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AUDIT OF  
INDUSTRIAL REACTIVATION  
FUND OPERATIONS UNDER  
USAID/PERU LOAN NO. 527-F-093

Audit Report No. 1-527-87-10  
January 29, 1986

# AGENCY FOR INTERNATIONAL DEVELOPMENT

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January 29, 1987

## MEMORANDUM

FOR: USAID/Peru Director, Donor Lion  
FROM: RIG/A/T, *Coimage N. Gothard* Coinage N. Gothard  
SUBJECT: Audit Report No. 1-527-87-10, "Audit of Industrial Reactivation Fund Operations under USAID/Peru Loan No. 527-F-093"

This report presents the results of audit of Industrial Reactivation Fund Operations. The objectives of this program results audit were to assess progress toward achieving planned objectives, the adequacy of internal controls, and compliance with AID requirements.

The program's effectiveness had been constrained by: (1) limited participation of private intermediate credit institutions in the program; (2) overly complex information required of loan applicants; (3) diversion of \$5.1 million in project funds early in the project, and the time required to recover those funds; and (4) delays in releasing the second tranche of local currency to the project, due to negotiations over the exchange rate to be used to generate the local currency. The system for monitoring compliance with loan special conditions needed improvement. The program was generally being implemented in compliance with AID requirements, except that the Government of Peru had not made maintenance of value contributions to the Fund as required in the program agreement.

The report findings describe the factors which had limited the participation of private sector lending institutions in the program, overly complex information required for loan applicants, the need for closer monitoring of loan special conditions, and the need to enforce compliance with a covenant requiring the Government of Peru to make annual maintenance of value contributions to the fund.

The recommendations are that USAID/Peru: (1) obtain a plan for increasing private intermediate-credit institutions' participation, and advise the fund trustee committee that loan selection criteria should be adhered to strictly; (2) obtain a simplified loan application; (3) see that procedures for monitoring compliance with loan special conditions

and remedies for non-compliance are established; and (4) enforce the requirement for annual maintenance of value contributions. The second and third recommendations are closed upon issuance of this report.

Please advise this office within thirty days of actions planned or taken to implement the remaining two report recommendations.

## EXECUTIVE SUMMARY

AID Loan 527-F-093 provided \$60 million to help Peru recover from economic problems caused by a combination of natural disasters in 1983. The equivalent of \$45 million of the local currency generated under the loan was to be used for an Industrial Reactivation Fund for loans to private businesses. At the time of the audit, the equivalent of \$15 million had been released to the fund. Including reflows, 183 loans equivalent to \$22.1 million had been made by June 30, 1986. The fund was managed by a quasi-independent office within the Industrial Bank of Peru.

The Office of the Regional Inspector General for Audit/Tegucigalpa conducted a program results audit of the fund's operations. The audit objectives were to assess progress toward meeting planned objectives, the adequacy of internal controls, and compliance with AID requirements.

The program's effectiveness had been constrained by: (1) limited participation of private intermediate credit institutions in the program; (2) overly complex information required of loan applicants; (3) diversion of \$5.1 million in project funds early in the project, and the time required to recover those funds; and (4) delays in releasing the second tranche of local currency to the project, due to negotiations over the exchange rate to be used to generate the local currency. The system for monitoring compliance with loan special conditions needed improvement. The program was generally being implemented in compliance with AID requirements, except that the Government of Peru had not made maintenance of value contributions to the FRI as required in the program agreement.

USAID/Peru had taken several positive steps to overcome problems experienced in implementing this program. After the Industrial Bank of Peru diverted the equivalent of \$5.1 million from the fund to cover its own operating expenses, the Mission required the Bank to repay those funds at an exchange rate which maintained their value in dollars. To cope with the constant devaluation of local currency in the fund, the Mission had secured tax-exempt status for interest earnings (allowing a greater portion of loan repayments to be re-lent) and had required the program office to charge the highest interest rates allowed by the Central Bank of Peru. In general, the Mission had maintained close oversight over this program and had taken aggressive action to solve problems as they arose.

This report contains four findings. First, due to several factors, the participation of private sector intermediate credit institutions in the program had been limited. Second, overly complex information was required from loan applicants. Third, an effective system for monitoring compliance with loan special conditions had not been established. Finally, the Government of Peru had not complied with a covenant requiring annual contributions to maintain the value of the fund in dollars.

The program paper and program agreement both stress the importance of the participation of private intermediate credit institutions in the Industrial Reactivation Program. However, as of June 30, 1986 only 36 percent of the loan disbursements was channeled through private sector institutions, and a number of factors suggested that private sector participation would not increase significantly during the rest of the program. As a result, the Industrial Bank may benefit disproportionately from a program which was intended to emphasize private sector participation. The report recommends that USAID/Peru obtain a plan for maximizing the participation of private financial institutions in the program, and advise the fund's trustee committee that loan approval criteria must be strictly adhered to. The Mission agreed with this finding and recommendation.

Only necessary information should be required of loan applicants. However, the program office required a great deal of information that was of no apparent use in evaluating loan applications. This information had been required from the beginning of the program and the program office had not since re-evaluated its information needs. The volume and type of information requested had acted as a barrier to participation of medium-sized businesses in the program. The report recommends that USAID/Peru obtain a simplified loan application. The Mission implemented the recommendation, which is closed upon the issuance of this report.

Sound management practice requires sufficient monitoring to ensure that programs are achieving their intended results. The program office, however, had no effective system for monitoring compliance with special conditions established to ensure that loans would be used for agreed-to purposes. Program office and AIF officials believed that this monitoring function should be performed by the intermediate credit institutions. As a result, in four out of six cases checked, loan recipients had not complied with all of the special loan conditions. The report recommends that USAID/Peru see that an effective system for monitoring compliance, and penalties for non-compliance, are established. USAID/Peru implemented the recommendation, which is closed upon issuance of this report.

The agreement for the Disaster Balance of Payments Support program requires the Government of Peru to make annual contributions to maintain the value of the Industrial Reactivation Fund in dollars. Because USAID/Peru had not enforced this requirement, the Government had not made any contributions for this purpose, and the fund was short between \$2.7 and \$8 million (depending on the method used to calculate its value) as of June 30, 1986. As a result, the program did not have at its disposal all the resources it should have had to benefit targeted industries. The report recommends that USAID/Peru enforce the covenant. The Mission agreed that the covenant should be enforced, but disagreed with us as to how the value of the fund should be calculated.

*Office of the Inspector General*

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INDUSTRIAL REACTIVATION  
FUND OPERATIONS UNDER  
USAID/PERU LOAN NO. 527-F-093

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PART I - INTRODUCTION

A. Background

During 1982 and 1983, Peru suffered a combination of natural disasters including extensive flooding all along the northern coast and severe drought in the southern highlands. Added to the persistent effects of the worldwide recession which severely depressed the prices of Peru's major exports, this natural disaster had a heavy impact on its balance of payments and foreign exchange reserves. To assist in the country's recovery from the economic problems resulting from the natural disasters, AID Loan 527-F-093 was signed on May 11, 1984, providing \$60 million at concessional terms. The dollar transfers were to assist the Government of Peru to meet its foreign exchange obligations while the local currency generated was to:

- provide liquidity for private sector business lending,
- make available counterpart funds to cover the Government's obligations to support AID and other donor projects, and
- help defray the local operating costs of the USAID Mission.

The Industrial Reactivation Fund (FRI) was managed by a separate office within the Industrial Bank of Peru.

When we completed our field work, the equivalent of \$15 million had been released to the FRI. A second disbursement equivalent to \$30 million had been delayed by negotiations over the exchange rate to be used to generate the local currency. Including reflows, the FRI had made 183 loans equivalent to \$22.1 million <sup>1/</sup> as of June 30, 1986.

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of the Industrial Reactivation Fund from August 12 to October 9, 1986. The audit covered approximately \$22.1 million in local currency disbursements made by the FRI Office from August 1984 through June 1986.

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<sup>1/</sup> The exchange rate used to calculate the dollar value of loans made from the FRI is the highest rate of exchange which was not unlawful at the time the loan was disbursed (i.e. the "financial rate"). Readers may refer to audit report No. 1-527-86-17 for additional information regarding exchange rates used to generate local currency under this loan.

The audit objectives were to assess the program's progress toward achieving planned results and compliance with AID requirements. The audit work included reviewing project files, records, and other pertinent data; and interviewing USAID/Peru officers, FRI representatives, officials from the Industrial Bank of Peru and other intermediate credit institutions, and sub-loan beneficiaries. Our evaluation of internal controls was limited to those affecting problem areas identified by the audit. The audit work was conducted in Lima, Arequipa, Trujillo, and Chiclayo, Peru. The audit was made in accordance with generally accepted government auditing standards.

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PART II - RESULTS OF AUDIT

The program's effectiveness had been constrained by: (1) limited participation of private intermediate credit institutions in the program; (2) overly complex information required of loan applicants; (3) diversion of \$5.1 million in project funds early in the project, and the time required to recover those funds; and (4) delays in releasing the second tranche of local currency to the project, due to negotiations over the exchange rate to be used to generate the local currency. The program's internal controls were generally sound, except that the system for monitoring compliance with loan special conditions needed improvement. The program was generally being implemented in compliance with AID requirements, except that the Government of Peru had not made maintenance of value contributions to the FRI as required in the program agreement.

USAID/Peru had taken several positive steps to overcome problems experienced in implementing this program. After the Industrial Bank of Peru diverted the equivalent of \$5.1 million from the Industrial Reactivation Fund (FRI) to cover its own operating expenses, the Mission required the Bank to repay those funds at an exchange rate which maintained their value in dollars. To cope with the constant devaluation of local currency in the fund, the Mission had secured tax-exempt status for the FRI Office (allowing a greater portion of loan repayments to be re-lent) and had required the office to charge the highest interest rates allowed by the Central Bank of Peru. In general, the Mission had maintained close oversight over this program and had taken aggressive action to solve problems as they arose.

This report contains four findings and recommendations. First, several factors had limited the participation of private intermediate credit institutions in the program. The report recommends that USAID/Peru obtain a plan for increasing their participation in the program, and inform the trustee committee that loans may be rejected only if they do not comply with the formal criteria for approval. Second, overly complex information was required from loan applicants. The report recommends that the Mission help the FRI Office develop a simplified application form. Third, an effective system for monitoring compliance with loan special conditions had not been implemented. The report recommends that an effective system be established. Finally, the Government of Peru had not complied with a special covenant requiring annual maintenance of value contributions. The report recommends that the covenant be enforced.

## A. Findings and Recommendations

### 1. Private Intermediate Credit Institutions Should Be Used More Extensively

The program paper and program agreement both stress the importance of the participation of private intermediate credit institutions in the FRI Program. However, as of June 30, 1986 only 36 percent of the loan disbursements was channeled through private sector institutions. Several factors favored the use of public over private sector institutions, including the lack of formal Mission control and links of Funds managers with the Industrial Bank. These factors also suggested that private sector participation would not increase significantly during the rest of the program. As a result, the Industrial Bank may benefit disproportionately from a program which was intended to emphasize private sector participation.

#### Recommendation No. 1

We recommend that USAID/Peru:

- a. obtain from the Industrial Reactivation Fund Office an operational plan to maximize the use of private intermediate credit institutions; and
- b. formally advise the Industrial Reactivation Fund trustee committee that loan applications may be rejected only for reasons stated in the program's formal, written criteria.

#### Discussion

The project paper and loan agreement both ratify AID's preference for working through private sector institutions. Loan recipients interviewed also expressed a preference for working with private sector intermediate credit institutions.

However, from the program's inception in August 1984 through June 30, 1985, only 36 percent of loan disbursements (13 percent of the loans) had been channeled through private financial institutions. Several factors suggested that private sector participation during the rest of the program would be similar:

- USAID/Peru had no formal means of controlling the amount of resources channeled through private versus public institutions (although it could exert informal pressure on the FRI Office).
- FRI Office managers were employees of the Industrial Bank of Peru. This, in our opinion, made them subject to informal pressure to channel a large proportion of the program's resources through the Industrial Bank.
- The FRI Office had not provided enough information to private lending institutions. Several private institutions we visited were not familiar with the program's policies and procedures.

There were no private sector representatives on the FRI trustee committee, which sometimes rejected loans for reasons not included in the formal, written criteria for loan approval (e.g., because businesses applying for loans were foreign-owned). This reportedly hurt the program's credibility with private lending institutions.

On the other hand, USAID/Peru had invested a great deal of energy in establishing a rediscount mechanism in the Central Bank <sup>2/</sup>, which was necessary before any loans could be made through private institutions.

USAID/Peru needed to take action to ensure that the Industrial Bank of Peru did not benefit disproportionately from a program intended to emphasize private sector participation. It should obtain a plan from the FRI Office detailing how the use of private lending institutions will be maximized, and ensure that the trustee committee does not reject loan applications arbitrarily. Also, while we are not making a formal recommendation on this matter, it may be useful to include a private sector representative on the trustee committee. This would likely make the trustee committee more sensitive to private intermediate credit institutions' concerns.

#### Management Comments

USAID/Peru pointed out that while it was not required to do so, it had been successful in developing a rediscount mechanism which was needed before any private intermediate credit institutions could participate in the program. It recognized that continued vigilance was needed to ensure that maximum participation of private financial institutions in the program. The Mission had implemented part "b" of the recommendation, and was in the process of implementing part "a" of the recommendation.

#### Office of Inspector General Comments

As discussed in the finding, we recognize that the Mission has worked hard to maximize the participation of private intermediate credit institutions. Part "b" of recommendation No. 1 is closed upon issuance of this report.

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<sup>2/</sup> The rediscount mechanism allows the FRI Office to automatically transfer loan disbursements to private lenders, and automatically collect payments when they become due.

## 2. Overly Complex Information Was Required from Loan Applicants

Only necessary information should be required of loan applicants. However, the FRI Office required a great deal of information that was of no apparent use in evaluating loan applications. This information had been required from the beginning of the program and the FRI Office had not since re-evaluated its information needs. The volume and type of information requested had acted as a barrier to participation of medium-sized businesses in the FRI program.

### Recommendation No. 2

We recommend that USAID/Peru obtain from the Industrial Reactivation Fund Office a simplified loan application form that requests only essential information from potential borrowers.

### Discussion

Only necessary information should be solicited from loan applicants in order to minimize the transaction costs to both the borrower and lender.

The FRI Office required applicants to provide a great deal of information which was of no apparent use in evaluating loan applications. According to credit institution officials and loan recipients interviewed, this was an obstacle to the participation of medium-sized business in the program. Information requirements were first developed when the FRI Office was less experienced in reviewing loan applications, but had not been refined in light of later experience.

By the end of the audit, the FRI Office had drafted a new loan application form which eliminated certain information requirements. USAID/Peru should work with the FRI Office to eliminate further information requirements from the loan application.

### Management Comments

The Mission had implemented this recommendation. It made a case for continuing to require an economic analysis of loan applications whose utility we had originally questioned.

### Office of Inspector General Comments

Recommendation No. 2 is closed upon issuance of this report.

### 3. Closer Monitoring of Compliance with Special Conditions Was Needed

Sound management practice requires sufficient monitoring to ensure that programs are achieving their intended results. The FRI Office, however, had no effective system for monitoring compliance with special conditions established to ensure that FRI loans would be used for agreed-to purposes. FRI and AID officials believed that this monitoring function should be performed by the intermediate credit institutions. As a result, in four out of six cases checked, loan recipients had not complied with all of the special loan conditions.

#### Recommendation No. 3

We recommend that USAID/Peru obtain evidence that the Industrial Reactivation Fund Office has established:

- a. a system for monitoring compliance with loan special conditions; and
- b. remedies for non-compliance with the special conditions.

#### Discussion

FRI loan agreements included a number of special conditions which were intended to ensure that the loans would be used for agreed-to purposes, and to ensure that the loans would be repaid. The most common conditions were that: (1) no loans be made or repaid to stockholders, (2) stockholder's equity be increased, and (3) delinquent loans be refinanced.

Sound management practice requires monitoring to ensure that programs are achieving their intended results. In the case of the FRI program, this would include monitoring compliance with special loan conditions.

The FRI Office did not routinely monitor compliance with the special conditions, and no penalties or remedies for non-compliance had been established. FRI had begun to implement an evaluation system, but it did not include verification of compliance with special loan conditions.

FRI Office and AID officials believed that monitoring compliance with special conditions was primarily the responsibility of the intermediate credit institutions. We agree, but we also believe the lending institutions should communicate the results of their supervisory visits to the FRI Office. The special conditions were included in the loan agreement at the FRI Office's insistence, and that office was responsible for seeing that the program achieved its intended results.

As a result of monitoring weaknesses, FRI could be making resources available for purposes other than those stated in the Loan Agreement. In four of six cases checked, loan recipients had not complied with all of the loan conditions and the FRI Office had not taken action to remedy non-compliance. We did not review a larger sample because documentation such as loan agreements and audited financial statements were not on file in the FRI Office.

Management Comments

USAID/Peru stated that during the early years of the program, the priority was on reviewing subloan applications and improving the program office's internal controls. It stated that the monitoring and follow-up process, which was initiated before the audit, would receive equal priority now that the office has a substantial portfolio and adequate internal controls have been established. The Mission had taken the specific actions called for by the recommendation.

Office of Inspector General Comments

Recommendation No. 3 is closed upon issuance of this report.

#### 4. Maintenance of Value Requirement Should Be Enforced

The agreement for the Disaster Balance of Payments Support program requires the Government of Peru to make annual contributions to maintain the value of the FRI in dollars. Because USAID/Peru had not enforced this requirement, the Government had not made any contributions for this purpose, and the fund was short between \$2.7 and \$8 million (depending on the method used to calculate its value) as of June 30, 1986. As a result, FRI did not have at its disposal all the resources it should have had to benefit targeted industries.

#### Recommendation No. 4

We recommend that USAID/Peru enforce the requirement that the Government of Peru make annual contributions to maintain the original dollar value of the Industrial Reactivation Fund.

#### Discussion

The program agreement requires that the Government of Peru make annual contributions to maintain the value of the FRI in dollars. This requirement could be interpreted in two ways. The first interpretation, which we prefer, would be that the Government of Peru should maintain the value of the fund's corpus (i.e., the original \$15 million), and that any interest payments into the fund should go to increase the value of the fund beyond the original \$15 million. USAID/Peru's interpretation, on the other hand, was that the Government of Peru should make maintenance of value contributions only if the value of the fund including interest income fell below \$15 million.

Using either interpretation, the maintenance of value requirement had not been enforced, because USAID/Peru was preoccupied with recovering \$5.1 million diverted from the fund by the Industrial Bank of Peru in 1984. Therefore, the Government of Peru had not made maintenance of value contributions, and the fund was worth only \$7 million excluding interest earnings, or \$12.3 million including interest earnings, as of June 30, 1986. Therefore, the FRI office did not have all the resources it should have had to benefit targeted companies.

While we continue to prefer our interpretation of the maintenance of value requirement, which would provide more resources for loans to private businesses, USAID/Peru's position is not without merit. We have worded our recommendation in such a way that the interpretation of the covenant is left to the Mission's discretion.

#### Management Comments

USAID/Peru's comments on the draft audit report present arguments for including interest income in the calculation of the fund's value, and list actions already taken to help maintain the value of the fund. The Mission expected that the value of the fund (including interest earnings) would be very close to \$15 million by December 31, 1986, and stated that it would require the Government of Peru to make good any shortfall.

Office of Inspector General Comments

This recommendation can be closed when USAID/Peru has determined the fund's value as of December 31, 1986, and the Government of Peru has made the required contribution.

B. Compliance and Internal Controls

1. Compliance

The Government of Peru had not made annual maintenance of value contributions required by the program agreement (Finding 4). Except for this condition, tested items were in compliance, and we found nothing that would indicate that untested items were not in compliance with applicable laws and regulations.

2. Internal Controls

The program's internal controls were generally adequate, except that FRI's system for monitoring compliance with subloan special conditions needed to be improved (Finding 3).

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PART III - APPENDICES

UNITED STATES GOVERNMENT

# Memorandum

APPENDIX 1  
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TO : Mr. Coinage N. Gothard, RIG/A/T

DATE: December 3, 1986

FROM : Mr. *George A. Hill*  
George A. Hill, Deputy Director, USAID/PERU

SUBJECT: Mission comments on Draft Audit Report on USAID/PERU local currency lending program under the Disaster Assistance Program Loan, No. 527-F-093.

## Introduction:

The Mission has implemented corrective actions to carry out audit recommendations, No. 2, 3 and 4. The comments detailing these actions are outlined below. Corrective action to carry out audit recommendation No. 1 is being implemented and should be completed shortly.

The draft audit report states that the Industrial Reactivation Fund (FRI) local currency lending program was generally being implemented in compliance with AID requirements and the program's internal controls were generally sound. The draft audit report, nonetheless, states that the FRI program's effectiveness had been partly constrained by the limited participation of private intermediate credit institutions (ICIs). The Program Assistance Approval Document and the Program Loan Agreement indicated that the major part of the local currency corresponding to the first \$15 million dedicated to the lending program would likely be disbursed through the Industrial Bank of Peru (BIP). Both documents indicated that only prior to the disbursement of the second tranche of \$30 million, USAID and the Government of Peru would evaluate ways to maximize the use of private sector ICIs. While it was not expected to do so, the Mission was successful in assisting FRI to set up the rediscount mechanism early on during the disbursement of the local currency corresponding to the first tranche. As a result, private ICIs signed up intermediation agreements in late 1984 and eleven percent of the value of the first tranche (\$1.65 million) was disbursed through private ICIs. Pending availability of the local currency corresponding to the second tranche of \$30 million, FRI has continued lending from loan repayments, expanding the participation of ICIs to 36 percent of the total lent. The Mission recognizes the need for continued vigilance to ensure the maximum participation of private ICIs in channelling the local currency corresponding to the second tranche of \$30 million and is implementing draft audit recommendation No. 1 which addresses this issue.



Generally, the Mission believes that this draft audit report and the previous RIG/A/T audit of this Program confirm the important effect of the FRI lending program in assisting private firms to recover from the consequences of the 1983 natural disasters.

USAID disagrees with RIG/A/T's position to the effect that interest earnings should not count towards the calculation of the value of the lending fund even though those earnings are part of the lending fund. USAID has prevented significant loss of value of the lending fund by instituting a revolving trust fund mechanism whereby FRI charges the maximum interest rate allowed and all loan repayments are tax exempt and recapitalize the lending fund. As a result, and despite high rates of devaluation and inflation which at times exceeded 250% p.a., the value of the lending fund has been essentially maintained over the past years, with some sudden increases or losses of value vis a vis the Dollar as the rate of devaluation of the Peruvian currency slows or increases in relation to FRI's interest rate. Nevertheless, the GOP has recognized its obligation to provide maintenance of value contributions, and USAID will require them, if the value of the lending fund has been reduced by year's end.

#### Audit Recommendation No.1

That USAID: a) obtain from FRI an operational plan to maximize the use of private ICIs, and b) formally advise the FRI trustee committee that loan applications may be rejected only for reasons stated in the FRI program's formal, written criteria (Annex 1).

#### USAID Action

USAID has requested from FRI an operational plan to maximize the participation of private ICIs. An important feature includes the presence of two representatives of the private sector ICIs in the meetings of the FRI trustee committee. USAID has also met with the appropriate officials of the Government of Peru to reaffirm the need to make maximum use of private ICIs to channel the local currency corresponding to the second \$30 million disbursement. USAID has formally advised the FRI trustee committee that loan applications may be rejected only for reasons stated in the program's formal criteria.

USAID will actively continue to monitor and promote the maximum participation of private ICIs.

USAID believes the recommendation can fully be implemented shortly. We will report separately to RIG/A/T upon receipt of needed documentation.

#### Audit Recommendation No.2

That USAID obtain from FRI a simplified loan application form that requests only essential information from potential borrowers.

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USAID Action

USAID assisted FRI to prepare a simplified subloan application form and to reinstate procedures which greatly limit and simplify the information required from potential borrowers (Annex 2).

The FRI Program Office requires basic background (products, markets, suppliers) and financial (cash flow projections, audited annual reports) information which, by law, is already requested by participating ICIs. The emphasis of the lending program is on maintaining and increasing productive employment and promoting industrial exports by providing working capital loans to private sector firms which are viable, economically and efficiently, in the long run. The scarcity of domestic credit in an environment of economic distortions, with political and economic uncertainty, necessitates a review of each subloan application by the rediscount facility, screening out capital flight and financial speculation, to channel FRI Program liquidity to efficient firms which do not depend on subsidies but rather contribute to private sector led economic growth. The typical case is a \$260,000 loan to a medium sized industry, affected by the 1983 disasters, which needs financing to purchase raw materials to meet recovering sales demand.

As a result of the FRI financial and economic review procedures for loan requests, the audit did not find any improper uses of FRI loans. The economic analysis procedure (domestic resource cost) adjusts financial statements for economic distortions (tariffs, price controls, etc.) to finance only enterprises which make a net positive contribution to the economy.

Given the severity of the distortions in the Peruvian economy, the lack of an economic analysis might lead to allocation of scarce FRI resources to finance an inefficient industry, which would make the country poorer. USAID contracted a consultant in mid 1984 to prepare a simple, abbreviated yet accurate, methodology for the economic analysis to be conducted by FRI. The FRI Program Office, however, to make procedures uniform, wished to incorporate a more complex methodology required by the Interamerican Development Bank. FRI has been instructed by USAID, and agreed, to return to the simple methodology prepared by USAID which significantly reduces the need for information.

USAID believes that the recommended action has been completed and requests that RIG/A/T report this recommendation closed.

Audit Recommendation No.3

That USAID obtain evidence that FRI has established: a) a system for monitoring compliance with subloan conditions; and b) remedies for non-compliance with the special conditions.

USAID Action

USAID assisted FRI to implement a system for monitoring compliance with subloan conditions which also specifies penalties for subborrower non-compliance with the special conditions (Annex 3).

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FRI was created, on an emergency basis, to provide quick disbursing liquidity to viable private firms which had been affected by the natural disasters of 1983. USAID provided technical assistance to the BIP which enabled FRI to start operations within three months after the Loan Agreement was signed in May, 1984. Since its inception, FRI has had a monitoring and control unit and a supervision system which is a part of the FRI operating procedures. Some special conditions were imposed on occasion to insure that the loans would result in actual production and would not be used for refinancing other previous debts, or for speculation or capital flight. FRI concentrated its initial staff efforts and the efforts of USAID technical assistance on subloan applications, on improving its internal controls and on procedures to process loans. This was done in order to disburse funds quickly, yet after a rigorous screening. As a result of this effort the audit review did not find any improper use of loan funds. The monitoring and follow up process, which was initiated before the audit review, will receive equal priority now that FRI has built a substantial portfolio and its staff has terminated the setting up of adequate internal control procedures.

USAID assisted FRI to revise its procedures so that the ongoing evaluation system will include a complete verification of compliance with special loan conditions. FRI will also specify penalties for violation of special loan conditions. These penalties include cancelling the loan by debiting the ICI account with the Central Bank.

USAID believes this action has been completed and requests that RIG/A/T report this recommendation closed.

#### Audit Recommendation No.4

That USAID enforce the requirement that the Government of Peru (GOP) make annual contributions to maintain the original dollar value of the Industrial Reactivation Fund.

#### USAID Action

USAID has obtained the recognition by the Government of Peru of its obligation to make annual maintenance of value contributions. FRI will determine by the end of the calendar year 1986 the amount of any maintenance of value contribution which may be needed. USAID will require that the Government of Peru make any needed contributions.

USAID strongly disagrees with RIG/A/T's statement to the effect that interest earnings should not count towards the value of the lending fund. USAID believes that particularly in a high inflation economy, interest rates reflect savers' wishes to maintain the value of their capital by demanding a correspondingly high return which just about restores the real value of their initial capital. Savers cannot count the high nominal yield on their deposits as a high real profit since it only represents, at best, a recapitalization of their original investment. Similarly, FRI must use all interest reflows to recapitalize its lending fund given the high inflation environment. In 1984 and 1985

inflation fluctuated between 115% and 250% on an annualized basis. Since all loan repayments, whether original capital or interest, are available for new lending, the value of the lending fund must include all the actual resources available to it, not a nominal, historical amount which has minimal significance to the amount of resources available for lending and to its value in terms of US dollars.

Futhermore, USAID has a policy objective with regard to maximizing interest rates and earnings of the FRI lending fund. To exclude interest earnings from fund value calculation, as RIG/A/T suggests, undermines a key objective of this Program namely, the concept of providing loans to the private sector at market rates of interest. Also, three quarters of interest earnings would be lost as taxes and FRI, USAID and GOP staff would devote considerable time and energy to recover those amounts as maintenance of value contributions from the GOP treasury, as part of the GOP annual budget. This would require a protracted, cumbersome process which takes over nine months to implement. During this period the resources would not be available for FRI lending. Additionally, by the time the maintenance of value contribution became available both the lending fund and the scheduled contribution would have lost value resulting in a vicious circle as new contributions would need to be budgeted.

USAID has been vigilant of the need to protect the value of the lending fund as the best way to promote efficiency in FRI discount operations and proper GOP economic policies (market rates of interest) rather than relying on a protracted effort to obtain sizable contributions from the overburdened national treasury. USAID has insisted that FRI charge the maximum effective interest rates legally allowed and that all repayments of principal and interest recapitalize the credit fund on a revolving basis. As a result, FRI's lending rates have been the most expensive in the market. For instance, since FRI's inception, its lending rates have greatly exceeded the lending rates of the World Bank's lending fund to small industry, PROPEM (Annex 4, Exhibit 1).

USAID, early on, addressed the need to maintain the value of FRI and requested the GOP to make needed MOV contributions. The GOP recognized its obligation but requested that FRI first try to maintain by itself the value of the lending fund. USAID thus negotiated with the Peruvian government to exempt FRI from all taxation, making it a revolving trust fund of the BIP (Annex 4, Exhibit 2). Under the AID Agreement with the GOP, FRI charges to subborrowers an administrative fee to cover the cost of operating the discount mechanism.

The revolving trust fund mechanism, designed for FRI, enables it to maintain the value of the lending fund largely from its own capital and interest reflows, occasionally necessitating GOP contributions to complete the full value of the fund.

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Since, as stated above, the revolving trust fund mechanism recapitalizes FRI from repayments of interest and principal, FRI gains or loses real value, vis a vis the U.S. dollar, when its lending rate is above or below the devaluation rate of the Peruvian currency. Despite a high rate of devaluation (June 1984 - June 1985: from 100% p.a. to over 250% p.a.), FRI was able to largely maintain its value. However, the Peruvian Government over devalued the Peruvian Sol by 40% by July 1985 which seriously decapitalized the lending fund. However, since then the fund has rapidly regained value. As of October 30, 1986 the value of the FRI lending fund is about \$13 million or 87% of its original value. Projections indicate that on December 31, 1986 the lending fund will be worth very close to \$15 million.

The BIP in late 1984 diverted from FRI the equivalent of \$5.1 million. The Mission entered into protracted negotiations with the GOP to recover the U.S. dollar value of the funds diverted. The BIP claimed that the shortage was due to a regular loss of value which the GOP should cover. USAID's position was that FRI had to be made whole from whatever GOP source. The GOP instructed the BIP to complete the return of the \$5.1 million which the BIP completed in mid 1986. The GOP wrote to USAID recognizing the obligation of the GOP to effect maintenance of value contributions (Annex 4, Exhibit 3). Once FRI closes its annual books for 1986, USAID will determine the amount of the contribution needed from the GOP, if any.

USAID believes the recommendation has been fully implemented given that the value of the FRI lending fund is being maintained in a reasonable manner in a difficult environment, and that the mechanism for maintaining the value of the FRI meets all generally accepted accounting principles for achieving the program objectives. On the basis of this undertaking, USAID requests RIG/A/T to report this recommendation closed.

List of Report Recommendations

	<u>Page</u>
<u>Recommendation No. 1</u>	4
We recommend that USAID/Peru:	
a. obtain from the Industrial Reactivation Fund Office an operational plan to maximize the use of private intermediate credit institutions; and	
b. formally advise the Industrial Reactivation Fund trustee committee that loan applications may be rejected only for reasons stated in the program's formal, written criteria.	
<u>Recommendation No. 2</u>	6
We recommend that USAID/Peru obtain from the Industrial Reactivation Fund Office a simplified loan application form that requests only essential information from potential borrowers.	
<u>Recommendation No. 3</u>	7
We recommend that USAID/Peru obtain evidence that the Industrial Reactivation Fund Office has established:	
a. a system for monitoring compliance with loan special conditions; and	
b. remedies for non-compliance with the special conditions.	
<u>Recommendation No. 4</u>	9
We recommend that USAID/Peru enforce the requirement that the Government of Peru make annual contributions to maintain the original dollar value of the Industrial Reactivation Fund.	

APPENDIX 3

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