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LESSONS FROM EXPERIENCE VOLUME III: THE USES AND LIMITATIONS OF PROJECTS IN IMPROVING CAPITAL MARKETS FOR SMALL BUSINESSES

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LESSONS FROM EXPERIENCE:

THE USES AND LIMITATIONS OF PROJECTS IN IMPROVING

CAPITAL MARKETS FOR SMALL BUSINESSES

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I. INTRODUCTION

The Bureau for Private Enterprise (PRE) was established within the Agency for International Development in 1981, with the purpose 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 eight years of operation the Bureau has accumulated a portfolio of 36 credit projects that provide credit to micro-, small- and medium-scale enterprises and strengthen local financial markets.

Most 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 for on-lending to small enterprises, and in other cases Revolving Fund loans are to be used as a guarantee; in some cases the purpose of sub-loans was short-term credit to finance exports or imports, while in other cases the objective was to encourage IFIs to provide long-term investment capital; in a few projects before the establishment of the revolving fund, the IFI with which PRE worked was owned by the government, while thereafter almost all projects were carried out with private institutions. 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 development objectives and specific target groups 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 project approach discussed here involves direct loans by PRE to private businesses or venture capital companies in developing countries. Again, these projects differ from one another in several important respects including project size, types of other investors in the project, and the proportion of project capitalization represented by the A.I.D. loan. These projects have several common features:

- providing term loans at commercial rates of interest to private businesses 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 (54 percent), with a substantial share in Latin America and the Caribbean (25 percent) and Africa (21 percent), and several additional South Pacific Regional and worldwide projects. The full list of currently active projects includes the following:

ACTIVE BUREAU FOR PRIVATE ENTERPRISE CREDIT PROJECTS
As of September 30, 1988

LOAN PORTFOLIO

	IFI PROJECTS	LOAN AMOUNTS ($)	GRANT AMOUNTS	LOCATION
1.	Banco de Desarrollo Finade, S.A.	2,000,000	50,000	Dominican Republic
2.	Healthlink Credit	314,000		Thailand/Indonesia
3.	National Development Leasing Corp.	2,500,000		Pakistan
4.	WAFABANK	2,500,000	50,000	Morocco
5.	Financiera de Guayaquil	1,400,000		Ecuador
6.	Caribbean Basin Corporation	1,200,000		Caribbean/Latin America
7.	Accion Micro Lending Guaranty Fund	1,000,000	191,000	Carib/Latin America
8.	Agribusiness Investment Corp.	146,000		Africa
9.	Bank Niaga	2,000,000	50,000	Indonesia
10.	Overseas Express Bank	2,850,000	50,000	Indonesia
11.	Thai Danu Bank	2,350,000	50,000	Indonesia
12.	Far East Bank & Trust I	2,000,000		Philippines
13.	Société Marocaine de Depot et Credit	2,000,000		Morocco
14.	International Multifoods Revolving Credit Facility	1,000,000		Latin America/ Caribbean
15.	Union of Bolivian Banks	2,000,000	60,000	Bolivia
16.	Financiera Ibero-Americana, S.A.I.	1,400,000		Ecuador
17.	EDESA	2,000,000		Sub-Saharan Africa
18.	Metropolitan Bank & Trust	2,100,000		Philippines
19.	Philippines Commercial International Bank	2,400,000		Philippines
20.	Bank of the Philippine Islands	2,400,000		Philippines
21.	Securitized Trade	2,400,000		Turkey
22.	South Pacific Loan Guar. Facility	1,750,000		South Pacific
23.	Guatemala Commercial Financial Institutions	3,000,000		Guatemala
24.	Diamond Trust	1,000,000		Kenya
25.	Thai Venture Capital	3,000,000	50,000	Thailand
26.	Bank of Jordan	3,000,000		Jordan
27.	Cairo Amman Bank	2,000,000		Jordan
28.	Standard Chartered Bank	5,000,000		Botswana
29.	Barclays Bank	750,000		Botswana
30.	Bank of Credit & Commerce	350,000		Botswana
31.	Masstock Ltd.	3,000,000		Zambia
32.	Far East Bank II	2,186,000		Philippines
	DIRECT LOANS			
1.	Thailand Livestock Meat Processing	2,500,000	70,000	Thailand
2.	Serum Institute of India Pvt., Ltd.	1,000,000		India
3.	Trident Foods, Ltd.	2,000,000		Mauritius
4.	NovaGene Group Partnership Ltd.	2,000,000		ASEAN Region

PRE projects typically offer credit to a target group of businesses and establish mechanisms to deliver these credit products. Loans under PRE projects are provided either through a local intermediate financial institution (IFI projects) or directly by A.I.D (direct loan projects). The projects reviewed here provided the following credit products:

(1) Short-term working capital credit;
(2) Import credit;
(3) Export credit;
(4) Term loans, used primarily for the acquisition of fixed assets, sometimes provided in conjunction with equity investments by other investors.

From the perspective of the business owner or manager, the project is seen as a credit window in a local financial institution, or in some cases several institutions, from which the business can obtain credit.

PRE projects can also be viewed in terms of the arrangements that are required to induce local financial institutions to provide loans to targeted small business clients. From this "behind the credit window" perspective, a project uses a specific financing mechanism to open a credit window to certain borrowers or to induce an IFI to provide certain credit products. Sub-borrowers often know nothing about project mechanisms, only seeing the final loan terms.

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.

A project is a means for putting a credit "product" into place or expand its use. For example, the Bank Niaga Project consists of a guarantee facility established to encourage Bank Niaga to provide term credit to SMSEs outside of Jakarta. In the Business Venture Promotion Project, PRE used a direct loan to encourage local banks to establish a venture capital firm in Thailand. Once established, Business Venture Promotion provided both equity and debt capital to small- and medium-scale enterprises (SMSEs) in Thailand.

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

MATRIX OF PRODUCTS AND MECHANISMS

MECHANISM

	Direct Loan to Business	Direct Loan to IFI	Loan Guarantee Facility
Working Capital Short-term			MICRO-LENDING FAR EAST BANK & TRUST
Import Credit			FAR EAST BANK & TRUST II FINANQUIL FINIBER WAFABANK
Export Credit			FINADE SOCIETE MAROCAINE SECURITIZED TRADE
Term Loan	TRIDENT FOODS THAI-RFM MEAT PROCESSING ANTIGUA SHRIMPERY SERUM INSTITUTE NOVAGENE GROUP LEATHER INDUSTRIES OF KENYA MALAWI BRIDGE FINANCING MASSTOCK	KCFC SIAM COMMERCIAL BANK	HEALTHLINK NDLC BANK NIAGA WOMEN'S WORLD BANKING 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 Bank of Jordan Cairo Amman Standard Chartered Botswana Barclays Bank Botswana BCC Botswana
Investment Quasi-Equity		THAI VENTURE CAPITAL CARIBBEAN BASIN CORPORATION AGRIBUSINESS INVESTMENT CORP.	

Learning Lessons from Experience

As part of its catalytic role within A.I.D., PRE collects, analyzes and disseminates information on the impacts and cost-effectiveness of its efforts. Because Revolving Fund's loan portfolio has grown rapidly, the program has given increased attention to project monitoring, and during 1987 and 1988, PRE took steps to upgrade its monitoring and evaluation procedures. These steps included improved systems for monitoring financial performance and contract compliance, and sponsorship of periodic project evaluations.

The first attempt to perform project assessments was completed in 1987 by Management Systems International (MSI), with a second and third set of studies completed in 1988 and 1989. The goals of the case studies are twofold: first, to provide immediate feedback on how well each project has met its objectives and to quantify benefits obtained by smaller enterprises; and second, to discover general lessons about effective means of assisting smaller enterprises and strengthening private sector financial institutions.

Resulting from these studies is a set of fourteen case study reports on the projects and a series of three analytical reports called Lessons from Experience. This report is the third in the Lessons from Experience series. Study findings have also been included in a manual for private sector officers, The Design and Management of Credit Projects for Small- and Medium-Scale Enterprises: Guidelines for Working with Commercial Financial Institutions, prepared by MSI and published by PRE, and in a training module incorporated in PRE's 2-week training program for A.I.D. officers.

Research for the fourteen case studies was carried out by MSI during 1986, 1987 and 1988. Each case study included the following tasks:

- review of PRE documents and interviews with investment officers;
- identification and review of relevant experiences of other donors;
- conduct of site visits to examine operation of the project, visits to a representative sample of sub-borrowers, and conduct of debriefings for USAID Mission staff.

The cases examined to date include:

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)
Bank Niaga [Indonesia] (guarantee facility)
Securitized Trade [Turkey] (trade finance facility)
Accion Micro Lending [Mexico & Paraguay] (guarantee facility)
Leather Industries of Kenya (direct loan to business)
Antigua Shrimpery Ltd. (direct loan to business)
Thai Venture Capital [Thailand] (venture capital company)
Thai RFM Company, Ltd. [Thailand] (direct loan to business)

The Theme of Volume III of Lessons from Experience

In addition to providing credit to smaller enterprises, most PRE projects have important programmatic objectives, such as privatization and capital market development. The emphasis of this third volume of Lessons from Experience is on the role, uses and limitations of relatively small credit projects within larger private sector development programs.

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 include 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: building the capabilities of local financial institutions to lend to SMSEs; stimulating competition and efficiency in SMSE credit markets; and creating capabilities within USAID Missions to design and implement SMSE credit projects. Other institutional objectives of interest include:

- Demonstrating to local governments and NGOs viable SMSE development approaches.
- Initiating policy dialogue within local governments leading to rationalization of financial markets policies, movement toward market-determined interest rates, provision of favorable policies for SMSEs, and privatization of financial markets.

PRE projects are generally very small in relation to the economies of the host countries in which they operate. For example, the Far East Bank and Trust project added $2 million to an economy with total financial assets of over $11 billion, the Thai Danu Bank Project added $2.35 million to a financial system with more than $30 billion in assets, and the Kenya Commercial Finance Company Project contributed only $2.5 million in an economy with $1.8 billion in outstanding commercial bank credit in 1987. Typical $2.5 million IFI projects provide loans to between 40 and 150 businesses spread throughout a country. Generally, in addition to the businesses served by a PRE IFI project, there are tens of thousands that go unserved.[1]

Because of the small coverage that is achieved when project funds are limited to several million dollars, the most significant impacts of small credit projects usually arise from their institutional effects. These include the

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[1] In smaller countries like Morocco, Mauritius or Antigua, however, PRE projects may contribute a much larger share of total outstanding credit in the economy than in countries such as Thailand, Philippines or Kenya.

examples projects provide to local financial institutions, donor agencies and host governments concerning how credit can be provided to smaller borrowers on an unsubsidized basis. By encouraging institutional changes in local financial markets, either in local IFI practices or government policies, credit projects potentially have impacts that go far beyond providing project funds to specific local businesses.

Major institutional impacts that have been identified in the case studies include the following:

- Providing an example to the A.I.D. Mission for replication on a larger scale (Thai Danu Bank in Thailand, Kenya Commercial Finance Company (KCFC) in Kenya);

- Providing an example to private financial institutions of a market that can be profitably served by the private sector (Far East Bank and Trust in the Philippines, Bank Niaga in Indonesia); and extending the range of smaller borrowers considered acceptable to private commercial institutions by providing an opportunity to experiment with small business loans (Bank Niaga, Thai Danu Bank, Siam Commercial Bank, Accion);

- Giving the local government an example of how credit to small businesses can be provided on an unsubsidized basis (Thai Danu Bank and Bank Niaga);

- Encouraging private banks to compete in markets traditionally dominated by the government (Bank Niaga, Thai Danu Bank, Siam Commercial Bank);

- Demonstrating constraints facing smaller businesses caused by government intervention in financial markets (Siam Commercial Bank, Thai Danu Bank, Bank Niaga, KCFC, Finiber and Finanquil);

- Establishing personal and institutional links between private financial institutions and development agencies (Siam Commercial Bank, Thai Danu Bank, Bank Niaga);

- Establishing a mechanism by which microenterprise lenders can obtain funds from private commercial banks (Accion).

- Encouraging government revision of policies on foreign currency accounts in order to improve the efficiency of foreign trade (WAFABANK in Morocco).

Because credit projects can have significant institutional impacts in addition to their direct development impacts of providing project credit to smaller businesses, projects often play a key role in larger private enterprise programs carried out by A.I.D. In fact, there is some reason to believe that credit projects can often play roles that cannot be accomplished by any other component of a private enterprise portfolio. The principal purpose of this volume is to outline the special ways in which credit projects of the sort implemented by PRE can fit into private enterprise programs.

II. DESIGNING PROJECTS TO SOLVE CAPITAL MARKET CONSTRAINTS

This chapter presents findings and recommendations concerning the uses and limitations of small credit projects for addressing capital market constraints.

1. Finding: A variety of different capital market constraints can limit access by smaller enterprises to productive capital. These constraints differ from country to country and from target group to target group.

Discussion. Based on the fourteen cases reviewed, the capital market constraints facing the local businesses included the following: [2]

Kenya Commercial Finance Company
1. Government administered ceilings on interest rates for both deposits and loans.
2. Lender inexperience with SMSE lending.
3. Lack of long term credit for capital investments.

WAFABANK
1. Shortage of foreign exchange credit.

Thai Danu Bank
1. Lack of lender experience with rural SMSE lending.
2. Government administered ceilings on interest rates for both deposits and loans.

FINADE
1. High inflation causing negative real rates of interest and lack of domestic savings resulting in low domestic banking liquidity.
2. Government limits on foreign exchange lending.

FINIBER/FINANQUIL
1. High inflation and negative real interest rates.
2. Lack of foreign currency.

Far East Bank and Trust
1. Contraction of commercial lending during a recession.
2. Lender inexperience with SMSE lending.
3. Lack of adequate protection for lender's security rights.

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[2] Projects also addressed policy constraints in areas other than capital markets. These policies, and their effects on smaller enterprises, are discussed in S. Haggblade, C. Liedholm, and D. Mead. "The Effect of Policy and Policy Reform on Non-Agricultural Enterprises and Employment in Developing Countries: A Review of Past Experiences." A.I.D. EEPA Discussion Paper No. 1. March 1986.

Bank Niaga

1. Government subsidies for SMSE credit.
2. Lack of long term credit for capital investments.
3. Lack of models for unsubsidized SMSE lending.

Securitized Trade

1. Lack of fixed rate long term instruments for borrowing from international credit markets.
2. Government foreign exchange regulations.

Accion Micro Lending

1. Lack of funds for microenterprise lending programs.
2. Lack of access of micro lending institutions to commercial credit markets.

DIRECT LOAN PROJECTS

Leather Industries of Kenya

1. Scarcity of long term credit for fixed capital investments.

Antigua Shrimpery Ltd.

1. Shortage of foreign exchange.
2. Shortage of commercial credit for new starts.

Thai Venture Capital

1. Lack of venture capital models in the country.
2. Lack of long term start up financing.
3. Weak local securities markets.

The structural causes of these capital market problems can be summarized in the following general categories:

A. <u>Inappropriate Government Policies and Their Consequences.</u>

i. <u>Interest rate regulation and credit availability</u>. Interest rate ceilings on deposits often resulted in difficulties for local financial institutions in raising loan funds. This, in turn, resulted in shortages of funds for lending to private enterprises because the administered interest ceilings set the "price" of money below what the market required to balance credit supplies and credit demand.

With limited funds, those that were available were usually channelled to businesses with substantial assets, easily attachable collateral, long commercial histories and political prominence. In addition, where lending interest rate ceilings established by the government were insufficient to cover the additional administrative costs and perceived risks of lending to smaller enterprises, lenders made such loans only if compelled to do so.

Government regulated interest rates were often associated with unmet demand for credit among borrowers, particularly smaller businesses, rural enterprises and new starts. Whichever type of interest rate ceiling (on deposits or on loans) caused the constraint, the result was a shortfall in the supply of funds that financial institutions were willing to lend to these borrowers. As a result, the capital market distortions introduced by interest rate ceilings caused the opportunity cost of diverting funds from relatively safe, older clients to SMSEs to be unacceptably high.

ii. Subsidized Government Credit Programs: In many countries visited, governments and international lending agencies operate major programs providing credit to smaller enterprises. Loans under these programs were often subsidized, and in some cases interest rates were substantially below private sector prime lending rates. In these cases, it was difficult for private institutions to lend to businesses that have access to subsidized funds.

In some markets studied, businesses had also grown accustomed to borrowing under government programs without repaying their loans. Private institutions were therefore reluctant to lend to firms in market segments that had shown poor loan payback practices under government programs.

iii. Shortage of Foreign Exchange Credit and Unstable Foreign Exchange Rates: In several countries, government foreign exchange policies have resulted in a scarcity of foreign exchange credit. Some of these countries also experienced frequent devaluations of their exchange rates. This causes serious difficulties for industries dependent upon foreign exchange for production inputs and capital goods, and for investors seeking to invest foreign currency in local assets. Frequent devaluations induce depositors to hold their assets offshore in hard currencies to minimize the risk of devaluation losses in their deposits. In countries like Indonesia and Kenya this results in a short term deposit base in local commercial banks, and an unwillingness by these banks to make term loans.

B. Underdeveloped Financial (and Regulatory) System.

i. Collateral Recovery: It was often particularly difficult for IFIs to recover security from smaller enterprises. Reasons for this included lack of legal protection for security interests in property such as agricultural land and personal residences, and the high costs of litigation.

ii. Lack of Suitable Financial Instruments: Particularly in the case of trade finance and equity investment, local institutions sometimes lacked the necessary legal and procedural instruments to provide appropriate funding to smaller enterprises.

C. Intra-bank Deficiencies in Knowledge or Capacity.

i. Lender Inexperience: The apparent conservatism of financial institutions appeared often to be a result of inexperience on the part of individuals and organizations regarding the special needs of smaller enterprises. Prudence on the part of lenders translated this inexperience into deliberately high estimates of risk. Reluctance to finance smaller enterprises also reflected an institution's recognition that dealing profitably with smaller borrowers may entail substantial investment in initial mistakes and in development of new skills and procedures.

Recommendation: Project design must begin by identifying which constraints are preventing credit from being provided to smaller enterprises. Identifying constraints requires a careful examination of the local financial market and government intervention in this market.

2. Finding: Certain capital market constraints affecting smaller enterprises can be influenced by small pilot, demonstration and/or capacity building projects. Others are likely to be influenced by projects only when the projects are massive in scale and/or are combined with related policy reform efforts.

Discussion: Each of the above constraints suggests one or more measures that, if successfully undertaken, can help to reduce or eliminate the constraint. Some of these capital market constraints can be attacked through small projects, while others require projects linked to a policy reform program.

An example of a constraint that can be attacked using a small project without an accompanying policy reform effort is lender inexperience with SMSEs. Projects that induce local banks to experiment with SMSE lending can demonstrate to financial institutions that SMSE lending is profitable. In addition, the project can assist IFIs in building capacity to lend to small businesses by improving marketing, credit analysis and loan management procedures.

Credit projects also highlight the problems that government policies cause for smaller businesses. For example, the Bank Niaga Project demonstrated that private banks cannot lend on an unsubsidized basis to businesses that are eligible for government subsidized credit, and the Kenya Commercial Finance Company Project demonstrated that under current interest rate ceilings in Kenya, small business lending has too high an opportunity cost to be sustained without donor subsidies.

Types of Projects for Solving Constraints

A review of the fourteen cases suggest that there were five ways small credit projects addressed credit market constraints. These five ways correspond to five types of loan projects.

Three project types have shown significantly greater success than others in encouraging financial institutions to provide credit to smaller enterprises and in addressing basic financial market constraints. These are demonstration, capacity building, and credibility building projects. Following is a discussion of project types:

(A) Pilot Projects identified in the cases tested models and mechanisms for providing credit to smaller enterprises. Projects of this type were usually designed primarily to develop and test techniques, approaches, procedures and hypotheses, and are sometimes termed research and development projects.

In many cases, a pilot project was a first step in identifying viable solutions to local constraints. Implicit in such projects was the assumption that models must first be developed and tested before larger replication and demonstration projects can disseminate these new approaches to SMSE lending. Examples of pilot projects include:

- Securitized Trade, a project that tested a mechanism for raising trade finance funds by using trade paper as security;
- The Thai Danu Bank, Far East Bank and Trust and Bank Niaga projects, which tested the "set off" model of loan guarantees;
- The Business Venture Promotion Project, which developed an institutional model for venture capital that maximizes involvement of local businesses;
- The Accion Project, which tested mechanisms enabling microenterprise lenders to obtain funds from commercial credit markets.

(B) Demonstration Projects. Many projects aim to demonstrate to key individuals and organizations new or better ways of doing things.[3] Implicit in demonstration projects is the assumption that lack of first-hand experience with particular kinds of lending is a major factor inhibiting local financial institutions from serving certain business markets. It is also assumed that exposure to these markets and to new techniques for serving these markets will make it clear to local institutions that small business lending can be profitable.

There were three demonstration approaches used in PRE credit projects. First, projects were used to demonstrate that a particular market can be served profitably by private institutions. Second, projects demonstrated that there are financial instruments or procedures that enable local institutions to lend to smaller businesses. Finally, projects sought to demonstrate to local financial institutions and governments that there are specific constraints that make it difficult for smaller businesses to obtain credit from the private sector.

Examples of projects that demonstrate the viability of an underserved market include KCFC, Thai Danu Bank, Bank Niaga and Far East Bank and Trust projects. Credit projects that set out to demonstrate that a particular market niche is profitable often induce local IFIs to experiment with that market. Through first-hand experiments, IFIs can determine from their own experience whether it is worthwhile to lend to a particular type of business. In general, for demonstration projects of this type to work, it must be true that the key missing factor is that local institutions lack experience or knowledge of the viability of a particular market.

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[3] Such as loan marketing techniques that target smaller businesses, credit appraisal procedures suited to smaller accounts, collateral requirements for small businesses.

Several cases provide examples of projects that demonstrate lending techniques or procedures:

- The FINIBER and FINANQUIL projects in Ecuador provided local finance companies with a loan guarantee model to stimulate export lending;

- Business Venture Promotion demonstrated to Thai financial institutions how venture capital companies operate;

- The ACCION Microlending Project showed micro-lending institutions how to use guarantees to obtain funds from private commercial credit markets;

- The Bank Niaga, Far East Bank and Trust, KCFC and Thai Danu Bank projects provided models for lending procedures for small businesses;

- The Securitized Trade Project was intended to demonstrate how private corporations in Turkey could obtain long-term fixed rate credit from international financial markets.

Designers of projects of this type assume that local institutions are inexperienced, or lack information about effective procedures and techniques for lending to the target group, and that if they were exposed to workable approaches, they would adopt them.

Projects can serve to demonstrate constraints as well as solutions. Projects that demonstrated problems caused by financial market constraints include:

- The Bank Niaga Project, which showed the problems arising from the government's credit and credit insurance subsidy programs;

- The Thai Danu Bank Project, which gave a clear example of ill effects on rural lending caused by government administered interest rate ceilings;

- The WAFABANK Project, which made it clear to the government that foreign currency banking regulations needed reform.

In many cases, demonstrating constraints caused by government policies may be an unintended by-product of implementing a credit project. Nevertheless, these projects do provide opportunities for policy dialogue on these constraints.

(C) Capacity building projects often seek to rectify deficiencies in human, organizational or physical abilities in local financial institutions. The purpose of a capacity building project is to provide missing skills, systems and procedures through technical assistance. Projects of this type are also frequently termed infrastructure projects.

The PRE projects reviewed aimed to build capacity through two means:

i. Training IFI staff in lending techniques and procedures for a particular target group. Many projects provided training grants to IFIs in order to build small business lending capabilities. These grants were usually for $50,000, and were generally used to hire local consulting firms to provide specialized training. All the grants listed on page *** (with the exception of Accion, which received a grant to pay staff costs) were intended to build capacity.

ii. Inducing IFIs to gain first-hand experience with lending to a particular type of businesses. By lending to new, smaller clients, IFIs accumulated valuable experience with these markets, and could experiment with changes in procedures needed to establish a profitable lending program for targeted businesses. The assumption made in this type of project is that institutions lack experience or financial instruments and procedures suited to this kind of lending, that these deficiencies keep institutions from lending to the target group, and that the lending procedures to overcome these deficiencies must be developed by experimentation and practice.

(D) Credibility Building Projects. A fourth type of project sought to establish credibility, build personal relationships and collect data necessary for participation in a larger private sector program. Credibility building projects were often used for A.I.D. to "get a foot in the door", an initial step in establishing ties in local capital markets on which later projects and policy dialogue efforts can be built.

This type of project is particularly important when a financial market development program is beginning, serving as a mechanism to build relationships with local people and institutions, to "advertise" the types of assistance available under the program, and to discover how the local financial markets actually operate. Implicit in such projects is the objective of maximizing program (rather than project) impact. Examples of credibility building projects include:

- The Bank Niaga Project, which allowed both PRE and USAID/Jakarta to gain direct experience with constraints in Indonesian financial markets resulting from subsidized government credit programs;

- The LIK Project, which established a relationship between USAID/Kenya and Industrial Promotion Services-Kenya.

- The Thai Danu Bank Project, which provided PRE and USAID/Thailand officers opportunities to build relationships with Thai bankers, and established the credibility of A.I.D. in banking and finance areas.[4]

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[4] The Siam Commercial Bank and Thai Danu Bank projects provide excellent examples of the critical role of credibility building in private enterprise programs. These two guarantee facilities were followed by a PRE project to establish a venture capital firm in Thailand. The response of local bank officers to the idea of investing in the new venture capital firm is best summed up in the words of one senior officer: "We have seen A.I.D. play a leading role in improving our capital markets. When they approached us with the venture capital idea, we decided that if they felt it would strengthen our financial markets, then we would join in. We have seen the innovative role that A.I.D. can play."

(E) Operational Projects. Operational projects seek to provide critical goods and services directly to a target population by replacing or bypassing traditional organizational channels. Implicit in such projects is the assumption that "projectizing" routine operations is an efficient way to satisfy a pressing short-term need (such as foreign exchange), and that continuing needs will be met by additional projects or by absorption of project activities by existing organizations. The key here is the shift in focus away from institution building and toward providing short term benefits.

Examples of operational projects include Far East Bank and Trust, which injected much needed export financing into the financial markets in the Philippines during a recession; WAFABANK, which added $2.5 million in import credit during a period when very little import credit was available in Morocco; and the FINABER and FINANQUIL projects, which made $2.9 million in import credit available when foreign exchange was scarce in Ecuador.

When dealing with structural problems that prevent smaller enterprises from getting loans from private financial institutions, it was found that projects that were only operational often missed opportunities for larger policy reforms and institutional development. It was also found that operational projects were rarely associated with any permanent changes in commercial intermediaries. Providing local businesses with term loans under a project that stops lending after a few years contributed relatively little to longer term solutions of financial market problems. Generally, therefore, successful operational projects needed demonstration, capacity building and credibility building objectives in order to bring about important and lasting effects.

Direct loan projects often provided important direct benefits to local economies, while also contributing to the AID/PRE goals of advancing privatization and capital markets development. For example, the Thai-RFM Project enhanced the competitiveness of the Thai fresh meat industry, generated a supply of fresh meat and pork for export, helped to privatize the Thai slaughter industry and created demand for cattle produced by small farmers. Similarly, Kenya Leather Industries produced a supply of locally-produced, high quality leather for use in local leather fabrication industries.

Attacking Constraints using Project Strategies

Some constraints facing smaller enterprises are very difficult to "solve" using small credit projects. These constraints are often the result of government regulations or policies, with examples being government administered interest rate ceilings and overvalued local currency. Under these circumstances, solving the problems facing smaller businesses requires government policy reform. Other constraints reflect lack of knowledge, skills, experience, or mechanisms in the local financial market. These constraints are often resolvable by building local capacity for SMSE lending.

The case studies suggest that small credit projects can help in solving both of these types of constraints. The most effective project strategies were: (i) demonstration of lending mechanisms, markets or policy issues (demonstration strategies); (ii) building capacity to serve new markets, use new instruments, and to carry out policy reform (capacity building strategies); (iii) building relationships and credibility to establish a development agency's role in financial markets (credibility building strategies).

Each strategy has a logic and a set of management implications associated with it. Pilot projects were sometimes successfully used to develop means of lending to smaller enterprises. Once models were established, however, substantial impact was achieved only if they were sustained and replicated on a large enough scale to have widespread effects. Thus, pilot projects required the addition of demonstration and capacity building strategies in order to be fully effective.

Both pilot and demonstration projects have been effective vehicles in some cases for introducing new financial mechanisms into a country. For example, the ACCION Project showed how loan guarantees can be used to raise capital on local financial markets for microenterprise lending. The Business Venture Promotion Project demonstrated to local financial institutions how a venture capital company can operate in Thailand. The Securitized Trade Project was intended to demonstrate how trade receivables can be used to secure international borrowings, but this model was not fully implemented. In such cases, sustainability depended on the commercial viability of the new approaches, and replication depended on dissemination of information about successful efforts to other local institutions.

Demonstration, pilot, and operational projects have been effective in inducing local IFIs to experiment with lending to new types of clients. Well designed projects usually offered IFIs loans or guarantees to induce them to lend to a particular target group. In most cases, the target group included businesses that were not served adequately by private credit institutions. In several cases, once the IFI gained experience with the target group, it assessed whether or not loans to this group were profitable. If the loans were profitable, then the IFI often continued this lending after assistance from PRE ended.

Once capacity to serve the target market has been strengthened by a project, however, dissemination of these new skills and knowledge among local financial institutions is necessary. Dissemination typically requires follow-on projects for other local financial institutions to establish similar lending programs and financial mechanisms, and provision of information about successful projects through bankers' associations and similar business organizations.

PRE pilot projects have often been followed by Mission projects aimed at spreading successes to a wider audience. One example is the Siam Commercial Bank Project, which led to the Thai Danu Bank Project and then to the Small Industries Credit Guarantee Fund set up by USAID/Thailand. Other examples include the Far East Bank and Trust Project which led to a subsequent PRE project involving three local commercial banks, and the KCFC Project which was followed by a major SMSE credit project carried out by USAID/Kenya.

Establishing credibility of a USAID Mission is often an important prerequisite to engaging a government in policy dialogue. As mentioned above, several projects built A.I.D.'s credibility within local financial markets through activities that (i) demonstrate the agency's ability to initiate effective financial market development projects; (ii) establish local contacts within the business community; (iii) demonstrate the resources that the agency has to contribute to private sector development. These activities are often key foundations for subsequent policy dialogue.

Both pilot and demonstration projects have been effective in encouraging policy dialogue efforts carried out by A.I.D. Missions. Projects such as Thai Danu Bank, FINADE, Bank Niaga and Far East Bank and Trust demonstrated that unsubsidized small business credit models can work in their respective countries, and highlighted the constraints placed on local financial markets by government regulations and subsidy programs. In most cases, however, credit projects were effective in encouraging changes in financial market policies and regulations only when they were coupled with a strategy for policy dialogue.

Solving basic financial market problems often required activities to draw public attention to policy and regulatory problems. Thus, most small credit projects seemed to require both a dissemination strategy for successful models, and a policy dialogue strategy to help resolve the basic policy or regulatory constraints. When linked to policy reform efforts, projects helped identify opportunities for policy dialogue, and provided specific issues to be addressed in policy dialogue efforts.

In many cases, longer term dissemination, replication and policy dialogue efforts were actively supported by the local USAID Mission's private sector program. For example, both Kenya and Thailand Missions treated PRE credit projects as components of their larger programs. In both examples, success in resolving financial market conditions facing smaller enterprises was heavily dependent upon ongoing dissemination, replication, credibility building and policy dialogue activities carried out by the Missions. In both cases, Mission activities were guided by larger, well planned private enterprise development programs.

Recommendation: Projects are most effective in resolving underlying financial market problems when they have several features:

i. A project plan (or logical framework) that includes key long-term objectives such as demonstration, capacity building, and credibility building;

ii. Management that emphasizes long-term, higher level objectives such as demonstration, policy reform, and credibility building as well as direct delivery of credit.

3. Finding: Key determinants of a project's success in stimulating self-sustained lending to smaller businesses are the profitability of a particular small business market niche, and development of cost-effective means of delivering credit to this market.

Discussion: Many factors cause local banks and financial institutions to avoid lending to small enterprises. Loans to small businesses are perceived as more expensive to administer (as a proportion of total interest revenues) than big loans, and more expensive to collect in cases of default. In addition, smaller enterprises are often newer businesses, are characterized by less sophisticated financial reporting than large businesses, and are often in market niches that are not traditionally served by formal sector private financial institutions.

For these reasons loans to smaller enterprises are often less profitable and have greater credit risk than loans to large enterprises.

Inducing local IFIs to lend to smaller enterprises requires demonstrating that these loans <u>can be made on a profitable basis</u>. Making profitable loans, in turn, usually requires reducing administrative costs of lending and loan collection, charging higher interest rates and account fees on loans, and learning how to minimize credit risks. In some cases, however, local IFIs have <u>unreasonably</u> high estimates of the costs and risks associated with small enterprise lending. In these cases, private financial institutions can begin profitable loan programs for small enterprises with minimal change in their usual credit procedures once they see that this market is profitable.

Credit projects have been useful in helping IFIs to overcome many impediments to small business lending. For example, the Thai Danu Bank, Bank Niaga and Far East Bank and Trust projects contributed to the development of lending procedures that reduced the administrative requirements of making and managing small loans. The projects accomplished this through a combination of training and experimentation with lending procedures.

In successful PRE projects, inducing local IFIs to lend to businesses previously under-served by private financial institutions required allowing the IFIs themselves to identify viable market niches, to develop new administrative procedures for that market, to quantify the risk premiums that need to be charged, and to create effective client selection procedures. Examples of banks that accomplished this include Thai Danu Bank, which used the PRE project as an opportunity to develop an effective rural and agribusiness lending program; Far East Bank and Trust, which developed and refined its small business export credit program with help from the PRE project; Bank Niaga, which used the resources of the PRE project to implement its consumer lending strategy; and FINADE, a bank that developed its agribusiness lending activities under the project. Another example comes from the Accion Project in Latin America. Here, local commercial banks in Mexico and Paraguay began lending to microenterprises either directly or through Accion affiliates. In both countries, banks also decided to set up microenterprise programs using their own funds. These programs gave the banks a chance to experiment with the new market.

<u>Recommendation: Designs for small business credit projects should include (1) feasibility analysis of the markets to be served, (2) agreement with the institutions involved on potentially profitable market niches that are acceptable under the project, and (3) packages of technical assistance and training to help the financial institutions develop improved lending procedures suited to the target market.</u>

4. <u>Finding</u>: Project benefits will be sustained after project termination only if the intervention initiates long-term 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, as noted above the small size of A.I.D. projects relative to the problems they

address, and their limited duration, should prompt donors to use credit projects to seek more permanent institutional change. Only through institutional change can the project continue to produce benefits for SMSEs after the project's end.

Institutions that are subject to change include not only organizations receiving A.I.D. funds (such as Kenya Commercial Finance Company, Ram Dis Ticaret, WAFABANK, Antigua Shrimpery Limited and Thai Danu Bank), but also other financial institutions involved in the project (such as Bank of Antigua, Industrial Promotion Services-Kenya, and other local commercial banks), government agencies (such as the Central Bank, ministries of agriculture, industry and finance), other local industries and financial institutions, and 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 and management for institutional objectives. Institutional effects also take a considerable time to materialize and to be assimilated by banks. It is perhaps for this reason that the institutional effect of projects reviewed were, in many cases, less encouraging and obvious than those projects' direct development impacts.

There are three levels at which long term change can be sought:

(A) Continuation of project or comparable activities by the original IFI;

(B) Adoption of these practices by other IFIs;

(C) Government policy changes.

Each of these must be approached in a different way. For example, sustainability of lending by the original IFI appears to depend largely on the profitability of the target market. This in turn is influenced by:

i. whether the lender can obtain an adequate spread in subsequent lending;

ii. whether the lender can obtain appropriate sources of funds necessary to provide the credit products that the target market needs, such as long term or foreign currency funds;

iii. whether the lender has learned enough about the target group or type of service to judge risks and profitability;

iv. whether the operation can be integrated into the usual operations of the financial institution.

Often these conditions are difficult to satisfy, as the lack of one or more of them may have made the project necessary in the first place.

Perhaps the most important condition is whether the IFI can obtain sufficient return on its loans to the target group. Running a profitable lending program for smaller businesses may also require that an IFI change its:

Perhaps the most important condition is whether the IFI can obtain sufficient return on its loans to the target group. Running a profitable lending program for smaller businesses may also require that an IFI change its:

(a) Loan marketing procedures;
(b) Credit application and approval procedures;
(c) Means of predicting and providing for anticipated loan losses;
(d) Standards for loan collateral;
(e) Procedures for administering and monitoring loans;
(f) Procedures and techniques for collecting non-performing loans.

A major function of IFI projects is to give participating IFIs opportunities to develop suitable procedures during the project's life. PRE's credit projects did this through two means: first, by providing IFIs opportunities to experiment with loans to the target group under circumstances of limited risk; and second, by giving IFIs training in new techniques of loan appraisal and management. Once the new procedures and techniques are developed, experience suggests that institutions usually will sustain the lending program after the project ends as long as this program is profitable.

PRE projects differed greatly from one another in terms of the profitability of the new loan programs introduced. The KCFC Project did not solve the basic problems that prevented banks from obtaining longer term funds, nor did it establish profitable small business lending procedures, and therefore project sustainability was doubtful. Thai Danu Bank, in contrast, used the project to build a branch network outside of Bangkok and thus will have a permanent infrastructure to sustain targeted lending after the project.

Often sustainability may be partial, but still significant. Some of Far East Bank's clients, for example, graduated from guaranteed to unguaranteed loans after proving to be worthy clients. In some cases, there were small changes in bank attitudes, such as reduced collateral requirements, knowledge of a target group or understanding of cash flow lending.

Spread to other institutions usually occurred because competitors of the original IFI decided they wanted to participate in similar projects. For example, as a result of the KCFC Project in Kenya, two other large commercial banks in Kenya decided to participate in USAID/Kenya's Rural Private Enterprise Project. In the Philippines, PRE began three guarantee facilities as a result of the demand stimulated by the Far East Bank and Trust Project.

Changes in government policies only occasionally result from 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 viewed as part of a longer series of efforts by A.I.D. and other donors to use projects, policy dialogue, and other interventions to encourage change.

<u>Recommendation: Given their small size relative to the economic problems they address, A.I.D. enterprise development projects should pursue 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>.

5. Finding: Sustainability and broader institutional impact require charging interest rates and fees that reflect the true cost of providing credit to businesses in the target markets.

In most of the projects studied, PRE provided a guarantee to an IFI to cover 50% of the risk of lending to smaller businesses, and received a fee in exchange for the guarantee. The fee charged to IFIs was determined by both PRE's estimated risk cost of providing the guarantee and what the local market would bear.[5]

Loans provided to targeted businesses under the facility were then provided from the IFI's own funds at prevailing local market rates. Thus, the IFI was obliged to raise funds at prevailing rates, charge whatever the market would bear for loans, assume 50 percent of the credit risk, and pass 50 percent to A.I.D. for a charge that approximated the real risk cost.[6]

Using this market-oriented approach promotes institutional improvements in several ways. First, to lend under the guarantee, an IFI must raise funds locally, and this reinforces the local commercial credit system by encouraging a match between deposits and loans. This small point is in fact an important difference with many donor-run credit programs, because many of these provide subsidized funds. Providing subsidized funds weakens demand for local deposits, and disrupts the market balance between supply of funds (i.e., local deposits) and demand for loans (i.e., local business credit needs).

Because PRE guarantee projects do not subsidize the IFI's funds, the IFI can assess the profitability of the target market under the same circumstances that it would face under actual market conditions. In addition, because the IFI does not receive a windfall profit from funds subsidies, it has an incentive to modify its usual operations to minimize costs over the long term.

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[5] It should be noted that very few guarantee programs worldwide offer such a low guarantee percentage. PRE has been able to use this relatively small guarantee effectively because:

(1) PRE selects IFIs that have independently adopted strategies of attempting to increase their lending to the designated target group;

(2) Institutions chosen by PRE have historically low loan loss ratios, sound loan screening procedures, and select low risk clients, so their actual risk exposure under PRE projects has been very low (generally in the area of .5% to 1.5%);

(3) PRE loan projects are quite small, and do not significantly increase the risk exposure of participating institutions. Therefore, IFIs are willing to accept a lower guarantee coverage then they would typically accept under a larger program.

(4) Procedures for obtaining payment under the guarantee in the event of loan losses are relatively simple and quick in PRE projects.

[6] In some projects, PRE does not assume any of the credit risks of loans to sub-borrowers.

In numerous PRE projects, the fact that there was no credit subsidy encouraged participating IFIs to change their lending program to find profitable ways of lending to the target market. Banks such as Far East Bank and Trust, Bank Niaga, Thai Danu Bank, and WAFABANK were aware that they had to charge interest rates in the target market that matched those of their competition. In several cases this induced the IFIs to streamline lending procedures for smaller businesses and to search for new ways of identifying good clients.

Providing smaller borrowers with unsubsidized credit often gives small businesses access to loans that are <u>much cheaper</u> then their usual informal sector sources. Businesses that received loans under the Accion, KCFC, Thai Danu Bank and Far East Bank and Trust projects were small enough that many would have borrowed from informal sector lenders if they had not received guaranteed loans. Thus, although they did not receive "subsidized" loans, their interest rates were significantly lower than the prevailing informal market rates.

Even microenterprises are usually best served by programs that provide unsubsidized credit. This is illustrated by the Accion case. In Paraguay, microenterprises were given loans at a yearly interest rate of 114%. This rate covered the IFI's lending costs, including training and technical assistance, and was considerably lower than rates that micro-businesses were charged by informal moneylenders. The rate that microenterprises pay under the project is also 44% higher than rates that local commercial banks charge to eligible borrowers, and 37% higher than the rates charged by finance companies. Because the rate offered under the project is between the prevailing rates charged by commercial banks and moneylenders, microenterprises get a major interest rate reduction from informal sector rates, but nevertheless have an incentive to seek loans from local commercial banks in order to receive even lower rates.

<u>Recommendation: The higher the credit or risk subsidy provided under a program, the more likely it is that the program will be unsustainable and will harm the development of local financial markets. Provide as little subsidy as possible under credit projects.</u>

6. <u>Finding</u>: Direct loans to enterprises offer special problems and opportunities for improving local capital markets.

<u>Discussion</u>: The direct loan projects studied were generally more costly to implement than IFI projects, but often had major institutional and policy impacts that would have been difficult to achieve through other types of project or policy dialogue efforts. Significant impacts have included:

* <u>Creation of new industries</u>.

The Leather Industries of Kenya, Thai-RFM, and Business Venture Promotion Projects all played key roles in establishing new industries in their respective host countries. These industries set industrial production and pricing standards, and served as models for other private companies entering the industry.

The two direct investments in Thailand also encouraged competition within their respective industries, thereby encouraging economic efficiency. The Thai-RFM Project set up a modern slaughterhouse that now competes directly with government slaughterhouses and other local private meat processing companies. The Business Venture Promotion Company stimulated competition among private commercial banks and finance companies in the direct equity investment market. The Leather Industries of Kenya Project substantially modernized Kenya's leather industry.

Similarly, these projects all had industrial linkages to raw materials suppliers and finished goods buyers that encouraged competition, quality improvements, increased value added, and development of new industries. Leather Industries of Kenya increased the technological competence of the leather industry in the country, providing backward linkages to cattle farms, and forward links to leather goods manufacturers. Although more difficult to assess, the Business Venture Promotion Project stimulated demand for specialized technical and financial services, thereby strengthening these infant industries in Thailand. All direct loan projects that established new productive plants created demand for locally produced capital goods, stimulating local capital goods industries.

- Continued policy dialogue with the host government and local financial institutions.

The Business Venture Promotion Project raised several important policy issues in Thailand, including the role of sound business proposals, accounting systems and financial reporting in securities markets. The Thai-RFM Project served as a basis for general discussions of government privatization and export promotion policies, and provided a model example of private sector involvement in extension services to small farmers. This project also played a major role in helping the government develop and implement a privatization policy for the meat industry. In addition, both the Thai-RFM and the Kenya Leather Industries projects had significant although small impacts on government environmental waste treatment policies, by setting standards for their respective industries.

- Transfer of technology

The Thai-RFM, Leather Industries of Kenya and Antigua Shrimpery projects all encouraged transfer of technologies that were new in their host countries. Two of the projects, Thai-RFM and LIK, also transferred modern waste treatment technologies that later were adopted by the host governments as industrial standards for these industries.

- High visibility for A.I.D.

The Business Venture Promotion, Leather Industries of Kenya and Thai-RFM companies demonstrated to local business communities in Thailand and Kenya that A.I.D. could play a leading role in financial markets development and could work effectively with the private sector in industrial development.

Problems of Direct Loan Projects

Direct loans tend to be riskier for the sponsoring agency than IFI projects, and success depends critically on the involvement of a strong local partner. As an indication of the risk involved, one of five direct loan projects examined in this set of case studies failed completely. In contrast, no IFI projects have failed financially.

Strong partners played critical roles in the Thai-RFM, BVP and LIK projects. In two of these cases, partners maintained the confidence of other investors despite troubles during business start-up. In the one case that failed, Antigua Shrimpery Limited, lack of a strong principal partner was cited as a main reason for failure.

The five direct loan projects reviewed demonstrate clearly that successful direct loans rely heavily upon project management to maintain the confidence of investors during start-up. The critical qualities possessed by project backers were technical and managerial expertise to carry out the project largely unassisted, and financial stability to weather problems commonly encountered during business start up.

A second problem commonly associated with direct loan projects is that they tend to be expensive to implement. The direct loan projects examined required considerable staff time to set up the new business, to obtain government approvals and permits to operate, and to keep partners involved in the project. All direct business loans examined here required significantly larger management efforts by A.I.D. staff than PRE's usual IFI projects.

Recommendation: Consider using direct loan projects when the objectives include the following: (1) privatization of an industry; (2) highlighting constraints introduced by government, industrial and state enterprise policies; (3) establishing a new industry. Use IFI projects when the objectives include (1) encouraging marginal changes in banking practices; (2) highlighting constraints on the financial system introduced by government financial market regulations or programs; and (3) providing a limited amount of credit to a small target group.

7. Finding: While relatively small credit projects can assist local IFIs and governments to make policy and procedural changes, such projects are rarely sufficient to induce meaningful changes if the government or local IFIs collaborating on the project do not share the project's objectives.

Discussion: Experience from IFI projects suggests that project objectives were achieved only where the business strategy of the IFI fit the market niche and lending objectives implicit in the project. For example, the objectives of the Thai Danu Bank Project included providing loans to rural businesses with net fixed assets less than $400,000. Just before the project was designed, the bank adopted an objective of beginning a rural small business lending program. This strategy was a means of meeting government rural lending requirements and diversifying the bank's client base.

Similarly, under the Accion Project, financial institutions in Mexico and Paraguay began lending to microenterprises because they thought this would be a profitable new market. Their involvement with the PRE project was largely a means breaking into this market by working with existing microenterprise programs.

In the Far East Bank and Trust and Bank Niaga cases, the banks had adopted strategies of lending to smaller companies in order to diversify away from their traditional larger corporate markets. In the Far East Bank and Trust case, the target market under the bank's new strategy was the same as the project's target market, with the result that the bank successfully "hit" the project's target market. In the Bank Niaga case, the bank's strategy was to expand lending to high net worth individuals and successful professionals. This market was similar to the market that PRE wanted to reach, but not the same. To the extent that the bank's target market overlapped with PRE's, the bank successfully "hit" the clients that PRE wanted to reach. To the extent that Niaga's target market did not fit PRE's target group, however, the bank "stretched" the terms of the loan agreement with PRE and provided guaranteed loans to businesses that were outside of the group desired by PRE.

In the Securitized Trade Project Ram Dis Ticaret, a large Turkish trading company, did not have a corporate policy of lending to the target group that PRE wanted to reach. The result of this mismatch of targeting objectives between PRE and the trade finance company was that the company continued to lend to those few smaller businesses that were already its clients, but refused to add new small businesses to its portfolio. Because the company pursued corporate objectives that did not coincide with the project's, the target market that PRE had intended to reach was not served.

The Thai-RFM Project provides an excellent example of a project in which PRE and key agencies in the host government had common objectives. Under this project, PRE set out to establish the first private slaughterhouse in Thailand. Up to that point, the government had dominated the industry with its large, inefficient and unhygienic facilities. PRE and local USAID Mission officers worked with private investors, the Government's Department of Livestock and Ministry of Agriculture that supported the privatization of this industry for three years before the Interior Ministry and Department of Defense (the agencies that ran the public slaughterhouses) agreed to allow private slaughterhouses to be set up. Without the active support of the Ministry of Agriculture and Livestock Department the project would not have succeeded.

<u>Recommendation: For credit projects, select local financial institutions that have business strategies that support the project's objectives. The IFI's objectives must include undertaking a lending program for the target group specified in the project.</u>

<u>For projects that require policy or legislative changes by a host government as a prerequisite for implementation, it is important during project design to identify government agencies that support the project's objectives and to involve these agencies actively in project implementation.</u>

8. Finding: Opportunities for promoting policy dialogue with host country officials arising from projects are often informal and unexpected.

Discussion: Credit projects often play a key role in supporting policy dialogue. Examples include:

Thai RFM Project: For many years, the USAID Mission in Thailand has suggested to the Thai Government that the government should undertake a privatization program. The Thai-RFM Project provided an excellent example to the government of the benefits of privatization, demonstrating how allowing private companies to compete with public ones increased market efficiency. The Mission has used the project in its ongoing efforts to show the government the benefits of this type of policy.

Thai Danu Bank: The Thai Danu Project and the Mission project that followed (the Rural Industries and Employment Project) helped the Mission to encourage the government to amend its interest rate ceilings. These ceilings have been a key constraint limiting credit to rural areas.

WAFABANK: The WAFABANK Project contributed to A.I.D. policy dialogue efforts in Morocco by highlighting damage to the economy caused by foreign exchange controls and credit restrictions.

Bank Niaga: The Bank Niaga Project could have demonstrated to the government key constraints in local financial markets if it had been managed for this opportunity. The Mission had carried on dialogue with the government for several years on liberalization of financial markets. Mission private sector officers were aware that large government risk and interest subsidies for SMSE credit made it difficult for private banks to lend in this market. The Bank Niaga Project provided a clear example of these difficulties by promoting SMSE lending on a non-subsidized basis. However, because the Mission was not actively involved with the project and there was no public dissemination of information about the project, the Bank Niaga Project did not play a significant role in the ongoing policy dialogue efforts of the Mission.

Finiber and Finanquil: Although overall impact of these projects was low, they allowed the USAID Mission in Ecuador to begin a discussion with the Ministry of Finance on adjustable rate instruments for import credits. This dialogue also led to the government approving the issuance of public import finance bonds.

In general, project activities have revealed a number of government policy and procedural constraints that can form the basis for ongoing policy dialogue efforts. These issues provide concrete illustrations of the serious problems that often result from specific government policies.

Recommendation: Project managers and evaluators should identify how each project contributes to A.I.D.'s ongoing policy dialogue in a host country. During implementation it is important for managers to seek productive areas for policy dialogue. This requires careful monitoring of how the project is affected by capital market constraints.

Policy issues arising from projects are best (a) identified at the project level on a periodic basis (perhaps once a year); and (b) acted on through use of resources available for policy dialogue and institution building. These resources can include provision of information to government agencies and NGOs involved in policy dialogue, and strengthening institutions such as business NGOs, research institutes, and government policy agencies.

III. TARGETING

Inducing and assisting financial institutions to provide credit or services to an under-served target group is an essential element in solving financial market problems facing smaller businesses. As a result, the issue of targeting plays a key role in project design, implementation and evaluation. This chapter summarizes findings and recommendations from the fourteen cases concerning targeting credit to smaller enterprises.

1. Finding: Careful definition of a project's target group is a key part of achieving project objectives.

Discussion: The following table lists the target markets and businesses actually served for each of the IFI projects reviewed here:

PROJECT	TARGET MARKET	ACTUAL MARKET SERVED
KCFC	Rural companies with total assets of less than $1.5 million.	Rural manufacturers, food processors, distributors and transport companies; all within project asset limits.
WAFABANK	Private companies owned by Moroccans; net fixed assets below $763,800.	Importers of capital goods and raw materials; all borrowers within project asset limits.
Thai Danu Bank	SMSEs outside Bangkok with under $400,000 net fixed assets.	Agricultural and manufacturing companies outside Bangkok; all within project limits.
FINADE	Nontraditional exporters with net fixed assets less than $1 million.	All borrowers were within project limits.
FINIBER/ FINANQUIL	Agribusinesses with net fixed assets less than $300,000.	Finiber: 28% of clients were agribusinesses; 63% had net fixed assets over the asset limit. Finanquil: only two loans made, both to qualifying agribusinesses.
Far East Bank & Trust	SMSE exporters with net fixed assets of less than $1 million.	Manufacturers in furniture, garments, agricultural and marine industries; almost all were within project limits.

Bank Niaga	SMSEs outside Jakarta with less than $400,000 in monthly gross revenues; should be for new starts or expansions of existing businesses.	Manufacturers, insurance, publishing, and other service companies; 25% of borrowers were greater than project limit; no new starts, 65% were expansion companies.
Securitized Trade	70% of all borrowers should be exporters with net fixed assets (excluding land) less than $1 million. All transactions financed should be export related.	Funds were mixed with Ram's general pool of credit funds. Thus, it was impossible to identify specific PRE program borrowers. In the general portfolio, 46% of borrowers qualified in terms of net fixed assets. 84% of loan funds were provided for export transactions.
Accion Micro Lending	Enterprises w/5 or fewer employees, and fixed capital of $2000 or less.	71% of borrowers had 5 or less employees, and 21% had fixed assets less than $2000.

Six of nine IFI projects sought to induce an IFI to lend to a market that the institution previously had not served.[7] The remaining four projects involved supporting (and improving) the lending programs that IFIs already provided to targeted sectors.

Of the six projects that attempted to induce IFIs to lend to a new type of client, three (Far East Bank and Trust, Thai Danu Bank and Bank Niaga) appear to have stimulated changes in lending behavior that will be sustained after the end of the project. In the remaining three projects, either the IFI made little or no change in its portfolio and lending procedures, or the IFI lent to the target group with the intention of discontinuing these loans after the project.

Two factors seemed to determine a project's success in inducing local institutions to lend to new clients. First, projects seemed to be successful if the IFI had adopted a corporate strategy of lending to the target market. The IFI may have adopted this strategy because of factors entirely independent of the PRE project, including declining profits in traditional markets, substantial profit potential in target markets, government regulations that compelled the IFI to lend to the target market, and perceived need to diversify client base. Once the IFI adopted lending to the target market as a corporate objective, the PRE project simply helped the institution do what it already intended to do.

The second factor associated with successful targeting was that the target market was <u>profitable</u> for the IFI. In practical terms, this meant that the IFI was able to charge interest rates that gave it a spread that covered the administrative costs of making the loans, a risk premium that covered anticipated costs due to non-performance and default, and a reasonable profit.

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[7] These were Bank Niaga, Far East Bank and Trust, Thai Danu Bank, KCFC, Finiber/Finanquil, and Securitized Trade.

In target markets with interest rate ceilings, excessively small loans, poor payback practices or available subsidized credit, it was often difficult for an IFI to establish a profitable loan program.

In general, when the target market in a credit project was not profitable, either project IFIs did not comply with loan targeting requirements or they did not continue lending to the target group after the project. The Finiber/Finanquil Project is a case where IFIs could not establish a profitable lending program for the target group because there was little demand for unsubsidized credit from this market. The KCFC Project targeted businesses that turned out to be only marginally profitable for the IFI because of poor payback practices and high administrative costs of the lending program.

Some IFI projects targeted businesses that the IFI already served. Examples are the Accion, WAFABANK, and Finade projects. In all three cases, the IFIs already had well developed lending programs for businesses targeted by the project. In these cases the projects sought to either (i) alleviate a temporary financial markets constraint (shortage of foreign exchange in Morocco and Dominican Republic), or (ii) provide a new mechanism for the IFI to obtain funds from private sources (Accion). When the IFI is already lending to the target group before the start of the project, the targeting issue becomes a less important project objective.

Recommendation: Projects that intend to induce IFIs to lend to a new type of client should select markets that will be profitable for the IFI and that fit with the business strategy of the IFI. Projects of this type should be viewed as experiments: it is often unknown if the IFI can establish a profitable lending program for targeted businesses at the beginning of the project. Project designs should consider the profitability of the target market as well as the business strategies of the participating IFIs.

2. Finding: Offering credit at terms that no types of businesses other than microenterprises want can be an effective means of targeting credit.

Perhaps the best example of this comes from the ACCION Microlending Project in Paraguay. In this case, the project offered credit at a nominal interest rate of 114%. This was less than half of the prevailing cost of credit from informal moneylenders, but still significantly higher than rates charged by private commercial banks. (At that time, commercial banks were charging 28% and finance companies 35%.) By setting the interest rate at this level, the project discouraged businesses that were too large from receiving loans because these businesses could receive cheaper credit from commercial banks. On the other hand, microenterprises that received loans under the project had an incentive to graduate from the program as soon as possible, because graduation to borrowing from private commercial banks meant that they could substantially reduce their interest costs.

There is often a middle point between rates charged by money lenders (which can be over a hundred percent per year in real terms) and rates charged by local commercial banks. By setting interest rates between the formal and informal levels, a project can encourage sustainability and compliance with project guidelines concerning business size.

On a separate but related point, the cases reviewed indicated that when projects tried to promote exports by providing foreign currency lines of credit, these funds were often used to finance imports. If the target group is exporters, then it is appropriate to provide a credit instrument that can only be used by exporting companies.

Recommendation: An effective means of targeting credit is to provide a credit product that only the target group wants.

3. Finding: Another means of delivering credit to targeted businesses is through establishing vertical linkages between large manufacturing companies and small businesses.

Discussion. Vertical linkages are commercial and production relationships that firms establish with suppliers of production inputs and with purchasers of outputs.[8]

In nine of the fourteen cases examined, important vertical linkages were created or strengthened. Perhaps the best example of this was the loan to LIK. At full production, LIK requires 1000 cow hides per day, all of which are provided by local herders and slaughterers. In addition, because of quality concerns, LIK has a program to improve skinning and rangelands practices of ranchers by offering bonuses for higher grade hides, thus improving livestock management. Finished leather goods will be used by local shoe manufacturers who in turn provide substantial employment for skilled and semi-skilled workers.

Linkages created by credit projects are often an effective mechanism for assisting smaller enterprises. These links can be used to channel credit and technical assistance to businesses that supply raw materials or purchase outputs from larger companies associated with the project. An example of this kind of linkage is the Thai-RFM Project, which provided a grant of $70,000 to Thai-RFM to help it establish a technical assistance program for small cattle farmers. Local commercial banks now provide loans to cattle farmers supplying livestock to Thai-RFM.

Recommendation: Search for linkages that a project can create for local small business. In some cases, credit can be channeled to target businesses by using the linkages between a central large company and a number of smaller enterprises that supply the central company.

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[8] For more complete discussion of project linkages, see "Lessons from Experience: The Design and Implementation of Commercial Lending Projects by A.I.D.'s Bureau for Private Enterprise", Management Systems International, 1988, pages 37-38.

4. Finding: Putting restrictions on eligible borrowers in project agreements reduces the pool of available borrowers.

Discussion: The cases suggest that defining a target group narrowly often makes the market too small to be economically viable. The size of a market decreases rapidly every time a restriction is added.

PRE projects typically included one or more of the following eligibility restrictions: business size, sector, type of business activity, location, and nationality of ownership. Some restrictions appeared to be difficult for IFIs to meet. Examples include requirements that urban-based banks make rural loans or loans to specific sectors such as producers of health products or new agribusinesses. When a single, narrow target group was specified, it proved to be expensive and difficult for an IFI to identify enough sub-borrowers to lend all project funds.

Recommendation: Some restrictions on eligibility are needed to target credit for development impacts consistent with A.I.D.'s mission. However, these restrictions should usually be kept to a minimum. If particular projects have a primary objective and several secondary objectives, focus should be placed on the primary objective.

5. Finding: It is very difficult to reach smaller businesses through trade credit projects.

Discussion: PRE projects that provided trade credit have primarily served the top end of the SMSE market. Many borrowers under these projects were businesses at or near the limits set in project agreements in terms of asset size and corporate sales, and a significant proportion of businesses were larger than project limits allowed.

The reason larger businesses tended to receive the lion's share of trade credit was that larger businesses were most capable of dealing with the complicated requirements of international trade, in as much as successful international trading usually demands relatively sophisticated banking and finance skills.

Recommendation: If the target market is primarily small enterprises and an important objective is to promote exports or imports, then some type of technical assistance in using trade credit should be provided through the project. On the other hand, if a credit project's objective is primarily to serve the lower end of the SMSE market, then the project should normally not have an import or export focus.

6. Finding: Microenterprise lending is very different from SMSE lending. It is similar to consumer credit or retail lending by commercial banks in many ways, and is most successful if lending programs take special steps to (i) minimize administrative costs, and (ii) minimize credit risks.

Discussion: The Accion Microlending case supported earlier research findings indicating that lending to microenterprises is much more expensive than the usual lending programs carried out by commercial banks. There are three principal costs that tend to make microenterprise lending unattractive to financial institutions:

A. Administrative costs: Because amounts provided to microenterprises are small, administrative costs tend to consume a very high proportion of loan earnings;

B. Risk and default costs: Even though small and microenterprise lending programs have been found to have default rates comparable to larger scale enterprise programs,[9] lenders are generally not able to obtain security for loans comparable to that obtained from larger borrowers;

C. Opportunity costs: Diverting funds and personnel from high earning medium and large enterprise accounts to microenterprise lending programs often results in significantly lower earnings on scarce funds and personnel resources.

Under the Accion Project, IFIs make loans that are much smaller than under any previous PRE project. Average loan size made by Accion in Paraguay, for example, was $175, and in Mexico was $1,881. To minimize administrative costs of micro loans, both programs used lending procedures that were very different from common commercial banking practices for larger clients. Differences included:

(A) Accepting cross guarantees from credit solidarity groups as security;

(B) Extending repeated loans to successful borrowers, using business analyses only for the first loan;

(C) Using solidarity groups to reduce collection costs by involving them in collecting delinquent loans;

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[9] Haggblade, Liedholm and Mead suggest that arrears and default rates on many micro- and small-enterprise schemes compare favorably with schemes to larger borrowers. ("The Effect of Policy and Policy Reform on Non-Agricultural Enterprises and Employment in Developing Countries: A Review of Past Experiences." EEPA Discussion Paper No. 1. A.I.D. Bureau for Science and Technology, Enterprise and Employment Division. March, 1986. Pp. 21-22.) These findings are also supported by studies carried out by Management Systems International on lending projects in Kenya ("Evaluation of the USAID/Kenya Private Sector Program." Management Systems International/Arthur Young Company; A.I.D. Bureau for Private Enterprise, Washington, D.C. 1989).

(D) Lending based on character rather than collateral or detailed project analysis;

(E) Charging interest rates that were significantly above prime rate.

Use of these modified practices was a major reason for the financial viability of Accion lending programs.

Recommendation: Encourage microenterprise credit programs to include the following features:

- Lending interest rates substantially above prime rates to compensate for higher risk and administrative costs of small loans;

- Assessment of a client's business income only for the first loan, if at all; subsequent loans granted if previous loans are successfully repaid;

- Loans primarily for short-term working capital, often starting small, and growing larger as the client establishes a successful repayment record;

- Automated account management and loan collection to the largest extent possible.

7. Finding: Venture capital may not be a successful mechanism for commercializing technology.[10]

Discussion: The Business Venture Promotion Project in Thailand indicates that venture capital may not be an effective model for providing credit to fund new technologies. According to BVP's senior staff, the venture capital company established by PRE adopted a policy of funding established technologies, that is, technologies that have been tested, have proven production costs and methods, and have established markets. Of BVP's investments up to November 1988, all were in projects that use technologies that have been commercially available for over a decade. Of BVP's pending applications, only 15 percent involve high technologies (ones that do not have established markets or known production costs), 70 percent involve established technologies, and 15 percent involve businesses in the traditional service or "no tech" industries (such as restaurants, tourism and entertainment).

BVP's management decided that they take on enough risk by funding new starts, and that investing in technologies that are not established would involve too much additional risk. The company's management adds that BVP, like other firms in this new industry, must stress confidence building by investing in relatively safe projects.

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[10] This finding is based only on four cases, Thai Venture Capital, and three firms supported by ATI.

These findings in Thailand are supported by other venture capital experiments in Indonesia, Thailand, the Philippines.[11] Appropriate Technology International (ATI) established venture capital companies in these three countries in 1984 and 1985, with one of the objectives of these projects being to develop "... means to move innovative technologies into the marketplace." The companies invested in several newly created businesses that employed new technologies. These included a wingbean soysauce production plant and a fiber-reinforced roofing tile company in Indonesia, bamboo grassmat production in Thailand, and village coconut meal production in the Philippines. Major investments were made by the new companies in developing and refining production techniques and in finding buyers for their products. Eventually each of these "new tech" industries had serious problems during start up, and resulted in losses for the local venture capital companies.

An alternative model for commercializing technology was recommended by venture capitalists in Thailand. This approach involves providing guarantee facilities for established corporations to fund internal technology commercialization efforts. Many larger corporations have both the financial resources to take on the risks associated with commercialization of technology, and established R,D&E facilities that can be used to develop new technologies.

Recommendation: If an important objective of venture capital projects is to provide funds for commercializing new technologies, then significant changes need to be made in the venture capital model employed by PRE in Thailand.

IV. ADMINISTERING AND MONITORING LOAN PROJECTS

PRE credit projects usually pursue two basic goals: (i) delivery of credit and services to SMSEs, and (ii) promotion of institutional development in local financial markets. One of the emerging lessons of the case studies is that the greatest impacts are achieved when managers give equal attention to both institutional objectives and direct delivery of credit. The findings and recommendations of this section emphasize the role of management in achieving both institutional and direct development goals of credit projects.

1. Finding: Private sector credit projects are like commercial bank loans in many respects. In particular, IFI projects establish an ongoing account relationship between the IFI and A.I.D., and these account relationships need promotion and management if project objectives are to be achieved.

Discussion: IFIs working with PRE on credit projects often view their relationship with A.I.D. primarily as a banking relationship. PRE provides a loan or letter of credit facility for which the IFI pays interest and fees. The local institutions then use the facility or loan to make profitable loans. The fact that there are additional "developmental objectives" attached to this

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[11] "Venture Capital for Small Enterprise Development: Lessons Learned from the ATI Experience". Paul Bundick and Michael O'Donnell, Appropriate Technology International. Final Draft, July 1988.

banking relationship is usually viewed by the borrowers as an incidental aspect of the transaction.

Because borrowers often view a project as basically a banking relationship, they generally expect careful, constant and professional account service from A.I.D. and other banks involved in the project. When the local institution has questions about calculation of fees and interest, repayments, borrower eligibility or other operational aspects of the project, they expect the same kind of prompt service from A.I.D. and the collateral bank that they would from their usual correspondent banks. In practice, project IFIs needed assistance in operating their guarantee facilities on a fairly regular basis, on the average two or three times per year.

When an IFI has received prompt, careful service, it is obvious during evaluation visits that the IFI's staff takes an interest in their account relationship with PRE, and that they are careful to adhere to project agreements. Strong account relationships like this have been established with Thai Danu Bank and Far East Bank and Trust.

On the other hand, when communication between PRE and the bank was infrequent and slow, IFIs seemed to have persistent problems in understanding and implementing project objectives. Examples where IFI officers had little idea of project objectives and doubts as to the value of the "account relationship" with PRE include Securitized Trade, Finanquil, KCFC and Bank Niaga.

Characteristics of project relationships common to successful IFI projects include the following:

- Careful explanation of the developmental objectives of the project to IFI personnel;
- Thorough explanation of the operation of the facility to the implementing staff;
- Prompt answers to questions about terms in the project and loan agreements;
- Demonstration that compliance with project terms and loan agreements is an important IFI obligation;
- Prompt attention to any claims arising out of the project;
- Willingness to make changes in the operation (and sometimes objectives) of the facility as problems arise.

One feature of IFI projects that is very different from banking is that projects have broader development objectives.[12] Examples of these include privatization of financial services, enhancement of competition in credit

[12] These are commonly referred to as purposes and goals in A.I.D.'s logical framework terminology.

markets, dissemination of unsubsidized credit models, employment generation and policy reforms such as exchange rate and interest rate deregulation.

When projects have objectives beyond providing credit directly to smaller enterprises, success in achieving these often depends upon project officers actively managing for these objectives. For example, one reason for the success of the Thai Danu Bank Project in policy dialogue on interest rate ceilings was that USAID Mission staff engaged the government in discussions of interest rate policy while the project was being implemented. The result was that the government gave a waiver on interest rate ceilings under the Mission's follow-on project.

A contrasting case is the Bank Niaga Project in Indonesia. This project did not have any activities directed at disseminating models of unsubsidized lending nor any effort to raise critical policy issues such as government interest and risk subsidies. In addition, the IFI feared that informing clients of an A.I.D. guarantee would result in poor loan payback, and therefore there was little dissemination of information about the project.

<u>Recommendation: Allocate sufficient staff time to credit projects to allow for frequent "servicing" of the account. Services should include: careful explanation of project operation and objectives to implementing staff in the IFI, prompt response to questions concerning project operation, and monitoring and enforcement of compliance on a regular basis. When possible, provide management resources for implementing higher level as well as operational goals of projects</u>.

2. <u>Finding</u>: Integrating an credit project into the usual operations of an IFI minimizes administrative costs and encourages change in the IFI, but may make the project difficult to monitor.

<u>Discussion</u>: This agrees with findings in the previous edition of this report. Using normal commercial lending procedures in a SMSE credit project minimizes costs, increases the success of implementation, and maximizes the long-run institutional benefits to a participating IFI. For a thorough discussion, please see "Lessons from Experience: The Design and Implementation of Commercial Lending Projects by A.I.D.'s Bureau for Private Enterprise" (1988), pages 50-51.

In several cases, however, integrating funds provided by PRE into the IFI's general pool of funds also made it difficult to assess the impacts of project loans on loan recipients. For example, in both the Accion and Securitized Trade cases, PRE made funds available to add to a general pool of loan funds in the IFI. The institutions used this pool to lend to their usual clients. Because PRE funds could not be tracked to particular borrowers, there was no way to determine the impacts resulting from project loans.

<u>Recommendation: When designing credit projects, it is 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>.

In projects that contribute project funds to a larger pool of unsegregated funds, however, it may be necessary to drop or modify sub-borrower reporting requirements. An alternative is to monitor the IFI's entire loan portfolio in order to track changes in its composition and size.

3. Finding: Proper monitoring and enforcement of the terms of a project agreement plays a key role in the achievement of project objectives.

Discussion: In several IFI projects, there was little enforcement of the terms of project agreements concerning business eligibility. Under the Securitized Trade, Bank Niaga and Finiber projects, the IFIs made numerous loans to enterprises larger than limits established in project agreements, and only limited steps were taken to encourage the IFIs to comply with these terms. The result of this lack of enforcement was that the IFIs often failed to serve the intended target group.

In most instances, noncompliance with sub-borrower requirements could have been detected by careful monitoring of a project. While no cases involved malfeasance and all resulted in full repayment to A.I.D. at commercial rates of interest, non-compliance often diluted the projects' intended benefits.

Weaknesses in monitoring had three principal causes:

(A) First, many IFIs did not prepare and submit required sub-borrower reports. Experience suggests that to cut administrative costs, businesses and banks often resisted sub-borrower reporting. Many IFIs considered collecting required information to be an unnecessary and onerous responsibility.

(B) IFIs often had difficulty collecting valid information on sub-borrowers, particularly data on sales, employment, assets and earnings. In these cases the IFIs either would not submit required data, or would provide information that was clearly wrong.

(C) IFI staff responsible for implementing loan programs often do not understand reporting responsibilities. In addition, PRE's experience suggests that when non-compliance occurs, an IFI may not take action because loans are made by officers who have little knowledge of the A.I.D. project agreement, and sub-borrower reports are prepared by administrative divisions that are unaware of requirements. In some cases, the IFI's staff felt that there were no significant sanctions associated with non-compliance.

Recommendation: Meeting project objectives requires active involvement by investment officers in monitoring and enforcing project agreements. This involvement should include (1) assuring that regular reports are submitted by the IFI; (2) checking that information contained in reports is reasonably accurate; (3) comparing information in reports with terms in the project agreements; and (4) notifying the IFI when unacceptable levels of noncompliance are found.

In general, monitoring and enforcement of sub-borrower conditions should be carried out by officers knowledgeable about project requirements and objectives. These functions cannot be successfully carried out by home office staff when they do not have direct involvement in field projects.

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.

CASE DESCRIPTIONS

As noted above, the lessons from experience presented in this document are drawn, in large measure, from fourteen field evaluations. Full reports of these field investigations are presented as case study reports available from PRE/DP. This annex briefly summarizes 14 of these reports. The initial five case studies conducted in 1987 have not been summarized.

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 Ter 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.

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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 participation 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.

3. Thai Venture Capital

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Lack of long-term capital for new businesses.	Establish a a working venture capital company.	Long-term loans.	BVP had made 4 investments when the evaluation was completed.
2. Lack of business planning skills.		Direct loan to BVP.	BVP was successful venture capital model for other firms.
			BVP contributed to improvements in local capital markets.

PRE, in cooperation with six Thai commercial banks, established Thailand's first capital company, Business Venture Promotion, Ltd., (BVP). PRE also provided BVP a loan of $3 million for ten years. BVP pays PRE interest of 4% on the loan for 10 years, and 20% of all net profits earned for 15 years. Because BVP was a new business, the loan was structured to provide as little "up-front" cost as possible, while still providing the Revolving Fund with an effective rate of return equal to the commercial prime rate in Thailand. The loan agreement between A.I.D. and BVP was signed on March 30, 1987.

PRE also provided a training grant for $50,000, and has given limited technical assistance to BVP throughout the start-up period. BVP is owned by six Thai commercial banks; these shareholders provided an additional $3 million in equity to BVP.

BVP makes direct investments in new starts, expansion and "turn-around" companies. Qualifying investments must meet two criteria: Projects funded by BVP must be located in Thailand, and BVP's equity share of a company must not exceed 25 percent (amended to 35% in November 1989) of that company, with a total allowable investment in any single company of $625,000.

The objectives of the Thai Venture Capital project were:

1. to establish a working venture capital company in Thailand to serve as a model for the venture capital industry;

2. to provide long-term investment capital to manufacturing and agribusinesses with good profit potential;

3. to strengthen local capital markets by encouraging companies to properly disclose financial operations and to list on public stock markets;

4. to establish a private sector mechanism for transferring U.S. technologies to Thailand.

Project Impacts

BVP is still too new for a complete evaluation. BVP's first investment was made in May 1988, fourteen months after the company was formed. As of October 1988, BVP had made only four investments, totalling $1,292,500. At that time only one of the investee companies was in production. All four investments were carefully considered, and the projects all show clear indications that they will become profitable companies. BVP's Managing Director plans to make at least seven investments in 1989.

BVP plays a key role in this infant industry

There is lots of interest in venture capital in Thailand, with 12 new companies started since the BVP project agreement was signed. As of November 1988, there is, however, little evidence that the venture capital industry is currently viable in Thailand, because other than BVP's four investments, almost no other companies have made any investments. Nevertheless, BVP plays a high visibility role in leading the industry, with almost all venture capitalist interviewed for the PRE studies reported that they view BVP as a leader in adapting venture capital practices to Thailand.

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BVP is contributing to the development of capital markets in Thailand.

1. BVP encourages professional management in companies by concentrating its investments in companies run by entrepreneurs with "modern" approaches to business.

2. BVP builds the quality and quantity of securities available in Thailand's stock markets by using sound project appraisal techniques, and by encouraging companies to establish sophisticated accounting and control systems and by requiring companies to operate on a "transparent" basis.

3. BVP improves financial disclosure practices in Thailand by promoting sound accounting systems, and by encouraging entrepreneurs with a financial interest in proper disclosure.

Commercial banks played an important role in the viability of the BVP project. The six commercial bank shareholders were active investors in the project, served as a key source of new projects, and provided additional loan financing for projects. On the negative side, however, giving commercial banks an active role in a venture capital project encouraged BVP to be slow and conservative in its investment approach.

The role of the Over the Counter Market. The weakness of Thailand's OTC market could cause serious problems for the venture capital industry in Thailand and for BVP in particular. Venture capital companies rely on selling their investments through the OTC as one principal exit strategy. In Thailand, however, entry onto the OTC exchange is extremely easy, and the market is extremely small and reportedly speculative. It is possible that the failure of a single company listed on the OTC exchange could cause a severe drop in OTC stock prices, with the result that venture capital portfolios will depreciate significantly and the OTC market will lose its viability as an exit route. On the other hand, BVP's conservative investment strategy may make it more stable if the OTC market falls.

BVP did not prove to be a viable vehicle for commercializing new technologies. The Managing Director of BVP stated that for his company to make an investment, the project must use established technology, with established production costs, and products must have established markets. If A.I.D. wishes to identify viable means of involving the private sector in commercializing technologies, then significant changes may need to be made in the venture capital model currently employed in Thailand.

A.I.D. as a Dealflow Source. PRE commissioned 10 project proposals for BVP to provide an initial source of possible investments. These proposals did not result an any investments by BVP. BVP staff, as well as numerous other respondents, suggested that "to have a project, you must first have a good local entrepreneur." Sending project feasibility studies from the U.S., when they do not include an entrepreneur with real interest in the project, is not a productive dealflow source.

Importance of representing A.I.D.'s management interest. During the second year of the project, the contract expired for PRE's Personal Services Contractor in Bangkok. Because there is no full-time representative in Bangkok, it is unclear who will continue to represent PRE's management interests in BVP. It is also worthwhile to note that one reason for the success of this PRE project has been the active involvement of a Bangkok-based PRE representative and the Mission Private Enterprise Officer.

4. Thai-RFM Meat Processing Project

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Governmental control of the slaughter industry.	Establish the first private slaughterhouse in Thailand.	Long-term loan.	The company is operating on a commercial basis.
2. Lack of market outlets for small livestock producers.		Direct loan to Thai RFM.	The Government has allowed privatization of the livestock slaughter industry.

The Thai RFM Meat Processing Project carried out by PRE helped to establish Mah BoonKrong-RFM, the first privately-owned, modern slaughterhouse and meat processing company in Thailand. The original loan agreement between the Mah Boonkrong-RFM Co., Ltd. and A.I.D. was signed September 5, 1984. After major Thai shareholders encountered difficulties in paying up their capital pledges, new Thai investors replaced the old ones, and the company's name was changed to the Thai-RFM Company, Ltd. The new company was 51% Thai and 49% foreign owned.

The project involved constructing a plant complex consisting of an abattoir, processing, canning and cold storage facilities. The plant would produce top grade sausage for the local market, and canned and fresh meat products for export, all under license to use the Swift & Co. brand name.

PRE had six principal objectives for this project:

1. Privatize the slaughter and meat processing industry;
2. Provide market outlets for small livestock farmers;
3. Increase the volume and quality of processed meat products in Thailand;
4. Transfer agribusiness technology from the U.S. to Thailand;
5. Establish a fresh meat export industry;

6. Continue policy dialogue with the government on deregulation of private investment.

Problems During Implementation

After the first loan agreement was signed, the project encountered numerous problems that prevented disbursement of the PRE loan for over three and a half years, until May 1988. For over one year the company waited for changes in local laws affecting the slaughter industry, for Board of Investment approval, and approval to begin construction. Other delays encountered during start up included difficulties in clearing imported equipment through local customs, and slow approval of the company's commercial licence because the company's sophisticated wastewater treatment facility needed to be reviewed by the government before the license could be granted.

Slow implementation caused the RFM Corporation, the newly established Mah Boonkrong-RFM Company and PRE to incur significant costs, particularly in staff time, to keep the project alive. These costs were considered acceptable because of the project's important role in meeting PRE's objectives for privatization and livestock industry development.

The Current Project Loan Agreement

The July 2, 1987 Amended Loan Agreement between Thai-RFM Co., Ltd. and A.I.D. provides Thai-RFM Co. with a $2.5 million dollar, ten year loan to establish a slaughterhouse, meat processing and cold storage facility. The total cost of the project is estimated at $21.5 million. The Agreement also provides a grant of $70,000 for Thai-RFM to finance assistance in designing and implementing a technical assistance program for small and medium-sized livestock producers. Under the agreement Thai-RFM must "exercise its best efforts to procure at least 50 percent of its livestock from small- and medium-sized Thai producers."

The PRE loan's interest rate is 10.25 percent. Loan principal is to be repaid in 15 equal semi-annual installments, beginning after a three year grace period.

Current Status of the Company

The plant complex is located in Pathum Thani Province, about 30 kilometers from central Bangkok. It presently employs 131 people, many of them workers who were laid off when the government closed one of its slaughterhouses.

The plant complex contains administrative offices, a slaughterhouse, processing and cold storage facilities. The plant has the capacity to slaughter 700 head of hogs and 200 head of cattle per day, to process 20 metric tons of meat products per day, and to have in cold storage 1,800 metric tons of meat products at any given time.

Construction of the plant was completed in April of 1988. The plant machinery and equipment were installed in the summer of 1988, and test runs of the equipment continued until the Fall. The plant was designed to conform to USDA and EEC meat processing standards, and includes facilities for Halal slaughter for meat intended for Islamic markets. Thai-RFM has imported $747,653 worth of capital equipment from the United States.

Thai-RFM has a 10 year technical assistance agreement with RFM-Philippines and a licensing agreement with Swift Company, covering only the use of Swift's brand name. The Board of Investment has given the project investment promotion privileges, including relief from all corporate income tax obligations for seven years.

The Company has Begun Commercial Operations

The company received its commercial operations license in November 1988, and began producing commercially at the end of that month. Test marketing has been completed, and extensive marketing arrangements have been established in Bangkok-area grocery stores and supermarkets.

Thai-RFM will produce several brands of processed meats, with Swift as its top brand. The Swift line, marketed under license with the Swift Company, includes frankfurters, Chinese style sausages, deli meats, meat balls and fresh meat.

Thai-RFM is a Pathbreaking Privatization Project

The Thai-RFM Company is the first modern, non-governmental slaughterhouse in Thailand. The Thai-RFM project is a successful privatization effort undertaken by PRE, and is an excellent example of technical cooperation between U.S. and ASEAN businesses. Since the project began, the government has closed the Preserved Foods Organization slaughterhouse, an organization that had a monopoly on "modern" slaughter operations. In addition, since Thai-RFM started there have been 6 other private slaughterhouses approved by the Board of Investment, and several projects have been started.

After the Royal Thai Government decided to consider privatizing the slaughter industry in 1983, Thai-RFM became a test case in helping the government to formulate effective policies for privatization of the meat processing industry. These policies would, by 1988, include (i) closing government-owned slaughterhouses; (ii) passing laws allowing the establishment and operation of privately-owned slaughterhouses; and (iii) provision of Board of Investment promotion privileges to the abattoir industry.

This project is a clear example of how a development agency can induce a private company with substantial managerial and technical resources to collaborate in pursuing development goals.

The Project has had High Visibility in Thailand

This has been a very high visibility project in Thailand, and has stimulated widespread interest in privatization in the country.

Major Project Impacts

The Thai-RFM Company began operations during November of 1988. Because the company is still basically a new start, it is difficult to evaluate the full impact that this ten year PRE project will have once the company begins full commercial operation. Nevertheless, the project already has had major impacts on the livestock industry and the government's policies toward the meat industry. Major impacts include:

- Introduction of higher technical standards into slaughter and processing industries;
- Introduction of improvements in cattle farming, and cattle and hog marketing;
- Increasing the availability of high quality, hygienic fresh beef and pork in Thailand. Control of the product from the hoof to the market gives consumers higher quality products. Thai-RFM is the first meat processing plant in Thailand to follow this practice.
- Production of meats of high enough quality to enable Thailand to meet fresh meat import standards in foreign markets.
- Introduction of direct competition with government-owned slaughterhouses, pressuring them to improve quality and efficiency.
- Improving standards for livestock industry waste treatment.
- Development of better technical assistance programs for livestock production and feedlot businesses.
- Increasing demand for high quality livestock. Since the project was begun, the IFCT has received several proposals to fund feedlot companies. Thai-RFM's demand for finished steers has created a market for better cattle and a new industry: small farmer feedlots. Inquiries are presently being made by Zuellig to import American Brahma breeding stock to upgrade the breedstock in local herds.

Privatization can be slow and costly, underscoring the importance of having strong private sector partners

The Thai-RFM Company is well managed, with sound business plans, and good financial records. The project illustrates the critical importance of involving strong backing in direct loan projects, and also shows how costly and slow privatization efforts can be. A.I.D. and the RFM Company have invested large amounts of staff time and other resources to keep the project alive during periods when the government was considering the privatization issue.

A strong private sector partner is critical to project success

RFM's 10 year technical assistance agreement with RFM-Philippines is critical to the project's profitability. This arrangement made it possible for the project to minimize costs that are associated with high technology start up projects in developing countries, and also made it possible to maintain investor confidence during a long and difficult start up period. This highlights the importance of having strong partners for direct loan projects.

The project is accomplishing its goals for assisting small farmers

According to the terms of the loan agreement, Thai-RFM is required to try to buy 50 percent of its livestock requirements from small farms. Because "small and medium-scale farm" is not defined in the loan agreement, it is difficult to determine whether Thai-RFM is complying with the requirement that 50 percent of livestock supplies come from small producers.

Nevertheless, by November 30, 1988, Thai-RFM had ten cattle feedlots producing 85 head or less per month under purchase contracts, with these farmers currently supplying about 40 percent of the company's cattle requirements. In addition, Thai-RFM has identified approximately 100 farmers feeding less than 20 head of steers that are being considered for accreditation.

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.

[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.

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 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.	1) Stimulate exports.	Short Term Export Credit	Facility fully utilized. Encouraged major commercial bank to expand SMSE lending. Provided a model for three follow-on guarantee projects.
Unwillingness of local commercial banks to lend to SMSEs.	2) Induce a major commercial bank to lend to SMSEs.	Offset Guarantee Facility	

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.

7. Bank Niaga

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Lack of term credit for SMSEs.	1. Encourage major private bank to lend to SMSEs.	1. Term loans.	1. Over 43 SMSE loans were made.
2. Unwillingness of private banks to lend to SMSEs.		2. Guarantee facility.	2. Term of loans increased.
			3. Collateral required was lower.

The PRE Bank Niaga project established a $2 million loan guarantee facility for Bank Niaga to encourage it to lend $4 million to qualifying SMSEs. Bank Niaga is the second largest private commercial bank in Indonesia. The project was authorized in August 1985 and began operating in 1986.

The project sought to induce Bank Niaga to lend to smaller borrowers by guaranteeing 50 percent of the principal of loans to qualifying borrowers. Loans were targeted for Indonesian businesses with monthly sales of $300,000 or less. The loans were also supposed to finance start-up or expansion investments by these small companies. In addition, Bank Niaga was obligated to provide over 50 percent of its guaranteed loans to businesses with monthly sales less than $150,000, and 50 percent or more of the loans were supposed to go to businesses outside of Jakarta.

To establish the facility, A.I.D. entered into a $2 million, 7 year loan agreement with Rainier National Bank under which Rainier agreed to set up a L/C standby facility to provide letters of credit to Bank Niaga. The letters of credit issued under the standby facility guarantee up to 50 percent of the principal of Bank Niaga's loans to qualifying sub-borrowers. Once fully utilized, PRE's $2 million guarantee facility stimulates $4 million in rupiah loans by Bank Niaga to SMSEs.

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PRE's loan to Rainier Bank serves as collateral for letters of credit issued by Rainier Bank to Bank Niaga. In the event of a loan default in Bank Niaga's guaranteed portfolio, Bank Niaga can shed 50 percent of the principal loss to PRE. This 50/50 arrangement gives the bank enough risk so that it takes great care in making loans, while giving it an incentive to lend to the target group of SMSE businesses.

Indonesia's serious structural problems

The project was carried out in difficult financial market environment. Indonesia's financial markets are seriously impaired by large government credit subsidies, poor credit appraisal and collection practices in state banks, frequent foreign exchange devaluations, and continuing political uncertainty. Subsidized SMSE credit programs have made it difficult for private commercial banks to compete in many SMSE market segments. In addition, the extremely short-term of deposits held by most private banks has made it difficult and risky for banks to make long-term loans. In this context it was difficult for a guarantee project working through a private commercial bank to accomplish significant change in financial market practices.

Project Impacts

The PRE project induced Bank Niaga to extend over 43 medium term loans worth more than $4,734,000 to SMSEs during a period of economic stagnation in Indonesia. When this evaluation study was conducted in October 1988, there were 27 outstanding loans, with total credit outstanding of $1,832,315. Average interest rate on outstanding loans was 23 percent and average loan term was 4.5 years. The average loan under the guarantee project was $110,111. There have been no defaults under the project.

The majority of businesses receiving loans used the funds for business expansion, and this resulted in significant increases in employment. The study team estimated that the project was associated with a total employment increase of 900 full time jobs in businesses that received guaranteed loans, 117 of these jobs going to women employees. Guaranteed loan recipients performed very well during the project both because sound businesses were selected as loan recipients and because these businesses made sound investments with guaranteed loan funds.

The loan recipients were medium-sized by local standards, with average total assets of $795,440, and average yearly net income of $76,714. Businesses ranged in total asset size from a furniture manufacturing company with gross assets of $108,647 to an insurance company with over $9.1 million gross assets in 1987. Seventy-five percent of sub-borrowers were service businesses, while 25 percent were manufacturers.

The PRE guarantee had two primary effects on the lending behavior of the bank: it increased the average term of loans to 4.5 years during a period when average term of the bank's funds was less than one month, and it decreased collateral requirements by 22 percent. Because collateral requirements dropped from over 150 percent to 125 percent on guaranteed SMSE loans, Bank Niaga was able to provide larger loans to its SMSE borrowers. One result of these changes was that almost 60 percent of the businesses receiving PRE guaranteed loans were able to use the money to expand their operations by buying fixed assets and machinery.

In general, however, the project had low additionality and some compliance problems. Almost no new starts were funded, most of the businesses were established commercial borrowers, and in many cases the companies were owned by larger conglomerates. In several cases, loan recipients had greater monthly sales than was allowed under the project agreement.

Impact on USAID/Indonesia

The Bank Niaga project has not been replicated by the Mission's private enterprise program. The project has not been used as a model for Mission projects, there has been no policy dialogue with the government based on issues arising from the Niaga project, and the Mission has not worked directly with Bank Niaga staff on other activities in the Mission's program.

The project had little impact on the Mission for two main reasons: first, when the project began, it was not designed to fit into the Mission's private sector development programs; and second, lack of clarity about responsibilities for implementing the project led to difficulties in coordination between the Mission and PRE. Nevertheless, Mission private sector officers stated that observing the project provided an opportunity to learn how the private commercial credit market operates and has helped to develop contacts with private banks. The project has also encouraged the Mission to increase private banks' involvement in policy dialogue and to include private sector banks in their current private enterprise program.

8. Micro-lending Guaranty Fund

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Lack of access of microenter-prises to formal sector credit.	1. Provide microenterprise IFIs access to funds from private financial markets.	1. Short-term loans.	1. In Paraguay 514 loans were made. In Mexico 12 loans were made.
2. Shortage of funds for microenterprise loans.		2. Guarantee facility.	2. The Paraguay project enabled the ACCION affiliate to raise funds from private banks.

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The purpose of the Micro-lending Guaranty Fund project is to "increase income and employment generation among urban poor, capitalizing a fund which will guarantee local currency borrowings by local organizations which make small loans to micro-entrepreneurs." The project encourages financial discipline by requiring foundations to charge interest rates that reflect both the full cost of funds and of training and technical assistance (TAT). In addition, the project was designed to involve local commercial banks in serving the credit needs of microenterprises.

A.I.D./PRE established a U.S. $1 million guarantee facility through a loan to ACCION International in September 1985. ACCION also received total grants of $191,000 to cover costs of technical assistance to its affiliates. The A.I.D. loan was deposited in a collateral account in a U.S. bank (Chemical). Using this account as security, Chemical Bank issues standby letters of credit (LCs) in favor of local Latin American banks. With this guarantee, the local banks provide credit from their own resources to local affiliates of ACCION. The affiliates use these resources for on-lending to microenterprises.[2]

A model standby LC (negotiated in each country) is issued in favor of local lending banks. As of November, 1988, LCs for $150,000 and $100,000 respectively had been issued for Asesoría Dinámica a Microempresas, A.C. (ADMIC) and for Fundación Paraguaya (FP), the ACCION affiliates in Mexico and Paraguay. Subsequently, LCs were issued to banks in Chile ($100,000) and in Ecuador ($50,000). A disbursement of $200,000 for Mexico was made in July 1989, bringing total facility utilization to $600,000.

Initially the standby LCs were to guarantee up to 90% of loans by local banks to the affiliates. ACCION was to use its best efforts to reduce the percentage of guarantee coverage, especially after successful repayment of earlier loans. In Mexico the percentage guarantee provided by the PRE facility is potentially only 17.65% because the rediscount line from the Guarantee Fund for SMSEs (FOGAIN) of $1.7 million is guaranteed by the $300,000 of PRE funds.

Findings and Conclusions

1. In Mexico and Paraguay the institutional impacts of the ACCION Project were more significant than direct impacts on borrowers.

PRE funding was added to existing credit programs, and many borrowers had received loans from the foundations before. These factors made it difficult to determine the specific impacts of PRE funding on borrowers. The most obvious positive impact of the project was on the relationship between ACCION affiliates and commercial banks, because the A.I.D. project provided microenterprise lending institutions with access to funds from private financial markets.

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[2] An exception to this is Mexico where, due to the use of a rediscount facility the ACCION affiliate is not permitted to lend directly to microenterprises. Instead, the local bank lends its funds to microenterprises with the guarantee of the PRE collateral account.

2. The language of the model letter of credit may potentially create difficulties with commercial banks.

In Mexico the LC was accepted without modifications, but only because of a high level of personal contacts between ADMIC and BANORTE. In Paraguay the LC was rejected by nine banks. The affiliate finally found a local bank that accepted a modified LC. The major problems with the LC were due diligence, jurisdiction, collection procedures in the event of default, and the A.I.D. requirement for access to the commercial bank's records. In March 1989 the model LC was simplified by PRE/I. There have been no further problems in the negotiations with local banks.

3. Evidence suggests that it is necessary to waive some standard banking practices in order to reach large numbers of microenterprise borrowers.

Because of a liquidity problem in Mexico, the bank uses the rediscount facility for reimbursement of bank funds lent to ADMIC borrowers. This had "overbureaucratized" the program by requiring borrowers to (a) complete loan forms of three institutions, (b) have two or three visits made to their businesses, and (c) go through three credit approvals. The processing time was approximately three months. During the first half of 1989, the ADMIC/BANORTE relationship was restructured. ADMIC now has almost full authority to approve loans. Bank processing time has been reduced to 17 days.

Fundación Paraguaya's program shows that the guarantee mechanism works best when a microenterprise lending institution borrows directly from a private bank, and then on-lends to microenterprises. FP lends to microentrepreneurs with a credit delivery lag time of 10-15 days. The solidarity group concept also allows the program to reach more borrowers and allows less rigorous credit analysis because of the "cross guarantee". Clearly, independent bank appraisal of loans is a less effective approach if the objective is to reach a large number of borrowers.

In Paraguay as of October 31, 1988, approximately 514 loans had been made from the $90,000 disbursed as of that date, but a much larger amount of loans had been lent as a result of the reflows from these short term loans.[3] In Mexico as of September 31, 1988, 12 loans for a total of $22,270 had been disbursed from the guaranteed funds.

4. The sustainability of a microenterprise program requires charging fees and interest rates that are sufficient to cover the program's real costs.

In Mexico, because ADMIC is not the lender, ADMIC receives no interest income, only a 10% one-time processing fee. Prior to the recent restructuring, ADMIC's fee was only 3%. This was inadequate to cover operating and TAT costs. Consequently, ADMIC had to subsidize costs of the PRE program with earnings from other programs. Fundación Paraguaya charges an interest rate that is higher than

[3] The exact amount is difficult to calculate due to reflows from other programs being commingled with the PRE guaranteed funds.

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commercial rates (but lower than money lenders) - 72% per year, add-on, which is a 114% effective rate. This rate allows FP to cover most of its costs and to move towards self-sufficiency.

5. A savings component should be part of microenterprise lending programs.

Some borrowers have suffered the consequences of unforeseen expenses, nonpayment by clients, and other problems. As a result, they have not been able to make their loan payments. If they had an emergency fund of savings, these situations could normally be covered.

Recommendations for Successor Activities

1. If measuring specific borrower impact of A.I.D. guaranteed loan funds is desired, disbursement and reflows of loans made using these funds should be tracked separately and a requirement established for separate accounts. However, this may not be practical (in terms of costs and institutional capacity). If the loans being made with A.I.D. funds are for similar purposes as other loans, then borrower impact could be measured using a random sample of all borrowers. The same baseline data collected at time of application should be compared with data collected at regular intervals.

2. If the letter of credit mechanism is to be used, it should remain simplified and, under some circumstances, a legal representative of A.I.D. should be present to expedite negotiations with the commercial banks.

3. Ideally, the borrower of PRE guaranteed funds from the commercial bank(s) should be the ACCION affiliate rather than the microenterprises. This precludes the need for independent bank appraisal and allows more borrowers to be reached. However, the Mexico program indicates that effective mechanisms can be developed even if funds do not flow directly to the affiliates. The key point is that the affiliate should have primary responsibility for loan processing and analysis.

4. There are two possible approaches to establishing interest rate: a) cost center approach - each source of funding is considered a separate program that must cover its own costs of capital, administration and TAT or b) establishing a weighted cost of capital and charging the same interest rate for all loans. In Mexico the affiliate is prohibited by law from being the actual lender, but does the loan processing. In such a case the bank should be able to cover its cost of capital, but the affiliate should be able to charge fees for the administrative and TAT costs.

5. ACCION affiliates should emphasize to borrowers the importance of savings to cover unforeseen expenses and to facilitate payments on loans. This could be done by offering a savings course or establishing appropriate savings vehicles such as passbook accounts or short-term certificates and by developing and/or joining with local savings institutions such as credit unions.

9. Securitized Trade Finance

PROBLEM	STRATEGY	PRODUCT MECHANISM	MONITORING EVALUATION
1. Lack of access by Turkish corporations to long-term, fixed rate funds.	1. Provide trade finance companies with a mechanism for raising long-term fixed rate funds.	1. Short-term credit.	1. Most credit went to large businesses.
2. Scarcity of long term funds for SMSE exporters and importers.	2. Encourage major trade finance company to provide long-term credit to SMSEs.	2. Guarantee facility.	2. Credit terms for SMSEs did not improve.
			3. Ram did not change its policies for SMSEs.

The Securitized Trade Finance (STF) project was designed to help companies move away from short-term, variable rate loans by giving a major trade finance company initial access to U.S. capital markets. The project had two major purposes: (1) To implement an innovative new strategy for mobilizing foreign exchange credit for small and medium-scale enterprises (SMSEs) that export; (2) to help expand SMSE trade financing through private sector involvement. Turkey was chosen because it had an international standing midway between OECD and Less Developed Countries. This fact permitted a testing of the format with less concern for country risk.

A.I.D./PRE provided a $2 million co-guarantee to facilitate the borrowing of $10 million from the U.S. capital market by Ram Dis Tiçaret A.S., a wholly owned subsidiary of Koç Holding, A.S. Four million dollars of the borrowing was to be used to finance trade transactions for SMSEs (net fixed assets, excluding land, of no more than $1 million) and Ram agreed to use its best efforts to assure that not less than 50% of the remaining $6 million of the proceeds would also be used for the benefit of SMSEs. The borrowing was to be secured by trade receivables, the full faith and credit of Koç, and an additional $8 million guarantee by a consortium of international banks.

Finding and Conclusions

1. The STF facility assisted Koc in its plan to obtain long term fixed rate foreign currency credit in the U.S. capital market and possibly influenced the successful negotiation of a subsequent borrowing, but did not create an new capital market mechanism for Turkey.

The A.I.D. co-guarantee expedited gaining access to offshore fixed term capital markets and reduced the Koç Group's dependence on short-term, variable rate commercial bank Eurocurrency financing, but it was not a significant factor in permitting Koç to get an AAA rating from Standard and Poor's. According to both Koç and Ram management, Koç could have received this rating with the support of Postipankki (the lead bank).

The experience with the STF facilitated the company's negotiations for the German DM30 million Morgan Guaranty/IFC private placement. However, the successful negotiation of this note placement may have resulted from both the STF and Koç's international reputation. The greatest impact of the A.I.D. participation was in obtaining the participation of the other members of the consortium of guarantors without which Postipankki would not have provided the full $10 million guarantee.

The STF facility did not create a new capital markets mechanism for Turkey as was intended (Investment Proposal-IP, Sec. 1.08). First, the STF loan was to be guaranteed by existing trade receivables, but there was no evidence that Ram's trade receivables were used as security. Second, there were no Turkish institutions involved in guaranteeing Ram's notes nor any observable impact on other Turkish financial institutions. Although anticipated that other Turkish borrowers would use the STF as an alternative funding source, there were no follow-on projects carried out to test the STF model through a smaller company.

2. The amount of trade financing provided to SMSEs probably increased as a result of the project, but credit terms to SMSEs did not become more favorable.

Some qualifying borrowers were benefitted. Out of a sample of 14 borrowers [4] representing Ram's whole trade finance portfolio, 50% were within the target group currently, but the amount lent to qualifying borrowers represented only 13% of total credit available to the sample. As of November 30, 1988, average net fixed assets of the enterprises in the sample was $2.3 million.

The benefits of the fixed rate, medium term financing obtained by Ram were not passed on to SMSEs as originally intended. In the sample, except for one credit, all loans went to clients with pre-existing lines of credit from Ram, and most of the loans were renewals of previous credits, again in contrast to original project design. The project had little, if any, incremental effect on the size of credit lines extended.

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[4] See p. 19 of report regarding selection of sample.

3. Measurement of borrower impact was impossible because funds were commingled and required sub-borrower reports were not submitted to PRE.

The STF funds were commingled with other credits and no disbursement/ repayment accounts are kept on a source of funds basis. As a result semi-annual reports submitted by Ram cannot specifically identify STF borrowers. In addition, Ram does not keep records concerning sub-borrowers' assets, loan terms, purpose of finance, dollar volume of exports and imports, employment, or production as was required by the Project Agreement. It is therefore impossible to determine the level of compliance from monitoring reports.

4. The STF project did not encourage Ram to change its policies and procedures for SMSEs.

As far as could be determined from records submitted by Ram, the project had no significant impact on the type or terms of credit provided to SMSEs. In addition, there was no significant change in the composition of Ram's trade portfolio. Ram continues to lend to companies that are either subsidiaries of Ram or have long trading relationships with Ram. There was virtually no marketing effort associated with the project to attract new small enterprises.

5. This is not a securitized trade finance facility in the strict sense.

According to original design (IP, Sec. 4.02), this project involved collateralization of the STF loan with Ram's trade receivables. As implemented, the bank consortium guarantee backing the Koç guarantee served as collateral rather than trade receivables. Therefore the securitized trade finance model for SMSEs finance has not been tested by this project, and more complete tests will be necessary to determine the viability of the STF mechanism.

6. Staff in the implementing divisions of Ram did not know about or understand the terms and requirements of the PRE/Ram project agreement.

Despite the major role played by the sales and finance departments in Ram's trade finance operations, they were only superficially informed of the provisions of the A.I.D./STF Agreement. For example, Ram's finance staff were not told to segregate the STF loans under the facility into separate accounts. As a result, compliance with the terms and objectives of the project was mixed.

Recommendations for Successor Activities

1. Testing the STF model could usefully be carried out with companies smaller than Koç to determine whether PRE's credit enhancement mechanism can provide new access to long-term fixed rate capital on a replicable basis and thus create a new capital markets mechanism. Koç is not at all representative of typical trade finance companies in developing countries.

2. In addition, if the STF mechanism is to promote the use of trade receivables as collateral for international loans, then projects must require that receivables be included as collateral.

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3. In order to assure that SMSEs receive the benefits of financing terms obtained by the IFI, parameters for the terms of the sub-loans linked to the IFI loan should be established as a specific requirement for project implementation.

4. PRE should either (A) actively enforce periodic reporting and sub-borrower lending requirements or (B) drop sub-borrower reporting and lending requirements.

5. In order to monitor sub-borrowers, it may be necessary for IFIs to establish a separate account for PRE project loan proceeds. In addition, the establishment of a system to periodically record required information on sub-borrowers should be a condition precedent to disbursement of funds. Without such a system impacts on borrowers and compliance with sub-borrower requirements cannot be determined.

6. In order to encourage the IFI to expand the number of SMSEs receiving loans, a guarantee fund should be established for the sub-loans.

7. IFI operational staff responsible for the project should be informed of the project terms and requirements from the outset. This would significantly enhance achievement of project objectives.