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Analysis of Funding Mechanisms For the Small and Micro Enterprise Development Project Egypt

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GEMINI

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Analysis of Funding Mechanisms for the Small and Micro Enterprise Development Project Egypt

by

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EXECUTIVE SUMMARY

The Small and Micro Enterprise Development (SMED) Project of the U.S. Agency for International Development in Egypt was designed to create a system to provide credit and improved business and technical skills to small- and micro-scale enterprises (SMEs). The project, which was approved in September 1988, established two foundations, one in Alexandria and one in Cairo, to carry out the project.

The principal structure of the credit component of the SMED project was the lending mechanism, which involved USAID/Cairo as the supplier of funds, two nonprofit foundations as credit facilitators, and commercial banks to handle the mechanics of the flow of funds. The lending mechanism was designed to deliver credit to small- and micro-scale enterprises in an efficient and effective manner. The structure of the lending mechanism is straightforward, minimizes lending costs, and is easy to manage. The key element in creating the lending structure was the funding mechanism. The design of the funding mechanism took into account several factors including maintenance of value, ease of management, instillation of financial discipline in the foundations, minimizing costs to borrowers, and ensuring sustainability after the end of the project. The funding mechanism selected was a U.S. dollar-denominated collateral account with a right of offset.

The dollar collateral fund has been used as the funding mechanism by the Alexandria and Cairo Foundations for two-and-one-half years. This funding mechanism is working well and all of the participants are satisfied with the operations and mechanics of the fund.

Alternative funding mechanisms that were examined were collateral funds in currencies other than U.S. dollars, guarantee facilities, and disbursing funds to the foundations for direct on-lending to SME borrowers. An analysis of the alternative funding mechanisms indicated that the current dollar collateral fund is the best way to achieve the purposes for which the funding mechanism was designed. None of the other alternatives examined were determined to be as effective or efficient in meeting those objectives. The dollar-denominated collateral fund protects the integrity of the fund against decapitalization due to devaluation, is easy to manage, and ensures the future viability of the program after the end of the project. The last feature is particularly vital as it points to the important role of the foundation in the financial deepening of Egypt's financial system.

The foundations provide a transitional link for the SME sector as it moves from informal to formal financial services. None of the borrowers has access to the formal financial system. The foundations are the means by which the SME sector has access to the commercial banks and entry into the formal financial system. Involving commercial banks in the lending mechanism introduces the borrowers to the formal financial system and teaches commercial banks about the SME sector. The SME borrowers are learning about the discipline of repaying on time. The commercial banks are shedding misperceptions that all SME borrowers are high risk and that the transaction costs associated with SME borrowers are too high. Experience gained with the

SMEs will lead to future borrowers for the commercial banks as the SMEs outgrow the capacity of the foundations to provide them with loan funds.

INTRODUCTION

The Small and Micro Enterprise Development (SMED) Project of the U.S. Agency for International Development in Egypt was designed to create a system to provide credit and improved business and technical skills to small- and micro-scale enterprises (SMEs). The project, which was approved in September 1988, established two foundations, one in Alexandria and one in Cairo, to carry out the project.

Based on the initial successful results of the foundations in Alexandria and Cairo, USAID/Cairo is considering expanding the project to several other cities in Egypt. In assessing the current project and the possible expansion, USAID/Cairo decided to review the funding mechanism. The purpose of the consultancy was to examine the funding mechanism for the project to determine its effectiveness and efficiency. The scope of work for the consultancy is provided in Appendix A.

A two-person team carried out the examination between May 3, 1992 and May 14, 1992, during which time it assessed the current dollar fund and explored alternative funding mechanisms. Interviews were conducted with persons in the USAID Mission, the foundations in Cairo and Alexandria, and commercial banks — both commercial banks participating in the current funding mechanism and commercial banks not part of the funding mechanism. A list of the persons contacted is provided in Appendix B. This report presents the findings and recommendations of the team.

The report is divided into four sections. The first section reviews the objectives of the funding mechanism for the SMED project and looks at the economic picture of Egypt as it relates to this mechanism. The second part of the report assesses the dollar collateral fund that is in place and functioning for the foundations in Cairo and Alexandria. The third section examines alternative funding mechanisms. The last section presents the team's recommendations and conclusions.

SECTION ONE

BACKGROUND

This section reviews the objectives of the funding mechanism for the Small and Micro Enterprise Development Project and looks at the economic picture of Egypt as it relates to the funding mechanism.

PURPOSE OF FUNDING MECHANISM

The funding mechanism designed for the SMED project was a U.S. dollar-denominated collateral fund. The design of this collateral fund sought to address four key issues: sustaining the funding mechanism, minimizing the costs of the lending operations, demonstrating the viability of lending to the SME sector, and teaching financial discipline to the foundations.

- Sustainability. The issue of sustainability dealt with maintaining the value of the funding mechanism during the life of the project and also ensuring the continuation of the foundations after the end of the project. The manner in which the SMED project design team addressed the issue of maintaining the value of the fund is presented below under the economic outlook.

- Minimize Costs. Another aspect in the design of the funding mechanism was to incorporate the commercial banks in the lending operations. The foundations were to focus on facilitating the delivery and management of credit and the commercial banks would handle the funds. The purpose of this arrangement was to significantly decrease the operating costs of the foundations.

- Demonstration. An additional objective in involving commercial banks in the lending operations was to demonstrate to commercial banks that qualified SMEs can be good clients. The aim of the demonstration was not to have commercial banks replace the foundations but to show the commercial banks that SMEs can be bankable clients.

  Commercial banks are not interested in clients (regardless of size) who borrow less than £E50,000, because of the operational costs associated with loans. The niche of the foundations is to assist SME borrowers who do not meet the commercial bank threshold of £E50,000. The average loan size of the two foundations is £E1,400 for microenterprises and £E5,600 for small companies. None of the commercial banks lend to SME borrowers even if the need of these borrowers exceeds £E50,000. This is due to misperceptions about lending to SMEs, including the perception that any lending to SMEs involves high transaction costs and is highly risky. By working with commercial banks, the SMED project would demonstrate that SMEs are responsible borrowers by repaying their loans on time and that as the SMEs outgrow the capability of the foundations to assist them, the commercial banks can provide the financial services to the SMEs. This would enable the SMEs to move into the formal financial sector of the commercial banks.

- Education. A fourth purpose in the design of the funding mechanism for the SMED project was to instill a sense of financial discipline in the foundations. The design used a collateral fund as a guarantee for the loan funds of the foundations instead of giving the foundations a grant and letting them disburse the funds directly to the SME borrowers. Under this design, the foundations pay the commercial banks for their loan funds, which produces an awareness by the foundations of the need to charge commercial rates of interest to the borrowers. The purpose was not to turn the foundations into commercial banks but rather to channel credit to SMEs efficiently. The design was geared to teach the foundations how, in working with the commercial banks, to operate on a businesslike basis.

ECONOMIC PICTURE

In selecting a U.S. dollar collateral fund as the funding mechanism for the SMED project, the design team considered two key factors in maintaining the value of the fund — the effects of devaluation of the Egyptian pound (£E) and the effects of Egyptian inflation. Each factor would negatively affect the value of the collateral fund by decreasing the value of the fund — a process known as decapitalization. By being denominated in dollars and earning interest in dollars, the collateral fund is protected against the effects of a currency devaluation of the £E as well as provided with a hedge against Egyptian inflation. The fund increases in value in relation to the £E, enabling growth of the overdraft account that provides funding for the SME clients.

Design of Collateral Fund

Historically, the £E has depreciated against the dollar. In 1988, when the SMED project was in the design phase, the exchange rate was around £E2.6 to the dollar. One of the reasons for denominating the collateral fund in dollars was to provide protection against erosion of the amount of the overdraft line backed by the collateral fund. Since the establishment of the fund (in 1989, for both the Alexandria and Cairo Foundations), the exchange rate has gone from £E2.6 to the U.S. dollar to the current rate of £E3.3 to the dollar. The current exchange rate has been steady for over a year. As the table below shows, this has been an unusually long period of time for exchange stability of the £E.

TABLE 1

EGYPTIAN EXCHANGE RATES

Date	£E per U.S. dollar
1988	2.60
November-December, 1989	2.73
January-June, 1990	2.76
July-December, 1990	2.82-3.00
February, 1991	3.20
March 1991-May 1992	3.30-3.31

As can be seen, since the creation of the collateral funds, the £E has devalued more than 27 percent against the dollar. That the fund is denominated in dollars has protected the foundations from the effects of devaluation of the £E. In effect, the dollar-denominated fund provides leveraging for the foundations by increasing the amount of pounds available for lending.

Outlook for the £E Exchange Rate and the Collateral Fund

Discussions with economists and bankers during the examination of the funding mechanism revealed a unanimous feeling that the £E is overvalued and due for devaluation. At the same time, however, no one is certain how long the current stability will last. Estimates on how long the exchange rate will remain stable (with a possible fluctuation of 1 percent) range from August 1992 to the end of 1992 to the spring of 1993. Presently the elements for exchange rate stability are in place. These include historically low dollar deposit interest rates, high £E deposit interest rates, and a satisfactory level of Egypt's net foreign exchange reserves — in excess of $9 billion. Should there be changes in any of these elements, there will be growing pressure to devalue the £E.

Several factors indicate that the stability of the £E may last only through 1992. The factors propping up the £E are:

- Interest rates. A low U.S. deposit dollar interest rate combined with a high £E deposit interest rate. This has resulted in an influx of dollars switching into pounds. However, once dollar deposit interest rates begin to rise as the United States comes out of its recession, the demand for dollars is expected to increase.

- In August 1992, import restrictions will be lifted as part of the liberalization program. The lifting of import restrictions combined with the nascent privatization program is expected to result in an increased demand for dollars for imports and investment.

- There is tremendous disparity between the internal purchasing power of the £E (as reflected by inflation) and the exchange rate. The steady £E exchange rate for the past 12 months is an anomaly. The £E exchange rate does not reflect the amount of inflation in Egypt which is estimated to be over 25 percent during the same period of time.

- The trade deficit of Egypt is increasing rapidly. The overvalued £E has made Egyptian exports expensive compared to exports from other countries. The trade deficit serves to apply pressure for a devaluation to increase the demand for exports and reduce the trade deficit.

- Under the International Monetary Fund (IMF) program, Egypt has embarked on a two-fold course of economic stabilization and economic reform. The stabilization program (stabilizing interest rates, exchange rates, and prices), is well under way and appears to be successful. To achieve economic development, Egypt needs to implement economic reforms. These reforms include such elements as establishing a well-defined privatization program, laying the foundation for a capital market, and improving the investment climate. Many of the laws that must be in place by the end of the current Egyptian fiscal year (ending June 30, 1992) for the underpinning of the IMF stabilization program are a long way from being promulgated. These include capital market, banking, tax, labor, and tenant-landlord laws.

The slow pace in achieving economic reform combined with high Egyptian inflation rate, the rising Egyptian trade deficit, and the emergence of the U.S. economy from the recession (and consequent rising U.S. deposit interest rates) will exert immense pressure on the £E to be devalued. It is estimated that over the next three years, the £E will be devalued between 35 and 50 percent. This argues strongly for keeping the collateral fund in dollars to maintain the value of the overdraft checking line and protect against decapitalization of the fund due to devaluation.

SECTION TWO

U.S. DOLLAR COLLATERAL FUND

This section analyzes in more detail the funding mechanism of the SMED project. A description of the operation of the fund is followed by the experience of the Alexandria and Cairo Foundations with their funds. The last two parts will explore the benefits of the collateral fund.

OPERATION OF THE LENDING MECHANISM

The lending mechanism of the SMED project involves four actors — USAID/Cairo, which provides the money for the collateral fund; commercial banks, which hold the collateral fund and provide money to the foundations; foundations, which are credit facilitators; and SME borrowers, who are the ultimate beneficiaries.

Every month, the foundation submits a lending report to USAID/Cairo. The report shows the amount of funds in the collateral fund, the amount of loans outstanding, and the projected lending activity for the next 90 days. Based on the lending activity projected by the foundation, USAID/Cairo disburses a dollar check to the foundation. The foundation deposits the check into a dollar interest bearing account with an Egyptian commercial bank. This dollar account is the collateral fund. The interest generated on the account is reinvested into the same account.

The collateral fund serves to guarantee the commercial bank in establishing an overdraft checking account in pounds for the foundation. The amount of funds that the foundation can draw from the overdraft checking account is equivalent to the funds in the guarantee account as determined by the prevailing exchange rate between dollars and pounds. The foundation identifies qualified SME borrowers and disburses funds by means of a check drawn on its overdraft account with the commercial bank. Repayments by the SME borrowers are made through the commercial bank and deposited to the overdraft account of the foundation. The figure on the next page shows the flow of funds between the different actors in the lending mechanism.

The funding mechanism is called a "collateral account with the right of offset." The commercial bank can draw on the collateral account only if there is a default. To date, neither of the foundations has experienced any defaults.

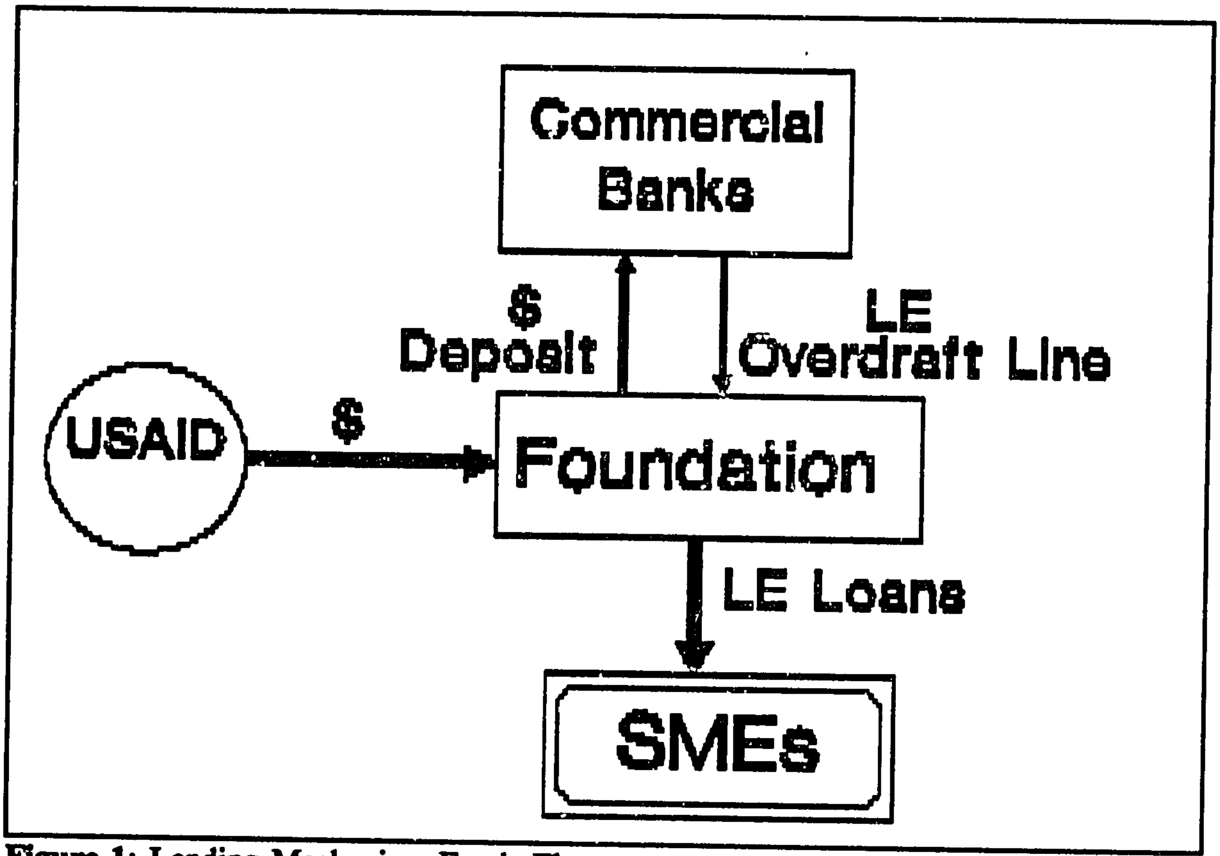

Figure 1: Lending Mechanism Funds Flow

The structure of this lending mechanism is straightforward, minimizes lending costs, and is easy to manage. The interest accruing on the outstanding balance of the checking account is calculated daily by the commercial bank with the total charged to the foundation at the end of the month. The loan repayments of the SME borrowers are paid directly to the commercial bank and deposited into the foundation's checking account, which reduces the overdraft line and hence the interest charges to the foundation.

On a daily basis, the commercial bank faxes the foundation a list of each loan repayment received. The information provided by the bank includes the name of the SME borrower who made the loan repayment, the identity number of the borrower, and the amount of the payment.

The experience of the banks is that this funding mechanism is relatively easy to administer. Although the banks handle hundreds of the foundation's clients daily, as far as the commercial bank is concerned, it is dealing only with the foundation, because loan disbursements and loan repayments flow through the same account.

This lending mechanism allows the foundation to be credit facilitators, focusing on identifying the borrowers, monitoring loan payments, and following up on delinquent borrowers. The foundation conducts its activities without having to handle any funds directly. The mechanics of handling the funds and the collection of the repayments is handled adequately by the commercial bank.

Under the SMED project, USAID/Cairo has allocated $16 million ($8 million for each foundation) for the collateral fund. The operation of the lending mechanism is the same for both foundations. The experience of each foundation with the funding mechanism follows.

Alexandria Businessmen's Association

In 1989, the Alexandria Businessmen's Association (ABA), a nonprofit foundation, established the Small and Micro Enterprises Project as an intermediary financial institution to provide credit to SMEs in Alexandria. The foundation began disbursing loans in January 1990. Since beginning operations, ABA has established collateral funds with two commercial banks. The relationship with the Export Development Bank of Egypt dates back to late 1989. In March of this year, a relationship was begun with the Alexandria Maritime and commercial bank. In addition, ABA has begun using the National Bank of Egypt to assist in loan collections and expects to establish a collateral fund with the bank later this year.

USAID/Cairo disbursements to the collateral fund for the ABA and interest earned on the dollar deposits in the fund through the end of 1991 are as follows:

TABLE 2

ABA COLLATERAL FUND
(US$ 000)

	1990	1991	1992	TOTAL
Disbursements to collateral fund	1,311	854	425	2,590

Source: Small and Micro Enterprise Development Project Midterm Evaluation, March 1992 and ABA

Of a total allocation of $8 million for collateral funds, the ABA has received $2.59 million, or about 30 percent, as of the time of this assessment. Current placement of the funds is as follows:

Commercial Bank	Amount US$ (000)
Export Development Bank of Egypt	$2,200
Alexandria Maritime and commercial bank	390
TOTAL	$2,590

The interest rate the ABA receives from the banks on the dollar deposits in the funds is currently around 4 percent, but has averaged 6 percent during the project.

Interest charges for the ABA on the overdraft account are currently the same for both banks, 19 percent per annum on the outstanding balances. This compares with the banks' current lending rate to its clients of around 22 percent per annum. The favorable interest rate for the ABA on the overdraft account is due to the collateral fund, which eliminates risk to the commercial banks in providing funds to the ABA. Also, because of the collateral fund, the banks do not charge the ABA any additional fees or commissions. An added free service provided by the banks is sending the ABA daily faxes detailing the activity in the overdraft checking account.

Currently the ABA charges SME borrowers a nominal annual interest rate of 22 percent on the original loan amount, with no additional fees. With an average loan term of seven months, the effective interest rate to SME borrowers is around 36 percent per year.[1]

Egyptian Small Enterprise Development Foundation

The Egyptian Small Enterprise Development foundation (ESED) is a nonprofit foundation that was established in 1989 to provide credit to SMEs in Cairo. The foundation started disbursing loans in November 1990. ESED has developed collateral fund accounts with three commercial banks in Cairo. ESED has had a relationship with the Export Development Bank of Egypt for two years, with National Bank of Egypt for one and one-half years, and has just started an account with Banque du Caire.

USAID disbursements to ESED for the collateral funds total $1.428 million as outlined in Table 3.

[1] The nominal interest rate is the stated rate of interest of the financial institution. The effective interest rate is the actual rate of interest being charged. To properly compare interest rates, it is necessary to look at the effective interest rate.

TABLE 3

ESED COLLATERAL FUND
(US$ 000)

	1990	1991	1992	TOTAL
Disbursements to collateral funds	136	892	400	1,428

Source: Small and Micro Enterprise Development Project Midterm Evaluation, March 1992 and ESED

Like the ABA, ESED has an allocation of $8 million for collateral funds. As of the time of this assessment, ESED has received $1.428 million, or about 18 percent of the total allocation. Current placement of the funds is as follows:

Commercial Bank	Amount US$ (000)
Export Development Bank of Egypt	$ 697
National Bank of Egypt	518
Banque du Caire	213
TOTAL	$1,428

The interest rate ESED receives from the banks on the dollar deposits in the funds currently averages 4 percent per annum. As with the ABA, ESED has averaged interest income on the U.S. dollar deposits of 6 percent during the project.

ESED has discovered that the collateral fund is sufficiently of interest to commercial banks that the banks are willing to offer preferential rates of interest on the overdraft checking account. There is a significant difference among the interest rates charged by the three banks as follows:

	Interest rate charged ESED on overdraft checking account
Export Development Bank of Egypt	19.5% p.a.*
National Bank of Egypt	17.0% p.a.
Banque du Caire	17.0% p.a.

* In addition to the interest rate, Export Development Bank charges £E3 for each daily fax to ESED on its overdraft position and £E1 for each loan repayment made by the borrower. The other two banks do not charge ESED any additional fees.

Because of the sizable disparity in the interest rates and fees charged by the Export Development Bank of Egypt, ESED plans to either negotiate a more favorable rate in line with its other two banks or transfer the collateral fund to another bank.

ESED charges its SME borrowers interest based on the original loan amount, not the declining balance of the loan, and charges no additional fees. Although the nominal annual rate of interest is about 21.6 percent, the average length of ESED's loans of seven months results in an effective annual interest rate of around 37 percent.

FOUNDATIONS AND THE COLLATERAL FUND

Both the ABA and ESED were satisfied with the funding mechanism involving the dollar collateral fund. They had no interest in changing to any other type of funding mechanism. The fund presented many advantages that could not be matched by an alternative funding mechanism. Advantages cited are listed below.

- Maintenance of value. The foundations have a stable source of capital to guarantee their overdraft line from commercial banks — this capital will not devalue and increases as interest earned on dollar deposits is capitalized.

- Long-term viability for the foundations. It is vital that the foundations continue their activities after USAID/Cairo withdraws from the project. The foundations act as an essential gateway for the SME sector to connect with the formal financial system. As borrowers graduate from the lending capacity of the foundations to the commercial banks, a new set of borrowers will continue to emerge requiring assistance to gain access to the formal financial markets. The structure of the funding mechanism provides permanent equity capital to the foundations, which will continue to use the collateral fund to facilitate SME access to credit after the project assistance completion date (PACD).

- Lower operational costs. The foundations work synergistically with the commercial banks, taking advantage of the branch network of the banks. By having the commercial banks handle the funds and the collection process, the foundations are saved from having to create loan collection centers and to establish mechanisms for safely handling money. This in turn allows the foundations to concentrate on loan generation, monitoring, and follow-up.

  The lending mechanism supported by the collateral fund allows the foundations to pay only for the funds in use. The foundations avoid having to manage the flow of funds.

- Competitive interest rates. The foundations receive a competitive rate of interest from the commercial banks, because the banks have no risk on their loans to the foundations. The foundations are receiving the most competitive interest rates on the dollar deposits as well as being charged the most competitive interest rates on the overdraft checking account. This in turn enables the foundations to make credit available to their SME borrowers at reasonable rates.

Aside from obtaining a competitive interest rate, the fund also enables the foundations to bargain with the commercial banks for additional services. ESED officials said that they intend to shift their collateral funds to commercial banks that not only provide competitive interest rates but also show a willingness to consider seriously the leveraging the collateral funds in the future.[2]

- Protection from social pressure. The structure of the funding mechanism protects the foundation from pressure from agencies of the Government of Egypt to lower the interest rate. If the foundation was to disburse the funds directly, it would come under heavy pressure to lower the interest rates charged the SMEs as the perception is that the funds received from USAID/Cairo are cost-free to the foundation. With the collateral fund, the foundation can account for the funds received from USAID/Cairo. Paying interest to the commercial banks on the overdraft line, the foundation has a cost of funds that is included in its lending rate.

- Ease of management. The commercial banks handle the mechanics of the loan repayment process and all of the funds. In addition, the commercial banks provide the foundations with daily reports on account activity including loan repayments.

COMMERCIAL BANKS AND THE COLLATERAL FUND

The commercial banks participating in the funding mechanism were satisfied with the structure and operations of the collateral fund. They had no complaints and preferred the US dollar collateral fund to other funding alternatives. Benefits mentioned by the commercial banks are noted below.

- Risk-free lending. The collateral fund provides the commercial banks with a guarantee against any losses on the overdraft account, which is the source of funds the banks provide to the foundations for lending to SMEs.

- Source of funds. The dollars in the fund can be used by commercial banks for a variety of uses including financing imports, establishing letters of credit, paying collection drafts drawn on their customers in dollars, or investing in longer-term dollar instruments for a higher yield. All of these uses provide a greater source of income than the interest paid to the foundations.

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[2] Leveraging the collateral funds means that the commercial banks would be willing to increase the amount of the overdraft line in excess of the amount covered by the collateral fund, thus putting commercial bank funds at risk.

- Interest income. Credit ceilings imposed by the Central Bank limit loans of public and private banks to public sector institutions. The low demand in borrowing from the private sector has resulted in the commercial banks being flush with pounds and few options to place the pounds other than Egyptian treasury bills. Interest earned by the commercial banks on the overdraft line to the foundations, while only marginally profitable is still desirable.

  Banks participating in the funding mechanism reported marginal profits on the transactions with the foundations. The banks make narrow spreads between their cost of funds and the interest charged the foundations. One bank reported monthly profits of only £E1,200 (about US$350). The commercial bank looks at the relationship as serving other purposes such as social responsibility and the possibility of future clients.

- Social responsibility. The image of the commercial banks is enhanced with the Government of Egypt and the public by aiding the economic development of the country.

- Future clients. Because of the collateral fund, commercial banks are willing to have small and medium clients of the foundations repay them directly. The foundations are thus introducing the SMEs to the banks and paving the way for them to graduate to be bank customers.

  As the credit requirements of the SME clients of the foundation grow, and the foundation is not able to meet the needs, these borrowers can become bankable credit and savings clients of the commercial bank. The ABA requires all customers with a credit line of £E5,000 (about US$1,500) or greater to open an account with the commercial bank. (In most cases this is a checking account but in some instances savings accounts are opened.) Although a small measure, this is the start of financial deepening.

Several commercial banks participating in the funding mechanism have indicated a willingness to leverage the collateral fund, in other words, lend their own funds above the amount of pounds covered under the collateral fund. The commercial banks have been impressed by the absence of loan defaults in the foundations' experience to date. The ABA reported that once in a while the Alexandria Maritime and Commercial Bank has extended its overdraft account with the ABA up to 1.5 times. In general, however, the commercial banks are still reluctant at this time to leverage the collateral fund. Based on the continued success of the lending program of the foundations, commercial bank officials stated they would be willing to leverage 1.5 to 2 times the amount of the collateral fund. It may be a further one or two years before the commercial banks feel sufficiently satisfied with the track record of the foundations to put their own funds at risk.

Although many of the advantages cited by the foundations and the commercial banks are applicable to a collateral fund, whether denominated in pounds or dollars, the following points are applicable only to a U.S. dollar-denominated collateral fund:

1. The value of the fund is maintained at a lesser cost to the SME borrower. It is also less management intensive for USAID/Cairo and for the foundations; and

2. The commercial banks have a greater demand for dollars than for pounds. As a direct result of this, the foundations enjoy a lower rate of interest on the cost of funds from the commercial bank, which is passed on to the SME borrower.

SECTION THREE

ALTERNATIVE FUNDING MECHANISMS

The alternative funding mechanisms to a U.S. dollar collateral fund can be grouped into three categories: collateral funds (in currencies other than the dollar), guarantee facilities, and dispersing the funds to the foundations for on-lending. Each of these alternatives is presented below with pros and cons of each alternative compared to the current fund. In the conclusion, we examine the effect of the alternative on the four key players in the lending mechanism — USAID/Cairo, the commercial banks, the foundations, and the SME borrowers.

COLLATERAL FUND

This alternative involves two options: a collateral fund in Egyptian pounds or a collateral fund in a hard currency other than the U.S. dollar.

Collateral Fund Denominated in Egyptian Pounds

This would be placed with a local commercial bank that in turn establishes an overdraft account for the foundation.

Pros

- Higher deposit rate on the collateral fund.
- Lending mechanism does not require foreign currency.

Cons

- Although the current financial yield of 18 percent per annum on £E deposits appears to be higher than the U.S. deposit rate of 4 percent per annum, because the rate of inflation is over 18 percent (in the range of 20-25 percent), the collateral fund would be decapitalized. When the inflation rate exceeds the deposit rate of interest, the result is a negative real interest rate. To maintain the value of the collateral fund, inflation must be taken into account. Maintaining the value of the collateral fund will be either management intensive (to constantly calculate the rate of inflation and "top-up" the fund for the effect of inflation as well as calculating the interest lost), or too costly for the borrowers (as the borrowing rate would increase dramatically to include the expected cost of inflation over the period of the loan).

The typical way of maintaining the value of the fund is through indexing the fund to the exchange rate. This method does not take inflation into account. In the case of Egypt, which has a high inflation rate, the real value of the fund is decapitalized. An example may illustrate this point.

Assume, over the course of a year, that the inflation rate in Egypt is 25 percent and that the £E is devalued by 10 percent relative to the dollar. In this example, under traditional methods of maintaining the value of the fund, the collateral fund would be increased by 10 percent (reflecting the devaluation of the £E). However, because of the inflation rate of 25 percent, the real value of the fund would be decapitalized by 15 percent. To maintain the true value of the collateral fund, the fund would have to be increased by the amount of Egyptian inflation. A difficulty in calculating the effect of inflation is that few people can agree on the level of inflation in Egypt for a given year.

Another point about maintenance of value is what happens when USAID/Cairo concludes the project. If a satisfactory mechanism could be developed for maintaining the value of the collateral fund by topping-up the fund, at PACD there is no one to maintain the value of the collateral fund and it will decapitalize.

This element could be overcome by having the foundation charge higher interest rates than it currently does to cover the negative real interest rate. In the current economic environment of Egypt, the interest rates to the SME borrowers would increase significantly (to over 50 percent). The significantly increased borrowing costs to the SMEs might price the cost of borrowing from the foundation out of the market, meaning there would be little demand for the funds as compared to the price of funds from the informal sector. This would leave the marketplace without a transitory financial institution and cut off the SMEs from access to the formal financial sector.

- Truly free exchange rates take inflation into account. In the current Egyptian financial environment, there is a lack of financial instruments to protect against the effects of inflation. To cover inflation, the foundations would need higher-risk financial instruments.

- With a collateral fund denominated in pounds, the commercial banks have said that the overdraft lending rate charged to the foundations would be higher. At current rates, the commercial banks would charge the foundations around 22 percent for the overdraft rate as opposed to the 17-19.5 percent rates presently charged. The foundation would pass on the higher overdraft lending rates to the SME borrower, thus increasing the cost to the ultimate beneficiaries of the project.

- Commercial banks are flush with pounds due to the lack of demand for pounds (partly due to high lending interest rates). There is a limited use for pounds and the tight profit margins would likely lead the commercial banks to charge the foundation for services that are currently provided for free. The foundation would pass on the increased service charges by the commercial banks to the SME borrower, and thus the borrowers would pay a higher interest rate for borrowed funds than under the U.S. dollar collateral fund.

Conclusion

Establishing a collateral fund in pounds presents an apparent advantage over a collateral fund in dollars, in that the foundation could earn a higher interest rate on the deposits resulting in additional income for the foundation; in other words, currently, 18 percent for pounds against 4 percent for dollar deposits. However, in real terms there would be a loss as the 18 percent deposit rate would not compensate the foundation for the 20-25 percent rate of inflation. The result is a negative real interest rate and consequent decapitalization of the £E collateral fund.

This can be overcome through either of two means, both of which have a high cost. The collateral fund could be continuously topped up so that it maintains the value against inflation. This method would be highly management intensive. The other way is to have the foundation maintain the value of the fund by including the expected rate of inflation in its cost of funds. This method would substantially raise the cost of borrowing to the SMEs, perhaps prohibitively, with the result that the foundations would not lend to the SME sector.

If the collateral fund is to be topped up to maintain the value against inflation, this will result in more management costs for USAID/Cairo to calculate the amount of decapitalization of the collateral fund due to inflation. If the value of the fund is to be maintained through higher interest rates, USAID/Cairo and the foundation will need to closely monitor and continually adjust interest rates to cover expected rates of inflation.

The commercial banks could accept a collateral fund denominated in pounds but would charge the foundations more for the overdraft line. The commercial banks prefer a collateral fund denominated in dollars.

This alternative is not attractive to the foundations. Their main concern is with maintaining the value of a £E collateral fund. The dollar collateral fund maintains the value against devaluation with no management costs. This alternative is also not attractive to the SMEs as they would be charged a higher borrowing rate than under the dollar fund.

Collateral Fund Denominated in a Hard Currency (Other Than the U.S. Dollar)

The collateral fund (denominated in Deutsche Mark, Yen, Eurocurrency, Swiss Franc, French Franc, or £Sterling) could be placed in a local commercial bank that in turn could establish an overdraft account for the foundation. A slight variation on this alternative would be to allow the foundations to continuously swap the currencies of the fund in an effort to obtain the maximum deposit rates for the fund.

Pros

- Higher deposit rate on the collateral fund.

Cons

- The fluctuation of currencies could decapitalize the collateral fund. The following example demonstrates the risks involved. At today's interest rates, the U.S. dollar one-month deposit is about 3 7/8 percent while the Deutsche Mark (DM) one-month rate is about 9 7/8 percent. Although on the surface it would appear to be more advantageous to convert from dollars to DM and place the funds in a one-month deposit yielding 6 percent more, there is a possibility that the DM may devalue against the dollar. The key factor will be if the devaluation is less than 6 percent over the one-month period. If the DM devalues more than 6 percent against the dollar over the month, the collateral fund will be decapitalized.

Conclusion

Prudent banking practices indicate that if the collateral fund is to be established in a hard currency, the currency to be selected should be the U.S. dollar. The dollar is the cross currency between any currency and the £E; in other words, to move between any hard currency and pounds it is necessary to go through dollars.

Assuming that the foundation makes the decisions on which currency to be used for the collateral fund as well as the length of the deposit periods, USAID/Cairo will have the same role as it does under the current fund.

For the commercial banks, the preferred currency for a collateral fund denominated in a hard currency is dollars, as the dollar is the cross currency for all transactions with the £E.

Using another currency is not attractive to the foundations as they do not have the expertise to make the currency decisions. They prefer to concentrate on credit facilitation and not engage in foreign exchange trading. The SME borrower would be little affected under this system.

GUARANTEE FACILITY

There are two options for establishing a guarantee facility to support the operations of the foundations.

1. **USAID/Cairo provides a dollar guarantee to a local commercial bank.**

The local commercial bank would establish an overdraft account for the foundation.

2. **USAID/Cairo provides a dollar guarantee to a U.S. bank, which then provides a guarantee to a local commercial bank.**
The local commercial bank would establish an overdraft account for the foundation.

Both of these options have similar pros and cons.

Pros

- Guarantee facility maintains value against depreciation of the £E.

Cons

- The foundation earns no interest income, which it currently receives on deposits with commercial banks.

- Commercial banks would charge the foundation a higher interest rate for the overdraft account. At current rates, the commercial banks would charge the foundations around 22 percent for the overdraft rate as opposed to the 17-19.5 percent rates presently charged. The foundation would pass on the more expensive overdraft lending rates to the SME borrower, thus increasing the cost to the ultimate beneficiaries of the project.

- USAID/Cairo would charge the commercial banks a guarantee fee (if not USAID/Cairo then certainly the U.S. banks), which would be passed on to the foundation and finally the SME borrower.

- The commercial banks have indicated that they prefer to have a collateral account physically in their bank rather than rely on a guarantee mechanism. With a collateral account, the bank can debit the collateral account whenever there is a missed loan repayment instead of having to go through the mechanics of getting repaid through a guarantee (which the commercial banks view as resulting in bureaucratic delays).

- Using a guarantee to back up the foundation's loans will necessitate setting up a reimbursement mechanism. This may incur increased USAID/Cairo management effort.

- There is no long-term sustainability of the project. The viability of the foundation and the project would be threatened at PACD.

- Because the guarantee is less desirable than a collateral account, the foundations have less clout with the commercial banks in being treated as a favored client.

- With regard to the SMED project, it should be noted that under the project agreement with the Government of Egypt, USAID is to capitalize two foundations. A guarantee facility would not transfer funds and would thus not meet the terms of the project agreement.

Conclusion

In this alternative, no funds are actually transferred to the foundation. The only reason for considering using this option is if USAID/Cairo has alternative needs for U.S. dollars. USAID/Cairo could leverage its funds by setting aside a small portion of the amount guaranteed, based on the anticipated loan loss rate of the foundation. However, in the event of catastrophic losses, USAID/Cairo would be liable for the entire amount guaranteed.

For this alternative, USAID/Cairo would have to establish a reimbursement mechanism and any reimbursements to the commercial bank would involve USAID/Cairo management time. This compares to the present arrangement under the dollar collateral fund where the commercial bank simply debits the collateral fund in the event of a loan default. It should also be noted that USAID/Cairo does not have authority to issue guarantees.

The commercial banks prefer a collateral account to a guarantee facility. Establishing and implementing the guarantee facility would make this alternative the most bureaucratic in time, effort, and expense.

The foundation's main concern with this alternative is what happens to its support after the end of the project. The SME borrower faces increased borrowing costs from the foundation if this alternative is selected.

DISBURSEMENT OF FUNDS TO THE FOUNDATION FOR ON-LENDING

USAID disburses pounds directly to the foundation, which on-lends the funds. (NOTE: In this alternative the foundation essentially moves from performing a credit processing function to a banking function.)

Pros

- The foundation does not have to pay the commercial bank for the overdraft checking account.

Cons

- The foundation earns little interest income on deposits with the commercial bank compared to the interest income earned from the collateral fund.

- Setting up an organization for direct on-lending of the funds incurs greater operational costs for the foundation, particularly for establishing a structure for collection of loan repayments and an accounting system.

  Under the current arrangement with the commercial bank, the foundation handles virtually no funds. The foundation receives a check from USAID, deposits the check with a commercial bank, disburses funds by a check drawn on the commercial bank, and the borrowers repay the commercial bank. The commercial bank provides the foundation with a daily report on the activities of the account. The foundation incurs minimal operating costs by relying on the bank to handle the banking mechanics of lending and collection. This arrangement allows the foundation to concentrate on selecting borrowers, monitoring their record of repayment, and following up on any problems. Having the foundation take o the banking mechanics may burden the foundation such that it is less able to perform the follow-up activities crucial to a well-functioning credit system.

- The foundation would come under social pressure to decrease the interest rate charged to the SME borrowers because outsiders would incorrectly view the funds received by the foundation as having no cost and consequently pressure the foundation to lower its lending rate.

- To preserve the value of the pounds received from USAID/Cairo, the foundation's lending rate would consist of three elements: inflation, the increased cost of operations, and reserve for bad loans. The ensuing lending rate would be substantially higher than the rate under the current dollar collateral fund, perhaps prohibitively higher, resulting in SME borrowers not having access to loans. The loan fund would devalue in the long run unless the lending rate charged by the foundation to the SME borrowers incorporated inflation. A devalued loan fund would undermine the objective in providing credit to SME borrowers.

Conclusion

This alternative is a significant departure from the original intent of the role for the foundation. The foundation would shift from a role of a credit facilitator to that of a lender. In its current structure, the foundation has additional tasks of providing training and technical assistance to the SME. The major effect of this alternative is to turn the foundation into a non-deposit-taking bank. It will also sharply increase the operational costs of the foundation in having to establish mechanisms for the safe handling of money. This may cut into the ability of the foundation to provide the other services.

USAID/Cairo's role in this alternative is limited to disbursement of the funds.

The commercial banks do not play an active role in this alternative.

The foundations have no desire to become banking institutions. They prefer to be credit facilitators and leave the banking operations to the banks. The substantially higher lending interest rates, which would result from this alternative due to operational and inflationary costs, indicate that this alternative is not as efficient as the present dollar fund in delivering credit to SMEs.

This is the least favorable alternative for the SME borrowers. Under this option, the SME borrowers will have the highest borrowing rate and the cost of borrowing from the foundation might become too expensive, thus denying SME borrowers access to formal credit.

SECTION FOUR

RECOMMENDATIONS AND CONCLUSIONS

Based on a review of the funding mechanism in use under the SMED project and an evaluation of several alternatives, it is recommended that the current dollar-denominated collateral fund be retained for the current foundations as well as be used in any expansion of the project. The recommendation is based on the following points:

- The rationale for creating a dollar-based collateral fund was both to protect the integrity of the fund as well as help ensure the future viability of the foundations. The current dollar collateral fund is practical and is working smoothly. It is the best system to meet the objectives for creating the collateral fund. Furthermore, the current system is both efficient and not management intensive. None of the other alternatives examined was determined to be as effective or efficient in meeting the objectives of the collateral fund.

- One of the key arguments for continuing with the current system is that it is working well and none of the participants are dissatisfied with it -- not the foundations, not the commercial banks, not the SME borrowers.

  -- The foundations are very happy with the present system. There is clear agreement by both foundations that the present system works well and meets their needs. The foundations could envision no better alternative system and saw no reason to change the current arrangement.

  -- The commercial banks participating in the current lending mechanism are satisfied with the operations of the fund. They feel that the present mechanism is preferable to alternative systems. Of the alternative funding mechanisms, the commercial banks have a strong preference for a collateral account. Furthermore, given a choice of currencies in the make-up of the collateral account, the commercial banks prefer dollars.

  - The current collateral fund arrangement offer the most competitive interest rate for the SME borrower. Each of the other alternatives examined would result in higher borrowing costs for the SMEs.

- The current collateral fund is the least management intensive compared to the other alternatives examined.

We strongly recommend the retention of the present funding mechanism. In particular, the current system should remain intact for the two existing foundations, ABA and ESED. The system is in place, is working smoothly, and all parties are pleased with the arrangements.

Other conclusions reached as a result of the assessment are reviewed below.

- The commercial banks participating in the current lending mechanism are making minimal profits on the transactions with the foundations. The foundations receive the most competitive interest rate on their deposits and are charged the most competitive interest rate on the overdraft account.

- The £E is overvalued. There is consensus among bankers and economists that the £E exchange rate will weaken. The steady £E exchange rate for the past 12 months is an anomaly reflecting the temporary wide difference between dollar interest rates and interest rates on Egyptian tax-free treasury bills. Devaluation may come as soon as the end of 1992.

  The current stability of the £E should not be taken as a sign that the dollar collateral fund is not necessary. Prudent banking practices indicate that to protect the future value of the collateral fund from being decapitalized, resulting from the devaluation of the £E and inflation, the collateral fund should remain denominated in dollars.

- The combination of the foundations working with the commercial banks is more cost-efficient in channeling credit to the SME sector than arrangements whereby commercial banks lend directly to SMEs or foundations are converted into commercial banks.

- The foundations act as an essential gateway for the SME sector to connect with the formal financial system. As borrowers graduate from the lending capacity of the foundations to the commercial banks, a new set of borrowers will continually emerge requiring assistance to gain access to the formal financial markets. The structure of the funding mechanism provides permanent equity capital to the foundations, which will continue to use the collateral fund to facilitate SME access to credit after the end of the project.

APPENDIX A

SCOPE OF WORK

SCOPE OF WORK

Small and Micro Enterprise Project (263-0212)

USAID/Cairo has been supporting a project to provide financing and some ancillary support to small (6-15 employees) and micro (1-5 employees) enterprises in the metropolitan areas of Cairo and Alexandria through two private, non-profit "foundations". The two organizations are the Egyptian Small Enterprise Development Foundation (Cairo) and the Alexandria Businessmen's Association (Alexandria). End-use lending began in Alexandria in January 1990 and in Cairo in November 1990. To date, over L.E. 19 million (US$ 6 million) has been extended in nearly 9,000 loans. No default has been experienced to date with late payments of less than 3% of the portfolio. Given the success of the project, USAID is considering expanding the project to other urban areas of Egypt, but desires the services of a banking expert to review the current financial arrangements among USAID, the foundations, and the local banks.

Funds are provided by USAID to the two foundations. The foundations are placing the funds in local banks in a "collateral account with right of offset". The funds provided to the foundations are denominated in U.S. dollars, which acts as a guarantee for a credit line in local currency. The foundations, utilizing their credit line(s), extend loans to small and micro entrepreneurs, marking up the interest rate on the credit line in order to cover their expenses. The foundations also carry out the necessary tasks of new client identification, generating the loan documentation, and supervising the borrowers to ensure timely repayment.

The banking experts will be required to:

1. Review the current financial arrangements among USAID/Cairo, the foundations, and the local banks. This review should examine the effectiveness and appropriateness of the procedures, mechanisms, terms, and conditions that exist.

2. Review the costs and returns to the foundations, participating banks, and USAID of alternative financial arrangements, such as: the use of a collateral account with right of offset (local currency or U.S. denominated), or the provision of local currency directly to the foundations to be utilized as loan capital. It is expected that the banking expert will hold extensive interviews with the foundations, local banks and relevant USAID/Cairo personnel.

3. Provide detailed descriptions of alternative financial arrangements that could be applied with an analysis of potential strengths and weaknesses of each approach, and recommend to USAID/Cairo the preferred arrangements.

4. Prepare a report that describes detailed rationale, findings, and recommendations. Present major findings and recommendations to USAID management.

This assignment is meant to be completed within four person weeks. The Mission requests either one person for four working weeks or two people working for two working weeks.

APPENDIX B

PERSONS CONTACTED

APPENDIX B

PERSONS CONTACTED

USAID/Cairo

Hank Bassford	Mission Director
Jeffery A. Malick	Program Office
Samuel L. Skogstad	Chief Economist
Randall Parks	Evaluation Officer
Timothy Hammann	Deputy Director, Office of Finance and Investment
Karl F. Jensen	Contractor, Office of Finance and Investment
Magdy S. Khalil	Project Officer, Office of Finance and Investment
Robert Kirk	Project Officer, Office of Finance and Investment

Alexandria Businessmen's Association (ABA)

Mohamed Ragab	Chairman and Executive Director
Ali Orfi	Member of Executive Committee

Small and Micro Enterprises Project (Alexandria)

Nabil A. Elshami	Executive Director and Member of ABA Executive Committee
Ezz El Sharkawi	Technical Advisor

Egyptian Small Enterprise Development Foundation (Cairo)

Mohamed Abdel-Aziz Hosni	Executive Director
Sayed M. Hassanein	Technical Advisor
Ahmed Mokhtar	Finance and Administrations Manager

Urban System, Inc.

Robert G. Blayney	SMED Project Backstop Officer

Export Development Bank of Egypt (Alexandria)

Youssef K. Moustafa	Manager, Credit and Marketing Department

Bank of Alexandria (Alexandria)

Abdel Kader Salem	Senior Executive General Manager
Mohamed Bakr	Deputy Credit Manager

Credit Guarantee Corporation for Small Scale Enterprises

Ahmad Abdel Salam Zaki	Chairman and Managing Director
Medhat Hassanein	Consultant/Economist

Arab International Bank (Cairo)

Omar Abdel Halim	Deputy General Manager

National Bank of Egypt (Cairo)

Mahmoud M. Khalil	Vice General Manager, Credit Sector

Suez Canal Bank (Cairo)

Mostafa Hablas	General Manager
Mohamed M. Shehata	Assistant General Manager

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42. "Evaluation of the Micro and Small Enterprise Development Project (MSED) in Bolivia." William Fisher, Jeffrey Poyo, and Ann Beasley. GEMINI Technical Report No. 42. June 1992. $10.60.

43. "Analysis of Funding Mechanisms for the Small and Micro Enterprise Development Project, Egypt." Kenneth J. Angell and John M. Porges. GEMINI Technical Report No. 43. June 1992. $3.80.

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Special Publications:

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*2. *Financial Management of Micro-Credit Programs: A Guidebook for NGOs*. Robert Peck Christen. ACCION International. Special Publication No. 2. 1990. $19.00

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