A

FRAMEWORK FOR A SMALL LOAN PROGRAM

as part of the Bosnia Reconstruction Finance Facility — Onlending Management Unit

Prepared for the U.S. Agency for International Development-Sarajevo by BRFF-OMU/DAI

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DAI

7250 Woodmont Avenue, Suite 200, Bethesda, Maryland 20814

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I. INTRODUCTION

This paper proposes a framework for the development of a Small Loan Facility within the BRFF-OMU for making loans in the 50,000 DM to 200,000 DM range, a range somewhat below the current BRFF-OMU.[1] This plan was prepared during the period of May 4 - 29, 1997. The plan draws on business lending experiences in Bosnia over the past year by the World Bank, the BRFF-OMU, the BBAC, local banks, and other international organizations. To gain insight into local market conditions for such a facility, discussions were held with representatives of USAID, five private Bosnian banks, loan officers and management personnel from BRFF-OMU, consultants with BBAC, USAID's Economic Restructuring Project, the World Bank and IFC representatives, and owners of eight Bosnian businesses.

In the course of developing this Small Loan Facility Plan, it has become clear that this presents an opportunity to accomplish two objectives at the same time:

- Expanding the BRFF-OMU program into a new market segment, and
- Providing Bosnian banks with new opportunities to expand their capability and experience as market based lenders.

In many respects the second objective may well have greater value for the long run than the first. While serving the smaller end of the market certainly provides benefits to a new and dynamic segment of the market, in the short run resources and market factors will continue to constrain the numbers of individual transactions which can be completed, even with a streamlined lending approach. However, by using the Small Loan Facility as a means for expanding the skills and capabilities of the Bosnian banks, BRFF-OMU lays the groundwork for eventual normalization of financial markets and transfer of the entire BRFF-OMU program to local operations.

Four options were considered as possible locations for operating a small loan program:

- Operate through existing BRFF-OMU using the same (perhaps more expedited) procedures;
- Operate through local banks as the principal delivery and loan management vehicles, using BRFF-OMU for bank strengthening, operations support, and oversight;
- Give the funds to the World Bank PCU to operate in the same fashion as its current program; and
- Create a new organization such as a development finance institution.

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[1]Until recently the BRFF-OMU was not considering loans under approximately 600,000 DM. However, under policies now in effect, loans above 200,000 DM will be considered by the direct lending program of the BRFF-OMU.

After careful review of the options, it was determined that the second of the above options provided the most fruitful direction for a future program.

The option of using BRFF-OMU to directly lend to small companies was rejected principally because of personnel constraints. The existing program already puts tremendous demands on the staff for producing new loans. While we believe it is possible to streamline processing in both the small loan facility as well as the current program, we do not believe it is possible to reduce processing time sufficiently to offset the time required for a large number of new transactions. Currently the target for loan officers is to produce approximately 2.5 loans per month at an average 1,000,000 DM each. Small loans are expected to average 100,000 DM to 150,000 DM each. Considering those differences, an loan officer would need to process about 8 times as many small loans to generate the same DM volume as in the current BRFF program. While it may well be possible to cut average processing time by as much as one-half in the small-loan program, reductions of 80% are more are not possible. We do not believe that resources are available to fund a staff of 8 times the current size.

The option of giving additional funds to the World Bank was rejected principally because we believe there are some significant structural flaws in its program design. Even though it is serving a market similar to that planned for SLF, we do not feel that it makes proper use of the participating banks. We believe that it is missing an opportunity to strengthen the banks in the fashion proposed in our SLF plan. We also believe it operates through too many banks without proper monitoring controls over the use of funds. Even though current evidence suggests that the program is doing well, we think the approach being used puts too great of a risk on the funding source.

Creation of a new institution was considered and rejected. Starting a new institution *de novo* would required a long lead time and a significant investment in systems and personnel to get started. Ultimately the investment in that effort would be better spent if concentrated on existing private banks.

We believe that establishing a program using Participant Banks, while simultaneously using the SLF as a means of upgrading bank capabilities offers the most efficient method of finding loans and the greatest long term investment of USAID funds. By working with several banks, the number of entry points and the potential geographic coverage for borrowers is increased. Investments in upgrading and capacity building will benefit not only the SLF component, but more importantly the bank in its overall operations.

Almost everyone interviewed believes that loans in 50,000 DM to 200,000 DM range would be extremely popular and quite helpful to private Bosnian businesses. However, there are quite differing opinions as to the approach which should be taken in providing that capital, and the risk/loss outcomes which one might expect. This plan attempts to take into account the many different opinions expressed by the interviewees, to provide an approach which will put capital into the target market without creating an unacceptable level of risk for USAID/BRFF-OMU, and to avoid introducing extreme market distortions within the participating banks.

This framework for a Small Loan Facility has been developed as a way of expanding the market reach of the BRFF-OMU. It is not a substitute for the current BRFF-OMU but rather a means of providing financing in smaller amounts and to less complex situations which currently do not now qualify for BRFF-OMU financing.

The following are some of the guiding principles for this new Small Loan Facility.

- The Small Loan Facility (SLF) will provide a means of delivering credit to private Bosnian companies in amounts of 50,000 DM to 200,000 DM.

- The SLF will rely to a substantial degree on private (or predominantly private) Bosnian banks as the means of delivering the credit, with BRFF-OMU's role (after an initial start-up period) primarily being one of guidance, training, and oversight.

- During the initial start-up period, the program will have characteristics of a market test with a limited number of banks and limited initial lending authority for each bank. As the concept proves itself viable, and as each participating bank demonstrates its ability to function satisfactorily, the SLF can expand to more banks and more autonomy will be granted to the individual banks. Technical assistance, training, and new systems development from BRFF-OMU/MIT will be provided to each bank to upgrade their ability to participate effectively in this and other BRFF-OMU programs.

- A simplified and standardized loan analysis procedure will be employed. This will substantially reduce the time involved in processing individual transactions as compared to the current BRFF-OMU. This simplified approach is considered appropriate because it is expected that the individual businesses being financed will be less complex than the typical BRFF-OMU transaction. Most of the analysis will be done by the participating bank.

- USAID/BRFF-OMU will share the financial risk of the project loans with participating banks. In cases of defaults, banks will be required to liquidate all available collateral, and after that the bank and BRFF-OMU will share losses equally.

- USAID will be asked to relax some of the programmatic limitations currently in effect for BRFF-OMU, such as the ratio of jobs created to financing and the prohibition on financing service businesses.

II. THE PARTICIPATING BANKS

The Role of the Banks

The Participating Banks will be instrumental in implementation of the SLF. All applications will be originated, analyzed, closed, and serviced by the banks. A bank will be required to pass a test of competency and viability before being certified to participate in the program. Banks will be required to operate according to standards and procedures established by BRFF-OMU and USAID in order to receive lending funds through the BRFF-OMU. They will be required to participate in BRFF-OMU/MIT training courses, to use the analytical approach prescribed by BRFF-OMU, to report in a timely and complete manner according to formats established by BRFF-OMU, and to undergo periodic review by BRFF-OMU staff. They will be granted limited autonomy for making loans at the beginning and will gradually earn additional autonomy as they prove themselves capable.

The BRFF-OMU program has always intended there to be a natural evolution of the role of Agent Banks. Currently they serve purely as agents who identify loan candidates, refer applicants to BRFF-OMU, and provide collection and monitoring services for a fee. As they gain knowledge and experience, it is intended that they would take on greater responsibilities as a way of preparing them for eventual full market operations. The SLF provides a means of moving the banks one more step down the road to this independent lender status. The technical support, training, and capital provided by BRFF-OMU can give the banks the experience and confidence to become market-based lenders. At the same time, close monitoring of the BRFF-OMU will provide protection for USAID's funding.

Procedures and Criteria for Selecting Banks

An initial group of three or four banks will be chosen based on evaluations conducted with the assistance of KPMG's Bank Supervisory Program, the EBRD, and compliance surveys conducted by the BRFF-OMU. After the program has been pilot tested with selected banks, a broader competitive selection will be open to all banks in Bosnia with at least 51% private ownership will offered an opportunity to compete to become Participant Banks.[2] The selection will be made jointly by BRFF-OMU and USAID personnel. Criteria for selection will consist of the following:

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[2]The World Bank small loan program allowed all Bosnian banks to supply loans. We do not recommend following a similar course. It would not be possible for BRFF-OMU to guide and monitor a program in all 28 Bosnian banks, and without such guidance and monitoring, we believe there is a very high probability of an unacceptable loss outcome.

Acceptance of Program Objectives, Design, and Procedures

Banks must demonstrate an understanding of the objectives of the SLF, that management and key staff are in agreement with the program objectives and design, and they must agree to operate under the policies and procedures established for the program. The banks must be willing to participate in credit training, establish independent credit departments, operate in accordance with written credit policies and procedures, establish effective audit functions, and install credit-audit programs.

Demonstrated Capability to Participate

Banks must demonstrate that they have management and staff personnel who are able and willing to operate within the procedures and guidelines of the SLF. Among the factors which will be used to judge this capability are: knowledge and experience of the key loan personnel in the bank, extent to which the bank has participated in BRFF-OMU bank training programs; extent to which the bank has been an active and effective participant in BRFF-OMU and World Bank's small loan program; and the extent to which the bank already has an active client base of private companies.

Adequacy of Technology and Management Systems

Banks must demonstrate that they have compatible computer technology to prepare the loan analysis required under the program, and management systems to account for and service the SLF loans. Under certain circumstances banks may be permitted to request small amounts of designated USAID funding from BRFF-OMU to upgrade management systems as part of participating in the SLF.

Financial Viability

Banks must demonstrate financial viability and adequate capital to bear some of the risk of possible borrower losses. We believe that a strict capital adequacy ratio test typical of a U.S. bank supervision environment would be too limiting in the Bosnian context, but capital adequacy cannot be ignored when banks are being put into a risk sharing role.

Participation Arrangements

Once selected, banks will enter into Loan and Participation Agreements[3]. Under the Loan Agreement, a specific amount of funding will be approved for each Bank. The Bank can draw from those funds as it makes qualified loans, and disburse the BRFF funds to sub-borrowers. The Loan and Participation Agreement will define the terms and conditions under which the

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[3]The precise legal form of these agreements will be developed in consultation with USAID's legal and contract office, and will be consistent with current Bosnian commercial law.

Bank can make use of the available funds. By approving loan terms and the specific agreements which each bank, the USAID Mission Director will have complied with his requirement to approve each BRFF loan. Individual sub-loans made by Banks will not require subsequent approval by the Mission Director so long as the Bank is fully in compliance with all SLF Program requirements. The amount of funding made available to each bank will be determined as part of a negotiation between BRFF-OMU and each bank, and will be based on a judgment by BRFF-OMU of the bank's ability to effectively use the available funds. Starting amounts would be negotiated on a case-by-case basis taking into consideration the ability of each bank to effectively use the available capital, while also taking into account the Bank's appetite for risk and its capital adequacy. It is expected that the starting amounts will be in the range of 1,000,000 - 2,000,000 DM. The Participation Agreements will bind the banks to operating under the various terms and conditions of the SLF.

Banks will be required initially to submit all of their proposed loans to BRFF-OMU staff. BRFF-OMU will have the right to reject any or all of these if: 1) the loan is not for purposes authorized by the program; 2) the analysis is incomplete or otherwise improperly done; or 3) the BRFF-OMU credit officer does not agree with the viability analysis. Once a bank has completed three to five acceptable loans and has been certified by BRFF-OMU as fully qualified to originate loans, it can be authorized to approve loans up to 100,000 DM without prior approval by BRFF-OMU. Banks will have to submit each approved loan package to BRFF-OMU to receive funding. While BRFF-OMU will not subject each of these to an independent credit analysis, they will be checked for completeness and general approach. If BRFF-OMU believes that a bank is not complying with program regulations, or failing to perform adequately in any significant way, funding can be halted while corrective action is undertaken.

All loans above 100,000 DM must be submitted to BRFF-OMU for approval. For those loans which BRFF-OMU must approve, BRFF-OMU staff would normally spend no more than two days on the review of each loan, including a site visit. At the discretion of BRFF-OMU, the bank's individual lending authority may be increased to 150,000 DM or 200,000 DM.

The Bank will issue all loans in the name of the bank using loan agreements, promissory notes, security agreements, acceptance drafts, and other documentation acceptable to BRFF-OMU. BRFF-OMU will provide funding for these loans by allowing draws against the funds made available through the loan agreement between BRFF-OMU and the bank. All of the project loans will carry an assignment clause allowing BRFF-OMU to take possession of these loan agreements and act in the name of the bank to collect, liquidate, or sell the loan should the bank fail to act properly in managing the program.

The Bank and BRFF-OMU will share the risk on individual loans. A number of risk sharing arrangements are possible. After consideration of a variety of possible options, it is proposed that BRFF-OMU and the Bank share equally in all losses after first liquidating any collateral and guarantees offered by the borrower as part of making the loan.

In keeping with the risk-sharing and autonomy principles, banks should be permitted to charge higher interest rates for the smaller sized projects and to use the additional margin to build reserves and capital. It is proposed that banks receive funding at a "wholesale" rate of LIBOR + 2% and then be permitted to charge a spread of up to 7% above the cost of funds. Banks would create a loss reserve fund in which they would deposit 2% of the spread to cover a portion of their loss risk. If actual losses are less than the reserve account at the end of the program, they will be allowed to transfer the account surplus to their own capital.

Loan agreements with banks should carry a five year term and banks should be given the right to reuse funds as they are repaid by borrowers. This provides additional incentives for banks to lend the funds, and to collect from borrowers. Additional reasonable processing fees could be permitted. Banks will be required to provide monthly reports on the status of the portfolio funded by BRFF-OMU funds.

Program Set-up and Training

A key to the success of this program will be proper set-up with the Participant Banks. This set-up consists of three parts: a consistent loan analysis technique for evaluating borrowers, training of bank credit officers in the use of these analytical techniques, and a monitoring and reporting system for the banks. As referenced previously, it may be appropriate to allow banks to purchase hardware and software from program funds to be used both for project analysis and monitoring.

Participant banks would be required to put their credit officers through a training course of one to two weeks on credit analysis for small loan borrowers, and on the use of the analysis and monitoring systems. This would be a prerequisite for receiving the first draw of funds.

A program of small business training and technical assistance will be undertaken jointly by BRFF-OMU and BBAC. This will consist of two elements: a basic business skills training course for sub-project applicants, and a training course for local small business consultants. The details of this course will be elaborated separately in a program plan prepared by BBAC. It is envisioned that for the small loan facility BBAC will mirror its consultancy initiative now functioning as part of the BRFF-OMU, but using local Bosnian consultants which BBAC will train and certify.

III. THE BORROWERS

Borrower Characteristics

It is expected that companies financed through the Small Loan Facility will be primarily single owner or family/closely held businesses with local or regional markets and employment (before financing) in the range of 5 - 20 people. They are likely to cover a range of business sectors including small scale production, agriculture and agri-businesses, and certain types of business and personal services. The eligible financing will be in the range of 50,000 DM to 200,000 DM. Typically these financings will entail primarily equipment, materials and supplies, inventories, and working capital, with very little of the capital for construction of facilities. While it is expected that financing may increase total employment for the company by perhaps 50% or more over time, it is also expected that in many instances it will be difficult to achieve the "*one job for 10,000 DM*" financing. Therefore, it will be requested that this be relaxed to a portfolio target rather than a financing requirement.

Many of these companies will be engaged in production, often as suppliers to larger industrial concerns or to retail businesses. This production could include metal working such as bending and welding, woodworking and furniture production, stone cutters, clothing production, leather working, and small scale food processing. However it is also recommended that certain types of services be made eligible. These could include equipment and vehicle repair and maintenance and construction trades such as plumbing, electrical, roofing, and ceramic tile installation. In the course of preparing this plan, we visited Bosnian companies which are now engaged in retail trade, but which are interested in starting their own production operations. Those should be eligible borrowers. Consideration should be given to financing medical, dental, and optical clinics as a way of encouraging the return of professional service providers. Prohibitions against bars, restaurants, trading operations, hair salons, massage parlors, and other similar personal services should remain in place.

No attempt has been made to quantify the size of this market, or to systematically profile the characteristics of borrowers. Overall the country of Bosnia-Herzegovina has a population of approximately 4.2 million with about half of that in the Federation. We estimate that in a country of two million people, perhaps one-half to one percent of the population will own and operate a small business. The BRFF-OMU program is further limited at present to only the US-SFOR sector. That suggests a potential market size of about 10,000 to 20,000. Excluding those which are micro-scale or only marginally viable, and excluding retail and personal service firms, the true market size for loans in the 50,000 DM to 200,000 DM is probably in the range of 1,000 to 2,000 companies.

Eligibility Criteria and Approval Procedures[4]

Two types of eligibility criteria will govern the approval of borrowers for financing: Programmatic eligibility criteria and financial viability. Each applicant will complete a loan application and be subject to a viability analysis. For a project to be approved, the applicant must comply with both types of criteria.

Programmatic Eligibility Criteria

- A majority of the shares must be owned by private (non-governmental) entities, and preferably, 100% of the ownership will be private.
- The project must be located in U.S. eligible territory of Bosnia-Herzogovenia
- The project must be for a business purpose not excluded under BRFF-OMU regulations

Project Viability Criteria

- Ownership and Management
  - Owners are private individuals who are engaged on a day to day basis in the operation
  - Owner/Managers have proven experience in the operation of this or similar type business
  - Owner/managers display reliability and integrity, verified by references from banks, clients, suppliers, etc.
- Market demand for products
  - Products are of the type that demand is identifiable and proven
  - Competition by other producers/suppliers not excessive relative to demand
  - Company can generate a reliable projection of revenues for the next two years
- Company/management experience
  - Company has at least one years (preferably more) verifiable experience in the market,
  - Owner/manager has had relevant experience (probably before the war) in at least one of the key functional areas of the company (production, sales, finance, etc)

[4] To be refined as part of SLF set-up.

- Revenue, expense, profitability, and cash flow

  - Company can identify and present its production and operating costs
  - Estimated revenues exceed estimated costs by an acceptable margin
  - Company can provide cash flow projections which, including debt repayment, are positive with an acceptable margin.

- Balance sheet stability

  - Company has acceptable balance sheet ratios: debt to equity; current assets to current liabilities; etc
  - Quality of assets is acceptable (no inflated or unrealistic values)
  - No hidden liabilities, or payout requirements are not manageable

- Suitability of Proposed Financing Terms

  - Adequate contribution by applicant: total proposed financing no more than 60% of company assets after the loan is made
  - Collateral: first position on all available assets
  - Other terms as required by BRFF-OMU and bank (to be determined)

- Sound Environmental Practices

  - All borrowers must demonstrate that their projects do not pose an undue hazard to the environment or to their employees.

IV. MONITORING AND CONTROL

Monitoring must be applied at two different levels: the Participant Bank and the individual project borrowers. The Participant Banks will have the primary responsibility for monitoring borrowers, but BRFF-OMU will need to make periodic spot-checks of borrower performance. BRFF-OMU will need to put a considerable amount of effort into monitoring the Participant Banks. As banks are able to prove that they can function effectively in this program they are given additional autonomy and lending authority. Therefore, it is essential that bank performance is properly monitored so that this improvement in capability can be adequately gauged. Banks which are failing to perform as required can be suspended or terminated from the program.

Banks should be expected to provide the BRFF-OMU with three types of information on a regular basis:

- A tracking sheet of client prospects, work in process, and active loans;
- A financial report on the status of borrower payments (including an aging schedule)
- A portfolio quality report which, in particular, will provide information on any problem loan situations which may be developing.

In addition, Banks will be required to maintain a loan file on every borrower following a format established by BRFF-OMU. These files will be available for inspection by BRFF-OMU but will remain in the possession of the banks. Information in the loan files should include documentation such as:

- The loan application from the borrower
- The analysis and recommendations by the bank
- Loan agreements and other documents related to the loan transaction
- Correspondence between bank and borrower
- Reports on monitoring visits and other critical contact between bank and borrower.

V. IMPACT TARGETS

As noted in the introduction, there are two objectives which can be achieved simultaneously through the Small Loan Facility:

- Assisting banks with growth and development of market-based skills, and

- Moving the BRFF-OMU into a new market segment of smaller and younger private businesses.

While we believe there is a large and active pool of potential borrowers in the identified financing range, we are proposing a cautious approach to the market in the initial phase. Over the period of a few years it is quite probable that the number of transactions in a Small Loan Facility could exceed the number of BRFF-OMU borrowers. However, because of the smaller size of transaction, it is less likely that the dollar volume of lending will exceed that of BRFF-OMU.

A key limiting factor in the number of transactions achieved by SLF will be the capacity of Participant Banks to identify, process, and service clients. We believe that a likely number of transactions per bank after one year of full operation will be approximately 10 to 15 loans.

We believe it is possible to bring three or four banks up to a level of certification and full-scale operation during the first full year of operations, and that this in itself is an important impact measure apart from lending volumes and jobs created. An additional four banks could be added during the second full year of operation.

As referenced previously, we believe it is not likely that the current target of one job for every 10,000 DM financed can be achieved by the Small Loan Facility. A more realistic target is likely to be in the range of one job for every 20,000 DM.

VI. IMPLEMENTATION REQUIREMENTS AND TIMETABLE

There are three sets of actions which must be completed in order to launch the Small Loan Facility. We propose that USAID undertake the first of these steps during the current contract period. The second and third should not be undertaken until USAID has decided exactly in what form and at what level it will fund the BRFF after the expiration of the current contract. The three steps to launch are as follows:

Step 1: Prepare Program Operating Documents and Systems

- Loan Operations Manual
- Criteria and Selection Procedures for Bank Participation
- Loan tracking and reporting systems
- Specific formats and parameters for reports
- Acquire and customize as appropriate computer software for loan tracking
- Design a training program for banks

Step 2: Pre-launch implementation activities

- Select banks for participation
- Install monitoring systems for loan tracking
- Carry out training programs for participating banks

Step 3: Project Launch

- Undertake loan outreach through participating banks
- Initiate loan operations

A draft scope of work for all elements in Step 1 except customizing the computer software is attached as Annex 1. This Scope of Work calls for a level of effort of approximately 60 person days from a team of two or three consultants. The work can be completed in approximately five to six weeks.

ANNEX I
DRAFT SCOPE OF WORK FOR PREPARATION OF SLF SYSTEMS AND DOCUMENTS

Objective: To complete all systems and documents for the Small Loan Facility

Estimated LOE: 60 Person-days (two to three person team)

Time Frame: 5 to 6 weeks beginning approximately July 15, 1997

Activities:

Prepare Loan Operations Manual for SLF

- Prepare a Procedures Manual for the SLF laying out the policies and procedures under which the Participant Banks will operate. This Manual will include, but not necessarily limited to:
- Methods and procedures for marketing the program and soliciting applicants.
- Methods and procedures for evaluating loan applications
- Standardized loan agreements for project sub-borrowers
- Standardized loan file formats for project sub-borrowers
- Monitoring and reporting procedures
- Standard report formats for Participant Banks
- Procedures for handling delinquencies, defaults, and liquidations

Refine criteria and procedures for selection of Participant Banks and evaluate the initial group of banks for participation.

- Review draft criteria in Section II-B of the "Framework for a Small Loan Program"
- Provide specific tangible measurements to operationalize the criteria

Prepare training program for Participant Banks

- Develop a curriculum guide and training materials for a course which will be implemented by the training unit of the BRFF-OMU.

ANNEX II
STANDARDIZED LOAN PACKAGING, APPRAISAL, BOOKING AND MONITORING

As mentioned in the proposal, the key to the success of the program will be proper set-up with the Participant banks in respect to consistent loan analysis techniques, training and the ability to monitor and report on the loan portfolio. During the last year, more than 300 loan officers in Bosnia participated in the MAS training courses which provided the analysis tools required to evaluate the credit worthiness of the small business loan applicants and to effectively monitor a small business loan portfolio. Although the skills are standard, the training program does not ensure standard application of the these skills. Sound operational policies and systems do.

To ensure that loan officers in Participant Banks are consistent and thorough in their utilization of commercial loan analysis and monitoring tools, the Small Loan Program will standardize the loan packaging, appraisal, booking and monitoring process. The starting point for this standardization will be documented loan policies and procedures including clearly defined loan products and application formats. The appraisal process will defined a series of analytical steps which include project and company cash flow profitability, growth potential, character assessment, review of corporate structure, and employment generation. Loan documentation, funding, registration and perfection of liens, commonly referred to as "booking the loan", will be share common features but be customized to each participant bank. Standard monitoring procedures and reports will be developed for sharing information between the borrowers and the Participant banks and between the Participant bank and the OMU. Effective and timely loan monitoring will be critical to the success of the program.

A decision must be reached prior to project start-up on the level of automation to use in managing the lending process. The cost and benefits of using a manual or electronic system for each part of the loan must be assessed . A manual system would rely on a loan file or folder which included standard application form, credit analysis, and loan recommendation, followed by a standard loan document. Provided with strong supervision, manual system are effective in maintaining quality standards but as volume increases, can often become inefficient.

An electronic process would provides a higher level of control and forces standardization in terms of format. Electronic systems provide additional support to the loan managers by ensuring that each officers follow the appropriate steps in packaging and appraising the loan. The volume of transactions per bank estimated in the program would most certainly suggest the unitization of a computer based system for loan monitoring and maintenance of a general ledger. Electronic loan appraisal and monitoring systems are costly and can increase operational risk if the software is not fully debugged. If a bank choose to use an electronic system, and the systems stops working, quite often the entire loan process stops functioning. Signing a maintenance agreement which provides reliable technical support is an absolute necessity with any system purchase.

The table below provides an initial estimate of cost involved with purchase and customization of hardware and software for participant banks. Estimates are derived from retail price information provided by vendors who provide required systems.

System	License Fees (Per Bank)	Cost of Customization	Maintenance Contracts (Per Bank)	Total Estimated Cost
Loan Monitoring System and General Ledger	$25,000 (x2)	$75,000	$12,500(x2)	$150,000
Loan Packaging and Appraisal System	$10,000(x2)	$30,000	-----------	$50,000
Hardware - Five Desktop 486 Pentium PC's and Printer	$30,000(x2)			$60,000

The cost for development a complete system for two banks in the pilot phase of the project would be at a maximum of $260,000 or a minimum of $210,000, should the program decide to automate the loan monitoring and general ledger function. Given that customization cost are the most expensive part of the integrated software package ($105,000), economies of scale can be achieved as the program expands. The table below provides analysis of how the development and installation cost might be spread across a number of banks as the program expands.

System	Two Pilot Banks (Cost Per Bank)	Three Banks (Cost Per Bank)	Five Banks (Cost Per Bank)	Ten Banks (Cost Per Bank)
Full System (Loan Appraisal, Monitoring and GL)	$130,000	$112,500	$104,000	$88,000
Basic System (Loan Monitoring and GL)	$105,000	$92,500	$88,500	$75,000

These issues and the development of clear specifications for tendering for appropriate software will be further investigated during the next four weeks. As stated in the proposal, **Step 1** toward launch will include preparation of the Program Operating Documents and Systems. These will include the Loan Operations Manual, Loan tracking and reporting systems, Specific formats and parameters for reports and the design a institutional development training program for participant banks.

It is anticipated that the operational manual, systems specifications documents and training program design will be completed by August 30, 1997.

ANNEX III
RISK AND THE SMALL LOAN FACILITY

Risk in any investment activity arises from a number of different sources and factors. This annex addresses the risk associated with BRFF-OMU Lending, with particular attention on the Small Loan Facility.

Bosnia is emerging from four years of war. Before the war the country was part of communist Yugoslavia. These facts alone make doing business in Bosnia a very hazardous prospect. The war has destroyed lives and facilities, disrupted markets, and has left behind tensions which will take years to dissipate. There is no local currency, no acceptable commercial code or institutional practices to govern financial transactions. Markets which were previously local (Croatia, Slovenia, Serbia) are now international and in some cases entirely unavailable. All business dealings in Bosnia carry a level of risk far above normal western standards.

Before the war there was Communism and substantial state ownership of enterprises. Some small private enterprises and farms did exist, but production was predominantly in the hands of state enterprises. As in the rest of the former Communist world, these companies often operated with outmoded technology, management which was driven more by politics than business interests, overloaded staffing subsidized by the state, and many other noncompetitive practices. Even though communism effectively ended several years ago, state owned enterprises still dominate the production markets, and may still operate in the old inefficient manner. Information needed for managing an efficient production operation is either not collected at all or is not in a useful form for analysis. Even where information may have existed before, much of it has been destroyed in the war.

In other words, business and finance at all points along the spectrum in Bosnia is enormously risky. The relevant question concerning the SLF is to what extent risk in that market segment and in the particular approach outlined differs from that in the overall BRFF-OMU. There are two factors which differentiate SLF lending from the current BRFF-OMU program: the size of the transactions and the role of the Participant Banks.

<u>Risks Associated with Small Scale Borrowers</u>

The conventional view by bankers is that smaller companies and financings are inherently riskier than larger ones. Some of the reasons typically cited are:

- Small companies have limited markets and product lines and are therefore vulnerable to changes in demand and competition

- Small companies cannot obtain resources to upgrade technology and products

- Managers/owners are unsophisticated and cannot employ modern management techniques

- The loans are typically working capital and light equipment which has little value as collateral

While many of these are undoubtedly true, in Bosnia there are a number of offsetting factors which mitigate the relative risk of smaller vs. larger companies.

- There is a high correlation between "larger" and "state or former-state enterprises". In those cases, poor management practices typical of the former Communist system greatly increases risk. Smaller companies are almost certainly purely private, and as such, often more entrepreneurial.

- The larger enterprises in Bosnia often require a substantial amount of sales to be made in "external" markets. The war has badly disrupted those market relationships. Smaller companies can often achieve their revenue targets entirely with local markets.

- The smaller individual transactions makes the overall portfolio less vulnerable to a major wipe out loss from a single bad loan.

On balance, then, the risk relationship of "big vs. small" is not so clear cut in Bosnia. Even accepting that there may be some greater correlation of risk vs. size, it is felt that the true nature of that risk differential in the Bosnia market is not really significant.

<u>Risk Associated with Participant Banks</u>

As a means of ultimately achieving processing efficiencies, and as a way to improve operations in private banks, the SLF relies on private banks to handle a substantial amount of the loan review, approval, and servicing. The banks are also expected to carry some of the risk of the projects which they approve. This new role for banks does introduce several new risk factors into the lending equation. Two in particular stand out:

- Reliance on bank personnel and systems -- Banks are expected to play a major role in the analysis of loan applications, approvals, and servicing. SLF must rely on the competence and integrity of personnel, and on the adequacy of systems and procedures, to a far greater extent than in the current BRFF program.

- Financial risk borne by the banks -- Banks are expected to share in the financial risk of borrower losses. Normally this might be considered positive, since the ultimate risk borne by the project would be lowered. However, because the banks have such limited capital, most do not have the financial stability to absorb the loss which they might take on. Therefore, not only doesn't the risk sharing offer any real financial protection to BRFF, there is the added risk that if a bank absorbs too great of a loss, the entire bank could collapse.

The SLF does attempt to deal with the first risk factor by providing a high degree of technical support and systems development for the banks. Banks will be put through a structured growth process which is designed to upgrade their skills while gradually giving more funding authority to the banks. While the risk cannot be totally discounted, a successful program of capacity upgrades will go a long way toward eliminating this risk factor.

Nothing can be done directly to eliminate the risk that a bank may not be able to cover its obligations in the event of large losses. To the extent that upgrading capacity does reduce overall losses, the risk of financial collapse is also reduced. The only solution to this problem comes from having stronger banks with more capital. One small feature which can contribute to an improvement in bank stability will be allowing banks to earn a spread on financing. This extra revenue can be put into reserve accounts to help fund a risk reserve which would be available in the event of losses. The borrower market can probably absorb pricing increases of a few percentage points each year which can be used to fund a reserve account to partially cover losses.

ANNEX IV
THE WORLD BANK SMALL ENTERPRISE LOAN PROGRAM

Beginning in the middle of 1996, the World Bank initiated its Emergency Recovery Project for financing small enterprises in Bosnia. This is probably the one experience most relevant to the proposed Small Loan Facility of the BRFF. Loans made under the World Bank program ranged from 30,000 DM to 300,000 DM. A total of 161 loans have been disbursed with an average size of 203,826 DM, for a total lending volume of 32,816,010 DM.

World Bank loans have been made using local banks as intermediaries. The World Bank program is open to all banks in Bosnia, and loans have been made through 28 banks. The largest participant has generated approximately 3.7 million DM. Five have produced over 2.0 million DM, and 14 have produced over 1.0 million DM.

The World Bank supplies funds to the banks at DM LIBOR - 2% and allows the banks to re-lend at DM LIBOR +5%. In other words, banks are lending for approximately 8% and earning a 7% spread over their costs. The banks are responsible for 100% of the credit risk.

Agriculture and food industry loans account for 11.3 million DM, or 32.3% of the total. Wood processing and furniture making account for 6.3 million DM, or 18.0% of the total. Construction materials and glass account for 5.1 million DM, or 14.4% of the total. Additional other categories including textiles, shoes, stone cutting, optical shops, metal processing, chemicals, and graphics account for the remaining 35% of the loans.

No servicing reports are available on the portfolio. However, according to representatives of the Project Coordination Unit, all loans are current and being paid.

ANNEX V
EASTERN EUROPEAN ENTERPRISE FUND PROGRAMS

As the Eastern European countries began to open their markets, USAID introduced the Enterprise Fund program as a way of providing capital to small and medium sized companies. While the Enterprise Fund programs and the BRFF have a number of different characteristics, they also have some important similarities. All of the countries in the region are emerging from Socialist/Communist regimes, and as such have only rudimentary knowledge of private enterprise and market economics. The economic environments vary quite considerably, from relatively hospitable in Czech Republic and Hungary, to moderately inhospitable in Bulgaria, to extremely inhospitable in Bosnia.

In all of the Enterprise Fund countries, the programs have evolved into a two-tiered structure: larger transactions (often equity or combinations of loan and equity) in excess of $1 million each, and smaller transactions, often in conjunction with local banks, in amounts under $200,000.

In 1995, DAI conducted an evaluation of the first group of Enterprise Funds, which at the time had been in operation for three to five years. As a useful comparison, the following is a collection of performance data on these funds.

TABLE 1
ENTERPRISE FUND INVESTMENT AND LENDING ACTIVITY (1990 - 1994)

Country/Activity	Yrs. Open as of 9/30/94	Numbers of transactions	Average Size Transaction	Total Dollars of Transaction
Hungary				
Large Investment	4	31	$1,179,392	$36,561,160
Smaller Loans	4	166	$40,225	$6,677,390
Poland				
Large Investment	4	30	$3,495,000	$104,850,000
Smaller Loans	4	2,787	$23,257	$64,817,321
Czech & Slovak				
Large Investment	3	49	$402,939	$19,744,000
Smaller Loans	3	35	$78,372	$2,743,027
Bulgaria				
Large Investment	2	5	$611,720	$3,058,600
Smaller Loans	2	15	$22,144	$332,166

SMALL LOAN PROGRAM BUDGET

Phase I				
I. Labor	**Daily Rate**		**Budgeted Days**	**Budgeted Amount**
Commercial Banker I	$1,299.00		60	$77,940.00
Total Labor				**$77,940.00**
II. Travel	**Amount**		**Quantity**	**Budgeted**
Flights	$1,883.00	/trip	2	$3,766.00
Local Transportation	$10.00	/day	15	$150.00
Misc. Travel Exp.	$80.00	/trip	2	$160.00
Lodging	$229.00	/day	15	$3,435.00
Per Diem	$74.00	/day	15	$1,110.00
Total Travel				**$8,621.00**
III Other Direct Costs	**Amount**		**Quantity**	**Budgeted**
Danger Pay	25% actual salary			$1,500.00
Document Translation				$3,400.00
Training Materials				$3,000.00
Total ODC				**$7,900.00**
Total Budget, Phase I				**$94,461.00**
Phase II				
I. Labor	**Daily**		**Budgeted**	**Budgeted**
	Rate		**Days**	**Amount**
Systems Installation				
Industry Specialist	$829.00		25	$20,725.00
Training				
Commercial Banker I	$1,299.00		30	$38,970.00
Total Labor				**$59,695.00**
II. Travel	**Amount**		**Quantity**	**Budgeted**
Flights	$1,883.00	/trip	5	$9,415.00
Local Transportation	$10.00	/day	55	$550.00
Misc. Travel Exp.	$80.00	/trip	5	$400.00
Lodging	$229.00	/day	55	$12,595.00

Per Diem	$74.00	/day	55	$4,070.00
Total Travel				**$27,030.00**
III Other Direct Costs	**Amount**		**Quantity**	**Budgeted**
Danger Pay - Specialist	25% actual salary			$1,875.00
Danger Pay - Com. Bank.	25% actual salary			$2,250.00
Systems Installation Cost				$87,000.00
Total ODC				**$91,125.00**
IV Commodity Costs	**Amount**		**Quantity**	**Budgeted**
Min. Systems Installation				$210,000.00
Max. Systems Installation				
Total Commodity				**$210,000.00**
Total Budget Range, Phase II				**$387,850.00**
Phase III				
I. Labor	**Daily**		**Budgeted**	**Budgeted**
	Rate		**Days**	**Amount**
Full Time - Ex-pat				
Commercial Banker I	$1,299.00		266	$345,534.00
Bank Audit				
Commercial Banker I	$1,299.00		40	$51,960.00
STTA				
Commercial Banker I	$1,299.00		30	$38,970.00
Full Time - Local				
TCN/Local Labor	$85.18		532	$45,315.76
Total Labor				**$481,779.76**
II. Travel	**Amount**		**Quantity**	**Budgeted**
Flights	$1,883.00	/trip	8	$15,064.00
Local Transportation	$10.00	/day	70	$700.00
Misc. Travel Exp.	$80.00	/trip	8	$640.00
STTA Lodging	$229.00	/day	70	$16,030.00
LTTA Lodging	$2,000.00	/month	12	$24,000.00
Per Diem	$74.00	/day	70	$5,180.00

Local Travel	$518.00	/month	12	$6,216.00
Total Travel				**$67,830.00**
III Other Direct Costs	**Amount**		**Quantity**	**Budgeted**
Danger Pay: Ex-Pat	25% actual salary			$26,600.00
Danger Pay: Audit	25% actual salary			$4,000.00
Danger Pay: STTA	25% actual salary			$3,000.00
Advertising	$1,200.00	/month	1	$1,200.00
Total ODC				**$34,800.00**
IV Commodity Costs	**Amount**		**Quantity**	**Budgeted**
Computers	$4,500.00		3	$13,500.00
Total Commodity				**$13,500.00**
Total Budget, Phase III				**$597,909.76**