124017

BY THE U.S. GENERAL ACCOUNTING OFFICE

# Report To The Administrator Agency For International Development

# AID's Management Of The Housing Guaranty Program


Worldwide economic conditions have adversely affected operations of AID's Housing Guaranty program. Some countries have been consistently in arrears on their loans and some have stopped participating in the program due to economic problems. The debt reschedulings of developing countries threaten the liquidity of the program's reserve fund. U.S. government contingent liabilities for Housing Guaranty loans exceed $1 billion while reserve fund assets have declined to about $20 million.

Loans should be programmed with more care to protect the U.S. government from contingent liability claims, and GAO recommends that a thorough risk analysis be made for each proposed loan, no loans be extended to any country where U.S. government contingent liability exceeds the reserve fund, and loans not be exempted from host-country debt reschedulings.



124017



GAO/NSIAD-84-75
APRIL 26, 1984


028696

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are $3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are $1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

B-206203

APRIL 25, 1984

The Honorable M. Peter McPherson
Administrator, Agency for
International Development

Dear Mr. McPherson:

This report presents the results of our review of the management of the Housing Guaranty program. It suggests ways to improve program management, including the placement of loans, and more carefully protect the U.S. government from contingent liability claims and expenditures.

We initiated this review to evaluate the Agency's use of the program in an environment of high external debt, balance-of-payments difficulties, and other economic problems in recipient countries. AID's comments on the report are at the appendix.

The report contains recommendations to you on pages 21 and 46. As you know, 31. U.S.C. §720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the Agency's first request for appropriations made more than 60 days after the date of the report. We would appreciate receiving copies of your statements to the committees.

We are sending copies of the report to the Chairmen of the four above committees, interested House and Senate authorization committees, and the Director, Office of Management and Budget.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE ADMINISTRATOR,
AGENCY FOR INTERNATIONAL
DEVELOPMENT

AID'S MANAGEMENT OF THE HOUSING
GUARANTY PROGRAM

## D I G E S T

The Housing Guaranty program is the Agency for International Development's (AID's) principal means for providing shelter assistance to developing countries. The U.S. government provides a "full faith and credit" guaranty of repayment of principal and interest for commercial rate loans made by private U.S. lenders.

An up-front fee of 1 percent on new loans and an annual fee of one-half of 1 percent on the unpaid balance of disbursed loans provide AID's Office of Housing and Urban Programs with income. A reserve fund finances office operations when fee income cannot both meet operating expenses and satisfy lender claims for delinquent payments.

The objective of this review was to assess AID's use of the program in an environment of high external debt and other economic problems.

Worldwide economic conditions have adversely affected program operations. Heavy debt levels and the international recession have undermined economic stability in many program countries. Several countries have been consistently in arrears on their loan repayments; some have not participated in the program due to high interest rates charged on the loans. AID reported in November 1982 that as of March 1982, 22 percent of housing loans were in default because of monetary devaluations, foreign exchange shortages, and homeowners' delinquencies. As of September 1983, AID had paid U.S. investors approximately $33.7 million under its guaranty agreements. Rescheduling of loans and depletion of the reserve fund are potential problems.



Tear Sheet

GAO/NSIAD-84-75
APRIL 25, 1984

AID's Office of Financial Management reported that the reserve fund was not adequate and recommended that AID seek a $25 million appropriation as "short-range protection for the program." As of September 1983, the U.S. government's contingent liability for program loans was over $1 billion. The program's reserve fund has never exceeded $50 million and as of September 1983 was about $20 million.

## HOUSING GUARANTY PROGRAM ACCOMPLISHMENTS AND PROBLEMS

AID has successfully demonstrated that core housing, sites and services, and slum upgrading are viable low-cost shelter solutions. Convincing host countries to adopt these solutions has been difficult. (See pp. 8 through 11.)

The Office of Housing has had some difficulties in validating host-country median-income statistics and thus the potential beneficiary groups whose incomes fall below it. Incorrect statistics can lead to shelter solutions which are too expensive for target groups. (See pp. 11 and 12.)

Self-sustaining finance mechanisms, which include cost recovery, are central to successful housing delivery systems. A major program objective is the elimination of government subsidies and adoption of cost-recovery policies and practices. Nevertheless, the countries GAO reviewed have large subsidies in their shelter programs. (See pp. 12 through 16.)

Devaluations in relation to the U.S. dollar and inflation in host countries make cost recovery technically and politically difficult. Governments may face increased loan-servicing costs at the same time that investment in the housing sector becomes a lower priority.

In the future, the Office of Housing may not have the option of contracting multiple, large-scale Housing Guaranty loans in selected

countries. The use of small loans, narrowly focused on technical assistance and pilot projects, is an option that AID might use to continue institution building, demonstrate low-cost shelter alternatives, and elicit clearer host-country priority for and commitment to the shelter sector. (See pp. 16 through 18.)

NEED FOR COUNTRY RISK ANALYSIS

The Office of Housing included economic analyses in its Housing Guaranty loan proposals but should also have conducted country risk analyses. Risk analysis allows the lender to assess the level of risk and the implications that risk has for its larger financial position. The Office of Housing missed opportunities to identify trouble spots and consequently minimize the level of contingent liability risk for the U.S. government.

In contrast to the Office of Housing, the U.S. Export-Import Bank, for example, regularly performs country risk analyses. U.S. bank regulatory authorities, such as the Federal Deposit Insurance Corporation, have adopted a uniform examination system for evaluating and commenting on country risk to U.S. banks with large foreign lending. (See pp. 29 through 35.)

EFFORTS TO PROMOTE NEW LENDING

Office of Housing efforts to promote new lending included offering loans for their foreign exchange value; developing creative financial packages; and modifying the requirement for host-country government full faith and credit guaranties on loan repayment to the U.S. government. For example:

--Housing Guaranty loans provide the host country with immediate balance-of-payments support, do not require procurement of U.S. goods and/or services, have small import requirements, and are disbursed relatively fast.

--Creative financial packages offer host countries slightly lower interest payments in

return for some risk of increased loan costs. The packages also increase risks for the Housing Guaranty reserve fund and ultimately the U.S. government, due to financial strains that changed loan conditions could cause host countries.

--Modifying the requirement for host-country government guaranties to include "equivalent" guaranties, is similar to a prior AID policy. That policy contributed to nonrecoverable costs to the reserve fund of $18 million as of September 1983 because of nonguarantied loan arrearages. The Office of Housing needs to define equivalent guaranty. (See pp. 35 through 38.)

DEBT RESCHEDULING STRATEGY

Various AID analyses point out that potential host-country debt rescheduling would be costly to the program. Under a rescheduling agreement, the host country ceases some portion of its payment of outstanding debt for a specified period of time. The Office of Housing would have to make up any shortfall in loan payments from its reserve fund.

The Office of Housing has a high concentration of large loans in selected countries--$191 million in Israel, $93 million in Korea, and $86 million in Peru. AID's Office of Financial Management has noted that the Overseas Private Investment Corporation was required "to maintain reserves equal to 25 percent of the maximum contingent liability for guaranties issued. . . ." Housing Guaranty cash reserves were only about 5 percent of the contingent liabilities as of September 1979; by September 1983 they were only about 1.8 percent.

In May 1983, the government of Peru announced its intention to reschedule its debt, including $86 million in Housing Guaranty loans. Its opening position for negotiations would have cost AID $20 million. AID requested that Housing Guaranty loans be exempted from the rescheduling process and the Departments of

the Treasury and State agreed to this. In return, AID would reschedule more of its development assistance loans than would ordinarily be required. Exempting the Housing Guaranty program from reschedulings could eventually undermine the overall effectiveness of the process, establish an undesirable precedent, relieve the Office of Housing of the risk associated with its loan program, and transfer costs to the U.S. Treasury. (See pp. 40 through 45.)

RECOMMENDATIONS

GAO recommends that the Administrator of AID have the Office of Housing and Urban Programs:

--Make preproject surveys in its host countries to insure that income levels of intended beneficiaries in each project are actually below the median income. (See p. 21.)

--Emphasize institution-building and cost recovery as the shelter programming goals which offer the most promise for future programs. (See p. 21.)

GAO also recommends that the Administrator of AID prepare an action plan to stem further deterioration in the level of the reserve fund and to minimize the contingent liability exposure of the U.S. government. The plan should include assurance that no Housing Guaranty loans be extended to any country where U.S. government contingent liability for such loans exceeds reserve fund assets, determine where the Housing Guaranty program ranks as a development assistance mechanism, and consider replenishment of the reserve fund from AID budget resources. (See p. 46.)

GAO recommends that the Administrator of AID not seek exemption of Housing Guaranty loans, within the internal U.S. government decision-making process, from any country's debt rescheduling which includes AID loans. (See p. 46.)

In addition, GAO recommends that the Administrator of AID have the Office of Housing and Urban Programs:

--Prepare a thorough country risk analysis for each proposed Housing Guaranty loan.

--Define "equivalent" guaranty and establish criteria under which such a guaranty may be substituted for a host-country government guaranty, and exercise caution in extending Housing Guaranty loans which do not have host-country government guaranties. (See p. 46.)

AGENCY COMMENTS

AID agreed with our recommendations to define the term "equivalency" and to exercise caution in extending Housing Guaranty loans which do not have host-country government guaranties. AID also said it would continue to emphasize institution building and cost recovery, along with its other emphases. It said it would revise its country risk analysis methodology and do more thorough analyses.

AID agreed to prepare an action plan and to consider replenishment of the reserve fund from AID budget resources, but it did not concur with GAO on limiting loan amounts to individual countries to a level equal to the reserve fund. AID said that this amounts to either the need for major refunding of the program's reserve fund or suspension of the program. GAO believes its recommendation might limit program operations but would not necessarily result in suspension of the program. It would also defuse potential contingent liability claims against the U.S. government.

AID said that it "is no longer seeking to exclude [Housing Guaranty] loans from . . . reschedulings [at the international level] but reserves the right to overreschedule AID loans if this is in the best interests of the [Housing Guaranty] program." The GAO recommendation, which has been clarified, did not refer to reschedulings at the international level but dealt with internal U.S. government decisions on bilateral negotiations of debt reschedulings. GAO believes that exemption of Housing Guaranty loans from debt

rescheduling departs from normal U.S. government operating procedures, could eventually undermine the rescheduling process, establishes an undesirable precedent, relieves AID of the risk associated with the Housing Guaranty program, and transfers costs to the U.S. Treasury.

AID also disagreed with the recommendation to make surveys to insure that intended beneficiaries are below the median-income level. AID said its project evaluations in time would reveal this data. GAO believes that a preproject survey would provide data to prevent errors while an evaluation would note errors after they had been made. The GAO recommendation has been clarified.

AID provided detailed comments, which are at the appendix, on specific issues discussed in the report. GAO considered these comments and revised the report as appropriate.



Tear Sheet

# Contents


| | | Page |
|---|---|---|
| DIGEST | | i |
| CHAPTER | | |
| 1 | INTRODUCTION | 1 |
| | Program history | 1 |
| | Prior GAO reports | 2 |
| | Objectives, scope, and methodology | 3 |
| 2 | HOUSING GUARANTY PROGRAM ACCOMPLISHMENTS IN A DIFFICULT ENVIRONMENT | 5 |
| | Program objectives | 5 |
| | Major investments | 6 |
| | Promotion of affordable solutions | 8 |
| | Financial self-sufficiency remains elusive | 12 |
| | Housing delivery systems make slow progress | 16 |
| | Current private-sector emphasis | 18 |
| | Conclusions | 20 |
| | Recommendations to the Administrator of AID | 21 |
| | Agency comments and our evaluation | 21 |
| 3 | FINANCIAL DIFFICULTIES FACING THE HOUSING GUARANTY PROGRAM | 26 |
| | Housing Office's financial operations | 26 |
| | Office is alerted to threats to reserve fund | 29 |
| | Efforts to promote new lending | 35 |
| | Actions to bring claims under control | 38 |
| | Debt rescheduling strategy | 40 |
| | Conclusions | 45 |
| | Recommendations to the Administrator of AID | 46 |
| | Agency comments and our evaluation | 47 |
| APPENDIX | Letter dated February 17, 1984, from AID | 53 |


## ABBREVIATIONS

| | |
|---|---|
| AID | Agency for International Development |
| CABEI | Central American Bank for Economic Integration |
| FAA | Foreign Assistance Act |
| FM | Office of Financial Management |
| GAO | General Accounting Office |
| HG | Housing Guaranty |
| OMB | Office of Management and Budget |
| OPIC | Overseas Private Investment Corporation |
| PPC | Bureau for Program and Policy Coordination |

# CHAPTER 1

## INTRODUCTION

The Agency for International Development's (AID's) Housing Guaranty (HG) program has guarantied more than $1 billion to finance housing and related infrastructure activities for 43 countries, Taiwan, and 2 regional banks. Its initial authorization began in 1961. In 1969 the program was consolidated with an initial capitalization of $50 million to meet its operational needs and to cover payments required to be made under terms of the specific guaranty agreements. Program recoveries and fee income earned were available for reuse to maintain and regenerate the fund. The program is administered by the Office of Housing and Urban Programs within AID's Bureau of Private Enterprise.

Under the program, U.S. private sector lenders provide long-term financing at commercial interest rates for housing and shelter-related projects undertaken by developing countries; the U.S. government provides a "full faith and credit" guaranty of repayment of principal and interest to the lenders. AID charges the developing country an initial fee of 1 percent of the amount of the loan, which is deducted from the loan disbursement, and a fee of one-half of 1 percent per annum of the unpaid principal balance of the guarantied loan.

### PROGRAM HISTORY

The President may issue housing guaranties under authority of the Foreign Assistance Act of 1961, as amended (22 U.S.C. §§2181-2183).

The HG program, originally termed the Housing Investment Guaranty program, provided an opportunity for U.S. construction firms to build housing projects in Latin America demonstrating advanced methods of construction and finance in order to produce multiplier effects on host-country housing activities. In 1965, the Congress reoriented the program toward institution-building so that housing could be provided on a continuing basis by the host country after the HG demonstration projects were completed. The program was expanded to include countries in Africa and Asia in 1969. Before 1974, the HG program provided housing which was not affordable to lower-income groups. In 1973 amendments to the Foreign Assistance Act, Congress placed the program within its New Directions policy mandate for development assistance, and directed that the program serve the poor majority in developing countries.

The HG program has a guaranty authority of $1.72 billion and as of September 30, 1983, $1.27 billion in loan guaranties

was under contract. In recent years, the program has operated in an environment of developing-country austerity budgets and mounting debt-service ratios. During the last few years, the international economy has undergone recession, with high interest and inflation rates in the industrialized countries contributing to even higher interest/inflation rates in much of the developing world. The combination of these factors has led to balance-of-payments problems.[1]

In fiscal year 1979, $78.4 million was contracted with borrowers under the HG program; in fiscal year 1980 this dropped to $32.0 million and then rose slightly in 1981 to $38.4 million. For the most part, these loans were traditional long-term, fixed-interest rate loans, but in 1981, U.S. lenders began proposing and borrowing countries and AID began accepting innovative financing arrangements such as floating rates based on the interest rates for certain U.S. Treasury bills. With the acceptance of floating rates, AID reported that the pace of HG lending accelerated; for fiscal year 1982, $150.1 million in loans was contracted, and for fiscal year 1983, $141.8 million was contracted.

## PRIOR GAO REPORTS

We reviewed the HG program in three prior reports. Low-Income Groups Not Helped by Agency for International Development's Housing Investment Guaranty Program (B-171526) November 1974, stated that the housing provided under the program was not affordable to lower-income groups in the developing countries but that it had helped to develop some host-country institutions. AID complied with our principal recommendation that it define the program's policies to determine whether and how the program could serve low-income groups.

The Challenge of Meeting Shelter Needs in Less Developed Countries (ID-77-39), November 1977, cited the importance of developing a plan that included improved shelter conditions as an integral part of development assistance efforts. We stated that the HG program had been heavily concentrated in a small number of countries and recommended that AID (1) distribute housing guaranties among a greater number of low-income countries to maximize the program's demonstration effect, (2) work more closely with host-country officials to minimize the subsidies in housing programs and to insure that host-country institutions were developed which can replicate HG housing, (3) improve coordination within AID to insure that HGs are planned and programmed as part of a country's overall development, and

---

[1]See GAO report entitled U.S. Development Efforts and Balance-of-Payments Problems in Developing Countries, (GAO/ID-83-13), Feb. 14, 1983.

(4) improve the economic analyses of countries where HG projects are planned, particularly balance-of-payments prospects and debt-servicing capability.

Agency for International Development's Housing Investment Guaranty Program (ID-78-44), September 1978, noted that AID had made dramatic changes in the kinds of housing financed in order to serve the poor majority in developing countries and had helped to effect important changes in host-countries' housing policies and delivery systems. The report recommended that AID (1) assign housing officers directly to AID missions and decrease, as appropriate, the responsibilities and functions of regional housing officers, (2) improve financial reporting, and (3) schedule more timely financial audits of the program with independent verification of source data and operating procedures.

## OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of this review was to assess AID's use of the HG program in an environment of high external debt, balance-of-payments difficulties, and other economic problems in recipient countries. We examined overall program management as well as the (1) loan management process in the Office of Housing and at the AID regional housing and urban development office and AID mission level, (2) program impact on the external debt profile and balance-of-payments situation of host countries,[2] (3) housing sector subsidies paid by host governments, (4) replication of prior HG projects by the host-country public or private sectors, and (5) private-sector participation in HG-financed housing. This report also follows up on our recommendations in the prior reports.

In Washington, D.C., we met with officials of AID, the Departments of the Treasury and State, Office of Management and Budget, Export-Import Bank, Inter-American Development Bank, and a private-sector housing consultant group. We used documents and statistical data from AID and State, the World Bank, International Monetary Fund, and Chase Econometrics/Interactive Data Corporation.

We selected Ecuador, Peru, Kenya, the Ivory Coast, and Tunisia for fieldwork, as each country had a history of prior HG program involvement and probable HG loans for the future. The economic conditions in the countries varied from good in Tunisia to poor in Ecuador and Peru. The countries were specifically

---

[2]See GAO reports, Bank Examination for Country Risk and International Lending (GAO/ID-82-52), Sept. 2, 1982, and Unrealistic Use of Loans to Support Foreign Military Sales(GAO/ID-83-5), Jan. 19, 1983.

selected and may not be representative of all HG loan-recipient countries.

We performed work at the U.S. embassies and/or AID missions in each country, and at the AID regional housing and urban development offices in Panama City (which is responsible for Ecuador and Peru), Abidjan, Nairobi and Tunis. We reviewed embassy and mission economic data, AID HG program documents, such as project plans, status reports, evaluations, cables and financial data. We met with U.S. and host-country officials from the respective ministries of finance and housing, officials of the central banks, and private housing-sector businessmen and financial institution officials. We also met with representatives of other donor institutions, such as the Inter-American Development Bank and World Bank. We visited project sites which we selected in each country.

Our work was done in accordance with generally accepted government auditing standards.

# CHAPTER 2

## HOUSING GUARANTY PROGRAM

### ACCOMPLISHMENTS IN A DIFFICULT ENVIRONMENT

AID has used its HG program since the mid-1970s to promote self-sustaining shelter delivery systems for families below the median income. The Office of Housing has identified five objectives which are integral to achieving this goal: (1) lowering housing standards to levels affordable for below median-income families, (2) making the housing sector self-financing, (3) strengthening public-sector housing institutions, (4) encouraging continuous private-sector participation in low-income housing, and (5) preparing comprehensive national housing policies. We reviewed the HG program in Ecuador, Peru, Kenya, the Ivory Coast, and Tunisia for progress in achieving these objectives.

The current economic environment has greatly complicated the Office of Housing's pursuit of its objectives. Inflation and currency devaluations have undermined self-sustaining shelter finance systems and put many shelter solutions beyond the reach of large segments of the target population. Government austerity budgets have resulted in reduction of the housing sector as an investment priority.

AID has made substantial progress in the five countries we reviewed, in achieving affordable shelter for the poor and, to a lesser degree, in strengthening shelter delivery systems. However, the crucial problem of establishing housing finance systems is largely unresolved, as large-scale subsidies continue to undermine the financial health of the housing sector. Additionally, the program faces significant obstacles to obtaining increased private-sector participation in low-income housing on a continuing basis.

### PROGRAM OBJECTIVES

The Foreign Assistance Act of 1961, as amended, recognizes that AID cannot provide shelter for all those who need it. The act therefore outlines HG program objectives as a demonstration of low-cost housing approaches and techniques, through pilot projects, to mobilize host-country resources for replication of HG projects on a self-sustaining basis. Under the 1973 New Directions policy mandate, and in accordance with congressional objectives, the Office of Housing adopted five general program objectives together with development of an overall national housing policy framework for each host country. These objectives are:

1. Establish shelter solutions affordable for those below the median income.

2. Develop systems for financing shelter for the target group with minimum subsidy requirements.

3. Develop institutions capable of sustaining a level of production of shelter commensurate with the needs of the population.

4. Encourage an increased private sector involvement in low-income shelter construction.

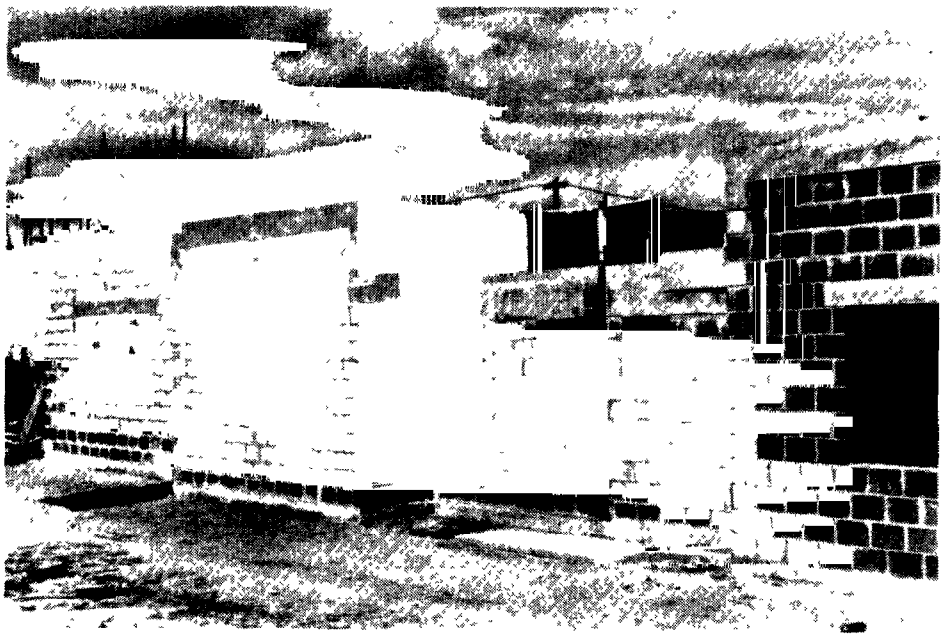
5. Prepare comprehensive national housing policies.

The objectives represent a fundamental shift away from the kinds of housing policies traditionally pursued by many developing countries. Traditional housing policies frequently targeted upper-income groups as the client groups; promoted high-standard construction which the below-median income family could afford only with large government subsidies; and resulted in the destruction, rather than upgrading, of slum areas. The Office of Housing faced long-standing policies and attitudes as it sought to change host-country policies and to implement its new objectives.

MAJOR INVESTMENTS

The Office of Housing has been involved in shelter development in Ecuador, Peru, Kenya, the Ivory Coast, and Tunisia for many years; its investment for contracted loans varies from a low of $17.0 million in Kenya to a high of $105.9 million in Peru. As shown in table 1, the Office has contracted a total of 27 loans for $238.3 million in these countries and has authorized 6 additional loans for $125.5 million.

AID's investment has enabled each country to undertake major housing projects. For example, targets for the latest HG project in the Ivory Coast are the preparation of 735 housing sites with installed service connections, construction of 1,866 low-income rental units, and upgrading of 870 slum units. AID estimates that under a recent HG loan in Peru, 17,300 houses were connected to electrical systems and 19,700 homes to water and sewerage systems; another 4,800 serviced lots were prepared and 550 home improvement loans made. In Tunisia 5,600 new units housing approximately 30,000 people were constructed and neighborhoods affecting another 45,000 people were upgraded.



Source GAO

**"Core housing" in Solanda project, Quito, Ecuador.**

Table 1

Loans Contracted and Authorized

| Country | Loans contracted (millions) | Number of loans | Years | Loans authorized (millions) | Years | Total (millions) |
|---|---|---|---|---|---|---|
| Ecuador | $ 27.4 | 3 | 1969-82 | $ 25.0 | 1982 | $ 52.4 |
| Peru [a] | 105.9 | 12 | 1962-82 | 12.5 | 1983 | 118.4 |
| Kenya | 17.0 | 3 | 1969-75 | 53.0 | 1979-83 | 70.0 |
| Ivory Coast | 53.0 | 5 | 1967-83 | 10.0 | 1983 | 63.0 |
| Tunisia | 35.0 | 4 | 1966-79 | 25.0 | 1979 | 60.0 |
| Totals | $238.3 | 27 | | $125.5 | | $363.8 |

Source: Agency for International Development, September 30, 1983.

[a] AID cancelled $6 million in three loans in 1963-65 at a cost to AID of $3.1 million.

Housing financed by the HG program alone, however, cannot reduce in any meaningful way the housing deficits in developing countries. Estimates of annual housing unit construction requirements in Tunisia are 100,000, in Kenya 60,000 and in the Ivory Coast 30,000 for Abidjan alone. Ecuador has an annual need for 42,000 urban units and Peru for 100,000. AID maintains that "the housing policies advocated by the HG program . . . will lead to a meaningful reduction of housing deficits over time," but this is predicated on host countries adopting policies advocated by AID and replicating HG demonstration projects.

PROMOTION OF AFFORDABLE SOLUTIONS

The first building block of a national housing policy is to identify shelter solutions which below median-income families can afford. The Office of Housing developed the following types of minimal-standard, low-cost solutions which met with varying degrees of acceptance.

--Core housing: one- or two-room units which often include a bathroom plus connections to available services, such as water, electricity, and sewerage. The basic structure can be expanded beyond the core shell as the owner's income permits.

--Sites and services: a graded lot and service hookups. Construction is generally accomplished through "self-help" efforts by the owner.

--Slum upgrading: provides services such as water, sewerage, and electricity; roads may be built, small home improvement loans made, etc.

The Office of Housing generally faces a lengthy period of resistance prior to getting host countries to accept its low-income shelter solutions. For example, in the early 1970s it developed a program for low-income families in Ecuador which included core housing and sites and services. Following considerable discussion and negotiation with AID, the government of Ecuador rejected the program as inappropriate for its people, and continued to focus its policy on construction of high-standard, middle- and upper-income housing located in the major cities.

In 1979, when an elected, civilian government took office in Ecuador and expressed an interest in affordable, low-income housing as proposed by AID, the Office of Housing developed a core-housing project. A $20 million HG loan was contracted in 1982 for the "Solanda" project and is now being implemented.

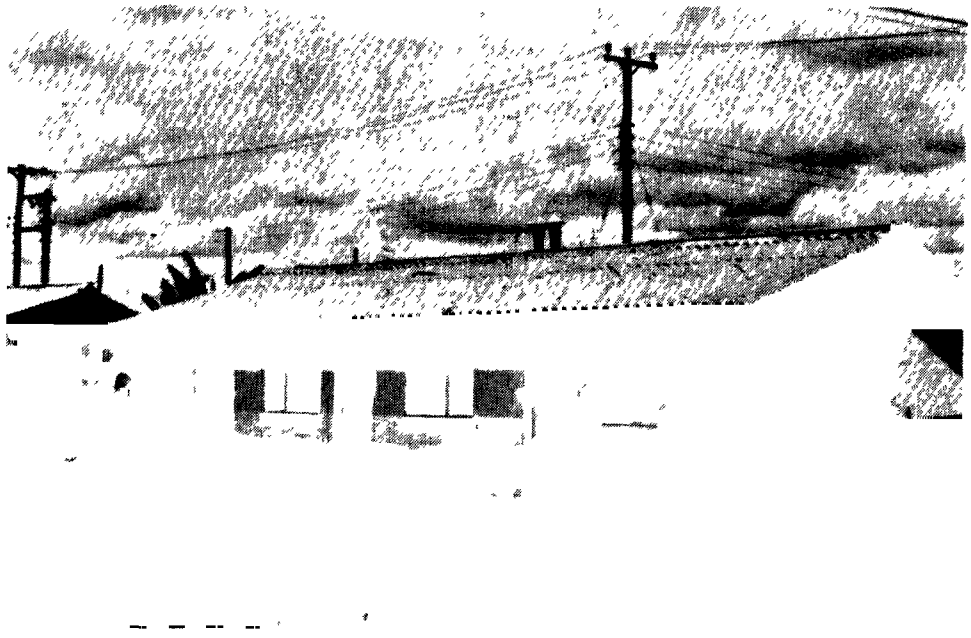
Due to contracting and implementation delays and accompanying inflationary cost increases, the core-housing project originally designed has become too costly for the intended low-income target groups. AID has redesigned the project to provide more minimal housing (e.g., a basic housing structure with bathroom) but has encountered resistance from the target beneficiaries and the private foundation which is implementing the project; both groups expected their investment to yield "real" houses and not what a foundation spokesman termed "slums." As a result, the government of Ecuador has been reluctant to support Office of Housing concepts for this project, but has indicated a willingness to reduce shelter standards for future HG loans.

AID stated that the government of Ecuador has always been in agreement with AID on the issue of standards, and the private-sector foundation which is implementing the Solanda project has recently agreed to reduce standards. However, as we note above, the government of Ecuador has not always been in agreement with AID on housing standards; even the civilian government which assumed office in 1979 was reluctant to reduce standards beyond a certain point for the Solanda project but agreed to AID standards for future HG projects.

The Office of Housing has been successful in getting the government of Tunisia to adopt slum upgrading in place of destroying such homes and displacing the inhabitants. The government has also established a national office to promote the upgrading projects. Tunisia has also adopted the concept of core housing and has committed its own funds to replicate AID demonstration projects.

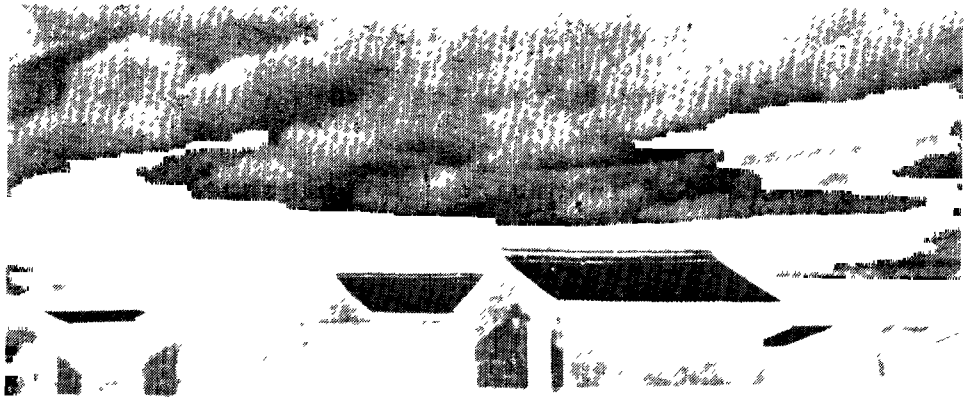
AID also succeeded in having the government of Kenya adopt its various shelter solutions. It has had less success with the Ivory Coast, but due to economic pressures and sharply curtailed budget expenditures, the government of the Ivory Coast now appears to be moving toward acceptance of minimal shelter solutions. AID said that the report "ignores the contributions made by AID officials through long dialogue and through extensive training and continuous policy education of Ivory Coast officials." We recognize AID's training and policy education of Ivory Coast officials, but AID documents clearly illustrate the difficulties that the agency has had with the government of the Ivory Coast; the government of the Ivory Coast has not adopted many AID recommendations and has even reneged on agreements it has made with AID.

Peru devotes most of its housing sector resources to constructing high-standard, high-cost houses and apartments which are fully completed. Government sites and services projects also have high standards which tend to increase costs. AID's accomplishment of introducing the concepts of sites and services and slum upgrading are thus somewhat minimized. AID stated that while it has financed "upgrading" projects in Peru, it has not



Source GAO

HG-financed "expanded core-housing" by National Housing Corporation, Kenya



Source GAO

Low-income, one-room "core" house replicated by the government of Kenya from prior HG-financed housing.

financed sites and services projects. However, we visited an attractive sites and services project in Lima, Peru, which AID was financing for a college and grade-school teachers' housing development.

## Goals hampered by income miscalculations

The Office of Housing has demonstrated that affordable, low-income shelter solutions are available and can work for those countries committed to their development. The impact of the emphasis on affordability, intended to open up housing opportunities to low-income groups, can be diluted if median-income calculations for target groups are too high.

The definition of "target group" for HG loans is of particular importance due to the program's legislative mandate that a minimum of 90 percent of the participants in HG loan projects be below the median income.[1] AID can either accept a host country's figures for median income or establish its own figures. We found the way AID collected, analyzed, and adjusted income data produced questionable results in Peru and Ecuador.

During the period July 1977 to April 1979, the AID mission in Peru used average family income, which was higher than median family income, to determine program eligibility. This had a double effect. Some families declared eligible for HG housing were in fact not eligible, and project designers used questionable data in deciding which shelter solutions were affordable to the AID target group. The data was reported to be corrected in April 1979 but we found that there were continuing problems in 1980. The U.S. embassy reported April 1980 average monthly salaries as $175 for white-collar workers and $127 for blue-collar.[2] The AID mission's maximum allowable income for program eligibility was $252. In June 1980 an AID consultant computed median family monthly income as $175; the mission was using a $284 figure at that time.[3] By mid-1983, after various adjustments for inflation, devaluations and other factors, the mission's median family income stood at $240 per month.[4]

---

[1]Section 223(j) of the Foreign Assistance Act of 1961, as amended, states "not less than 90 per centum [of HG loans] shall be issued for housing suitable for families with income below the median income (below the median urban income for housing in urban areas) in the country in which the housing is located."

[2]Conversion rate of 268 soles to $1 as of Apr. 11, 1980.

[3]Conversion rate of 285 soles to $1 as of June 1980.

[4]Peru had a rolling devaluation in 1983; at May 15, 1983, the conversion rate was 1,440 soles to $1.

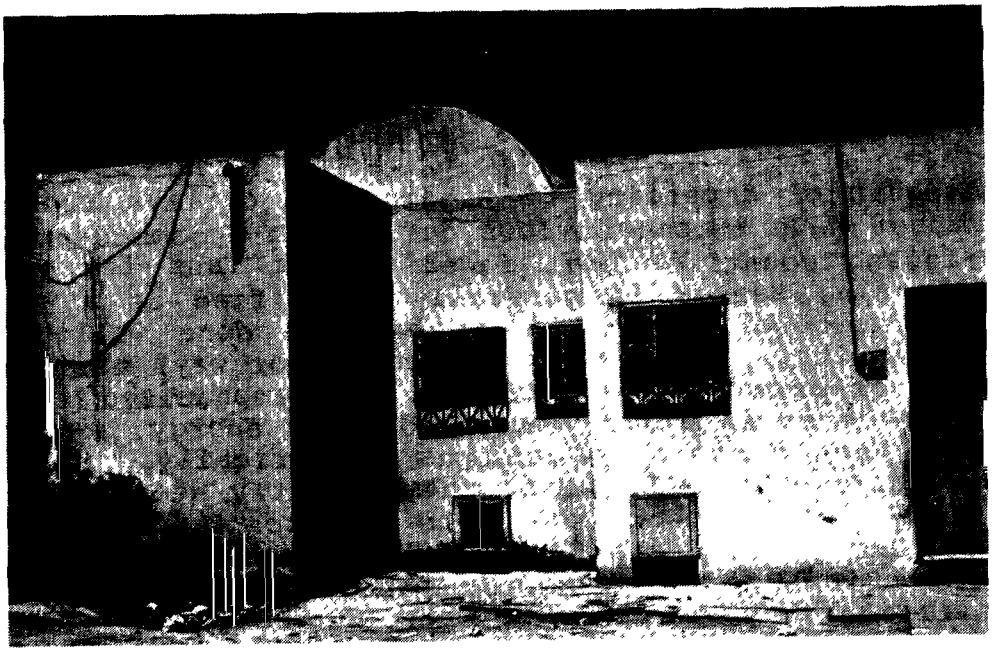
Income statistics for Ecuador also raise questions. Increased material and labor costs combined with an estimated inflation rate of 14 percent in February 1981 threatened to drive HG housing costs beyond the means of AID's target group. The AID mission began periodic adjustments to median family income figures to account for inflation and currency devaluations. Since 65 percent of HG project beneficiaries were employed by private-sector companies which provided various "benefits" in addition to salaries, AID incorporated these "real income benefits" in determining median family income. This procedure does not account for individuals such as the self-employed who may not have benefits supplementing their incomes; it obscures actual disposable cash income which low-income families have available for housing costs. One-third of the HG project beneficiaries may be priced out of the housing market as their incomes do not include the benefits AID used in its computation.

We recognize the technical difficulty inherent in estimating median-income statistics during a period of rapid inflation. However, incorrect statistics have the potential to hamper the HG program in assisting its intended beneficiaries. Faulty income statistics can lead to shelter solutions which are too expensive for target groups. We believe that it is in the interest of both the host countries and the HG program to take the steps necessary to arrive at reasonably reliable figures and to keep them updated.

## FINANCIAL SELF-SUFFICIENCY REMAINS ELUSIVE

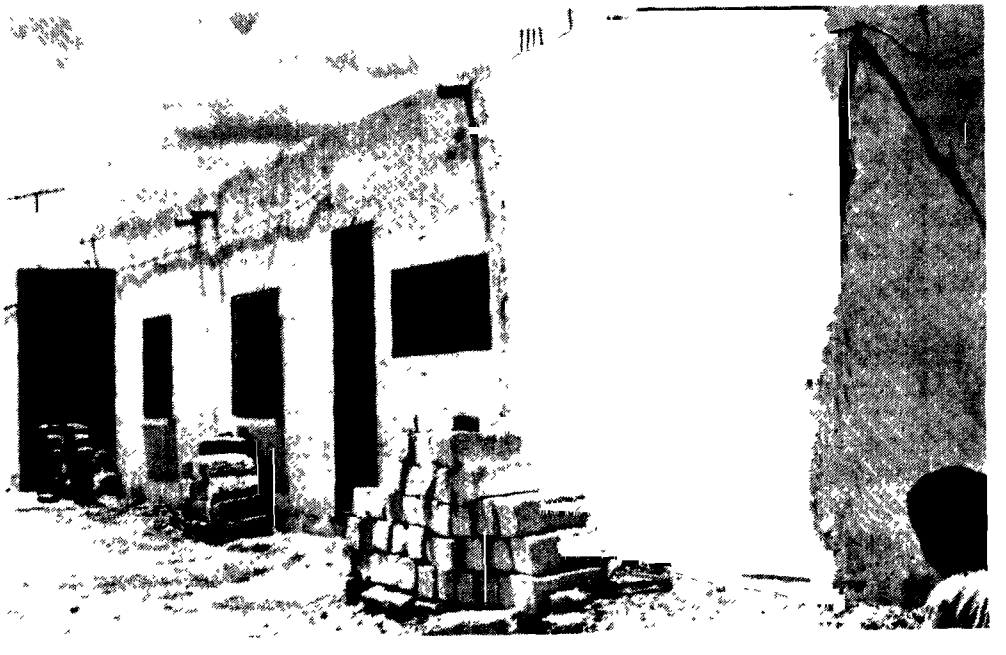
AID does not have sufficient available resources to finance more than a small portion of the needed shelter in the HG-recipient countries. Additionally, the relevant legislation stresses the demonstration nature of the Office of Housing's activities. Thus, a key goal for the HG program is to identify a steady source of housing financing which will endure after AID leaves. A parallel concern is the level of resources made available to the housing sector. A goal of the Office of Housing is to have the provision of shelter equal the demand. Both goals have proven difficult to achieve.

The countries we reviewed have chosen to fund public-housing finance institutions in order to provide resources to the housing sector. The general practice in many developing countries of subsidizing shelter costs has, however, threatened the financial viability of these institutions. Interest-rate subsidies result in financial losses, which have forced the institutions to turn back to their central governments for new funds. Some governments earmark resource flows to recapitalize the institutions on a regular basis while others do so only as needed. Some governments facing budget pressures have been reluctant to provide funds to the institutions in need of



Source GAO

**HG-financed housing in Ibn Khaldoun, Tunis, Tunisia**



Source GAO

**HG-financed home improvements in Mahdia, Tunisia**

recapitalization--institutions in Ecuador, Peru, and the Ivory Coast are currently facing such problems. Some institutions have stayed solvent through external borrowing, such as through the HG program.

The dangers of depending on significant outlays from the national budget have become obvious during the economic turmoil which developing countries have faced in the last few years. Since the housing sector is generally classified as a social rather than a productive sector, it has not done well as an investment priority. Governments searching for ways to improve their balance-of-payments difficulties have emphasized investment in such sectors as agriculture, industry, energy, and transportation. Even Tunisia, which has historically put great emphasis on increasing its housing, has recently decreased that sector's share of investment from 16 to 12 percent. The governments of the Ivory Coast and Kenya are seeking to reduce their participation in the housing sector through stimulating local private investment.

Economic turmoil has hampered realization of the Office of Housing's objectives of developing self-sustaining finance institutions and insuring increased housing resources. However, balance-of-payments difficulties faced by these countries have given the Office of Housing an opportunity to encourage necessary policy changes. HG loans are dollar-denominated and thus attractive to governments trying to deal with foreign exchange shortages. The Office has used the promise of new HG loans to get governments to take steps toward needed reforms. The budget constraints in Ecuador, Peru, the Ivory Coast, and Kenya, for example, have stimulated interest in housing policy reforms which could decrease demands for new funds from housing finance institutions by encouraging operations on a cost-recovery basis.

## Office of Housing promotes cost recovery

The Office of Housing's general position has been that housing-finance institutions should be self-sustaining, e.g., should recover costs for housing and related infrastructure and the cost of money through realistic interest-rate charges. Such an approach would entail the elimination or reduction of subsidies to insure an adequate and continuing flow of moneys back to the housing institutions. Inflation and devaluations of host-country currencies make this objective both politically and technically difficult to achieve.

In some countries, such as the Ivory Coast, even if a full-cost recovery approach is possible, it may come too late to redress, in the short run, the considerable damage caused by

large-scale subsidies. The Ivory Coast provides numerous subsidies, such as free land for state-constructed housing, low national interest rates, caps on rent increases, tax forgiveness on building materials, and free or low-cost primary infrastructure for municipalities. Such subsidies not only result in loss of funds by financial institutions (which cannot recoup their costs for land, or raise rents and interest rate charges to maintain parity with market costs) but also in expenses to the national budget.

The Office of Housing's 1976 HG project, while not yet completed, provided two mechanisms for cost recovery: (1) a system for increasing rents on rental housing while still maintaining affordability and (2) a community betterment tax to capture community upgrading costs. Despite AID's cost-recovery demonstration, the Ivory Coast refused to adopt the concept as national policy until the country's housing finance system had collapsed. For example, a state-owned housing development corporation established in 1963 to build urban and middle-income rental housing is now deeply in debt, and the government has prohibited it from undertaking any new construction. The debt is attributed to contracting expensive foreign loans, poor management, and government-imposed rent controls which effectively prohibited cost recovery. The foreign debt includes two HG loans which are substantially more expensive in terms of local currency, due to devaluations, than when they were originally made. The housing fund of the Ivory Coast, one of its primary resources for financing public sector housing, has been absorbed in the central government's budget and is being used to pay off the large foreign debt, particularly of the various government housing institutions. The Ivory Coast is currently financing very little new housing on its own.

The World Bank and the Ivory Coast government have reached agreement, as part of a structural adjustment loan (which permits a country to reorganize its budget allocations and economic priorities during a period of severe financial strain). Under the agreement, the government will institute major policy reforms, including a policy of housing cost recovery.

Cost recovery techniques can reduce the eventual loss of resources used in housing finance, but they may not be able to eliminate all losses and still allow for reaching the targeted low-income levels. The effects of inflation and devaluation are technically and politically difficult to remedy within a cost recovery framework. The inflation rate is rising in most developing countries; in Peru it is projected to be close to 100 percent for 1983. Accordingly, if mortgage interest rates were indexed to the rate of inflation as proposed by the World Bank and AID, the cost of money could be recovered. Indexation could be adopted with minimal problems if incomes kept up with inflation: however, lower level incomes have not kept up with inflation particularly, in Ecuador and Peru. If these countries

adopted indexation, homeowners with declining real income might not be able to meet their indexed and rising mortgage payments and thus be forced into default.

A related question involves costs in local currency against the U.S. dollar. In Peru, the government assumes devaluation costs and housing institutions are now covering approximately 22 percent of payments due on loans contracted 5 years ago with the government assuming 78 percent. External borrowing in this situation only aggravates costs as it requires the borrowing government to cover any devaluation losses. We noted in our 1978 report[5] that housing should not be a development effort continually funded by external capital. We believe that the observation is still relevant today.

The Office of Housing may not be able to realize its goal of establishing self-sustaining housing systems in the current economic environment; progress can be made, but housing banks may not be able to serve the very poor and still completely recoup losses. As a result, housing banks will need to depend in varying degrees on their central governments for capital, which raises issues on sectoral priorities and budget allocations.

## HOUSING DELIVERY SYSTEMS MAKE SLOW PROGRESS

Policies for making housing affordable or mobilizing financing capital are implemented through housing delivery systems. Institutions with the technical and management skills to design projects, administer loans, and undertake construction serve as the delivery system link which translates government policy into shelter solutions for project beneficiaries. Failure to build effective institutions can lead to inefficient use of available housing sector resources.

The Office of Housing has a long record of establishing and strengthening housing institutions. The process takes years of effort, often combining the need for financial and technical assistance. For instance, savings and loan associations in several Latin American countries were established over a decade through a program of technical assistance coupled with financial aid in the form of "seed loans." The process demands the full commitment of the recipient government to realize its investment. For example, when the Peruvian savings and loan institutions were threatened with decapitalization because of inflation and lack of cost recovery, the government of Peru put new capital into the system. In contrast, a major Ivory Coast developer

---

[5]See Agency for International Development's Housing Investment Guaranty Program (ID-78-44), Sept. 6, 1978.

which AID was attempting to strengthen is out of the housing business, at least temporarily, because of financial problems and lack of government financial support. Ecuador and Peru are at varying stages in their institutional strengthening process, with Peru having a fairly well-developed system and Ecuador in the early stages of development.

Ecuador's principal housing institutions comprise a public housing institution, which sets policy, coordinates public and private institutions operating in the sector, and constructs housing projects, and a housing bank which plans, contracts, and finances shelter. The national social security agency also provides home financing to participants of the social security system and to the private savings and loan institutions which AID had a major part in creating during the 1960s.

Ecuador's institutions are inexperienced and suffer from limited absorptive capacity. The lead agency for AID's 1982 Solanda project has had problems in coordinating the participation of various groups in the project which has contributed to long delays in program implementation and subsequent cost increases due to inflation. Because of these cost increases, the price of units may be beyond the reach of the target beneficiaries.

In Peru, several mature financial and policymaking institutions and private-sector savings and loan banks participate in public housing. The Ministry of Housing prepares overall investment plans, defines lines of action, establishes specific program guidelines, and allocates housing funds for various programs. The ministry's development agency plans, designs, and puts housing projects out for bid, and monitors on-going projects.

Two major Peruvian finance institutions supply and regulate financing. The Central Mortgage Bank, established in 1929, had assets of $507.4 million at the end of 1981. It produces mostly upper-income housing and some basic low-income housing. The Housing Bank of Peru, created in 1962, obtained its initial capital through an HG loan and has borrowed $91 million in HG loans since 1966. It also works with the savings and loan system and acts as agent for the Peruvian Housing Fund in providing upper-income housing.

Peru recently created the Materials Bank to provide low-income loans in the form of building materials for the construction or expansion/improvement of low-income housing. The Peruvian government deserves credit for inaugurating this highly innovative approach to assisting low-income families in self-help housing. It appears quite successful. AID reallocated $5 million from an ongoing HG loan to finance some of the activities of the Materials Bank. Office of Housing officials said

they were trying to interest the government of Ecuador in creating a similar bank.

The housing institutions of Kenya and the Ivory Coast are still developing. Kenya's institutions have insufficient capacity to implement some projects; the Ivory Coast's housing institutions are excluded from guiding investment in the sector due to political factors. Tunisia's institutions, on the other hand, are well developed and capable of planning, constructing, and financing housing solutions, from upper-income homes to slum upgrading.

AID stated that while institution-building and cost recovery are important goals, it believes "equally promising are those goals which would have governments eschew direct construction of completed housing in favor of providing only those elements not easily provided by homeowners themselves (land, water, infrastructure) with the . . . private sector being encouraged and given the freedom to build and finance completed units."

## CURRENT PRIVATE-SECTOR EMPHASIS

Economic problems in the countries we reviewed have frequently resulted in (1) lower priorities for housing development because it is not a "productive" investment, (2) smaller budgets as countries have cut back generally, and (3) housing sector goals going unfulfilled while housing deficits mount. In the face of these problems, governments in several countries are looking for ways to boost the financial and management resources available for housing without putting new pressure on already tight budgets. The Office of Housing has recently devoted more attention to private-sector involvement in its projects as a response to the financial problems facing its host countries.

Prior to the New Directions policy, the Office of Housing had actively engaged in building up private-sector participation. For instance, in Latin America the Office worked to create and strengthen private savings and loan institutions; private-sector developers undertook HG projects which were not oriented toward lower-income groups. Since New Directions were adopted, the Office has had some difficulty in interesting the private sector in low-income shelter although some construction has continued to be performed under subcontract by private firms. However, in the countries we reviewed, attention has been focused on strengthening the public-sector institutions which are the main source of formal shelter solutions for the below-median-income population.

The Office of Housing is beginning again to emphasize private-sector participation in meeting low-income housing demands. Private-sector participation includes management of HG

funds as well as construction of units. The Office faces serious obstacles in gaining continuous participation following completion of specific projects. Attitudes and the issue of profitability frequently work against the Office's aims. For instance, in the Ivory Coast and Tunisia, the private sectors do not perceive a sufficient opportunity to make profits. In Peru, private-sector institutions see low-income housing as a responsibility of government. Tunisian government officials also viewed this as a government responsibility. For almost 10 years, the government of Kenya has expressed an interest in involving the private sector in low-income housing. However, several problems must be solved before private-sector participation occurs. For instance, land is so costly in Kenya that a commercial developer would have to deal in large developments of 500 to 800 units before it could lower prices to a level which low-income families could afford. However, financing for such a project is not available for more than 1 year at a time.

A United Nations report, as well as Kenyan private-sector representatives, noted the following additional obstacles to private-sector involvement.

--Greater profits are possible from a few larger loans than from many smaller ones because administrative costs are similar for all values of mortgages.

--Default rates on mortgages to low-income people are assumed to be much higher than for people at higher income levels.

--Lenders do not consider sites and services or expanded core-house units as sufficient collateral because of their perceived poor quality.

--Problems associated with getting clear land titles complicate access to financing.

Kenyan private-sector lenders have expressed some interest in pursuing the development of low-income housing since the demand for upper-income housing has fallen off. However, there is little actual private-sector development of low-income housing under way.

HG loans may have no trouble gaining some short-term participation of the private sector; the HG program has already achieved that end to some extent in Peru. However, obtaining a sustained, long-term commitment by the private sector is difficult. In the other countries we studied, the private sector is reluctant to become involved in low-income housing. Low profit expectations for the work and risk involved appear to be a key

factor in holding back participation, and some system of incentives may be necessary. However, incentives will likely require new government expenditures, creating the very situation the governments hope to avoid by using the private sector.

## CONCLUSIONS

AID has had mixed success in achieving its HG program shelter objectives. It has successfully demonstrated that core housing, sites and services, and slum upgrading are viable low-cost, affordable shelter solutions. Convincing host countries to adopt these solutions has proven to be a complex and lengthy process. Also, the Office of Housing has had some difficulties in validating below-median-income target groups.

AID's shelter finance resources may well be constrained for the immediate future. Given this situation, AID may wish to maximize the HG program's impact by concentrating on the program's demonstrated strength in institutional development. The use of small HG loans which are narrowly focused on technical assistance dealing with institution-building and cost-recovery techniques, as demonstrated through small pilot projects, is an option which AID might consider.

Creating self-sustaining finance mechanisms is central to successful creation of a housing delivery system, yet these are the furthest from realization and seem to raise the most troubling questions. Elimination of subsidies and adoption of cost-recovery policies and practices are a core element of HG program objectives. Self-sustaining finance mechanisms require effective cost recovery. We recognize that this is technically and politically difficult, but we believe progress can still be made in this area. All the countries we reviewed have wide ranges of subsidies in their shelter programs despite years of AID dialogue and investment. While such costs may currently pose little burden to a country such as Tunisia, they create a problem for countries facing financial difficulties. HG loans themselves, since they represent external borrowing (and since host countries assume any costs associated with currency devaluations), increase shelter-sector costs to host countries. Thus, housing systems will inevitably draw on budgetary resources rather than existing as self-sustaining systems. Through the HG program, AID has contributed to creating shelter delivery systems yet their viability is threatened by inappropriate host-country policies. It is therefore difficult to justify the programming of additional HG loans to countries which do not minimize shelter subsidy costs.

Ways for host-country private sectors to compensate for the resource gap in low-income housing seem limited. AID has had a struggle to reduce shelter standards to a level that low-income families can afford, yet these reduced standards raise questions

of whether they will permit sufficient profit to encourage private sector involvement. If not, governments will need to consider compensating the private sector through various incentives such as tax write-offs for any potential losses. Developing countries facing budget restraints do not appear inclined to provide such incentives at present.

## RECOMMENDATIONS TO THE ADMINISTRATOR OF AID

We recommend that the Administrator of AID have the Office of Housing:

--Make preproject surveys in host countries to insure that income levels of intended beneficiaries in each project are actually below the median income.

--Emphasize institution-building and cost recovery as the shelter programming goals which offer the most promise for future progress.

## AGENCY COMMENTS AND OUR EVALUATION

AID disagreed with our recommendations about preproject surveys but accepted the recommendation to emphasize institution building and cost recovery.

AID stated that it does not view its role as continually insuring that HG-financed housing is forever occupied by below-median-income households. It further stated that the Congress intended that HG housing be suitable for, but not necessarily restricted to, below median-income people. However, our point is that AID should make preproject surveys to ensure that HG projects are designed and affordable for below-median-income groups. We recognize that after projects are sold and occupied, AID involvement in the project ends and AID has little control over what low-income beneficiaries do with their homes. Legislation for the HG program states that AID should finance "pilot projects for low-cost shelter" for "low-income people." As we note on p. 11, the legislation states that 90 percent of the housing should be suitable for below-median-income families. We do not state that AID is not complying with the rule; we do state that some statistics being used in Peru and Ecuador are incorrect and might hamper the program in assisting its target beneficiaries. We visited an attractive project in Lima, Peru, which was for grade-school teachers and college professors. HG funds were financing water, electricity, roads, and sidewalks. The project clearly did not appear to be for low-income beneficiaries. We believe that a preproject survey would have found income level discrepancies. We revised our recommendation to clarify any misunderstandings.

In commenting on our second recommendation, AID stated that it "believes that these are important goals and will continue to emphasize them" and that:

> "equally promising are those goals which would have governments eschew direct construction of completed housing in favor of providing only those elements not easily provided by homeowners (land, water, infrastructure) with the . . . private sector being encouraged and given the freedom to build and finance completed units."

Private sector emphasis

AID stated that our definition of "private sector" was too restrictive and that the private sector was "defined as everything other than the public sector." AID's definition includes self-help efforts by an individual to build or improve his or her house. We believe that the various sectors should be defined as "private sector," "public sector," and "informal self-help sector," which are terms that AID has used in the recent past and that the development community continues to use. The current AID definition is too broad to accurately describe AID's involvement with the generally understood concept of private sector. AID also commented on various obstacles to increased private-sector participation in low-cost housing and stated that host countries could adopt various cost-free incentives to spur the private sector (such as simplifying of permit and licensing procedures). AID did not address our principal point, that private-sector representatives do not see low-income housing as profitable and/or that greater profits can be made through investment in sectors other than housing.

Housing sector role in an economy and host-country budget allocations

AID disagreed with our statement that since the housing sector was viewed as a social nonproductive sector, developing countries facing economic difficulties were reducing their budget allocations to the sector. AID stated that housing was a major factor in any country's construction industry and that notions that housing was a nonproductive sector were rapidly changing. AID cited El Salvador, Hong Kong, and Singapore as examples of where housing construction was used as an "engine of growth."

AID also stated that developing countries should be free to set their own priorities and determine where housing ranks in these priorities and that AID policy is to maximize the impact of existing housing budgets and not to try to increase such budgets.

We believe that housing can be a major factor in a developing country's economy and specifically in the construction industry, not per se as AID maintains in its comments, but only if it is done by the public and/or private sectors which offer long-term employment opportunities and consumption of processed building products. AID's promotion of self-help housing contributes to neither of these factors. Host-country housing and/or finance officials consistently said that the housing sector was viewed as a nonproductive sector and that developing countries facing foreign debt and balance-of-payment difficulties need to invest in sectors which contribute to the production of exports and thus generate needed foreign exchange; the housing sector adds little to exports or the generation of foreign exchange. When El Salvador, Hong Kong, and Singapore undertook their large-scale public housing projects as "engines of growth," they were not facing severe debt and balance-of-payments problems and the immediate need to stimulate exports for foreign exchange generation.

We agree with the AID comment that developing countries "should be free to set their own shelter priorities," and indeed they are free to do so. However, when these priorities conflict with or ignore AID policy and the legislative objectives for the HG program that host countries replicate HG-demonstrated housing, the extension of additional HG loans does not appear to be justified. A developing country's commitment to the housing sector as a development priority and its actions to replicate HG projects can generally be seen by its various budget allocations for housing; a development plan's low ranking of the housing sector as a development priority would indicate a host-country's low commitment to the housing sector. We do not recommend that developing countries increase their budget allocations to the housing sector, particularly given most developing countries' other, more pressing needs.

## Subsidies and cost recovery in HG projects

AID stated that it opposes subsidies but that since all countries choose to subsidize some things, housing is a legitimate candidate for subsidies; that its policy is to "rationalize" subsidies (which is an analysis of subsidies and usually leads to the conclusion that they are neither useful nor effective); and that where subsidies cannot be eliminated, it tries to direct them toward the poor. AID also stated that "cost recovery and minimal subsidies are . . . not the only policy changes advocated by AID." We discussed subsidies and cost recovery since they are principal factors in AID program objectives and HG program legislation.

AID's promotion of "rationalization" of subsidies has not been accepted in most host countries. For example, AID has been extending HG loans to Peru for 20 years and to a level exceeding

$100 million; presumably during this period AID has tried to get the government of Peru to eliminate, minimize, or at least redirect its housing subsidies. However, Peru continues to subsidize all levels of housing and the rich benefit from even greater subsidies than do the poor. The government of Tunisia, which has been receiving HG loans since 1966, does not even charge interest on its housing loans in rural areas.

AID further said that our suggestion that currency devaluations negatively affect cost recovery incorrectly assumed that foreign exchange risks are on, or should be on, each HG project. AID said that it tries to insure that HG dollars and local currency are separately managed and result in a positive rate of return. AID said a government which had the use of HG dollars should bear the foreign exchange risk;

> "if the HG dollars are borrowed at 10 percent interest and used to retire 15 percent interest dollar debt or invested in [an] imported item, say a tractor, producing a 50 percent per annum rate of return, then the dollar side of the transaction makes sense and should stand alone."

We believe that foreign currency costs cannot be separated from local currency costs for HG loans. We agree that U.S. dollars provided by HG loans can be used for balance-of-payments or debt-service purposes. We also agree that the U.S. dollars could be productively invested and that if such investment yields a rate of return equal to any devaluation costs incurred, the HG loan costs would balance out. AID officials said, however, that they had not analyzed the use of HG-supplied dollars and that AID cannot determine whether they were productively invested or not.

Any devaluation of local currency in relation to the U.S. dollar makes the repayment in dollars of HG loans more costly. Since hardly any country has full cost recovery in its HG projects and since most governments assume devaluation risk and costs in HG loans, the loans incur costs to host governments which would not have been incurred in the absence of HG loans. When a host government assumes devaluation risks or costs for HG projects, it is subsidizing the project. Furthermore, government officials in Peru, Kenya, and the Ivory Coast told us that, given their economic problems, their governments would not be undertaking housing projects in the absence of HG loans. Since these countries all subsidize housing, they are incurring new budget costs directly attributable to the HG loans. In Peru, housing institutions are paying only 25 percent of the real cost of HG loans since the government has assumed devaluation costs and is paying 75 percent of loan costs.

An HG program objective is to establish self-sustaining housing systems. In the absence of cost recovery, to include eliminating or minimizing subsidies, such systems cannot be established. As budget costs attributable to subsidies increase, a host country's ability to replicate HG projects and provide housing for its low-income people decreases.

# CHAPTER 3

## FINANCIAL DIFFICULTIES FACING THE HOUSING GUARANTY PROGRAM

The heavy debt levels and international recession faced by developing countries have undermined economic stability in many of AID's client countries. The Office of Housing management was slow to adapt to the changing situation and the negative impact it had on the HG reserve fund and program operations. Earlier action could have minimized the adverse effect of many of the problems the HG program subsequently faced. We found that:

--Declining program income and rising claim payments reduced the program's reserve fund.

--The Office of Housing did not perform country risk analyses for proposed HG loans and consequently missed the opportunity to minimize the level of contingent liability risk to the U.S. government.

--High interest rates for HG loans made some countries reluctant to assume new loans.

--Potential debt reschedulings in countries where HG loans have been concentrated threaten to bankrupt the program.

### HOUSING OFFICE'S FINANCIAL OPERATIONS

AID's Office of Housing has essentially operated on a self-sustaining basis. An up-front fee of 1 percent on new loans and on an annual fee of one-half of 1 percent on the unpaid balance of disbursed loans provide the Office with income. A reserve fund, originally of $50 million, was established to finance Office operations through periods when its own income could not both meet operating expenses and satisfy lender claims for missed payments on guarantied loans. According to AID documents, the existence of this reserve fund has served to create investor confidence that claims will be promptly paid; without adequate reserves, lenders are unlikely to participate in the HG program since they have demanded the assurance that reserves are available to meet claims in a timely fashion without going through the process of seeking an appropriation. Since it could use reserve fund moneys, AID has not had to approach the Congress for an appropriation in years when its income has fallen short of claims plus operations expenses. Should HG reserves be exhausted, payments to meet claims and operations would have to be provided through congressional appropriations.

AID has requested legislative changes to permit it "borrowing authority" in the event that the reserve fund should be depleted and AID would not be able to consequently meet its obligations to U.S. lenders. The borrowing authority is a proposed legislative change which has not been accepted, as yet, by the Congress and thus cannot be termed a "compliment to cash reserves," as AID maintains, at this time.

The AID Administrator has delegated authority to the Office director to run the program and to take appropriate actions as needed to maintain the program's effectiveness. The Office operates overseas through its worldwide system of regional housing and urban development offices. Regional office staffs program HG loans in coordination with relevant AID bureaus and overseas missions and report directly to the Office of Housing director. AID commented that each new HG project is authorized by the regional bureaus after receiving recommendations from many agency offices, including the Office of Housing. Because the Office of Housing pays its own administrative expenses, it does not have to compete within AID for appropriate expense moneys.

However, because some host countries failed to make loan payments, program costs exceeded Office income in 1980 and 1981 (see table 2), leading to increased costs for the reserve fund, the assets of which were already facing steady erosion due to payments to U.S. lenders because of host-country delinquencies. In 1981, the Congress amended the Foreign Assistance Act to permit the Office of Housing to retain interest earnings on HG reserves which were held on account by the Treasury. This step improved the financial status of the program.

The Office of Housing still faces potential financial problems in attempting to maximize its income. A 1983 AID report projected that it was necessary for the Office to program new loans totaling $150 million per year in order to earn enough fee income to minimize a decline in program income and reserve fund assets. However,

--there are a limited number of countries for which HG loans can be programmed; the poorest developing countries, such as Haiti and Uganda, cannot afford the loans (because of interest rate and fee charges) and do not have the capacity to implement HG projects; and

--the repeated programming of multiple, large-scale loans to the same selected countries (as shown in table 3) increases the level of U.S. government liability exposure, while the reserve fund level is inadequate to protect the U.S. government.

Table 2

Office Financial Status in
Fiscal Years 1980 through 1983

| | Fiscal year | | | |
|---|---|---|---|---|
| | 1980 | 1981 | 1982 | 1983 |
| | (millions) | | | |
| Income | $5.3 | $5.3 | $9.9[a] | $10.7 |
| Administrative expense | 2.8 | 3.3 | 3.5 | 4.6 |
| Contracting expense | 1.8 | 1.5 | 2.0 | 1.8 |
| Project rehabilitation expense | 0 | 0.2 | 0.3 | 0 |
| Income before payments to lenders | 0.7 | 0.3 | 4.1 | 4.3 |
| Compensating loan payments[b] | 1.9 | 2.2 | 2.7 | 2.7 |
| Foreign exchange loss payments[c] | 0.08 | 0.09 | 0.04 | 0 |
| Net income (loss) | ($1.3) | ($2.2)[d] | ($1.4)[e] | $2.3[f] |

[a]Includes $2.7 million in investment income.

[b]Payments made by AID to U.S. lenders because of host country failures to meet loan payments.

[c]AID payments to compensate for foreign exchange losses in host-country loan repayments.

[d]Includes fee loss of $42,000 and prior year adjustment loss of $112,000.

[e]Includes fee loss of $37,000 and prior year adjustment increase of $14,000.

[f]Includes claims recovery of $1.0 million, fee loss of $34,000, receivables written-off of $1.2 million and prior year adjustment increase of $908,000.

Source: Agency for International Development.

Repeated programming of loans to the same countries may also conflict with the legislative focus of the program: to promote "demonstration" projects which would show host-country investors and institutions that low-income housing is financially viable. Thus, the program is not designed to serve as a mere transfer of U.S. resources to aid the housing sectors in developing countries. AID commented that this concentration of loans in selected countries is a result of development and foreign

policy considerations. However, in our 1977 report, we noted that the HG program's "demonstration effect has been narrow . . . because most loans went only to a few countries," and we recommended that HG loans be distributed more widely "so that the demonstration effect of individual projects will be greater." While AID has distributed the number of loans more widely among various countries since 1977, selected countries, such as Peru, continued to get the large loans.

## OFFICE IS ALERTED TO THREATS TO RESERVE FUND

Beginning in 1980, AID's Office of Financial Management (FM) warned the Office of Housing that deteriorating economic conditions in developing countries were a potential source of problems for the reserve fund. FM stated that due to economic trends and host-country debt burdens, the countries might not be able to honor their HG obligations.

FM was concerned that as of September 1979, Office of Housing contingent liabilities for guarantied loans were $752.5 million while its reserve fund was only $39.3 million. FM noted that the Overseas Private Investment Corporation was required by law "to maintain reserves equal to 25 percent of the maximum contingent liability for guaranties issued. . . ." In comparison, HG program central reserves were only about 5 percent of the contingent liabilities as of September 1979; by September 1983 they were only about 1.8 percent.

An AID report dated November 23, 1982, noted that as of March 31, 1982, 27 of 118 (or 22 percent) housing project loans were in default because of such reasons as monetary devaluations, foreign exchange shortages, and homeowners' delinquencies. AID had to assume regular loan payments to the U.S. lender. As of September 1983, AID had made payments to U.S. investors of approximately $33.7 million under the U.S. Housing Guaranty agreement.

A February 1983 FM financial analysis of the program, reiterating the 1980 warning, said that the reserve fund would reach a critically low level by the end of fiscal year 1984. It cited public debt rescheduling by countries with HG loans as a specific trend which seriously threatened the cash liquidity of the reserve fund.

Reschedulings are a particular threat to the reserve fund because under a rescheduling agreement, the debtor government ceases some portion of its payment on its outstanding debt for a specified period of time. The shortfall in payments is then aggregated as tantamount to a new loan to the debtor government and rescheduled for payment over a period of years in the

Table 3

AID Housing Guaranty Loan Authorizations
by Year and Recipient

(millions of dollars)

| Recipient/Year 19 __ | 62 | 63 | 64 | 65 | 66 | 67 | 68 | 69 | 70 | 71 | 72 | 73 | 74 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Biape | [a] | | | | | | | | | | | | |
| Barbados | | | | | | | | | | | | | |
| Belize | | | | | | | | | | | | | |
| India | | | | | | | | | | | | | |
| Seychelles | | | | | | | | | | | | | |
| Sri Lanka | | | | | | | | | | | | | |
| Mauritius | | | | | | | | | | | | | |
| Togo | | | | | | | | | | | | | |
| Liberia | | | | | | | | | | | | | |
| Morocco | | | | | | | | | | | | | |
| Lebanon | | | | | | | | | | | | | |
| Botswana | | | | | | | | | | | | | |
| Paraguay | | | | | | | | | | | | | |
| Zambia | | | | | | | | | | | | | |
| Cameroon | | | | | | | | | | | | | |
| Portugal | | | | | | | | | | | | | |
| Iran | | | | | | | | | | | 7 5 | | |
| Zaire | | | | | | | | | | | 10 0 | | |
| Ethiopia | | | | | | | | | 1 5 | | | | |
| Bolivia | | | | | | | | 3 6 | | | 6 0 | | |
| Costa Rica | | | | | | 2 0 | | | | | 4 6 | | |
| Senegal | | | | | | | 5 0 | | | | | | |
| Guyana | | | | | 1 2 | 0 4 | | | | | | | |
| Taiwan | | | | 4 8 | | | | | | | | | |
| Thailand | | | | | 5 0 | | | | | | | | |
| Guatemala | | | 4 8 | | | 3 0 | | | | | | | |
| Nicaragua | | | | 6 9 | | | | 4 0 | | | | 15 0 | |
| Argentina | | | 4 9 | | 13 0 | | 5 8 | 10 0 | 6 0 | | | | |
| Colombia | | 8 2 | 10.2 | 8 5 | | | | | | | | | |
| Dominican Rep | | | 3 3 | 2 1 | | | 6 0 | | | | 4 9 | | |
| El Salvador | | | 4 5 | 4 5 | | | 1 9 | | | | | | |
| Mexico | | 10 0 | | | 0 8 | | | | | | | | |
| Zimbabwe | | | | | | | | | | | | | |
| Kenya | | | | | | | | 2 0 | | | | | 15 0 |
| Chile | | | | | | | 4 7 | | | | | | |
| Ecuador | | | | | | | 1 4 | 6 0 | | | | | |
| Ivory Coast | | | | | | 2 0 | | | | | 10 0 | | |
| Tunisia | | | | | 5 0 | | | | | | 10 0 | | |
| Panama | | | | 3 0 | | 1 5 | | 3 6 | | 5 5 | | 9 0 | |
| Jamaica | | | | 11 3 | | | | 1.9 | | | 1 1 | 10 0 | |
| Venezuela | | | 7 0 | 6 6 | | 5 9 | 2 9 | 20 0 | 6 0 | | | | |
| Honduras | | 2 9 | 1 5 | | | | | 0.8 | | 2 2 | | | |
| Korea | | | | | | | | | | | 10 0 | | 20 0 |
| Israel | | | | | | | | | | 50 0 | | 25 0 | 25 0 |
| Cabei | [b] | | | | | | | 10 0 | | | 11 0 | | 41 9 |
| Peru | 1 2 | | 4 8 | 8 7 | 2 9 | | | | | | | | |
| Recipient Year 19 __ | 62 | 63 | 64 | 65 | 66 | 67 | 68 | 69 | 70 | 71 | 72 | 73 | 74 |

| 75 | 76 | 77 | 78 | 79 | 80 | 81 | 82 | 83 | Total |
|---|---|---|---|---|---|---|---|---|---|
| | | | 15 0 | | | | | | 15 0 |
| | | | | | | | 10 0 | | 10 0 |
| | | | | | | | 2 0 | | 2 0 |
| | | | | | | 20 0 | | 10 0 | 30 0 |
| | | | | | | 2 5 | | | 2 5 |
| | | | | | | 25 0 | | 10 0 | 35 0 |
| | | | | | 6 0 | | | | 6 0 |
| | | | | | 15 0 | | | | 15 0 |
| | | | | 10 0 | | | | | 10 0 |
| | | | | 25 0 | | 17 0 | | | 42 0 |
| | | 15 0 | | | | 15 0 | | | 30 0 |
| | 2 4 | | | | | | 15 0 | | 17 4 |
| 4 0 | | | | | 8 0 | | | | 12 0 |
| | 10 0 | | | | | | | | 10 0 |
| 10 0 | | | | | | | | | 10 0 |
| 20 0 | 20 0 | | | | | | | | 40 0 |
| | | | | | | | | | 7 5 |
| | | | | | | | | | 10 0 |
| | | | | | | | | | 1 5 |
| | | | | 4 0 | | | | 15 0 | 28 6 |
| | | | 11 4 | | | | 20 0 | | 38 0 |
| | | | | | | | | | 5 0 |
| | | | | | | | | | 1 6 |
| | | | | | | | | | 4 8 |
| | | | | 15 0 | | | | | 20 0 |
| | | | | | | | 10 0 | | 17 8 |
| | | | | | | | | | 25 9 |
| | | | | | | | | | 39 7 |
| | | | | | | | | | 26 9 |
| | | | | | | 15 0 | | | 31 3 |
| | | | | | 9 5 | 5 5 | 5 0 | 5 0 | 35 9 |
| | | | | | | | | | 10 8 |
| | | | | | 25 0 | | 25 0 | | 50 0 |
| | | | | 17 0 | 16 0 | | | 20 0 | 70 0 |
| 55 0 | | | | | | | | | 59 7 |
| | | | | | 20 0 | | 25 0 | | 52 4 |
| | 8 4 | 12 6 | | | | 20 0 | | 10 0 | 63 0 |
| | 10 0 | | 10 0 | 25 0 | | | | | 60 0 |
| | 3 4 | 15 0 | | 30 4 | | | | 25 0 | 99 4 |
| | | 15 0 | | | | 15 0 | | 25 0 | 79 3 |
| | | | | | | | | | 51 3 |
| | | | | | 10 2 | 35 2 | | | 52 8 |
| 50 0 | 10.0 | 15 0 | 25 0 | | | | | | 130 0 |
| | 25.0 | 25 0 | 25 0 | | 25 0 | | | | 200 0 |
| | | | 15 5 | 28 5 | | | | | 106 9 |
| | 43.3 | | 10 0 | 15 0 | 20 0 | | | 12 5 | 118 4 |
| 75 | 76 | 77 | 78 | 79 | 80 | 81 | 82 | 83 | Total |

Footnotes:

[a]Inter-American Savings & Loan Bank.
[b]Central American Bank for Economic Integration.

GAO note: Chile has repaid in full $4.7 million in loans and Guatamala has repaid $11.1 million. PRE/H terminated loans for Biape, $9 million; Bolivia, $4 million; Nicaragua, $10 million. A $2-million loan to the Caribbean Development Bank was terminated in 1981. AID cancelled $6 million in loans to Peru and paid the U.S. lenders $3.1 million from its reserve fund.

future. There can be a lengthy grace period before even the first payment is due. Since the Office of Housing guarantees payments to private lenders, it must make up any shortfall in payments from its reserve fund; under a typical rescheduling arrangement, it would then have to carry what amounts to a new loan from the reserve fund to the rescheduling government for a substantial period of time.

FM reported in 1983 that, while the U.S. government's contingent liability for HG loans was close to $1 billion,[1] the HG reserve fund was only $27 million, $3 million of which was legislatively allocated to AID's Productive Credit Guaranty Program.[2] FM projected that the reserves could be down to $8 million by the end of 1984 and recommended that the Office of Housing seek an immediate $25 million appropriation from the Congress as "short-range protection for the program." An FM official said that the $25 million figure was a "very conservative" estimate of need.

Office reactions to warnings

Because of the Office of Housing's more positive assessment of its portfolio in 1980, no concerted long-range plan was made to deal with the consequences of deteriorating economic conditions in many HG countries. Office management labeled the FM report as "inaccurate" and said that "the FM analysis approaches a 'worst-case' analysis short of a general collapse of the international monetary system."

Despite the deteriorating economic conditions in its host countries, which were apparent by 1980, the Office did not perform country risk analyses for proposed loans, although it did include economic analysis with data of balance-of-payments and debt service ratios. It also continued to concentrate loans in selected countries where U.S. government contingent liability already individually exceeded reserve fund assets. It did not have a system in place to identify governments likely to reschedule their public debt.

---

[1]As of Sept. 30, 1983, AID reported U.S. government contingent liability for the HG program as $1,073.0 billion; this figure is slightly understated since it does not include accrued interest payable to U.S. investors. The reserve fund's assets were reported as $19.6 million.

[2]See GAO report Improved Management of Productive Credit Guaranty Program Can Minimize U.S. Risk Exposure and Costs (GAO/NSIAD-84-3), Nov. 28, 1983.

In contrast to the Office of Housing, the U.S. Export-Import Bank, for example, regularly performs country risk analyses. As we have reported, U.S. bank regulatory authorities--the Office of the Comptroller of the Currency, Federal Reserve, and Federal Deposit Insurance Corporation--as part of the broader bank examination process, have adopted a uniform examination system for evaluating and commenting on country risk to U.S. banks with relatively large foreign lending.[3]

The concept behind country risk analysis is that whether a country repays its loans depends not only on the financial viability of the individual project to be financed, but also on factors such as domestic peace, exchange rate stability, debt burden, and availability of foreign exchange. Country risk analysis allows the lender to assess the level of risk represented in making a loan and the implications that risk has for the lender's larger financial position. The Office, by not performing country risk analysis, missed the opportunity to identify where the trouble spots lay and to decide what was an acceptable level of risk for its new loans. The Office also considered each new loan proposal without addressing total U.S. government exposure for HG loan contingent liabilities in individual host countries, which increased the risk to the U.S. government, given the low reserve fund level.

By 1980, when the financial risks to the HG program had become more apparent, the Office of Housing had not begun country risk analyses on its proposed HG loans. The following guaranties may not have been financially justified if the Office of Housing had made country risk analyses.

--In late July 1981, Costa Rica notified 139 creditors, including AID, that "temporary delays" in its debt service payments would continue, as it was attempting to roll over short-term debt. On August 1, 1981, the Office of Housing guarantied $6.6 million of a $11.4 million loan (which had been authorized in 1978) to Costa Rica, bringing total U.S. government HG contingent liabilities in that country to $13.2 million. At this point, private banks were no longer increasing their exposure in the country. On August 12, 1981, an FM official told the Office that Costa Rica "will possibly" reschedule its debt. On September 29, 1982, the Office authorized another $20 million loan; on August 1, 1983,

---

[3]See GAO report Bank Examination for Country Risk and International Lending (GAO/ID-82-52), Sept. 2, 1982.

$4.0 million of this loan was contracted (leaving a noncontracted balance of $16 million) as was the remaining $4.8 million of the August 1981 authorized loan.

AID stated that it held up the 1982 $20 million loan until it had investigated the Costa Rican debt situation; polled other U.S. government agencies, the World Bank, and the International Monetary Fund on their intentions to do business in Costa Rica; and tailored the loan to ease the "Costa Rican short-term debt servicing problem." We recognize that the loan was extended for balance-of-payments reasons, (see p. 39) and that AID made inquiries of the World Bank and International Monetary Fund. We do not believe, however, that the loan could have been justified on financial grounds (as stated on p. 33) if AID had conducted country risk analysis.

--The Office contracted a $15 million HG loan with Peru in April 1977 and authorized another $10 million loan in August 1978. Shortly thereafter, Peru rescheduled its public debt.[4] In February 1982, the Office contracted two new HG loans with Peru for $35 million, bringing outstanding U.S. government exposure for contingent liabilities to over $86 million. While the AID mission in Peru was discussing a proposed $100 million, multi-year HG program with the government of Peru, the government announced the rescheduling of its public debt (including HG loans) in May 1983. In September 1983 a new $12.5 million loan was authorized. In November 1983 the United States signed its rescheduling agreement with Peru.

--Between 1969 and 1980, the Office had contracted three loans worth $13.6 million with Bolivia; as of September 30, 1983, U.S. government contingent liability was $12 million. In February 1983, FM warned the Office that Bolivia was "potentially susceptible to debt reschedulings affecting [the] HG program." In April 1983, the Treasury projected Bolivia as a high-risk country with potential interruptions

---

[4]HG loans were specifically exempted from the rescheduling and AID rescheduled 19 Foreign Assistance Act loans to cover costs; see discussion on pp. 40 to 45.

on payments of U.S. loans. In July 1983, the Office authorized a $15 million HG loan for Bolivia.

AID's Bureau for Program and Policy Coordination (PPC) is the agency's office for economic analyses. PPC officials told us that they review HG proposals and have been unsuccessfully trying to get the Office of Housing to incorporate country risk analyses in the proposals. AID has improved its economic analyses since mid-1983, and stated that it "is developing more sophisticated risk analysis methodology and is already applying this to new projects." However, we believe that the Office of Housing should prepare a country risk analysis for each proposed HG loan which would include the following points; the Office may wish to draw upon other government agencies' analyses:

--A thorough discussion of trends and prospects, with supporting statistics, of the country's terms of trade, foreign exchange reserves, and foreign debt servicing requirements, including the likelihood of any debt rescheduling.

--The U.S. government contingent liabilities for guarantied loans, with HG program data presented by individual loan.

--The country's debt servicing record, noting any delinquencies over the past 2 years, for all loan payments as well as HG loans due the U.S. government.

The analysis should also discuss total costs of the loan to the host country. In the case of loans carrying so called "creative financing" terms (see pp. 36 and 37), the analysis should project the total costs based upon recent trends.

EFFORTS TO PROMOTE NEW LENDING

Office of Housing efforts to promote new HG lending included offering HG loans for their foreign exchange value; developing creative financial packages for more flexible lending; and modifying the requirement for host-country government guaranties.

HG loans for foreign exchange

Since HG loans do not require procurement of U.S. goods and services and housing construction generally has relatively small import requirements, the loans provide untied foreign exchange (U.S. dollars) to the borrowing country. HG loans can also be disbursed quickly, thus providing the country with immediate balance-of-payments assistance. However, the host country must

allocate an equivalent amount of its own currency for specific expenditure in the housing sector, regardless of where the sector fits in the country's development needs or priorities.

Due to the high U.S. interest rates between 1980 and 1982, some countries refused to accept HG loans. For example, we were told that the government of Kenya refused to assume two HG loans authorized in 1979 and 1980 for a total of $33 million because of their high interest rates and the need to address other, higher priority development areas. These loans were still not contracted in September 1983 when an additional $20 million was authorized.

Tunisia also refused to contract for a $25 million loan, which had been authorized in 1979, due to the high interest rates. Office of Housing staff in Tunisia began promoting the new loan for its foreign exchange value. A 1982 Office of Housing analysis stated that:

> "In essence, HG loans can generally be viewed as [providing] needed foreign exchange to a government. . . Little of this will be utilized for the construction of low-cost housing, which is primarily a local currency investment. . . It is this view which has motivated those who have utilized the Housing Guaranty authority over the past year."

Creative financial packages

The Office began using so called creative financial packages in order to sign up new clients (lenders and borrowers). The packages included

--"Variable rate" loans, which tie the interest rates to the going rates in the financial markets.

--"Put" loans, which give the lender the option of calling the entire loan after a specified period of time.

--"Balloon" loans, which typically allow the borrowing country to make small interest payments during the life of the loan but then require a very large final payment.

Variable rate loans may be an operational necessity in current financial markets. While the creative financial packages may offer the borrowing host country slightly lower interest payments, there are accompanying increased loan risks. If a lender calls a loan under the terms of put or balloon

loans, the host country can be faced with finding new financing which could be on less than advantageous terms, paying off the loan with potentially negative effects on its budget, or defaulting on the payment which would then have to be covered by the Office of Housing from the HG reserve fund. The creative financial packages thus increase risks for the HG reserve fund and ultimately the U.S. government. The Office of Housing contracted five put and two balloon loans.

AID stated that it did not see itself as promoting the HG program but as making resources available to help meet developing country needs, that the U.S. banking community promoted creative financial packages rather than AID, and that AID accepted creative financial packages because they offered lower interest rates than did "more conventional loan arrangements."

AID further stated that we ignore a point made in our 1977 report that the HG program should be an integral part of AID's development efforts "and not, by implication, a private business run for the benefit of its owners." We do not intend to give the impression that we advocate operation of the program as a business (see pp. 39 and 40), however, we believe that the financial implications of HG loans on the U.S. government should be responsibly considered in planning HG loans.

Host-country government guaranties

Before 1970, AID did not require that host-country governments provide full faith and credit guaranties for HG loans. Many arrearages on loan repayments involve loans without such guaranties. As of September 30, 1983, the Office of Housing had unrecoverable losses of $17.6 million in non-government-guarantied loans in Argentina, Costa Rica, the Dominican Republic, Jamaica, Mexico, Nicaragua, and Peru.

In 1970, AID instituted the requirement for host-country government guaranties of loan repayment in order to protect the U.S. government from loan defaults. This policy did not, however, cover regional banks, such as the Central American Bank for Economic Integration (CABEI) which borrows without government guaranty. In 1983, AID changed its policy to permit acceptance of "equivalent" guaranties in lieu of the requirement for host-country government guaranties. An Office of Housing official said that the change rationalized the CABEI situation and gave the Office of Housing discretion in lending to countries whose governments might not want to guaranty a loan but where there is a strong financial institution which can serve as loan guarantor. For example, the government of India refused to guarantee a $20 million HG loan which had been authorized in 1981. In January 1983, the Office of Housing contracted the 11-year balloon loan with a private Indian corporation; repayment is guarantied by the State Bank of India.

In March 1983, the Office instructed its regional offices that its rationale for not performing country risk analysis for proposed HG loans was that such analysis:

> "is extremely difficult and not very productive . . . the emphasis has been on obtaining full faith and credit guaranties from the countries. Barring a complete collapse of international credit systems, such guaranties assure the eventual repayment of HG loans."

In its newly revised handbook on Housing Guaranties, AID permits host-country government guaranties to be replaced by "equivalent" guaranties (e.g., State Bank of India).

The Office of Housing has not defined the term "equivalent" guaranty or established criteria for when acceptance of such a guaranty is appropriate, although an AID official said that there is an "understanding" of what such a guaranty is and when it can be accepted. We believe that the Office should define the term "equivalent" guaranty and develop criteria under which such a guaranty would be an acceptable alternative to a host-country government guaranty; an equivalent guaranty should provide the same degree of financial protection to the U.S. government as a host-country government guaranty. We believe that until such a definition and criteria are approved by AID, the Office of Housing should exercise caution in extending loans with equivalent rather than host-country government guaranties.

## ACTIONS TO BRING CLAIMS UNDER CONTROL

The Office of Housing has taken several steps in an effort to bring loan delinquencies under control. It has improved its claims collection process, attempted to revise old loan agreements which are not government guarantied, and added a clause to its escrow account agreements giving it access to escrow moneys.

Following the 1980 FM report, the Office of Housing assigned responsibility for pursuing outstanding claims to the Portfolio Review Committee which is composed of representatives from the Office of Housing, General Counsel, and Financial Management. This step began the process of better organizing and integrating the Office's claims collection procedures and more clearly delineated responsibilities, particularly of the Portfolio Review Committee. In addition, in 1982, when an Office of Management and Budget (OMB) official expressed concern that the Office of Housing was not vigorously pursuing its claims, the Office of Housing contracted with a consultant to write a report on how claims collection could be better managed.

After the consultant's report (Hoffman Report) was received, the Office initiated a series of reforms. Systems

were established to quickly identify delinquencies in payments to the lender and to notify borrowers of payments owed. FM and the Office of Housing continue to monitor the delinquency until payment is made and/or specified actions to collect the claims are taken according to a set schedule. With the new system, the regional offices are alerted early in the collection process, kept informed of progress, and mobilized to pursue the claim. Total unrecoverable program losses as of September 1983 were $17.6 million, and the Office had recoverable cumulative claims against host countries of $15.1 million. It recovered $13.1 million of $19.9 million incurred claims in fiscal year 1983, and it "wrote off" a $700,000 loss in Iran.

The Office has undertaken steps to improve its financial position by revising its nonguarantied loan agreements where possible and to change its escrow agreements.

Efforts to revise nonguarantied loan agreements

Almost simultaneous with the commissioning of the Hoffman Report, the Portfolio Committee also decided to pursue claims arising from non-guarantied loans in the context of negotiations for new HG loans. Specifically, in several countries with foreign exchange shortages, the administrators of nonguarantied HG loans have had difficulty converting their local currency into dollars so that they can make their loan payments. Bolivia, Costa Rica, and El Salvador guarantied the convertibility of HG repayments as a condition for negotiating new HG loans.

We question the Office of Housing's application of this policy to countries in imminent danger of default and thus on the road to debt rescheduling. For example, the Office negotiated an agreement with the Costa Rican government to guarantee currency convertibility at the very time that private Costa Rican businesses could not buy dollars from their central bank for imports necessary to the Costa Rican economy. At that time, the U.S. government was seeking ways, with other donors, to provide dollars to Costa Rica because of its troubled private-sector economy.

While we recognize that the Office is attempting to stem the deterioration of its reserve fund, we believe that its steps to insure currency convertibility on old loans should be very carefully applied. We believe its use of this mechanism as a condition to the extension of new HG loans to Costa Rica (which the Costa Rican government needed for foreign exchange) may not be consistent with U.S. government efforts to promote a rapid adjustment of Costa Rica's economy and with larger U.S. strategic interests in regional economic stability.

Changes to escrow agreements

In May 1983, the Office of Housing added a new clause to its host-country escrow agreements authorizing it to use undisbursed HG loan money from a loan's escrow account to meet any missed payments, including those occurring due to a debt rescheduling. The new clause could conflict with U.S. rescheduling policy. The purpose of debt rescheduling is to give debtor governments temporary relief from debt repayments to permit them to get their finances in order. Countries which reschedule their debts are generally under very tight domestic budget restraints. The new escrow agreement allows the Office of Housing to take money in a country's loan account to maintain HG loan repayments during the country's debt rescheduling. This money belongs to the host country, and its receipt is conditioned only on the country meeting certain project-related requirements. Damage to the country's finances can occur when the Office of Housing uses funds in the escrow account which the country is counting on for reimbursement of expenditures made.

Again, we recognize that Office actions are being taken to protect its vulnerable reserve fund. However, cutting what are, in effect, reimbursement funds to a country facing severe economic problems could be at variance with larger U.S. government interests as expressed in the U.S. willingness to reschedule host-country debts.

DEBT RESCHEDULING STRATEGY

By early 1982, the Office of Housing had developed a strategy to deal with reschedulings which posed serious danger to its reserve fund. The principal element in its strategy was to get HG loans exempted from debt rescheduling processes and to shift the burden to the U.S. Treasury.

On March 10, 1982, the Office sent a memo to the Assistant Administrator of the Bureau for Program and Policy Coordination who also served as AID's coordinator for debt reschedulings. The memo outlined the Office's concern "that if the HG reserves drop precipitously due to the effect of short term reschedulings, lenders, OMB, and the Congress will become alarmed and seek to curtail the HG Program." The Office requested the following two actions to safeguard the HG reserve fund.

1. HG loans be reclassified as private rather than public debt for the purpose of debt rescheduling. This would allow HG loans to escape some reschedulings and receive more favorable treatment in others.

2. In the event that HG loans cannot be reclassified, AID would over-reschedule its development assistance (FAA) loans on a more generous basis than otherwise required and by correspondingly exempting HG loans from the rescheduling. In such a case, the [host country] would receive the same total amount of debt relief but, internally, AID would shift the burden of the rescheduling from the HG reserves to the FAA loan portfolio.

The Office of Housing cited the 1976 Zaire rescheduling as precedent for such action.

> "In this case, the United States agreed to defer and reschedule eighty-five percent (85%) of the [Zaire's] principal repayment on the combined amount of FAA and HG loans due in certain years. Included in the list of official debt to be rescheduled was a HG loan. The [rescheduling agreement] provided that Zaire would service the HG loan in full but that AID would defer and reschedule more than eighty-five percent (85%) of the principal due on FAA loans so that Zaire would still receive from the U.S. the same total amount of debt relief. Since FAA loan repayments go to the miscellaneous receipts account of the Treasury, the effect of this was to protect limited HG reserves and shift the burden to the deeper pocket of the Treasury."

On March 16, 1982, the Assistant Administrator rejected the Office request on the basis that it would not be in the overall interests of AID or the U.S. government. He further stated that the adoption of such a practice:

> ". . . would relieve [HG] of a substantial part of the risk associated with its loan operations, and more broadly viewed could lead to requests from OPIC and Exim for similar treatment by AID since their circumstances are essentially the same. Moreover, the formalization of such a practice could present problems for the Agency with regard to its periodic audits by the GAO. The Agency would be hard pressed to explain such a formalized policy, given GAO's broader perspective of the impact of AID's loan management policy on the overall finances of the U.S. Government rather than the more narrow impact on [HG's] reserve fund. Indeed such a formal policy could be viewed by the Congress as another means of backdoor financing."

On March 3, 1983, the Office of Housing appealed to the Administrator, repeating its 1982 request for exemption of HG loans from debt reschedulings. The Administrator agreed in April that when HG and AID development loans are rescheduled, the development (FAA) loans would be rescheduled to the maximum extent as a substitute for rescheduling the HG loans.

AID had its first opportunity to implement this new strategy in May 1983 when the government of Peru announced its intention to reschedule its public-sector debt. Peru's opening position for negotiating the rescheduling would have resulted in a $20 million shortfall in HG loan payments over a 2-year period. The AID Administrator sent a letter to the two lead departments in the U.S. rescheduling process--the Treasury and State--requesting that they approve AID's request to exempt HG loans from Peru's debt rescheduling. In return, AID would reschedule more FAA loans than were necessary to fully compensate the Peruvian government for the exemption.

As shown in table 4, repayments of FAA loans are made directly to the miscellaneous accounts of the U.S. Treasury; repayments of HG loans are made to private U.S. lenders. Failure to repay an FAA loan results in a loss to the U.S. Treasury while failure to pay an HG loan triggers a payment to the U.S. lender from the HG reserve fund. Over-rescheduling in effect shifts resources from the U.S. Treasury to the reserve fund. As the Office of Housing pointed out to the Administrator, over-rescheduling has no effect on AID's funding but does affect the receipts of the U.S. Treasury. As the Assistant Administrator of PPC noted, the over-rescheduling policy proposed by the Office of Housing in 1982 "could be viewed by the Congress as another means of backdoor financing."

In June, Treasury officials agreed to support AID's request, within the U.S. government decisionmaking process on rescheduling, with the following conditions.

--AID will seek a congressional appropriation to bring the reserve fund up to a reasonable level; "the size of the replenishment should be at least large enough to enable the Reserve to absorb a complete loss on loans extended to the largest borrower in the HG program, and should be maintained at that level."[5]

---

[5]As of September 30, 1983, the Office of Housing's largest borrower was Israel; its exposure there amounted to about $190 million. Its exposure in Korea was $93.3 million; in Peru, $86 million; and with the Central American Bank for Economic Integration, $83.7 million.

Table 4

Effect of HG Loan Exemption
From a Debt Rescheduling Standpoint

| FAA loans are rescheduled | HG loans are rescheduled | HG loans are exempted from rescheduling and FAA loans are over-rescheduled |
|---|---|---|
| —Host country stops loan payments to miscellaneous accounts in the U.S. Treasury. | —Host country stops loan payments to U.S. private lenders. | —Host country continues HG loan payments to U.S private lenders. |
| —U.S. government absorbs postponement of loan payment moneys and either cuts expenditures or borrows money to compensate for deferred loan repayments. | —AID makes loan payments from the HG reserve fund to U.S. lenders for host-country payments. | —Host country stops payments to U.S. Treasury on more FAA loans than would be usual under a rescheduling. |
| | —There is no cost to the U.S. government unless the reserve fund is depleted. | —U.S. government absorbs postponement of FAA loan payment moneys and either cuts expenditures or borrows moneys to compensate for deferred loan payments in order to exempt the HG program from making payments with its own (nonappropriated) money. |
| | —If the reserve fund is depleted, the Congress appropriates money to make loan payments to U.S. lenders as substitutes for host-country payments. | |
| | —HG program undergoes congressional questioning as it seeks an appropriation. | |

--Exemption of HG loans from the Peru debt rescheduling will not be interpreted as a precedent in any subsequent rescheduling process.

--"To the extent that it is possible to offset this exemption by 'over-rescheduling' AID direct loans to Peru, AID will do this in its implementing agreement," and "if 'over-rescheduling' is not possible, the HG program will arrange a new loan to Peru in an amount greater than the payments exempted from rescheduling, recognizing that any new project must meet the usual housing guaranty criteria."

The State Department responded to AID that:

"Once a decision to reschedule is made, all [U.S. government] agencies... reschedule on an equal basis. Ad hoc exemptions from debt rescheduling of the sort you suggest seriously undermine the effectiveness of the rescheduling process by encouraging other creditors to seek similar treatment. . . Such exemptions also jeopardize the principle of burdensharing, both within the [U.S. government] and multilaterally . . . ."

However, given the precarious condition of the Housing Guaranty reserve fund, State agreed to support the exemption of HG loans provided that AID over-reschedule its development assistance loans, extend a new HG loan to Peru, and "take action to increase [the HG program] reserves quickly to a level consistent with the underlying risk of its portfolio. . ."

State and the Treasury's condition that AID extend a new HG loan to Peru, in effect, will permit Peru to continue its payments on existing HG loans. The cognizant State official for the Peru rescheduling said that this new loan to Peru will basically be a refinancing loan.[6]

Office of Housing officials have been reluctant to go to Congress for an appropriation to replenish the diminishing reserve fund despite internal AID recommendations to do so. The Office has continually described its program as self-sustaining, operating at no cost to the U.S. government; an appropriation would fundamentally alter the program's "no cost" status. However, in response to State and the Treasury's condition for supporting exemption of HG loans from the Peru debt rescheduling

---

[6] In September 1983 the Office of Housing authorized a $12.5 million loan for Peru.

and the obviously inadequate level of the reserve fund,[7] Office officials said that AID requested OMB approval to seek a $40 million fiscal year 1985 appropriation for the HG reserve fund. As of September 30, 1983, the reserve fund level was about $20 million. OMB rejected the AID request and proposed that AID seek authority from the Congress to borrow up to $40 million from the Treasury; the borrowing would occur in "as needed" increments in order to meet claim payments presented to the U.S. government by private lenders and following depletion of the reserve fund.

The exemption of HG loans from debt rescheduling processes departs from normal operating procedures of the U.S. government. The Office of Housing concentrated loans in countries now facing debt repayment problems and debt rescheduling. Exempting the HG program from reschedulings could eventually undermine the overall effectiveness of the process, establish an undesirable precedent, relieve the Office of Housing of the risk associated with its HG loan program, and transfer costs to the U.S. Treasury.

## CONCLUSIONS

The Office of Housing authorized and contracted HG loans without conducting country risk analyses in several high-risk countries facing severe economic difficulties. It has concentrated large HG loans in selected countries, adopted creative financing packages, and modified the need for host-country government guaranties. These steps have increased potential loan risks to the U.S. government. We believe the Office of Housing should prepare a country risk analysis for each proposed HG loan, drawing on analyses of other government agencies as much as possible, as discussed on p. 35.

It is evident that the concentration of HG loans in selected countries has exposed the U.S. government to costly bail-outs for the program. Office of Housing proposals to guarantee more loans to the same countries--a proposed additional $100 million to Peru, for example--raise questions of the long-term potential problems such exposure levels could cause the U.S. government. Additional HG loans should not be extended to any country where U.S. government contingent liability for such loans now exceeds reserve fund assets, and future U.S. government contingent liability exposure in any one country should not exceed the reserve fund assets.

---

[7] A comparison is the Overseas Private Investment Corporation which is required to maintain reserves equal to 25 percent of its outstanding portfolio; a similar requirement for the HG program would necessitate a reserve fund of $250 million.

The Office of Housing modified its policy of requiring host-country government guaranties on HG loans in order to permit acceptance of "equivalent" guaranties. The Office of Housing should define its terms and develop criteria which provide the same degree of financial protection to the U.S. government as host-country government guaranties. Also, HG loans should not be exempted from any country's debt rescheduling if such an exemption would entail over-rescheduling other AID loans. Exemption of HG loans shifts a rescheduling burden from the HG program where it ought to reside, to the U.S. Treasury.

OMB's rejection of AID's request to seek a $40 million appropriation for the HG reserve fund in favor of AID's seeking congressional authority to borrow up to $40 million from the Treasury may result in total depletion of the reserve fund. U.S. government contingent liability for the program as a whole is in excess of $1 billion; there are individual exposure levels of $190 million in Israel, $93.3 million in Korea, $86 million in Peru, and $83.7 million for the Central American Bank for Economic Integration. AID should determine where the HG program ranks as a development assistance mechanism and if the program warrants it, should consider replenishment of the HG reserve fund through the AID budget allocation process.

## RECOMMENDATIONS TO THE ADMINISTRATOR OF AID

We recommend that the Administrator of AID prepare an action plan to stem further deterioration in the level of the reserve fund and to minimize the contingent liability exposure of the U.S. government. The plan should include assurance that no HG loans be extended to any country where U.S. government contingent liability for such loans exceeds reserve fund assets. It should determine where the HG program ranks as a development assistance mechanism and consider replenishment of the HG reserve fund from AID budget resources.

We further recommend that the Administrator of AID not seek exemption of HG loans, within the internal U.S. government decisionmaking process, from any country's debt rescheduling which includes AID loans.

In addition, we recommend that the Administrator of AID have the Office of Housing and Urban Programs:

--Prepare a thorough country risk analysis for each proposed HG loan.

--Define "equivalent" guaranty and establish criteria under which such a guaranty may be substituted for a host-country government guaranty, and exercise caution in extending HG loans which do not have host-country government guaranties.

## AGENCY COMMENTS AND OUR EVALUATION

AID agreed with our recommendation to prepare an action plan and to consider replenishing the HG reserve fund from AID budget resources. It also agreed to define the term "equivalency" and to exercise caution in extending HG loans which do not have host-country government guaranties.

AID said it would "revise its country risk analysis methodology from that which was in effect when the audit occurred" and "do more thorough country risk analysis."

AID disagreed with the recommendation to limit loan amounts to individual countries to a level equal to the reserve fund. AID also disagreed with the recommendation that HG loans not be exempted from any country's debt rescheduling which includes AID loans.

### Country risk analysis

AID stated that it has been performing country risk analysis "in the form of debt service analysis and balance-of-payments analysis," which is "the type of risk analysis. . . recommended in the 1977 GAO audit of the program."[8]

In 1977, we recommended that AID improve its "economic analysis" with emphasis on balance-of-payments and debt service ratios for proposed HG loans. AID has improved its economic analyses; however, such analysis is but one element of country risk analysis, as discussed on p. 35.

AID further stated that HG host countries are not credit worthy over a 30-year period, that "risk analysis is not infallible and cannot be relied upon with confidence for more than 3 to 5 years of the 30-year life of a HG loan,"[9] and that very few countries would have survived a GAO-recommended country risk analysis "10 to 20 years ago when the bulk of the HG loans were made. . . ."

We recognize that country risk analysis is commonly understood to be valid only for 3- to 5-year projections. However, we believe that AID should have begun making country risk analyses for the placement of its loans, as discussed on pp. 29 to

---

[8]See GAO report, The Challenge of Meeting Shelter Needs in Less Developed Countries (ID-77-39), Nov. 4, 1977.

[9]Of 27 loans contracted between 1980 and September 1983, 20 had terms of 29 or 30 years; loans to Costa Rica, Ecuador, El Salvador and Peru had terms of 20 to 25 years and the loan to India had terms of 11 years.

35, in 1980 when deteriorating economic conditions in its host countries became apparent and Financial Management issued its warning on potential debt reschedulings and their impact on the reserve fund.

Our recommendation is based upon the fact that AID's various HG project papers contain no risk analysis; Office of Housing officials said that they did not conduct risk analysis; PPC officials said that they had been trying unsuccessfully to get the Office of Housing to conduct risk analysis; and the Office of Housing memo discussed on p. 38 states that no risk analysis is done.

Limit on loan amounts to individual countries

AID stated that it "does not propose to require, as a condition to HG lending in a given country, that reserves exceed contingent liability." It said that such a rule would be arbitrary; would cut off some countries from further HG funds, and would be tantamount to calling for a major refunding of the reserve fund or suspension of the program.

We do not believe that the reserve fund can be built to an adequate level to offer reasonable protection to the U.S. government unless AID stops HG lending to countries where HG loan exposure exceeds the reserve fund.

As discussed on pp. 42 and 44, the Treasury supported AID's proposal for exempting HG loans from the Peru debt rescheduling with certain conditions. The Treasury included the condition that AID would seek a replenishment of the reserve fund "large enough to absorb complete loss on loans extended to the largest borrower in the HG program. . ." and the reserve fund "should be maintained at that level." As we note in the report, AID's largest borrower in the HG program was Israel at about $190 million, followed by Korea at $93.3 million and Peru at $86 million.

AID's proposal, in effect, to permit continued lending to countries which already have loan levels far in excess of the reserve fund departs from the Treasury's condition and increases the possibility that the U.S. government may be faced with contingent liability claims if certain countries should become delinquent on, or reschedule, their loans.

HG program assets and the reserve fund

AID stated that we "misstate the purpose and use of the reserve fund," and emphasized that while the reserve

"fund has dropped from $49.9 million at the end of fiscal year 1970 to $21.6 million at the end of fiscal year 1983, receivables rose from $0.8 million to $24.9 million over the same period. This can be described as a shift in assets of $24.1 million from cash to receivables."

A discussion of program assets, the majority of which are receivables, gives a misleading impression. The receivables are missed payments from the very countries which are now in economic difficulties and cannot, or may not be able to, meet their debt obligations. Many of these receivables are from loans which do not have host-country government guaranties and thus AID does not even have assurance of eventual repayment. Should claims exceeding the $21.6 million cash available be presented, an appropriation would be needed to meet U.S. government obligations; this is particularly true given the continued threat of developing country debt reschedulings. For rescheduled debt, the HG reserves would have to make the quarterly payments that the rescheduling country would forgo. For example, Peru's quarterly payments for July-August 1983 were $4,018,941; payments of this magnitude for just a few rescheduled countries could bankrupt the reserve fund.

AID also stated that "of the approximately $25 million claims paid and outstanding, none of the claims paid correspond to projects authorized since January 1981. . . ." However, our review of these claims shows that some of these claims are from loans which AID contracted in 1981 and 1982 and AID has authorized additional loans since 1981 for countries in the $25 million claims category.

The purpose of the reserve fund is to enable AID to fulfill its obligations to U.S. investors by making loan payments a host country misses or cannot meet. AID documents also state, as we note on p. 26, that the reserve fund creates investor confidence that claims will be paid promptly and that investors are unlikely to participate in the HG program if inadequate reserves indicated that the investor would have to wait for payment while AID sought an appropriation. A substitute procedure, such as borrowing authority, which AID cites as a supplement to the cash reserves, is an alternative recently proposed by AID and OMB but not yet approved by the Congress; borrowing authority thus cannot be accepted as a complement to the HG cash reserves until it is approved.

Host-country government guaranties

AID stated that it had not eliminated the need for host country government guaranties since:

"the rule requiring host-government guaranties arose as an internal Office of Housing procedure . . . . The way this procedure was

> applied was generally to obtain a host-government backup guaranty. . . . From time to time, as early as 1969 with CABEI, the Office has made judgments that certain borrowers were themselves sovereign governments or the equivalent and could protect themselves. . . ."

However, AID's own documents, including the memorandum cited on p. 38, and the Office of Housing's fiscal year 1983 annual report, state that host-country government guaranties are required for HG loans.

Except for loans to the CABEI, all HG loans extended from 1973 until the 1983 India loan had host-country government guaranties. In 1983, AID revised its Housing Guaranty Program Handbook and permitted "equivalent" guaranties to be substituted for host-country government guaranties. We have revised the report to note that AID modified its procedures.

HG loan exemption from debt reschedulings

AID stated that it "is no longer seeking to exclude HG loans from Paris Club reschedulings but reserves the right to over-reschedule AID loans if this is in the best interests of the HG program."

The Paris Club is the creditor forum chaired by the French Treasury and composed of Western governments, including that of Japan, which provide the bulk of official loans in international lending. Each country's official debts are listed in the tables of Paris Club debt relief obligations. HG loans are classified as official debt and thus included in the Paris Club, and U.S. government policy requires that guarantied loans, including HG loans, be classified as official debt.

AID's agreement not to seek HG loan exemption from debt rescheduling at the Paris Club does not address our discussion on pp. 40 to 45. Our point is that HG loans can be exempted from a debt rescheduling only in the internal U.S. government decisionmaking process. Our recommendation has been clarified to prevent misunderstanding by AID. AID's comment that it "reserves the right to overreschedule AID loans if this is in the best interests of the HG program. . ." seems to indicate that AID will continue to request HG exemption from debt rescheduling processes. We believe that exemption of HG loans from debt rescheduling processes departs from normal U.S. government operating procedures, could eventually undermine the rescheduling process, establishes an undesirable precedent, relieves AID of the risk associated with the Housing Guaranty programs, and transfers costs to the U.S. Treasury.

Office reactions to a changed environment

AID stated that "AID and the Office of Housing did not ignore warnings of risk" (AID underscoring); that projections on the status of the reserve fund have been made yearly since the late 1970s and discussed with OMB; that a major 1978 study resulted in the Office of Financial Management operating on a "proactive" versus "reactive" method; that AID sought and obtained congressional approval to retain interest earnings on its reserve fund held by the Treasury; and that the Office of the Assistant Director, Finance, was established in the Office of Housing to coordinate debt rescheduling policy.

Our position is that the Office of Housing was slow to react to warnings of risk and not that it ignored such warnings. It had no concerted long-range plan for dealing with the consequences of deteriorating economic conditions in many HG countries. The Office of Housing:

--Labeled Financial Management's 1980 proactive report as inaccurate and declined to adopt cost-saving cuts in operational expenses. It did seek and obtain congressional approval to retain reserve fund interest earnings.

--Made no country risk analyses for its proposed-HG loans and continued to place loans in countries where U.S. government contingent liability exceeded reserve fund assets. It also continued to place loans in high-risk countries.

--Initiated operating reforms on loan arrearages in response to OMB inquiries in 1982.

--Did not act on a February 1983 Financial Management recommendation to seek an "immediate" appropriation for the reserve fund until the fall of 1983.

--Submitted a personnel action to fill the position of Assistant Director of Finance in January 1984.

Allocation of local currency for HG projects and where housing fits as a priority

AID said that we are wrong in stating that in order to obtain the U.S. dollars provided through an HG loan, "the host country must allocate an equivalent amount of its own currency for specific expenditure in the housing sector, regardless of where the sector fits in the country's development needs or priorities."

As we discuss on pp. 34 to 36, one of the attractions of the HG program for developing countries is that it provides U.S. dollars for use as the host country wishes. The actual HG projects financed by the loan are undertaken using the host country's own currency. The host country allocates for the housing sector an amount of its own currency equivalent to the amount of U.S. dollars it receives under an HG loan.

AID said that the HG project design process concentrates on local currency, uses Shelter Sector Assessments and Country Development Strategy Statements (both AID documents), and determines whether each proposed project is consistent with the country's priorities and needs.

We do not disagree with AID that its projects are planned using AID's Shelter Sector Assessments and Country Development Strategy Statements. We do question programming loans to countries for which housing sector development is a low priority in terms of where the country spends its own funds. As discussed on p. 36, Kenya refused to accept HG loans because it had other, high-priority development concerns; the Office of Housing encouraged Kenya to accept the loans for their U.S. dollar value. The Ivory Coast and Peru are using very little of their own funds to construct housing as housing ranks fairly low as a development priority in their national budgets and development plans, and officials in both countries said that they would be constructing no low-income housing in the absence of HG loans. We therefore believe that our statement that "a country receiving HG assistance must allocate equivalent local currency to the housing sector regardless of where the sector fits in the country's development needs or priorities" is correct.

APPENDIX

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

OFFICE OF
THE ADMINISTRATOR

February 17, 1984

Dear Mr. Conahan:

The purpose of this letter is to respond to your letter of January 16, 1984 and the draft GAO report on AID's Management of the Housing Guaranty Program (GAO Assignment Code 471970).

The Housing Guaranty (HG) program is an important foreign assistance activity using a unique financing mechanism to advance U.S. foreign policy and international development interests. It has been the subject of extensive and almost continuous audit by the GAO and other external agencies over the past ten years. These audits have been constructive and all have consistently recognized the valuable contribution made by the HG program. AID values this oversight and wishes to express its appreciation to the GAO for the spirit of cooperation in which this latest audit was conducted over the past calendar year.

In summary, we view the Report as being positive on the developmental effectiveness of the HG program but negative on the issues which relate to using the guaranty mechanism in times of worldwide economic problems.

AID's detailed response to the Report appears in two attachments to this letter. In the first attachment, which is a page by page response to the Report, you will note that AID accepts many of the GAO recommendations including developing more sophisticated country risk analysis for HG projects and updating its action plan to strengthen the reserve account. However, we do not agree with the recommendation that would have the HG program cease doing business in countries where contingent liability on total HG lending exceeds HG reserves. This later GAO recommendation would effectively prevent the HG program from serving important development and foreign policy interests in many important LDCs.

Mr. Frank C. Conahan, Director
National Security and International
Affairs Division
U. S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

The second attachment illustrates the financial condition of the HG program from its inception. A review of this attachment will demonstrate that the program has been financially successful and that reserve problems today result not from the factors cited in the Report but rather from conscious decisions made by successive Administrations to operate the HG program as a mainstream development program rather than solely as a profit making business.

In general, we believe the management of the HG program has been successful in adjusting to continual changes in the world economic scene while keeping its eye on its principal development objectives.

Major points appearing in the attachments are as follows:

-- We are pleased that the Report praises the accomplishments of the HG program, using phrases such as "AID has made substantial progress in the five countries reviewed in achieving affordable shelter for the poor". Indeed the Report confirms the development direction of the HG program, the appropriateness of its policy emphasis, and the leadership role AID has played in the sector.

-- Contrary to suggestions of "indifference" to changing economic conditions in LDCs, AID management of the HG program has had formal procedures in place since the late 1970s to assess risk as it relates to HG reserves. Annually, FM and PRE/H submit to OMB projections on HG reserves and potential claims. These projections are subject to discussion and negotiations with OMB and result in apportionments of budget authority to meet anticipated claims. The annual budget negotiations with OMB also focus on the level of new guaranty authority to be appropriated by the Congress--taking into account conditions in LDCs.

-- AID and OMB projections view the problem with reserves as a short term liquidity problem. All of the HG portfolio originated since the late 1960s is guarantied by sovereign governments or the equivalent. Assuming the world economic order does not collapse, the prospects are that HG loans will be repaid. The debt rescheduling phenomenon accounts for much of the recent decline of the reserve account. As rescheduled debts are repaid, the HG reserves will begin to grow.

-- The recent economic conditions in LDCs have affected the financial position of the HG program in the same way such conditions have affected the financial

position of all public and private creditors doing business in LDCs. It cannot be fairly said, as the GAO suggests, that the financial position of the HG program results from a failure to do more complex country risk analysis. While AID has done country risk analysis, had the Agency relied solely upon such analysis 10-20 years ago (when much of the HG portfolio originated) countries eligible for HGs would have been limited to a group of middle income countries, many of which have serious short-term liquidity problems today.

-- The reduced reserves of the HG program result neither from mismanagement nor from lack of concern. Rather the reserve position today is due to (a) the unexpected worldwide recession which has reduced cash HG reserves while at the same time exacerbating development needs of the LDCs, (b) the failure of the Congress to initially establish the program on a fully self-sufficient basis by allowing the reserves to be credited with interest earned and by appropriating additions to reserves when Congress increased the guaranty limits by over 300%, (c) the overall U.S. Government policy on debt rescheduling which changed the Paris Club rules to reclassify the private bank HG debt as "public" debt, (d) the roughly 10% of the non-host government guarantied loans in the portfolio which were made in the first years of the HG program.

-- AID has been well aware of the country risk implications of guarantying 30 year loans to LDCs. Agency decisions to authorize HGs have been made by balancing the developmental and foreign policy considerations against perceived risks. AID is improving its methodology for assessing country risk. However the ultimate decisions to extend 30 year guaranties cannot be made solely on risk considerations. Otherwise no guaranties would be extended and no development gains realized.

-- The total assets of the HG program today consist of ready cash reserves plus assets in the form of receivables. These liquid and non-liquid assets are the real measure of the financial soundness of the HG program. AID would prefer sizeable ready cash reserves. However, the relative size of the ready cash HG reserves, while of concern to AID, is neither the sole measure of the integrity of the program nor the sole basis for extending or withholding guaranties to countries otherwise found to benefit by the program.

-- Recently AID sent forward a budget amendment requesting that funds be appropriated to augment the HG reserve account. The Executive Branch rejected AID's request and in so doing has reflected a reasonable judgment that (a) an appropriation is not strictly necessary since it is anticipated LDCs will eventually repay their rescheduled (not defaulted) debt and reconstitute the HG reserve fund, (b) the HG reserves will not completely erode, and (c) even if they did, borrowing authority being sought from Congress will be a substitute for reserves to meet the cash needs of the program in the near term. The Executive Branch view, as indicated in the results of the OMB decisions, is that the status of the HG program resulting from LDC debt problems is no different than the status of similar USG agencies and that the Administration's decision to not seek a Congressional appropriation for HG reserves should not adversely effect the day-to-day conduct of the program.

-- We believe that the GAO misunderstands the nature of the risks facing the HG program and thus overstates its recommendations as to how AID should react. When an LDC is unable to make an installment payment on a HG loan, this does not mean that there will be an acceleration of the loan or that the HG reserves will have to make a full payment of outstanding principal of the loan. Rather, the underlying agreements are written to permit the HG reserves to make the semiannual payments for an intervening period in the life of the 30 year term; during which time it is assumed that the debtor, through improvements in its economy assisted by rescheduling, IMF support, or other devices, will be able to resume debt service payments and repay AID for payments made by AID in the interim on the borrower's behalf. Thus AID's exposure at any one time can be covered by a smaller cash reserve fund than might be appropriate for other guaranty programs.

-- The HG device is the only substantial source of AID funding specifically available for the critically important shelter sector. Over the years the HG program has provided over $1 billion in assistance to LDCs and at minimal cost to the U.S. taxpayer. HG lending, at terms equal to or better than IBRD terms in today's market, is far more attractive to LDCs than commercial terms. Furthermore HG lending accomplishes specific development goals. Simply put, the program is a bargain for LDCs and the U.S. taxpayer.

An important underlying issue in the Report is where to draw the line between the HG program's pursuit of high risk development goals as an integral part of AID's country programming and the preservation of the HG program's reserves. AID will continue to monitor the situation and seek new opportunities to increase reserves to a level that more appropriately matches its contingent liability. Nevertheless, we believe the enactment of the borrowing authority mentioned earlier to complement the cash reserves will enable the HG program to continue to operate in the near term at a reasonable pace of operations.

Sincerely,

Jay P. Morris
Acting Administrator

Enclosure

A. AID's Detailed Response to Draft GAO Audit No. 471970
B. Financial Highlights of the HG Program

AID Response to Draft GAO Audit No. 471970

The following specific comments to the draft GAO Report are keyed to the numbered pages of the GAO Report.

Digest

p. i The effect of currency devaluations on domestic LDC finance systems will differ, depending whether the systems have both borrowed foreign exchange and have retained the exchange risk. The GAO statement about devaluation in its unqualified form is incorrect.[1]

p. ii AID opposes subsidies and believes that no LDC can afford the deep subsidies in the housing sector that the U.S. and most developed nations provide. However, AID recognizes that all countries choose to subsidize some things in their society and that shelter, as a basic human need second only to food, is a legitimate candidate sector for subsidy. Rather, AID's policy is that shelter subsidies be analyzed and then steps be taken which will lead to a rational, economically sound shelter program for a country. As a practical matter, the rationalization process usually leads to a conclusion that subsidies are not useful or effective in most LDCs and should be sharply curtailed or eliminated. Where subsidies cannot be eliminated, AID policy is to try to direct the subsidies to the poor.

p. ii The Digest states that external loans, such as HG loans, make cost recovery in the shelter sector more difficult and that such loans may even aggravate economic problems. This theme is repeated from time to time in the Report and deserves comment:

The purpose and analysis of a HG project is based on project lending criteria. But the benefit of the HG activity is the same as that seen in project and program lending. To varying degrees in a HG project, the resources needed to construct the project are local currency resources. Similarly, the cost recovery for the project is realized in local currency. The HG dollars are exchanged for local currency by the borrowing country with the project getting the local currency and the host country's central bank getting the dollars. Ideally the entity that keeps and invests the dollars should retain the foreign exchange risk. If this occurs, cost recovery in the shelter sector will not be affected by devaluations. For a HG loan to make sense, two separate analyses or judgments are required. First, that there is a positive rate of return on the investment of local currency swapped for the HG dollars; second, that the dollars borrowed on comparatively advantageous HG terms (30 years, below market interest rates) can and will be used to the borrowers

[1]Deleted from digest.

GAO Note: The page numbers have been changed to reflect their current position in the final report.

advantage, e.g. to retire higher interest rate debt or substitute for planned future borrowings at higher rate terms. The Report, throughout, should take into account the dual nature of the dollar/local currency transactions in a typical HG loan.

The Digest asserts that the HG program operations should be reduced to correspond to its smaller cash reserve fund. The Digest fails to indicate that the assets of the HG program consist of more than cash reserves. The Executive Branch is requesting authority from the Congress to augment HG cash reserves with standby borrowing authority. Should the request be honored, the current liquidity aspect of the reserve fund problem should be solved.

p. iii The Digest states that failure to do country risk analysis has resulted in increased liability for the USG. The Report does not demonstrate why this assertion is true. In view of the rapidly changing conditions in LDCs, it is difficult to assert (as the GAO attempts) that more complex risk analysis, if done by AID in the 1960s and 1970s, would have resulted in a different risk exposure of the USG. Loans cited by the GAO to support its proposition are those for which AID did perform the kind of country risk analysis recommended by the GAO in its 1977 report and loans for which there was vigorous internal debate on risks versus gain. In general, the Report fails to acknowledge the lengthy and thorough process of HG project review in AID where differing viewpoints are heard and reconciled by the appropriate regional assistant Administrators.

p. iv The Digest, and later the Report, make constant reference to AID's elimination of its host country guaranty requirement. AID has not eliminated this requirement. The rule is that AID requires a host country guaranty or the equivalent so that the debt can be viewed as "sovereign debt." Equivalent means equivalent. Rarely has AID used the host government guaranty equivalency rule. Never has this been a problem. The point does not merit the emphasis given in the Report.

p. iii-iv The Digest says that so-called creative financial packages for HG loans increase risks for the USG. These "creative" loans were all proposed by private U.S. banks in accordance with standard commercial practice. The borrowers and AID agreed to the terms because such terms were deemed to be necessary to achieve lower interest rates. Whether such terms increase or decrease risk depends upon the alternatives that were available at the time to the borrower. For example where loans have both "put" and "call" options (deemed to be creative by the GAO) the potential risks and benefits to lenders and borrowers are equal. It is wrong for the GAO to perceive these terms as only productive of risk. At a minimum the Report should discuss the tradeoffs in cost (i.e. lower interest rates over a 30 year term.)

p. v The Digest recommends: that AID prepare an action plan to stem deterioration of reserves and minimize contingent liability of the U.S. Government, that no HGs be extended to countries where contingent liability will exceed reserve fund assets, and that AID consider replenishment of the reserve fund from AID budget resources.

Current AID plans to protect the reserve account appear in a memorandum dated March 1983 and are further reflected in recent legislative initiatives. Nevertheless, AID agrees to prepare an action plan. Current AID plans concerning reserves contemplate the replenishment of the reserve fund with AID budget resources if the situation eventually requires it.

AID has been continually reviewing the status of the reserve account in collaboration with OMB. AID does not propose to require, as a condition to HG lending in a given country, that reserves exceed contingent liability. Such a rule would be arbitrary and would cut off some countries from HG assistance that are good credit risks and where good progress is being made from a development standpoint. The GAO recommendation is tantamount to calling for a major refunding of the HG reserve account or suspending the HG program in the majority of countries where it has been most successful. At present, neither action is justified. Even if there were a major refunding of the HG reserve account, the GAO recommendation would cut off the HG program in a number of developing countries where the program is needed.

p. vi AID accepts the recommendations to do more thorough country risk analysis and to follow the GAO recommendations regarding host country guaranties.

Chapter I

AID accepts Chapter I, subject to the change of certain factual errors as discussed informally with GAO staff.

Chapter 2

Page 5 The Report states that the program faces significant obstacles to obtaining increased private sector participation in low-income housing on a continuing basis. We believe the GAO is thinking only of the "formal" private sector. AID believes that the private sector (defined as everything other than the public sector) in LDCs accounts for the vast majority of low income shelter production and that this will always be the case. The objectives of the HG program have been to persuade the public sector to do two things: (a) deregulate to give the private sector the freedom to build so that private housing production will be "legal", and (b) adopt the practices of the private sector so that shelter is designed to be affordable to the purchasers and that the costs be recovered. The GAO should reconsider and redefine the "obstacles" referred to.

Page 6 The Report appears to endorse the shelter objectives listed. If indeed these objectives are deemed worthwhile, the Report should so indicate. The Report omits a fifth objective central to the HG program: the preparation of comprehensive national housing policies.

Page 8 The Report, noting that the HG program alone cannot significantly reduce country urban housing deficits, should be clarified to indicate that the housing policies advocated by the HG program which are incrementally linked to each physical project actually financed by HG loan funds will lead to a meaningful reduction of housing deficits over time.

Page 9 In discussing the evaluation of AID's long policy dialogue with Ecuador, the Report fails to indicate that (a) the government has always been in agreement with AID on the issue of standards and (b) the dialogue has finally resulted in the agreement of the private sector foundation (which was recalcitrant) to reduce standards on the most recent HG project and proceed with project implementation.

Page 10 The Report cites economic pressures as motivating the Ivory Coast's acceptance of minimal shelter standards. It ignores the contribution made by AID officials through long dialogue and through extensive training and continuous policy education of Ivory Coast officials.

The Report cites the more costly practice in Peru of running wires underground as an example of less than perfect acceptance by Peru of minimal cost solutions. In fact, this practice in Peru saved costs in the long run due to the inhibiting effect the placement of underground wires has on piracy of electricity and on rust. The Report should note that AID finances upgrading in Peru but has not financed site and services projects.[2]

The Report concludes that AID's goals have been hampered by income miscalculations of the target group. In the final chapter 2 recommendations (page 21), the Report urges that AID conduct surveys to insure that incomes of beneficiaries in every HG project are below the median. AID evaluations of HG projects do, in fact, attempt to characterize the beneficiary population and in a number of evaluations a full census or sample survey of beneficiaries has been conducted to generate detailed portraits of the beneficiaries, including household incomes. Although AID finds these detailed (and expensive) surveys useful in understanding the effectiveness of plot allocation procedures and occupancy patterns over time, it does not view its proper role as continually ensuring that units, once allocated according to agreed-upon procedures, are forever occupied by below-median income households.

[2]Deleted from report.

The Report should also note that Congress never intended AID to ensure this result. In fact, in enacting FAA Section 223(j) which governs the target beneficiary issue, Congress specifically rejected a rule which would require beneficiaries per se to be eligible and instead placed the burden of the rule on the type and cost of shelter unit to be constructed. Thus the statute requires that shelter be "suitable" for below median income people. The statute also allows for a 10% leeway, due to the difficulty of applying the rule. The Report, after recognizing the technical difficulty in compiling accurate statistics, overstates the importance of these statistics in AID's pursuit of its development goals. We believe a review of the statutory history of the below median income rule together with AID's compliance with the rule will indicate that AID is in compliance with the statute. We are disappointed that the Report fails to comment on this excessively complicated legislation and fails to recommend a more useful statutory scheme to assure the goals of the Congress.

Page 12 The Report notes that LDC budgets for housing are being reduced in times of economic difficulty, with housing being generally classified as a social, non-productive sector as a basis for determining budget priorities. AID believes that housing production is a major factor in any country's construction industry and also that notions of housing as a non-productive sector are rapidly changing. In any event, AID does not view with alarm the trend of housing budgets in LDCs. We believe that the public sector should rarely attempt to be a heavy producer of housing but rather should fashion a policy environment which permits the private sector to produce housing. In this framework, AID does not necessarily believe that national housing budgets should be increased. LDCs should be free to set their own shelter priorities. Often housing is a higher priority item in LDCs than in developed countries. El Salvador, Singapore and Hong Kong have used their housing budgets as engines of growth. AID's general policy is to maximize the impact of a country's existing housing budget and not attempt to increase budgets per se.

Page 14-15 The Report suggests that cost recovery (which it notes AID is promoting effectively) is hampered by devaluation of local currency compared with the dollar HG loans. This assumes, incorrectly, that the burden of the foreign exchange risk in HG lending is or should be on each project. This has not been AID's preferred policy since the late 1960s. As noted earlier in this attachment, AID attempts to design projects so that the dollar and the local currency transactions in each HG activity are managed separately--each resulting in a positive rate of return. (See AID comments for page iv of the Digest.) Generally, HG dollars will be disbursed to "reimburse" the LDC for local currency expenditures made in connection with a shelter project. When AID approves the cost recovery plans of a specific project, knowing that project

beneficiaries repay their loans, mortgages, etc. with local currency, AID ensures that to the extent politically feasible, the funds generated from the project will repay the capital costs of the project together with interest at a rate that reflects the internal interest rates in the country. AID does not expect that the project beneficiaries will bear a foreign exchange risk. In these cases (with perhaps a rare exception) the government or central bank which has the use of the dollars--exchanging equivalent local currency for the project--is expected to bear the foreign exchange risks and rewards. If the HG dollars are borrowed at 10% interest and used to retire 15% interest dollar debt or invested in a imported item, say a tractor, producing a 50% per annum rate of return, then the dollar side of the transaction makes sense and should stand alone. While AID does not trace the dollars directly, we do satisfy ourselves that the results of IMF, IBRD, AID and State overview of a country's economic efforts suggest that the country receiving assistance is on track. The Report should be corrected to reflect the fact that since the late 1960s, in general and preferred HG practice, project cost recovery is not related to the costs of devaluation or the benefits of revaluation.

Page 16 The Report's analysis about the ability of Housing Banks to serve the poor is deficient in its presentation of the problem. The Report fails to note that most (perhaps 80%) low income housing is financed outside the "formal" housing finance sector. For this reason, AID's major goal has been to limit public sector housing construction in favor of construction of infrastructure.

Page 17 The Report speaks of inflation in Ecuador putting the price of units in a HG project out of reach of target beneficiaries. However in the Project in question, the government has agreed to reduce standards using a "piso techo" model and thus the target group will be served.

Page 20 The Report speaks of "elimination" of subsides as being a core element of the HG program. (See AID comments on page iii of the Digest.)

The Report states it is difficult to justify the programming of additional HG loans to countries which do not minimize subsidies. AID can forsee situations where a country would benefit from HG assistance in areas of institution building, reduction of physical standards and economic pricing costs of housing produced, as well as training and technical assistance, even though the country insists on maintaining its subsidies. In such a case, AID would seek policy change in other areas while working quietly and indirectly on the subsidy issue. The Report, elsewhere, notes correctly that the fundamental policy change that AID promotes in its shelter programs are lengthy efforts achieved incrementally over time. Cost recovery and minimal subsidies are also not the only policy changes advocated by AID.

Page 20-21 The Report speaks of budget constraints and thus the inability of LDCs to provide incentives to the private sector. AID believes that the public sector can encourage the private sector through cost free incentives such as the redrafting of restrictive building and zoning codes, and the simplification of procedures to acquire building permits and licenses. Of greater importance, the public sector can provide infrastructure to support the activities of the informal private sector which produces most low income shelter.

The Report recommends surveys to ascertain the income levels of HG project beneficiaries. AID believes that project evaluations in due course will reveal this information. (See the response on this issue appearing earlier in this attachment.)

The Report recommends that AID emphasize its institution building and cost recovery goals as those which offer the most promise. AID believes these are important goals and will continue to emphasize them. We believe equally promising are those goals which would have governments eschew direct construction of completed housing in favor of providing only those elements not easily provided by homeowners themselves (land, water, infrastructure) with the formal and informal private sector being encouraged and given the freedom to build and finance completed units.

Chapter 3

Page 26 The Report states that AID management was slow to adapt to the changing world conditions and that earlier action could have minimized the adverse impact of worldwide economic problems on the HG program. AID disagrees with these statements. The worldwide recession was not predicted by either the private or public sector in the U.S. When it occurred, AID officials, balancing the perceived risks with developmental gains, decided to continue the HG program. The only action AID could have taken to significantly minimize the impact of declining LDC fortunes would have been to stop HG development programs in countries at risk. Such action would have been contrary to U.S. foreign policy interets, would have seriously jeopardized development progress and goals in such countries, would have denied needed long term resources to these countries at the time such resources were most needed, and would have encouraged other public and private sector lenders to follow suit and cut off lending, contrary to the overall goals of the USG and IMF to keep long term credit lines open to LDCs during the time of greatest need. Balancing the obvious risks, AID decided for the most part to continue HG operations as an integral part of AID's country programming. At the end of FY 83, of the approximately $25 milllon claims paid and outstanding, none of the claims paid correspond to projects authorized since January 1981 when the worldwide recession occurred.

The Report fails to recognize throughout a point made emphatically in the 1977 GAO Report that the HG program should be an integral part of AID's development efforts and not, by implication, a private business run for the benefit of its owners.

The Report states AID did not perform country risk analysis for proposed HG lending and thereby missed an opportunity to minimize contingent liability. AID's country risk analysis is generally performed in the context of a broad CDSS exercise which examines the political and economic prospects of each country on a three-to-five year period and determines the mix of AID resources appropriate to the country. Risk analysis is also done in each Project Paper in the form of debt service analysis and balance of payments analysis. This type of risk analysis is exactly as recommended in the 1977 GAO audit of the program.

The Report is incorrect when it states that AID did not perform country risk analyses. It is equally incorrect when it states that such analysis would have minimized contingent liability unless the Report were to explicitly recognize in the same sentence that: (a) the very need for U.S. guaranties confirms, correctly, that the borrowing countries are not credit worthy over the time period (30 years) of HG loans, (b) LDC country risk analysis is not infallible and cannot be relied upon with confidence for more than 3 to 5 years of the 30 year life of a HG loan, and (c) 10-20 years ago when the bulk of the HG loans were made, the only countries that might have survived more sophisticated country risk analysis of the type proposed by GAO are countries like Iran, Venezuela, Brazil, Mexico and Argentina--countries that today have the most serious payment problems.

The Report suggests that lack of concern of AID officials has contributed to the problem. This is not true. Annually, beginning in the later 1970s, the health of the HG reserve account has been a principal issue in the formal AID/OMB budget review processes. Each year the Office of Housing and FM prepare projections on claims and the reserve account and forward these to OMB. OMB examiners review these projections and often make changes. This formal process guides OMB decisions on budget authority. If AID underestimates the claim payments it will make in the next fiscal year, AID has to go through budget amendment process before it can get funds apportioned to make the claims payments. Projections of claims versus reserves is a serious interagency exercise that occurs annually.

The Report states that debt reschedulings in HG countries threaten to "bankrupt" the program. AID believes the correct phrase is "deplete the ready reserves" not "bankrupt" the program. In fact there are many differing projections of the effect of LDC debt rescheduling on HG reserves. OMB, after studying AID projections in detail, has acted on the belief that reserves will not entirely

disappear and that even if this happens, the reserves will be reconstituted as the result of LDC payments of deferred debt. For these reasons, OMB declined AID's request to seek an appropriation to augment HG reserves by a $40 million amount. Instead OMB has proposed that AID rely on borrowing authority from the Treasury in the event the reserves are depleted. Otherwise, argues OMB, the eventual build up of HG reserves, together with the requested $40 million, would produce an unnecessarily large reserve account. It should be noted that the net worth of the HG program has not declined seriously, and indeed has increased in each of the last two years. Only the liquidity of HG program assets has changed due to the economic situation in LDCs. (See Attachment B.)

Page 26 The Report misstates the purpose and use of the reserve fund. It states that without adequate reserves, lenders are unlikely to participate in the program. AID believes that without reserves or other substitutional procedures to acquire funds quickly, such as borrowing authority, lenders will be unlikely to participate. The Report should include this underlined statement. The GAO is aware of the proposal of the Executive Branch to operate the HG program using contingent borrowing authority. Its failure to acknowledge this compliment to cash reserves is not helpful to a full understanding of the issue. AID strongly prefers an appropriation to its HG reserves but believes the pragmatic approach suggested by OMB is workable for the near term.

Page 26 The Report should note that each new HG project is authorized by Regional AAs after receiving recommendations from many offices including PRE/H.

Page 27 Contrary to the Report and any citations, AID does not intend to operate the HG program at any specific level (e.g. the $150 million level cited) in order to earn income and affect its overall balance sheet. In the last two fiscal years, where the program level has been less than the $150 million, income has exceeded expenses. AID does not see itself as "promoting" the HG program. Rather, we are making resources available to help meet LDC development needs.

The concentration of HGs in certain countries results from both development and foreign policy considerations. The Report should so indicate.

Page 32 The Report states that the office ignored early warnings from FM as to the depletion of reserves, did not perform country risk analysis, and continued to concentrate HG lending in risky countries. AID and the Office of Housing did not ignore warnings of risk. Every year, beginning in the late 1970s, the Office of Housing and FM prepare projections on the status of the reserve account. These projections are reviewed formally by OMB as part of a budget process. Hard decisions on annual operating authority and apportionment of funds are made from this formal process. Issues of risk are always

discussed. In 1978 the Office of Housing together with FM jointly commissioned a major study by Peat, Marwick and Mitchell designed to result in more efficient financial control procedures to enable better risk management and early warnings. The basic recommendations of the Peat Marwick Mitchell report were that FM would operate a "proactive" versus "reactive" method of reporting. This study was followed up by numerous actions. The 1980 FM warnings and projections on reserves were reviewed in an inter-office meeting chaired at the Assistant Administrator level. In response to the FM alert, AID made a decision to go to the Congress to get authority to keep interest earnings on its reserves. At that time, internal memoranda used to obtain Agency and OMB consensus on the congressional approach indicated that the reserve situation needed monitoring. This congressional action was justified as a first step to improve the reserve situation on the understanding that other steps could be needed if worldwide conditions worsened.

The Office of Housing has always favored the strengthening of reserves--if for no other reason than to keep pace with the expanding guaranty authority. Administration decisions to not seek reserves were made generally on the basis that the need was not yet critical. The Administration has made a similar decision recently. The Report should be amended to indicate that procedures were in place to monitor the situation and that no AID official has ignored the situation.

Page 32 Contrary to GAO suggestions, when LDC rescheduling became a serious problem the Office of Housing established procedures to monitor new situations. The Assistant Director, Finance, office has been created in PRE/H and charged with coordinating debt rescheduling policy, working with the Portfolio Committee which prior to this, had such responsibility.

Page 33 The Report in describing the Costa Rica authorization suggests that country risk analysis was ignored. In fact, AID held up the authorization of this project until it had investigated the debt situation in Costa Rica, polled other USG agencies, the World Bank and the IMF on their intentions to do business in Costa Rica, and finally tailored the HG loan to ease the Costa Rica short term debt service problem. A special AID/W visit was made by the USAID's acting Mission Director to make the case to the Office of Housing and the LAC Bureau on why the HG loan should proceed. The GAO Report is wrong in its failure to narrate these efforts in a section of the Report designed to show AID's purported indifference to country risk. In general the Report fails to acknowledge the numerous AID/W and field offices that are required to approve each HG project and the gauntlet of project approval procedures that every project must travel through.

The Report is misleading when it suggests that the insufficient country risk analysis and thus the authorization of the loans cited (Peru, Costa Rica, Bolivia) account for the reserve problem. Rather, the problem derives mostly from the entire portfolio of loans made 10-20 years ago. We disagree with the concept that AID's alleged failure to analyze risk in these loans has affected the health of the HG Program. AID agrees to improve its country risk analysis. But it would be wrong to conclude that such a procedure will both protect the USG from long term risk and allow the HG program to operate as a going concern.

Page 34 The Report, again, fails to reflect the enormous effort prior to project authorization to analyze and discuss country risk in Peru and Bolivia. Even casual research would have revealed the deep divisions within the Agency on some of these loans and the balancing of interests reflected in the regional AA authorizations.

Page 35. The Report says PPC has been unsuccessfully trying to get the Office of Housing to incorporate country risk analysis in its proposals. The Office of Housing and PPC are in agreement that country risk analysis has been done in the past, in the form of balance of payments and debt service analysis, and that the methodology will continue to be improved. There is discussion underway on how to improve such analysis.

Page 35 The Report states that a country receiving HG assistance must allocate equivalent local currency to the housing sector "regardless of where the sector fits in the country's development needs or priorities." AID believes this statement is wrong. The project design process concentrates on the local currency side of the transaction and, using Shelter Sector Assessments and Country Development Strategy Statements--determines whether each proposed project is consistent with the country's priorities and needs.

Page 36 The Report states that the Office of Housing began promoting creative financial packages in order to sign up new clients. In fact it was the U.S. banking community in accordance with their own evolving financial packaging practices for both domestic and foreign clients, who proposed these creative terms to LDC borrowers. In accordance with AID policy to promote mature banker-client relationships and to introduce LDCs to U.S. capital markets, AID consented to guaranty these so-called creative loans.

Page 37 The Report concludes that creative financial packages increase the risk to borrowers and the U.S. Government. The reason for borrower/AID acceptance of such packages is to decrease the interest rate otherwise presented in a more conventional loan arrangement. The Report should indicate this tradeoff.

Page 37, 38 The Report speaks of the history of the host country guaranty requirement and says AID eliminated the rule in 1983. It asks for clarification of the new rule. The GAO has been advised that the rule requiring host government guaranties arose as an internal Office of Housing procedure in the late 1960s to shift the risk of foreign exchange losses from homeowners to governmental institutions or entities which could use the dollars and thus be in a position to better protect against the risks. The way this procedure was applied was generally to obtain a host government backup guaranty. The effect of this has been to make over 90% of the outstanding HG loans equivalent in value or risk to AID's direct development loan portfolio. From time to time, as early as 1969 with CABEI, the office has made judgments that certain borrowers were themselves soverign governments or the equivalent and could protect themselves against the foreign exchange risks and the host country guaranty was superseded by another device. This was the case in 1981 when AID agreed to let the wholly government-owned State Bank of India reguaranty a loan in lieu of a full faith and credit Government of India guaranty. In this case the State Bank was granted a specific license by the Government of India, Ministry of Finance to extend the guaranty. Upon these facts the Portfolio Committee determined that the State Bank guaranty was "equivalent" to a host government guaranty. In 1983 when AID Handbook 7 was generally revised, this notion of equivalency was recorded. No change of policy was intended or reflected. Nevertheless AID is pleased to clarify the rule.

Conclusions

Page 45 The Report concludes that increased loan risks to the USG were caused by (a) failure to conduct country risk analyses, (b) use of creative financing packages, and (c) the elimination of host government guaranties.

AID believes that worldwide economic recession has increased the risk to the USG for HG loans and equally as well for development loans, Ex-Im loans, CCC credits, FMS credits, PL 480 loans, etc. Contrary to the Report, country risk analyses were performed in accordance with AID guidelines (and as recommended in the 1977 GAO Report which stresses debt service analysis). Nevertheless AID is developing more sophisticated risk analysis methodology and is already applying this to new projects.

As explained elsewhere, AID has not eliminated the need for host country guaranties. Also, the use of creative loan terms has an equal prospect of reducing risk and cost as well as increasing risk.

Page 45 The Report criticizes the concentration of HG loans in selected countries. The Report incorrectly gives the impression that of all LDCs eligible for HG assistance, AID has concentrated HG lending

among a class of LDCs that is worse off compared to the others. AID believes that country selection is the result mainly of development considerations and foreign policy considerations. AID shares the GAO concern about country concentration but finds it difficult to reconcile its development objectives which often dictate such a concentration of effort with its efforts to preserve its reserve fund.

AID agrees to define "equivalency" for purposes of its long standing internal procedure to require host country guaranties or the equivalent.

AID is no longer seeking to exclude HG loans from Paris Club reschedulings but reserves the right to overreschedule AID loans if this is in the best interests of the HG program. AID, however, continues to review its policies in this area.

The Report concludes that HG loans should not be extended to any country where contingent liability would exceed reserve fund assets. AID rejects this conclusion as being tantamount to the suspension of the HG program and thus the elimination of one of AID's successful development efforts. The GAO alternative to suspension (increasing HG reserves) is not feasible in the short run. AID will continue to pursue this goal in the long run if events call for such action.

Page 46 The Report, noting OMBs rejection of AID's request for an appropriation concludes that AID should consider replenishment of the HG reserve through its budget allocation process. AID's ability to transfer funds to the HG reserve is controlled by the Foreign Assistance Act. Only ESF funds may be legally so transferred. Should a transfer be necessary, AID will consider this. However, the need to have a large reserve fund is a question on which there are differing opinions in the Executive Branch. AID strongly prefers a large, healthy reserve fund. OMB views the reserves however as a cash management device, one for which other compensating devices (i.e., borrowing authority) could be substituted. OMB, contrary to the GAO view, does not view the reserves as the "capitalization" of the HG program.

Recommendation to the Administrator

Page 46 AID agrees to prepare a plan to guide decisions to authorize new HG activity taking into account development, foreign policy, and risk considerations and the difficulty of long range economic forcasting in LDCs.

AID agrees to not seek special Paris Club debt rescheduling exemption for the HG loans--therefore HG debts will be listed in the tables where total debt relief obligations per creditor are listed.

Page 46. AID agrees to revise its country risk analysis methodology from that which was in effect when the audit occurred.

AID agrees to define "equivalency" and exercise caution in extending HG loans to countries which do not provide host government guaranties.

GC/H:MGKitay:gjg #1235P 1/24/84 revised 1/30/84 - 2/16/84

## Financial Conditions of the Housing Guaranty (HG) Program

The following is intended to illustrate the financial condition of the HG Program over a broader time span than that appearing in the GAO Report. The following indicates that over this broader time span, the program has truly been self-sufficient and that country risk analyses of HG projects that are having payment problems would not have resulted in avoidance of problems presented by the present situation.

1. The first HG was authorized on December 5, 1962 for Peru and the first Guaranty Agreement, for this project, was signed April 22, 1963. As of September 30, 1983, over $1.25 billion was disbursed by U.S. lenders and the principal balance of all outstanding loans was $1.1 billion.

2. The present HG program and the Office of Housing came into being in January 1970. Since then the Office of Housing has administered the HG program at no cost to the U.S. Government. At the close of FY 1970 the program had assets of $50.8 million which included $50 million from fees collected for the prior Investment Guaranty Program. At the end of FY 1983 the program assets amounted to $47.2 million, a decrease of only $3.6 million while generating over $1.25 billion in loan disbursements subject to the HG.

3. Although the amount of the reserve fund held by the U.S. Treasury has dropped from the $49.9 million at the end of FY 1970 to $21.6 million at the end of FY 1983, receivables rose from $0.8 million to $24.9 million over the same period. This can be described as a shift in assets of $24.1 million from cash to receivables. This does not indicate a loss of this amount as implied by the GAO report.

4. $22.2 million of these receivables is subject to host government dollar guaranties of repayment and $5.1 million had already been rescheduled as of September 30, 1983. Additionally, these amounts are subject to interest which presently amounts to about $1.5 million per year.

5. At the close of FY 1981 the total assets of the program had declined to their lowest level at $42.8 million. However, despite world conditions, the HG program experienced operating gains in both FY 1982 and FY 1983 which increased the total assets to $47.2 million at the end of FY 1983.

6. Actually, the cumulative operating loss of the program since January 1970 has only been $4.3 million. Thus, it might be said that the HG program has generated over $1.25 billion in guarantied loans at a net cost of only $4.3 million, which actually came out of prior fee income and not from appropriated funds.

7. Effective with the creation of the Office of Housing in January 1970, the type of insurance covered by a HG was substantially changed. Prior to that time A.I.D. took the devaluation risks for most projects; after, A.I.D. insisted upon a host government or other strong guaranty of repayment in U.S. dollars. Of the $18.3 million in claim payments that have been written-off since the inception of the program, $16.8 million has been for projects authorized prior to this 1970 policy change. $0.8 million of claims that have been written-off is for two projects in Costa Rica, authorized in FY 1972, and some of this should be recovered as a part of present debt rescheduling negotiations for Costa Rica. $0.7 million has been for a project in Iran which was also authorized in FY 1972.

8. Looked at another way, $16.8 million in claims written-off as of FY 1983 applied to loan disbursements of $173.6 million for projects authorized prior to January 1970. The $1.5 million written-off for Costa Rica and Iran apply to $1.1 billion of loan disbursements for projects authorized since January 1970. This amounts to a write-off ratio of only 0.12% on loans for projects authorized since 1970.

9. At the end of FY 1983 the U.S. Treasury held $21.6 million and an adjustment of an additional $1 million was being processed. In other words there was a total of $22.6 million in funds with the Treasury to cover an outstanding loan portfolio of $1,073 million. This amounted to a cash reserve ratio of 2.1% of the loan balance. The adequacy of this reserve for the current year may be demonstrated by the fact that during FY 1983 the net outflow for all claim payments amounted to only $8.4 million or 0.87% of the outstanding loan portfolio as of the start of the year. We presently have a ratio almost two and a half times that.

10. With regard to all projects that have had claims written off, during FY 1983 there was only a net outflow of $246 thousand or 0.02% of the loan portfolio. There was also a net outflow of $8.2 million for recoverable claims, but, since these should be recovered plus interest, they do not constitute a loss. Only the net write-off of $246 thousand constituted a loss for FY 1983.

11. Unlike other guaranty programs, the HG program was not given the authority to invest its reserves until 1982. Had this authority been granted from the inception of the program, the reserve with the U.S. Treasury would have amounted to over $95 million as of FY 1983. And this would have been despite $18.3 million in expenses for claims written-off, $20.4 million expended for recoverable claims, and $51.8 million expended for the operational expenses of the program. Thus, had the program been permitted to operate like other guaranty programs, or private insurance companies, the profitability of the program would have been clearly demonstrated by having nearly doubled the reserve with the U.S. Treasury plus having accumulated about $25 million in receivables. All-in-all there would have been an overall profit of about $70 million had the program been allowed to invest its Treasury funds from the start.

12. The following chart relates recoverable claims outstanding as of September 30, 1983, both subrogated and rescheduled, to when the loans were authorized.

| When Authorized | Amount of Subrogation | Amount Rescheduled |
|---|---|---|
| Prior to 01/01/80 | 13,585,739 | 5,107,862 |
| from 01/01/80 to 12/31/80 | 1,565,000 | 0 |
| from 01/01/81 to 12/31/81 | 31 | 0 |
| from 01/01/82 to 12/31/82 | 0 | 0 |
| from 01/01/83 to 12/31/83 | 0 | 0 |

PRE/H:RFreed 2/9/84 #1252P

GAO Note: Nine pages of financial tables which AID included in the comments have been deleted. The tables are available upon request from the General Accounting Office, National Security and International Affairs Division, Development Assistance Group.

(471990)

28/10

**AN EQUAL OPPORTUNITY EMPLOYER**

UNITED STATES
GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE,$300

POSTAGE AND FEES PAID
U. S. GENERAL ACCOUNTING OFFICE

**THIRD CLASS**