

DRAFT AUDIT REPORT

USAID/CHILE

HOUSING INVESTMENT GUARANTY PROJECT 513-HG-006I. BACKGROUND AND SCOPEBACKGROUND

ON JUNE 30, 1975, AID ISSUED A \$55 MILLION GUARANTY AUTHORIZATION, ASSURING AGAINST 100 PERCENT OF ANY LOSSES WHICH ELIGIBLE U.S. INVESTORS MIGHT SUFFER ON LOANS MADE TO THE CENTRAL BANK OF CHILE FOR THE PURPOSE OF FINANCING HOUSING PROJECTS IN CHILE. PURSUANT TO THIS GUARANTY AUTHORIZATION, HIG PROJECT 513-HG-006 (HG) IS PROVIDING LOAN FUNDS IN TWO INSTALLMENTS TO THE CENTRAL BANK. THE FOLLOWING LOAN AND GUARANTY DOCUMENTS HAVE BEEN EXECUTED TO CARRY OUT THE HG PROJECT.

ON JANUARY 26, 1976, A LOAN AGREEMENT FOR THE FIRST INSTALLMENT OF HG LOAN FUNDS, IN THE AMOUNT OF \$30 MILLION, WAS SIGNED BETWEEN THE REPUBLIC OF CHILE (GOC/BORROWER-ACTING THROUGH THE CENTRAL BANK OF CHILE), AND THE U.S. INVESTOR, THE FEDERAL HOME LOAN BANK OF NEW YORK (FHLB). ON THE SAME DATE, GUARANTY AGREEMENTS WERE SIGNED BETWEEN AID AND THE FHLB, AS WELL AS BETWEEN THE GOC AND AID. IN EFFECT, THE FULL FAITH AND CREDIT OF THE GOC IS PLEDGED TO GUARANTY TO AID ANY AMOUNTS WHICH AID MAY HAVE TO PAY TO THE FHLB FOR ANY LOSSES SUFFERED ON LOANS MADE TO THE BORROWER UNDER THE LOAN AGREEMENT.

A LOAN AGREEMENT FOR THE SECOND INSTALLMENT OF HG LOAN FUNDS, IN THE AMOUNT OF \$25 MILLION, WAS SIGNED BETWEEN THE GOC AND THE U.S. INVESTOR, MORGAN GUARANTY TRUST COMPANY (MORGAN GUARANTY) ON FEBRUARY 23, 1977. ON THE SAME DATE, GUARANTY AGREEMENTS WERE SIGNED BETWEEN AID AND MORGAN GUARANTY, AS WELL AS BETWEEN THE GOC AND AID. AGAIN THE FULL FAITH AND CREDIT OF THE GOC IS PLEDGED TO AID UNDER THE GUARANTY, AS STATED ABOVE.

IN ADDITION, TWO IMPLEMENTATION AGREEMENTS WERE SIGNED BY THE GOC AND AID ON THE SAME DATES AS THE LOAN AND GUARANTY DOCUMENTS. THOSE AGREEMENTS PROVIDE THE PROCEDURES BY WHICH THE CENTRAL BANK IMPLEMENTS AND ADMINISTERS THE HG PROJECT IN ACCORDANCE WITH THE LOAN AND GUARANTY AGREEMENTS. THE CENTRAL BANK RELENDERS THE HG LOAN FUNDS TO:

THE CHILEAN SAVINGS AND LOAN SYSTEM (SINAP)

THE HOUSING AND URBAN DEVELOPMENT SERVICE OF THE
MINISTRY OF HOUSING (SERVIU)

THE COOPERATIVE FINANCE INSTITUTE (IFICOOP)
(A PRIVATE COOPERATIVE BANK OWNED BY MEMBER COOPERATIVES)

THESE THREE SUBBORROWERS THEN USE THE HG LOAN FUNDS FOR LONG-TERM FINANCING OF MORTGAGES ON COOPERATIVE HOUSING AND HOME IMPROVEMENT LOANS TO FAMILIES EARNING BELOW THE MEDIAN INCOME LEVELS. SUBLOANS TO IFICOOP ARE TO BE USED TO FINANCE HOUSING UNITS NEAR TO OR IN RURAL MARKET TOWNS.

THE BASIC OBJECTIVES OF THE HG PROJECT ARE:

1. TO ASSIST THE HOUSING COOPERATIVE MOVEMENT TO SOLVE THE HOUSING NEEDS OF LOWER INCOME FAMILIES;
2. TO ENCOURAGE AND PERMIT THE SAVINGS AND LOAN INDUSTRY TO PARTICIPATE IN THE FINANCING OF COOPERATIVELY ORGANIZED HOUSING PROJECTS FOR LOWER INCOME FAMILIES;
3. TO SUPPORT A COOPERATIVE MOVEMENT EFFORT TO DEVELOP A HOUSING CREDIT AND TECHNICAL DELIVERY SYSTEM FOR FAMILIES RESIDING IN RURAL MARKET TOWNS AND ADJACENT AREAS; AND,
4. TO SUPPORT THE GOC INTEREST IN STRENGTHENING THE "OPEN" CO-OPERATIVE APPROACH.

AS OF APRIL 30, 1977, \$27.7 MILLION OF THE FIRST INSTALLMENT LOAN HAD BEEN DISBURSED BY THE U.S. INVESTOR TO THE CENTRAL BANK. THE REMAINING \$2.3 MILLION IS BEING HELD IN ESCROW UNTIL THE GOC CAN CERTIFY THAT THIS AMOUNT IS SUPPORTED BY ELIGIBLE MORTGAGES AT THE SUBBORROWERS, IN ORDER TO SATISFY A CONDITION PRECEDENT TO FINAL DISBURSEMENT UNDER THE FIRST LOAN AGREEMENT. AS OF

THE SAME DATE, \$10 MILLION OF THE SECOND INSTALLMENT LOAN HAD BEEN DISBURSED TO THE CENTRAL BANK. ADDITIONAL DISBURSEMENTS OF THE REMAINING \$15 MILLION ARE PLANNED IN LATE-1977 AND MID-1978.

AS OF APRIL 30, 1977, THE FOLLOWING AMOUNTS HAD BEEN DISBURSED BY THE CENTRAL BANK TO THE SUBBORROWERS, AND, IN TURN, TO THE CONTRACTORS BUILDING HOUSING UNITS:

	<u>MAXIMUM AVAILABLE</u>	<u>AMOUNT RECEIVED</u>
SINAP	\$20,000,000	\$12,987,120
SERVIU	30,000,000	19,231,115
IFICOOP	<u>5,000,000</u>	<u>99,609</u>
TOTALS	<u>\$55,000,000</u>	<u>\$32,317,844</u>

WITHIN THE USAID MISSION IN CHILE, RESPONSIBILITY FOR HG PROJECT MONITORING RESTS WITH THE RESIDENT HOUSING AND URBAN DEVELOPMENT ADVISOR. OVERALL PROJECT MANAGEMENT AND ADVISORY SERVICES ARE PROVIDED BY THE REGIONAL HOUSING AND URBAN DEVELOPMENT OFFICER IN PANAMA. THAT OFFICER OPERATES UNDER THE DIRECTION OF THE DIRECTOR OF AID'S OFFICE OF HOUSING IN WASHINGTON.

SCOPE

THIS IS THE INITIAL AUDIT OF PROJECT 513-HG-006 AND COVERED THE PERIOD FROM JANUARY 26, 1976 THROUGH APRIL 30, 1977. THE PURPOSE OF OUR AUDIT WAS TO EVALUATE THE DEGREE OF ACHIEVEMENT OF PROJECT OBJECTIVES, COMPLIANCE WITH APPLICABLE AGREEMENTS, AND PROJECT MANAGEMENT. WE REVIEWED RECORDS AND HELD DISCUSSIONS WITH OFFICIALS AT THE USAID, CENTRAL BANK, SINAP, SERVIU AND IFICOOP. WE ALSO VISITED 45 COOPERATIVE HOUSING SITES THROUGHOUT THE COUNTRY, INSPECTED SOME HOUSING UNITS, AND TALKED TO INDIVIDUAL HOMEOWNERS.

II. FINDINGS AND RECOMMENDATIONS

PROJECT STATUS

THE HG PROJECT IN CHILE IS CLEARLY A SUCCESS IN SUPPLYING HOUSING UNITS TO LOWER INCOME FAMILIES. WITH THE EXCEPTION OF DELAYS TO RURAL HOUSING, PROJECT OBJECTIVES ARE BEING MET SATISFACTORILY. SITE VISITS VERIFIED THAT THE HOUSING UNITS ARE WELL CONSTRUCTED, OCCUPIED SOON AFTER COMPLETION, AND THE RELATED ORGANIZATION FACILITIES ARE IN PLACE.

THERE ARE APPROXIMATELY 3,000 WORKERS EMPLOYED DIRECTLY IN HG CONSTRUCTION. THE CHAMBER OF THE CONSTRUCTION INDUSTRY IN CHILE ESTIMATES THAT A FACTOR OF 2.5 MAY BE APPLIED TO DETERMINE THE APPROXIMATE INDIRECT EMPLOYMENT EFFECT OF EACH JOB IN THE CONSTRUCTION INDUSTRY. THUS, INDIRECT EMPLOYMENT MAY BE ESTIMATED AT 7,500, FOR A TOTAL OF 10,500 WORKERS EMPLOYED AS A RESULT OF THE HG PROJECT.

OUR EXAMINATION OF RECORDS AT THE CENTRAL BANK, SERVIU, SINAP AND IFICOOP VERIFIED THAT ACCOUNTING AND REPORTING OF HG FUND DISBURSEMENTS ARE SATISFACTORY AND TIMELY. COOPERATIVES HAVE JUST BEGUN TO MAKE REPAYMENTS, AND AT THE TIME OF OUR AUDIT ALL WERE CURRENT. THE CENTRAL BANK HAS PAID ALL FEES AND INTEREST TO THE U.S. INVESTORS IN ACCORDANCE WITH THE LOAN AGREEMENTS.

RELATIONS BETWEEN THE CENTRAL BANK AND THE SUBBORROWERS ARE GOOD. THERE IS NO UNDUE CONCERN WITHIN THE MISSION WITH REGARD TO THE SOUNDNESS OF THE GOC'S GUARANTY.

HOUSING UNITS

THE CAPITAL ASSISTANCE PAPER OF JUNE 24, 1975, PROPOSED THE CONSTRUCTION OF 15,500 HOUSING UNITS WITH HG 006 FUNDS. BECAUSE THE CONSUMER PRICE INDEX ROSE MORE RAPIDLY THEN THE GOC-CONTROLLED DOLLAR/PESO EXCHANGE RATE, MORE DOLLARS THAN ORIGINALLY ESTIMATED HAVE BEEN NEEDED FOR CONSTRUCTION COSTS. THE GOC'S MONETARY POLICY WAS OUTSIDE THE SCOPE AND CONTROL OF THE HG PROJECT.

AS A RESULT THE INCREASE IN DOLLARS EQUIPED FOR OVERALL CONSTRUCTION, FEWER HOUSES CAN BE BUILT UNDER THE PROJECT. CONSEQUENTLY, THE PLANNED NUMBER OF HOUSES WAS DECREASED 20 PERCENT, TO 12,444 UNITS.

OF THE 8,624 HOUSING UNITS TO BE CONSTRUCTED UNDER THE FIRST INSTALLMENT LOAN, 4,140 WERE COMPLETED AND 4,484 WERE IN PROCESS AS OF APRIL 30, 1977. IT WAS AGREED THAT THE IN-PROCESS HOUSES WOULD BE COMPLETED WITH FUNDS FROM THE SECOND INSTALLMENT LOAN. IN ADDITION, FUNDS FROM THE SECOND LOAN WILL BE USED FOR CONSTRUCTION OF THE 3,820 HOUSING UNITS REMAINING UNDER THE PROJECT. THE IMPLEMENTATION AGREEMENT OF FEBRUARY 3, 1977, REQUIRES THAT ANY SHORTAGE OF FUNDS FOR CONSTRUCTING THE 3,820 HOUSES WILL BE PROVIDED BY THE GOC, THUS INSURING THAT THE PLANNED NUMBER OF HOUSES, 12,444, WILL BE CONSTRUCTED.

NO RECOMMENDATION IS INDICATED IN CONNECTION WITH THIS ISSUE.

RURAL HOUSING

THE RURAL HOUSING SEGMENT OF THE HG PROJECT HAS BEEN DELAYED, WITH NO RURAL HOUSING CONSTRUCTION UNDER WAY AS OF APRIL 30, 1977. THE IMPEDIMENTING AGENCY FOR RURAL HOUSING, IFICOOP, HAS HAD PROBLEMS IN LOCATING COOPERATIVES THAT COULD MEET ELIGIBILITY REQUIREMENTS. ATTEMPTS BY IFICOOP WERE DILIGENT BUT NOT ENTIRELY SUCCESSFUL.

INITIALLY, IFICOOP ATTEMPTED TO ARRANGE RURAL HOUSING AMONG COOPERATIVES CONNECTED WITH THE LAND REFORM PROGRAM UNDER A PRIOR AID LOAN. THE LAND REFORM CORPORATION (CORA) HOLDS MORTGAGES ON ALL REFORMED LAND AND AGREED TO GUARANTEE THE COOPERATIVES' HOUSING PAYMENTS IF THE COOPERATIVES COULD MEET CORA'S CREDIT REQUIREMENTS AND ALSO THE PROVISIONS OF THE HG LOAN AGREEMENT. TO DATE, FIVE RURAL COOPERATIVES HAVE BEEN PROPOSED TO CORA FOR DETERMINATION OF LOAN ELIGIBILITY. TWO HAVE BEEN REJECTED AND THREE ARE STILL UNDER REVIEW.

IFICOOP ALSO STUDIED THE POSSIBILITY OF FINANCING RURAL HOUSING ON SMALL FARMS OUTSIDE OF COCA COOPERATIVES. THEY FOUND THAT THE MEMBERS OF THESE COOPERATIVES HAVE SMALL TRACTS OF INHERITED LAND FOR WHICH THEY CAN NOT PRODUCE CLEAR TITLE. THUS, THESE COOPERATIVES ARE NOT ELIGIBLE FOR HOUSE FINANCING UNDER THE HG PROJECT.

FINALLY, IFICOOP LOCATED SOME RURAL COOPERATIVES WHOSE MEMBERS ARE SMALL FARMERS AND LANDOWNERS WITH CLEAR TITLE TO THEIR LAND AND WHO RESIDE IN RURAL MARKET TOWNS. THE CENTRAL BANK ESTABLISHED SPECIAL CRITERIA FOR THESE COOPERATIVES TO BE ELIGIBLE FOR HG FINANCING. THE MEMBERS MUST RESIDE IN RURAL MARKET TOWNS WITH A POPULATION UNDER 5,000. OR, IF THE MEMBERS RESIDE IN RURAL MARKET TOWNS OF FROM 5,000 TO 20,000 POPULATION, ONE-HALF OF THE RESIDENTS MUST BE ENGAGED IN EITHER MINING OR AGRICULTURE. UNDER THESE CRITERIA, FIVE COOPERATIVES WITH SEVEN HOUSING PROJECTS HAVE BEEN PROPOSED FOR FINANCING. THREE PROJECTS HAVE BEEN ACCEPTED, AND ^{bid} INVITATIONS ~~FOR BIDS~~ FOR CONSTRUCTION OF 213 UNITS WERE PUBLISHED IN MAY 1977.

THEREFORE, AFTER A YEARS DELAY, THE RURAL HOUSING PROGRAM IS JUST GETTING STARTED. WHEN THE DELAY FIRST DEVELOPED, THE FUNDS DESTINED FOR IFICOOP UNDER THE FIRST INSTALLMENT LOAN WERE RE-ALLOCATED TO SERVIU AND SINAP. SUBSEQUENTLY, UNDER THE SECOND LOAN, IFICOOP RECEIVED ITS PLANNED \$5 MILLION ALLOCATION FOR RURAL HOUSING.

AT THE PRESENT TIME IT IS NOT CLEAR WHAT PART OF THE HG LOAN CAN BE USED BY FARMERS ON REFORMED LAND. HOWEVER, ANY SHORTFALL OF PROJECTS ON PROPERTY IN THE LAND REFORM PROJECT CAN LIKELY BE MADE UP WITH PROJECTS IN RURAL MARKET TOWNS.

AT THIS TIME NO RECOMMENDATION FOR CORRECTIVE ACTION IS INDICATED.

VALUE ADDED TAX

HG PROJECT FUNDS ARE BEING USED TO PAY THE GOC'S 20 PERCENT VALUE ADDED TAX (IVA TAX) ON CONTRACTOR'S MATERIALS PURCHASED AND USED IN CONSTRUCTION OF PROJECT HOUSING. THE HG LOAN AGREEMENTS ARE NOT CLEAR REGARDING THE PAYMENT AND FINANCING OF GOC TAXES INCURRED IN CONNECTION WITH PROJECT IMPLEMENTATION.

FOR EXAMPLE, THE FOLLOWING TWO PERTINENT SECTIONS OF THE HG LOAN AGREEMENTS IMPLY THAT EITHER NO TAXES WHATSOEVER ARE PAYABLE ON PROJECT PAYMENTS, OR THAT THE BORROWER, IN ITS PERFORMANCE OF THE PROJECT, WILL PAY ALL TAXES IN FULL.

SECTION 2.01(D) STATES: "NO PAYMENTS PREVIOUSLY MADE OR TO BE MADE BY OR ON BEHALF OF BORROWER HEREUNDER AND UNDER THE NOTES TO INVESTOR, OR TO ANY ASSIGNEE, TRANSFEREE, OR PLEDGEE OF INVESTOR NOT DOING BUSINESS IN CHILE OR TO AID FISCAL AGENT, AND NO PAYMENTS TO AID OF THE AID GUARANTY FEE, ARE OR WILL BE SUBJECT TO ANY INCOME, WITHHOLDING OR OTHER TAXES WHATSOEVER OF CHILE..."

SECTION 2.01(F) STATES: "BORROWER WILL PAY IN FULL AND IN A TIMELY MANNER ALL DOCUMENTARY STAMP TAXES OR OTHER TAXES, LEVIES, IMPOSTS, CHARGES OR FEES, IF ANY, AND ANY PENALTIES ASSESSED BY VIRTUE OF LATER PAYMENT THEREOF, WHICH ARE OR MAY HEREAFTER BECOME DUE AND PAYABLE UNDER ANY APPLICABLE LAW OF CHILE IN CONNECTION WITH THE ISSUANCE OF THE NOTES, THE MAKING BY INVESTOR OF THE LOANS, THE RECEIPT BY INVESTOR OR AID FISCAL AGENT OF PAYMENTS PURSUANT TO THE NOTES, THE GUARANTY OF THE NOTES BY AID, THE ENFORCEMENT IN CHILE BY INVESTOR OR AID OF ANY RIGHTS PURSUANT TO THIS AGREEMENT, THE IMPLEMENTATION AGREEMENT OR THE CHILE GUARANTY AGREEMENT OR OTHERWISE IN CONNECTION WITH THE EXECUTION, DELIVERY OR PERFORMANCE BY BORROWER, INVESTOR OR AID OF THIS AGREEMENT, THE CONTRACT OF GUARANTY, THE IMPLEMENTATION AGREEMENT OF THE CHILE GUARANTY AGREEMENT" (UNDERLINING ADDED)

IT HAS LONG BEEN THE INTENT OF THE U.S. GOVERNMENT THAT ITS OVERSEAS ACTIVITIES NOT BE SUBJECT TO FOREIGN TAXES. WITH RESPECT TO THE FOREIGN ASSISTANCE PROGRAM IN CHILE, THIS POLICY IS IMPLEMENTED THROUGH THE BASIC AGREEMENT FOR TECHNICAL COOPERATION (THE BILATERAL) OF JULY 27, 1951, AND THE VARIOUS PROJECT AND PROGRAM AGREEMENTS. THE USAID DOES NOT PAY ANY IVA OR OTHER IDENTIFIABLE TAXES IN CONNECTION WITH ITS DIRECT PROGRAM AND PROJECT FUNDING. FURTHERMORE, DISCUSSIONS ARE NOW UNDERWAY BETWEEN THE USAID AND THE GOC REGARDING A PROCEDURE FOR EXEMPTING OR REIMBURSING THE USAID FOR ALL SUCH TAXES PAID ON ADMINISTRATIVE SUPPORT COSTS OF THE MISSION.

WHILE THE HG PROJECT IS NOT FINANCED BY APPROPRIATED FUNDS OF THE U.S. GOVERNMENT, WE BELIEVE THAT THE PAYMENT OF HIGH FOREIGN TAXES WITH PROJECT FUNDS DILUTES THE HG AUTHORITY LEVEL PROVIDED BY CONGRESS. IN OUR OPINION THE AID GUARANTY SHOULD PROVIDE FINANCING FOR HOUSE CONSTRUCTION, NOT INDIRECT BUDGET SUPPORT TO THE GOC. IT IS AID'S POLICY THAT ALL SHELTER RESOURCES - GRANTS, LOANS AND GUARANTIES - WILL BE INTEGRATED WITH ITS ANNUAL COUNTRY PROGRAM, AND WILL BE INVESTED IN PROJECTS THAT DIRECTLY OR INDIRECTLY BENEFIT LOW INCOME GROUPS.

THE IVA TAX IS A READILY IDENTIFIABLE TAX, SINCE IT AMOUNTS TO THE TOTAL TAX ON THE FINAL SALE OF A PRODUCT. THE TAX IS STATED SEPARATELY ON ALL VENDOR'S INVOICES AND IS THUS PAID AS A SEPARATE ITEM BY THE INDIVIDUAL CONTRACTORS. THE CONTRACTORS, IN TURN, SUBMIT THEIR PROGRESS BILLINGS COMPUTED IN SUCH TERMS AS CUBIC METERS OF FOUNDATION, SQUARE METERS OF WALL, NUMBER OF WINDOWS, ETC.

IN ORDER TO DETERMINE THE EXACT AMOUNT OF IVA TAX INVOLVED IN CONSTRUCTING THE NUMEROUS HOUSING UNITS IN CHILE IT WOULD BE NECESSARY TO AUDIT ALL MATERIAL INVOICES OF ALL CONTRACTORS, A DIFFICULT AND TIME CONSUMING TASK. ALTERNATIVELY, WE LEARNED

THAT SERVIU OFFICIALS HAD RECENTLY ANALYZED COSTS OF THE HG HOUSING UNITS FINANCED BY THEM. THEY ESTIMATED THAT 70 PERCENT OF ALL CONSTRUCTION COSTS WERE FOR MATERIALS. BASED ON THIS ESTIMATE, WE COMPUTED THE IVA TAX FINANCED WITH HG LOAN FUNDS AS FOLLOWS:

TOTAL DISBURSEMENTS BY SINAP AND SERVIU TO CONTRACTORS AS OF 4-30-77	\$32,218,235
ESTIMATED COST OF MATERIALS - 70 PERCENT	\$22,552,765
IVA TAX COMPUTATION $-\$22,552,765 \times 20$ PERCENT	<u>\$4,510,551</u>

RECOMMENDATION No. 1

AID'S OFFICE OF HOUSING (SER/H) SHOULD DETERMINE WHETHER OR NOT THE CHILE HG PROJECT FUNDS CAN BE USED TO PAY AND FINANCE THE GOC'S IVA TAX INCURRED IN CONNECTION WITH PROJECT CONSTRUCTION.

IF SER/H DETERMINES THAT HG FUNDS ARE NOT TO BE USED FOR IVA TAXES, THE USAID SHOULD NEGOTIATE WITH THE GOC TO, (1) EFFECT A DEPOSIT INTO THE HG LOAN ACCOUNT AT THE CENTRAL BANK AN AMOUNT EQUAL TO THE TAXES PAID TO DATE, AND (2) DEVELOP PROCEDURES TO AVOID THE FINANCING OF SUCH TAXES IN THE FUTURE.