.

Loans were divided almost equally between small scale enterprises (56 percent) and medium scale enterprises (45 percent), and usually

1. The collateral account loan structure was developed by PRE in 1984 to minimize the foreign exchange risk to a borrower. Basic features include a three party agreement between A.I.D., the borrower, and a bank located in the United States (Depository Bank); after disbursing loan proceeds into the collateral account, the depository bank invests those proceeds into an investment approved by A.I.D., typically U.S. Treasury obligations; the depository bank then issues a letter of credit guarantying an extension of local currency credit, receiving a security interest in the collateral account in the event a payment must be made under the letter of credit.

represented between 5 and 20 percent of the total line of credit authorized for the individual borrower. Borrower use of the fund averaged three loans at $54,800 each during the period, and ranged from 27 loans for a total of $1.8 million by one company to one loan for $9,600 for another. All loan proceeds were used to finance foreign goods or equipment, and many of these loans resulted in obvious cases of technology transfer. Despite substantial emphasis on exporting in the original project documentation, only four of the 17 borrowers interviewed by the team were actively involved in export activities.

The collateral guarantee provided by PRE enabled WAFABANK to expand the availability of foreign exchange commercial credit to its clients. The modified agreement provided a legal and acceptable mechanism for avoiding the restraints on credit imposed within Morocco and the ceiling on foreign exchange credit made available by Credit du Nord to WAFABANK. For the sub-borrowers, the program provided more efficiencies in obtaining supplies and savings in terms of prevailing interest rates.

There is a clear indication that this facility provided needed foreign exchange at a time when none was available from other external commercial banks, but at present little indication that the project directly provided funds to businesses which would otherwise not have received them or that it caused major policy changes within WAFABANK itself. However, bank officials were pleased with the program and wished to see it continued. Other local banking interests also expressed a desire to participate in similar projects. Credit du Nord clearly indicated that the guarantee from PRE was the determining factor in its decision to extend additional credits and that their continued participation remained contingent on the maintenance of an A.I.D. guarantee. The Central Bank of Morocco, whose restrictions on credit had, in effect, been avoided through the project, expressed satisfaction with the program and indicated that its success had led them to re-examine certain foreign exchange policies.

The USAID Mission in Morocco was not deeply involved in the project and has not programmed any specific follow-on projects. The PRE involvement, however, was regarded by members of the Mission Staff as a direct stimulus to increased contacts between USAID/Morocco and that country's private sector, specifically in the banking community.

* * * * *

The two cases of PRE loans to intermediate financial institutions (IFIs) display important similarities and several significant differences, each of which contributes to an overall understanding of the model.

In both instances the loans were intended to provide credit to the SMSE sector, and in both cases the IFIs successfully on-lent to this sector. In Kenya, several of the borrowers had never sought financing through formal banking channels before this program. Although most

Moroccan borrowers had established lines of credit with WAFABANK prior to the program, net additional credit did enter the country and in all likelihood was made available to more marginal borrowers.

The banks used by PRE in Kenya and Morocco both had well established branch networks throughout their respective countries, and were regarded as large and well managed commercial institutions. In addition to loans, both IFIs received grants for management training in the area of SMSE lending. After some initial delays in arranging an adequate training resource, WAFABANK has recently initiated a program for its loan officers. KCFC used its grant to install a computer system for its loan evaluation and to train additional members of its Business Advisory Service.

WAFABANK is a 100% privately held financial institution, as is required of all recipients of PRE Revolving Fund loans. KCFC, which received its loan from PRE before the establishment of the Revolving Fund, is a subsidiary of KCB which is wholly owned by the Government of Kenya but receives no subsidies, pays regular dividends, and operates similarly to a private commercial bank.

In both cases, loans provided by PRE were matched 1:1 by the recipient institution. Kenya Commercial Bank, Ltd., the parent corporation of the IFI lender KCFC, was the guarantor of that loan and matched the amount in local currency. Credit du Nord, WAFABANK's correspondent, agreed to match the PRE loan 1:1 in hard currency, with WAFABANK and A.I.D. acting as guarantors.

In both instances the loans were in response to perceived needs of the financial sector at the time of program initiation. Kenya borrowers lacked the requisite medium and long term loan facilities through which to finance capital expansion. The medium term nature of this program filled this niche. In Morocco import credits had been discontinued by international banks prior to the agreement. Although currently such restrictions have been eased considerably, there still exists in Morocco a serious shortage of foreign currency for importation of needed goods and equipment.

On-lending in both cases was intended for the SMSE sector. However, the nature of the credit was very different. The KCFC loan was intended to provide medium term financing for rural SMSE's that were unable to obtain this type of financing because of their size and lack of credit experience. The vast majority of loans made under the program were to rural industries, many of whom were start-up or first-time borrowers.

In Morocco, the target group was SMSEs who were dependent on imported goods for some portion of their production process. Although most were established clients of the IFI, and several were sophisticated businesses, all had operated immediately prior to the loan program under severe foreign exchange shortages which affected their efficiency or level of production.

The two IFIs handle reflows from their borrowers in distinctly different fashions. KCFC does not recycle repayments back into the SMSE term loan program, but rather incorporates these funds into its overall lending pool which primarily serves short term borrowing needs of larger, urban enterprises. WAFABANK, on the other hand, relents its reflows to other SMSEs on the same terms and conditions as those prevailing in the initial round of loans. At the time of the evaluation, these funds had been lent twice to Moroccan businesses.

Another major difference concerned the administrative treatment of the loan program by the participating IFIs. KCFC went to great pains to segregate its A.I.D. monies from its other loan funds. In fact, they created a separate division within the bank to monitor programs of this type. They were thus able to provide specific cost/revenue figures for the program. WAFABANK chose to incorporate the monies and administration of the program into its existing loan pool. Although specific records were maintained on which businesses received loans under the project, no profitability figures were available for the program.

IV. LESSONS LEARNED

A. Operational Lessons

Evidence from the four intensive case studies and a more cursory review of other donor-financed credit programs suggest a number of operational guidelines for the design and management of such programs. Among the most salient of these lessons are the following:

1. Undertake private sector credit programs only where project designs permit rapid and flexible response to changing circumstances.

   Unlike the general agricultural, rural development, family planning and health conditions addressed by most traditional development projects, private sector financial markets are extremely volatile. These markets are directly and immediately influenced by changes in government or central bank policy and by changes in the international economic environment. Projects designed to respond to or rectify specific deficiencies in these financial markets must therefore be sufficiently flexible to respond to such changes as and when they arise and to seize the opportunities which sometimes result from these shifts.

   One reason for the general success of the PRE efforts studied was their ability to be implemented quickly and to alter course when necessary. Such flexibility is often difficult to achieve in conventional USAID projects. For example, PRE was able to design, sign and fully disperse its KCFC loan during the time it took USAID/Kenya to prepare and obtain the necessary approvals for a comparable project; and PRE was able to respond to changing policies in Morocco in ways that would have been very difficult under normal USAID project procedures.

   Even though each of the projects reviewed was based on efforts to achieve specific development goals, each also had an effect on financial market problems of a more general nature. In Kenya, for example, the problem involved limited liquidity in the system which in turn inhibited credit availability for "marginal" enterprises. In Morocco, government regulations were inhibiting the development of enterprises dependent on imported materials. In both of these cases, SMSE development was the basic objective, but the investment also addressed a specific constraint in national financial markets. In Kenya, the structural problem turned out to be temporary. In Morocco, the problem remained, but the success of the PRE intervention provided the means for certain entrepreneurs to avoid the constraint and suggested one means by which the government might address the overall constraint.

The general lesson learned from this experience is the need for A.I.D. to find creative devices for accelerating the pace of design and approval for private sector credit projects as well as to build maximum flexibility into their implementation machinery for these projects. One specific technique for accelerating implementation might be that used by USAID/Kenya, namely to use PRE funds to initiate activity with Mission funds providing subsequent, and more substantial, funding for comparable activities once a number of the initial problems have been addressed.

Another aspect of flexibility concerns the extent to which it is necessary to be directly responsive to host government policies and procedures. The Morocco project was "successful" in part because the Moroccan Central Bank permitted the project to circumvent normal government banking regulations. This latitude was possible in part because the program was not a claim against bilateral funds. This loan permitted WAFABANK and PRE not only to exploit a specific market opportunity, but also, in the process, to influence the future policies of the Central Bank. The lesson learned from this experience is the importance of bilateral programs seeking such means to provide them the flexibility to adopt an experimental and "problem solving" approach in their private sector credit programs, particularly where host government restrictions constitute a significant part of the "problem".

2. Undertake private sector credit projects only where a strong and competent local intermediary organization exists.

USAID personnel lack the time, and often the specific skills, to provide technical oversight for private sector credit projects. Contractor teams frequently lack the detailed local knowledge and institutional capability to implement such programs on a sustainable basis. It is thus a major lesson learned from this review that the presence of a strong and committed local intermediary institution, with the incentive as well as the capability to ensure project success, should be virtually a sine qua non for initiating private sector credit projects. Experience appears to suggest that it is extremely desirable for the financial exposure of this local institution to be at least equal to A.I.D.'s.

In the case of IFI projects, there is need for confidence in the efficiency, experience and motivation of the bank(s) involved; in the case of direct loans, the need is for an effective venture capital or investment oversight firm. Only one of the four projects reviewed, Antigua Shrimpery, lacked such a institutional base, and that was the only one of the projects to experience significant, and in this case potentially fatal, problems.

A review of World Bank small enterprise lending projects, published in 1986, identified advantages and disadvantages of commercial banks, development finance companies (DFCs) and promotional agencies as IFI's. The major conclusion reached regarding choice of intermediary was that commercial banks, although conservative about lending to new enterprises, have shown the greatest capacity for channeling credit to small enterprises in those countries where the banking system is relatively developed. Distinct advantages cited in using commercial banks as intermediaries for SMSE lending were the following: (i) they are better able to provide working capital than DFCs, and small scale entrepreneurs tend to find it more convenient to seek their term loans for new investments from the same sources that provided them with working capital; (ii) they offer a greater variety of banking services; (iii) they usually have a large branch network permitting contact with small enterprises on a local basis; (iv) they are better able to respond quickly to the needs of small businesses; and (v) they are more experienced in debt collection than DFCs.

In contrast, DFCs tended to be too concentrated with few or no branch offices; were frequently accustomed to requiring extensive documentation of clients; and generally lacked domestic resources for working capital. Disadvantages associated with commercial banks as intermediaries included: (i) a tendency to view small businesses as particularly risky and administratively expensive; (ii) a preference for short term lending in keeping with their sources of funds; (iii) a reliance more on collateral and credit worthiness than on project appraisal; and (iv) a reluctance to provide technical assistance or extensive supervision of clients so long as repayments were satisfactory.

Several disadvantages of using promotional agencies as IFIs were noted in the review of World Bank projects. Promotional agencies generally suffered from poor financial management; were prone to political influence in both staff appointments and loan approvals; were more subject to abrupt changes in government policies by virtue of being dependent on continuous government budgetary support; and often suffered from over-optimistic projections occasioned by the conflict between their promotional and development roles.

In the absence of a strong local intermediary organization, the evidence suggests the importance of focusing project activities on institutional strengthening and incorporating specific institutional development objectives and resources as important elements in the initial projects pursued.

The evidence also suggests that it is critically important, for both substantive and motivational purposes, to involve these intermediary organizations actively in the process of project design and to devote special attention to ensuring that these organizations' interests and points of view are adequately reflected in the final designs of these projects.

3. <u>In implementing private sector credit programs, work through normal commercial institutions, and observe normal commercial lending criteria, to the maximum extent possible</u>.

As suggested above, the experience with government-owned DFCs and with other donor-created and donor-financed credit institutions has generally been a dismal one. The cases reviewed in this study strongly underline the desirability of using normal commercial institutions and criteria wherever possible. This experience also suggests that it is often feasible to reach SMSEs through the imaginative use of these vehicles and approaches.

Where commercial institutions and conditions appear to be incompatible with project objectives or target groups, concern should be registered as to the viability and sustainability of the proposed approach. When commercial banks or private investors are reluctant to participate in a project, careful analysis of the basis of their reluctance can often serve to suggest important modifications to initial project designs.

On occasion, reluctance by commercial institutions to participate in a project may simply reflect their inexperience with the type of credit or credit terms proposed. If, after making every effort to identify and address the basis of their reluctance, these institutions continue to resist participation, experience suggests the desirability of identifying the closest available alternative (e.g., a nationalized commercial bank or a socially motivated venture capital fund) with which to begin.

According to Levitsky of the World Bank, while it may sometimes be necessary to increase normal commercial spreads in order to induce lending by commercial intermediaries to designated businesses or target groups, there does not appear to be any evidence to suggest the necessity or desirability of providing loans to sub-borrowers at below market rates. On the contrary, evidence from non-commercial lending institutions in Kenya and Morocco suggests that (unlike KCFC and WAFABANK) these institutions experience considerable pressure to make loans on criteria other than the commercial viability of the projects and businesses involved.

In the literature on financial intermediation in LDCs, there have been widespread appeals for more "commercial" interest rate policies. As noted by Anderson and Khambata in the January 1985 issue of <u>Economic Development and Cultural Change</u>, such appeals have been made by analysts representing a broad range of views on development policy including those associated with concern for equity issues, such as Gunnar Myrdal, Michael Lipton, and Hla Myint. Commonly expressed views are that special financing schemes for small-scale enterprises naturally attract, and for the most part are absorbed by, influential borrowers of good standing who already have access to institutional finance; encourage over-investment in equipment; and limit the capacity and willingness of IFIs to raise their own resources to sustain donor financed schemes.

4. <u>In most cases, guarantees are more appropriate and more effective loan mechanisms than direct loans</u>.

Whether dealing directly with businesses or through intermediate financial institutions, there is ample evidence to suggest the general superiority of credit guarantees over "direct" loans from the U.S. Government.

Limitations of direct loans for providing capital to the private sector in LDCs were noted in a 1981-82 review of A.I.D. lending programs by the PPC Office of Evaluation. The discussion paper indicated that (i) A.I.D. tended to lend directly only when the amounts involved were relatively large; (ii) not much was achieved in the way of long-term institutional benefits; (iii) direct loan programs were very staff intensive compared to the level of resource flow, particularly in connection with those problem projects which experienced repayment difficulties; and (iv) the direct loan program required staff with very specialized skills. Direct loans also place foreign exchange risk with the borrower.

Experience from the cases reviewed in this study suggests that important exceptions to the general observations noted in the previous paragraph concern cases where there is a genuine shortage of liquidity or foreign exchange at the national level. In some such cases, A.I.D. funds can perhaps supplement overall credit availability and/or leverage participation by other donors and commercial entities. In other cases, credit shortages tend to reflect risk preferences of credit institutions and/or credit policies of the Central Bank; and given the fungibility of money, cash transfers are unlikely to accomplish anything which could not be accomplished more efficiently, flexibly and appropriately by means of suitable guarantee mechanisms and/or policy changes.

Despite the usual preferability of guarantee rather than direct loan programs, World Bank evidence suggests certain operational problems that can reduce the effectiveness of credit guarantee schemes. Delays in meeting claims due to inadequate funding or staff have directly undermined the credibility of many such schemes. There is also need to establish clear procedures to avoid uncertainty as to the obligations of each institution, especially in pursuing defaulters, maintaining incentives for collections by participating institutions, and assuring adequate review of sub-projects before providing guarantees.

5. <u>Provision of loans by A.I.D. to specific enterprises should be considered only under limited and specific conditions</u>.

A.I.D.'s capacity to deal with other financing institutions far surpasses its experience and effectiveness in dealing with individual businesses. Moreover, providing credit through local financing institutions creates a capability to reach borrowers that would otherwise be much too small to deal directly with foreign creditors or guarantors.

Nevertheless, there are occasions where it may be quite appropriate for A.I.D. to extend credit to specific enterprises, and both LIK and ASL are illustrative of the kinds of circumstances under which such mechanisms might be appropriate. Specifically, such loans appear to be worthy of consideration when and only when individual projects are too large for the domestic financial institutions to undertake alone, have major foreign exchange requirements, have significant linkages and demonstration effects, have reasonably high probability of success, have been developed (and are being overseen) by competent investment organizations, and provide extensive visibility for A.I.D. with the domestic private sector. In such cases, A.I.D. involvement is probably best understood as part of a larger strategy for contributing to private sector development in a given country.

Experience with LIK and ASL, as well as with other direct loan projects, suggests that serious problems are likely to ensue when any of the above conditions are not adhered to.

6. <u>Only intermediate financial institutions having a branch bank network should be considered for implementation of private sector credit programs in rural areas</u>.

In the IFI model, one institutional characteristic judged to be particularly important to the success of the projects was the existence of outreach capabilities. Both WAFABANK and KCFC had extensive branch bank systems which played an important role in project implementation. Such a branch system is especially crucial where the investment is intended to affect development in rural areas. In such cases, on-site supervision by branch personnel who are familiar with their communities and knowledgeable regarding individual borrowers is a major factor in determining the success of an on-lending project.

The proximity of the lending institution to the borrower provides significant advantages to both sides throughout the process. This is especially true where small and medium scale enterprises are the targeted group. The familiarity of the lender's personnel with both the individual borrower and the potential local market for the proposed output of the enterprise provides an opportunity for verifying information obtained during the feasibility analysis. Once the loan is approved, local branch personnel are better placed to monitor potential problems with the business, and to provide advisory services to the borrower if necessary.

7. <u>Some degree of risk is inherent in all private sector interventions, and technical assistance efforts which attempt to eliminate all risk do not promote private sector development</u>.

While professionalism demands a thorough investigation of all major elements of any proposed investment, it must also be realized that a certain amount of business failure is one of the characteristics of the free enterprise system. A measure of "economic Darwinism" is inherent in all such programs. The key policy decision is the <u>amount</u> of risk and <u>proportion</u> of business failures deemed tolerable by those designing and managing the project. A decision to hold this risk to a minimum has obvious implications for the selection of projects and sub-projects and for the level of training and supervision provided to clients.

The cases examined within the IFI model demonstrate certain aspects of the effort to meld development with private enterprise promotion. In both of the cases, grant funds were made available with the apparent intention of providing technical assistance where necessary to minimize the probability of business failure. These grant components were not used as had been expected. In Kenya, for example, the Business Advisory Service did not focus its efforts specifically on the intended target group (small scale enterprises) and the grant had no measurable effect on the project as a whole. In Morocco, the grant funds were not used for over a year due to confusion over who could be contracted for services under the terms of the grant.

The history of sub-borrowers under the KCFC project showed mixed results in the area of success or failure of individual enterprises. The loans themselves, however, were being paid off. Accordingly, it is sometimes argued that an approach which combines conservative commercial loan practices with the provision of specifically targeted additional financial resources should eliminate the need for traditional technical assistance. Experience with SMSE lending suggests, however, that such a view may be too simplistic in the context of many developing countries.

A recent survey of small enterprises in World Bank projects found that these enterprises were typically run by former skilled workers who tended to be proficient in the manufacturing process, but were weak in management and marketing. In small enterprises started by merchants, marketing and financial management skills were often better developed, but operational efficiency of the production process was often deficient.

While there is no simple answer to the issue of "appropriate risk", two lessons are particularly noteworthy. First, the degree of tolerance for risk, business failure and default should be discussed explicitly during project design along with the implications of such decisions on project implementation and program sustainability. And secondly, it is probably necessary for project designers and implementors to recognize that "success at all cost" is not only an impractical approach to private sector programming but also that the level of intervention it suggests is unlikely to be countenanced by individuals with genuine entrepreneurial potential.

8. Information necessary for monitoring the development impact of credit programs should be collected on a regular and consistent basis as part of project implementation.

The monitoring of specific development objectives (e.g., increased sales, employment generation, increased income for rural women, etc.) should be an integrated part of the project management process. The information necessary for this monitoring process should be collected, to the extent possible, within the context of normal supervision by the lender, or as part of some regular procedure.

Nine development impact indicators were proposed in an earlier MSI report as useful indicators of the effectiveness of Revolving Fund interventions. That report also suggested that data on these indicators could perhaps be collected through as "augmented audit" carried out by local accounting firms in conjunction with obligatory annual financial audits. In order to test the feasibility of this approach, several accounting firms were surveyed to determine their capability to collect this information, and to ascertain the additional cost that this effort would represent above that of a typical annual audit.

The opinion of the firms contacted was that data on most of the indicators could feasibly be obtained, if requested. The cost of this additional effort was less easily established and was based mainly on estimates of the additional time requirements needed to obtain this data. A range of 20% to 25% over the cost of a normal annual audit was suggested by the accounting firms interviewed.

Continued special evaluative studies would be necessary in order to verify the impact of projects on institutions or national banking systems. However, the augmented audit process represents a cost efficient way to monitor the more easily quantifiable elements of anticipated development impacts and to permit aggregation of the benefits across the entire Revolving Fund portfolio.

B. Development Impact Lessons

The projects reviewed and the evidence from other private sector credit programs suggest a number of lessons concerning the development impact of such programs and how to maximize it. Some of these lessons include the following:

1. There is normally a direct relationship between the "additionality" of credit programs and their riskiness.

   The more different a program or procedure is from that prevailing in the marketplace, the greater the risk investing in it. Lending to people or businesses otherwise considered uncreditworthy (e.g., small businesses or new starts), extending credit for longer terms than usual, or making loans for purposes different than those considered "appropriate" by local institutions usually increases the likelihood of loan default. On the other hand, if no such differences from standard practice exist, there is good reason to question the rationale for A.I.D. involvement.

   The KCFC project involved moderate "additionality". It limited lending (*de facto*) to individuals with a credit history and collateral, but nevertheless provided term financing for a number of new business starts in rural areas. WAFABANK, by way of comparison, had relatively low additionality by providing improved service to established businesses. It is, accordingly, no surprise that WAFABANK experienced little difficulty obtaining repayment from its borrowers and KCFC faced substantial problems in obtaining repayment. In a similar vein, PRE clearly represented the margin of difference in the ASL project while its funds were considerably less critical to the LIK project. Once again, the evidence confirms the correlation between risk and additionality.

   Experience suggests that it may be appropriate for A.I.D. to adopt a risk-averse posture in its initial activities in a given country in order to learn the detailed operations of the private sector and financial markets and earn a reputation for being associated with successful ventures. It might then be appropriate to undertake an increasingly innovative posture in subsequent activities.

   Efforts to mitigate risk may require some kind of technical assistance or special incentives or earmarking in order to infuse private enterprise with specific social or economic development priorities. In private enterprise development, however, it is critical that such project elements be carefully designed so as not to undermine essential private enterprise concepts of initiative, risk and reward.

2. <u>The development impact of small enterprise programs is often substantially different from that envisioned in initial project documents</u>.

Some of the most significant development impacts observed during the evaluation were unanticipated in the original project documentation. In Morocco, for example, a clever modification to the three party agreement enabled the full disbursement of this line of foreign exchange commercial credit, while opening a window of opportunity for policy dialogue with the Central Bank in this area. In Kenya, the LIK project initiated what may be a long and fruitful relationship between the local USAID and Investment Promotion Services of Kenya and the waste treatment facility financed by the project resulted in a new standard for industrial pollution control being set for the country. The KCFC and ASL cases also illustrate the prominence of unplanned effects.

The evidence from these cases and others is persuasive concerning the importance of unplanned effects in projects such as these and suggests that the occurrence of such effects is the rule rather than the exception. This lesson relates directly to the lesson noted above concerning flexibility in that the probability of positive unplanned effects is greatly enhanced when projects have the flexibility to respond to unexpected opportunities and constraints. This lesson also has major implications for future evaluative studies by suggesting that such studies devote substantial attention to identifying the (positive and negative) unplanned effects of projects as well as to assessing performance against projects' originally stated objectives.

3. <u>The extent of development impact is heavily influenced by the nature and extent of a project's vertical and horizontal linkages</u>.

A substantial portion of the direct development impact of the projects reviewed was accounted for by these projects' vertical and horizontal linkages. The importance of these linkages to overall project impact should have major implications for the selection, design and management of private enterprise projects.

In three of the four cases examined, substantial linkages existed, either forward, backward or in both directions. Perhaps the best example of this was the impact of the loan to LIK. At full production, LIK will require 1000 cow hides per day, all of which will be provided by local herders and slaughterers. In addition, because of quality concerns, LIK is making efforts to improve the skinning and rangeland practices of ranchers by offering bonuses for higher grade hides, thus improving livestock management of the ranchers in question. Finished leather goods will be used by local shoe manufacturers who can benefit from the skilled and inexpensive local labor pool.

Linkages resulting from IFI loans to sub-borrowers are also very evident. Sub-borrowers in Kenya were involved in transport, agricultural processing, and manufacturing. Loans were destined for fixed assets and in a high percentage of the cases were for start-up ventures. They purchased lumber, hides, grain, coffee and flour from local markets. Finished products often substituted for imports and in one case were destined for export.

Moroccan loans, which provided foreign currency for imports, were destined for a different sort of borrower, but involved several linkages as well. Althougn raw materials were usually imported, these were frequently combined with locally produced raw or semi-finished goods, as was the case for a large fish cannery, several textile operations, and small manufacturing firms. A large percentage of these businesses produced products that were subsequently used by some other commercial operation. Some firms also exported finished product, resulting in a net foreign exchange surplus due to value-adding.

4. Given their small size relative to the economic problems they address, all PRE projects and most A.I.D. enterprise development projects should be understood and evaluated as institutional development projects.

Although it is important to continue to monitor the direct effects of projects on such development indicators as sales, employment and exports, the true impact of these projects is most appropriately assessed with regard to their consequences for the evolution and change of the institutions involved in the program. These institutions include not only the organizations directly receiving A.I.D. funds (such as KCFC, WAFABANK, LIK and ASL), but also any intermediary financial institutions involved (such as Bank of Antigua, Industrial Promotion Services and Credit du Nord), government policy makers (such as the Central Bank), other in-country industries and financial institutions, and the USAID Missions themselves. While there is substantial evidence of significant institutional effects in the cases reviewed, it is also evident that the impact at that level was greatest where such institutional objectives were explicitly acknowledged and planned for.

The evidence also suggests that institutional effects often take a considerable time to materialize and to be truly institutionalized in the relevant organizations. It is perhaps for this reason that the institutional effect of the projects reviewed were, in general, less encouraging than those projects' direct development impacts. In addition to the above stated need to incorporate institutional change objectives into project designs, this lesson also has implications for project duration suggesting that longer durations or Phase II efforts be considered for projects attempting to introduce significant institutional changes.

5. <u>While it is generally counter-productive to incorporate excessive constraints and requirements on enterprise creation projects, it is critical that any objectives which are included in projects be supported by adequate implementation and monitoring machinery</u>.

By requiring complex documentation or limiting excessively the uses of project funds, project designers severely curtail the capacity of projects to operate in a truly commercial way or to exploit the available opportunities for private sector stimulation. It is evident from the cases reviewed that successful projects require as much freedom as possible from such constraints.

The evidence also suggests, however, that specific target groups or objectives are unlikely to be realized in the absence of equally specific mechanisms for earmarking funds and monitoring their use. Exporting by WAFABANK clients and outreach to women entrepreneurs in Kenya are conspicuous examples of project objectives which were largely unrealized as a result of the absence of suitable implementing and oversight mechanisms.

The implication of this finding is that specific targeting should be included in project objectives only where it is considered essential to a project's rationale; and where included, such targets should be reinforced by suitable earmarking and monitoring mechanisms.

6. <u>The overall sales and employment effects of direct loan and IFI loan projects of the type piloted by PRE appear to be in line with international standards</u>.

Although difficult to assess with methodological certainty, there is some evidence that the immediate economic effects of the projects reviewed (with the exception of ASL) are generally in line with those projected in the projects' appraisal reports and in general guidelines developed by the World Bank, IFC and UNIDO concerning cost per job created and value added per dollar invested. The one case (KCFC) where it was possible to link actual employment increases to those projected by the sub-borrowers themselves added confirmation to the rule of thumb of several project planners suggesting that such targets tend to be over-estimated by approximately a factor of two.

7. <u>Private sector initiatives frequently result in the transfer of new technologies to recipient organizations</u>.

Technology transfer can be a significant impact of both direct and IFI loans, although direct loans seemed to promote a greater degree of technology transfer than was possible under the (usually much smaller) sub-loans made through IFIs.

Loans to LIK and ASL were destined, in part, to finance the installation of more modern production technology in the form of leather processing techniques and mariculture, respectively. In both cases, these businesses were to have possessed state of the art facilities in their given regions. Interestingly, additional transfers took place that were unforeseen by project planners at the onset, such as pollution control processes and the promotion of improved livestock techniques associated with LIK.

In the case of sub-loans by IFIs, transfer of new technologies is likely to be more ad hoc unless made a condition of the IFI loan, which it was not in the two IFI cases studied. These cases nevertheless included several instances of sub-borrower loans used to finance new processes, such as textile machinery, commercial fishing, agriculture and manufacturing processes.

C. Replicability/Sustainability Lessons

Based on the cases reviewed, several tentative observations concerning the replicability and sustainability of these interventions can be made:

1. A thorough analysis of the structural and policy constraints existing in a given economic system should precede all investment decisions.

The most important lesson of experience to emerge from the early World Bank SMSE projects was that the policy environment often represented a significant constraint to the development prospects of small enterprises, even to those provided financial and technical assistance. Export subsidies, import controls and licensing procedures in some cases explicitly excluded small and medium scale enterprises, but more often involved procedures too onerous for SMSEs. Investment incentives, such as relief from taxes and duties on capital equipment and favorable depreciation treatment, often worked against SMSEs and encouraged overly capital intensive investment. Various regulatory procedures in obtaining licenses for the acquisition and use of vehicles, electrical and telephone connections were often burdensome to small enterprises.

These general conclusions were corroborated in the four cases reviewed in this document. This experience also underlines the key role of the Central Bank in determining the extent and nature of credit availability, and suggests that individual SMSE lending programs cannot, by themselves, be expected to provide sufficient leverage to effect major changes in overall government or Central Bank policies. It was clear, for example, that unfavorable Central Bank decisions regarding credit rationing or interest rates could easily undercut the net impact of any of these projects. This conclusion suggests a need to be aware of the possible institutional and policy impact of specific lending projects while recognizing the frequent need to pursue other specific policy dialogue measures if these projects are to have the desired impact on small enterprise development.

The direct loan model typically operates under the assumption that the national financial system is a "given." Individual investments are not normally intended to create or influence significant structural change within that system. The problems of access to foreign exchange and the potential risks in foreign exchange transactions are, for the most part, analyzed in terms of the enterprise involved, and the focus is on a specific product or function within the system rather than on the system itself. In the case of IFIs, however, the system itself is a necessary focus for the analysis. Whether or not they are explicitly acknowledged in the project design, the constraints addressed by IFI projects (e.g., non-availability of long term financing for SMSE's and regulatory restrictions on foreign exchange transactions), are systemic problems.

While investment programs or projects may be designed with specific development objectives as their primary focus, experience suggests the importance of a careful and hard- headed examination of the system within which the investment would operate. To the extent that an investment is intended to stimulate a change in the system, the analysis must be more detailed, and take into account economic, political and institutional influences which are necessarily dynamic in nature.

2. An explicit strategy for long term institutional and structural changes should be included in initial program design in order for these benefits to be sustained once A.I.D. intervention ends.

In order for a desired change to be institutionalized by host country institutions, the key elements of an incentive structure should be identified and reflected in the initial project plan.

The sustainability of, and principal incentive for, any commercial endeavor depends on its financial viability. For bank lending programs, this necessitates that interest rate spreads be wide enough to cover any incremental risk or administrative expenses entailed in the new program. In the case of WAFABANK, this was the case since the program entailed substantial spread, required very little additional administrative oversight and assured WAFABANK (although not necessarily Credit du Nord) a reasonable return. For KCFC, although there appeared to be an adequate spread and bank managers indicated that the program was "profitable," additional administrative costs associated with the influx of small new rural borrowers, increased risk associated with long-term lending, and increased delinquencies may have been disincentives to program sustainability. In the direct loan cases, the loans were commercially competitive to both borrower and lender and hence financially sustainable, given reasonable performance by the businesses involved.

A recent review of World Bank lending projects concluded that commercial banks generally need a 5 to 6 percent spread for lending to SSEs in order to be profitable and avoid the need to subsidize such lending from other operations. If technical assistance is provided, the World Bank study concluded that a spread of 8% may be required.

Institutionalization of change also demands that qualified personnel and an adequate organizational structure exist within recipient institutions. This was apparently the case with both IFIs and with LIK. ASL, on the other hand, lacked much of the managerial and organizational capability to bring the enterprise on line, which has certainly contributed to the project's poor performance.

A key point for IFI sustainability is the availability of additional resources once loan/guarantee intervention is ended. In Kenya, KCFC's inability to find sources of medium-term deposits hampered efforts to continue the program. Morocco's foreign currency deficits and the reluctance of correspondent banks such as Credit du Nord to continue to lend without outside guarantees is likely to inhibit that program's future once A.I.D.'s guarantee has ended.

Host government policies and how they relate to the project are also crucial to its initial success and continuity. If policies restrict or prevent private sector investment in the economy, initiation as well as sustainability would be in doubt. While Kenya, Morocco, and Antigua had committed their development strategies to encouraging the growth of a strong private sector, even these countries have policies such as administered interest rates that impede the sustainability and replicability of PRE's efforts there.

In sum, the degree of benefit continuation is the bottom line of development efforts. Several factors contribute to private sector project sustainability, the foremost being profitability, organizational capability, local resources, and government policies. These issues should be addressed at the planning stage, and built into project activities and assumptions at that time.

3. <u>Due to the necessity of viewing financial intermediation as a long-term process, successful intervention requires local USAID Mission commitment and continuing involvement</u>.

The Investment Office of PRE is a centralized, small unit with a mandate to identify and administer its activities worldwide. This organizational structure inherently relies heavily on local USAID Mission involvement in the identification, implementation and monitoring stages of its lending program.

Local Mission personnel are most familiar with host government policy, economic priorities, and business potential in their respective countries. Local Mission involvement can be crucial during the loan identification and negotiation process. Once the program is underway, the local Mission serves as an important player in troubleshooting and problem resolution processes. And finally, an ongoing loan program often provides a wealth of data to be used in fine-tuning the Mission's ongoing program and developing possible follow-on efforts.

Viewed from PRE's perspective or the perspective of a USAID Private Sector Officer, individual projects are seen as opportunities to promote long term institutional change within the USAID itself. Innovative credit projects, particularly those entailing relatively high exposure to prime actors within the international and local business communities, present excellent opportunities to introduce Mission staff to new ways of doing programming for or through the private sector. To achieve this objective, however, it is essential that initial projects be selected that have a high probability of success; and that project design and management be carried out in such a way as to maximize involvement by Mission personnel on a regular basis.

4. <u>The more closely a project fits into existing credit delivery systems, the more likely is its sustainability and the less likely is its impact on institutional change</u>.

The two cases of IFIs demonstrate different approaches to increasing credit availability. KCFC set up a separate unit called KCFC "Schemes" to accommodate the additional credit made available from OPEC, IFC and A.I.D. The funds were lent out once and net earnings were used to help capitalize the KCFC system which includes little by way of term lending or lending to small businesses.

In the case of WAFABANK, Bank of Antigua and IPS, the PRE-supported program was thoroughly integrated into normal credit delivery mechanisms and became another service to already established customers. The WAFABANK program, for example, could be viewed as an expanded and more efficient provision of credit rather than as a new program. The KCFC program, clearly treated as something apart from the bank's normal operation, represents an effort to promote a more radical change in the institution itself than does the WAFABANK program. The different approaches taken by these institutions can be seen as logical consequences of the choice of interventions, with the KCFC program being considered as an innovation and WAFABANK as simply an extension of existing services to meet development objectives.

In establishing priorities for intervention in private sector credit, choices must be made as to the optimal trade- off between the magnitude of institutional change and the probability of such changes being effectively sustained. It is most likely that a project that involves the establishment of credit facilities that are significantly different from normal practices of a given institution will require substantially more time to become integrated into that institution's operations.

5. <u>Impact of loans/guarantees to IFIs is enhanced if specific provision is made for sub-borrower reflows to be re-lent to comparable sub-borrowers, at least during the life of the loan agreement</u>.

A curious contrast between IFI cases was the use of loan reflows from sub-borrowers. KCFC Schemes to which A.I.D. authorized $2.5 million for 12 years (matched 1:1 by Kenya Commercial Bank), transferred repayments of loan principal and interest into its main loan pool, in essence using the funds one time only. WAFABANK, which received a $2.5 million loan guarantee fully payable in five years (matched 1:1 by Credit du Nord), recycled loan repayments back into the program.

After four years of participation, KCFC had fully on-lent its PRE loan to 95 sub-borrowers, with terms averaging six years and never exceeding eight. All loans were to be paid-off well before the end of KCFC's 12 year term, and there were no plans to expand the sub-borrower population beyond the initial group. WAFABANK, on the other hand, had established a short term revolving credit pool and had on-lent almost $10 million in 171 sub-loans in the two years since the project began. Although principal repayment had begun to decrease their reflow pool, WAFABANK still expected to on-lend an additional $5 million before the end of the program three years hence.

As these examples illustrate, sub-loan reflows are an important leveraging mechanism which enhance IFI program impact. Care should be taken to ensure that language is included in the initial agreement concerning this issue, and that issues (exchange rates, profitability, risk) that would make this condition unattractive to an IFI are addressed in a mutually satisfactory manner.

V. REPLICATION PLAN

An essential aspect of this study is to provide information on replication of the two models discussed herein for USAID staff in other countries interested in private sector programming. The previous section discussed in detail the lessons learned during this exercise. While it is hoped that these lessons themselves will have an impact on the design and implementation of future projects, certain additional basic information may be helpful.

For a USAID Mission wishing to become involved in projects of this type, one of the first steps in analyzing potential opportunities for intervention would be contact with other donors and institutions at the local level. In many instances, adding capital inputs and USAID development objectives to a program already in existence represents a low risk, cost effective way to enter into the private sector programming arena.

Once the Mission has gained a clear understanding of the existing private sector, established an array of private sector contacts, and identified specific constraints to private sector development, contact with PRE is highly recommended. Several centrally funded PRE program activities are designed to provide assistance to Missions interested in promoting enhanced private sector programming. Inclusive of these programs are the following:

1. Program Development and Support: PRE staff and business experts provide program development and problem solving assistance to Missions, host country governments, and private businesses. Assistance is generally short-term in nature, and address design issues, management/technical problems, and project assessment and evaluation.

2. Revolving Loan Fund: Focusing on three main areas; i) capitalization or expansion of private financial intermediaries to provide financing to small and micro-enterprises; ii) support for small and medium scale agribusinesses which value-add to agricultural produce and need technical assistance, production inputs, credit and marketing services; and iii) research and development including the development of innovative investment techniques, concepts, and instruments.

3. Investment Development and Packaging: A pool of resources is available to fund investment analyses and other technical studies of potential projects, as well as to provide limited technical assistance for strengthening a potential borrower's institutional capacity.

4. Private Enterprise Development Strategy and Support: This project focuses on interventions which will result in better overall Mission approaches to provide enterprise strategy, and on host country policy and institutional reform that promotes

privately-led economic growth.

5. Financial Markets Development Project: To develop capital markets, which can play a crucial role in mobilizing savings and capital into priority investment activities, PRE provides assistance which includes:

   - performing analyses required to support specific action or policy revision;

   - providing training to groups essential to the growth of financial markets (bankers, businessmen, investors, etc.);

   - providing advice and personnel to assist in establishing components of the financial system that are important for the expansion of capital markets (debt instruments, regulatory agencies, etc.)

6. Divestiture and Privatization: The goal is to assist in creating a policy climate to accelerate transfer of state-owned or controlled enterprises to the private sector. This is accomplished by providing technical expertise needed by Missions for preparing country and sector-specific divestiture and privatization strategies; developing a list of components of a policy dialogue with host country public and private sector leaders; and implementing divestiture and privatization actions in selected countries.

7. Training Development: PRE provides support to selected developing management training schools in new curriculum design, staff upgrading and establishment of developing country/U.S. institutional relationships. In addition, PRE conducts a course on the "Role of the Private Sector in Development" for host country nationals from both the private and public sectors, A.I.D. personnel, international donors, PVO staff and U.S. businesses.

8. International Executive Service Corps: This not-for-profit organization partially funded by PRE has recruited thousands of highly-skilled retired American executives to share their "know-how" with their developing world counterparts. A secondary role is to provide linkages between American businesses and those in developing countries.

9. Commercialization of Technology: The program's focus in on; (i) the development of R&D limited partnerships for product development, manufacture, and marketing in developing countries; (ii) test marketing in developing of new or adapted products; and (iii) preparing business plans to raise capital for developing country businesses to market or manufacture products in high priority sectors.

Several studies exist which serve as practical, general references for those interested in initiating private sector lending programs. PRE's case study series describing and evaluating specific projects and models is a good place to begin. In World Bank Lending to Small Enterprise: A Review, Jacob Levitsky reviews SSE lending objectives and impacts, then focuses on such issues of program design as financing arrangements and subloan terms. Blayney and Otero's paper, Small and Micro Enterprises: Contributions to Development and Future Directions for A.I.D.'s Support, provides a useful framework for analyzing factors that influence credit extension.

The ARIES Strategic Overview Paper examines characteristics of small and micro enterprises; compares principal types of SSE resource institutions; identifies general models of SSE assistance programs; and reviews recurrent problems of SSE resource institutions. The A.I.D. Program Design and Evaluation Methods Report No. 6, A Manual for Evaluating Small-Scale Enterprise Development Projects, presents low, medium, and high level-of-effort methodologies for evaluating technical assistance and credit institution performance as well as SSE project impact. An excellent discussion of the formal lender-small borrower relationship, and the difficulties inherent in lending to this group, is presented by Johanna Looze in Credit and the Small Borrower: Bridging the Gap Between Borrower Lending Programs, and Funding Sources. Finally, an evaluation system for private sector investments is discussed in Proposed Evaluation Systems for the Investment Office of A.I.D.'s Bureau of Private Enterprise, written by Lawrence S. Cooley, of MSI. Other references and information can be obtained by contacting PRE's Program Office or PPC's Center for Development Information and Evaluation.

Additional information and assistance in establishing IFI, direct loan or other private sector programs may be obtained from the Bureau for Private Enterprise, United States Agency for International Development, Washington, D.C. 20523.