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STRUCTURAL AND ORGANIZATIONAL CHARACTERISTICS OF FINANCIAL MARKETS INTERVENTIONS IN LDC'S

PART II

**Lessons Learned
In Design and Implementation
With Emphasis Upon Section 108**

**Working Constraints Involved in
Conducting Financial Markets Assessments
and Developing Facilities**

Prepared for

**Agency for International Development
AFR/MDI
Contract No. AFR-0438-C-00-5037-00
Task No. 38**

Prepared by

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I. BACKGROUND

In recent years, the Agency for International Development (A.I.D.) and A.I.D. Missions have sought alternatives for financing local businesses in LDC's, which would offer greater visibility for the Agency, while at the same time making more efficient use of scarce resources and private financial institutions as intermediaries. Increasingly, A.I.D. assistance in the development of local financial markets is taking the form of technical assistance support in the development of a local Intermediary Finance Institution (IFI), or channeling financial resources to private lenders for on lending to majority locally owned, value added enterprises.

An example of the latter type of transaction with a local financial intermediary is the increasing use of PL480 Title I Section 108 loan programs, for the financing of businesses working through existing lenders and development financing institutions making both debt and equity financing available. These include: (1) the Jamaica Agricultural Development Foundation (JADF), a development finance company which commenced operations in 1984, using proceeds of PL480 commodity sales to make loans and take equity participations in agricultural enterprises; (2) the Trafalgar Development Bank Ltd., also located in Jamaica, and doing local project lending with Section 108 funds; and (3) a proposed Section 108 Private Sector Lending Program for Moroccan businesses.

In this Working Paper, the structural and organizational characteristics of each of these facilities are examined. Also discussed is the proposed structure and organization for a new venture capital company being developed for direct investment in local businesses in Sri Lanka, sourcing its capital through equity participation of local and foreign investors. Following the summary discussions of these facilities, the author compares to the extent possible and relevant the key lessons learned from implementation of existing operations, with design considerations being built into current project proposals to address identified problems in design, execution and management of IFI's for local project financing.

A. The Jamaica Agricultural Development Foundation (JADF)

1. Structure

The Jamaica Agricultural Development Foundation (JADF) was established in early 1984 as a not for profit private sector venture capital institution, whose primary objective was to promote and develop sustainable enterprises in agricultural production and processing. Founders of the JADF were Land O Lakes, Inc., the Rockefeller Brothers Fund and Grace Kennedy & Company Ltd. of Jamaica, with support from USAID.

Primary activities were to be financing of locally owned businesses, with strong emphasis upon equity participation, and provision of technical services to project sponsors in project preparation and analysis, and to a more limited extent, implementation. Its primary source of funding has been proceeds from the sale of bulk cheese and butter provided by the U.S. Government under the PL480 Title II food grant program. In addition, USAID made available $1 million in Technical Assistance Grant Funds, to be used to cover consultant assistance to project feasibilities, staff training costs, fixed asset purchases (computer equipment), and related institutional development costs.

The JADF was originally structured to function as a privately run venture capital corporation, appraising projects and making financing available largely in the form of direct investments, tied to a specified type of return and policy for equity payback. As noted, heavy emphasis was also placed upon institutional capability to provide clients with technical services improving project quality and the sponsor's capacity to implement.

Because of its unique role as provide of equity through a not for profit venture capital corporation, the facility was granted tax relief through 1994. Originally, JADF was structured to accept food commodities, contract to have them processed, and handle sales of processed products to distributors. Because these front end functions have consumed so much of staff time (up to 40%), the organization now accepts and sells commodities directly at the dock, to a processor responsible for processing and sale of products to local distributors.

At the June, 1987 evaluation conducted by the International Science and Technology Institute, Inc. (ISTI), the JADF was carrying out the following activities:

- o Accepting deposits
- o Making term loans (average amount $585,0000; average tenor 6 years; up to four years grace; 15% interest on new loans at 6/87 evaluation).
- o Making equity investments in the form of common stock and cumulative preference shares, on which dividends were payable only if operating cash flow permitted it (average equity participation $433,000; average 25-30% return).
- o Providing reimbursable grants for covering project technical costs.
- o Selling food commodities to make possible expanded loan and equity investments.

- Providing in-house technical services in project preparation and analysis, and where necessary, outside consultant services, without fee for service charges.

JADF was not making guarantees to encourage lending by local banks, to smaller scale agricultural activities than it could reasonably service, largely due to lack of interest among lending institutions. The Foundation had begun in 1987 to administer a $7 million USAID funded agricultural research program focusing upon small farmer issues, with costs to be charged to projects.

The JADF had as of June 1987, received 240 projects and approved 52 for loans, equity investments or grants (in some cases a combination of both debt and equity financing). In contrast to anticipated activity, the Foundation was making far more loans than direct equity participations (loan portfolio of J$18.7 million vs. equity portfolio of J$5.6 million, more than three to one loans/equity). Sizes of actual project commitments ranged from as low as $100,000 to as high as $2.0 million (combined loan/equity); commitments were 50/50 in the size categories of (1) $500,000 and under (2) $500,000 to $1 million.

JADF was structured to meet a number of additional targets or objectives. These included:

- Use of a substantial volume of some $26 million in food commodities projected to be provided over 6 years, to make equity participation and loans to agricultural sector enterprises; although no set amount of commodities were to be provided.

- Develop and operate with targets for mix of financial products (equity participations, loans, reimbursable grants) sector goals, and specific buy-back policies for equity.

- Develop and implement a plan for use of A.I.D. Technical Assistance Grant Funds; draw down and use those monies for activities including operating manuals, policy development, and a high visibility promotional program.

- Closely coordinate JADF activities with those of other agricultural sector institutions and private lenders, to improve marketing and project quality.

At the June 1987 evaluation, the Foundation had failed to meet the above targets, with results that are further discussed in Section 3, Lessons Learned.

The Evaluation Team found that after three years of operations, JADF was a functioning private sector institution with a capable all Jamaican staff, serving some of the real development financing needs of the agricultural sector. Its relationships with USAID were good and the institution enjoyed sufficient liquidity to keep operating in the near term.

At the same time, the JADF was, as indicated by the team financial analysis, facing serious long term problems, due to a cost structure which was too high for the level of revenue generated by the facility. The Evaluation Team recommended specific and immediate measures to be considered, in line with increasing revenues and decreasing costs. These included:

- Charging of fees for all project design and implementation assistance.
- Placement of a higher proportion of assets in higher yielding investments, such as preference shares with profit sharing "kickers".
- Charging higher rates on loans and cumulative preference shares, to the extent the market will bear.
- Increase average loan and equity sizes.
- Determine if JADF can adopt and use less costly servicing methods employed by other DFC's.
- Develop other interest or fee based financial services.

Reasons for poor prospects for longer term sustainability, and possible continued dependence upon donor funds to survive without such redress measures, are discussed in Section 3, Lessons Learned.

2. Organizational Characteristics

JADF was organized to function with an operating structure comprised of: (1) a Managing Director responsible for overall operations and institutional financial performance, (2) a Deputy Managing Director with general operating responsibilities, (3) a Technical Services Section for project analysis, and (4) a Marketing Director responsible for program promotion and administration of grant funds for local projects.

Project analysis is conducted by the Technical Services staff, and will extend to sponsor evaluation, management, marketing, inputs sourcing, production capability, financing plans, economic/social impact and financial projections. Projects found acceptable are recommended by the technical staff, sent to an internal committee of review, and finally to the 13 member Board of Directors for approval. Once approved, project implementation and monitoring responsibilities fall to the project analyst for loan and equity projects, with monthly visits during implementation. Loans over 90 days and other serious problems, receive the attention of the Deputy Managing Director.

While the Board plays a very active role in policy making and project approval, the institution has suffered from lack of forward planning and targeting of financial activity to reach a certain mix of equity, debt and grant financing. Failure to develop and work within a Business Plan, projecting a mix of financial products, has resulted in lower yielding investments which are sometimes more costly to service, a higher proportion of loans vs. equity investments, and an inadequate base for projecting amounts of food commodities which would be needed for resale and expansion of lending and equity activities.

JADF has also through lack of planning and targeting, developed a market image as a lender of reasonable cost and accessible debt financing, rather than an equity institution. This has in turn contributed to the skewing of demand for and utilization of its services toward debt financing.

3. Results and Lessons Learned -- JADF

Results of the 1987 Evaluation, and the reasonably wide array of sub-sectors represented by equity investments and lending activity, indicate that JADF has accomplished to a significant degree its objective of strengthening the agricultural sector in Jamaica. Industry breakdowns of some 30 active projects commitments indicate some impact as well upon agricultural diversification -- in aquaculture, livestock/dairy, non-traditional crops and agro-processing. Procedures used to appraise, approve and monitor projects were found to be sound and thorough.

At the same time, the facility has encountered significant problems, not uncommon to a development lending institution of this type. Identified problems will require a major rethinking of its revenue and cost structure, its financial structure, and substantial upgrading of its business planning capacity, if the institution is going to be able to survive far beyond the projected end of USAID grant support in 1988.

As indicated earlier, JADF has been operating at an unfeasibly high cost level vis a vis the income stream generated from loan interest, and returns on equity investments. At the 1987 evaluation, revenues were 16.4% of average earning assets, before the 6.1% effect of USAID grant funds. Costs totaled 19.3% of average earning assets.

Without the continued grant assistance, the facility would be losing money. In addition, recurring problems with inconsistency of supply/availability of food grant shipments has strained the contractual relationship between JADF and the processor/reseller, and affected the facility's ability to expand lending and equity investment activity in predictable way.

High operating costs have bee in part due to the intensive and costly technical assistance provided for client businesses, and failure to develop and install a realistic fee structure for recouping some of these costs. Contributing factors have also been lack of a cost control strategy for developing more cost effective servicing techniques, and keeping costs low as a percentage of revenues.

Low revenues in comparison to the costs to generate them, have in part been due to inadequate business planning. Although it was as noted a program target, the JADF failed to develop and install early on a Business Plan projecting the mix of financial products to be offered, and calling for periodic review of the "fit" of that mix with the market's needs <u>and</u> the revenue requirements of the facility itself. Similarly, key policies such as those for equity buy-back were not set in place.

The result was largely unplanned growth of the portfolio, both in terms of volume and mix, largely driven by market factors rather than a combination of market, profitability and risk management factors.

Failure to plan for a blended portfolio based projected targets, constrained the facility's ability to estimate on a yearly basis the quantities of commodities which would be needed to generate sales proceeds allowing for expanded financial activity. One result was the much slower than anticipated draw-down of commodities (by three years into the program, only $9 million of the projected $26 million had been drawn-down).

By neglecting to develop and implement a plan for use of the USAID Technical Assistance Grant Funds, the JADF in part generated a reasonably low rate of use of these monies to put essential institutional capacity and training in place. One expenditure not made as projected under the USAID grant was installation of an adequate MIS system using computer equipment. Lack of such a system for standardizing reporting information and tracking loan and investment performance, has contributed to the significant proportion of past due loans (20.3% of outstanding at 1987 Evaluation), and the reported need to expand staff to handle monitoring and servicing of the portfolio.

USAID technical assistance monies were intended to be used as well for development and implementation of a promotional program, which would increase the impact of marketing JADF's services, and improve project quality. Such a plan had not been developed at Evaluation, to target and promote services to desired markets, and effectively coordinate with other institutions working with agriculture to improve quality/cut costly servicing required for investment projects brought in.

This series of costly mistakes in planning and financial management was made in a situation where the financial facility or intermediary was operating on the basis of interest free money. Failure to plan or target a desired portfolio mix and operate to achieve it, not only lowered profitability but diluted the skills and institutional development capabilities of JADF. Dedication of significant resources to lending activities requires a different viewpoint and diverts attention away from the specialized requirements of making and managing direct equity investments.

The results of the JADF experience made a strong case for considering several revisions to design and implementation of future IFI's, whether they are funded through leveraged borrowings, direct capital investments or vehicles like Section 108. The principal lessons learned are:

1. Intermediate financial institutions should not be launched or financially supported without the requirement that management develop and implement up front a Business Plan incorporating specific policy decisions, regarding targets for the mix of financial products (loans, equity, grants), and sector goals.

2. Specific policy should be set regarding equity buy-back mechanisms, expected returns on direct investments and exit horizons.

3. Financial planning for new or restructuring IFI's should give due consideration to the fact that the orientation required and the requirements for launching a soundly managed facility, are very different for unsecured venture capital, as opposed to collateralized lending. Running an equity program entails higher risks, is more difficult, requires more investment in management and different approaches than running a loan program. Those institutions which are set up to address evident needs for equity in a local market, should concentrate their resources upon building skills in fulfilling those needs profitably, before considering opening of other windows.

4. IFI's should be launched and operated based upon a performance driven salary and incentive plan. Failure to do this, and reliance upon free or low cost money to support financing activities, have been contributing factors to poor targeting and lack of financial sustainability.

5. Intermediary financial institutions should begin operations based upon a specific training plan, adequately funded to develop needed skills in operating within a targeted Business Plan. Training should address flexibly reviewing and making revisions to the product mix and sectoral targets based upon market, performance and other factors.

6. Such institutions should be required to operate from the start within a well articulated promotional program, coordinated with other institutions serving target markets, to improve project quality and the rate of receipt of sound projects.

7. Excessive dependency upon unreliable sources of financing, such as the availability of food shipments, should be avoided. In response to this set of constraints, it would be wiser to plan financial facilities such as those launched with Section 108, over shorter and more clearly defined time horizons (18 months to two years). A.I.D. should flexibly adjust access to further resources based upon rate of use of facilities by participating institutions, market demand, and commodity availability considerations.

4. <u>The Trafalgar Bank Experience -- Jamaica</u>

Available information on this project lending facility indicates that with the changeover of its USAID funded loan facility from direct loans to Section 108, the Trafalgar Development Bank (TDB) may encounter difficulties similar to those experienced by the JADF, possibly compromising its future financial viability. Under its original USAID loan facility, the bank received loan approval for some $20 million in two tranches of $10 million each, repayable at 5% per annum on actual loan balance utilized.

The full amount of the facility was to be available in U.S. dollars with maximum $6 million available for conversion to Jamaican dollars for local procurement. The second $10 million tranche would be extended subject to capitalization levels of TDB and a project evaluation. The entire loan facility was subject to loan limits (15% of net worth), leverage ratios (5:1) and credit extension to certain industries.

Foreign exchange risk for the USAID loan was covered through parallel agreement with the Government of Jamaica. The Central Bank would absorb this risk and accept payment from TDB in J$, while repaying USAID in US$, under a separate agreement.

In late 1986, USAID changed the structure of this facility due to internal budget reductions and overall funds availability. The new credit structure formalizes a limit of US$12.5 million to be made available under the original terms, and converts the remaining $7.5

million into a J$ equivalent available through PL480, Title I, Section 108. The terms and conditions of the second tranche may have a negative impact upon TDB's financial viability.

As with other Section 108 arrangements, the new facility will be funded under the PL480 Section 108 program, providing US commodities for sale in Jamaica, the proceeds of which will be available to the Government of Jamaica. Under the Loan Agreement between USAID and GOJ, the equivalent of J$5 million was to be specifically allocated to TDB (1987 commodity sales). It was USAID's plan that the remaining equivalent of J$2.5 million would be made available to the bank during 1988 from the US$7.5 million in commodities which were requested.

The change in these terms from USAID was expected to affect the TDB in the following ways:

1. Although USAID appeared certain of the ultimate availability of funds, there is no legal commitment on the part of the US Government to provide the commodities for resale. The recent uncertainty about the availability of surplus dairy products under the JADF program, created instability for that program's growth, and stimulates concern about this USAID funding source. This residual uncertainty causes TDB to have to create contingency plans for the development of other, higher cost funds, even though they may not be needed.

2. In the new arrangement, TDB is losing a significant amount of US$ availability, which partially compromises its uniqueness and competitiveness in the market. This comes at a time when the TDB is experiencing low profit margins. On the other hand, restrictions on the use of Section 108 funds are more lenient, which should work to TDB's advantage.

3. Since the funds are to be denominated in Jamaican dollars, TDB would have its effective lending capacity compromised in the event of a significant devaluation of the Jamaican dollar.

4. Lack of hard currency availability to TDB customers, with the actual foreign exchange risk passed on to the Government of Jamaica, could be detrimental to TDB's development lending goals, to the extent that US dollars are not readily available through the weekly currency auction.

5. Finally, the shorter grace period (2.5 years) and shorter final maturity date (10 years), will probably cause TDB to utilize alternative credit sources earlier than originally projected. These other lines will be more expensive for the bank, and raise the impact of interest expense upon average earning assets (%).

At the same time, the circumstance of being forced to source higher cost funds for re-lending may have the effect of causing TDB to tighten its project appraisal standards, reduce costs of servicing and operate a more profitable lending facility, with higher returns to investors.

B. Proposed Private Venture Capital Company for Sri Lanka

The design and organization of a proposed Venture Capital Company for Sri Lankan business, offers a direct contrast to the circumstances under which the JADF facility was launched, and appears to correct a number of the errors made in structuring and targeting the equity facility.

During the spring of 1988, a consultant team was fielded by the International Science and Technology Institute, Inc. (ISTI), to develop with a group of potential Sri Lankan investors the design, capital and management structure for a private venture capital corporation. The first such venture to be developed in the country, the Venture Capital Corporation (VCC) evolves from the initiative of local private investors representing six companies, which have become the working steering committee for its organization.

The operational model which was developed for A.I.D. and the private investor group specifically limits the mix of financial products going in, to the provision of equity investments in locally owned and managed businesses. Size of operations, number and type of investments, financial projections, management and capital structure, are addressed within a Business Plan which gives careful attention to risk management, and building the venture capital institution on an incremental basis, allowing management and the business community to develop the skills to work with this new investment concept. At the same time, business planning has allowed for sufficient flexibility to adjust the product mix as the facility gains experience in the market, and demand for other services develops.

Projected A.I.D. support is <u>non-financial</u>. At a proposed level of $500,000 over three years, A.I.D. funding would specifically underwrite the higher than normal costs for a US venture capital corporation set up, necessary to introduce the concept of venture capital in this country. Funded costs would include training in country and overseas for Sri Lankan management, technical advisors, feasibility studies, development and implementation of a promotional program and some capital equipment. Support would be provided in the form of a non-reimbursable grant.

1. Structure

The proposed Venture Capital Corporation would be incorporated in Sri Lanka as a privately run venture capital company, as opposed to an investment company, for the purposes of securing reduced tax status as a special and pioneering type of financial vehicle in this market. The capital base will be direct investments by a core group of interested investors. Operations are projected to begin in 1988, with a capital base of about Rs. 30 million ($1 million). Capital structure calls for increasing this base to Rs. 100 million ($3.3 million) as the operation expands.

There is general agreement among the core investors that if market conditions are right, the facility will go to public offering to raise this additional capital, with limits upon the maximum stock purchase by any one private or public entity. As a result of A.I.D. activity to date, several international investors have expressed interest in investing in the corporation. These include: the International Finance Corporation (IFC) and the Asian Development Bank (ADB). The involvement of USAID is seen as an additional benefit, or catalyst to induce foreign investors to participate.

Under the operational plan, equity investments would be made by the VCC in profitable projects, with established or new businesses in productive sectors broadly defined as agro-industrial sector. Portfolio chosen will be projects having returns of 20 to 30% over 4 to 9 years. The basis for return on venture capital invested will be (1) dividends or (2) sale of shares.

International investors will be encouraged to invest in the capital. It should be noted that the emphasis in making direct investments will be placed upon projects which are predominantly locally owned and managed, although there may in some instances be foreign partners for management and technical inputs. This model rather closely follows the example of the Kenya Equity Management Company, which is designed to serve the local market, in this case with both loans and equity participations, as the market indicates lack of such loan funds from other sources.

The Sri Lankan VCC is seen as an important mobilizer of equity capital funds for small and medium scale privately owned businesses, and a stimulus to development of this capital market through spin off or encouragement of several other venture capital funds under similar models. Considerable reliance will be placed upon US venture capital experience, and technology of US VCC's will be transferred through technical advisors, training visits here for Sri Lankan management and other technical support under the USAID grant. Management is also expected to become part of the venture capital network which presently exists in North America, Europe and Asia, to speed development of improved venture capital management, new markets, and additional investment.

Careful attention will be given to the exit mechanism, and the long 5 to 9 years necessary before profits can be realized on target investment sectors and types. A related factor which will impact the process of selling investments easily is the low present level of stock market activity in Sri Lanka. The establishment of the VCC should be a positive factor in stimulating growth in registration of new issues, and increased turnover.

Field interviews with the business community indicated strongly that acceptance of the VCC would be greatly enhanced if it were perceived as being broadly based in terms of ownership, and not controlled by one group. Therefore, numbers suggested for maximum ownership by one group are in the 10 to 25% range. The intent is to become a public company, once the VCC has a demonstrated track record in the market.

The level of activity projected in the Business Plan is approximately Rs. 80 million ($2,600,000) in direct investments over the initial operating years, at an average investment of Rs. 5 million ($166,000). This assumes a capital base of Rs. 100 million ($3.3 million), with 20% in cash to produce income from the capital base to pay operating costs.

2. Organizational Structure

The recommended structure includes a Board of Directors, a Managing Director and a small technical staff. Both the Managing Director and the technical staff would receive a good deal of independence and responsibility for making sound investment judgments. They would be responsible to the Board for consistency and conformity with policy guidelines set by the Board.

As management quality is the factor which makes or breaks a venture capital institution, the organizers of the proposed facility would seek management personnel with the highest level of related competence and experience. Management would be expected to have a good knowledge of financial instruments, and be expected to develop creative ways to profitably sell off or divest shares.

Further, management would be expected to follow the three prime principles in venture capital investment in making and managing investments. These include:

- "Due diligence" in thoroughly screening investments.

- "Adding value" to investments by making timely and crucial management inputs.

- Developing effective "exit mechanisms" for investments made.

Management would be compensated based upon performance, with rewards for good financial performance, and responsibility adjustments or dismissal for poor performance.

During the design phase due consideration was given to the question of whether the facility should seek and accept loans, from A.I.D. or other sources for financing of equity investment. After reviewing this form of financing, and the purpose of the facility which is to make direct investments in third party businesses, it was concluded that a loan would not be appropriate. Projected cash flow could not service such a loan in the initial several years, and investments in such an operation should be equity in nature.

Similarly, it was decided based upon market factors and the nature of a venture capital operation, not to open a loan window within this facility in the foreseeable future. It has been soundly argued that the management and orientation required for venture capital investment is very different from that required for a collateralized lending operation. Further, beginning a lending program initially would compromise the primary activity and most pressing market need in Sri Lanka -- Equity investments.

3. Lessons Learned

The structure and organization of this proposed VCC illustrate some of the important ways in which designers and implementing investor groups can through well thought out business planning, and sound policy setting, minimize the associated risks with venture capital investment in a new market, and enter the market on a sound footing. Several design and organizational features are discussed here, with specific reference to lessons learned from the other venture capital set ups examined through JADF is Jamaica.

In contrast to the Jamaican facility, the proposed VCC for Sri Lanka has or is in the process of putting in place key planning and policy controls in six (6) areas which should help to minimize the potential for loss of control over the investment mix, lower profitability and excessively high cost structure. These include:

1. Development of a Business Plan at the outset, specifying the mix of financial products to be offered, with projected levels of activity and average exposure. Early use of such a tool will both assist management in achieving financial goals and objectives, and serve as the basis for periodic review of the product mix to ascertain whether it is still

addressing the market's needs, and making changes in the cost and revenue structure based upon market change and performance of investments.

2. Operation from the start within a carefully thought out promotional plan, designed to attract higher profit potential investments from the local market, needed offshore investment and foreign technology in venture capital management.

3. Determination of the specific vehicle to be used to pay for costs of extra servicing which will be required for investments in a new venture capital market. It is assumed that clients will need costly assistance in project analysis and preparation going in. The decision has been made early on that the facility cannot probably hope to realize significant income on fees for such services during the first two to three years. Therefore, USAID grant money will be used to support these costs.

4. Targeting the use of USAID monies within a specific and market oriented training plan, for facility managers and for the local business community to which venture capital must now be introduced. Within a plan under development, management will benefit from both on site and US based training in the concept and the basics of venture capital investment. The concept will simultaneously be introduced to local investors using a promotional and educational program tailored to the needs of the business community.

5. Cost cutting in project marketing during start up, by utilizing other institutions to prospect the market for sound investments, and expand market reach. One such institution used will be the Development Finance Corporation of Ceylon (DFCC), a core investor in the proposed facility.

6. Willingness to develop the investment facility on a gradual basis -- in response to the pace at which local managers must learn to work with the unfamiliar concept of venture capital. This willingness and the establishment of key forward planning and targeting tools, would have avoided a number of the mistakes made by the JADF in evolving an investment mix, and at the same time trying to do so with a blend of both profit-making and developmental motives. Any such financial intermediary, regardless of the source

of its financing base, must address early and realistically the central dichotomy which will ultimately affect its sustainability as an institution:

> Is the objective of the financial facility to achieve sustainability of the institution, or is it to realize sustainability for the client businesses?
>
> Can it do both, and what adjustments in product mix, cost and revenue structure will be necessary?

Much of this decision making can and does go on at the development of the Business Plan and financial projections for such a facility. These planning tools then become a basis for flexibly reviewing and adjusting these factors during the course of operations, to address changes in the market, performance of investments and institutional objectives.

C. The Proposed Morocco Section 108 Lending Program

While this project is only at proposal stage, and does not offer direct experience by way of comparison, it has been included in this examination of relevant Intermediate Financial Institutions, because the proposed source of financing is Title I Section 108. It is presented also due to the inclusion of several key management controls which could significantly impact the lending results, inn terms of funds allocation and optimal use of private sector lenders and intermediaries.

The Morocco Section 108 Lending Program has been developed at project design report stage by the team of Arthur Young and Company and International Resources Group (IRG), under the PRE Financial Markets Project. During the November, 1987 design mission, the consulting team was charged with developing for USAID documents which could lead to a functioning private sector loan program for private sector businesses, and would at the same time conserve the limited resources available. Section 108 was seen as a vehicle for doing this, making available funds for project loans in local currency generated by PL480 sales.

Of particular concern to A.I.D., and to Government officials, was the identifiable impact of such a facility on the poor. Although this group was not directly targeted, the decision to specifically encourage loans through the program to agricultural projects for the local market, should attract people from that part of the economy to increased jobs generated.

1. Structure

The proposed facility would be structured as a loan facility available for drawdown by financial institutions which meet the following eligibility criteria:

- o Private sector ownership with Moroccan majority.

- o Financially sound, well established, and capable of making and administering the sub-lending activity foreseen by Section 108.

There are five eligible institutions, including the five major private Moroccan banks: BCM, BMCI, SGMB, SMDC and Wafabank.

It was recommended that non-bank IFI's also be considered for eligible use of the facility by the Interagency Policy Group governing PL480 programming in country, at the latter's full discretion and on a case by case basis. Requirements would be that (1) one of the five eligible IFI's fully and unconditionally guarantee the non-bank IFI's obligations to the US Government, and (2) that the guarantor IFI would oversee and ensure procedural compliance by the non-bank IFI.

The recommended facility was a dirham equivalent of $9.5 million (roughly 75 million dirhams at 11/87 exchange rates), with an initial availability of 15 million dirhams per IFI, assuming all five participate. After six months of market testing, amounts available to each would become "subject to availability", and could be re-allocated to various IFI's based upon effective demand which they generate. This design/control factor will help to offset the possible inconsistent availability of PL480 commodities for sale, and local currency generation for on lending.

The rate structure recommended was based upon standard rate for normal borrowers under the program, set at 8.5% per annum and fixed to final maturity. A "targeted" rate was also set at 6.5% per annum, for borrowers specifically applying funds to (1) sub loans to agricultural enterprises for domestic markets only, (2) loans to private borrowers to acquire shares in Moroccan parastatals undergoing privatization, and (3) loans to private enterprises having a US investor (33 to 49%), and sales not exceeding DH 100 million in the year prior to the loan.

The proposed rates are fully in line with Moroccan market rates for funds applicable to banks from interbank or discount window sources (8.5%), and for funds available to banks for rediscountable loans to the agricultural sector (6.5%). Tenor of loans should be seven years from date of first disbursement of principal. Exceptions could be made at terms of seven to no more than 10 years, at the IPG's discretion and upon request by the IFI, based upon natural and purpose of the sub loan requiring such a term.

Drawdowns would be made by IFI's based upon simple request of the borrower to the USAID Comptroller. Lenders would make funds available to borrowers within 30 days of the request, by interbank transfer. Drawdowns could be made at any time from signature of loan agreement, until 18 months following the signature.

Under the loan facility, sub borrowers would have to meet the following eligibility requirements:

- o be 100% privately owned;
- o at least 50.1% Moroccan owned; and
- o any foreign minority ownership must be from the US or another country eligible for PL480 assistance.

Sub loans would have to be:

- o for productive purposes;
- o for agricultural sector, only if for domestic market; and
- o consistent with Moroccan banking laws and regulations.

In line of A.I.D.'s emphasis upon securing maximum participation of private lenders in the Section 108 program, lenders would be free to:

- o Make sub loans to borrowers of their own choosing, subject to the above criteria and at their own risk.
- o Apply terms and conditions of their own choosing to sub-loans.
- o Inform the USG subsequently (but not in advance) of the use of Section 108 funds; borrowers, terms and the conditions. This would be verified annually by an A.I.D. commissioned auditor as well.

Only one master Loan Agreement document would be used, for signature between the U.S. Government and the IFI. The same document would be used in the case of guarantees extended by an eligible IFI, to permit participation by a non-bank IFI.

2. <u>Organizational Structure</u>

The proposed facility is designed to function within the normal lending operation, and according to customary prudent lending criteria applied by the commercial banks. This vehicle would both greatly reduce USAID's administration and monitoring costs, and generate good visibility for the Mission, in that banks are always willing to showcase successful loans. The Section 108 mechanism offers the further advantage of making efficient use of private sector lending resources, as lending staff involved in the program would be paid through margins generated on the loans.

Comparatively little monitoring and oversight infrastructure would be required, beyond the policy making and oversight role to be carried out by the Interagency Policy Group which guides and directs the PL480 process in country, and the audit carried out yearly by the USAID commissioned auditor.

3. Lessons Learned/Key Features for Project Design

Several key features of this project design are of interest, in that they would improve program management and control in other settings where Section 108 lending facilities might be considered. These include the following:

1. The streamlined nature of the loan facility, permitting the lender to make direct drawdowns based upon actual demand, with a minimum of paperwork and administrative expense.

2. The absence of a mechanism specifically tieing the IFI borrowing or terms of repayment to those of individual sub loans. This addresses the reality that there is no real incentive in Morocco for an IFI to borrow Section 108 funds, until it has a sub loan to which it can apply the funds.

3. The precluding in the Loan Agreement between the U.S. Government and the lender, of any IFI borrowing to finance itself generally, rather than engage in a specific lending activity to a sub-borrower.

The most replicable features of this facility for future programming, are the streamlined design of the fund, with accompanying careful controls over disbursement by the USAID financial system and the interbank transfer, and the flexibility which the facility allows for participating lenders. Under the proposed structure, banks only draw down based upon specific creditworthy activities to which they will apply the loans. In turn, USAID and the lenders will operate after the initial six months market testing period, within a funds allocation system based upon actual demand generated through each IFI. This control mechanism offers USAID and participating lenders the further advantage of being able to plan within relatively short disbursement periods (18 months to two years), a hedge against possible fluctuating supply of PL480 commodities over the short to medium term.