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LESSONS FROM EXPERIENCE : II

THE DESIGN AND IMPLEMENTATION OF COMMERCIAL LENDING PROJECTS BY A.I.D.'S BUREAU FOR PRIVATE ENTERPRISE

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FOREWORD

The Bureau for Private Enterprise (PRE) reflects A.I.D.'s growing emphasis on the private sector as the primary engine of growth in the developing world -- an emphasis which is increasingly shared by the governments and people of the developing world.

The Agency charged the Bureau for Private Enterprise with helping to identify, test and disseminate effective approaches for promoting and improving the performance of the private sector in developing countries. As part of this effort, the Revolving Fund was established on November 14, 1983 with the mandate to develop approaches to direct investment by A.I.D. as a tool for accomplishing development objectives, and to disseminate the results of this experience throughout the Agency.

The initial experience of the Bureau concentrated on testing and refining two basic "models" or approaches for direct investments -- direct loans to facilitate the establishment of industries, and loans or loan guarantees to private intermediate financial institutions (usually banks) in developing countries for on-lending to small and medium sized businesses.

This report analyzes the Bureau's experience to date in both its direct loan program and its loans to intermediate financial institutions. It is based primarily on field assessments of nine projects:

Leather Industries of Kenya
Antigua Shrimpery Ltd.
Kenya Commercial Finance Company
WAFABANK [Morocco]
Thai Danu Bank [Thailand]
FINADE [Dominican Republic]
FINIBER [Ecuador]
Far East Bank and Trust [Philippines]
FINANQUIL [Ecuador]

The report also draws on experience gained from other comparable projects in the portfolios of PRE's Investment Office, various USAID Missions, the World Bank and the International Finance Corporation.

The intent of this document is to assist in the dissemination of lessons learned -- both positive and negative -- from PRE's initial experience. The primary intended audience for the document is field practitioners charged with designing and implementing private sector activities. The document should also be of considerable interest to researchers and policy makers concerned with planning or assessing efforts to promote the private sector.

As with all lessons derived from experience, the conclusions and recommendations of this document are necessarily tentative, having been drawn from relatively few cases each of which began implementation less than six years ago. It is our intention to continue to monitor these projects and to collect comparable data on additional projects in an effort to enrich our understanding of private sector development.

Neal Peden

Neal Peden
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EXECUTIVE SUMMARY

This report summarizes lessons that have been learned from the Bureau for Private Enterprise's work with commercial institutions to provide assistance to Small- and Medium-Scale Enterprises (SMSEs). It also reports on the impact and cost-effectiveness of PRE credit projects. It is based upon a review of nine Investment Office loan projects in seven countries. With the exception of the PRE Investment Office's recent venture capital company projects, the report examines all of the project mechanisms that have been used by PRE to provide credit to SMSEs.

Using a simple model of the private sector project cycle, the report identifies 28 lessons that have been learned. Each lesson consists of a research finding, a discussion of the finding and a recommendation. The lessons cover identification of private sector credit problems, development of strategies for solving these problems, working with local financial institutions, effective project designs, and monitoring and evaluating commercial credit projects. Presented below are the 28 recommendations intended to improve the effectiveness of private sector credit projects and programs.

RECOMMENDATIONS BASED ON LESSONS LEARNED IN THE NINE CASE STUDIES

Problem Identification and Strategy Development

1. A thorough analysis of the economic and financial framework should precede all investment decisions. Key economic and financial variables should also be monitored during implementation of the project, so that flexible responses can be made to changing conditions. (p. 34)

2. Preliminary analysis of a project must begin by identifying which structural and institutional factors are applicable and which the project can address. Whether or not they are explicitly acknowledged in the project design, the constraints addressed by IFI projects are systemic financial sector problems. (p. 35)

3. Design private sector credit programs to permit rapid and flexible response to changing circumstances. Build flexibility to changing economic and business conditions into project agreements. (p. 36)

4. The important roles of vertical and horizontal linkages to overall project impact should be explicitly considered during selection, design and management of private enterprise projects. (p. 37)

5. Given their small size relative to the economic problems they address, A.I.D. enterprise development projects should seek to accomplish institutional development objectives in addition to direct developmental impacts on SMSE borrowers. An explicit strategy for long term institutional and structural change should be included in initial credit project designs. (p. 38)

6. In developing and implementing their credit programs and policies, USAID Missions should seek ways of collaborating with PRE that take advantage of PRE's comparative advantages as a centrally funded and specialized technical unit with more statutory latitude than is currently available to USAIDs. At the same time, PRE should make maximum effort to incorporate the Mission into project design, implementation and follow-up. (p. 40)

Working with Local Financial Institutions

1. Undertake projects only where there is a strong and competent local intermediary financial institution, or where the project will augment the competence of the local IFI. Where possible, emphasize the use of commercial banks and venture capital companies. (p. 42)

2. Selection of local IFIs should be influenced by the credibility of the selected IFI with other local lending institutions. Selecting IFIs that are particularly large, market-making institutions or that are respected for sound management and profitability will improve the likelihood that the project will influence local credit practices in the long term. (p. 44)

3. Projects should include an explicit strategy concerning the degree of risk that they are willing to incur in the interest of additionality, the incentives that they are willing to provide to induce the IFI to take risks, and their intended approach for ensuring sustainability of these activities after completion of project funding. This is always a matter of striking a balance that suits the time, country and participating institutions. (p. 45)

4. Project analysis should focus on the nature of incentives in the financial system and ways to make best use of these to encourage commercial institutions to undertake development activities. In addition, wherever possible, select IFIs that have business strategies that are compatible with the development objectives of the credit project. (p. 48)

5. Financial incentives to IFIs should be commensurate with the degree to which they are asked to modify their conventional banking practices. (p. 48)

6. Only intermediate financial institutions having the service delivery mechanisms necessary to reach intended project targets should be considered for implementation of private sector credit

programs. If the target group is in rural areas, select IFIs with adequate rural branch networks. (p. 50)

7. When designing credit projects, it is usually advisable to integrate project administration into existing credit delivery systems. Separate administrative arrangements for credit delivery should be established only when the type of lending required by the project is radically different from the IFI's usual operations. (p. 50)

8. Developmental objectives should be few and specific, and should be included as terms in project agreements in a clear and verifiable form. It is critical that these terms should be monitored throughout the life of a project. (p. 51)

9. If technical assistance is required to augment a commercial institution's ability to implement a lending program for SMSEs, it is normally necessary to fund this "institution building" portion of the project on a grant basis and to manage it with the same care that goes into effective institution building projects in other sectors. (p. 52)

Identifying Specific Financing Products and Mechanisms

1. Project designers should consider guarantees when reaching new borrower groups or developing new credit products is the project objective. (p. 54)

2. In most situations where objectives include encouraging the development of private sector businesses, making particular goods and services available commercially, or building local financial institutions, guarantee facilities are the most appropriate project mechanisms. Provision of loans by A.I.D. to individual business ventures should be considered only under limited and specific conditions. (p. 55)

3. A.I.D. should set guarantee percentages through a negotiating process to be as low as the bank will accept for a particular target group. Percentages as low as 50 percent may be acceptable for a number of purposes. (p. 57)

4. If project designers want to make credit available primarily to new or small businesses, they should normally not undertake projects that mainly provide international trade credit. If a primary objective of a project is to stimulate general economic activity or to earn foreign exchange, however, international trade credit is an important credit product. (p. 58)

5. Where credit projects include provision of technical assistance to SMSEs, commercial banks should be considered as a possible source of such assistance. (p. 59)

6. A.I.D. credit programs through IFIs should normally make explicit provision for the use of reflows to continue lending operations of the type carried out under the project. (p. 60)

7. If SMSEs are to have the opportunity to make optimal capital investments, it may be necessary to provide blanket waivers of standard A.I.D. procurement regulations for SMSE credit projects. (p. 61)

Monitoring and Evaluation of Loan Projects

1. The Bureau for Private Enterprise appears to have developed substantial expertise in SMSE lending and should develop mechanisms for disseminating and replicating the best of this experience. (p. 62)

2. Monitoring and evaluation of SMSE credit projects should focus specific attention on the observed and expected institutional impacts of projects. (p. 63)

3. Information necessary for monitoring the development impact of credit programs should be collected on a regular and consistent basis as part of project implementation. Information should include both compliance with terms of project agreements, and changes in local economic and financial conditions that represent deviations from important project assumptions. (p. 63)

4. Project implementors and monitors should be prepared to pursue unpredicted benefits, and scopes of work for project evaluations of SMSE commercial credit projects should devote considerable attention to the possible unplanned effects of these projects. (p. 64)

5. In instances when A.I.D. requires extensive information from banks that is not routinely collected during regular operations, A.I.D. should consider making appropriate payments for the information. The automated monitoring system recently developed to collect and analyze information on the financial and development effects of PRE/I's revolving loan fund should be adapted and disseminated for use by USAID Missions. (p. 65)

LESSONS FROM EXPERIENCE: THE DESIGN AND IMPLEMENTATION OF COMMERCIAL LENDING PROJECTS BY A.I.D.'S BUREAU FOR PRIVATE ENTERPRISE

CHAPTER ONE: INTRODUCTION

The Bureau for Private Enterprise (PRE) was established within the Agency for International Development in 1981 with the objective of increasing the role of the private sector in development. In 1983, Congress authorized the creation of the Private Sector Revolving Fund within the Bureau. The purpose of the Fund was to provide a flexible and self-sustaining mechanism for channeling assistance to commercially viable projects with strong development payoffs. After seven years of operation the Bureau has accumulated a portfolio of 38 projects using several project mechanisms that provide credit to small- and medium-scale enterprises (SMSEs) and contribute to the development of private enterprise.

The majority of PRE projects work through Intermediate Financial Institutions (IFIs) to encourage these institutions to lend to smaller businesses. In some cases, A.I.D. funds have been provided as a direct loan to an IFI to be used for on-lending, and in other cases to be used as guarantee collateral; in some cases the purpose of SMSE sub-loans was short-term credit to facilitate exports and/or imports by local producers, while in other cases the objective was to encourage provision of long-term investment capital by IFIs; in a few cases before the establishment of the revolving fund the IFI was owned by the government, while thereafter funds were channeled through private commercial banks. In each case, however, these programs were:

* providing funds at commercial rates of interest for a fixed period through normal commercial channels;
* designated for specific target groups and specific development objectives not adequately served by existing financial mechanisms;
* provided in the form of relatively small (normally $1-3 million) centrally-funded projects;
* matched at least 1 to 1 by funds from the IFI; and
* intended to be sustained and possibly replicated without further need for A.I.D. financial support.

A second PRE project approach that is discussed in this document involves direct loans by PRE to private businesses in developing countries. Again, these projects differ from one another in several important respects including the size of the investment, the nature of the equity participants in the project, the extent of earmarking of the A.I.D. funds, and the proportion of project capitalization represented by the A.I.D. loan. There are, however, several significant common features of these projects which are used here as defining features of the direct loan "model". These features include:

* providing term loans at commercial rates of interest to private businesses registered and operating in developing countries;

* financing the start up of new businesses and/or new products;

* specifically encouraging the transfer of technology, backward and forward linkages, foreign exchange savings and employment creation.

Bureau for Private Enterprise loans have been concentrated in the Asia/Near East region (49 percent), with a substantial share in Latin America and the Caribbean (24 percent) and Africa (21 percent), and small shares in the South Pacific Region (2 percent) and worldwide projects (4 percent). The full list of projects undertaken to date includes the following:

All Bureau for Private Enterprise Projects
As of September 30, 1987

LOAN PORTFOLIO

IFI PROJECTS	LOAN AMOUNTS ($)	GRANT AMOUNTS	LOCATION
1. Kenya Commercial Finance Company	2,500,000	250,000	Kenya
2. Women's World Banking	200,000		Worldwide
3. Bolivia Water & Sanitation	2,000,000	250,000	Bolivia
4. American Express Agribusiness Pool	2,500,000		South East Asia
5. Banco de Desarrollo Finade, S.A.	2,000,000	50,000	Dominican Republic
6. Healthlink Credit	2,500,000		Thailand/Indonesia
7. National Development Leasing Corp.	2,500,000		Pakistan
8. WAFABANK	2,500,000	50,000	Morocco
9. Financiera de Guayaquil	1,400,000		Ecuador
10. Caribbean Basin Corporation	1,200,000		Caribbean/ Latin America
11. Accion Micro Lending Pool	1,000,000	100,000	Carib/Latin Americ
12. Agri-business Investment Corp.	2,500,000		Africa
13. Bank Niaga	2,000,000	50,000	Indonesia
14. Overseas Express Bank	2,850,000	50,000	Indonesia
15. Thai Danu Bank	2,350,000	50,000	Thailand
16. Far East Bank & Trust	2,000,000		Philippines
17. Societe Marocaine de Depot et Credit	2,000,000		Morocco
18. International Multifoods Revolving Credit Facility	1,200,000		Latin America/ Caribbean
19. Union of Bolivian Banks	2,000,000		Bolivia
20. Financiera Ibero-Americana, S.A.	1,500,000		Ecuador
21. EDESA	2,000,000		Sub-Saharan Africa
22. Metropolitan Bank & Trust	2,100,000		Philippines
23. Philippines Commercial International Bank	2,400,000		Philippines
24. Bank of the Philippine Islands	2,400,000		Philippines
25. Securitized Trade	2,400,000		Turkey
26. South Pacific Loan Guar. Facility	1,750,000		South Pacific
27. Guatemala Commercial Financial Institutions	3,000,000		Guatemala
28. Diamond Trust	1,000,000		Kenya
DIRECT LOANS			
1. Antigua Shrimpery	250,000		Antigua
2. Thailand Livestock Meat Processing	2,500,000	70,000	Thailand
3. Malawi Bridge Financing Loan	2,000,000		Malawi
4. Subproductos de Cafe	2,500,000	50,000	Central America
5. Leather Industries of Kenya	1,400,000		Kenya
6. Sayyed Machinery, Ltd.	800,000	200,000	Pakistan
7. Serum Institute of India Pvt., Ltd	3,000,000		India
8. Trident Foods, Ltd.	2,000,000		Mauritius
9. NovaGene Group Partnership Ltd.	2,000,000		ASEAN Region
VENTURE CAPITAL COMPANIES			
1. Thai Venture Capital	3,000,000	50,000	Thailand

As an experimental program intended to perform a catalytic role with the Agency, PRE collects, analyzes and disseminates systematic information on the impact and cost-effectiveness of its efforts. Because the magnitude of outstanding loans has grown rapidly, the program has devoted increased attention to monitoring its portfolio and, during 1987, took specific steps to upgrade its monitoring and evaluation procedures. These steps included improved systems for monitoring financial performance and contractual compliance, sponsorship of a number of project evaluations, and instituting standard procedures for monitoring and reporting program impact.

A recent report to PRE proposed that reporting and monitoring needs be met by implementing a monitoring and evaluation system with three basic components:

* To provide basic management information, an automated monitoring system with information on key financial and development indicators and suitable for production of real time, monthly and quarterly portfolio analyses; action alerts on missing documentation; and detailed project status reports on an "as needed" basis. These reports would be primarily for the use of PRE personnel.

* To provide for accountability and overall assessment of program impact, a system of "augmented audits" verifying the development impact and financial performance of each project in the portfolio; and an Annual Report modeled on corporate annual reports and directed to Agency Management and Congress.

* To provide a vehicle for disseminating lessons learned, a series of periodic assessments of the "models" developed and/or tested by PRE. These assessments would be based on the evaluation of selected field projects. While using individual projects as the primary source of data for these assessments, the "model", and not the individual project, would be the unit of analysis in these reports to maximize the transferability of lessons learned. These assessments would be intended principally for use by A.I.D. personnel and officials of other development agencies.

A full description of this monitoring and evaluation system can be obtained from PRE/PR. This report represents a first attempt to perform the type of periodic assessment of financing models called for by PRE's new monitoring and evaluation system.

In order to help A.I.D. Missions and others learn from PRE's experience in providing credit to SMSEs, the PRE Office of Program Review commissioned a major study of PRE Investment Office loan projects. During the period from October 1986 to December 1987, nine in-depth studies were conducted of projects in a total of seven countries. The cases reviewed in depth were:

Leather Industries of Kenya (direct loan to business)
Antigua Shrimpery Ltd. (direct loan to business)
Kenya Commercial Finance Company (direct loan to IFI)
WAFABANK [Morocco] (guarantee facility)
Thai Danu Bank [Thailand] (guarantee facility)
FINADE [Dominican Republic] (guarantee facility)
FINIBER [Ecuador] (guarantee facility)
Far East Bank and Trust [Philippines] (guarantee facility)
FINANQUIL [Ecuador] (guarantee facility)

The goals of the case studies were twofold: first, to provide immediate feedback on how well each project was meeting its objectives and the degree to which SMSEs had benefitted from the projects; and second, to discover general lessons about effective means of providing assistance to SMSEs and strengthening private sector financial institutions. The result of these studies is a set of case study reports on the projects and this summary report.

The research on which the summary report is based was carried out by Management Systems International during 1986 and 1987, and included were the following tasks:

* review of available documentation on relevant projects in the portfolio and interviews with investment officers;

* identification and review of relevant experiences of other donors;

* conduct of site visits to nine projects to review recipient organization records; hold discussions with borrowers, their competitors and collateral institutions; visit a representative sample of sub-borrowers; prepare reports; and conduct debriefings for local USAID Mission staff; and

* preparation of a final document and case studies for submission to PRE.

CHAPTER TWO: A PROCESS MODEL OF THE SMSE CREDIT PROJECT CYCLE

To help organize the lessons learned from the cases reviewed, the following simple flow model of the SMSE project cycle has been employed:

(1)		(2)		(3)		(4)
ANALYSIS OF PROBLEM AND CONTEXT	>>>	IDENTIFICATION OF STRATEGY AND OBJECTIVES	>>>	IDENTIFICATION OF SPECIFIC FINANCING PRODUCTS AND MECHANISMS	>>>	MONITORING AND EVALUATION OF FINANCIAL AND DEVELOPMENT IMPACT

1. PROBLEM AND CONTEXT

SMSEs typically face one or more of several basic problems in obtaining adequate services from local commercial credit markets. Typical problems facing SMSEs include:

* Lack of experience among commercial banks in lending to SMSEs, and beliefs among commercial financial institutions that SMSEs or rural businesses are not acceptable borrowers;

* Unwillingness of banks to assume certain types of risks;

* Credit markets that lack essential trade finance instruments;

* Inability of banks to charge interest rates adequate to cover the incremental risk and administrative cost they associate with lending to SMSEs;

* Lack of financial liquidity in local credit markets which causes banks to lend exclusively to large industries.

2. STRATEGY AND OBJECTIVES

A strategy, simply stated, is a general plan of attack to solve the problem, a plan that includes analysis of a problem, choice of objectives, an overall view of the context, and actions to address the problems and meet the objectives. A project is one action element in a strategy.

Three of PRE's initial strategies have been to strengthen local credit markets, to develop and disseminate effective project models, and to serve as a catalyst within A.I.D. Examples of more specific strategies adopted by PRE are working with private sector institutions, developing new financial instruments, encouraging competition in SMSE credit markets, building institutional capacity to appraise and administer SMSE loans in financial institutions, and creating advisory services to assist SMSE clients in using credit effectively. Choice of strategies is an essential stage in evolving a private sector project.

The objectives of SMSE development projects carried out by PRE are established in general terms by the Bureau's and Revolving Fund's legislative mandate. In general, these objectives can be summarized in the following categories:

(A) Direct Development Objectives: increasing sales, production and employment in SMSEs. Other direct development objectives of interest include:

- Increasing foreign exchange earnings.
- Encouraging appropriate technologies and technology transfer.

(B) Institutional Change: making local financial institutions more capable of lending to SMSEs; stimulating competition and efficiency in SMSE credit markets; and creating capabilities within USAID Missions to design and implement SMSE credit projects. Other specific institutional objectives of interest include:

- Demonstrating to local governments and nongovernmental institutions viable SMSE development approaches.
- Initiating policy dialogue within local governments leading to rationalization of financial markets policies, movement toward commercial interest rates, provision of adequate facilities for SMSEs, and privatization of financial markets.

A more complete listing of objectives for A.I.D.- assisted SMSE lending projects is presented in Annex 1 as a possible checklist for use by project designers.

3. FINANCING MECHANISMS AND PRODUCTS

Implementing a strategy involves selecting a product or service to offer to SMSEs and a mechanism by which to produce and deliver the product or service. In the case of credit projects, "products" are credit instruments that are offered to SMSEs either by an intermediary financial institution or directly by A.I.D. The projects reviewed here included four products made available to SMSEs by PRE, namely:

(1) Short-term working capital credit
(2) Import credit
(3) Export credit
(4) Term loans, used primarily for the acquisition of fixed assets

From the perspective of the SMSE owner or manager, these products are typically seen as specific credit windows or services in a financial institution, or in some cases several institutions, from which he or she can obtain certain types of credit.

PRE projects can also be viewed from another perspective, from "behind the credit window", where a project employs a specific financing mechanism to open a credit window to certain borrowers and to induce an IFI to provide certain credit products. Behind the window are activities by A.I.D. (and the IFI) aimed at producing particular credit products and services for target businesses. Sub-borrowers often know nothing about those mechanisms, while A.I.D. and the local IFI are deeply concerned with this back window perspective, with how the credit products are structured and priced.

Implementing mechanisms used by PRE in the cases reviewed include:

(1) Direct loans to businesses;
(2) Direct loans to IFIs for on-lending to SMSEs; and
(3) Loan guarantee facilities.

Thus, a project is a mechanism for putting a credit "product" into place. For example, the Thai Danu Bank project consists of a guarantee facility established to encourage Thai Danu Bank to provide medium-term credit to SMSEs outside of Bangkok. Without the guarantee, Thai Danu would not have offered term credit to this target group. In the two Ecuador projects, PRE used a guarantee mechanism to encourage two international banks to provide U.S. dollar trade credits to Ecuadorian commercial banks for on-lending to local capital goods importers.

The following table presents the projects undertaken by PRE to date (with those evaluated here in bold) in terms of the product delivered and the mechanism employed by each:

MATRIX OF PRODUCTS AND MECHANISMS

MECHANISM

	Direct Loan to Business	Direct Loan to IFI	Loan Guarantee Facility
Short-term Working Capital			
Import Credit			FINANQUIL FINIBER WAFABANK
Export Credit			FINADE SOCIETE MAROCAINE SECURITIZED TRADE
Term Loan	TRIDENT FOODS THAILAND LIVE MEAT PROCESSING ANTIGUA SHRIMPERY SERUM INSTITUTE NOVAGENE GROUP LEATHER INDUSTRIES OF KENYA MALAWI BRIDGE FINANCING	KCFC	HEALTHLINK ACCION BANK NIAGA FAR EAST BANK & TRUST OVERSEAS EXPRESS BANK THAI DANU BANK BANK OF PHILIPPINE ISLANDS EDESA SOUTH PACIFIC LOAN GUARANTEE FACILITY GUATEMALA COMMERCIAL FINANCE DIAMOND TRUST UNION OF BOLIVIAN BANKS PHILIPPINE COMMERCIAL BANK METROBANK SIAM COMMERCIAL BANK WOMEN'S WORLD BANKING NDLC
Equity Investment		THAI VENTURE CAPITAL CARIBBEAN BASIN CORPORATION AGRIBUSINESS INVESTMENT CORP.	

4. MONITORING AND EVALUATION

When a project is implemented, both the project mechanism and the credit products have direct effects on target SMSEs, and longer term institutional impact on local financial institutions, the host government and the local USAID Mission. For example, the guarantee mechanism ideally induces banks to change certain of their operations and to lend to businesses that otherwise would not have been considered eligible for credit. These changes may or may not continue after the project is completed, but sustainable change in lending institutions and operations is an important private sector project objective.

In addition, the credit that is provided to target businesses is intended to have impacts on the operations of the businesses themselves. Positive impacts include increased production and employment, greater efficiency and productivity.

During project implementation, A.I.D. is expected to monitor compliance with the terms of the project agreement to assure that problems encountered during implementation can be identified and solved. In addition, in order to learn lessons and improve private sector programming, projects are periodically evaluated with respect to their development and institutional effects.

CHAPTER III: STUDY METHODOLOGY

As noted above, nine loan projects were selected for in-depth study. Projects were selected according to two criteria:

(1) that they represented the range of mechanisms and products in PRE investment projects;

(2) that projects were fully operational for long enough to have had noticeable effects on the SMSE sub-borrowers and on local institutions.

A multiple case study research methodology was used. In this design, each project was treated as a separate case. In each case, comparable data was collected from multiple sources using a structured data collection guide and structured interviews with key personnel listed below. The data collection guide is attached as Annex 2. All case studies involved extensive visits to businesses that had received loans under the project. In each case, information was collected on the following topics:

* Operation of the loan program;
* Impacts on sub-borrowers;
* Impacts on the local government and other local financial institutions;
* Impacts on the IFI receiving the loan/grant;
* Impacts on the local USAID Mission.

Each study was carried out by a team of two to three persons that spent two to three weeks in the field collecting data. (See Annex 3 for a list of study team members.)

Specific performance indicators investigated included those appearing in the Congressional mandate and policy directives establishing PRE and the Revolving Fund. These included:

* sustained project activities after withdrawal of A.I.D. funding;
* changes in IFI loan appraisal terms and criteria;
* changes in IFI portfolio composition;
* disbursement and repayment rates;
* replication in other host country institutions of approaches tried in target institution;

* improved local capability to identify, process, monitor and recover relevant loans;

* money invested by other sources in SMSE credit projects;

* sales generated and jobs created;

* foreign exchange generated or saved;

* participation by women in business ownership and employment.

In each of the nine projects, reviews of documents and records were supplemented by 20-30 personal interviews with a range of individuals involved in, or knowledgeable about, the project. Those interviewed included:

For Direct Loan Projects

PRE personnel
USAID personnel
Senior managers of the enterprise
Officials of co-financing institutions
Officials financing and/or implementing comparable projects
Operators of horizontally or vertically linked enterprises

For IFI Projects

PRE personnel
USAID personnel
Senior managers of the IFI and those responsible for management of the project
Officials of other comparable banking institutions
Officials of the Central Bank
Officials of correspondent banks
Representative sample of sub-borrowers (i.e., those receiving loans under the project)

Although many of the interviews were, of necessity, conducted in an informal manner, the standardized interview guides helped to direct interviews and to provide an organized means of recording responses.

Following each field investigation, a preliminary case study was prepared and discussed with the local USAID Mission prior to the team's departure from the country. These case study reports, and the associated debriefings, were tailored wherever possible to incorporate the special information needs and interests of Mission personnel, while continuing to serve the primary purpose of case studies examining basic models of assistance.

In addition, after case studies were completed, interviews were conducted with officials in A.I.D., the World Bank and International Finance Corporation who had been involved in similar projects, and a variety of previous reports on the subject were reviewed. (A bibliography listing the documents reviewed is included as Annex 4.) The results of these interviews and documentary reviews were used to supplement, or in some cases modify, the lessons learned from the nine case studies. Where additions or changes were introduced, they are explicitly acknowledged. After the case studies were completed, this report was written to synthesize lessons learned in the cases.

Finally, based on the lessons learned and reported in this study, a manual has been prepared offering operational guidelines on the design and management of SMSE commercial lending projects. This document is available upon request from the Program Office of A.I.D.'s Bureau for Private Enterprise.

CHAPTER FOUR: CASE DESCRIPTIONS

As noted above, the lessons from experience presented in this document are drawn, in large measure, from nine field evaluations. Full reports of these field investigations are presented as separate documents. This Chapter briefly summarizes the reports.

A. Direct Loans

1. Leather Industries of Kenya

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Lack of vertical linkages in the leather industry. 2. Need for foreign exchange.	Create local demand for and supply of leather.	Long Term Credit Direct Loan to Leather Industries of Kenya	LIK facilities properly constructed and producing as planned. Vertical linkages established. Modern tannery techniques transferred.

The Agency for International Development provided the Leather Industries of Kenya (LIK) a $1.4 million loan at 12 percent interest for ten years. This loan was part of a $9 million investment package financed by a group of Kenyan and international investors, both private and public, to build a processing plant for manufacturing finished leather. The project objective was to create a market for locally-produced hides, to provide raw materials for leather manufacturing industries, and to increase the amount of finished leather goods exported from Kenya. PRE's investment in LIK was made before the establishment of the Bureau's Revolving Fund and was channeled through an international commercial bank.

At the time the project was formulated, Kenya was one of the few countries that was still exporting most of its hides and skins in raw or semi-finished form. At full production, the tannery is expected to process approximately 13 percent of Kenya's total production of hides, employ 400 Kenyans, and generate $60 million in foreign exchange earnings over a period of 10 years.

The LIK venture was organized and managed by Industrial Promotion Services (Kenya) Ltd. (IPS), an arm of the Aga Khan Foundation for Economic Development. IPS was recognized as a major player in Kenyan commercial circles, and had been the recipient of previous investment financing support from the International Finance

Corporation of the World Bank and other international investment institutions.

PRE's investment, and that of the other organizations, provided long term credit which was not available through the Kenyan commercial banking system or, at the time, the development banks. It also provided commercial credit during a period of reduced credit flows from international banks to businesses in Kenya. While there is no evidence that PRE participation directly stimulated investments by other institutions, the PRE loan was an important part of the financial package.

The LIK project was responsible for introducing modern tanning technologies to Kenya, and encourages improved animal husbandry practices among LIK's suppliers. A crucial element of the LIK venture was the transfer of modern leather processing technology used in exploiting a resource with high export market potential. Transfer of modern technology has been institutionalized by the equity and management participation of the technical collaborator, a well-established Belgian tannery.

The tanning operation is unique in Kenya because it aims specifically at export markets for high quality finished leather. In the short run, however, LIK is concentrating its initial marketing on more traditional markets for Kenyan products, both in and outside of Kenya.

The company's concern for quality is also aimed at improving the backward linkages to raw hide suppliers, and this has resulted in increased income for livestock raisers. This is taking place through the provision of improved equipment for use in the flaying process, and through a premium incentive payment of 40 percent to suppliers of higher quality hides.

Another impact of PRE's involvement in this venture was the transfer of environmental protection technology. A.I.D.'s participation was conditional upon strict environmental requirements and fulfillment of these requirements resulted in the construction of a "state of the art" effluent treatment facility at the tannery.

While newly opened and operating at only 30 percent capacity at the time of the study, the tannery appeared well on the way to establishing its niche in the export market, and was having no trouble selling its products internationally and domestically.

The LIK project has created a strong connection between the USAID Mission and IPS, an important private sector institution in Kenya. The project is generally regarded as "successful" by all involved, and other efforts to stimulate development through the local private sector are already being designed by USAID/Kenya in cooperation with IPS.

2. Antigua Shrimpery Limited

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Heavy dependence on food imports.	Encourage private sector import-substituting industries.	Term loan	Project never met production or financial targets.
2. Shortage of foreign exchange.	Encourage local commercial bank to fund new starts.	Direct loan to ASL.	
3. Shortage of commercial credit for new starts.			

The Antigua Shrimpery Limited (ASL) project, whose initial loan was also made before the establishment of the Revolving Fund, was originally developed and appraised by the World Bank's Caribbean Project Development Fund. As implemented by PRE, the project involved a co-financing loan for the installation of a commercial shrimp production facility on the island of Antigua in the eastern Caribbean. A financing agreement was arranged by which a local bank, the Bank of Antigua, made a seven year loan totaling $270,000 to the company, and sold a portion ($150,000) of the loan to A.I.D. This procedure was used to establish a buffer between A.I.D. and the company, and to help ensure direct involvement by Bank of Antigua in monitoring and supervision of the financial management of the enterprise. The bank was also expected to provide short term financing in the form of overdraft facilities to ASL.

The purpose of the loan was to finance construction and start-up of a modern commercial shrimp production installation composed of a nursery/quarantine building and 12 two-acre grow-out ponds. Full production was expected to reach a level of 65,000 lbs. of heads-on shrimp per year for sale to local tourist-oriented businesses, replacing dependency on imported shrimp.

The Bank of Antigua and A.I.D. were the only debt participants in the financing. Equity was supplied by several private investors, most notably the young American entrepreneur who also served as the company's Chief Executive Officer and principal technician. A.I.D.'s partici tion was the major factor in encouraging the involvement of

Bank of Antigua. ASL became that bank's largest loan, representing approximately 10 percent of its entire loan portfolio.

The venture was plagued with difficulties from the beginning. After the withdrawal of one of the technically qualified partners before the construction began, technical management of the enterprise was weak. Major additional costs subsequently arose due to the collapse of a government-maintained dam near the site, closure of the company that was to provide growing stock for the operation, and the need to install electrical power facilities when the Antiguan Electricity Authority refused to extend power lines to the farm.

The Bank of Antigua continued to provide overdraft credit to the enterprise up to $150,000, three times what was originally anticipated. At the time of the study, the farm had generated approximately $13,000 in total revenues after one year of operation, had ceased operation, and was essentially bankrupt. A corporate restructuring occurred, and in January of 1987 a new company was created with ownership passing to a major international corporation with substantial holdings in the Caribbean.

There was little, if any, involvement of regional USAID officials in designing, monitoring or supervising this activity. The Bank of Antigua which itself had limited financial or managerial resources, overextended itself in providing support to the venture to the point that failure of the operation would likely have a major impact on the future of the bank itself.

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The two cases of direct loans to new ventures, LIK and ASL, share several features in common. Although the loan amounts were substantially different in absolute amounts, both were relatively small projects and each A.I.D. loan represented approximately 25 percent of the total capitalization of the venture and approximately half of the debt portion of that capitalization.

Both ventures were aimed at introducing relatively sophisticated technology intended to use unexploited natural resources for export generation or import substitution. In both cases, market studies indicated that the enterprises would be very profitable if production goals were met, and the anticipated income from both enterprises would have beneficial effects on foreign trade balances of the respective countries.

The role of other international investment organizations, particularly the International Finance Corporation, was important in both cases. In the case of LIK, the IFC participated in the feasibility study and became both a debt and equity participant in the venture. In the case of ASL, the Caribbean Project Development Fund, a branch of the IFC, was responsible for preliminary feasibility analysis and for bringing the venture to PRE's attention.

In both instances, a close supervisory role was assumed by a local commercial entity, and neither PRE nor the USAID Mission played a major part in monitoring the activity once the initial conditions were fulfilled and the loan was disbursed. The role of the institutions closest to each project was of a different nature, but in both cases the direct involvement of those institutions in the capitalization of the venture was sufficient to stimulate an interest in monitoring progress of the projects.

Both investments responded to similar macroeconomic and financial market conditions. The banking systems in both Kenya and Antigua were not disposed to make long term credit available for new enterprises, and flows from international banks were at a low ebb at the time. These factors made assistance from non-traditional sources of financing such as PRE a key element in getting the venture under way.

The two cases begin to diverge in areas of technical and managerial backup. The investment in LIK was backed up by a major local institution with substantial human, technical and financial resources, and long experience in Kenyan business. In the ASL case, on the other hand, technical and managerial support was divided between the principal project organizer (a relatively inexperienced entrepreneur) and the major debt participant, the Bank of Antigua, which was itself relatively small and only able to handle financial aspects of the project. ASL was, in many instances, managed in a relatively unprofessional manner while the LIK venture was carried out with a high degree of professionalism on all sides. The fact that operations of the failing ASL venture have been taken over by a major international company provides additional evidence that management and financial backstopping may indeed be major factors accounting for the enterprise's problems.

The general USAID climate in which the two ventures were proposed and implemented was also different. The Kenya situation had a substantial amount of PRE/USAID interaction. The Antigua project, on the other hand, showed little, if any, direct involvement or monitoring by regional USAID personnel.

B. IFI Loans

1. Kenya Commercial Finance Corporation (KCFC)

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
Local banks unwilling to lend to rural SMSEs.	1) Induce major commercial bank to lend to SMSEs. 2) Provide KCFC with experience in SMSE credit. 3) Increase credit availability in rural areas.	Term Loans Direct Loan to IFI	Funds fully utilized and many new starts funded. High rate of delayed payments but few defaults.

The Bureau for Private Enterprise provided a $2.5 million direct loan to the Kenya Commercial Finance Corporation, KCFC, for long-term lending to Kenyan-owned small- and medium-scale rural agribusinesses. KCFC matched the fund with $2.5 million in local currency. In addition, a $250,000 grant was provided to KCFC's parent corporation, the Kenya Commercial Bank, to strengthen its Business Advisory Service.

This loan was for 12 years at a 10.5 percent interest rate, and was made before the establishment of the Revolving Fund. KCFC is a non-bank financial institution (NBFI) and a subsidiary of KCB, a government-owned commercial bank with branches throughout Kenya. KCFC had administered similar SMSE lending programs in the past, supported by the International Finance Corporation (IFC) of the World Bank and the Organization of Petroleum Exporting Countries (OPEC).

The project was an attempt to provide long term credit to enterprises which were generally unable to obtain such credit in the commercial banking sector. At the time of the loan, banking liquidity in Kenya was low, and this further restricted the traditionally conservative lending practices of commercial banks in the country. Moreover, commercial banks could not take term deposits that would allow them to make longer maturity loans.

Subloans under the project were made at an annual rate of 19 percent, the prevailing rate for all non-bank financial institution loans in the country. These loans were made, however, primarily to finance long-term capital investment and had terms of 6 to 8 years. The operation is managed by KCFC "Schemes", a division established specifically for administering special projects. Reflows from subloan payments become part of KCFC's general loan pool, and are not relent under the program.

The loan fund was fully lent to the targeted group. Seventy-five percent of the loans went to finance new enterprises. Several loans were provided to existing businesses that had never received commercial credits before the PRE project, and project loans resulted in significant increases in output of agricultural goods.

At the time of this study, the program was fully committed, with a total of approximately 74 million Kenya shillings pledged to 95 sub-borrowers. Most sub-borrowers had regular savings accounts at KCB and learned of the program from the bank. Sub-borrowers demonstrated a broad range of sizes of enterprise, business knowledge and management experience. Forty-four percent were small scale grain millers, although these millers accounted for only 8.6 percent of the funds lent. Larger enterprises in manufacturing and distribution received 9 percent of the loans but accounted for almost 40 percent of the funds. Enterprises in the transport sector accounted for an additional 23 percent of the funds lent.

The loan fund appears to have had a substantial impact on the operations of a number of the businesses surveyed, with many of those businesses reporting significant sales increases over the period of the loan.

Strict collateral and legal requirements imposed by KCFC reflect traditional conservative banking practices which were adhered to in administration of the project. While a significant portion of sub-loans are currently in arrears, experience with the IFC and OPEC programs indicates that these loans can probably be expected to be serviced over time, particularly when legal action is threatened.

The PRE loan to KCFC, along with the programs financed by IFC and OPEC, appears to have been generally profitable for the bank and to have resulted in some change in the institution's perception of the risks involved in term lending to SMSEs. There is also evidence of impact on the commercial banking system as a whole in that other private commercial banks are now participating in a follow-on USAID/Kenya project. The PRE project was a successful model for this follow-on small business credit project financed by the Kenyan USAID Mission.

2. WAFABANK

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
Lack of foreign exchange for international trade.	1) Provide dollars to importers during life of the project. 2) Initiate policy dialogue with government.	Short Term Import Credit Collateral Account Guarantee Facility	Funds fully utilized for clients with previous accounts with WAFABANK. Project stimulated changes in Central Bank trade credit policies.

A loan of $2.5 million from PRE's Revolving Fund was matched by WAFABANK, Morocco's second largest privately owned bank, to create a $5 million loan fund in foreign currencies for small and medium sized enterprises. The loan from PRE was deposited in a collateral account[1] in the New York branch of the French bank Credit du Nord, WAFABANK's main correspondent bank. The funds were immediately invested in Treasury Bills and used as a guarantee to support expansion of WAFABANK lending to Moroccan SMSEs needing foreign currency to import raw materials, finished goods and equipment.

In order to respond to the credit ceilings imposed by the Central Bank of Morocco on all local banking institutions, the original structure of this project was modified such that Credit du Nord, a foreign bank, became the lender of record for the loans to Moroccan enterprises. In addition to increasing WAFABANK's effective foreign currency credit ceiling by $5 million, this change had the additional benefits to sub-borrowers of reducing real rates of

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1. The collateral account loan structure was developed by PRE in 1984 to minimize the foreign exchange risk to a borrower. Basic features include a three party agreement between A.I.D., the borrower, and a bank located in the United States (Depository Bank). After loan proceeds are deposited into the collateral account, the depository bank invests those proceeds in securities approved by A.I.D., typically U.S. Treasury obligations; the depository bank then issues a letter of credit guaranteeing an extension of local currency credit, receiving a security interest in the collateral account in the event a payment must be made under the letter of credit. Actual foreign exchange transactions occur only in the event of a default that qualifies for reimbursement under the terms of the guarantee agreement.

interest and permitting them to make prompt payment for imported supplies in a number of foreign currencies.

The loan program was managed for the most part by WAFABANK's Small- and Medium-Scale Business Division, which oversees approximately 2,600 clients. The bank's standard oversight process used for this project is rigorous, requiring a thorough analysis of a company's financial health as well as the viability of its marketing plans.

Loans made under the project were short-term, with none of the credits used up to the time of the study exceeding a six month term. A total of 177 loans totaling $9.7 million to 54 different SMSEs had been made, and the absence of payback delinquencies had enabled the fund to "revolve" twice in less than two years of operation.

Loans were divided almost equally between small scale enterprises (54 percent) and medium scale enterprises (46 percent), and usually represented between 5 and 20 percent of the total line of credit authorized for the borrower. Borrower use of the fund averaged three loans at $54,800 each during the period, and ranged from 27 loans for a total of $1.8 million by one company to one loan for $9,600 for another. All loan proceeds were used to finance imports of foreign goods or equipment, and many loans resulted in technology transfers. Despite emphasis on exporting in the original project documents, only four of the 17 borrowers interviewed by the team were actively involved in export activities.

The guarantee provided by PRE enabled WAFABANK to expand the availability of foreign exchange credit. The modified project agreement provided a legal, acceptable mechanism for avoiding the restraints on credit imposed within Morocco and the ceiling on foreign exchange credit made available from Credit du Nord to WAFABANK. For sub-borrowers, the program provided an efficient vehicle for obtaining supplies and provided relatively low interest rates.

This facility provided foreign exchange at a time when none was available from other external commercial banks, but at present there is little indication that the project provided funds to businesses which would otherwise not have received them, or that it caused major policy changes within WAFABANK itself. Bank officials were, however, pleased with the project and wished to see it continued.

Other Moroccan banks also expressed a desire to participate in similar projects. Credit du Nord officers stated that the guarantee from PRE was the determining factor in the decision to extend additional credits and that continued credit was contingent on continuation of an A.I.D. guarantee. The Central Bank of Morocco, whose restrictions on credit had, in effect, been avoided through the project, expressed satisfaction with the program and indicated that its success led them to re-examine certain foreign exchange policies.

The USAID Mission in Morocco was not deeply involved in the project and has not programmed any specific follow-on projects. The PRE involvement, however, was regarded by members of the Mission staff as a stimulus to increased contacts between USAID/Morocco and the country's private sector, specifically in the banking community.

3. Thai Danu Bank

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
Concentration of economic opportunities in Bangkok area. Unwillingness of commercial banks to lend to SMSEs.	1) Encourage respected local commercial bank to undertake SMSE lending. 2) Provide term credit to SMSEs outside of Bangkok.	Term Credit Offset Guarantee Facility	Facility fully utilized; IFI successfully encouraged to undertake SMSE lending. Provided model for follow on guarantee project in Thailand.

PRE established a $2.35 million guarantee facility for the Thai Danu Bank in Thailand. The guarantee covers 50 percent of the credit risk of Thai Danu Bank's loans to small- and medium-scale businesses outside of the Bangkok metropolitan area. In order to fully use the facility, the bank must make $4.7 million in loans to qualifying borrowers. Thai Danu Bank is a 100 percent privately owned commercial bank, and is ranked eleventh out of thirteen commercial banks in the country in terms of asset size.

The project addressed two major development problems in Thailand. First, banks are generally unwilling to lend to SMSEs, particularly in rural areas because of traditionally conservative lending practices. Second, despite Thailand's recent impressive economic growth record, economic activity has been highly concentrated in metropolitan Bangkok. Government services, public infrastructure, investment capital and employment opportunities are increasingly concentrated around the capital city, while unemployment and economic stagnation are common in rural areas. The Thai Danu Bank project was aimed at stimulating private commercial lending to SMSEs outside of Bangkok, and at directly providing long-term credit to this target sector.

The strategy adopted to address these problems was to encourage a highly respected local commercial bank to begin to lend to rural SMSEs. The project used a guarantee mechanism to encourage the bank to provide term credit to target borrowers.

The project was managed by the credit department, with lending integrated into the department's usual credit operations. As of September 1, 1987, 76 loans had been made under the facility. The average loan under the project was $63,690. Recipients were all small businesses by local standards, ranging from extremely small rural farms with practically no assets to several modern manufacturing and retail companies with over $350,000 in net fixed assets. The average borrower had about $97,000 in net fixed assets. All of the sub-borrowers reviewed appeared to have excellent business prospects and had used the loans for productive purposes. There have been no defaults as of September 1987 by sub-borrowers under the facility.

The timing and fit of the facility with the bank's longer term strategy was excellent. The project was integrated into normal operations of the bank, and provided a strong underpinning for its new branch expansion strategy. From a national economic perspective, use of a guarantee rather than a direct loan was an appropriate mechanism in the high liquidity situation that existed at that time.

Loans under the guarantee facility resulted in significant increases in production and employment outside of Bangkok. Two areas where production increases were particularly large were in agricultural produce (such as chicken, pork, fresh-water fish, and oranges), and in traditional Thai handicrafts. All of the businesses visited had used the loans for productive purposes, with approximately one-third of the loans going to new starts. Estimated total employment generated up to the half-way point in the project was 325 full time and 255 part time jobs. Approximately one-quarter of the businesses used guaranteed loans to acquire new technologies.

The additionality of this project, the extent to which it resulted in the provision of credit to businesses that otherwise would not have received commercial bank credit, was very high. Thai Danu Bank officials stated that most of the businesses receiving guaranteed loans under the project were new to the bank, and that the majority of all PRE project borrowers would not have received loans if no guarantee had been available to Thai Danu. It is clearly true that the project induced the bank to change its usual lending practices and to lend to rural SMSEs that otherwise would not have been eligible for loans.

Through its experience in lending to rural SMSEs the bank gained significant expertise in identifying small business loans, and it is apparent that long term changes have been made in the bank's ability and willingness to lend to SMSEs. Bank officers also stated that they intend to continue to lend to these types of businesses after the termination of the project.

The project was closely monitored by USAID/Thailand, and it subsequently provided a successful model that has been incorporated into the design of the Small Industries Guarantee Facility, a larger USAID/Thailand financed guarantee scheme in Thailand.

4. Far East Bank and Trust Company

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
Serious economic recession in Philippines. Unwillingness of local commercial banks to lend to SMSEs.	1) Stimulate exports. 2) Induce a major commercial bank to lend to SMSEs.	Short Term Export Credit Offset Guarantee Facility	Facility fully utilized. Encouraged major commercial bank to expand SMSE lending. Provided a model for three follow-on guarantee projects.

PRE provided a $2.0 million guarantee facility to the Far East Bank and Trust Company (FEBTC) to be used to cover 50 percent of the principal value of up to $4 million in short-term export credits to SMSEs. SMSEs were defined as businesses with net fixed assets less than $1 million. PRE's funds were deposited in a collateral account in the Rainier bank, and this account served as the basis for the guarantee facility. FEBTC is the second largest private commercial bank in the Philippines, has an excellent reputation for sound management and financial prudence, and has substantial experience in trade finance.

The project was designed during a period of serious need for increased business activity in the Philippines. At that time, business-owners and investors were postponing new investments until the political and economic situations showed signs that they would stabilize. In addition, local commercial banks are traditionally reluctant to provide credit to SMSE exporters, forcing these businesses to borrow from informal sector moneylenders or to operate with insufficient capital. Given the conditions of uncertainty, many SMSEs with good business prospects faced a serious shortage of short-term credit.

PRE's strategy to address these problems was to encourage a major Filipino commercial bank to begin to lend to SMSE exporters. The bank would thereby provide an example to other banks while stimulating competition and increasing the supply of export credit in one of the few economic sectors with significant near-term prospects for strong economic growth. The mechanism used was a loan guarantee facility covering part of FEBTC's credit risk to SMSE exporters.

Prior to the beginning of the project, FEBTC established two divisions to carry out actual lending and loan administration operations for SMSE loans. These SMSE units were set up after senior officers in the bank made a decision to expand the bank's SMSE portfolio.

As of September 4, 1987, FEBTC provided a total of 85 businesses with guaranteed credit lines, and a total of 216 disbursements have been made under these credit lines. The average credit size has been $80,000, and average borrower has had net fixed assets of $247,000.

The project provided a significant stimulus to economic activities during a period of uncertainty and recession in the Philippines. The $2.35 million loan has stimulated more than $60 million in export earnings, with employment generated for approximately 517 workers. Most sub-borrowers were in wood and rattan furniture, garments, marine and agricultural products industries. There has been only one default as of September 1, 1987, for a total of $78,138.

In most cases, credits were made available to firms that had established credit histories. Nevertheless, there were several sub-borrowers who were new to commercial credit, and perhaps several others who may have lost their access to legal commercial credit during these times of local economic and political uncertainty.

The project encouraged one of the largest commercial banks in the country to increase its SMSE lending activity, which fostered increased competition and market efficiency in SMSE credit markets. FEBTC officers stated that the project made it possible for them to lend to businesses that otherwise would not have qualified for loans, and that they will continue to lend to this type of sub-borrower after the project ends.

Although the FEBTC project is centrally funded, it demonstrated to the Mission the effectiveness of the guarantee mechanism for SMSE development. Mission staff concerned with capital development projects are now designing a follow-on project using lessons learned in the FEBTC project.

5. FINIBER and FINANQUIL

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
Critical shortage of foreign exchange for importing production inputs	1) Provide means of supplying foreign exchange to importers.	Short Term Import Credit Collateral Account Guarantee Facility	FINIBER made many loans to businesses that did not meet terms of project agreement. Facility only partly used. FINANQUIL made only two credits under the facility.

PRE established separate US$ 1.4 million guarantee facilities in each of two IFIs in Ecuador, Financiera Iberoamericana (FINIBER) and Financiera de Guayaquil (FINANQUIL). The facilities provided letters of credit denominated in dollars to Ecuadorean importers, responding to a critical shortage of foreign exchange credit following the economic crisis of 1983. Lending under the project was to target small agribusinesses with fixed assets of less than $300,000. The broader objective was to generate employment and encourage technology transfer by increasing the flow of capital to the agricultural sector.

The issue of underutilization of the guarantee facilities was very important in this case. FINANQUIL opened only two letters of credit; FINIBER's maximum utilization of the credit line reached only 27 percent of the total loan amount. The reasons for this, as identified by the evaluation team, included inadequate loan promotion by the banks, restrictive sub-borrower requirements, and changes in the economic environment after the facility was designed. After the facility began to operate, importers once again had a variety of credit options and had begun to rely on forms of import financing other than letters of credit.

The importance of rigorous in-country monitoring and project flexibility were the most salient lessons learned by the evaluation team. Effective monitoring would not only ensure stricter compliance with the guidelines established in the agreements, but would enhance project success by feeding back information on the "fit" between project design and the economic environment. In this case, the domestic financial market changed considerably after the project was conceived, and this contributed greatly to the program's underutilization. Routine reporting on utilization levels and other management issues, and greater flexibility to make design changes, would have ensured greater program success.

6. FINADE

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
Exports are concentrated in traditional products.	1) Provide local currency credit to SMSEs involved in non-traditional exports.	Short Term Export Credit Collateral Account Guarantee Facility	Facility fully utilized. Substantial production, employment and sales increases among sub-borrowers.

The US$ 2 million guarantee facility established for Financiera Nacional de Desarrollo (FINADE) was the first of this type to be funded by A.I.D. PRE established the facility to provide short term credit, denominated in local currency, to SMSEs involved in non-traditional exporting. Credit was to be used as working capital or to finance fixed assets, and to be applied exclusively to the non-traditional export part of a business. Lending was targeted to enterprises with fixed assets of less than $1 million, and production made up of at least 75 percent non-traditional exports. The broader objectives were to provide credit liquidity and contribute to employment generation, while stimulating new types of exports.

Financial market liquidity in the Dominican Republic has been seriously limited since the mid-1980s due to the Central Bank's policy of restricting the peso money supply in an effort to reduce inflation. These stringent measures have caused the inflation rate to drop significantly since 1985, but have caused operational problems for the Revolving Fund credit facility. FINADE encountered great difficulty in locating commercial banks willing to lend pesos against stand-by letters of credit issued by Chase Manhattan Bank. Likewise, Chase Manhattan, Dominican Republic, found its liquidity limited in June 1987 when reserve requirements were raised. This increase in reserve requirements disrupted the banking relationship between FINADE and Chase Manhattan, and made it difficult for the project to operate.

On the other hand, the illiquidity problem contributed to the full utilization of the guarantee facility by stimulating demand for import credit. Since other credit was virtually unavailable to importers at this time, there was substantial demand for credits under the facility. Consequently, FINADE was able to choose among its best customers, and assemble a portfolio of sound SMSE loans. The findings of the evaluation team confirmed that loans under the

PRE sponsored facility both enhanced producers' export capability and generated an impressive number of jobs.

The case of FINADE underlines the importance of selecting a strong local intermediary to manage a guarantee facility. A combination of the illiquidity situation in the country, and problems arising between Chase Manhattan Bank and FINADE over account maintenance balances and fees, will lead to an early termination of the program unless an orderly transfer of FINADE's portfolio to another acceptable institution can be negotiated.

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The cases reviewed of PRE loans to intermediate financial institutions (IFIs) display important similarities and differences, each of which contributes to an overall understanding of the IFI mechanism.

During the start-up phase of PRE/I's project activities, the mechanism commonly used to channel credit to SMSEs was direct loans to intermediate financial institutions. KCFC is an example of a direct loan to an IFI.

After several experiments with direct IFI loans, some drawbacks of the direct IFI loan mechanism were recognized. These included the following:

- direct loans denominated in U.S. dollars pass foreign exchange risk on to the local IFI;

- in direct IFI loan projects all of the sub-loan credit risk falls on the local IFI. Because A.I.D. does not share this risk, the Agency looses some of the "leverage" or ability to influence the IFI's lending policies.

For these reasons, the large majority of loan projects undertaken since the establishment of the Revolving Fund have been guarantee facilities.

In all the IFI loan projects examined here, loans were intended to provide credit to the SMSE sector, and in all but two, the IFIs successfully on-lent to this sector. In Kenya and Thailand, numerous borrowers had never sought financing through formal banking channels before this program. Although most Moroccan and Philippine borrowers had established lines of credit prior to the program, net additional credit did enter the country and in all likelihood was made available to more marginal borrowers.

The banks used by PRE in all cases except FINANQUIL, FINADE, and Thai Danu Bank, had well established contacts with target sub-borrowers before the projects started. IFIs often used the guarantee facility to expand lending operations into a desirable new business sector.

In addition to loans, three IFIs received grants for management training in the area of SMSE lending. After early delays in arranging an adequate training source, WAFABANK recently initiated a program for its loan officers. KCFC used its grant to install a computer system for loan evaluation and to train members of its Business Advisory Service. Thai Danu used the grant to defray costs of training bank staff in SMSE lending. It was generally true that grants did not result in training targeted specifically toward SMSE credit management, and that the training assistance components of the projects had not accomplished the goal of disseminating new SMSE credit tools and methods.

WAFABANK is a 100 percent private financial institution, as is required of all recipients of PRE Revolving Fund loans. KCFC, which received its loan from PRE before the establishment of the Revolving Fund, is a subsidiary of KCB which is wholly owned by the Government of Kenya but receives no subsidies, pays regular dividends, and operates similarly to a private commercial bank. Thai Danu and FEBTC are private commercial banks, while FINADE, FINIBER, and FINANQUIL are private development finance companies. Thus, with one exception, all IFIs were privately owned.

In all cases, loans provided by PRE were matched approximately 1:1 by the recipient institution. Kenya Commercial Bank, Ltd., the parent corporation of KCFC, was the guarantor of that loan and matched the amount in local currency; the same arrangement was made in the Thai Danu Bank case. Credit du Nord, WAFABANK's correspondent, agreed to match the PRE loan 1:1 in hard currency, with WAFABANK and A.I.D. acting as guarantors. Far East Bank and Trust, FINADE, FINIBER, and FINANQUIL also all matched the amount under guarantee coverage on a 1:1 basis with their own funds. This arrangement effectively doubled the credit mobilized under these projects.

In all cases the loans were made in response to perceived needs of the financial sector at the time of program initiation. Kenya borrowers lacked the requisite medium- and long-term loan facilities through which to finance capital expansion. The medium-term nature of this program filled this niche. In Morocco, import credits had been discontinued by international banks prior to the agreement. Although such restrictions subsequently eased considerably, there still existed in Morocco a serious shortage of foreign currency for imports. In the Philippines there was an urgent need to stimulate business activity, and encouraging export credit was one of the few available means given the uncertain economic conditions. The Thai Danu Bank project addressed a long-standing reluctance by commercial banks to lend to SMSEs outside of Bangkok. The FINIBER/FINANQUIL projects attempted to provide foreign currency credit during a period of illiquidity, while the FINADE project provided local currency export credit during a period of low liquidity.

Although on-lending in all cases was intended for the SMSE sector, several types of enterprises were offered credit under the projects. In addition, three types of credit "products" were offered under these projects: short-term import credits, short-term export credits, and term loans. The KCFC and Thai Danu facilities were intended to provide term financing for rural SMSEs unable to obtain this type of financing because of their small size and lack of credit experience. Both of these projects resulted in significant lending to businesses that would not have otherwise received commercial credit. In Morocco and Ecuador, the target groups were SMSEs needing imported production inputs. Although most were established clients of the IFI, and a majority were sophisticated, larger businesses, most had operated immediately prior to the loan project under severe foreign exchange shortages which affected their efficiency and level of production. In the Dominican Republic and Philippines cases, the target groups were exporters which required short-term credit to finance production of confirmed export orders.

The IFIs examined handle reflows from their borrowers in distinctly different fashions. KCFC does not recycle repayments back into the SMSE term loan program, but rather incorporates these funds into its overall lending pool, a pool that primarily serves short-term borrowing needs of larger urban enterprises. Thai Danu Bank also does not officially recycle repayments, but bank officers intend to continue to lend to this group after the project ends. WAFABANK, FINADE and FEBTC also relend their reflows to other SMSEs on the same terms and conditions as those prevailing in the initial round of loans. At the time of the evaluations, these funds had been lent twice to Moroccan businesses, and numerous times to businesses in the Philippines and Dominican Republic. Neither of the projects in Ecuador reached full utilization.

Another important difference concerned the administrative treatment of the loan facilities by the participating IFIs. KCFC went to great pains to segregate its A.I.D. monies from its other loan funds and developed a separate operations unit for the project. They were thus able to provide specific cost/revenue figures for the program. WAFABANK, FEBTC, FINADE, FINIBER, FINANQUIL, and Thai Danu Bank all incorporated the monies and administration of the project into existing loan funds. Although specific records were maintained on businesses receiving loans under the project, no separate profitability figures were available. This integrated approach encouraged institutional development in the banks by transferring experience directly into routine credit operations, and minimized administrative costs by avoiding duplication of bank functions.

Overall, there was relatively little active involvement of local USAID Missions in managing the seven loan projects. In four of the projects, the local Mission was involved in the project during the design phase, but in none of the cases was the Mission formally involved in implementing the project. On the other hand, in three of these cases (KCFC, WAFABANK and Thai Danu Bank) Mission staff were involved in monitoring the progress of the projects.

CHAPTER FIVE: LESSONS LEARNED

Evidence from the nine intensive case studies and a more cursory review of other donor-financed credit programs suggests a number of guidelines for the design and management of private sector credit programs. The following section presents the major lessons, organized according to the four stages of the process model presented in Chapter Two.

A. Problem Identification and Strategy Development

1. The feasibility and impact of private sector business ventures are directly influenced by the policy environment and financial market conditions in the host country.

Discussion. Research and experience in A.I.D. and the World Bank have shown that the policy environment often represents a significant obstacle to the development prospects of SMSEs, even to those that are given financial and technical assistance. Export subsidies, import controls, and licensing procedures in some cases explicitly exclude such enterprises, but more often involve procedures too onerous for them. Investment incentives, such as relief from taxes and duties on capital equipment, often work against SMSEs and encourage overly capital intensive investment. Procedures for obtaining licenses for the acquisition and use of vehicles, electrical and telephone connections are often burdensome to small businesses.

Effective projects exploit marginal situations: the policy and economic framework and the institutional environment must be positive enough that profitable opportunities for private business can be found. On the other hand, specific financial market constraints should exist that A.I.D. assistance can help to relieve. In general, IFI projects cannot affect the overall policy and economic framework beyond certain discrete aspects of the financial market. Therefore, such projects are advisable only when the broader framework is sufficiently positive to offer reasonable prospects of success. Expectations about (and subsequent evaluations of) the economic impact of IFI projects on sub-borrowers must take into account the economic settings in which such projects operate.

Often, substantial analysis of the economic policy and financial environment will already be available in A.I.D. Missions, other donor agencies or host country institutions. As a minimum, much of the data needed to perform the analysis will exist either as reports or as financial indicators. The need is thus more frequently for a careful review of available data than for the commissioning of the new study. What is essential, however, is that the needed information be obtained and interpreted as an input into project design.

Recommendation: A thorough analysis of the economic and financial framework should precede all investment decisions. Key economic and financial variables should also be monitored during implementation of the project, so that flexible responses can be made to changing conditions.

2. The limitations that constrain local IFIs from providing capital to SMSEs include credit and foreign exchange risks, shortage of foreign exchange, lack of liquidity in the financial system, government policies toward the financial sector, and inexperience with SMSE lending.

Discussion. Each of the projects reviewed attempted to achieve specific development goals by addressing one or more of the specific constraints in the financial system of the host country involved. In the cases of WAFABANK, FINANQUIL, and FINIBER, the principal constraint was lack of access to foreign exchange for imports. KCFC addressed structural problems that made it difficult for banks to extend term loans. The two Asian projects basically addressed bank inexperience with SMSEs, and perceptions that smaller borrowers are not reliable or are excessively risky customers. In Ecuador, the structural problem turned out to be temporary. In Morocco, the problem remained, but the success of the PRE intervention provided the means for certain entrepreneurs to avoid the constraint and suggested one means by which the government might address the overall constraint.

Changes in financial market constraints, or misdiagnosis of them, can seriously undermine project performance. This was demonstrated by the underutilization of the two lines of credit in Ecuador, which were premised on a constraint that no longer existed by the time the project began. In these cases, the facilities were designed under the assumption that the agricultural sector could not find sufficient import credit. When financial markets shifted so that import credit became widely available to agricultural goods importers, the projects faced a situation in which there was virtually no demand for their credits among qualifying sub-borrowers.

The Central Bank is a key in determining the nature of the local economic and financial environment. It is clear, for example, that unfavorable Central Bank decisions regarding credit rationing or interest rates could easily undercut the impact of any IFI project. Individual SMSE lending programs can rarely be expected to leverage major changes in overall government or Central Bank policies. This suggests a need to be aware of the possible need to pursue other policy dialogue measures if projects are to have the desired impact on enterprise development.

Recommendation: Preliminary analysis of a project must begin by identifying which structural and institutional factors are applicable and which the project can address. Whether or not they are explicitly acknowledged in the project design, the constraints addressed by IFI projects are systemic financial sector problems.

3. In general, private sector credit projects operate in environments that change more rapidly than those faced by most traditional A.I.D. projects. The success of private sector projects often depends critically on rapid and flexible responses to changing economic and financial conditions.

Discussion. Unlike the rural development, family planning, education and health conditions addressed by most traditional development projects, private sector financial markets are extremely volatile. These markets are directly and immediately influenced by changes in government or central bank policy and by changes in the international economic environment. Projects designed to respond to specific deficiencies in these financial markets must therefore be sufficiently flexible to respond to such changes as they arise and to seize the opportunities which sometimes result from these shifts.

One reason for the general success of the PRE efforts studied was their ability to be implemented quickly and to alter course when necessary. Such flexibility is often difficult to achieve in conventional USAID projects. For example, PRE was able to design, approve and fully disburse its KCFC loan during the time it took USAID/Kenya to prepare and obtain the necessary approvals for a comparable project; and PRE was able to respond to changing policies in Morocco in ways that would have been very difficult under normal USAID project procedures.

The general lesson learned from this experience is the need for A.I.D. to find creative devices for accelerating the pace of design and approval for private sector credit projects as well as to build maximum flexibility into the implementation machinery for these projects. One specific technique for accelerating implementation might be that used by USAID/Kenya, namely to use PRE funds to initiate activity with Mission funds providing subsequent, and more substantial, funding for comparable activities once a number of the initial problems have been addressed.

Another aspect of flexibility concerns the extent to which it is necessary to be directly responsive to host government policies and procedures. The Morocco project was "successful" in part because the Moroccan Central Bank permitted the project to circumvent normal government banking regulations. This latitude was possible in part because the program was not a claim against bilateral funds. The loan permitted WAFABANK and PRE not only to exploit a specific market opportunity, but also, in the process, to influence the future policies of the Central Bank. The lesson learned from this experience is the importance of bilateral programs seeking such means to provide them the flexibility to adopt an experimental and "problem solving" approach in their private sector credit programs, particularly where host government restrictions constitute a significant part of the "problem".

Recommendation: Design private sector credit programs to permit rapid and flexible response to changing circumstances. Build flexibility to changing economic and business conditions into project agreements.

4. The extent of development impact in a given project is heavily influenced by the nature and extent of a project's vertical and horizontal linkages.

Discussion. Vertical linkages are commercial and production relationships that firms establish with suppliers of production inputs and with purchasers of outputs. Horizontal linkages are commercial relationships among producers in the same industry. Horizontal linkages are the basis for competition in markets. Through competitive input and credit markets, producers develop horizontal linkages.

In six of the nine cases examined, substantial linkages existed, either forward, backward or in both directions. Perhaps the best example of this was the loan to LIK. At full production, LIK will require 1000 cow hides per day, all of which will be provided by local herders and slaughterers. In addition, because of quality concerns, LIK is making efforts to improve the skinning and rangelands practices of ranchers by offering bonuses for higher grade hides, thus improving livestock management of the ranchers in question. Finished leather goods will be used by local shoe manufacturers who in turn provide employment to members of the skilled and inexpensive local labor pool.

Linkages resulting from IFI loans to sub-borrowers are also very evident. KCFC sub-borrowers were involved in transport, agricultural processing, and manufacturing. Loans were destined for fixed assets and in a high percentage of the cases were for start-up ventures. They purchased lumber, hides, grain, coffee and flour from local markets. Finished products often substituted for imports and in one case were destined for export.

WAFABANK loans, which provided foreign currency for imports, were destined for medium sized importers, but involved several linkages as well. Although raw materials were usually imported, these were frequently combined with locally produced raw or semi-finished goods, as was the case for a large fish cannery, several textile operations, and small manufacturing firms. A large percentage of these industries made products that were subsequently used by some other commercial operation. Some firms also exported finished products, resulting in a net foreign exchange surplus due to value-adding.

Many of the most important impacts come from the horizontal linkages of a project. For example, by bringing a major commercial bank into the SMSE lending arena, A.I.D. increases competition in credit markets, which in turn strengthens market institutions and may lower the costs of obtaining SMSE credit. The Far East Bank and Trust Company has a substantial influence on local financial markets by virtue of its being the second largest private commercial bank in the country. By inducing this bank to undertake SMSE lending in a more serious way, the PRE-sponsored project encouraged competition in local SMSE credit markets. Because of FEBTC's horizontal linkages, other SMSE lenders were encouraged to compete with FEBTC by lending at lower rates and to businesses that otherwise might have been considered too small or too risky.

<u>Recommendation: The important roles of vertical and horizontal linkages to overall project impact should be explicitly considered during selection, design and management of private enterprise projects.</u>

5. Project benefits will be sustained after project termination only if the intervention initiates changes in financial institutions, local credit markets, and/or government policies.

<u>Discussion</u>. IFI projects are often motivated by desire to produce direct benefits among SMSEs, such as increased sales, employment and exports. However, the small size of A.I.D. projects relative to the problems they address, and their limited duration, should prompt A.I.D. to use IFI projects to seek more permanent institutional change. Only through institutional change can the financial system continue to produce direct benefits among SMSE clients after projects cease. The institutions that may change include not only organizations receiving A.I.D. funds (such as KCFC, WAFABANK, Leather Industries of Kenya, Antigua Shrimpery Limited and Thai Danu Bank), but also other financial institutions involved in the project (such as Bank of Antigua, Industrial Promotion Services and Credit du Nord, Chase Manhattan-Ecuador, Rainier National Bank), government policy makers (such as the Central Bank), other in-country industries and financial institutions, and the USAID Missions. In addition, private sector projects can also have significant impacts on financial markets as a whole by increasing competition, demonstrating the viability of particular financial products, and the creditworthiness of SMSE borrowers.

While there is substantial evidence of institutional effects in several of the cases reviewed, it is also evident that the impact at that level was greatest where there was explicit planning for, and acknowledgment of, institutional objectives. Institutional effects often take a considerable time to materialize and to be truly institutionalized in relevant organizations. It is perhaps for this reason that the institutional effect of the projects reviewed were, in most cases, less encouraging and obvious than those projects' direct development impacts.

In addition to the need to incorporate institutional change objectives into project designs, this lesson also has implications for project duration, suggesting that longer durations or second phase efforts should be considered for projects that attempt to introduce significant institutional changes.[2]

There are three levels at which long term change can be sought: continuation of project activities or comparable activities by the original IFI; adoption of such practices by other IFIs; and government policy change. Each of these must be addressed in a different way. Sustainability of lending within the original IFI depends largely on the operation's financial viability. This in turn depends on: 1) whether the lender can obtain an adequate spread in subsequent lending (generally 5% to 6% for SMSE lending, and up to 8% if technical assistance is provided)[3]; 2) whether the lender can obtain appropriate sources of funds, such as funds suitable for term lending; and 3) whether the borrower has learned enough about the specific target group or type of service to continue without outside support; and 4) whether the operation can be integrated into the organizational structure of the bank. Often these conditions are difficult to satisfy, as the lack of one or more of them may have provided the original project rationale.

PRE projects differed greatly from one another along this dimension. The KCFC project did not solve the problems of access to appropriate funds or of integration into routine operations, and therefore project sustainability was doubtful. Thai Danu Bank, in contrast, used the project to build its branch network outside of Bangkok, and so will have a permanent infrastructure to sustain targeted lending after project completion. Often sustainability may be partial, but

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[2] It is also worth noting that IFI staff sometimes expressed disappointment with the limited duration, usually five years, of PRE projects. For example, Thai Danu and Far East Bank and Trust Company officers stated that it takes over one year to bring the guarantee facilities to full utilization, and that the projects begin to phase down after only two years of operation. The phase down period lasts three years. Officers felt that they barely had enough time at full utilization to compensate the bank for training staff to lend to SMSEs.

[3] Jacob Levitsky. World Bank Lending to Small Enterprises: A Review. Washington, D.C.: Industry and Finance Series Vol. 16. World Bank, 1986.

it is nevertheless important. Some of Far East Bank's clients, for example, graduated from guaranteed to unguaranteed loans, after proving worthy borrowers. In some cases, there were small changes in bank attitudes, for example, reduced collateral requirements, knowledge about a target group or understanding of cash flow lending.

Concerning spread to other institutions, this has most often taken the form of desire by competitors of the original IFI to participate in similar projects. The KCFC loan helped USAID/Kenya convince two other large commercial banks in Kenya to participate in its Rural Private Enterprise Project, which was similar to the KCFC loan. In the Philippines, PRE subsequently began three guarantee facilities as a result of the demand created by the Far East Bank and Trust project, and similar programs are being developed by other entities in the country.

Stimulating governmental policy changes is only on occasion accomplished as a result of a single IFI project. This occurred in Morocco where the success of the WAFABANK loan prompted the Central Bank to reconsider its foreign exchange regulations. In most cases, however, an IFI project should be explicitly viewed as part of a longer series of efforts by A.I.D. and perhaps other donors, including projects, policy dialogue, and other interventions. In this respect, IFI projects often demonstrate how the system might work if one of the policy constraints were loosened, thereby reducing the perceived risk of a change.

<u>Recommendation: Given their small size relative to the economic problems they address, A.I.D. enterprise development projects should seek to accomplish institutional development objectives in addition to direct developmental impacts on SMSE borrowers. An explicit strategy for long term institutional and structural change should be included in initial credit project designs.</u>

6. PRE offers resources for private sector projects that can be helpful, or at times critical, additions to those available to USAID Missions. Conversely, due to the necessity of viewing development of financial institutions as an indigenous and long-term process, successful PRE intervention requires local USAID Mission commitment and continuing involvement.

<u>Discussion</u>. The Investment Office of PRE is a small, centralized unit with a worldwide mandate. Almost by definition, it needs Mission assistance in identifying and implementing its lending programs. Local Mission personnel are familiar with host government policy, the economic situation and business potential in their countries. This familiarity provides important information during project identification and design stages. Missions are often particularly strong in delivering technical assistance, and once a

project is underway, the Mission can serve as troubleshooter, helping to resolve problems.

From the Mission's perspective, PRE offers a range of services and other resources that can be useful to the Mission. PRE resources can contribute relatively low risk testing of innovative ideas and can provide introductions to important local financial institutions.

Several advantages that PRE offers include:

* The Bureau does not use bilateral funds for projects, which makes it easier, or in many cases unnecessary, to gain host government approval for projects.

* Missions wishing to use hard loans from Development Assistance or Economic Support Funds may not be able to develop loan setoff schemes, because of two legal prohibitions that they face. These same prohibitions do not apply to PRE, and in certain cases, PRE funds may be used for credit guarantee projects that are not legally possible for Missions.

* PRE project approval and obligation procedures are often faster than those that Missions are required to follow. This allows quicker responses to rapidly changing local economic conditions.

* As a central bureau, PRE has specific expertise in commercial finance and privatization that may not be present in many Missions.

The mutually beneficial potential has been illustrated in the relationship between PRE and USAID/Kenya. PRE's $2.5 million loan to KCFC helped provide information to USAID/Kenya on how to structure a $24 million term loan project. This second-phase project in turn spread small enterprise term lending from the one bank PRE worked with to the two other major commercial banks in the country. PRE's loan helped convince these two banks that such lending was feasible. Mission involvement was crucial to PRE's objectives of inducing long term changes in the financial system. Similarly, the LIK project initiated a working relationship between USAID/Kenya and the LIK sponsor, IPS(K), which has led to a $3 million line of credit from USAID/Kenya to IPS(K) for assistance to other projects IPS(K) promotes. The sustained presence of the Mission is crucial for maintaining dialogue on government policy reform. In Kenya, this has centered on ways to improve the private supply of local currency term credit, an issue at the heart of the KCFC loan. A similar set of interactions between PRE and Mission efforts has taken place in Thailand.[4]

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[4] See case study on Thai Danu Bank, pp. 40-43.

Recommendation: In developing and implementing their credit programs and policies, USAID Missions should seek ways of collaborating with PRE that take advantage of PRE's comparative advantages as a centrally funded and specialized technical unit with more statutory latitude than is currently available to USAIDs. At the same time, PRE should make maximum effort to incorporate the Mission into project design, implementation and follow-up.

B. Working with Local Financial Institutions

1. The single most important factor influencing the implementation and prospects of success of private sector credit projects is the presence of a strong and competent local intermediary organization.

Discussion. Evidence gained from the projects reviewed indicates that USAID personnel frequently lacked the time, and often the specific skills, to provide technical oversight for private sector credit projects. Contractor teams frequently lacked the detailed local knowledge and institutional capability to implement such projects on a sustainable basis. It is thus a major lesson learned from this review that the presence of a strong and committed local intermediary institution, with the incentive as well as the capability to ensure project success, should be virtually a sine qua non for initiating private sector credit projects. Experience suggests that it is desirable for the financial exposure of this local institution to be at least equal to A.I.D.'s.

In the case of IFI projects, there is need for confidence in the efficiency, experience and motivation of the bank(s) involved; in the case of direct loans, the need is for an effective financial investor, such as a bank or venture capital firm, to provide investment oversight. Only one of the nine projects reviewed, Antigua Shrimpery, lacked such an institutional base, and this was the project that experienced the most significant, and in this case fatal, problems.

A review of World Bank small enterprise lending projects published in 1986 identified advantages and disadvantages of commercial banks, development finance companies (DFCs) and promotional agencies as IFIs. The major conclusion reached regarding choice of intermediary was that commercial banks, although conservative about lending to new enterprises, have shown the greatest capacity for channeling credit to small enterprises in those countries where the banking system is relatively developed. Distinct advantages cited in using commercial banks as intermediaries for SMSE lending were the following: (i) they are better able to provide working capital than DFCs, and small-scale entrepreneurs tend to find it more convenient to seek their term loans for new investments from the same sources that provided them with working capital; (ii) they offer a greater variety of banking services; (iii) they usually have a large branch network permitting contact with small enterprises on a local basis; (iv) they are better able to respond quickly to the needs of small businesses; and (v) they are more experienced in debt collection than are DFCs.

In contrast, DFCs tended to have few branch offices, frequently required extensive documentation from clients, and generally lacked domestic resources for working capital. Disadvantages associated with commercial banks as intermediaries included: (i) a tendency to view small businesses as particularly risky and administratively expensive; (ii) a preference for short term lending in keeping with their sources of funds; (iii) a reliance more on collateral and credit history than on project appraisal; and (iv) a reluctance to provide technical assistance or extensive supervision of clients so long as repayments were satisfactory.

Several disadvantages of using agencies such as government development finance companies as IFIs were noted in the review of World Bank projects. Governmental or non-profit agencies generally suffered from poor financial management; were prone to political influence in both staff appointments and loan approvals; were more subject to abrupt changes in government policies by virtue of being dependent on continuous government budgetary support; and often suffered from over-optimistic projections occasioned by the conflict between their fiduciary and developmental roles.

Several other advantages of working with commercial IFIs were identified in the PRE case studies. If a project offers opportunities for profits, this is a significant motivation for commercial IFIs to commit resources to proper project implementation. In addition, commercial IFIs have staffs that are experienced in credit appraisal and management. Very little training needs to be given before a commercial bank staff is capable of implementing a credit project, and the staffs' extensive previous experience in credit will undoubtedly contribute to the building of a sound loan portfolio. Finally, the commercial IFIs evaluated had extensive networks of commercial contacts that proved useful in enabling the bank to establish contact with targeted businesses.

In the absence of a strong local intermediary organization, the evidence suggests the importance of focusing project activities on institutional strengthening and incorporating specific institutional development objectives and resources as important elements in the initial projects pursued.

The evidence also suggests that it is critically important, for both substantive and motivational purposes, to involve these intermediary organizations actively in the process of project design and to devote special attention to ensuring that these organizations' interests and points of view are adequately reflected in the final designs of these projects.

Recommendation: Undertake projects only where there is a strong and competent local intermediary financial institution, or where the project will augment the competence of the local IFI. Where possible, emphasize the use of commercial banks and venture capital companies.

2. Local IFIs cooperating in SMSE credit projects are more likely to influence changes in local financial market practices if they have either or both of two important characteristics: (1) large size in terms of assets or loans relative to other local IFIs; (2) a well established reputation for profitability and sound management. In every country there are generally a few IFIs that are large or considered outstandingly well-managed, and it is these institutions that will have the most significant influence on local credit practices.

Discussion. Changes in local lending procedures and standards can come about because the selected IFI is itself a major market-making institution, and/or is likely to be emulated by other financial institutions or the government, or both. Examples of each have occurred in PRE experience. WAFABANK, Far East Bank and Trust and KCFC were each leading banks in their countries. In each case, influencing their behavior could be considered an end in itself, simply because of their size and coverage. Moreover, because of the strong competitive position of each, other banks were likely to follow, simply to keep up, as occurred in both Kenya and the Philippines. In such cases, it may be appropriate for A.I.D. to allow somewhat more conservative projects than it otherwise might advocate, in order to work with such a prominent institution.

Thai Danu Bank offers a contrast. It is a small financial institution in Thailand, but it has an excellent reputation for sound management. It was also highly motivated to work with PRE in putting together an innovative project. By selecting Thai Danu, PRE was assured that the project would be well-run, and therefore, that it would be a good example for other Thai institutions.

In general, by selecting a large IFI, the chances of accomplishing major changes within the IFI are small while the prospects for substantial impacts on local financial markets may be large. On the other hand, projects involving small IFIs offer a high probability that the project will induce major changes in the institution, but small IFIs offer little prospect for stimulating major financial market changes. Therefore, the decision about the size of IFI to work with in a project is in many cases a tradeoff between large changes in a small institution and significant changes in local financial markets.

We should note one important reservation in working with small IFIs is that projects may expose the participating institution to excessive risk. For example, the Antigua Shrimpery project shows how imprudent decisions made by an IFI may be associated with developmentally-oriented credit projects. In this project, the Bank of Antigua originally agreed to provide a limited revolving credit to the newly established Antigua Shrimpery company. Exceeding the originally agreed upon credit limit, the bank later provided loans that represented almost 10 percent of the bank's total assets to a business (Antigua Shrimpery) that had to be financially restructured after substantial losses. While the A.I.D. project did not cause the bank to overextend itself, it provides an example of risks that small IFIs expose themselves to while participating in donor-assisted credit projects. In general, project designers must keep in mind the risks that participating in a project may bring to an IFI.

Recommendation: Selection of local IFIs should be influenced by the credibility of the selected IFI with other local lending institutions. Selecting IFIs that are particularly large, market-making institutions or that are respected for sound management and profitability will improve the likelihood that the project will influence local credit practices in the long term.

3. Some degree of risk is inherent in all private sector interventions. There is often a direct and positive relationship between the "additionality" of credit programs and their riskiness, and a negative relationship between their riskiness and their sustainability.

Discussion. The amount of risk in a credit project is determined by the target group, the type of service provided, and risks inherent in the financial system itself. Types of risk may include default risk, foreign exchange risk, interest rate risk, and liquidity risk. Most often the risk at issue in SMSE projects is the default risk associated with a new borrowing group. Such was the case in the Thai Danu and Far East Bank and Trust projects, and to a lesser degree in the Ecuador and KCFC projects. WAFABANK and FINADE in the Dominican Republic dealt mostly with foreign exchange risks and liquidity risks.

At the heart of the issue of risk are the financial losses that an IFI can expect from its loan portfolio. Viewed in this way, there are three kinds of risk: uncertainty, actual risk, and perceived risk.

(1) Uncertainty is often defined as ignorance about the chances that a given loan or portion of a loan portfolio will not be paid back or properly serviced. Banks are usually uncertain about potential default losses when they begin lending to a new group of customers and have no experience by which they can estimate potential loan losses.

(2) Actual risk is the known and verifiable probability of loan losses. Actual risk can be estimated on the basis of historical loan losses for a given type of customer or portfolio.

(3) Perceived risk is an individual's or institution's perception of the probability that a given loan will not be properly serviced or paid back. Depending on the information that an institution has about a client or group of clients, perceived and actual risk may be the same. On the other hand, when IFIs begin to lend to a new sector or type of client, perceived risk may be very different from actual risk.

Estimating risk is not an absolute science but rather is controlled by trial and error. Sometimes management hits the mark in allowing an acceptable percentage of losses and sometimes it misses. In all cases there is an <u>experience factor</u> that builds up in the individual lending officers as they come to understand their customers and the economic environment. These insights differ from situation to situation. The experience of one bank cannot automatically be applied to another, the experience of one set of borrowers often cannot be applied to another set of borrowers, and one economic and political situation cannot be applied to another country. As a result, risk estimates are almost always initially inflated by commercial institutions to allow for their "uncertainty" or ignorance regarding probable levels of loss or default.

Properly designed private sector credit projects help local IFIs transform uncertainty into known risk, thereby assisting local financial institutions to begin to lend to new, often misunderstood businesses. By providing IFIs with opportunities to experiment with SMSEs or rural agribusinesses loans, lending institutions gain experience with loan losses among these clients. And in addition to risk coverage through guarantee facilities, technical assistance can also be offered to IFIs as part of a credit project, to help them better understand and anticipate the risks associated with developmentally desirable lending strategies.

It is important to note that the more a lending program or procedure required by participation in a credit project differs from prevailing practice, the greater the uncertainty. Lending to businesses traditionally perceived as uncreditworthy (e.g. small or new businesses), extending credit for longer terms than usual, using new financial instruments, or making loans for purposes other than those considered appropriate by local institutions may increase the actual risk that an IFI faces, but almost always increases the uncertainty of the IFI.

On the other hand, if no differences from standard credit practice are required by an IFI's participation in an A.I.D. credit project, there is good reason to question the rationale for A.I.D. involvement, as additionality of the project will be quite low. In fact, a certain amount of business failure is one of the characteristics of the free enterprise system. A measure of "economic Darwinism" must remain in donor-supported projects that work with private enterprise. The key policy decision is the amount of risk and proportion of business failures deemed tolerable by those designing and managing a project.

Among the cases reviewed here, the KCFC project involved moderate risk and additionality. Loans went to individuals with a credit history and collateral, but were extended for longer terms than were otherwise available, and in many cases helped start new businesses in rural areas. WAFABANK, by comparison, had relatively low additionality, but did provide improved service to established businesses. It is, accordingly, no surprise that WAFABANK experienced less difficulty in obtaining repayment from its borrowers than did KCFC. In a similar vein, PRE clearly represented essential capital resources in the ASL project, while PRE's funds were considerably less critical to the LIK project.

While there is no simple answer to the issue of appropriate risk, two lessons are particularly noteworthy. First, the degree of tolerance for risk, business failure and default should be discussed explicitly during project design, along with the implications of such decisions on project implementation and sustainability. Projects should include a clear strategy with respect to the degree of risk they are willing to incur in the interest of additionality, the incentives they are willing to provide to induce the IFI to take risks, and their intended approach for ensuring sustainability of these activities after completion of project funding. Secondly, project designers and managers must recognize that a "success at all costs" strategy, when this means no tolerance for loan failures, is an impractical, cost-ineffective approach to private sector projects.

There are a variety of mechanisms for allocating risk in any credit project. Project design must take into account both how much risk a project entails and normal IFI standards for risk tolerance. Armed with this information, planners can decide how to structure a project. Most typically, planners have three parameters with which to work: eligibility criteria, guarantees, including both what the guarantee covers and the guarantee percentage, and the spread between borrowing and on-lending interest rates. The first of these determines the amount of risk as a whole, the second determines how much of the risk the IFI will bear, and the third determines how much the IFI will be compensated for bearing the risk. The combination of these elements is a crucial task for design and negotiation with IFIs. The more project planners know about the IFI, the more precisely they will be able to structure their offer to achieve project objectives without overcompensating or overprotecting the IFI.

Finally, experience suggests that it may be appropriate for A.I.D. to adopt a risk-averse posture in its initial activities in a given country in order to learn the detailed operations of the private sector and financial markets and earn a reputation for being associated with successful ventures. It might then be appropriate to undertake an increasingly innovative posture in subsequent activities.

Recommendation: Projects should include an explicit strategy concerning the degree of risk that the implementing agency is willing to incur in the interest of additionality, the incentives that it is willing to provide to induce the IFI to take risks, and the intended approach for ensuring sustainability of these activities after completion of project funding. This is always a matter of striking a balance that suits the time, country and participating institutions.

4. Commercial institutions show an interest in participating in development projects only where there are obvious financial incentives or direct government pressures to provide the services or to serve the particular target groups covered by a credit project.

Discussion. IFIs are generally willing to change their usual lending practices and clientele only if this will be profitable for the bank, will fit the bank's strategy, or is necessary for the bank to comply with government requirements.

Therefore, inducing a private sector IFI to participate in SMSE projects requires that the project offer tangible benefits to the IFI. For example, in the Thai Danu case, the Thai government had recently passed a law requiring commercial banks to lend 20 percent of deposits to rural businesses. Thai Danu Bank viewed the PRE project e bank not only complied fully with the terms of the project agreement, but also took steps to ensure that the facility remained as fully utilized as possible.

Recommendation: Project analysis should focus on the nature of incentives in the financial system and ways to make best use of these to encourage commercial institutions to undertake development activities. In addition, wherever possible, select IFIs that have business strategies that are compatible with the development objectives of the credit project.

5. Commercial institutions can be induced to cooperate with A.I.D. in achieving development objectives, if the institution is properly compensated for its risk and effort. Finding the right level of compensation for the IFI is one of the most important issues facing private sector credit project designers.

Discussion. Private sector SMSE credit projects expose IFIs to the risk of lending to businesses the IFI would not usually serve. This exposes the IFIs to credit risk. In order to induce a participating

IFI to assume the additional risk of lending to new SMSE clients or for providing new services, and to assume the increased administrative costs often involved, it is necessary to build adequate incentives into the project agreement in terms of spreads and/or grants. Spread refers to the difference between cost of capital and the interest rate charged to customers, plus fees charged to customers, and minus fees paid to A.I.D. and intermediary banks.

The actual change of bank practice to be introduced under a particular project must be negotiated during project formulation. The terms of the project agreement will determine how much A.I.D. must "pay" to induce the IFI to implement the project. It is appropriate to regard the development of such agreements as a negotiation between A.I.D. and the participating financial institutions.

In general, it is in the financial institution's interest to negotiate the <u>minimum change</u> in standard practice for the <u>maximum financial return</u> under a project. It is in A.I.D.'s interest to obtain the <u>maximum change</u> in standard practices for the <u>minimum cost</u>.

This is also true when IFIs ask for changes in a project after implementation has begun. When IFIs request changes in terms of project agreements, these changes often will have a direct impact on the profitability of the project for the IFI. If the changes will provide more substantial profits for the IFI, then it is often possible for A.I.D. project managers to ask for something in return for making the changes.

For example, during implementation of the Far East Bank and Trust Company project in the Philippines, the bank requested that sub-borrowers under the project not be informed that there was a U.S. government guarantee of their loans. In other projects, sub-borrowers had been informed that their loans were guaranteed. The A.I.D. officers managing the project informed the bank that not informing sub-borrowers of the guarantee would be acceptable under the terms of the project agreement. In this case, allowing the bank to withhold information about the guarantee gave the bank the opportunity to charge customers a slightly higher rate of interest. According to loan officers in the bank, if they had to tell customers about the guarantee, then the customers would demand a reduction in the interest rate charged to them. Here it may have been possible for A.I.D. to request specific additional concessions by the bank in its lending criteria in exchange for A.I.D.'s concession (such as providing more credits to new starts or rural businesses).

<u>Recommendation: Financial incentives to IFIs should be commensurate with the degree to which they are asked to modify their conventional banking practices.</u>

6. The success of projects involving IFIs depends heavily upon the IFI's having service delivery capabilities that easily reach the target group of borrowers.

Discussion. Among IFI projects, one institutional characteristic judged to be particularly important to success was the existence of outreach capabilities. Most of the IFIs involved in PRE projects had extensive branch bank systems that played an important role in project implementation. The proximity of a lending institution to the borrower provided significant advantages to both sides throughout the process. A branch system was especially crucial where the investment was intended to affect development in rural areas and where small- and medium-scale enterprises were the targeted group.

The familiarity of the lender's personnel with both the individual borrower and the potential local market for the proposed output of the enterprise provided an opportunity for verifying information obtained during the feasibility analysis. Once a loan was approved, local branch personnel were better placed to monitor potential business problems and to provide advisory services if necessary.

Recommendation: Only intermediate financial institutions having the service delivery mechanisms necessary to reach intended project targets should be considered for implementation of private sector credit programs. If the target group is in rural areas, select IFIs with adequate rural branch networks.

7. The more closely a project fits into existing credit delivery systems, the more likely is its sustainability and the less is its additionality.

Discussion. The IFI credit projects reviewed demonstrate a variety of different administrative arrangements for lending to targeted sub-borrowers. At one extreme, KCFC set up a separate division called KCFC "Schemes" to accommodate the special lines of credit from OPEC, the International Finance Corporation and A.I.D. The funds were lent out only once and reflows entered the general KCFC credit pool. Usual KCFC operations do not include any significant term lending to small businesses and because the SMSE lending unit was separate, practices developed by KCFC were not adopted by its parent organization, Kenya Commercial Bank.

At the other extreme, in the cases of WAFABANK, Bank of Antigua, IPS, Thai Danu Bank, and, to a large extent, Far East Bank and Trust Company, the PRE-supported program was thoroughly integrated into normal credit delivery operations. The WAFABANK program, for example, could be viewed as expanded and more efficient provision of foreign exchange credit rather than as a new program. The KCFC program was clearly treated as something apart from the bank's normal operation, and represents an effort to promote a more radical change in the institution. In contrast, The WAFABANK program did not attempt to induce major institutional changes in the operations of the bank.

Using normal commercial lending procedures in a SMSE credit project minimizes the cost, increases the success of implementation, and maximizes the long-run institutional benefits to a participating IFI. In both the Far East and Trust and Thai Danu Bank cases, the guarantee project was integrated into the bank's usual credit operations. This arrangement seems to have several advantages over the alternative of setting up a special operational division for SMSE credit projects. First, it minimizes administrative costs. It makes duplication of credit and accounting functions unnecessary, and allows the bank to use existing credit personnel to run the project, thus keeping the need for special training at a minimum. Second, it encourages maximum institutional learning by bringing experiences with SMSE credit directly into the mainstream of credit operations. When a credit officer dealing with a small business discusses his/her experiences with other officers who aren't assigned to SMSE accounts, knowledge of the problems and prospects of small business lending spreads quickly.

In establishing priorities for intervention in private sector credit, choices must be made as to the optimal trade-off between the deviation from standard credit management practice and the probability that such changes will be sustained. If a project involves the establishment of credit facilities that are significantly different from normal practices of a given institution, it will require substantially more time to become integrated into that institution's operations, and has a greater probability of never being effectively integrated.

<u>Recommendation: When designing credit projects, it is usually advisable to integrate project administration into existing credit delivery systems. Separate administrative arrangements for credit delivery should be established only when the type of lending required by the project is radically different from the IFI's usual operations.</u>

8. Financial institutions do not necessarily share A.I.D.'s development objectives, particularly when they conflict with the private business' interest in profit. Accordingly, lenders usually will not directly pursue development objectives, except to the extent that: a) they receive adequate incentive to pursue development objectives; and/or b) contract terms clearly hold them responsible for fulfilling specific goals.

<u>Discussion</u>. Specific requirements aimed at development objectives may reduce the attractiveness of loans, either to IFIs or to sub-borrowers, and accordingly, tend to be circumvented whenever

possible. A.I.D.'s best protection is to incorporate the objectives and requirements clearly in the legal agreement and to enforce the agreement.

FINIBER, for example, made loans to borrowers outside the agro-industrial target group and above the asset ceiling. It did this largely because demand by the target group was low, and FINIBER was in any case unused to dealing with that group. Although the agreement had set out eligibility rules, A.I.D. did not carefully monitor FINIBER's performance or enforce the terms of the agreement.

Commercial institutions implement SMSE credit projects according to the terms of the project agreement, not according to the development objectives expressed in PIDs or PPs. Therefore, development objectives must be translated into specific requirements in the terms of the project agreements, and compliance with the terms of the agreements must remain a concern until the end of a project. At the same time, conditions must be simple to implement and must preserve some flexibility. It is best to have straightforward rules and to support them by adequate implementation and monitoring mechanisms. Finally, A.I.D. should take corrective action when the IFI does not adhere to the terms of the agreement. SMSE projects using IFIs are essentially agreements with financial institutions that initiate ongoing partnerships.

This has several implications for project design and negotiation. First, development objectives should be specified, whenever possible, in terms of easily verified indicators, such as clear eligibility rules (maximum net asset size for sub-borrowers, specific types of products that sub-borrowers may produce, etc.) Second, conditions should be kept to the absolute minimum needed to meet the project's most important objectives. Third, these indicators should be set out in the agreement between A.I.D. and the lender, as lenders tend to give high priority to fulfilling contract terms. Fourth, A.I.D. should set up an adequate system for monitoring and enforcing lender performance.

Recommendation: Developmental objectives should be few and specific, and should be included as terms in project agreements in a clear and verifiable form. It is critical that these terms should be monitored throughout the life of a project.

9. The technical assistance grants for organizational development under IFI credit projects are frequently underutilized, and often do not make participant IFIs noticeably better at SMSE lending.

Discussion. Technical assistance and staff training grants were often provided along with guarantee facilities as add-on incentives to induce the IFI to undertake the project and to help prepare staff to lend to targeted sub-borrowers. Four of the nine projects examined here included technical assistance or training grants, ranging in size from $50,000 to $250,000. In several cases, notably Thai Danu Bank, WAFABANK and FINADE, the IFI was given the responsibility to determine how the training grants for staff development should be used.

Thai Danu Bank was provided with a $50,000 Investment Development Package as part of the loan project. The objectives of the grant were to provide staff training to improve capacity to lend to SMSEs, to defray costs of training bank staff to implement the project, and to send bank staff to examine SMSE lending practices in other Asian countries. In this case the bank fully utilized the grant, but did not provide staff with training that was specifically oriented to improve SMSE lending. Bank officials claimed that lending to SMSEs is not basically different from lending to larger businesses, and that therefore they felt it was acceptable to use the grant for general staff development.

This raises the issue of whether SMSE lending requires special training and technical approaches, and whether these should be offered under technical assistance grants. Thai Danu staff felt that the general finance and lending principles that are currently included in the bank's training programs are applicable to any business, large or small.

If there are no special techniques and procedures useful in SMSE lending then the bank staff should be prepared to undertake SMSE lending without receiving any special technical assistance. Others in the field of SMSE development, however, claim that SMSE lending requires a distinct set of skills and procedures, and that these are acquired through technical assistance. To the extent that there are actually distinct skills and procedures necessary for successful SMSE lending, participating IFIs should be provided with technical assistance that provides these specific skills and procedures. For example, because the administrative costs of lending to smaller businesses tend to be relatively high, IFIs may need assistance in streamlining lending procedures for SMSE clients. Technical assistance could help IFIs establish lending procedures that both minimize the usual administrative costs and still allow the bank to appraise and review prospective loans properly.

In general, the Thai Danu project illustrates why the provision of technical assistance and training via a grant should be treated as an independent institution building effort in IFI loan projects. Local IFIs, if they need staff development to begin lending to new types of clients, generally do not know the specific training that is required and the training materials and resources are available.

The guarantee facilities examined here also demonstrate the drawbacks of using grants to reduce SMSE credit risks. In most cases where grant funds were provided, grant funds were made available with the intention of providing technical assistance to minimize the probability of sub-borrower failures, by improving SMSE credit operations in the bank, or by delivering technical assistance directly to sub-borrowers. Several grants were not used as had been expected. In Kenya, the Business Advisory Service did not focus its efforts specifically on the intended target group (small scale enterprises) and the grant had no measurable effect on the project as a whole. In Morocco, the grant funds were not used for over a year due to confusion over who could be contracted for services under the terms of the grant.

The sub-borrowers under the KCFC project showed mixed success in terms of loan servicing. Although the bank had substantial problems collecting many SMSE loans, the loans were being paid off. Accordingly, it is sometimes argued that an approach combining conservative commercial loan practices with specifically targeted additional financial resources for small businesses would eliminate the need for traditional technical assistance. Experience with SMSE lending suggests, however, that such a view may be too simplistic in the context of many developing countries.

A recent survey of small enterprises in World Bank projects found that these enterprises were typically run by former skilled workers proficient in the business' manufacturing process, but weak in management and marketing skills. In small enterprises started by merchants, marketing and financial management skills were often well developed, but operational efficiency of the production process was often deficient.

<u>Recommendation: If technical assistance is required to augment a commercial institution's ability to implement a lending program for SMSEs, it is normally necessary to fund this "institution building" portion of the project on a grant basis and to manage it with the same care that goes into effective institution building projects in other sectors.</u>

C. <u>Identifying Specific Financing Products and Mechanisms</u>

1. Guarantee facilities are effective mechanisms to induce private financial institutions to lend to new target groups, especially smaller businesses.

<u>Discussion</u>. Banks avoid certain types of enterprises because they perceive them as too risky. The prospective borrowers may have poorly prepared business plans or financial statements; they may have too little collateral or unacceptable types of collateral; or they may simply be unfamiliar. Guarantees reduce the risk of default to the bank, and thus provide a sheltered environment in which a bank can experiment with a new target group. Guarantees have repeatedly proven effective at inducing banks to reach new groups. Thai Danu

Bank used the guarantee to extend loans to new businesses and businesses with less collateral than standard bank policy required. Far East Bank and Trust used the guarantee program to assist it in shifting from a purely wholesale operation into loans to SMSEs. The experience of the Small Business Administration in the United States underlines this finding as do many cases from developing countries.[5] Similarly, a guarantee can provide shelter for experiments with particular types of credit instruments new to an institution, such as letters of credit for trade finance or medium-term loans for rural businesses, though guarantees have not been used for this purpose quite as often as for reaching new borrowers.

It should be borne in mind, however, that if the spread on a loan is 5 percent between the cost of the funds and the interest rate on the loan it is not likely that a bank will undertake a risk substantially greater than that amount even if the loan is partially guaranteed. Banks do not make loans to lose money.

Recommendation: Project designers should consider guarantees when reaching new borrower groups or developing new credit products is the project objective.

2. Direct loans to individual enterprises are very difficult to appraise and monitor, and A.I.D. staff is generally poorly equipped to carry out commercial lending operations directly.

Providing credit through local IFIs, on the other hand, is a comparatively cost-effective and efficient way of making credit available to targeted businesses.

Discussion. PRE has commonly used three basic mechanisms in supplying credit to private enterprise: direct loans to individual businesses; direct loans to intermediate financial institutions for on-lending to targeted borrowers; and guarantee mechanisms. Each of these mechanisms has strengths and weaknesses that must be considered during project design.

Under certain circumstances it is appropriate for A.I.D. to extend credit directly to enterprises, as PRE did to Leather Industries of Kenya, Antigua Shrimpery Limited, and the Serum Institute in India. In these cases, the prospects of extraordinary developmental benefits from large individual projects drew A.I.D.'s support: for Antigua

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[5] See, for example, Dennis Anderson and Farida Khambata, "Financing Small-Scale Industry and Agriculture in Developing Countries: The Merits and Limitations of 'Commercial' Policies," Economic Development and Cultural Change, Vol. 33, No. 2 (1985), and Jacob Levitsky and Ranga N. Prasad, "Credit Guarantee Schemes for Small and Medium Enterprise," World Bank Technical Paper No. 58 (1987).

Shrimpery, use of local resources and foreign exchange earnings; for Leather Industries of Kenya, backward linkages and foreign exchange earnings; and for the Serum Institute, the prospect of transferring medical technologies.

Direct loans are appropriate when individual projects are too large for the domestic financial institutions to undertake alone, have major foreign exchange requirements, have significant linkages and demonstration effects, have high probability of success, are overseen by competent local financial institutions, and provide extensive visibility for A.I.D. in the domestic private sector. In such cases, A.I.D. involvement is probably best understood as part of a larger strategy for contributing to private sector development in a given country.

When a direct loan is contemplated, it is crucial that a locally based financial intermediary act as lead project promoter. A.I.D. needs to rely on the following capabilities. IFIs offer, even for non-IFI direct loans: 1) expertise in assessing project feasibility; 2) intimate knowledge of the local business community; 3) practice in evaluating and acting upon the trade offs between risks and returns; 4) mechanisms for monitoring and administering loans; and 5) ability to take swift remedial action when problems arise. The relative success of Leather Industries of Kenya in comparison to Antigua Shrimpery is due in large measure to the competence of the IFI partner for Leather Industries of Kenya (Investment Promotion Service), and lack of comparable experience by Antigua Shrimpery Limited's bank (Bank of Antigua). The collapse of Antigua Shrimpery Limited underscores how hard it is for A.I.D. to select individual ventures, even where they appear promising, and therefore serves as a general caveat about such lending.

Some of the limitations of the direct loan as a mechanism for providing capital to the private sector were noted in a 1981-82 review of A.I.D. lending programs by the PPC Office of Evaluation. The discussion paper indicated that (i) A.I.D. tended to lend directly only when the amounts involved were relatively large; (ii) not much was achieved in the way of long-term institutional benefits; (iii) direct loan programs were very staff intensive compared to the level of resource flow, particularly in connection with those problem projects which experienced repayment difficulties; and (iv) the direct loan program required staff with very specialized skills. Direct loans also place foreign exchange risk with the borrower.

Under most conditions, guarantee facilities or direct loans to IFIs are preferable to direct business loans as means of providing credit to private businesses. Both of these mechanisms employ the expertise of local financial institutions to appraise and manage loans to qualifying borrowers, while transferring the vast majority of administrative costs of these loans to the local IFI. Providing credit through local financing institutions uses the local IFI's capabilities to reach borrowers that would otherwise be much too small to deal directly with foreign creditors or guarantors.

Working through local IFIs has several institutional effects that tend to strengthen the local financial system. One benefit is that IFI credit projects build local capabilities to lend to targeted businesses by inducing financial institutions to lend businesses that are not traditionally served by commercial credit. These projects also stimulate efficiency in local credit markets by inducing competition among financial institutions in lending to targeted businesses. Loan guarantee facilities have the added advantage of strengthening financial markets by inducing IFIs to lend from their own funds, to take deposits to raise loanable funds, and to assume part of the risks of lending to targeted businesses.

Two types of guarantee mechanisms are commonly used by PRE: collateral account guarantee facilities, and offset guarantee facilities. Collateral accounts are loans to an IFI that are deposited in a blocked account in a second bank called the collateral bank. The funds in this account serve as the collateral for a guarantee of a specified portion of the principal for loans made by the IFI to qualifying sub-borrowers. Offset guarantee facilities are based on a collateral account that has deposits of only the value of expected defaults.

Loan guarantees are appropriate when the objective of a program is to induce an IFI to make loans it perceives as riskier in some respect than its normal policy allows, and when IFIs have sufficient liquidity to use their own sources of funds.

Direct loans to IFIs are appropriate when local IFIs do not have sufficient liquidity to provide credit to targeted borrowers, when no local IFIs are willing to undertake lending to targeted borrowers, or when legal restrictions make guarantees impossible.

<u>Recommendation: In most situations where objectives include encouraging the development of private sector businesses, making particular goods and services available commercially, or building local financial institutions, guarantee facilities are the most appropriate project mechanisms. Provision of loans by A.I.D. to individual business ventures should be considered only under limited and specific conditions.</u>

3. Guarantees that cover too high a percentage of the loan principal absolve banks of the responsibility to choose and manage loans prudently, while guarantees that cover too little do not induce banks to change their practices.

<u>Discussion</u>. The proportion of principal that a guarantee facility covers has a significant impact on the operation of a SMSE credit

project. As the guaranteed portion increases, the IFI's credit risk is reduced, and so is the incentive to be cautious in selecting customers. The PRE projects reviewed suggest that fifty percent guarantee is definitely small enough to be an incentive to prudent lending by the IFI, and is often still large enough to cover some of the risk that the IFI assumes in lending to unfamiliar SMSE clients.

Studies of loan guarantees have shown the optimal guarantee percentage to be in the range of 50% to 80% of principal.[6] PRE has used 50% as the coverage rate in its guarantee projects. This percentage was acceptable to the banks and resulted in noticeably different portfolios from the norm. In all cases, the number of defaults claimed was quite low; for example, one of 85 borrowers from Far East Bank had defaulted after eighteen months of operation, and none of Thai Danu Bank borrowers had defaulted.

<u>Recommendation: A.I.D. should set guarantee percentages through a negotiating process to be as low as the bank will accept for a particular target group. Percentages as low as 50 percent may be acceptable for a number of purposes.</u>

4. In the cases reviewed, PRE projects provided four principal credit products to private sector businesses: import and export credit, other working capital loans, and term loans. Each of these forms of credit can be targeted to a particular type of business and financial market constraint.

<u>Discussion</u>. In the Far East Bank and Trust, FINIBER, WAFABANK, FINANQUIL and FINADE projects, all of which provided credit for imports and/or exports, sub-borrowers tended to be medium-scale enterprises with established credit histories. In the majority of cases, sub-borrowers were existing customers of the local IFI, and therefore the additionality of these projects was relatively low.

In general, import and export trade credit is most accessible to larger businesses in the SMSE group, and tends to result in minimal lending to small enterprises and new business starts. On the other hand, revolving trade credits do stimulate substantial foreign exchange earnings and economic activity generally.

Term loans and general working capital loans, of the type provided under the Thai Danu and KCFC projects, tend to be particularly well suited to funding businesses during start up phases. The cases

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[6] See Levitsky and Prasad, pp. 4-5, and Elisabeth Rhyne, <u>Small Business, Banks and SBA Loan Guarantees: Subsidizing the Weak or Bridging a Credit Gap?</u>, Quorum Books, Westport, Conn. (forthcoming August 1988).

reviewed here demonstrate that the direct development benefits of this type of credit tend to be substantial.

<u>Recommendation: If project designers want to make credit available primarily to new or small businesses, they should normally not undertake projects that mainly provide international trade credit. If a primary objective of a project is to stimulate general economic activity or to earn foreign exchange, however, international trade credit is an important credit product.</u>

5. Commercial financial institutions can deliver certain technical and business management services effectively and efficiently to targeted businesses.

<u>Discussion</u>. Technical services, such as business and production management advice, can often be delivered effectively via the credit departments of commercial banks. In Thai Danu's case, advice on agricultural production and farm management was provided by an "agricultural credit officer" located in the bank's credit department. In the FEBTC case, credit officers delivered extensive business advice to SMSE clients. Because the account officer is supposed to develop a close relationship with a client, the account officer-client relationship can be a very effective linkage for the delivery of certain technical services to SMSEs.

Delivery of technical services via the account officer relationship can be both cost-effective and efficient for providing a wide range of business assistance to SMSEs. Account officers come to know the status and operations of their clients intimately, and can make well informed decisions about the types of services that are most important to the client. It is in the interest of the bank to see that the client prospers, and that the best technical and business assistance is delivered for the lowest possible cost.

By contrast, more conventional approaches to SMSE development involve providing credit and technical services through separate projects, or at least separate delivery systems. The loan to Kenya Commercial Finance Company, which supported technical assistance through a separate centralized unit, demonstrates the drawbacks of imposing specific organizational arrangements for delivering technical services on participating IFIs. Private IFIs are interested in implementing SMSE projects in the most cost-effective manner possible. Therefore it is generally true that financial institutions capable of effectively implementing private sector SMSE lending projects are also capable of determining the best organizational arrangements for a project, and this includes setting up efficient arrangements for delivering technical assistance. In most instances, the participating IFI should be responsible for determining the means of delivering technical services.

Recommendation: Where credit projects include provision of technical assistance to SMSEs, commercial banks should be considered as a possible source of such assistance.

6. Direct impact of loans/guarantees to IFIs is enhanced if specific provision is made for sub-borrower reflows to be re-lent to comparable sub-borrowers, at least during the life of the loan agreement.

Discussion. PRE projects differed substantially in their use of loan reflows from sub-borrowers. KCFC Schemes to which A.I.D. authorized $2.5 million for 12 years (matched 1:1 by Kenya Commercial Bank), transferred repayments of loan principal and interest into its main loan pool, using the funds one time only for project-related loans. WAFABANK, which received a $2.5 million loan guarantee fully payable in five years (matched 1:1 by Credit du Nord), recycled loan repayments back into the program. Far East Bank and Trust Company also recycled loan repayments to make over 200 short-term credits to over 85 sub-borrowers during the first eighteen months of the project.

After four years of participation, KCFC had on-lent its PRE loan to 95 sub-borrowers, with terms averaging six years and never exceeding eight. All loans were to be paid off well before the end of KCFC's 12 year term, and there were no plans to expand the sub-borrower population beyond the initial group. WAFABANK, on the other hand, had established a short term revolving credit pool and had on-lent almost $10 million in 171 sub-loans in the two years since the project began. Although principal repayment had begun to decrease its reflow pool, WAFABANK still expected to on-lend an additional $5 million before the end of the program three years hence.

As these examples illustrate, sub-loan reflows are an important leveraging mechanism which enhances IFI program impact. Projects that provide for loan reflows to be lent again to qualifying sub-borrowers provide the opportunity for substantially greater impact per dollar invested in a project. Therefore, care should be taken to ensure that language is included in the initial agreement concerning this issue, and that issues (exchange rates, profitability, risk) that would make this condition unattractive to an IFI are addressed in a mutually satisfactory manner.

Recommendation: A.I.D. credit programs through IFIs should normally make explicit provision for the use of reflows to continue lending operations of the type carried out under the project.

7. Allowing SMSEs to procure capital goods and services locally enables well-managed businesses to purchase packages of capital goods that are cost-effective and stimulate local capital goods industries.

Discussion. Normal A.I.D. procurement regulations apply to the purchases made by both the IFI itself and by the final borrowers in an IFI project. The applicable regulations are determined by the funding source, with grant funds subject to a narrower geographic code than loan funds. The rules apply to all sources of funding except government-owned local currencies. Applying procurement regulations to IFI projects may be quite cumbersome, particularly if the project does not provide access to foreign currency.

In several of the projects reviewed, SMSEs used guaranteed loan proceeds to purchase capital goods. This was especially true in the Thai Danu and KCFC cases, the two projects that provided medium-term (five year) credits. Among projects that provided short-term revolving credits for imports or exports, there were also numerous examples of businesses that took advantage of the fungibility of money and, in effect, used guaranteed credits to purchase capital goods.

Many SMSEs used their credits to acquire technologies that were both new to their country and appropriate in the sense that the investments involved a cost-effective mix of local and imported technologies and equipment. When assembling capital goods, well-managed SMSEs often hired local industrial consultants to design new facilities, purchased locally as much of the required machinery as was available, and then imported only those items that could not be purchased in the country. Capital goods were then assembled at the factory site using local labor in order to minimize costs.
Two examples from the Thai Danu project illustrate this point:

> Fresh Meat Company. Until the Fresh Meat Processing Company (FMC) began operating, virtually all fresh pork in Thailand was processed by traditional butchers under unhygienic conditions. In 1985, three employees of Thailand's largest agricultural supply company decided to set up a modern pork packing factory, with the hopes of selling to nearby Hong Kong, Singapore and Japan. Thai Danu Bank provided a five-year guaranteed loan to the company equal to about 40 percent of their initial capitalization.
>
> FMC hired a local university professor as a technical consultant and made plans for a 16 ton per day processing plant. After receiving the loan, FMC constructed the plant according to its consultant's design. The plant's equipment includes modern band saw, digital scales, and epoxy floors from the United States, and a German chilling machine. Almost all other equipment was fabricated locally using designs from the USDA Food Safety and Quality Service, Agriculture Handbook #570 as a guide.

The Pitichai Biscuit Factory. Mr. Pitichai and his wife run a small biscuit manufacturing factory. With a 40 year old gas fired oven they produce sweet biscuits. After operating the business for seven years, they have accumulated substantial profits and have been unable to keep up with demand for their products.

They hired a Malaysian consultant to design a new plant so that they could drastically increase production. Thai Danu Bank provided them with a revolving working capital loan under the A.I.D. guarantee facility and construction of the new plant is proceeding as planned. Capital has been judiciously selected so that most equipment was purchased locally and assembled on-site. Only those capital items that are not locally available have been imported. These included a metal chain-link conveyor belt, mixing machines, gas valves, and a cloth conveyor belt.

Recommendation: If SMSEs are to have the opportunity to make optimal capital investments, it may be necessary to provide blanket waivers of standard A.I.D. procurement regulations for SMSE credit projects.

D. Monitoring and Evaluation Loan Projects

1. The overall sales and employment effects of direct loan and IFI loan projects of the type piloted by PRE appear to be in line with international standards, and to represent effective uses of development assistance.

Discussion. Although difficult to assess with methodological certainty, the evidence indicates that the immediate economic effects of the projects reviewed (with the exception of Antigua Shrimpery Limited and the two projects in Ecuador) are in line with those projected in the projects' appraisal reports and with general guidelines developed by the World Bank, International Finance Corporation and UNIDO concerning cost per job created and value added per dollar invested.

The two cases (KCFC and Thai Danu Bank) where it was possible to link actual employment increases to those projected by the sub-borrowers themselves adds confirmation to a rule of thumb that employment and production targets tend to be over-estimated by approximately a factor of two.

In general it was concluded that PRE had developed several models, in particular the loan guarantee and direct IFI loan mechanisms, that are cost effective under appropriate circumstances for stimulating local capital formation and employment creation. The usefulness and operational strengths of these mechanisms have been demonstrated under relatively diverse local market conditions.

Recommendation: The Bureau for Private Enterprise appears to have developed substantial expertise in SMSE lending and should develop mechanisms for disseminating and replicating the best of this experience.

2. Several of the nine projects reviewed had significant institutional effects on local financial markets and institutions. These institutional effects were measurable and could be evaluated.

Discussion. In five of the nine cases there were measurable impacts on local institutions as a result of PRE investment projects. These included changes in central bank policies and initiation of policy dialogue with the government on policy reform because of the WAFABANK and FINIBER projects, changes in bank lending policies in the Thai Danu Bank and Far East Bank and Trust projects, increased private sector SMSE development programming in several USAID Missions (Thailand, Kenya, Philippines), and stimulation of competition in local SMSE credit markets in Philippines, Thailand, Kenya, and the Dominican Republic.

In many instances, institutional changes appear only in the long term, often years after the beginning of a project. Nevertheless, there are often leading indicators that enable evaluators to examine the nature and extent of institutional effects in such projects. These indicators include changes in traditional IFI credit appraisal and management procedures, changes in portfolio composition that show increases in lending to targeted sub-borrowers, initiation of projects based on the design of pilot projects, changes in the credit procedures and operations of competing IFIs, policy discussions between the local USAID and the government, and new policy initiatives in the local government.

Recommendation: Monitoring and evaluation of SMSE credit projects should focus specific attention on the observed and expected institutional impacts of projects.

3. Participating IFIs in several cases did not carefully follow guidelines established in project agreements. Monitoring of IFI compliance with terms of private sector project agreements is critical to project success. In addition, monitoring of economic conditions, and quick responses to changing conditions, are important factors contributing to successful project implementation.

Discussion. The need for effective monitoring is underlined in the FINANQUIL and FINIBER projects in Ecuador, where the assumption that there was almost no import financing available for agricultural capital goods importers did not prove true after the projects began. Once the projects started, there was very little demand for loans among the targeted sub-borrowers. Because of this lack of demand for credit under the guarantee facility, one of the banks began to lend to businesses that did not qualify as sub-borrowers. The bank's lack of compliance with terms in the project agreement was not discovered until almost mid-way through the project.

Recommendation: Information necessary for monitoring the development impact of credit programs should be collected on a regular and consistent basis as part of project implementation. Information should include both compliance with terms of project agreements, and changes in local economic and financial conditions that represent deviations from important project assumptions.

4. The development impact of small enterprise projects is often substantially different from that envisioned in initial project documents.

Discussion. Some of the most significant development impacts observed during the evaluation were unanticipated in the original project documentation. In Morocco, for example, a clever modification to the three party agreement enabled the full disbursement of this line of foreign exchange commercial credit, while opening a window of opportunity for policy dialogue with the Central Bank in this area. In Kenya, the Leather Industries of Kenya project initiated what may be a long, fruitful relationship between USAID/Kenya and IPS(K), and the waste treatment facility financed by the project resulted in a new standard for industrial pollution control being set for the country. The other projects also illustrate the prominence of unplanned effects.

The evidence from these cases and others is persuasive concerning the importance of unplanned effects, and suggests that their occurrence is the rule rather than the exception.[7] The probability of positive unplanned effects is greatly enhanced when projects have the flexibility to respond to unexpected opportunities and constraints. Another implication of this observation is that evaluations should devote substantial attention to identifying the positive and negative unplanned effects of projects, in addition to assessing performance of originally stated objectives.

Recommendation: Project implementors and monitors should be prepared to pursue unpredicted benefits, and scopes of work for project evaluations of SMSE commercial credit projects should devote considerable attention to the possible unplanned effects of these projects.

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[7] For a thoughtful essay on unplanned benefits, see Albert O. Hirschman, Development Projects Observed, The Brookings Institution (1967).

5. In an effort to improve monitoring and evaluation data, PRE now often requires IFIs to collect business information from their clients. Gathering this information on the economic impacts of project sub-loans is essential for A.I.D.'s efforts to examine project effects. But collection of valid impact information is also often a significant cost imposed upon participating IFIs. In some cases, these costs consume a substantial portion of earnings that IFIs gain from participating in projects.

Discussion. When the WAFABANK and KCFC project agreements were signed, IFIs were required to report little data on their sub-borrowers. Collecting information for quarterly reports under the WAFABANK and KCFC projects was reported to require only several staff days per quarterly report.

As PRE staff felt the need for more extensive information on the impacts of their investment projects, new reporting guidelines were given to participating IFIs, including numbers of employees, gross assets, foreign exchange earnings, developmental impacts, and credit record. In the Far East Bank and Trust Company and Thai Danu Bank cases, bank officers reported that reporting requirements included information that the IFI would not usually need for internal credit operations, and that the cost of collecting the data was significant. This is particularly true when information must be collected directly from rural sub-borrowers.

Recommendation: In instances when A.I.D. requires extensive information from banks that is not routinely collected during regular operations, A.I.D. should consider making appropriate payments for the information. The automated monitoring system recently developed to collect and analyze information on the financial and development effects of PRE/I's revolving loan fund should be adapted and disseminated for use by USAID Missions.

CHAPTER SIX: REPLICATION PLAN

An essential aspect of this study was to provide information on replication of the models discussed herein for USAID staff in other countries interested in private sector programming. The previous section discussed in detail the lessons learned during this exercise. While it is hoped that these lessons themselves will have an impact on the design and implementation of future projects, certain additional basic information may be helpful.

For a USAID Mission wishing to become involved in projects of this type, one of the first steps in analyzing potential opportunities for intervention would be contact with other donors and institutions at the local level. In many instances, adding capital inputs and USAID development objectives to a program already in existence represents a low risk, cost effective way to enter into the private sector programming arena.

Once the Mission has gained a clear understanding of the existing private sector, established an array of private sector contacts, and identified specific constraints to private sector development, contact with PRE is highly recommended. Several centrally funded PRE program activities are designed to provide assistance to Missions interested in promoting enhanced private sector programming. Among these programs are the following:

1. Program Development and Support: PRE staff and business experts provide program development and problem solving assistance to Missions, host country governments, and private businesses. Assistance is generally short-term in nature, and addresses design issues, management/technical problems, project assessment and evaluation.

2. Revolving Loan Fund: The fund focuses on three main areas; i) capitalization or expansion of private IFIs to provide financing to small and micro-enterprises; ii) support for small and medium scale agribusinesses which value-add to agricultural produce and need technical assistance, production inputs, credit and marketing services; and iii) research and development including the development of innovative investment techniques, concepts, and instruments.

3. Investment Development and Packaging: A pool of resources is available to fund investment analyses and other technical studies of potential projects, as well as to provide limited technical assistance for strengthening a potential borrower's institutional capacity.

4. Private Enterprise Development Support (PEDS) Project: This project focuses on interventions that enhance Mission approaches, strategies and projects related to private sector

development, and that foster host country policy and institutional reform related to privately-led economic growth.

5. Financial Markets Development Project: To develop capital markets, which play a crucial role in mobilizing savings and capital into priority investment activities, PRE provides assistance that includes:

   - performing analyses required to support specific action or policy revision;

   - providing training to groups essential to the growth of financial markets (bankers, businessmen, investors, etc.);

   - providing advice and personnel to assist in establishing components of the financial system that are important for the expansion of capital markets (debt instruments, regulatory agencies, etc.).

6. Divestiture and Privatization: The goal of this project is to assist in creating a policy climate to accelerate transfer of state-owned or controlled enterprises to the private sector. This is accomplished by providing technical expertise needed by Missions for preparing country and sector-specific divestiture and privatization strategies; developing a list of components of a policy dialogue with host country public and private sector leaders; and implementing divestiture and privatization actions in selected countries.

7. Training Development: PRE provides support to selected developing management training schools in curriculum design, staff upgrading and establishment of developing country/U.S. institutional relationships. In addition, PRE conducts a course on the "Role of the Private Sector in Development" for host country nationals from both private and public sectors, A.I.D. personnel, international donors, PVO staff and U.S. businesses.

8. International Executive Service Corps: This not-for-profit organization partially funded by PRE has recruited thousands of highly-skilled retired American executives to share their "know-how" with their developing world counterparts. A secondary role is to provide linkages between American businesses and those in developing countries.

9. Commercialization of Technology: The program's focus is on: (i) the development of R&D limited partnerships for product development, manufacture, and marketing in developing countries; (ii) test-marketing in developing of new or adapted products; and (iii) preparing business plans to raise capital for developing country businesses to market or manufacture products in high priority sectors.

PRE has prepared a guidebook titled The Design and Management of Credit Projects for Small- and Medium-scale Enterprises: Guidelines for Working with Commercial Financial Institutions. This manual is intended to assist A.I.D. field missions in designing and implementing private sector investment projects, and is based on the lessons learned through the evaluations of projects carried out by PRE/I.

Several studies exist which serve as practical, general references for those interested in initiating private sector lending programs. PRE's case study series describing and evaluating specific projects and models is a good place to begin. In World Bank Lending to Small Enterprise: A Review, Jacob Levitsky reviews SSE lending objectives and impacts, then focuses on such issues of program design as financing arrangements and subloan terms. Blayney and Otero's paper, Small and Micro Enterprises: Contributions to Development and Future Directions for A.I.D.'s Support, provides a useful framework for analyzing factors that influence credit extension.

The ARIES Strategic Overview Paper examines characteristics of small and micro enterprises; compares principal types of SSE resource institutions; identifies general models of SSE assistance programs; and reviews recurrent problems of SSE resource institutions. The A.I.D. Program Design and Evaluation Methods Report No. 6, A Manual for Evaluating Small-Scale Enterprise Development Projects, presents low, medium, and high level-of-effort methodologies for evaluating technical assistance and credit institution performance as well as SSE project impact. An excellent discussion of the formal lender-small borrower relationship, and the difficulties inherent in lending to this group, is presented by Johanna Looze in Credit and the Small Borrower: Bridging the Gap Between Borrower Lending Programs, and Funding Sources. Finally, an evaluation system for private sector investments is discussed in Proposed Evaluation System for the Investment Office of A.I.D.'s Bureau of Private Enterprise. A detailed survey of the state of small industrial enterprises throughout the developing world is provided by Liedholm and Mead: "Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications." These documents and other references and information can be obtained by contacting PRE's Program Office or PPC's Center for Development Information and Evaluation.

Additional information and assistance in establishing IFI, direct loan or other private sector programs, including copies of documents such as sample contracts and loan agreements, tripartite agreements, and project monitoring systems may be obtained from the Bureau for Private Enterprise, United States Agency for International Development, Washington, D.C. 20523.

ANNEX 1

REVOLVING FUND DEVELOPMENT OBJECTIVES

Survey instrument for assessing selected IFI investment projects' achievement of Revolving Fund development objectives as set forth in enabling legislation and A.I.D. Congressional Presentations.

Revolving Fund Development Objectives	Strong Impact	Moderate Impact	Absent	Evidence
INSTITUTIONAL DEVELOPMENT				
1.1 Policy reform in A.I.D.-supported IFI to Increase Assistance to Small and Medium-Sized Enterprises				
o Increased funding by IFI for small business lending				
o Probability of sustained project activities after withdrawal of A.I.D. funding				
o Changes in collateral requirements, loan appraisal terms and criteria				
o Changes in overall portfolio composition (additionality)				
1.2 Demonstration Effects in Other Host Country Institutions				
o Replication in other host country institutions of approach tried in A.I.D. supported IFI				
1.3 Institutional Strengthening of IFI				
o Improved capacity to identify relevant loans				
o Improved capacity to process and monitor relevant loans				
o Improved capacity to recover relevant loans				
o Improved capacity to provide technical assistance to sub-borrowers				

Revolving Fund Development Objectives	Strong Impact	Moderate Impact	Absent	Evidence
2.5. Direct Economic Development Impact on Sub-borrowers				
o Number of new jobs created in sub-borrower enterprises				
o Increased sales volume by sub-borrowers				
o Increased export earnings or import substitution by sub-borrowers				
o Alleviation of foreign exchange problem				
o Product innovations				
o New starts (# and %)				
o Forward and backward linkages				
POLICY DIALOGUE				
3.1 Rationalization of Financial Policy				
o Movement toward commercial interest rates				
o Change in government or financial market policy and procedures affecting small business finance				
3.2 Privatization				
o Privatization of banking activities				
o Use of loan funds to support transfer of businesses or other activities from government to private hands				

Revolving Fund Development Objectives	Strong Impact	Moderate Impact	Absent	Evidence
PRIVATE SECTOR SUPPORT				
2.1 Demonstration Effects in A.I.D.				
o Increased number or percentage of private sector projects that make use of or build on PRE "models"				
o Other spinoffs from PRE project activities				
2.2. Documentation and Dissemination of Successful Approaches				
o Preparation and distribution of descriptive and evaluative documents				
o Other dissemination activities (e.g., participation in work-shops, conferences, meetings, etc.				
2.3 Leverage of Investment Funds				
o Funds invested by other sources in PRE assisted projects				
o Evidence that PRE funds have supplemented and not replaced other sources of capital				
2.4 Assistance to Small Business, Agriculture and Exporting				
o Proportion of assistance to small business				
o Proportion of assistance to agriculturally related business				
o Proportion of assistance to exporting businesses				

Revolving Fund Development Objectives	Strong Impact	Moderate Impact	Absent	Evidence
TECHNOLOGY TRANSFER				
4.1 Encouragement of Appropriate Technology				
o Successful technology transfer by sub-borrowers				
OTHER				
5.1 Innovation				
o Innovativeness of financing mechanisms				
5.2 Other Project-Specific Objectives				
o Support for special population groups such as lending to women-owned enterprises or rural business				
o Achievement of other project-specific objectives				
5.3 Financial Viability				
o Portfolio disbursement and repayment				
o Financial health of sub-borrowers				

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ANNEX 2

MSI STUDY TEAM

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Marian Cosmides -	Small Business Specialist for FINADE, FINIBER and FINANQUIL Cases
Allen Eisendrath -	Small Business Specialist for Thai Danu and FEBTC Cases, and Principal Editor of Case Study and Analytical Reports
Jean de la Giroday -	Banking and Finance Specialist for WAFABANK Case
Tom Kelly -	Team Leader for LIK, ASL, Thai Danu and FEBTC Cases
Robert Rabatsky -	Team Leader for KCFC and WAFABANK Cases
David Schrier -	Team Leader for FINADE, FINIBER and FINANQUIL Cases
Jalil Shoraka -	Banking and Finance Specialist for KCFC, Thai Danu and FEBTC Cases
Robert Strauss -	Small Business Specialist for KCFC Case
Timothy Alexander -	Background Research and Secondary Data Analysis

ANNEX 3

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