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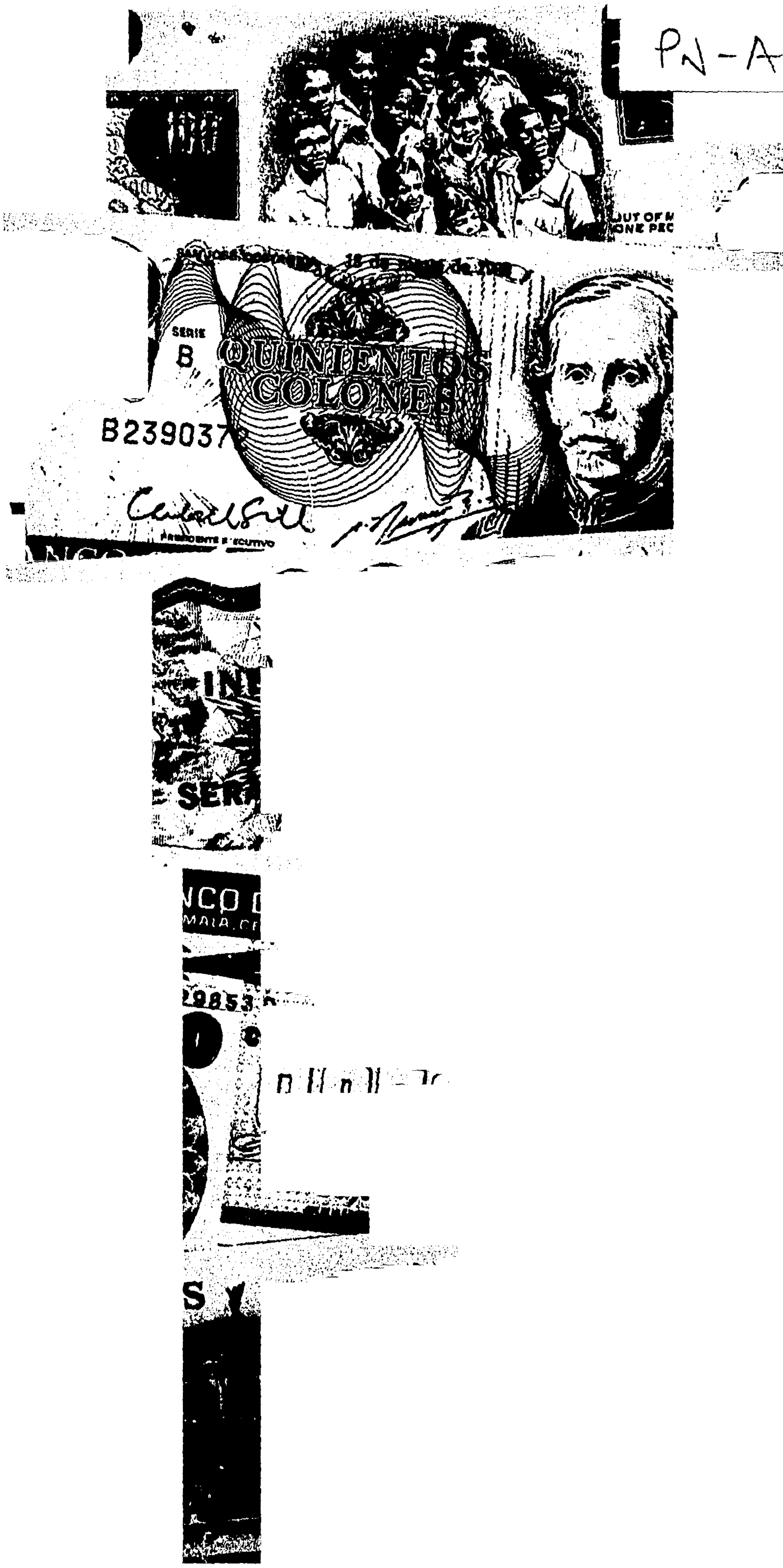

Design and Management of Credit Projects for Small and Medium Scale Enterprises:

Guidelines for Working with Commercial Financial Institutions

November 1988

Bureau for Private Enterprise

Agency for International Development

DESIGN AND MANAGEMENT OF CREDIT PROJECTS FOR SMALL- AND MEDIUM-SCALE ENTERPRISES:

GUIDELINES FOR WORKING WITH COMMERCIAL FINANCIAL INSTITUTIONS

CHAPTER I. INTRODUCTION: WORKING WITH COMMERCIAL CREDIT TO ACHIEVE DEVELOPMENT OBJECTIVES

This guidebook is intended to assist A.I.D. field Missions in designing and implementing private sector credit projects. It contains a distillation of lessons learned through evaluation of several of the projects carried out under the Investment Office of the Bureau for Private Enterprise (PRE), particularly through the Bureau's Private Sector Revolving Fund. The guidebook provides a general description of the types of assistance and implementing mechanisms. It also points out specific elements in design that have proved decisive in the success or failure of credit projects. Where possible, the guidebook takes into consideration the differences between PRE's operating mandate and the mandate that Missions with bilateral programs may face. While the guidebook is primarily intended for A.I.D. field staff, it is hoped that it will also be useful to a variety of institutions in developing countries.

The Private Sector Revolving Fund

Established by Congress in 1983, the Private Sector Revolving Fund was designed to encourage the use of private enterprise to stimulate economic growth and meet basic human needs in the developing world. One goal was that the Revolving Fund itself would be a self-sustaining mechanism for channeling capital to commercially viable projects with strong development payoffs. A second, equally important goal was that the fund would serve as a locus of research and development in private sector project design. Fund projects were to serve as models for A.I.D. Missions and developing country financial institutions. With two years of investment program activity prior to the Revolving Fund, and five years of Revolving Fund activity, PRE believes that a body of experience is developing that can be applied generally to A.I.D. sponsorship of credit projects.

The Revolving Fund will be capitalized over a period of several years, and is expected to grow to $100 million in total capital. Thereafter, the Fund will sustain itself through interest and fee income and reflows of principal. For this reason, it is crucial that Fund projects be financially viable. The Fund makes loans in U.S. dollars of up to $3 million (averaging between $1 and $2.5 million). These are extended mainly through direct loans and loan guarantee mechanisms to intermediate financial institutions (IFIs) that on-lend to final target enterprises. In a few cases, each involving a project with potential to produce exceptional development benefits, the Revolving Fund has lent directly to individual business projects.

According to the Revolving Fund's objectives set forth in its enabling legislation and Congressional presentations, projects eligible for Fund support must:

- Show strong direct development benefits, such as: meeting basic human needs, creating employment, earning or saving foreign exchange, transferring technology, or supporting agribusiness.

- Strengthen local financial institutions, or contribute to an improved local environment for investment.

- Target small- and medium-scale enterprises.

- Provide positive financial rates of return to the Revolving Fund (at or above the U.S. Treasury borrowing rate for comparable maturity).

- Release credit to end users at local market interest rates.

- Leverage financial institution funds at least equal to the Revolving Fund contribution, and total additional funds at least twice the Revolving Fund portion.

- Have good potential for replication by A.I.D. or local IFIs.

As of September 30, 1987 PRE had the following active loans:

3 Non-Revolving Fund direct loans	$3.6 million
6 Non-Revolving Fund loans to IFIs	$7.7 "
5 Revolving Fund direct loans	$9.6 "
25 Revolving Fund loans to IFIs	$50.4 "
Total	$71.3 million

Bureau for Private Enterprise loans have been concentrated in the Asia/Near East region (49 percent), with a substantial share in Latin America and the Caribbean (24 percent) and Africa (21 percent), and small shares in the South Pacific Region (2 percent) and worldwide projects (4 percent).

As stated, the purpose of this guide is to assist A.I.D. officers in designing and implementing private sector credit projects, in light of PRE Revolving Fund experience. Private sector credit projects may be defined as those in which A.I.D. assists in the provision of finance for private business ventures, either directly or through an intermediate financial institution

(IFI). In this guidebook, all such finance takes the form of credit, not equity. Before moving to the mechanics of project development, it is important to establish the broad objectives behind A.I.D. involvement in such projects.

Goals and Objectives of Credit Projects

If a common theme runs through these guidelines, it is that commercial institutions, particularly financial ones, can be used to achieve development objectives. To some, this may not be readily apparent. After all, aren't commercial institutions concerned with profit, not development? Yes, but very often profit and development coincide, or at least overlap significantly. Indeed, if development is to be sustained without continued donor support, they *must* coincide. It is up to A.I.D. to select private partners and to design private projects that meet both private profit requirements and public development goals.

Recognizing that A.I.D. resources will always be small relative to the private sector as a whole, A.I.D. Missions must also look beyond the immediate effect of projects to a longer term increase in the capacity of the local private sector. Thus, *every credit project should incorporate two types of objectives: first, direct development impact and second, institutional change.*

Direct Development Objectives. Private sector credit projects achieve direct development objectives through the effect of credit on the target businesses. Credit should enable businesses to begin or expand production, thus contributing to development goals such as increasing national income, employment and in some cases foreign exchange earnings (or savings). Expanded production can have ripple effects that extend to businesses linked to the target business, as suppliers and distributors are linked to manufacturers. When a significant proportion of the owners, employees or suppliers are from low income groups, business expansion also provides income for support of basic human needs. Some businesses produce other development benefits, such as companies producing health-related products, or those that develop or bring new technologies into a country, and these should also be encouraged.

Institutional Change. A.I.D.'s credit projects will normally be a small fraction of total funds available for investment in any country. Program designers and managers must therefore use A.I.D. resources strategically, to maximize long run effects. This means they should use credit projects to bring about institutional change. Through institutional change, A.I.D. can, in effect, leverage the larger pool of private investment resources over a longer period of time. If the strategy succeeds, the development benefits produced by the leveraged funds may far exceed the direct benefits produced by A.I.D.'s loan funds. Leverage is used here not in the narrow sense of funds required to be contributed in conjunction with A.I.D. funds, but in the broad sense of funds that A.I.D. influences through demonstration or policy change.

Institutional change can take place at three levels: first, in the financial institution A.I.D. works with during project implementation; second, in other financial institutions which learn from observation; and third, in the institutions that make financial market policy, such as the central bank, ministry of finance, and others. The intent at each level should be to convince private institutions that they can profitably offer services and credit products that result in greater direct development benefits of the types outlined above than those they ordinarily provide, even after A.I.D. assistance has ended. This may involve credit and services for new target groups, or financial instruments that deepen capital markets, or changes in government policy towards financial markets.

Because of the importance of institutionalizing innovations, this guidebook offers many suggestions on achieving such change objectives. If not carefully designed, a superficially similar credit project will have only a one-shot impact.

Organization of the Guidebook

This guidebook is oriented both to the process of design and the substance of projects. It follows the sequence a Mission would follow in selecting, designing and implementing a private sector credit project. The following section (Part II) describes the background work necessary for diagnosing problems and focusing on a credit project as an appropriate intervention. This includes both economic analysis and development of contacts within the private sector. Part III discusses the design of the project itself: target groups, types of credit to be offered, and implementing mechanisms. Part IV concerns certain critical details of project designs, including interest rates, provision of technical assistance, and particular credit products and implementing mechanisms. Part V discusses selecting and working with local financial institutions that directly implement projects. While this could appropriately be included under design, the topic is complex and crucial enough to warrant separate treatment. Part VI discusses implementation, monitoring and evaluation. Finally, an Appendix lists other resources available for those seeking to design private sector credit projects.

CHAPTER II. ASSESSING THE LOCAL SITUATION AND GETTING STARTED

It goes without saying that the more a project design team knows about a country's private sector, the better equipped it will be to design a good project. If analysis of the private sector reveals needs and opportunities for A.I.D. assistance, design work can focus more closely on target businesses, types of assistance needed, and the financial mechanism for providing assistance. This section describes how to assess the private sector and begin to develop a strategy for intervention.

Getting to Know the Private Sector

Business people often describe the private sector as a game. In that game, the main players make business deals with each other and join together to solve common problems, often problems of public policy towards business. An A.I.D. Mission that wishes to work actively in the private sector must join that game. It must define itself as an important player and seek to become recognized as such by others. The payoff to A.I.D. of joining the private sector game is reality-tested project designs. Equally important, by becoming a participant, A.I.D. can contribute to debate within the country on policy towards the private sector and future directions for business.

The best way to begin to participate in the private sector is to talk to its members. A fruitful starting point may be a systematic series of interviews. Those interviewed should include business people from commerce and industry, including businesses of varying size. People whose actions affect business operations should also be consulted, including government officials, business association leaders, and leaders in the financial sector. From such interviews a picture of the state of the country's private sector will begin to emerge. Mission staff will learn about the culture of private sector interactions in the country (the "rules of the game"), and will be able to identify important individuals and institutions. An on-going activity should be participation by Mission staff in key business associations, such as Chambers of Commerce or Rotary Clubs, that provide opportunities for discussing strategic issues, for planning action, and, perhaps most important, for informal personal exchanges.

Project planners should develop on-going relationships with some of the most insightful and strategically placed of the people interviewed. This group of people can act as a sounding board for proposals, and an important source of information and new ideas.

As strategy design progresses, a group of advisors will become increasingly important, and can alert planners to sensitive issues they may otherwise miss. For example, informal advisors often know the reputation and community standing of individuals and institutions with whom the Mission is considering working. The advisory group could be formalized, but it will probably function just as well through informal contacts. It is, however, also important to avoid becoming identified exclusively with one narrow group.

The analysis provided by interviews should be supplemented and put into context by analysis of statistics on private sector activity (such as those found in government documents) and a review of available literature. It is important to use both interviews and written sources, as each will correct biases inherent in the other.

During the process of getting to know the private sector, A.I.D. staff should bear in mind that some of those they contact (particularly financial institutions) are not potential beneficiaries, but potential partners in project implementation. As such, they differ in important respects from other A.I.D. partners, such as government agencies and private voluntary organizations. As mentioned, private lenders are primarily motivated by profit, while A.I.D.'s objectives are developmental. Both A.I.D. and the lender wish to see successful businesses result from loans, but for different reasons. The Agency may measure the success of a loan in terms of increased employment, while a lender will look at the same loan with an eye towards repayment and the likelihood of the business continuing to be a good customer. Awareness of both the similarities and differences in perspective is crucial to developing an effective working partnership with a lender.

Unlike many PVOs or government agencies, private financial institutions are not dependent on donor financing for continuation of their operations. This gives A.I.D. far less leverage over private lenders. If the Agency offers a deal the lender considers too troublesome or insufficiently profitable, the lender will simply say, "No, thanks." For this reason, expectations about the amount of institutional change that an A.I.D. Mission can induce should be modest. We will return to these private lender characteristics when we discuss negotiating project agreements later in the guidebook.

Analysis of Structure of Private Sector and Policy Climate

In interviewing business people, reviewing data, and reading other analyses, project planners should ask what the structure of the private sector is, and should identify both the greatest opportunities for growth and investment and the most important constraints. They should pay particular attention to the structure and policy environment of the financial sector, as this will be the focus of projects involving IFIs.

Policy and the Macroeconomic Environment. The primary aim of an investigation of government policies toward private business and of the macroeconomic setting is to determine whether conditions are positive enough to justify A.I.D. support directly to private enterprise. Typically, private sector credit projects do not address policy issues (with the exception of financial sector issues). Therefore, if a country's industrial policy is in need of a major overhaul, a credit project may not be advisable, and attention may be better focused on direct policy dialogue.

Government policies directly affect returns on investment available to private enterprise. Policies affecting business include taxes, trade policies (tariffs and quotas), price controls, investment approvals, licensing requirements, rules governing foreign investment, social regulation (e.g., environment, safety), labor policies, and special incentives to investment. These, together with factors such as levels of demand for a country's major exports, agricultural conditions, and the cost of major imports, combine to produce a macroeconomic environment with distinct growth and employment rates, inflation, trade balances and the like.

Many policies apply differently to different sectors, and smaller businesses may be affected differently than large ones. Thus, a second aim of the investigation of policies and macroeconomic conditions is to help identify appropriate target groups that need and can benefit from assistance.

Industrial Structure. Analysis of the structure of the private sector itself can be divided into interfirm and intrafirm phases. The interfirm phase might include a general overview of the private sector in terms of the distribution of output by sector (manufacturing, retail, services, etc.) and subsector (e.g., wood products, food and beverage), by size of business, and by market (domestic, export). The relationships between sectors, particularly agriculture and industry, play a major role in determining growth possibilities. Measures of economic health, such as growth in real output and capacity utilization, are useful. Both current status and recent trends should be understood. These types of analyses can usually be found in regular reviews of the state of the economy prepared by various institutions. The purpose of investigating this area is, again, to identify target groups. The target group should show reasonably good growth prospects, given financing.

The intrafirm review should look at the managerial, technical and financial capabilities of businesses. Constraints to growth should be examined, including, in addition to government policy, input supply problems (capital, labor, raw materials), and marketing problems. It may be useful at this stage to begin to concentrate on a few promising subsectors, as project interventions aimed at subsectors are frequently quite successful.

Not all of these areas can be studied in depth, though with the help of pre-existing material available on most countries, it is generally possible to develop a sufficiently detailed and comprehensive view within a reasonable time. If not, or if the first stage of analysis points in an unexpected direction, specific research can be commissioned. In the end, the analyst should be able to give a succinct statement of 1) the private sector's best development path given the country's comparative advantage; 2) its most likely development path; 3) the major policy and non-policy constraints to growth; and 4) the likelihood that constraints can or will be altered.

Financial Sector. The structure, current conditions and policies governing the financial sector require special scrutiny, as this is the immediate context of the majority of private sector credit projects that involve IFIs. One can go farther and state that IFI projects are only justified when they can help alleviate some type of constraint in the financial sector. The most important policies concern interest rates and the regulation of banking. Planners should know how interest rates are set and what interest rates have been, on both the deposit and lending sides, in recent times. They should know what regulations banks must follow with regard to capital and asset structure, liquidity requirements, loss reserves and the like, and they should know how these regulations are enforced.

The institutional structure of the financial sector is also of prime importance, and again, should include comparisons across institutions as well as assessments of internal capabilities. Questions to be answered include: What roles do the various types of financial institutions play within the economy? What services are offered? How capable are the managements of the institutions? How stable are the banks and other financial institutions? Finally, an assessment of current conditions would include, in addition to many of the items just listed, some estimate of the relative supply and demand for credit, and prevailing liquidity conditions among banks.

From this assessment, some idea of key credit constraints should emerge. This may involve a particular type of business that is not adequately served, it may involve particular types of financial services not offered, or it may involve severe macroeconomic imbalances resulting from temporary conditions. An IFI project will then be built to address one or more of these constraints.

Review of Donor Efforts

The traditional mechanism for donor assistance to business and industry, except for the smallest businesses, has been development banking, usually government supported. The International Finance Corporation, in contrast, is one of the few agencies to have worked directly and extensively with private businesses and financial institutions, and its experience in the country is therefore particularly relevant. Many European donors have investment banks that have done this to a lesser degree. It is instructive to consider the success of such interventions and of any private sector involvement by A.I.D. itself. The concept of comparative advantage can be applied to A.I.D. activities in asking what the Agency can bring to business and industry that others cannot.

Once a specific type of project has been chosen, it may also prove useful to compare attempts both by A.I.D. and other donors to provide a similar type of assistance in other countries.

Three Hurdles for Credit Projects

Armed with an understanding of the dynamics of the country's private sector and with contacts inside the business community, project planners can select possible project types. In order for a private sector credit project to be selected, the business outlook must be at least minimally positive. Three hurdles must be crossed. First, the policy climate set by the government should offer opportunities for investment with positive real rates of return. These investment opportunities must yield both positive financial and economic returns. Opportunities must be found among businesses that are net foreign exchange earners (or savers), and that use capital and labor efficiently. Financial viability should not be a product of price distortions such as import tariffs on competing products. If the policy climate is such that very few <u>economically</u> beneficial investments appear <u>financially</u> viable, a credit project should not be undertaken. Rather, it may be more sensible to pursue policy change directly with the government.

Second, financial market conditions are a concern in selection of credit projects. Potential partners in the financial sector must be financially sound, with reasonable managerial capability. Institutions must operate under conditions, particularly with respect to government policy, stable enough to insure that they will not have to alter their operations drastically or abruptly.

The final prerequisite is the flip side of the second. While financial markets must be reasonably capable, there must also be some credit constraint. If credit is already flowing freely, an A.I.D. loan will not be needed. An A.I.D.-supported credit project can be justified only if the supply of credit to the target group of enterprises is limited in some way.

If these prerequisites are met, the project design phase can begin. The next section focuses on the project development process, while the following section (Part IV) reviews the conditions appropriate for various project types, as well as specific design issues.

CHAPTER III. FORMULATING A STRATEGY AND TECHNICAL APPROACH

This section begins at the point when project planners have found that conditions warrant a private sector credit project and when they are comfortable and familiar with private sector representatives. It proceeds through detailed design, focusing on how to translate direct development and institutional change objectives into a project.

Additionality, Risk and Sustainability

Before proceeding to actual design, it is important to consider three interlocking concepts that will affect how well ultimate objectives are met: additionality, risk and sustainability. Additionality and sustainability are both attributes of successful projects. Risk influences the other two.

For a private sector credit project, additionality refers to the extent to which a credit project 1) causes loans to be made that would not otherwise have been made, and 2) causes business expansion that would not otherwise have occurred. If A.I.D. funds are lent to borrowers that would have received credit on substantially the same terms without A.I.D., the project itself has not achieved the intended benefit. Similarly, a project has not accomplished the intended benefit if borrowers use the loans to purchase consumer goods rather than to expand their businesses. It is important to note that the first definition concerns only finance, and that additionality of finance is a prerequisite to the second type of additionality, that of economic impact. Additionality of economic impact is very difficult to measure, because it requires detailed knowledge of the relationship between credit and investment decisions.

For lenders, greater additionality usually means greater risk. Bank practices usually reflect an explicit decision about how much risk to allow in operations. All business below the risk limit is accepted, and above the limit is rejected. Limits pervade bank policies, such as those regarding acceptable types of loan collateral. For this reason, any change in bank policy (by definition an aspect of additionality) is likely to involve a step up in risk, or at least perceived risk.

Banks deal with several types of risk: credit risk (risk of default), foreign exchange risk (risk that exchange rates will change, making repayment in a foreign currency more costly in local currency), interest rate risk (risk that interest rates will rise, causing higher costs to borrowers or fall, causing a squeeze between deposit and lending rates), or liquidity risk (risk that a bank will not be able to sell assets quickly enough to meet claims on liabilities). An IFI project with good additionality could well involve an increase in any of these risks. Most typically, borrower credit risk is at stake, as projects direct IFIs to new types of clients. A project aimed at extending loan maturities may increase several types of risk to a bank: credit risk, interest rate risk, and liquidity risk. Such a project should be considered additional even if its clients are already established in the bank.

Sustainability is simply the continuation of the project's activities after completion of external financial support. It is essential to the objective of creating institutional change. Without it, the most a project will contribute is its direct benefit to the immediate loan recipients. Sustainability often conflicts with risk, and hence with additionality as well. A project that asks lenders to change little will have good prospects for being continued, but will score low on additionality. Nevertheless, a small additional component sustained over a long time period may be more valuable than a large amount of additionality that is not sustained.

Private sector credit projects usually work by relieving IFIs of some type of risk constraint, thus allowing them to lend beyond their normal risk ceilings. It is obvious that a guarantee reduces the portion of risk an IFI bears, but other types of projects reduce risk as well. Loans provided in local currency eliminate foreign exchange risk, and direct loans reduce liquidity risk. In addition, projects often induce banks to take on more risks by giving them direct compensation. Specific risks can usually be translated into the expected cost they will mean to the lender. This provides a means to determine how much to compensate lenders for bearing it. In brief, assuring additionality during the life of a project is a matter of determining what increase in risk to ask of an IFI and structuring a package that will induce the IFI to accept it.

Sustainability, however, requires that the IFI learn to handle the new risk on its own, without external support. In most cases, the change in behavior will last only as long as the project, and thereafter lenders will return to their original practices. The new practice will only be maintained if one or a combination of several things happens in the interim:

- Banks see that they were mistaken about the amount of risk associated with a practice. For example, an entire target group, or some identifiable portion of that group, may be less default prone than feared.

- Banks use the sheltered environment of a project as an opportunity to learn how to reduce risks--and costs--of the new type of lending. For example, they may develop more efficient loan approval mechanisms that reduce costs, or that focus on more reliable indicators of creditworthiness.

- Bank regulators may see that the new type of lending is not overly risky, and allow banks to change their practices.

- Banks find other ways to diversify the new risks, such as charging borrowers or developing new mechanisms for interbank cooperation.

In short, the sustainability of the new type of lending depends on the ability of the project to induce a learning process in the IFI, and perhaps in the policy environment as well. It is essentially this process that is referred to throughout this guidebook as a strategy for institutional change, and if it is to be successful, it must be an explicit design-stage consideration, together with considerations of additionality and risk.

Design of an institutional change strategy centers on these three concepts, and on the tradeoffs among them. Both additionality and sustainability must be strongly pursued. The key to achieving both lies in design that handles risk creatively.

Before the 1930s, American banks did not make long term home mortgages. The Federal Housing Administration began a program of loan guarantees against default on 30 year mortgages. Its role was very similar to the one that A.I.D. might seek to play. Sheltered by the FHA program, banks were able to learn, first, that 30 year home mortgages were not as risky as they had expected, and second, how to administer them in a highly standardized, low cost way. FHA's assistance in risk management during the learning process made this possible. Today, the 30 year mortgage is the industry standard, and most are made with no FHA help.

Strategy for Institutional Change

Institutional change involves ensuring that project activities will be sustained into the future. In developing an assistance strategy, project planners should look at three levels of institutional change: the partner IFIs, other IFIs, and policy setting institutions. They should consider how their project will effect changes in each.

Projects should first aim to change the lenders that participate in them, and should be evaluated on how well they do this. If an approach is successful, other institutions may follow. This secondary effect can never be assured, but steps can be taken to make it more likely. Among these are the selection of an IFI that has the potential to perform well and to influence others. Large, prominent lenders are likely to be watched by others, and any change they make may be copied by others wishing to keep up with the competition. This effect can also be induced by selecting a smaller IFI with a reputation for excellence. At the highest level, the lessons from a project may influence financial markets policy. Areas in which such changes could occur include: interest rates, foreign exchange controls, reserve, collateral and liquidity requirements, loan maturities, size of borrowers, lending criteria, and acceptance of new financial market instruments. In many cases, a project will not be sustainable beyond A.I.D. financing without policy change because banking regulations prohibit or discourage some aspect of the activity (not necessarily because of a direct prohibition; often because of rules limiting credit risk or liquidity generally). Promotion of policy change requires the early development and continued maintenance of good relationships with the central bank or other bank regulatory agencies.

In most cases, the strategy for institutional change must reach beyond a single IFI project, as important structural changes generally take place over a longer period of time and as a result of several events. Planners should view a particular project as one step in a process that includes other IFI projects, some by other donors; policy dialogue, again with other donors; and finally, initiatives by local financial and business leaders themselves.

A long term strategy of A.I.D. in Kenya has been to induce Kenya's private financial institutions to provide more developmentally oriented credit, particularly term credit to SMSEs. This has involved a series of separate projects and policy changes. Progress has been slow, reflecting the deep conservatism of the Kenyan institutions, but after a number of years, distinct successes are visible. Early efforts, which included PRE, IFC and OPEC loans to Kenya Commercial Finance Corporation, involved selection of the most development-oriented of the major commercial banks, and provided it with a secure source of funds, to demonstrate the viability of SMSE term lending. These projects, together with dialogue with other commercial banks and the Government of Kenya, have enabled USAID/Kenya to implement a much larger term loan project in conjunction with other, larger lenders. This in itself is a major step forward for these traditional banks. The World Bank has begun preparation for a project of its own that would be modelled after A.I.D.'s project.

A pilot loan guarantee project is now experimenting with non-traditional forms of collateral, using government-owned local currency. At the same time, A.I.D. is working with the government and the financial sector to relieve the fundamental structural constraints, lack of sources of funds for term loans and a volatile liquidity situation that induces banks to lend short. Possibilities include a central bank refinancing facility and new money market instruments. Most of these are yet to occur, but the groundwork has been laid through discussions. The reforms now appear on the Kenyans' agenda, not just on A.I.D.'s.

Target Group Definition

Often, the primary focus of a credit project is a special target group. At other times the focus is a financial service or instrument. In either case, the selection of a client group should first of all be related to the direct development benefits expected to come from expansion of businesses in the group. It should also be in keeping with the diagnosis of existing constraints and opportunities. One very useful means of identifying target groups and the problems members face is subsector analysis, which looks at vertical channels of production for specified products.

The choice of target groups must also take institutional change strategies into account, as well as the considerations of additionality, sustainability and risk. Few A.I.D.-funded projects will be additional if they serve a group of regular bank clients. The exceptions to this are 1) if the project is meant to overcome a severe shortage of funds, and 2) if the service offered was not previously available. On the other hand, a target group radically different from the bank's normal customers is not recommended. Drawbacks of moving too far afield are that: the bank will charge very high fees to compensate for its perceived risk; the bank will not be well qualified to serve the group; the bank will have a strong incentive to cheat on the agreement by bending the target definition; and the project will not be sustainable. In order to judge where to draw the line, an understanding of bank attitudes is very important. Banks can perform very well in serving a new target group when they have an internal motivation to do so.

The target group issue is often seen as a quest to induce banks to lend to the small businesses A.I.D. planners perceive as having a key place in development, partly because of their contribution to employment and income for the poor. There are legitimate reasons for banks' reluctance to lend to small businesses. A principal reason is that administrative costs of lending to small businesses are higher relative to loan volume, both because of the high fixed cost of extending and collecting a loan and because of the difficulties in obtaining accurate information about small businesses. If lending to small groups is desired, then A.I.D. assistance may focus on designing ways to standardize and streamline loan processing. Planners should also be prepared to make allowances in loan pricing for higher administrative costs.

Another target group issue is that of new versus existing businesses. Although the creation of new businesses sounds like an appealing development aim, the risks of failure of new businesses are substantially higher than those of existing ones. Both banks and A.I.D. staff should be cautious about any loan program that focuses primarily on new businesses. This need not involve a sacrifice in goal achievement: existing businesses can generate substantial increases in production and employment. Nevertheless, there may be cases when the creation of new businesses is the desired objective. If so, it will be necessary to allow greater spreads to cover higher losses, to provide more technical assistance to borrowers and to take other risk-reducing measures.

Whatever target group is chosen, it is very important for successful implementation that eligibility rules be very easy to apply. The lender needs to be able to determine quickly whether a given applicant is eligible, and A.I.D. project managers need to be able to monitor clearly the lender's conformity to the rules. Rules relating to type of industry, geographic location, asset size or number of employees are relatively easy to enforce, while those relating to relative labor intensity are not. Moreover, any restrictions that are not absolutely essential should be resisted, as they will limit the pool of potentially successful borrowers.

CHAPTER IV. PROJECT DESIGN DETAILS

Interest Rates to Final Borrowers

A.I.D. policy stipulates that credit should be lent to the final borrowers at commercial or unsubsidized interest rates. It may be tempting to think that this policy is too harsh and that a lower rate would help borrowers more, but in fact, the policy is very well-advised. Subsidized credit can seriously undermine project objectives in both the short and long run.

In the short run, that is, during project implementation, subsidized credit subverts the resource allocation function of interest rates. One of the fundamental laws of economics is that prices are the best means of allocating scarce resources, as they result in application of those resources to the highest valued use. In the case of financial resources, very scarce in many developing countries, interest rates are the price. Subsidized rates result in investment in projects whose rates of return are too low. This result is not easy to see, as it does not affect individual recipients, but leads to a lower rate of economic growth for the nation as a whole.

In the longer run, subsidized credit creates bad precedents. It associates donor-funded credit with gifts, undermining repayment discipline, and it creates pressure for subsequent credit projects to receive subsidies. In the worst case, this could lead credit markets into dependency on continued donor assistance.

For all these reasons, A.I.D.-funded credit should be lent to final borrowers at or above market interest rates. In some cases, however, it is difficult to determine what the appropriate rate should be. In the ideal case, the interest rate should be the sum of the cost of funds, administrative costs and an allowance for risk and default loss. At times this precept cannot be followed, or will lead to unacceptable rates, for example, if the cost of funds is subsidized, if administrative expenses for a new target group are very high, or if interest rates are subject to legal ceilings. Countries experiencing very high inflation or sharp swings in the inflation rate pose particularly difficult problems. In such cases there may be a range of interest rates from which A.I.D. staff can negotiate. At a minimum, interest rates that meet this criterion must 1) be positive in real terms, that is, higher than inflation (expected inflation, which may be an average of several years' history), and 2) be the same or greater than that offered by commercial lenders to similar or more creditworthy clients. Rates with such characteristics, while they may technically include a subsidy, avoid the severest problems subsidies create, and leave some room open for providing incentives to banks to reach new target groups.

Governments often resist a full-cost interest rate policy, particularly for smaller businesses, and therefore, project designers may find themselves negotiating with government representatives. Project officers may attempt persuasion, may exploit the range of acceptable alternatives, but, finally, they should be prepared not to proceed with a project if the allowable interest rate is wholly unacceptable. Fortunately, it has often happened that a donor-funded project has helped convince skeptics that small enterprises can handle unsubsidized rates.

Technical Assistance

There are two levels at which planners may contemplate providing technical assistance or training as part of a private sector credit project, assistance to financial institutions and assistance to the target group of borrowers. These are discussed in turn.

Banks may need technical assistance if they are not as competent in certain areas as A.I.D. believes necessary, or if the project involves a type of service or borrower significantly new to the bank. Banks are likely to view the offer of technical assistance with ambivalence. On the one hand, they may perceive it as attempted interference with their own operations, and a slight to their professional competence. On the other hand, grant funds are attractive. Project designers should be aware of this possible ambivalence. They should also be wary about the ability of technical assistance activities to bring about major alterations in bank operations. The design and execution of technical assistance activities is not something in which banks have expertise. Therefore, unless the activity is very simple and easily administered, A.I.D. personnel should be prepared to be closely involved with design and implementation.

The types of technical assistance most often proposed for financial institutions include: staff training (short and long term) in loan appraisal, computer systems development, monitoring and evaluation, provision of project supervision staff and short term advisors. A particularly relevant subject area is often the special techniques required to lend to small enterprises. Little evidence is available to show how well these sorts of assistance work. Technical assistance should be designed with sustainability and incentive structures within the institution in mind.

Technical assistance to borrowers is quite a different issue, one that is largely outside the scope of these guidelines. Businesses use, and donors provide, assistance ranging from feasibility studies, to assistance in accounting, general management or production technology. Banks are well-positioned to be conduits for such assistance, because of their direct contact with large numbers of businesses, and because of their position as creditors, which gives their advice additional weight. Some banks are already proficient at providing or arranging for such assistance. The purpose of this comment is to alert planners to the possibility of bank involvement, not to advocate it for all or most projects.

Products and Implementing Mechanisms

The following pages discuss particular types of private sector credit projects. The first four sections cover "products", by which is meant the type of credit offered. Donors most frequently sponsor working capital credit, term credit, import credit, and export credit. From a borrower's perspective, these are the services he or she seeks from a bank, by stepping up to specific bank windows. The following three sections concern implementing mechanisms. These are the behind-the-window arrangements that enable A.I.D. funds to be transformed into a specific product. The three main implementing mechanisms are direct loans to IFIs, loan guarantees to IFIs, and direct loans to individual projects. Within each, a number of variants are possible.

Product 1. Working Capital Credit

Adequate working capital funding is the greatest financial need of most small and medium-sized industries. Moreover, projects that supply working capital credit tend to have better track records than those providing term loans. Research on the needs of small businesses and reviews of a large number of projects have clearly demonstrated both of these possibly surprising propositions (Liedholm and Mead, 1987).

Smaller businesses tend to be less capital intensive than large ones, and most invest a larger proportion of total available funds in working capital for input purchases and inventory. This is particularly true for non-manufacturing firms, such as retailers and wholesalers, and for non-integrated manufacturers. Working capital is perhaps most important and problematic for small firms. For very small firms, it is probably the only sensible form of credit to provide.

Fortunately, working capital credit is the product most commercial banks are best equipped to supply. Short term loans in the form of lines of credit with quarterly rollovers are the most common type of commercial loans in most countries. This type of credit with its flexible balances adjusts automatically to the fluctuating or seasonal needs of the borrower, and its regular renewal gives it an evergreen quality that provides longer term stability to the client.

Successful projects that provide working capital have tended to share some of these characteristics:

- The commercial bank partners are skilled at handling short term loans.

- The short payback terms allow close supervision of borrowers. It is possible to start with a small loan, and then, as the borrower's good faith and ability to repay are demonstrated, to increase the borrowing limit. The borrower's desire to continue receiving credit motivates prompt repayment.

- Adequate working capital helps borrowers through critical bottlenecks and fluctuations in their businesses. As funds are fungible, it may also help free funds for longer term investments.

- Working capital credit for the smallest businesses can also be combined with deposit and savings requirements that increase savings rates and monetize the economy more fully.

- Working capital projects tend to serve existing businesses, which are safer than new ones.

Because commercial banks already provide such credit, the challenge in the design of a working capital project is to ensure additionality, by encouraging banks to serve new (usually smaller) borrowing groups, or by encouraging them to use new credit instruments. An example of the latter is the use of unconventional sources of collateral to back loans to smaller businesses, such as accounts receivable, inventories or firm orders. To meet the challenge, it is important to investigate ways to streamline administration in order to reduce costs of lending to smaller clients. This can involve different loan approval and collateral registration procedures. In very rare cases, severe liquidity shortages in the financial system may justify a working capital project that serves existing bank customers.

Another form of working capital credit is that provided by suppliers who allow buyers to finance their purchases. Supplier credit pervades most economies, and may be the only type of credit many businesses use. It may be possible to use supplier or subcontractor relationships as a vehicle for providing credit to smaller firms, through commercial bank loans to the suppliers or contractors, who on-lend to small purchasers or subcontractors.

Except when it is directly linked to importing or exporting, as described below, most working capital credit should be provided and repayable in local currency.

One highly attractive model for very small working capital loans has been developed simultaneously by several well-known institutions in Asia and Latin America, such as the BKK in Indonesia, Grameen Bank in Bangladesh, the Banco Popular project in Costa Rica and the DDF and ADEMI projects in the Dominican Republic. In each of these cases, commercial banks or PVOs have set up special, decentralized operations to make very small short term loans (a few hundred dollars or even less), based only on character references. Administrative costs are kept down by highly simplified procedures. Loan officers may arrive in a locale on a motorcycle with a cashbox and client lists. They may collect old loans and approve and disburse new loans on the spot. Borrowers are given very small, very short term loans at first, and when they have proven their good faith, they become eligible for larger and longer-term loans. The prospect of repeat credit is a major incentive for repayment, and helps these programs show high recovery rates. In some cases groups of borrowers guarantee one another's loans. The conditions under which an IFI can establish such a program involve excellent management, staff motivation and institutional commitment, as well as knowledge of the target population. It is not a model for every bank or even every country. Nevertheless, these examples demonstrate that lending to such "risky" client groups is neither as difficult nor as costly as often perceived, given appropriately tailored methods.

<u>Product 2. Term Loans</u>

Despite the positive findings on working capital credit projects, the provision of term loans continues to be a staple of business finance projects. Term loan projects are most appropriate for medium-sized firms and the larger of the small firms. They should be used to finance fixed asset purchases, and the stream of repayment obligations should roughly mirror the stream of revenues the asset produces. Term loans are also appropriate for finance of major business start-up or expansion projects. In that capacity they can be structured with grace periods to act as a partial substitute for equity financing when sufficient equity is unavailable. It must be noted, however, that equity finance is significantly more effective at giving firms a good chance for success.

In many countries, including the United States, business loans of longer than three to five year duration make up a very small fraction of total commercial bank business portfolios, and most of these go to the best-established customers. Banks perceive term loans, especially those with fixed interest rates, as risky. Part of the risk lies with borrowers, whose businesses may change drastically in a few years. This is of course particularly a concern with start-ups. Another part of the risk lies in the structure of the financial system. Commercial banks typically have short term deposit bases. Fixed rate term loans leave banks vulnerable to sudden liquidity shortages and increases in the cost of funds. For these reasons, term loans have often been the responsibility of government-owned development banks, whose sources of funds are long term and whose mission is to finance riskier undertakings.

The purposes of an A.I.D.-financed term loan project carried out through a commercial bank should be to help the lender demonstrate to itself that term loans are not necessarily too risky, if wisely selected and monitored, and to demonstrate that even a portfolio based on short term deposits can safely hold a portion of its assets in illiquid form. This latter point is true because the level of bank deposits swings within a relatively predictable range, and only in the most unstable financial conditions is the sale of the most illiquid portion of a bank's assets needed. Because of the relationship between the structure of the financial system and bank reluctance to make term loans, the institutional change strategy accompanying a term loan project should incorporate plans to better equip banks to lend long term. These could include improvements in money markets, such as refinancing facilities, that increase liquidity and sources of term funds.

One of the elements in successful term lending that commercial banks are often ill-equipped to handle is project appraisal. Term lending, especially for start-up or expansion projects, cannot be based on the kinds of assurances often suitable for working capital loans, such as character and personal collateral. Term loan decisions should be based on an estimate of the revenues a business project will generate, and both term and revolving working capital loans should only be provided for projects that will generate enough cash to service the loan. A borrower whose poorly conceived project fails may repay his loan by selling his assets, but it is likely that such a loan has achieved no development objective. Moreover, it has probably cost the bank a significant amount in legal fees. The difficulty is that project appraisal requires a higher level of training than do collateral and character assessment. Possible solutions can include project appraisal by specialized units within or outside a bank, or training of loan officers and other bank decision makers.

Finally, if there is significant danger of currency devaluation term loans are best made in local currency, even if they finance capital imports. The foreign exchange transaction involved in the purchase of a capital good can be separated from term financing and handled immediately, to eliminate foreign exchange risk.

Product 3. Import Credit

Import credit usually takes the form of a direct payment by a bank in a foreign currency to an overseas supplier. The importer then repays the bank over a short period of time, generally ranging from one to six months. This payment may or may not be in foreign exchange. The instrument used is often a letter of credit.

There are limited conditions under which A.I.D. support for import credit is appropriate. First, the importations should not only be financially viable for the importer, they should also be economically beneficial for the country, given its foreign exchange position. Second, there should be some constraint in the import credit system that A.I.D. assistance can overcome.

If exchange rates are not in keeping with market forces, and particularly if they are overvalued, calculations of private profit to importers will diverge from calculations of national economic benefits. Scarce foreign exchange will be used for relatively unessential, unproductive items. A.I.D. should support only those imports that are both profitable and economically beneficial. In order to determine the economic viability of an import, it is necessary to compare its foreign cost and the local revenue it will generate, using the appropriate shadow exchange rate, and excluding the effects of tariffs and import quotas. Banks cannot be expected to do this. They respond to requests on the basis of financial viability alone. Neither can A.I.D. staff be expected to second guess individual bank decisions. Therefore, it is crucial that an economic analysis of prospective imports be carried out before the project is begun, and then be used to determine eligibility rules.

In general, importation of finished consumer goods will be least likely to merit the Agency's support, except for essential commodities. Consumer goods will be economically acceptable if the exchange rate is accurate, but if not, they may not offer as many economic benefits as producer goods. Producer goods, including capital equipment and raw materials, potentially offer the benefit of mobilizing local production, in some cases production for export. In evaluating producer goods, care must be taken to allow for the effect of import restrictions on finished goods that artificially protect inefficient domestic producers.

It may be better to draw up eligibility rules according to the types of goods imported rather than by the type of importer (e.g. retailer, distributor, manufacturer). This avoids disadvantaging small businesses that cannot afford the transaction costs of direct importing, and who buy instead from local merchants.

All of these comments should not override the fundamental credit project principle that eligibility rules must be simple. In many countries the exchange rate and trade regime will have such different effects on different goods that clear rules for eligibility will be hard to specify, and some compromises could be made in order to make a project administrativelv feasible. If this requires too great a sacrifice in economic benefits, import credit is probably not a good project idea.

The second condition for an import credit project is that it address a constraint in the financial system, above and beyond a simple foreign exchange shortage. In most countries, import credit is one of the first aspects of the financial system to be developed, as it gives financial institutions good returns. Areas of shortcoming may lie in lack of access to import credit by smaller or newer importers, or in lack of use of some particular import credit instrument. If the desired objective is broader access to import credit, one important consideration is the potential demand for such credit by the target group. Smaller businesses often purchase imported items from other importers because the transaction costs are too high for them, relative to the volume of imports they require. These costs include both dealing with government import regulations and locating and negotiating with overseas vendors.

The foreign exchange risk in an import credit project is appropriately bourne by the importer because risk is a factor in the pricing of the goods imported. As the credit is short term, the risk is relatively small and therefore bearable.

A final consideration in import credit project design involves procurement regulations for items bought with A.I.D. funds. These requirements differ, of course, with the source of funds. Planners should carefully evaluate the effect of procurement restrictions on loan administration and credit demand during the design phase.

Product 4. Export Credit

Export credit can be approached in much the same way as import credit, though it is usually easier to justify A.I.D. support to it because of the importance of exports for national development in so many countries. In the strictest sense, export credit refers to short term loans made to exporters on the evidence and backing of firm orders from overseas purchasers. The credit allows the exporter to prepare the order, for example by financing input purchases. A less frequent form of export credit is a loan to the purchaser (in effect, supplier credit) as part of an overall sales offer by the exporter. More generous credit terms may increase the buyer's interest. Finally, export-related credit is ordinary working capital or term lending aimed at exporters or potential exporters. Its only difference from ordinary credit is the greater ability exporters have to bear foreign exchange risk.

The conditions under which an export credit project is sensible are similar to those for import credit: economic benefits and credit market constraints. However, in the case of exports, the private financial viability is unlikely to diverge from the public economic good. Most profitable export opportunities will benefit the exporting country, because they help relieve the foreign exchange constraints that plague developing countries.

Credit market constraints again center on lack of access by non-established borrowers and on underdevelopment of certain credit instruments. Just as for imports, the access question is complicated by the difficulties small firms face in locating and negotiating with overseas buyers, and in handling government export regulations. These barriers are not overcome by increasing credit availability, and an export credit project aimed at small exporters may face weak demand. An example of the underdevelopment of financial market instruments is provided by Kenya, where banks would not accept export orders as collateral for loans, requiring the conventional forms of collateral (particularly real estate). Strictly speaking, export credit does not exist under such circumstances.

For export credit projects, foreign exchange risk is not a major obstacle. Exporters are hedged against currency devaluations because they are paid in foreign exchange. On the other hand, exporters may not control the foreign exchange that they earn because of local exchange regulations. Therefore, dollar loans for export credit may be acceptable under certain limited circumstances.

A final concern involves legislative restrictions placed on A.I.D. support of certain types of exports, particularly those competing with U.S. exports, through the Bumpers and Lautenberg amendments. Project designers should consult with their regional legal advisors concerning the implications of these two amendments for their proposed projects.

Mechanism 1. Direct Loans to Intermediate Financial Institutions

Direct loans to IFIs are fairly straightforward to design. A single loan is disbursed to one or more IFIs, and from these funds the IFI extends loans to final borrowers. Typically, the IFI bears all credit risk, which is an advantage of the direct loan mode, as this provides incentive for good loan supervision by the IFI. The IFI must usually lend some of its own funds to the same borrower. PRE loans have generally included a fifty-fifty matching requirement. In a direct loan project, project designers must consider the spread between the interest rate it charges the IFI and the rate at which the IFI will on-lend. This spread should be large enough to compensate the IFI for the cost of administration and the degree of risk involved in lending to the targeted group of borrowers.

The repayment of the loan to A.I.D. can be by pre-arranged fixed schedule, or by a schedule that depends on the timing of disbursements. Usually, the repayment to A.I.D. is set by a schedule far simpler than the uneven cash flows the IFI will receive from borrowers. If the loans are to be rolled over within the IFI, allowance must be made for that within the repayment schedule. Knowledge about how the cashflows are likely to coincide and how valuable any mismatch will be to the IFI is therefore important for negotiation. A.I.D. will make initial disbursements according to the IFI's certification that it will on-lend the funds requested within a short time (generally 30, but not more than 90 days). The certification process should be as simple and painless to the IFI as possible.

The main reason for using a direct loan mechanism is to overcome a fund raising constraint within the financial institutions. For example, many commercial banking systems depend on short term deposits and attempt to match maturities of deposits and loans. In such cases, term loans are made infrequently, and maximum maturities are rarely more than three years. Direct loans can provide a source of long term funding, overcoming the constraint. Another frequent fund raising constraint is liquidity. This is often a cyclical problem, though it can at times be quite severe. Banks experience liquidity crunches when the government pursues a tight monetary policy. Liquidity crunches are more likely to occur in countries with less developed money markets and in those with severe cyclical swings in the economy. If banks face a demand for loans they cannot meet because of an inability to raise deposits, a direct loan can overcome the problem.

The use of direct loans has one major drawback, however. It is at odds with the principle of using the existing commercial system, at least in the area of raising funds, and therefore it tends not to score high on sustainability. When a direct loan has been disbursed and then repaid, a bank may be unable to continue to make project type loans to small and medium scale enterprises, because the direct loan has not helped it solve its underlying fund raising problem. Alternatively, a bank may become a direct loan junkie, constantly seeking new donor-funded sources of funds. In neither case has sustainability been achieved. Direct loans that provide no protection against risk may also result in a more conservative lending policy than can be achieved through guarantees. If this is a difficulty, it is possible to provide risk protection either through a generous spread (which acts as a loan loss provision) or by combining the direct loan with a partial guarantee.

In order to inject greater sustainability into a direct loan project, the following can be tried: 1) demonstrating to banks and bank regulators that banks are not harmed by putting a portion of available funds into illiquid term loans; 2) institutionalizing a source of term funds, e.g., through a discounting facility; 3) development of the money market (interbank lending, trading of government securities) to make it easier for banks to overcome non-cyclical liquidity difficulties; or 4) using direct loans in specifically cyclical instances, when banks are likely to have their own funds to sustain the desired type of lending after the project has ended.

In most cases, as discussed above, it is desirable for loans to final borrowers to be extended and repayable in local currency. This is appropriate for businesses whose products are sold domestically, except when they purchase imported inputs. If a Mission has a source of local currency (counterpart funds or Sec. 108 Food for Peace funds), the design of a local currency loan is straightforward.

If dollar-denominated loans are used, however, including soft loans, the question of who bears the foreign exchange risk becomes paramount in project design. There are three possible locations for the foreign exchange risk: final borrowers, IFIs, or the government of the host country. A.I.D., however, does not in any case bear this risk, though it may pay a fixed fee to another entity for doing so.

In countries with a history of frequent currency devaluation, it may be unfair and unrealistic to expect domestic producers to bear foreign exchange risk, particularly if their main sources of inputs are domestic. Such risk is a new source of risk that businesses would otherwise not face, and have no way to hedge against if forced to bear it. Moreover, in most such countries, dollar-denominated debt is singularly unattractive. No one will step up to a dollar-denominated window.

If credit is used to purchase imported inputs, it is more appropriate for final borrowers to bear exchange rate risk; by buying from abroad the enterprise implicitly becomes part of a country's foreign exchange burden, and it is therefore more appropriate that it participate in the overall foreign exchange position. The counter-argument to this is that a country's foreign exchange position is often determined by world shifts in major commodity prices (both imported and exported ones) and by macroeconomic policies, rather than by anything related to small or medium sized industries, and therefore such smaller industries should not be saddled with that risk. Both arguments have some merit. The final decision will depend in part on specific country conditions. In any event, it will quite often be the case that desirable policy or lack of borrower demand require that someone other than the final borrower bear the foreign exchange risk.

If the foreign exchange risk is not expected to be very large, an IFI may be willing to bear it, for a fee. Willingness to bear foreign exchange risk can also be increased by allowing some flexibility in repayment schedules.

Some governments may be willing to take on foreign exchange risk. Again, a fee may be in order for this service. The risk can be handled easily if the loan is made to the government to be disbursed through a central bank window. A loan directly to an IFI could be covered by a separate government guarantee specifying the conditions for government risk assumption. If soft loans are used, in conjunction with a central bank window, the difference in repayment terms from the IFI to the government and those from the government to A.I.D. provides a comfortable cushion for absorbing a substantial amount of exchange rate risk.

However, all these mechanisms may prove unworkable. In this case, unless liquidity is a severe constraint, the foreign exchange risk may best be dealt with through a guarantee, as described below, which reduces the number of foreign exchange transactions and therefore actually eliminates much of the risk.

Mechanism 2: Loan Guarantees to IFIs

A loan guarantee is an insurance policy for a lender against non-performance of loans it makes with its own funds. Loan guarantees are generally appropriate when the objective of a program is to induce an IFI to make loans it perceives as riskier in some respect than its normal policy allows, and when IFIs have sufficient liquidity to use their own sources of funds. A loan guarantee can offer very broad coverage, or it can be tailored to cover only specified situations. Default or credit risk is the most usual type of risk covered, though foreign exchange risk could be covered as well.

The most important rule for design of loan guarantee programs is that the guarantee should not cover 100 percent of the credit risk an IFI faces from any given loan. If it does, the IFI has no incentive to select borrowers wisely or supervise loans carefully, and the repayment record is certain to be dismal. Guarantees in the range of 50 percent to 75 or possibly 80 percent have been effective in various programs worldwide. PRE has had a high level of success with 50 percent guarantees. Lower percentages fail to attract bank participation while higher percentages absolve them of responsibility. The sole exception to this rule occurs when a bank is merely an administrative mechanism for disbursing and collecting loans selected and supervised by another entity, such as a PVO. This is appropriate for the smallest borrowers who lack any potential to be accepted in the future as commercial bank borrowers on their own. Even in such cases, however, a partial guarantee would be preferable.

Another important design characteristic of good loan guarantee programs is that they combine two often conflicting features: first, they offer banks assurance of prompt and hassle-free payment of claims, and second, they involve the original lenders in collection on defaulted loans.

Good loan guarantee programs are tailored to a specific financial market constraint that needs to be relieved. A frequent mistake is to use guarantees for small business lending in cases where the real problem is not the risk of such businesses, but the administrative costs associated with lending to them. If administrative costs are too high, a loan guarantee will be ineffective, unless it is used to protect a bank while it experiments with less expensive administrative procedures (such as character-based rather than collateral-based lending). In fact, guarantees are highly suitable for inducing lenders not only to try new borrowing groups but also to try new credit instruments or types of services.

Ideally, a loan guarantee program should cover its costs through the payment of fees by the IFI to the guarantor. This is often impossible during the early stages, particularly if a program differs substantially from a lender's previous operations. However, full cost recovery should be embraced as a medium term objective. Another way to promote cost recovery is to define the target group to cover a wider population than necessary, cross-subsidizing the riskier portion of the target group.

To cut expenses, the administrative procedures for a guarantee program should avoid duplication of effort by lender and guarantor. In general, this means that the guarantor should rely on the credit appraisal procedures banks carry out rather than performing additional checks. The banks are likely to have a comparative advantage in this. However, as the guarantee percentage rises, the guarantor must be prepared to take on more administrative responsibility for checking the bank's work, as it will be less able to trust the bank's decisions.

Loan guarantee programs can be designed in two basic ways. The simpler is an agreement between a single IFI and a guarantor. Under this model, variations may involve mechanisms for payment of claims completely outside the IFI, may involve a deposit fund from which claims are paid, or in a few cases, a grant to a loan loss reserve. The last mechanism is not frequently used, but has the potential to be quite successful as it gives the bank the greatest incentive to be prudent, and requires little second-guessing by the guarantor.

The more complex model for loan guarantee design involves a separate guaranteeing entity that offers to guarantee loans made by a variety of lenders, in return for a fee. This is very much like loan insurance, and in fact, if fees cover costs, it is loan insurance. The advantage of such an arrangement is that it can involve a larger number of IFIs, and therefore loans, and that it can become a permanent part of the financial system. The main disadvantage is the difficulty of establishing a guarantee agency, both in terms of operating costs and in terms of achieving solvency. Loan guarantee agencies are typically established in central banks or other government agencies, though they could also be established in insurance companies, PVOs or by consortia of lenders.

PRE has structured some guarantees so that they apply only to default by the IFI as a whole, rather than to individual borrower credit risk. The guarantee comes into effect only if the IFI fails to repay its loans. Such is the case with some collateral account and loan set-off arrangements that use a third-party IFI as project facilitator. These arrangements, which are quite different in purpose from the kind of guarantee discussed here, are explained more fully in the section on funding sources.

<u>Mechanism 3: Direct Loans to Individual Projects</u>

Structurally, the simplest form of private sector credit project is a direct loan by A.I.D. to an individual business venture. Because of the transactions costs of such an investment, suitable projects are nearly always large. Direct investment has been practiced by PRE during the 1980s and for considerably longer by donor-supported entities such as the IFC, European Investment Bank, Commonwealth Development Corporation and others. However, there are several important reasons why such projects pose problems for A.I.D., and particularly for A.I.D. Missions. Accordingly, they should only be undertaken if the following two conditions exist:

- A strong locally present financial institution that can act as lead investor during both project preparation and implementation.

- A project that has the potential to produce extraordinary development benefits, above and beyond financial returns.

The rest of this section describes why these conditions are essential.

Perhaps most importantly, A.I.D. is not equipped to assess the viability of individual business ventures, to monitor their performance or take corrective action should problems arise. These activities require specialized financial, managerial and sometimes industry-specific skills, as well as a thorough knowledge of local business conditions and markets. These are skills A.I.D. Mission personnel do not normally have (nor need they, in general). Neither can these skills be easily found through consultants, who do not bear risk should projects fail, and whose long term involvement is difficult to arrange. These are the same reasons that the World Bank and European donors set up separate corporations for making direct investments, and staffed them with investment specialists.

In addition to the staffing problem, A.I.D. Missions face problems relating to their role and image within the host country. Individual business projects are often aligned with particular groups and factions, and the selection of one group's project over another may have political implications. If the funds used are bilateral, require consultation with the government, and are seen as part of official U.S. Government policy, those political implications can become very important. Missions may face pressure to select business projects that, while not offering high expected returns, are sponsored by members of the most powerful factions.

The existence of an active financial partner who is able to be involved with a project on an ongoing basis, and who has a stake in the outcome, can compensate for the shortage of expert staff. In Revolving Fund experience there is a high correlation between successful projects and those with a strong local financial partner.

The prospect of extraordinary development benefits can help mitigate the political and image factors associated with project selection. Examples of projects with such benefits might be those whose linkages reach a very poor segment of the population or those producing an essential health product. PRE has made loans to the Leather Industries of Kenya, whose suppliers include pastoral people with few other sources of income, and to the Serum Institute in India, which manufactures vaccines. Both projects appeal to those who view donor assistance as serving humanitarian and poverty relieving aims.

This said, project designers should not let other considerations, whatever they may be, lead to involvement in any business venture without a very solid prospect of producing substantial financial and economic returns.

The circumstances surrounding PRE's loan to Leather Industries of Kenya (LIK) met the conditions described above. First, the lead promoter, Industrial Promotion Services (Kenya), Ltd. (IPS), is an equity capital company with over ten years of experience in project start-up, and a reputation for prudence. Its ongoing commitment to the project was assured by its purchase of a sizeable share of LIK equity. IPS took the lead in assembling the project design team and in developing the financing package. It presented PRE with a well documented set of proposals and feasibility studies, making PRE's job of assessing the commercial viability of the project relatively simple.

At the same time, the LIK project promised an unusually large number of developmental benefits through creation of both forward and backward linkages. LIK is a tannery producing high quality finished leather for export. As Kenya has historically exported mainly semi-finished leather, the production of finished leather adds more value within Kenya's borders, increasing foreign exchange earnings. Working backwards, LIK's hide suppliers are small farmers, often subsistence farmers or pastoralists. LIK not only provides a market for them, it also helps them improve the quality of the hides they supply, leading to a potential overall improvement in their income and in the value of hides produced throughout Kenya. PRE's participation in this showcase project also helped A.I.D. become a more active player in Kenya's private sector.

The Implications of Funding Sources for Project Design

Funding for private sector credit projects sponsored by A.I.D. can come from a variety of sources, each differing from the others along several dimensions. These differences strongly influence how suitable the funds are for use in investment projects.

Furthermore, the source of funds often has a major impact on the choice of an implementing mechanism. This section considers the restrictions applicable to the various sources of funds as they affect project design and notes which sources have proved to be the most useful in combination with which implementing mechanisms. Missions are advised to be creative, but to consult with regional legal advisors.

There are a variety of sources of funds available to A.I.D. -- e.g., development assistance funds, Economic Support Funds, P.L. 480 local currency generations (including those specifically designated for private sector lending under Section 108), funds appropriated to the Private Sector Revolving Fund -- each with its own peculiar characteristics. In particular, each of these sources of funds is subjected to somewhat different legal authorities, such as those regarding developmental purpose, cash management, loan forgiveness, competition in contracting and procurement. Legal and practical differences determine whether and how a private sector project financed with these funds can address design problems, such as foreign exchange risk. The principal design problems are considered below.

Foreign Exchange Risk. As mentioned above, it is often very important that project designers avoid saddling private enterprises that receive assistance with foreign exchange risk. This means, at minimum, that private enterprises receiving loans financed by A.I.D. should be permitted to repay in local currency. Clearly, any source of loan funds already denominated in local currency is suitable for that purpose. The issue is usually whether a Mission can use such funds for private sector uses. In Latin America, Missions fund many private sector credit projects by placing a portion of local currencies generated through commodity import programs and the like in A.I.D.-owned trusts, with the approval of the host government. By contrast, few governments in Africa are willing to allow currencies that would otherwise support their budgets to be diverted to private enterprises. A promising innovation available to A.I.D. is the PL 480, Sec. 108 program, which can provide A.I.D.-owned local currencies specifically designated for on-lending to private projects, as long as governments can be persuaded to participate.

However, loans financed with Development Assistance dollars must be paid back in dollars. In that case, foreign exchange risk may be managed by using soft loans or grants. The concessional interest rates of soft loans can be used as an exchange rate risk cushion, and grant funds, with no repayment obligations, involve no foreign exchange risk. A.I.D. policy discourages soft loans or grants to private businesses or to IFIs. It is possible, however, to make a grant to an intermediary under instructions that the intermediary convert the grant funds to local currency, and use that local currency to make loans. Most often, this is the government itself, in the form of the central bank. The Agency can lend or grant funds, through a standard project agreement, to the government. The central bank can then extend credit in local currency to one or more IFIs. The advantages to setting up central bank windows of this type are: 1) loans can be disbursed through more than one IFI, without adding to A.I.D.'s administrative burden; and 2) the funds in the central bank can be reused, becoming a permanent facility for business lending if this proves desirable. Central bank windows should only be used when the central bank is administratively competent to handle the project and when all parties view the central bank's administration of such a window as appropriate to its role in the longer run. In the latter connection, use of the central bank should mesh with the broad institutional change strategy. Finally, if soft loans are used, the government must be willing to bear the residual exchange rate risk.

The intermediary could be a non-profit agency or NGO that has the capacity to make and service local currency loans. The intermediary could even be a for-profit entity such as a commercial bank -- provided, however, that the for-profit entity is required by its agreement with A.I.D. to treat the grant as a separate fund and not part of its capital. In practice, this means that (i) the interest and repayments of principal from the loans financed with grant funds could be used for grant purposes only (e.g., a second round of lending or subgrants to PVOs designated by A.I.D.), and (ii) the for-profit entity would earn a fee for administering the grant funds, but would have no claim on the funds themselves.

One method for establishing such a relationship with a commercial bank is a trust agreement. Under the trust agreement, the trustee bank becomes legal owner of the A.I.D. funds, but is given only limited rights with respect to their disposition. The trustee bank is required to use the principal and income of the trust for trust purposes only, and earns a fee for its efforts. When the trust terminates, the funds remaining do not become the property of the bank, but rather are distributed to the beneficiaries according to instructions in the trust agreement.

A.I.D. has used trust arrangements to obligate development assistance funds for private enterprise lending. But the mechanism is still quite new, and there is some opposition within the Agency to the use of trusts, apparently on policy grounds. It is unclear at this writing whether that opposition will prevail. Missions are advised to pay close attention to statements of Agency policy in this area.

Finally, U.S. dollar loans can support local currency lending through the use of a guarantee mechanism. This is the most frequent mechanism PRE has used for its Revolving Fund loans, under various names, such as "loan setoff" and "collateral account." In essence, such mechanisms avoid foreign exchange risk by avoiding foreign exchange transactions: very few dollars actually cross international boundaries.

The PRE model involves a dollar loan to a U.S. bank or U.S. office of a foreign bank. This bank uses these loan funds as backing or collateral for a standby letter of credit it issues to an IFI in the host country. That letter of credit pledges the U.S. bank to guarantee repayment of loans the local IFI makes, using IFI-owned local currencies. The IFI then extends loans to the target group of borrowers. Only if one of these borrowers defaults does a foreign exchange transaction occur; the U.S. bank pays the IFI for the portion of that loan it guaranteed and is reimbursed for that payment by a reduction in its principal repayment obligation on the A.I.D. loan. This type of mechanism is best used in a situation where local IFIs have sufficient liquidity in local currency that loans can be made without a direct injection of funds.

However, before Missions can proceed to use DA or ESF dollars in a "loan setoff" guarantee scheme, the General Counsel will have to determine whether the scheme runs afoul of Section 620(r) of the Foreign Assistance Act, which prohibits A.I.D. from forgiving principal or interest on FAA loans. [The Private Sector Revolving Fund is exempt from Section 620(r).] It is not appropriate here to delve into the technicalities surrounding this issue. Rather, it is most important to note that Missions could duplicate the results of the loan setoff scheme by simply signing contract of guarantee to a local IFI, as discussed below.

<u>Loan Guarantees</u>. The previous section on guarantees described reasons that guarantees are often a useful mechanism. This section discusses how A.I.D. Missions can implement them with Development Assistance funds.

A.I.D. has the authority under the Foreign Assistance Act to enter into contracts of guarantee with IFIs under which the Agency agrees, for example, to reimburse the IFIs in the event that an eligible IFI loan defaults. However, with certain exceptions not relevant here, A.I.D. may issue such loan guarantees <u>only</u> if it reserves dollar-for-dollar against its contingent liabilities. Thus, if a Mission were to contract to guarantee fifty percent of the principal of $1,000,000 in IFI micro-enterprise loans, it would have to maintain $500,000 as a reserve in the appropriate account. To support the contract of guarantee, the Mission (or AID/W) would issue a Letter of Commitment (similar to those issued by A.I.D. in connection with the purchase of goods and services with A.I.D. grants). Should an A.I.D.-guaranteed loan default, the IFI would be authorized to draw under the Letter of Commitment, and funds would be disbursed. In the absence of defaults, no funds need to be disbursed.

The amount of principal that can be guaranteed must equal the amount of funds obligated under the contract of guarantee. A.I.D. cannot use a reserve fund to leverage additional lending. The only leverage effect A.I.D. can obtain is to offer only partial guarantee coverage, which forces the IFI to take on a portion of the credit risk. PRE typically offers 50% coverage, but higher coverage would also be acceptable. Partial guarantees are advisable in any case, as they encourage IFIs to lend more responsibly. However, they do not begin to take advantage of the fact that the expected loss in a guarantee program is far lower than the total contingent liability. Under current rules, which require obligations to equal contingent liability, an A.I.D. Mission that funded a successful loan guarantee program (one with a low default rate) would be able to deobligate and reobligate a major portion of the original loan or reallocate the funds within the same project.

The dollar-for-dollar guarantee restriction applies to A.I.D. owned local currencies (including those generated by PL 480, Sec. 108), as well as DA, ESF and PRE Revolving Funds. Only government owned local currencies would be exempt.

Grants can be used to guarantee loans under certain conditions, and it may be possible to obtain more leverage in that way. A grant to a financial intermediary can be used to establish a guarantee fund. This fund can be used to pay guarantee claims on defaulted loans made by participating IFIs. But it must be clear that any guarantee coverage extends only to the fund itself, and that no further claims can be made on the United States. The grantee, not A.I.D., is the guarantor. IFIs that are fairly confident about the expected level of default should be willing to lend a larger amount of principal than the amount in the fund, up to several multiples of the fund. The amount of leverage achieved is determined by the borrowing group and the IFI's perception of the creditworthiness of that group. A fund such as this could be maintained by guarantee fees, and in the ideal (not often achieved), it could become virtually self-sustaining.

Local Government Approval. The relationship of the A.I.D. Mission to the host government will be a determining factor in the selection of a funding source for private sector credit projects. Most of the funds available to Missions, including DA, ESF and local currencies, either require local government approval or need government concurrence as a matter of maintaining good relations. Yet governments are often reluctant to release to the private sector funds that they regard as a resource for their budgets. In cases where the government is amenable to using bilateral funds for private sector credit projects, it is often in the interests of both A.I.D. and the government to have such funds administered outside the government, e.g., through A.I.D.-owned local currency trusts or through direct agreements between A.I.D. and IFIs. This absolves the government of administrative responsibility and reduces political pressure on it from loan seekers. If governments are unwilling to allow bilateral and related funds to be used for such purposes, the only remaining resource for Missions may be the PRE Revolving Fund, which does not require any government concurrence.

Competition for Selection of IFI. Whenever A.I.D. uses its own funds, including A.I.D.-owned local currencies, competition rules apply. Those rules stipulate the following:

- o Loans and co-financing arrangements do not require formal competition. This is true whether the loan is made directly to a business project or to an IFI, and particularly in the case of an unsolicited proposal. Nevertheless, when the project is initiated by A.I.D., Missions are encouraged to direct their requests for proposals to as wide a range of IFIs as possible.

- o Grants, contracts and cooperative agreements do require that normal competition procedures be followed. This applies to any technical assistance grant that accompanies a loan to an IFI, and to any grant used to establish a loan or guarantee fund.

Thus, despite the fact that loans do not require competition, many private sector credit projects will need to go through competitive procedures, because they will involve a grant or contract of some type. The only exceptions are grants to governments (though external contracts and subgrants that pass through the government must still be competed), and agreements funded by government-owned local currencies. In some cases, it will be appropriate to seek waivers of competition, in accordance with Agency and regional bureau policy.

Procurement. Normal A.I.D. procurement regulations apply to the purchases made by both the IFI itself and by the final borrowers in an IFI project. The applicable regulations are determined by the funding source, with grant funds subject to a narrower geographic code than loan funds. The rules apply to all sources of funding except government-owned local currencies. Applying procurement regulations to IFI projects may be quite cumbersome, particularly if the project does not provide access to foreign currency. If so, A.I.D.'s loan can be used to finance local costs, such as land, construction and working capital, rather than imports. In some cases, blanket waivers may already exist. Specific waivers can be sought, if necessary.

In summary, although it is sometimes difficult for A.I.D. Missions to find models of credit projects that will fit the local situation, many Missions have found ways to apply the models discussed here through creative project designs. Other Missions may learn from these experiences.

CHAPTER V. CHOOSING LOCAL INSTITUTIONS AND NEGOTIATING AN AGREEMENT

The success of a private sector credit project depends almost entirely on the quality of implementation by the lender, and this in turn depends on which institution project designers choose and the understanding they reach with it.

Four considerations should govern the choice of a financial institution: how the institution fits into an institutional change strategy, how willing it is to work with A.I.D., how competent it will be to implement the program, and how financially sound it is.

If one of the strategic objectives of a credit project is to demonstrate the success of a particular activity, with the hopes that other institutions will follow, then the chosen institution should be prominent or respected enough to influence others, and, possibly, to influence government officials. In fact, introducing significant change into a leading banking institution is in itself an important accomplishment. However, if the most prominent institutions are also the most conservative, there may be a mismatch of interests between it and the proposed project, indicating that planners should look to a somewhat less influential institution that will be wholeheartedly interested in making the project work.

In fact, the institution must be committed to the project and must see it as in its own interest. Short run profitability will always be a motivation, and therefore, A.I.D. officers may be able to buy cooperation by offering generous compensation. However, if short run profits are the only motivation, A.I.D. planners should recognize that they are likely to be working with an institution that may be reticent about fulfilling the project agreement.

The principles of strategic selection of IFI partners are illustrated well in PRE's choice of the Far East Bank and Trust in the Philippines and of the Thai Danu Bank in Thailand. The Far East Bank and Trust (FEBTC) is one of the leading banks in the Philippines. PRE's loan to the bank was instrumental in enabling it to begin lending to smaller businesses than it had previously served. The activity proved profitable for the bank. Because of the FEBTC's competitive position, many other Philippine institutions watched the project closely. Since then, a number have begun to seek assistance in serving the same target group, both from A.I.D. and from other donors.

In selecting Thai Danu Bank as its partner in Thailand, PRE took a different approach. Thai Danu is not a large commercial bank by Thai standards, but is known to be financially sound and profitable. It was also highly committed to the project goal of making loans to more businesses outside Bangkok. When it selected Thai Danu, PRE gave the project an excellent chance of success, and therefore maximized the chances that it would serve as a good demonstration to other banks in Thailand.

If possible, banks should see the project's client group or type of service as in harmony with their own long run development strategies, or with their self-concept as participants in national development. Even if a lender is skeptical about being able to lend to a client group without donor assistance, perhaps it sees other business benefits arising from the groups, such as deposits or the opportunity to provide services for fees. In some cases, government policies direct banks toward particular types of clients, and this may provide the necessary motivation. Whatever the motivations may be, they should relate directly to the substance of the project, and not only to the financial offer A.I.D. makes.

In addition to congruence of objectives, planners should also select institutions with which they are developing good working relationships. Some financial institutions may simply not be amenable to working with a donor; for example, those with a very centralized and confidential decision making style. To some extent, compatible interests and good relations go hand in hand, but A.I.D. staff can take positive steps to improve the relationship. The most important of these is early and frequent consultation with lender representatives on project design, even during initial project conceptualization. To the maximum degree possible, the managers of implementing institutions should regard the project as the institution's project, not A.I.D.'s, and should feel that their needs and ideas have been incorporated into project design. Participation, the word so often heard in working with community-based groups, is equally crucial for working with financial institutions. In the ideal case, A.I.D. project designers should act as facilitators for something the institution wishes to do but cannot yet do on a fully commercial basis.

The choice of financial institution should also take into account more concrete factors, particularly administrative competence and financial soundness. Project planners should assess the degree to which the lender already serves the client group or a relatively similar group, through an examination of the loan portfolio. They should also examine the bank's staffing and management procedures, with particular attention to the background and functions of loan officers, and the loan approval process. What sort of training do loan officers have? What are their duties, their caseloads? Are they marketers or passive application receivers? Do they specialize by industry? Who approves loans? How quickly are applications processed? How are loan officers and their supervisors evaluated and rewarded? An understanding of this last item is particularly important for design of an effective and sustainable project. The criteria the lender uses for loan selection is also important, beginning with the extent to which lending is character, collateral or project-based, and moving to documentation required and the like. A similar set of questions can be focused on collection procedures and the incentives of those who do collection. Another important area of investigation is the lender's ability to manage information on loans - to collect it, process it, retrieve it and most of all use it in ways that make operations more efficient. Finally, obvious physical capabilities, such as offices in the target area, should not be overlooked.

Assessment of the bank's overall financial condition should include delinquency and loan loss rates, adequacy of the bank's capital, and the liquidity position. Information on the cost and revenue structure facing a bank (cost of funds, administration and loan losses, sources of revenues, relative contribution to profit of various departments) will be of highest importance during later phases. Planners should evaluate all information in the context of the norms for the country, keeping in mind what local financial norms are prevalent. At the same time, for certain critical indicators, local IFIs need to be assessed according to absolute standards, such as minimum earnings and capital.

The more information project planners can get, the better their position first in selection, then in design, and finally, in negotiation. However, if not handled tactfully, the process of investigation can undermine attempts to build a cordial, trusting relationship. The cost to a project of earning a bank's bad will can hardly be underestimated. In the first place, asking banks to perform analyses of their operations that they do not routinely perform may be perceived as excessively costly and burdensome. Secondly, banks regard many of the facts planners would like to know as confidential, in particular those concerning defaults and loan losses. They may never have revealed such facts to outsiders, and may regard inquiries as intrusive. In the worst cases, lenders may mislead investigators by manipulation of information. It is important to find creative ways to minimize friction: ask as little as necessary, and only when necessary; rely to the maximum extent possible on existing or routinely produced information; ask about such things as management structures, processes and incentives in friendly, informal settings; and obtain as much information as possible from sources outside the institution (auditors, central bankers, bank associations, trusted advisors), securing permission from the institution when needed.

Perhaps most important is to regard the selection of one or more financial institutions as a process. This process works best when it begins with the broad financial system and focuses in on the selection of institutions through relatively informal investigation, so that formal answers or proposals are not required until the choice has narrowed and many aspects of the partnership have already been agreed in principle. Banks will be much more forthcoming when they know they are in the midst of designing a deal than when they believe themselves to be in a beauty contest with others. And the project will be much better as a result of having bank input as early as possible.

A complicating factor is that of meshing the selection process with A.I.D.'s competition regulations. As noted earlier, if grant funds are involved, requirements may apply for a competitive selection involving proposals and bids. The major obstacle presented by competitive procurement is that its formality is in sharp contrast to the informal, interactive process needed to develop a good working relationship and involve lenders in project design. In each case, planners must attempt to act in a way that minimizes tension between the two processes.

Elements of Successful Agreements with IFIs

The experience of PRE and many A.I.D. Missions has taught us a number of lessons about how to structure an IFI project successfully. In brief, the experience shows this: projects should make the most of current bank capabilities while pushing banks to stretch farther, and in asking banks to stretch, projects should compensate (but not overcompensate) them. This basic lesson is embodied in several more specific design principles, now described.

The target borrowers and the type of financial service provided should be close to those the lender already serves or provides. Of course, they should not be identical, as that would eliminate all additionality. Nevertheless, sticking close to current bank services keeps experimentation within manageable bounds, and allows banks to use their existing expertise. Projects that move into entirely new areas are likely to be administratively costly, as they will require development of new administrative systems. They are also more likely to encounter unforeseen difficulties or to fail altogether. If a radical departure from past practice is planned, it is crucial that the IFI be highly motivated to move into the new area and it is usually necessary that A.I.D. be prepared to remain committed to the effort for longer than the five year duration of most projects. The worst possible situation is to ask an IFI to do something it does not know how to do and cares little about.

A corollary to this principle is that projects should be implemented within existing bank practices and administrative structures to the degree possible. This will both enhance cost effective delivery and maximize sustainability. Practices include: credit terms, application and approval procedures, monitoring and collection procedures, and management information systems. A change in a specific practice will be integral to the purpose of many projects, for example, projects that aim to extend loan duration or those directed at businesses with unconventional forms of collateral. If so, it is important to consider carefully which practices must change and which can remain the same.

Use of existing management structures is equally important. Donor-supported projects are frequently carried out by separate units devoted to special projects, even some set up for a specific project. Donors sometimes encourage this if it makes it easier for them to audit or monitor the project or to assess its outcomes. The main advantage to using a separate unit is that it provides a controlled environment for the project in which the attention of those administering the project is focused rather than diffused. This critical mass of attention could be achieved in other ways, however. Separate units may be justified, however, for projects that involve radical departures from current bank practice and thereby make integration impractical.

Perhaps the greatest drawback to special units is that they isolate institutional learning within the special group, and therefore reduce the likelihood of sustained changes in bank activities after project completion. In addition, new project units often duplicate existing administrative functions, and so make project implementation both expensive and inefficient.

If an attempt is made to use existing bank structures to implement a project, issues of special importance will be the location of responsibility for the project within the bank's managerial hierarchy (high enough to have clout, low enough to have time to pay close attention) and its integration into existing reward structures for middle managers and loan officers.

PRE's loan to Kenya Commercial Finance Corporation (KCFC) shows how an otherwise successful project effected less long run institutional change because it was not integrated into the mainstream staff incentive structure. KCFC, a subsidiary of Kenya Commercial Bank (KCB), acts as a specialized unit within the bank. The PRE loan was intended to reach smaller, more rural businesses than those normally served by KCB or KCFC. KCFC, lacking branch offices, would have benefitted greatly from the knowledge of KCB's many rural branch managers in client identification and loan monitoring. However, KCB rewards branch managers for how they manage branch funds: first for generating savings deposits and second for putting a portion of branch funds into successful loans, usually with well-established clients.

The PRE/KCFC program's funds did not appear on branch managers' books, and therefore managers were not very active in it. This made administration more difficult for KCFC, and meant that fewer new relationships developed between the new PRE-sponsored clients and their local bankers.

Simple eligibility requirements are another element in good project design, as stressed earlier. Loan officers should be able to tell quickly whether an applicant meets the requirements of a project. Banks' eligibility requirements generally involve questions of creditworthiness, while A.I.D. is likely to be more concerned with development impact. The A.I.D. criteria may strike bank staff as irrelevant. A.I.D. project designers should try to limit the restrictions imposed by a project, and to cast requirements in terms that are easy to understand and verify. Project designers should consult with IFI staff, because restrictions that they see as sensible and straightforward may be seen by bank staff as confusing and difficult to apply.

Projects should make use not only of IFI administrative capacity, but also its fund-raising capacity. Therefore, well designed projects usually require that IFIs contribute some of their own funds. PRE has required lenders to supply at least half of all funds. This requirement can increase both sustainability and additionality, and it insures that banks will administer the project carefully. Loan guarantees rely solely on bank funds, and this is one of their advantages, as long as a significant portion of those funds remain at risk. Matching requirements can be included in direct loan agreements to secure an IFI contribution.

A relatively obvious principle of good design is that loan funds should be recycled and re-lent as much as possible within the time-frame allotted to the project, in order to maximize the number of clients that the project serves. This is particularly crucial when the project provides short term credit. It is best done using simple procedures that can be handled within the IFI. The project designer's role is to establish a reporting system that enables project managers to verify that funds are reused in a timely manner and for acceptable purposes. A.I.D. staff should not become involved in approving individual transactions.

Finally, project agreements should compensate IFIs for the additional risks and costs they bear, and pricing should create incentives for good performance by IFIs. Pricing is treated separately in the next section.

Pricing

Banks will not accept the costs and risks associated with carrying out an A.I.D.-funded project without adequate financial compensation. Nor, as private sector entities, should they. A.I.D. planners must accept the premise that the further a bank is asked to deviate from its normal operations, the greater the compensation it is likely to require. On the other hand, A.I.D. projects should not overcompensate banks. Banks are not the beneficiaries of these projects; businesses are. Adequate compensation may be likened to a fee for services provided. Overcompensation slips into subsidy.

For direct loans, the main structure of the pricing agreement is provided by the spread between the cost of the funds to the institution (the interest rate charged by A.I.D.) and the interest rate the institution charges borrowers. In principle, the spread should be sufficient to cover administrative costs, expected loan losses due to default, the expected costs of other forms of risk, and a reasonable profit for the lender. In practice, this pricing structure may become much more complex, as banks can receive compensation or bear costs in other forms. These include fees charged either by the lender to the client, or by A.I.D to the lender. Fees may be assessed upon initial loan extension, upon the occurrence of certain events during the life of the loan or project, or as an interest rate surcharge. Examples of fees banks charge their clients include fees for project or collateral appraisal, collateral registration, general loan application or commitment fees, fees for individual drawdowns, letter of credit fees, late payment fees, foreign exchange fees and others. Many such fees, especially those associated with trade credits, are important sources of bank earnings, and it is essential to consider these sources of "collateral revenues" or non-interest income when pricing and negotiating project agreements with IFIs.

A.I.D. project designers can also use fees to set up certain incentives for banks, such as fees for holding uncommitted funds, re-using funds, or for amending documents such as letters of credit.

Pricing for loan guarantees is somewhat less complex, as project designers do not have to second-guess the whole range of a bank's cost and revenue structure, but can concentrate on the effect of the guarantee on risk and hence on expected cost. In general, the type of client or service required under a project will have higher risks and perhaps higher administrative costs than normal bank operations. The guarantee itself should offset enough of those additional costs to make the project appear profitable, but not so much that the bank loses its incentive to lend and monitor loans prudently. A.I.D. frequently charges fees to banks for providing guarantees, which may or may not be passed on to borrowers. The effect of a fee is to place most of the expected costs on banks and/or clients, while the guarantee relieves banks of some of the credit risk.

The basic pricing principle for a loan guarantee, in brief, is this: fees should cover as much of the expected costs of claims paid by the guarantor as possible, and guarantees themselves should leave a significant chunk of the risk in bank hands. The ultimate goal is that a guarantee program be self-financing through fees, and although not all guarantee arrangements will reach this standard, it is useful to set this as a goal. One complicating factor may be that a guarantee project may cost a bank more not only in terms of default risk but also in terms of administrative cost. Project designers should be aware of this possibility, and be prepared to reduce the guarantee fee or provide other forms of compensation. In projects involving second IFIs, such as loan setoff projects, compensation must also be allowed for the intermediate institution.

Another factor complicating the pricing picture is the investment yields to banks on A.I.D. funds. The value of this to the bank depends on interest rate spreads available on short term low-risk lending, such as through money markets, and on how the repayment schedule by borrowers relates to repayments due A.I.D. It is also essential to consider the value of income-producing side business project clients generate that is not directly related to the project. This can include deposits, other forms of fee-paying business, and the expectation of establishing an ongoing banking relationship. For certain types of banking activity such as trade financing, fee-paying business, often referred to as collateral business, may be by far the largest source of earnings from the project, far surpassing the value of interest income.

Finally, technical assistance grants to IFIs can be a key aspect of IFI compensation, although A.I.D. staff should remember that, particularly if initiated by A.I.D., the bank may not believe it to be as valuable as it appears to A.I.D.

Negotiating an Agreement

The purpose of negotiation is to settle the exact program content, delineate responsibilities and set pricing. The basic premise of the negotiation is that A.I.D. will try to persuade the IFI to pursue the greatest development impact for the lowest cost, while the IFI will aim to maximize its profits. Generally, it is in A.I.D.'s interest to promote brief, comprehensible loan agreements offering a good degree of flexibility. However, it is important to be aware that IFIs may insist on more elaborated treatment of loan arrangements in writing.

In preparing to negotiate, project designers should carefully consider the points of congruence and divergence of objectives between A.I.D. and the IFI. This returns to the issue, discussed earlier, of the incomplete overlap between business and profit motives on the one hand and development objectives on the other. In order to negotiate well, it is therefore clearly important that A.I.D. staff understand as much as possible about A.I.D.'s own objectives and the parameters within which it is willing to move. These must include the long range institutional change objectives and questions of sustainability, as well as the more direct development objectives.

Negotiators must know as much as possible about the cost and return structure of the IFI, particularly because of the role of negotiation in setting pricing. The more negotiators know, the better they will be able to respond to IFI proposals. They will never know all the information relevant to the IFI's thinking, and therefore must be prepared to drive a hard bargain in order to reduce the chances that the final agreement will overcompensate the IFI.

The negotiating process for an IFI project is not a zero-sum game, where one party loses what the other gains. Rather, a successful negotiation is one in which both sides try to find areas where gains to one side outweigh losses to the other. This is the raw material for a mutually beneficial compromise. On A.I.D.'s side, this search can focus on ways to make a project more attractive to the IFI without sacrificing development goals. In order to be sure that no opportunities for mutual gains are passed up, A.I.D. negotiators should not hesitate to communicate their own objectives to the IFI. Such communication need not give away bargaining positions, and hence is not a strategy of weakness. Rather, it allows the IFI to search for ways to accommodate A.I.D. without harming its interest.

A final comment on negotiating with IFIs is the need to be cognizant of cultural styles in negotiation, such as the degree or formality or informality preferred, how the local business culture views and responds to direct confrontation, and the like.

CHAPTER VI. PROJECT IMPLEMENTATION, MONITORING AND EVALUATION

For the types of projects discussed here, implementation is overwhelmingly the responsibility of the IFI, or in the case of a direct loan to an individual project, of the project sponsors. A.I.D. staff are less involved in day-to-day operations and decisions than they are in many other types of projects. However, this does not mean that a project agreement can be signed and that all will operate as planned. A.I.D. project managers must monitor project progress on a regular basis, particularly during the initial stages. Generally, the purpose of monitoring is to see that funds are used in accordance with the terms of the agreement. Regular audits check that proper accounting is made of the funds. More frequent monitoring by A.I.D. project officers should focus on key project issues and objectives. Some of the most important are:

- Whether the IFI is fulfilling the developmental objectives set out in the project agreement, such as those concerning the nature of clients. This is particularly important if the IFI lacks interest in these objectives.

- Whether grant funds are being properly programmed and spent. This is frequently an area of weak IFI performance, in which A.I.D. staff assistance may be needed.

- Whether changing economic or financial conditions have altered any of the basic assumptions about the project, and if so, whether the project should also change to accommodate the new circumstances.

It is best for A.I.D. and the IFI to agree on regular monitoring activities in advance, optimally through the project agreement. This must be done early, to ensure that appropriate information is collected from the start and, more importantly, to ensure that A.I.D.'s desire to obtain such information is clear to both sides. Given the staff time that can potentially be used in fulfilling reporting requirements, and the resentment this fosters in many IFIs, project designers should limit requests for information to items seen as most important, such as those necessary to judge compliance with the agreement. The monitoring plan should specify:

- Accounting and audit requirements.

- A.I.D.'s rights of access to information about the program, including accounting statements, data on clients and permission to interview or visit clients.

- o Data the IFI is required to collect on clients and on applicants that do not become clients.

- o Reporting requirements by the IFI to A.I.D., specifying both frequency and content of reports.

- o Formal meetings between A.I.D. and IFI staff, if any are deemed necessary.

Where possible, information should be limited to the data the banks routinely collect on their clients and portfolios, and should be presented in the formats the bank already uses. If absolutely necessary, project negotiators can ask the IFI to modify its application forms or routine reports to include specific items. A.I.D. access to loan folders is particularly important, both for monitoring and subsequent evaluation, and it places no burden on the IFI.

If A.I.D. staff carries out monitoring responsibilities as planned, project managers will have an up-to-date picture of whether the IFI is performing as requested and whether the project is achieving its output targets. A.I.D. staff must be prepared to act on this information, and particularly to address problems as they begin to appear, rather than waiting until they mushroom. This advice cannot be overstressed, as project managers so often fail to follow it, delaying corrective action until it becomes unavoidable, by which time it is often too late.

Evaluation

A.I.D. generally performs two types of evaluations of its projects: management-oriented evaluations and impact evaluations. The former evaluates the production of project outputs and how well the implementors have performed. The second is concerned with final outcomes, that is, how the project has achieved its development goals. Impact evaluations are always more difficult to carry out than management reviews, and in the case of business credit projects they are particularly fraught with methodological problems. Because of this, it is often necessary to look for short-cuts to impact evaluations, using proxies and substitutes for the data one would most like to obtain. The rest of this section describes evaluation methods in more depth.

A management review limits itself to the specific actions required of the IFI in project agreements. This includes the following questions, among others:

- o Did the borrowers meet eligibility requirements?

- o Did the credit terms offered fit those stated in the agreement?
- o Have matching requirements and other stipulations of the agreement, been met?
- o Has the IFI managed the project smoothly and cost-effectively?
- o Has the program proceeded without undue delay?
- o Have technical assistance funds been spent appropriately?
- o How has the IFI reacted to the new target group or new product?

A management-level evaluation can help assess institutional change objectives, as it is concerned with the performance and reaction of the IFI and related institutions. Institutional changes may be subtle and slow to occur, but they are relatively easy to verify. Much of this evaluative work can be performed using the regular performance monitoring data noted above. If an on-site study is required, it should be performed by a team of evaluators with skills in organizational management, banking and finance.

An impact evaluation is focused on achievement of ultimate objectives; it looks beyond the production of outputs to real world results. This guidebook has stressed two types of objectives as essential for private sector credit projects: direct development benefits among assisted businesses and institutional change objectives within the financial sector. Probably the most important attribute of an institutional change assessment is that it be broad and open-ended in scope, because changes frequently occur in ways and in places that were not identified in the design stage. It is often observed that unplanned project effects are the rule, rather than the exception. For that reason it is best that early project documents specify certain institutional outcomes that are expected, but also leave room for a broad range of other outcomes or in certain cases, simply specify an overall institutional change strategy. Another caveat about assessing institutional change is that while it is easy to see what has changed, it is often hard to see how or to what degree the project led to the change.

In an essay on lessons from a number of World Bank development projects, A. O. Hirschman formulated the principle of the "Hiding Hand". He writes:

> If project planners ... had known in advance all the difficulties and troubles that were lying in store for the project, they probably would never have touched it....In some, though not all, of these cases advance knowledge of these difficulties would therefore have been unfortunate, for the difficulties and the ensuing search for solutions set in motion a train of events that not only rescued the project but often made it particularly valuable.

A. O. Hirschman, Development Projects Observed, The Brookings Institution, Washington, 1967. pp. 12-13.

Direct development benefits are much harder to discern, and their evaluation requires greater methodological sophistication. The question an impact evaluation must address is the following: how much growth in output, employment, number of businesses, income, net foreign exchange earnings, exports or other development effects has been produced as a result of the credit extended? The key difficulty lies in the phrase "as a result," because it is not enough to know what recipient businesses produce. One is trying to estimate how much of that production can be attributed to the receipt of the A.I.D.-funded loan. This in turn depends upon what would have happened had the loan been unavailable, that is, in the case of no intervention.

There are two ways to assess the no-intervention case. First, the performance of a control group of similar businesses that did not receive loans can be compared to that of recipients. Alternatively, the recipient can be asked what decisions he or she would have made in the absence of the loan, and that can be compared to actual performance. The former is a superior methodology for drawing inferences. However, it requires the observation of a control group at the start of the project, together with a baseline assessment of both the controls and the recipients. Control groups are virtually never set up at the beginning of loan projects, because of the expense and because of the difficulty in finding a group of businesses similar to recipients in all important respects except receipt of the loan. The second method, to ask recipients what they would have done, is far less reliable. Any given borrower might have had alternatives including finding another lender, financing from other sources, and modifying or simply cancelling plans. Not only is it virtually impossible to predict the effect of an alternative decision on business performance, the level of confidence in recipient responses is quite low. A recipient may not have investigated alternatives, and recall of the alternatives several years hence is likely to be poor.

Several points emerge from this discussion of methodological issues. Unless a primary purpose of a project is in itself research on the effects of credit, it is virtually impossible to set up an ideal impact evaluation of direct development effects. The implication of this for many projects is that an impact evaluation should not be undertaken, or that a simplified one is appropriate. One must bear in mind that virtually all of the relevant questions in impact evaluation are before and after questions. This means that if any evaluation is to be undertaken, it is crucial to collect data on the status of businesses at the time they receive loans, possibly as part of the application process. Of course, this requirement may conflict with the aim of placing as small a burden of information collection and reporting on IFIs as possible. Planners must weigh the two objectives.

Practical suggestions following from these observations are:

- Loan applicants that were not accepted may be the closest available proxy for a control group, particularly if they can be sorted by reasons for rejection. This is one reason for requiring IFIs to maintain records on rejected applicants. Evaluators may wish to interview these businesses to assess their performance during the project period.

- Loan folders completed during the application process are the primary source of baseline data on borrowers. Therefore, it is vital that they contain relevant information and that evaluators have permission to review them. The content of loan folders should be discussed during negotiation of the monitoring plan. Banks need not process the information in the folders prior to evaluation, but A.I.D. project monitors should check that folders are satisfactorily completed.

- A business must perform at some minimum level in order to repay its loans, provided loans are not repaid from other sources. Thus, loan repayment rates may serve as a lower-end proxy for business performance.

- Detailed case studies and/or a representative survey of a sample of recipients are probably the most reliable of the available methods for assessing development indicators.

- Much of this data can often be collected and tabulated on an annual basis by adding a set of impact questions to the operational issues addressed in standard financial audits.

Impact evaluation teams should include evaluation specialists, economists or social scientists who are familiar with these methodological questions, in addition to the types of experts needed for management evaluations. Institutional change may be best assessed by a management specialist and a financial sector economist.

APPENDIX I. ADDITIONAL RESOURCES FOR PRIVATE SECTOR CREDIT PROJECTS

An essential aspect of this manual is to provide information on replication of project models that have been used by PRE's Investment Office. These are discussed in more detail in "Lessons from Experience: The Design and Implementation of Commercial Lending Projects by A.I.D.'s Bureau for Private Enterprise", a report that is available from the Bureau for Private Enterprise.

An excellent basis for planning and designing private sector credit projects is provided by A.I.D.'s "Private Sector Development Framework", a report that outlines a simple and effective set of analytical tools to be used in assessing opportunities and constraints in a country's private sector. The "A.I.D. Financial Markets Development Policy Paper" also provides important guidance in understanding the Agency's policies concerning financial markets development.

Once a Mission has gained a clear understanding of the local 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. These activities include the following:

1. 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.

2. Private Enterprise Development Support: This project focuses on interventions which will result in better overall Mission approaches to private enterprise strategy, and on host country policy and institutional reform that promotes privately led economic growth.

3. Financial Sector 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 elements of financial systems that are important for the expansion of capital markets (debt instruments, regulatory agencies, etc.)

4. Divestiture and Privatization: The goal of this program 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 to 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.

5. 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.

6. 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.

7. Commercialization of Technology: The program focuses on: (i) the development of R&D limited partnerships for product development, manufacture, and marketing in developing countries; (ii) test marketing in development 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 references for those interested in initiating private sector lending programs. To start with, individual reports from PRE's case study series describe and evaluate specific projects that the Bureau has implemented. Case study reports exist for projects carried out in Kenya, Morocco, Thailand, the Philippines, Ecuador and the Dominican Republic.

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 System for the Investment Office of A.I.D.'s Bureau of Private Enterprise", written by Management Systems International. Other references and information can be obtained by contacting PRE's Development Planning Office or PPC's Center for Development Information and Evaluation.

Additional information and assistance for establishing IFI, direct loan or other private sector programs, including copies of documents such as sample contracts and loan agreements can be obtained from the Bureau for Private Enterprise, United States Agency for International Development, Washington, D.C. 20523.