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Development Credit Authority Guarantees for SME Finance

AMIR II Achievement of Market-Friendly Initiatives and Results

May 2006

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JORDAN AMIR II

Achievement of Market-Friendly Initiatives and Results

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Amman Bank and Bank of Jordan
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Development Credit Authority Guarantees for SME Finance

Final Report

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- Monitoring
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- SME loan portfolio

Abstract

USAID's Development Credit Authority (DCA) offers a flexible loan guarantee mechanism to encourage local lenders to provide loans to underserved borrowers at market rates and with appropriate collateral requirements. USAID/Jordan established a \$5 million loan portfolio guarantee in September 2005 to promote lending to SMEs and is currently exploring another \$5 million guarantee facility with a second lender to serve a smaller class of SME borrowers, both in support of USAID/Jordan's Strategic Objective 10 Improved Economic Opportunities for Jordanians. The consultants assisted USAID/Jordan and its local lending partners in: 1) establishing monitoring and reporting systems for the existing guarantee facility; 2) preparing the Concept Paper, Action Package, Monitoring Plan, Borrower Cohort Report, and related documentation to establish the guarantee under consideration.

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Executive Summary

Despite its small size and dearth of natural resources, Jordan is well positioned for economic growth given its strategic location, stability and desirability as a location for immigrants, good relations with Western trading partners, and world-renowned tourist attractions. Through donor assistance and the Government of Jordan's (GOJ's) own initiative, the country is undertaking economic reforms to reduce the time needed to register a business, increase wireless penetration, privatize state-owned companies, and make the country a more competitive location for international trade and investment. SMEs are a critical component of this economic growth, representing more than 90 percent of all Jordanian enterprises (as much as 98 to 99 percent by some estimates), employing most of Jordan's workers, and accounting for nearly 50 percent of Jordan's GDP.

However, the inability of SMEs to secure medium and long-term financing—or in some cases, even working capital—to start or expand their business remains a major obstacle to sustainable growth and domestic investment. SMEs are constrained by a conservative banking sector that views them as risky investments. USAID is using partial loan guarantees backed by its Development Credit Authority (DCA) to catalyze the extension of credit at market rates and with appropriate collateral requirements, helping demonstrate to Jordanian commercial banks the viability of lending to SMEs and the profit potential of this large segment of the economy. It is hoped that this will eventually stimulate SME lending at sustainable terms without the need for donor support.

The purpose of the consultants' assignment was twofold: 1) to establish monitoring and reporting systems for USAID/Jordan's existing DCA Loan Portfolio Guarantee (LPG) with the Bank of Jordan (BOJ); and 2) to assist USAID/Jordan in establishing a new DCA LPG with Cairo Amman Bank (CAB) to promote additional SME lending. The deliverables resulting from this assignment are included herein as appendices. However, outputs containing proprietary information about the lender have not been appended.

Contribution to USAID/Jordan and AMIR project objectives

The current and proposed DCA guarantees are designed to contribute to USAID/Jordan's Strategic Objective 10, Improved economic opportunities for Jordanians. By increasing financial intermediation for SMEs, the DCA guarantees will help to eliminate the economic "missing middle" in Jordan. Specifically, the guarantees support the efforts of USAID/Jordan's AMIR program under SO 10 to improve Jordan's national competitiveness and create sustained economic growth through the Enhanced Competitiveness Initiative (ECI) and to broaden and deepen Jordan's financial markets through AMIR's Financial Markets Development (FMD) component. The ultimate impact of the guarantees will be to: 1) deepen the financial market by increasing financial intermediation for SMEs; 2) help SMEs become more competitive on the domestic and eventually international market; and 3) contribute to increased production and employment opportunities, which will lead to economic growth.

Preparation

As part of the preparation for this assignment, the consultants completed the following tasks:

- Prepared draft concept paper for use by USAID/Jordan as the first step in establishing the CAB LPG.
- Conducted preliminary analysis of CAB's 2003 and 2004 financial statements (2005 financial statements were not available prior to the assignment)
- Reviewed relevant documentation, including Concept Paper, Action Package, Monitoring Plan, and legal agreement, for the BOJ guarantee
- Prepared preliminary timeline and action items for LPG development and USAID Credit Review Board approval process

Implementation and Monitoring Support for Existing Guarantee Facility

At the request of USAID/Jordan, the consultants designed and delivered two targeted workshops. The first was for the two USAID/Jordan employees and one AMIR employee charged with monitoring the existing LPG to report on development impact and ensure financial compliance. The second workshop targeted the Bank of Jordan employees primarily responsible for implementation of the guarantee to ensure that they were familiar with the provisions of the legal agreement with USAID, and that they were aware of their reporting responsibilities as the DCA partner lender.

To support these tasks, the consultants produced the outputs below, of which the first two items and the table of contents from the training packets are included as Appendices A through D.

Outputs

- Monitoring workshops for USAID/Jordan and Bank of Jordan
- Monitoring roles and responsibilities for AMIR USAID/Jordan, USAID/Washington, and the Bank of Jordan
- Briefing sheet on Annual Data Questionnaire
- Qualifying loans checklist for BOJ
- Annual site visit template for BOJ monitoring
- Quarterly follow-up guidelines for BOJ monitoring
- BOJ removal from coverage letter
- BOJ calendar of key dates
- BOJ monitoring & reporting contact sheet
- PowerPoint presentation: DCA Monitoring & Reporting for USAID/Jordan

Design of New Guarantee Facility

USAID/Jordan is proposing a second DCA LPG for SME lending in order to allow an additional partner bank to test various sectors of the SME market and reassess the appropriateness of its collateral requirements and other credit policies for SME lending. The selected lender, Cairo Amman Bank, has received technical assistance in SME lending from the EU and other donors, and has demonstrated an interest in entering that market. As part of the process for developing this new guarantee, the consultants assisted USAID/Jordan in preparing their Concept Paper, Action Package, and Monitoring Plan for submission to the Office of Development Credit (ODC) at USAID/Washington.

Additionally, the consultants prepared a preliminary draft term sheet for review by the Regional Legal Analyst and liaised with CAB to support USAID's negotiations, answer the lender's questions, and ensure timely submission of all required documentation to the ODC risk analyst. Finally, the consultants prepared a Borrower Cohort Report assessing the SME sector in Jordan, which is a required component of the LPG development process and which will be used by the ODC risk analyst to evaluate the risks of lending to the beneficiaries of the proposed CAB LPG. The Executive Summary of this report is attached herein as Appendix G.

Outputs

- CAB Concept Paper (initial and revised)
- CAB timeline and action items for Credit Review Board
- Action Package & Monitoring Plan for CAB guarantee
- Borrower Cohort Report for CAB guarantee
- Preliminary draft term sheet for CAB guarantee

Conclusions

Jordan is typical of many emerging economies, in that full economic growth potential is not being achieved due in part to limited access by SMEs to credit. Valid risk factors have made commercial banks cautious in lending to SMEs, but the degree of caution lenders have adopted is not proportional to the risks. There are creditworthy SMEs in Jordan who merely lack the assets required to meet the banks' onerous collateral requirements.

The current and proposed DCA LPGs will encourage USAID's partner lenders to expand lending to a greater number of SMEs, particularly those without sufficient collateral, and/or in sectors into which the lenders' nascent SME credit units have been reluctant to expand due to perceived volatility or susceptibility to external shocks, such as the tourism industry. The guarantees will help Jordanian SMEs obtain loans with longer terms and reduced collateral requirements to meet capital investment and working capital needs. Eventually, it is expected that the guarantees will provide a demonstration effect to the wider banking industry that lending to smaller SMEs is a viable and profitable business proposition, helping to spur competition and more affordable SME credit, and resulting in a more robust and sophisticated financial market.

**Appendix A. Monitoring Roles and Responsibilities for BOJ
guarantee**

Entity:	Bank of Jordan	USAID/Jordan	USAID/Washington (EGAT/DC)	AMIR program/ TBD project
Focus	DCA partner lender	Development monitoring, implementation, and field support to EGAT/DC on financial monitoring	Financial monitoring	Support to USAID/Jordan on development and financial monitoring
Development Monitoring Activities				
Placing Loans Under Coverage	Place loans under coverage to qualifying SME borrowers	Ensure assistance programs include linked technical assistance activities to support utilization	None	Encourage participating bank utilization through linkages to SME and financial institution technical assistance
Formal Reporting	Fill out Credit Management System (CMS) reports, including Annual Data Questionnaire (ADQ) and Qualifying Loan Schedule (QLS)	Request synthesized CMS and ADQ information from EGAT/DC to obtain qualitative measures of DCA impact	None	Prepare quarterly summary reports and any ad hoc reports as required on the following indicators: 1. Percentage utilization of total authorized amount 2. Number of new loans disbursed by the lender 3. Number of SMEs receiving loans
Offline Reporting	Provide development monitoring data to AMIR, if requested	Use data from AMIR and ADQ for SO and IR-level reporting	None	Develop and maintain a qualitative database of the bank's DCA usage
Financial Monitoring Activities				
Origination Fee	Pay origination fee	Ensure origination fee payment	Ensure receipt of origination fee payment	Support USAID/Jordan as required
Conditions Precedent	Fulfill conditions precedent	Certify fulfillment of conditions precedent	Confirm that conditions precedent are met	Support USAID/Jordan as required
Utilization Fee	Pay utilization fee based on QLS	Work with EGAT/DC to ensure timely and accurate fee payment	Ensure proper billing and collection of fees	Support USAID/Jordan as required
Legal Agreement	Ensure all loans placed under coverage qualify. Meet all other terms of legal agreement	Ensure resolution (usually RLA role) of any questions about the legal agreement	Ensure financial compliance of every QLS; discuss non-compliance issues with BOJ or ask Mission to do so	Ensure clear understanding of the legal agreement, reporting requirements, the definition of qualifying borrowers, and any other questions or issues that may arise

Development Credit Authority Guarantees for SME Finance

Entity:	Bank of Jordan	USAID/Jordan	USAID/Washington (EGAT/DC)	AMIR and TBD project
Entering loans into QLS and completing semi-annual reports in CMS	Enter all loans into QLS, complete Certification for Qualifying Loan Schedule (Appendix 3), and enter data for semi-annual reports into CMS.	Ensure semiannual reports sent by BOJ via CMS; follow-up as needed	Ensure proper report entry into CMS	Liaise with BOJ to ensure timely reporting in CMS
Annual financial statements	Submit audited financial statements when notice received from EGAT/DC, usually in March/April.	Follow up with BOJ if financial statements not received on time.	Send notice for financial statements in March/April.	Support USAID/Jordan as required.
Annual Data Questionnaire (ADQ)	Submit ADQ by June 30.	Follow up with BOJ if ADQ not submitted by June 30.	Design ADQ and send to BOJ on or about June 1. Collect and compile results.	Support USAID/Jordan as required.
Early Problem Identification	Enter all loans in CMS in a timely fashion and update QLS monthly with borrower payments, days in arrears, etc.	Inform EGAT/DC of any potential defaults that may be forthcoming	Compile monthly and quarterly reports on the DCA global portfolio	Monitor DCA portfolio for potential problem loans/defaults
Claims	Issue notice of full payment due to borrower. Pursue reasonable collection efforts. At least 90 days from notice of full payment, complete Request for Payment of Claim form (Appendix 1) and submit to USAID/Jordan and USAID/Washington. Certify loan writeoff.	Receive claims from BOJ and ensure documentation forwarded to EGAT/DC. If valid, Controller pays claim and obtains reimbursement.	Review claim for compliance, arrange approvals, and obligate funds	Work with bank to ensure appropriate collections practices for any claims
Post-Claim Recoveries	Submit Schedule of Net Recoveries by June 30 of each year; complete Certification of Post-Claim Recoveries (Appendix 4) and share appropriate recovery amount with USAID	Support EGAT/DC as required	Send out letters by first week of June to all partner lenders that have received a claim payment	Support USAID/Jordan as required
Regular Calls, Annual Site Visits and Biennial Reviews	Cooperate with annual site visits and biennial reviews	Ensure annual site visits are conducted. Send summary to EGAT/DC	Prepare for and conduct biennial reviews	Prepare for and conduct annual site visits

Appendix B. Agenda for USAID Monitoring Workshop

DCA Monitoring & Reporting
Training for USAID/Jordan
April 27, 2006

1. Introductions
2. Contact Information for EGAT/Office of Development Credit
 - a. Chris Ray, cray@usaid.gov
 - b. Carlos Maciel, cmaciel@usaid.gov
3. Overview of DCA Monitoring
 - a. Development Monitoring
 - b. Financial Monitoring
 - c. Overview of Roles and Responsibilities
4. PowerPoint presentation on Monitoring, Reporting & Utilization
5. Review Components of Bank of Jordan Monitoring Plan
 - a. Reporting
 - i. Transaction Reports
 - ii. Qualifying Loan Schedule
 - b. Fees
 - c. Annual Data Questionnaire
 - d. Claims
 - e. Recoveries
 - f. Mission Site Visits and EGAT/DC Biennial Reviews
 - g. Audits
6. Review Lender Forms and Information
 - a. Lender Welcome Packet from EGAT/ODC
 - b. Request for Payment of Claim
 - c. Qualifying Loan Schedule
 - d. Certification for Qualifying Loan Schedule
 - e. Certification of Post-Claims Recoveries
 - f. Key Individual Certifications Narcotics Offense and Drug Trafficking
7. Open Question & Answer

Appendix C. Agenda for BOJ Monitoring Workshop

1. Roles and Responsibilities

- Bank of Jordan
 - Designated Point of Contact
- USAID/Jordan
 - Ala' K. Shalan, Chief Financial Analyst
 - Amal Madanat, Financial Analyst
- AMIR (and follow-on project as designated by USAID)
 - Asma Abu-Taleb, Capital Markets and Banking Advisor
- USAID/Washington Office of Development Credit
 - Christopher Ray, Portfolio Monitoring Specialist
 - Carlos Maciel, Portfolio Monitoring Specialist

2. Review of Term Sheet from DCA Legal Agreement

3. Using the DCA Guarantee

- Placing loans under coverage
- Using the Credit Management System (CMS)
- Completing the Qualifying Loan Schedule (QLS)
 - Form: QLS (Legal Agreement Appendix 2)
 - Form: Certification for Qualifying Loan Schedule (Legal Agreement Appendix 3)
- Paying the utilization fee
 - Calculation
 - Treasury exchange rates <http://fms.treas.gov/intn.html> available after the 5th of the month
 - Notice of Payment Due
 - Payment of fee
- Filing claims and receiving payment for claims
 - Form: Request for Payment of Claim (Legal Agreement App. 1)
 - Reasonable collections efforts
 - What is Bank of Jordan procedure now?
- Post-claim recoveries
 - Annual reminder from ODC
 - Form: Certification of Post-Claim Recoveries (Legal Agreement Appendix 4)

4. Reporting

- Semi-annual reporting
 - Status of first report due on April 30
 - Second report due on October 31
- Annual Data Questionnaire
- Annual Submission of Financial Statements
 - Reminder sent by ODC
- Offline reporting to track development indicators
- Other reports as required by the legal agreement (change in bank ownership, etc.)

5. Calling Schedule and Annual Visits

- USAID/Jordan Regular Visits
- USAID/Jordan Annual Visits
 - Combined with USAID/Washington visit every other year
- Borrower Visits

Appendix D. Table of Contents for BOJ Monitoring Training Packet

TABLE OF CONTENTS

1. ROLES AND RESPONSIBILITIES

- ROLES AND RESPONSIBILITIES CHART FOR BOJ, USAID/JORDAN, USAID/WASHINGTON, AND AMIR

2. REVIEW OF TERM SHEET FROM DCA LEGAL AGREEMENT

- TERM SHEET

3. USING THE DCA GUARANTEE

- LENDER WELCOME PACKET
- REQUEST FOR PAYMENT OF CLAIM (LEGAL AGREEMENT APPENDIX 1)
- QUALIFYING LOAN SCHEDULE (LEGAL AGREEMENT APPENDIX 2)
- CERTIFICATION FOR QUALIFYING LOAN SCHEDULE (LEGAL AGREEMENT APPENDIX 3)
- CERTIFICATION OF POST-CLAIM RECOVERIES (LEGAL AGREEMENT APPENDIX 4)

4. REPORTING

- SAMPLE ANNUAL DATA QUESTIONNAIRE

5. CALLING SCHEDULE AND ANNUAL VISITS

- BANK OF JORDAN BUSINESS PLAN FOR GUARANTEE UTILIZATION

Appendix E. Agenda for Joint USAID-BOJ Meeting

Implementation of Bank of Jordan DCA Loan Portfolio Guarantee SME Lending in Jordan

May 4, 2006 – 11:30am

AGENDA

1. Introductions

- Each participant's name, organization, and role related to the DCA Guarantee
- Contact Sheet

2. Review Roles & Responsibilities Chart

- Cover questions / needed clarifications

3. Review Calendar of Key Dates

- USAID calling plan

4. Criteria for Qualifying Loans

- Checklist
- Questions

5. Removal from Coverage Form

6. Bank of Jordan

- Plans for utilization of the guarantee facility
- Participation in other USAID initiatives (i.e. Siyaha Project)

Appendix F. Briefing Sheet on Annual Data Questionnaire

Annual Data Questionnaire (ADQ)

The ADQ is due by June 30 of each year. CMS will generate e-mails to the key contacts of all guaranteed parties on or around June 1 to request that they complete the ADQ before the end of the month. The estimated time for completion of the ADQ is no more than 30 minutes.

The purpose of the ADQ is to obtain qualitative measures of the impact of DCA guarantees. The ADQ may be slightly different each year. Examples of the questions asked include:

- Collateral. Please describe if your institution has been able to lower the collateral requirements for Qualifying Borrowers because of this guarantee
- Loan Terms. Please describe if the USAID guarantee has resulted in your institution's ability to lengthen the repayment term (duration or tenor) for loans to Qualifying Borrowers?
- Sectors. What have been the top three sectors for loans to Qualifying Borrowers? Do you expect this to change next year or remain the same?
- Enterprise size. What is the average enterprise size (by number of employees) in your portfolio of Qualifying Borrowers?
- Other. What other impact has the USAID guarantee had on your ability to provide loans to Qualifying Borrowers? (For example, have you been able to make loans to these types of borrowers without the guarantee?)
- Example of a "success story" of the tangible benefits realized by one of the borrowers who productively utilized funds from a DCA guaranteed transaction.

Sample Annual Data Questionnaire

The screenshot shows a web browser window titled "USAID Credit Management System - Microsoft Internet Explorer". The address bar shows the URL: <https://beta.admin.cms.usaid.org/CreditMonitoring/CreditAgreements/4/AnnualDataQuestionnaires/CreateAnnualDataQuestionnaireForm>. The main content area is titled "Create Annual Data Questionnaire" and contains the following fields and sections:

- ADQ Fiscal Year: 1993
- Sum of Transaction Amounts During Period: 0.00
- Count of Borrowers During Period: 0
- Most Recent Loan Schedule Balance (USD): 0.0
- Other: A text input field.
- Is Collateral Lowered?: No
- If Yes, Please Explain: A text area.
- Is Interest Lowered?: No
- If Yes, Please Explain: A text area.
- Success Story: A text area.

A sidebar on the left contains a "Report" section with the following items:

- Loan Schedules
- Annual Data Questionnaires
- Origination Fees
- Utilization Fees

Appendix G. Executive Summary from Borrower Cohort Report

Jordan is a lower middle income, emerging market country on the verge of major economic growth. However, this growth is hampered by the inability of Small and Medium Enterprises (SMEs) to access credit to start or expand their business. This is in spite of the fact that SMEs are the backbone of nearly every sector of the economy. By ignoring what some estimate to be more than 99 percent of enterprises and 85 percent of the potential banking market in Jordan, lenders are not maximizing their profit potential.

Commercial banks in Jordan are generally conservative and unfamiliar with the SME market or methods for evaluating its creditworthiness. Rather than analyzing projected cash flows and other risk factors, banks in Jordan simply set high collateral requirements in their credit policies and then turn away any SME who cannot muster the requisite assets, regardless of the borrower's risk profile. This is due in part to the lack of a credit reference information system and to SMEs' limited capacity to approach lenders with professional business plans and financial statements. As a result, most SMEs can only access credit through family members or on a limited-term basis for working capital, primarily through overdraft accounts.

In order to stimulate lending to SMEs at market rates and with appropriate collateral requirements, USAID/Jordan is proposing a loan portfolio guarantee wherein 50 percent of the outstanding principal value of loans extended to SMEs will be secured against default by the full faith and credit of the United States Government, acting through USAID's Development Credit Authority. This assessment aims to compile relevant information on the creditworthiness and key strengths and weaknesses of the potential borrowers under the guarantee. The final product will be incorporated into the risk assessment conducted by USAID's Office of Development Credit as a tool to evaluate risks in lending to SMEs in Jordan.

In addition to lenders' lack of understanding about the market, SMEs in Jordan face legal and regulatory constraints related to business registration; a tax system that is not conducive to private sector growth; rising costs and the prospect of shrinking demand due to global oil price hikes; and a limited natural resource base. Would-be SME lenders must cope with a difficult enabling environment for contracts enforcement, which increases their unease about the possibility of borrower default since attempts at recovery on loans that are not fully collateralized are costly and time-consuming, with uncertain outcomes.

While lending to SMEs is far from risk free, a number of risk mitigants exist, such as an ongoing Government of Jordan economic liberalization and reform program that is being supported by well-targeted technical assistance efforts from USAID and other donors. These reform efforts, combined with Jordan's strong growth rate in GDP and Foreign Direct Investment, should help to decrease the actual and perceived risks of SME lending in the coming years. The proposed DCA guarantee will help to demonstrate to Jordanian lenders the viability of lending to SMEs and the profit potential of this large segment of the economy. It is hoped that this will, in turn, stimulate the extension of credit at market rates and with appropriate collateral requirements without the need for donor support.