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Development Performance Of AID-Assisted Development Banks In Latin America

B-175795

UNITED STATES
GENERAL ACCOUNTING OFFICE

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JUNE 16, 1972

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-175795

Dear Dr. Hannah:

The attached report presents the results of our review of the development performance of development banks assisted by the Agency for International Development in Latin America. Our observations are summarized in the digest included in the report.

A draft of the report was submitted to your Agency for comment and the response was considered in preparing this report.

Your attention is invited to section 236 of the Legislative Reorganization Act of 1970 which requires that you submit written statements of the action taken with respect to the recommendations. The statements
C1-2 are to be sent to the House and Senate Committees on Government Op- <150
erations not later than 60 days after the date of this report and to the
C3-4 House and Senate Committees on Appropriations in connection with the <30
first request for appropriations submitted by your Agency more than 60 days after the date of this report. We shall appreciate receiving copies of all statements submitted.

Copies of this report are being sent to the above committees, the 5130
C5 Senate Foreign Relations Committee, the Subcommittee on Foreign Operations of the Senate Appropriations Committee, the House Committee on Foreign Affairs, the Subcommittee on Foreign Operations and Government Information of the House Committee on Government Operations, the Secretary of State, and the Director of the Office of Management and Budget.

We wish to acknowledge the cooperation extended to our representatives during the review.

Sincerely yours,

Director, International Division

The Honorable John A. Hannah
Administrator, Agency for
International Development 97

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ABBREVIATIONS

AID	Agency for International Development
GAO	General Accounting Office
IDB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development

GENERAL ACCOUNTING OFFICE REPORT TO THE ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

DEVELOPMENT PERFORMANCE OF AID-ASSISTED DEVELOPMENT BANKS IN LATIN AMERICA
B-175795

D I G E S T

WHY THE REVIEW WAS MADE

The General Accounting Office (GAO) reviewed the development performance of development banks assisted by the Agency for International Development (AID) because of (1) the extent of U.S. dollar loan assistance, about $400 million since fiscal year 1958, and (2) the interest in these banks as indicated by the report of the President's Task Force on International Development. The President in his April 1971 foreign aid message also stressed the importance of development banks.

Development banks are financial institutions servicing the industrial sector which are organized and operated to assist in the economic development of less developed countries by financing and promoting private enterprise, particularly small- and medium-size ventures.

The review focused on Latin America because the banks located in this region received approximately 45 percent ($180 million) of total AID dollar loan assistance. To obtain a representative picture, the performance of eight banks in five Latin American countries was examined. The examination that included a review of the banks' loan portfolios was not restricted to AID funds but, where possible, included all funds regardless of source. No financial audits of the banks or borrowers were made.

FINDINGS AND CONCLUSIONS

The institutions reviewed received AID dollar loans of $72 million, or 40 percent of such assistance to development banks in Latin America. These loans were provided at concessionary rates of interest--it cost the United States more to obtain the funds than it would eventually receive from the borrowers. The additional cost for these loans will amount to about $74 million.

AID guidance stipulates that development banks may or should perform certain development functions. GAO evaluated the performance of the banks on the basis of these development functions. GAO found that the institutions had to some extent assisted in the economic development of the countries involved because most of their loans were of medium term and long term and were made to the private sector. In addition, a number of banks were successful in attracting non-AID foreign funds.

In the following areas, however, the banks' performance fell short of AID criteria and could be improved:

<u>Size of firm</u>--large firms received 75 percent of available funds.

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Size of loan--over 80 percent of available funds were for loans in excess of $100,000.

Stimulation of investment--over 75 percent of the banks' funds went to firms which could have obtained the necessary financing for their investments elsewhere, and therefore GAO believes that the banks stimulated relatively little new investment.

Capital markets--the banks did little to establish and broaden capital markets.

Technical assistance--the banks provided little technical assistance to borrowers.

Promotion--the banks did little to search out and promote new investment opportunities.

GAO also noted that, in general, bank investment priorities had not been established and that, by design, AID's monitoring of the development bank program was limited.

Eight of the 13 loan agreements reviewed were two-step arrangements whereby the host government received repayment from the development bank and assumed responsibility for final repayment to AID. In such instances the host government repays AID over a longer period of time and at a lower rate of interest than the development bank is required to repay the host government.

The two-step loan therefore results in substantial sums accruing to the host government. GAO found that none of the loan agreements or underlying documentation set forth the reasons for using the two-step arrangement or the rationale for the terms and that in some cases no provision was made for AID control of the funds generated.

Most of the AID loan agreements did not make provision for AID control over the banks' use of roll-over funds, i.e., funds obtained from repayments of loans made by the banks from the initial AID credit and held by the bank before repayment to AID or the host government.

RECOMMENDATIONS OR SUGGESTIONS

GAO recommends that AID monitor more closely its assistance to development banks through periodic analyses to determine whether the banks

--emphasize loans to small- and medium-size firms,

--stress moderate-size loans,

--consider a loan applicant's ability to obtain the necessary financing from other sources so that there is greater assurance that new investment is stimulated,

--establish and broaden capital markets,

--provide technical assistance to borrowers, and

--search out and promote new investment opportunities.

GAO also recommends that:

--AID, in conjunction with the host country, establish the specific priority activities to be financed with AID funds.

--In those instances where AID assistance is to be provided under the two-step arrangement, AID document the reasons for its use and establish controls over the amount and use of the funds generated.

--AID make provision in its loan agreements for control of roll-over funds.

AGENCY ACTIONS AND UNRESOLVED ISSUES

In its comments on GAO's draft report, AID stated that, on balance, its support of development banks has achieved a significant degree of success in strengthening the channels for investment of private sector funds. AID recognized, however, the continuing need for improvement in the program. GAO believes that its recommendations, if implemented, will assist in this endeavor.

Regarding the recommendation for improved monitoring, AID indicated it is reviewing its monitoring procedures. AID agreed with the recommendation that AID, in conjunction with the host country, establish specific priority activities to be financed with AID funds. AID stated that most two-step loans do provide for AID and host government agreement on the use of the local currency repayments. GAO believes that all two-step loans should provide for AID control over the use of the local currency repayments and that the reasons for use of the two-step loan and the rationale for the particular terms should be documented and explained.

AID disagreed with the recommendation regarding control of roll-over funds and stated that it is unnecessary and would be excessive. GAO believes that control of roll-over funds can provide AID with increased leverage to influence the banks' performance after their initial disbursement of AID funds.

CHAPTER 1

INTRODUCTION

Since fiscal year 1958, the Agency for International Development and its predecessor agencies have made available to financial institutions in less developed countries about $790 million in dollar loans and the equivalent of about $930 million in local currency assistance. AID has furnished assistance to both new and established financial institutions; to those servicing the manufacturing, mining, agricultural, and housing sectors and to credit cooperatives; to privately owned and government-owned institutions; and to mixed private and government institutions.

AID's assistance consists of direct dollar loans, technical assistance grants, and local currency resources generated (1) under nonproject or program loans whose purpose is to provide general budgetary and/or balance-of-payments assistance to the host country and (2) by the sale of agricultural commodities under Public Law 480.

The most important type of financial institution receiving AID support has been the development bank. About $400 million, or more than 50 percent of the AID dollar loans to financial institutions in less developed countries, has gone to such banks.

In their March 4, 1970, report, "U.S. Foreign Assistance in the 1970's: A New Approach," the President's Task Force on International Development recommended that the United States invest more capital in local development banks as a means of stimulating the development of the private sector in less developed countries. This recommendation has assumed more current importance because, in his April 21, 1971, message to the Congress on reorganization of U.S. foreign assistance, the President proposed creation of an International Development Corporation which would:

> "*** give high priority to projects and programs which promote private initiative in the lower income countries, and to this end would seek to increase U.S. lending to local development banks and other financial intermediaries."

AID defines development banks as financial institutions servicing the industrial sector that are organized and operated to assist in the economic development of less developed countries by financing and promoting private enterprise, particularly small- and medium-size ventures. Their primary purpose is to serve as a channel and catalyst for investment in the private sector by providing injections of capital, enterprise, and management into a developing economy. They provide financing in moderate amounts and on medium- or long-range terms. Development banks may serve to promote a capital market and may provide management, engineering, accounting, and legal assistance to borrowers. The banks should be encouraged to sponsor economic studies and surveys and to seek out, stimulate, and promote new investment opportunities and bring them to the attention of potential investors. They are also required to use AID funds to finance agreed-upon priority activities.

In addition to using their own resources, the banks use funds provided by AID, other foreign donors, international organizations, commercial banks, and the host governments to make loans and/or equity purchases.

By its own regulations AID is not required to become actively involved in the development performance of U.S.-financed development banks once assistance has been approved. AID's manual order on development banks would seem to restrict AID's role to approval of loans which are greater than a specified amount. For new and inexperienced development banks, this amount is generally $50,000; for older, more experienced banks, the amount may be as much as $500,000. Even for these larger loans where AID approval is mandatory, AID:

> "*** will usually limit its review to <u>general considerations</u> such as broad economic desirability and overall technical feasibilities, and not become involved in detailed analyses of engineering plans and specifications, item by item review of cost estimates, etc." (Manual Order 1524.1, p. 4)

AID evaluated selected industrial development banks in the spring of 1969 (Spring Review). The basis for this evaluation was AID Missions' responses to a questionnaire. Eighteen AID Missions submitted responses covering 27 banks financed by 39 AID dollar loans totaling $201 million. The main findings were that the banks have:

1. Stimulated substantial increases in industrial investment.

2. Improved the quality of investment--financed high-priority investment and improved financial and business practices by borrowers.

3. Strengthened the private sector.

4. Attracted non-AID sources of funds.

AID also found that development banks have:

1. Not had much success in developing capital markets.

2. Concentrated on the larger borrowers.

3. Concentrated on shorter term loans.

4. Provided only limited technical assistance to borrowers in planning and managing projects.

5. Stressed high collateral.

AID made the following comments on the evidence used for the Spring Review:

"There are two possible qualifications about the reliability of the observations. First, it must be recalled that a major part of the information for this evaluation has been supplied by reports from the field Missions who have had the primary responsibility for carrying out the (development bank) loan projects. This self-evaluation obviously has some limitations. There seemed to be internal evidence in a few of the reports that the projects were being viewed through glasses of at least a faintly rosy hue, and there may well be still other cases where this may be more real than apparent ***. Second, the general success suggested above is based largely on aggregates and averages. It seems clear that some of the projects did not share the general success ***."

Our review of the development performance of AID-supported development banks was conducted because of (1) the extent of U.S. assistance to these institutions and (2) the interest in these banks as indicated by the report of the President's Task Force on International Development.

The review focused on Latin America, which received approximately 45 percent ($180 million) of U.S. dollar loan assistance in support of development banks, and was conducted at AID headquarters in Washington, D.C., and at U.S. Embassies, AID Mission offices, AID-financed development banks, and selected borrower installations in Colombia, Ecuador, Nicaragua, the Dominican Republic, and the Republic of Panama.

The purpose of conducting the review in the above countries was to obtain a representative picture of the development performance of development banks in Latin America and not to single out particular banks or individual countries. The eight banks reviewed received approximately 40 percent of U.S. dollar loan assistance to development banks in Latin America. Further, we did not limit ourselves to a review of U.S. assistance only but, where possible, included all bank funds regardless of source.

The banks and the countries in which they are located are hereinafter referred to as:

Country	Banks
A	A1, A2
B	B1
C	C1, C2
D	D1
E	E1, E2

These banks received approximately $72 million in AID dollar loans, and the concessionary terms of this assistance will result in the United States absorbing about $74 million in interest costs (difference between what the United States pays in interest for the funds it has provided and the interest the United States will eventually receive as repayment for use of the funds). One bank also received the equivalent of about $60 million in local currency assistance. Appendix I to this report sets forth the terms of the dollar loan assistance to the eight banks.

CHAPTER 2

DEVELOPMENT CRITERIA

The AID manual order[1] on development banks sets forth AID's general objective in supporting such banks as being "to foster, promote and encourage the establishment and growth of sound Development Banks ***."

From the definition of development banks and the description of their functions and activities in the same manual order and the evaluation of development banks made during AID's Spring Review, which are discussed in chapter 1, the following, more specific, development goals emerge:[2]

1. Providing medium- and long-term loans.
2. Strengthening the private sector.
3. Attracting non-AID foreign sources of funds.
4. Financing small- and medium-size enterprises.
5. Providing moderate-size loans.
6. Stimulating investment.
7. Promoting capital markets.
8. Providing technical assistance to borrowers.
9. Promoting new investment opportunities.
10. Stimulating high-priority investment.

In conducting our review, we used the above goals as criteria to assess the banks' development performance. We also examined the collateral requirements of the banks. AID in its Spring Review expressed concern that the banks were overemphasizing security relative to consideration of the financial and development prospects of the projects which the banks helped finance.

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[1]AID manual orders are policy directives usually containing instructions for implementation of a program.

[2]This listing is not intended to rank the development goals.

Since the measurement of performance in stimulating new investment and stimulating high-priority investment is not self-evident, the remainder of this chapter discusses the methodology used to gauge performance in these areas.

STIMULATION OF NEW INVESTMENT

The extent to which development banks make credit available to firms which otherwise would not have access to long-term financing is, in our opinion, a good indicator of their stimulation of new investment. We therefore directed our attention to the financial characteristics of the banks' borrowers.[1]

In those instances where we determined that the borrowers were large, had good credit ratings, and had access to other sources of credit or significant internal funds, we concluded that the investment financed would have been undertaken without the bank's assistance. Where the borrower's financial characteristics were such that in all likelihood he could not have obtained the necessary credit other than from the bank, we concluded that the investment financed was new investment.

To corroborate the foregoing analysis, we visited a number of the banks' borrowers and asked them whether they would have continued with their projects had the development bank not been available as a source of credit. In

[1]To obtain data concerning the financial characteristics of a development bank's borrowers, we relied on available World Trade Directory Reports (reports prepared by the commercial attache of the applicable U.S. Embassy upon request of U.S. exporters which contain general and financial information on foreign business firms), Dun and Bradstreet credit ratings, and information from bank and Mission files. In addition, we visited a number of borrowers in each of the countries to determine whether their projects would have been undertaken had development bank financing not been available.

addition, we discussed the borrowers' capability to obtain other sources of credit with AID Mission officials and local commercial bankers.

STIMULATION OF HIGH-PRIORITY INVESTMENT

To ascertain whether development banks financed high-priority investment, we examined:

1. The nature of the countries' national development plans and, if appropriate, whether the banks' loans were in conformance with these plans.

2. The nature of any agreement between AID and the host country regarding priority activities to be financed with AID funds and, if appropriate, the banks' conformance to these agreements.

3. Whether the banks adopted their own development criteria and the nature of these criteria.

4. The extent to which the banks were financing high employment activities.

5. The extent to which they were financing export activities.

One reason for examining the employment and export performance of the activities financed by development banks is that we found that national development plans, AID-host country agreements, and the banks' own criteria generally did not provide the banks with specific guidance on priority activities. Employment creation and exports are also particularly significant for the development of less developed countries.

As stated in the Pearson Commission Report:

"The failure to create meaningful employment is the most tragic failure of development. All indications are that unemployment and under-utilization of human resources have increased in the 1960's and that the problem will grow even more serious."[1]

As an example of the magnitude of the employment problem, the Economic Commission for Latin America has estimated that about 30 percent of the labor force (economically active population) is unemployed or underemployed.[2] Although unemployment of unskilled labor is large, there is at the same time a shortage of skilled labor.

One of the major reasons for increased unemployment has been that industrial growth in the developing countries has been concentrated in the more capital intensive industries. Therefore, as an indicator of the employment impact of development bank loans, we determined whether the loans financed industries which are relatively capital and skilled labor intensive (which will be referred to as capital intensive) or industries which are unskilled labor intensive (which will be referred to as labor intensive). For purposes of this evaluation, "capital intensive industries" are defined as those manufacturing industries where value added (value of production minus cost of inputs purchased from other industries) per employee exceeds the average (median) value added of U.S. manufacturing as a whole. Labor intensive industries are those where value added per employee is less than the average (median) value added per employee for the entire manufacturing sector in the United States. This methodology is based on a recent study of the manufacturing exports of developing countries which shows that value added per employee is a good measure of capital intensity and that there is an international similarity in the ranking of industries by degree of capital intensity.[3]

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[1] L.B. Pearson, Partners in Development, Report of the Commission on International Development (New York: Praeger, 1969), p. 58.

[2] Economic Commission for Latin America, Economic Survey of Latin America, 1968 (Doc. E/CN.12/825), 1969.

[3] H.B. Lary, Imports of Manufactures from Less Developed Countries, National Bureau of Economic Research, New York, 1968.

Exports are important for development for several reasons. They permit a country to import necessary goods and services. Exports are a good indicator of the extent to which domestic goods and services are produced efficiently; if a significant proportion of a country's output is sold abroad, it is likely that domestic costs are reasonable because exports generally must be priced competitively with those of other countries. The quality of domestic output is likely to be high because exports, in general, must compete in quality as well as in price with the exports of other countries.

To gauge export performance, it would have been useful to determine the proportion of total exports to sales for those enterprises financed by the banks. We could not obtain the data for making this determination. Instead, in most instances we were able to obtain data on the number of bank loans to enterprises which exported at least a part of their production. We therefore used this to measure export orientation.

CHAPTER 3

DEVELOPMENT PERFORMANCE

This chapter deals with the banks' performance relative to the development criteria described in chapter 2.

LOAN MATURITIES

The banks have generally concentrated on providing medium- and long-term credit to the private sector.

To determine whether the selected banks concentrated on providing medium- and long-term credit, we computed the percentage distribution of their individual loan portfolios, for which information was available, by the following categories: short term, under 3 years; medium term, 3 to 5 years; and long term, in excess of 5 years. The following schedule shows this distribution.

Country and development bank	Percent of bank's total loan portfolio for which information was available	Percentage of total loan amounts		
		Short	Medium	Long
Country A:				
Bank A1	89	0	24	76
Bank A2	99	59	24	17
Country B:				
Bank B1	98	5	2	93
Country C:				
Bank C1	44	0	94	6
Bank C2	60	0	35	65
Country D:				
Bank D1	90	1	1	98
Country E:				
Bank E1	91	5	20	75
Bank E2	100	84	11	5

LENDING TO THE PRIVATE SECTOR

We found that virtually all the banks' loans were made to private firms.

NON-AID FOREIGN SOURCES OF FUNDS

Judged in relation to AID loans, the banks' performance in attracting other foreign funds is mixed.

The following schedule compares AID and non-AID foreign funds received by the banks.

Country and development bank	AID loans	Other sources				
		Total	IDB	IBRD	United States	Other foreign
		(millions in dollars)				
Country A:						
Bank A1	13.0	4.5	4.5	0	0	0
Bank A2	5.0	0.13	0	0	0.03	0.1
Country B:						
Bank B1	9.1	0.3	0	0	0.3	0
Country C:						
Bank C1	8.0	15.0	0	0	12.6	2.4
Bank C2	9.0	17.6	4.7	0.2	9.6	3.1
Country D:						
Bank D1	20.0	9.4[a]	3.0	0	0	6.4
Country E:						
Bank E1	5.0	31.0	12.5	10.3	0	8.2
Bank E2	3.0	12.7	0	0.8	8.1[b]	3.8

[a]Does not include $37.5 million in IBRD loans administered by bank D, but for the exclusive use of five lending institutions.

[b]Includes two loans from the Eximbank amounting to $4.5 million.

The banks in country C and country E have been able to attract relatively large amounts of non-AID foreign funds, but the others have not.

SIZE OF BORROWERS

The larger firms have been the chief beneficiaries of development bank loan assistance.

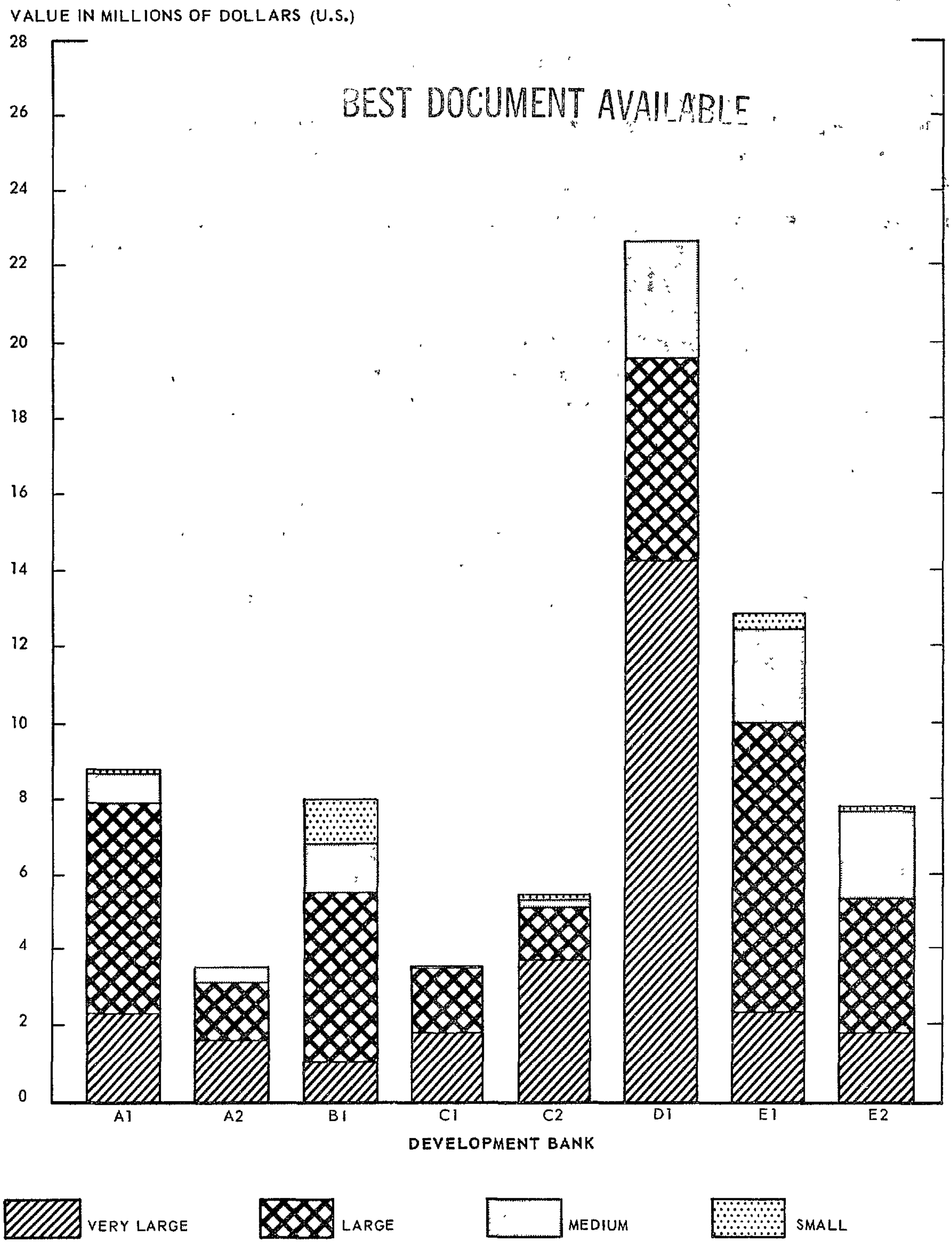
To categorize the size of firms receiving bank loans, we relied primarily on World Trade Directory Reports. These reports are prepared by the U.S. Embassy in each country and classify the size of certain host country business firms on a relative scale as small, medium, large, or very large. The following graph indicates the distribution by size of firm for that portion of each bank's loan portfolio for which we were able to obtain information.[1]

As can be seen from the graph, the very large and large firms have received the major part of the funds whereas the small- and medium-size firms have been relatively ignored.

1

Bank	Percent of total industrial loan portfolio for which information on size of borrower firms was available
A1	50
A2	81
B1	70
C1	27
C2	42
D1	24
E1	36
E2	40

**CLASSIFICATION OF DEVELOPMENT BANK
LOAN PORTFOLIOS BY SIZE OF FIRM RECEIVING LOAN**



BEST DOCUMENT AVAILABLE

Source: World Trade Directory Reports

Agency comments and our evaluation

AID stated that most of its loan papers and loan agreements do not stress concentration on small- and medium-size firms. Although servicing small- and medium-size firms is a desirable objective, it is difficult and often financially impossible for a development bank which is not heavily subsidized. There is a lack of effective demand or existence of well-prepared projects which give assurance of repayment on the basis of financial tests and the competency of management. AID's Latin American Bureau is assisting separate government-supported institutions to meet the needs of small business. AID also suggested that data on the distribution of numbers of loans by size of firm be presented.

We note that the AID manual order on development banks stresses assistance to small- and medium-size firms:

> "A Development Bank is defined as a financial institution which is organized and operated to assist in the economic development of less developed countries and areas by financing and promoting private enterprises <u>particularly ventures of small and medium size</u> ***."
>
> *　　*　　*　　*　　*
>
> "*** Such banks offer a practical solution to the difficulties of providing foreign exchange and local currency financing in moderate amounts and on medium or long-range terms <u>to qualified small and medium size enterprises</u> at reasonable rates of interest." (Underscoring supplied.)

On effective demand, we note that the AID Spring Review stated:

> "*** Although the evidence is not as clear cut, it is plain that most of those in a position to borrow from ICI's [development banks] belong to that small group of better educated, more sophisticated persons and are generally located in the 'westernized' part of the nation. <u>But the entrepreneural talent of the country is not necessarily</u>

similarly limited. The concept of a more widespread, more decentralized form of development is receiving greater consideration as exemplified, for example, by Title IX of the AID legislation." (Underscoring supplied.)

Furthermore, if in fact there is little effective demand by smaller enterprises, the use of technical assistance for these potential borrowers would alleviate the problem. Such assistance would enable the small- and medium-size firm to prepare sound bankable projects.

Chapter 6 of this report is concerned with the AID-supported small business loan funds. Such assistance is, however, relatively minor. The majority of AID funds are channeled through development banks.

The distribution of numbers of loans by size of firm is shown, as follows:

	Size of firm								
	Very large		Large		Medium		Small		
Bank	Number of loans	Percent	Number of loans	Percent	Number of loans	Percent	Number of loans	Percent	Total
A1	9	11.8	45	59.2	18	23.7	4	5.3	76
A2	9	22.5	23	57.5	8	20.0	0	0	40
B1	2	2.9	33	47.8	21	30.4	13	18.9	69
C1	14	46.7	13	43.3	3	10.0	0	0	30
C2	24	40.7	23	39.0	8	13.6	4	6.7	59
D1	20	57.1	11	31.5	4	11.4	0	0	35
E1	9	8.9	63	62.4	21	20.8	8	7.9	101
E2	69	19.1	195	54.0	87	24.1	10	2.8	361
Total	156	20.2	406	52.7	170	22.0	39	5.1	771

SIZE OF LOANS

We found that a substantial percentage of each bank's loans were in amounts in excess of $100,000. This is shown by the following graphic presentation of the distribution by amount of each bank's industrial loans.[1]

In the aggregate, about 80 percent of the banks' loans were in amounts in excess of $100,000.

As an additional example of the size of development bank loans, in country D we noted that five industrial borrowers, some of whom were substantially owned by large U.S. corporations, received approximately 81 percent of the first $10 million AID loan provided to bank D1.

Agency comments and our evaluation

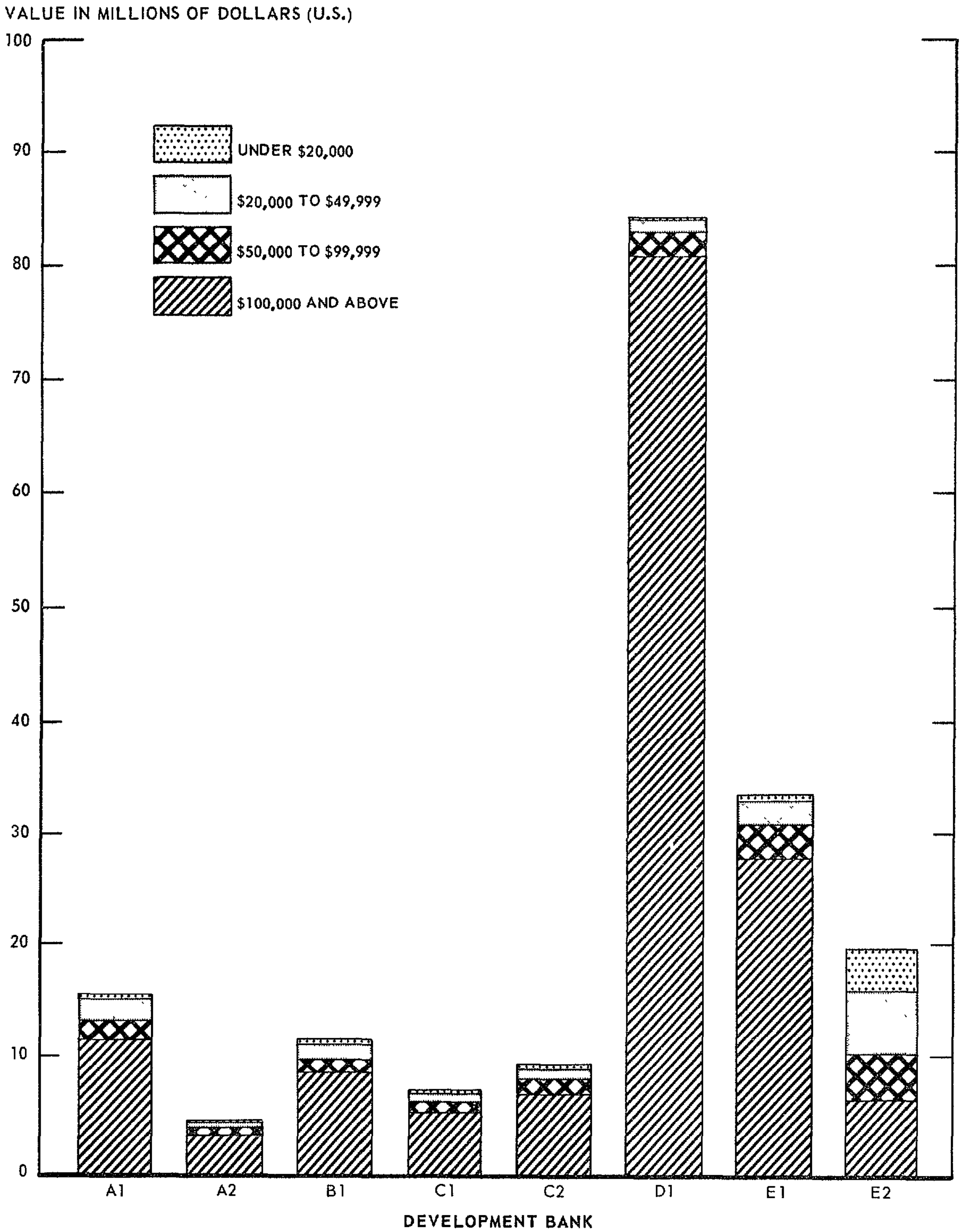
AID stated that a high interest rate spread may be required for development banks to provide small- and medium-size loans. AID also suggested that data on the distribution of numbers of loans by size of loan be presented.

According to AID's manual order on development banks, which emphasizes that the banks provide moderate-size loans to small- and medium-size firms, the interest rate on AID loans to the banks will be set at a level which will permit the banks to charge interest rates to cover administrative costs and generate sufficient earnings. Therefore it appears that AID can control the interest rate spread to accommodate smaller loans.

1

Bank	Percent of total industrial loan portfolio for which information on size of loan was available
A1	89
A2	100
B1	100
C1	54
C2	71
D1	90
E1	92
E2	100

CLASSIFICATION OF DEVELOPMENT BANK LOAN PORTFOLIOS BY SIZE OF LOAN



Source: Data furnished by Development Bank

We also found that a recent study on financing small manufacturing in less developed countries concluded that:

> "In the general lending conditions of most newly industrializing countries, a one- or two-percentage-point increase in the margin should in most cases make term loans as small as $50,000 to $100,000 almost as profitable as larger loans. A further one- or two-percentage-point increase in the margin might be required for loans varying from $25,000 to $50,000. And if loan procedures can be suitably adapted to accommodate manufacturers requiring amounts as small as $10,000 and the margin widened by another one or two percentage points even such small loans could frequently be served as profitably as larger loans."

The following table shows the distribution of numbers of loans by size of loan.

	Size of loans								
	Under $20,000		$20,000 to $49,000		$50,000 to $99,999		$100,000 and above		
Development bank	Number of loans	Percent	Number of loans	Percent	Number of loans	Percent	Number of loans	Percent	Total loans
A1	24	16.3	50	34.0	21	14.3	52	35.4	147
A2	7	13.7	15	29.4	9	17.7	20	39.2	51
B1	48	34.0	41	29.1	17	12.1	35	24.8	141
C1	26	26.3	29	29.3	13	13.1	31	31.3	99
C2	38	32.8	28	24.1	20	17.2	30	25.9	116
D1	6	3.0	32	15.8	31	15.4	133	65.8	202
E1	47	19.4	61	25.1	44	18.1	91	37.5	243
E2	412	57.5	195	27.2	68	9.5	42	5.8	717
Total	608	35.4	451	26.3	223	13.0	434	25.3	1,716

STIMULATION OF NEW INVESTMENT

Substantial amounts of bank funds were provided to firms which could have obtained the necessary financing elsewhere. Therefore it appears that the banks have stimulated relatively little new investment.

We used the methodology previously discussed on pages 11 and 12 and prepared the following schedule. It shows, for that part of each bank's total industrial loan portfolio for which we were able to obtain information, the percentage that we estimate went to firms which could not have obtained financing without the bank's assistance.

Country and development bank	Percent of bank's total industrial loan portfolio examined	Loan portfolio examined (millions) (A)	Loans to firms classified as requiring development bank assistance (millions) (B)	B as a percent of A
Country A:				
Bank A1	73	$ 12.7	$ 5.7	45
Bank A2	99	4.3	1.5	35
Country B:				
Bank B1	94	10.9	2.0	18
Country C:				
Bank C1	53	7.0	1.9	27
Bank C2	66	8.5	1.0	12
Country D:				
Bank D1	66	61.9	11.9	19
Country E:				
Bank E1	51	18.0	4.0	22
Bank E2	46	9.0	2.4	27
	63	$132.3	$30.4	23

We estimate that only about 23 percent of the industrial loan funds we were able to classify went to borrowers who would have been unable to obtain financing elsewhere. The remaining 77 percent went to firms whose financial characteristics were such that we concluded they would have made their investments regardless of the existence of the banks.

In addition to the above which we believe to be a reasonable indicator of the extent to which the banks have been effective as a catalyst of new investment, we obtained additional evidence, detailed below, which corroborates our analysis.

In country A, the commercial attache of the U.S. Embassy was of the opinion that the majority of bank A1 and bank A2 borrowers were first-class firms, representative of the industrial elite. He stated that he believed they would have been able to obtain requisite financing from other sources.

The president of bank A2 told us that he believed 100 percent of the loans made during the first 6 months and 75 percent of those made in the next 12 months of his bank's operations involved borrowers who would have continued with their projects regardless of the availability of bank A2 financing.

We also asked officials of four firms who had received approximately $1.4 million in loans (from either bank A1 or bank A2) what action they would have taken had the banks not been available as a source of credit. In each instance they advised us that they would have obtained the necessary financing elsewhere.

In country B, a Mission official stated that, in his opinion, most firms that received bank B1 loans could have obtained financing for their projects from commercial banks. He stated, however, that such financing would have been on less favorable terms and might have necessitated a reduction in the size of the project.

A 1968 Mission audit report suggested that the Mission and bank B1 management might want to consider making more loans to businesses that have had difficulty in obtaining credit at commercial banking institutions. Also, in 1965, AID officials approved a $600,000 bank B1 loan notwithstanding knowledge that the recipient had ready access to conventional funding resources, although on somewhat less favorable terms.

A Mission official in country C informed us that he believed 50 percent of the firms which received loans from bank C1 could have obtained funds elsewhere. An official of bank C2 told us that 50 percent of the AID loan funds received by his bank went to firms which, in his opinion, could have obtained financing from other sources although on less favorable terms.

In country D we found that two borrowers, one a wholly owned affiliate of the other, received loans from bank D1 that amounted to approximately $3.9 million, or 39 percent, of the total AID dollars disbursed by the bank. We visited the borrowing firms and found them to be large and technically advanced operations. Officials of the firms informed us that they would have been able to obtain financing from sources other than bank D1. AID had categorized the parent company as a large, well-established firm with substantial capital, assets, and earning power and had stated that there was absolutely no credit risk involved in lending to this company. Also, in the case of a $1.8 million loan by bank D1 to the parent company, the Export-Import Bank of the United States had previously indicated a willingness to finance the project.

Officials of 14 additional firms we visited in country D, which had received loans of about $19 million from bank D1, advised us that, had this financing not been available, they would have continued with their projects and obtained requisite financing from other sources.

In country E we visited nine firms which received bank E1 loans amounting to $4.5 million and asked officials whether they would have continued with their projects had bank E1 financing been unavailable. Officials of six of the firms which received $3.8 million, or 83 percent, of the funds involved stated that they would have continued with their projects and obtained the necessary financing elsewhere.

We also asked the above question of officials of nine firms which had received $2.2 million in loans from bank E2.

Officials of eight of the firms who had received $2.1 million stated that they would have continued with their projects and obtained funds elsewhere. Officials of two U.S.-owned commercial banks also advised us that most bank E2 borrowers were large, well-established firms, and one banker stated that the borrowers would be able to obtain credit from other sources.

Agency comments and our evaluation

AID questioned the above analysis on the basis that the evaluation (1) is subjective and (2) ignores the terms of alternative sources of finance. AID stated that it would be more meaningful to show data on the numbers rather than on the amounts of loans received by firms classified as requiring development bank assistance.

Our analysis of new investment was primarily based upon an evaluation of the financial status of borrowers. (See ch. 2.) In this evaluation we relied upon World Trade Directory Reports, Dun and Bradstreet credit ratings, and information from bank and Mission files. In addition, we asked borrowers in each country whether they would have undertaken their projects if development bank financing had been unavailable.

On the possible higher interest cost of borrowing from alternative sources, it should be noted that AID, in its Spring Review, did not consider such cost as a determinant of additional investment. Further, we found that frequently the rates of return on investment in Latin American countries are very high and as such appear to provide sufficient margin to finance investment at higher interest rates without the necessity of shifting any of the higher costs to the consumer. In country A officials of bank A1 and bank A2 informed us that local investors expected an investment to return about 40 percent annually. In country D a Mission official told us that public accountants often advised clients seeking investment funds to make use of "street money" which was selling at interest rates of approximately 36 percent annually.

We believe that, for assessing additional investment, the amounts of loans received by firms classified as requiring development bank assistance are more important than the numbers of loans received by such firms because the amounts of loans are directly related to amounts of new investment. Nevertheless we are supplying the following data on numbers of loans received by firms classified as requiring development bank assistance.

Country and development bank	Number of loans examined (A)	Loans to firms classified as requiring development bank assistance (B)	B as a percentage of A
Country A:			
Bank A1	107	37	35
Bank A2	46	13	28
Country B:			
Bank B1	118	35	30
Country C:			
Bank C1	98	17	17
Bank C2	103	14	14
Country D:			
Bank D1	144	44	30
Country E:			
Bank E1	126	34	27
Bank E2	306	76	25
	1,048	270	26

PROMOTION OF CAPITAL MARKETS

The banks, in general, have done little to promote the formation of capital markets.

Officials of both bank A1 and bank A2, as well as the Mission, advised us that nothing has been done to promote the creation of a securities market in country A. Bank A2 officials advised us also that they do not know how to proceed and that technical assistance would be required before such a market could be created.

In country B bank B1 officials advised us that they have not attempted and have no leverage to assist in the establishment of a securities market. They stated that the Government of country B has not passed necessary legislation to create a stock market and that existing laws discriminate against the small stockholder.

Neither bank C1 nor bank C2 in country C has exerted much effort toward creating a securities market. Bank C1 did attempt to establish a mutual fund but was prevented from doing so by a government decree.

There is a securities market in country D; however, few firms are listed in the market, and it has been characterized as being weak. Officials of bank D1 told us that neither they nor other officials of the central bank have extended assistance to help strengthen the market.

Although bank E1 was required by its charter to establish a securities market, no action was taken until January 1969, when the Government of country E ordered it to comply. As a result of action taken by the bank to comply with the order, there is now the beginning of a securities market.

TECHNICAL ASSISTANCE AND PROMOTION

The development banks have in general done little promotional work and have provided little technical assistance to borrowers.

Bank A1 does no promotional work, does not provide technical assistance, and does not prepare feasibility studies. A private technical assistance institute, under a contract with the Inter-American Development Bank, is, however, extending technical assistance to bank A1. This assistance consists of advising, assisting, and training bank personnel and providing technical assistance to borrowers when requested. According to officials of bank A1, assistance to borrowers involves approximately 15 percent of the institute's staff time.

Bank A1 officials advised us that the institute had prepared 12 feasibility studies regarding potential new industries and that it was working on eight additional studies. In addition AID has contracted with a U.S. firm to prepare 28 prefeasibility industrial studies and to provide training in the preparation of feasibility studies and promotion to one intermediary (a government agency) through which bank A1 funds are channeled.

Bank A2 officials advised us that they do not offer technical assistance to their borrowers. They stated that they do not have the staff to offer such assistance. They did indicate that when technical assistance is requested or deemed to be necessary, they will put the client in contact with a private consulting firm. In such cases, however, the client must assume the costs involved.

AID officials advised us that, because the majority of both bank A1 and bank A2 borrowers are relatively strong firms, there has been no demand for technical assistance.

Bank B1 officials told us that they do not offer technical assistance to their borrowers. Should a borrower require such assistance, he must obtain it elsewhere at his own expense.

We noted that, whereas AID in its first loan suggested that $100,000 be set aside for technical assistance to bank B1 itself, only $50,000 was used for this purpose before the bank considered itself sufficiently knowledgeable on developmental banking activities. The additional $50,000 was subsequently used to make additional loans.

In 1969 the Mission stated that bank B1 does not directly participate in arranging or directing managerial or technical assistance to borrowers. The Mission said that, in general, such assistance is not necessary, because most borrowers depend heavily on imported technology. The Mission also indicated that bank B1 does little in the way of research, surveys, and/or promotional work.

Our review indicated that neither bank C1 nor bank C2 provided a significant amount of technical assistance to borrowers. The lack of such assistance was in fact readily admitted by officials of both institutions.

An official of bank C1 informed us that most of the bank's clients do not want or need technical assistance. Further, what assistance is provided is chiefly in the financial area to firms in which the bank has an equity interest. Although the first AID loan provided $100,000 for technical assistance to bank C1, the bank did not want such assistance and these funds were ultimately used to make loans.

Despite having the capability to provide such assistance, bank C2 officials advised us that it is their policy not to furnish technical assistance to borrowers because they do not want to be held responsible for faulty implementation of their recommendations. They stated that the bank has made some exceptions to this policy in that it has provided a maximum of 1 or 2 man-days of assistance in a few cases.

On February 16, 1968, bank C2 requested that AID allow it to impose an additional 1-percent annual charge for loans to defray the costs of providing technical assistance. On February 28, 1968, AID issued implementation letters allowing the additional charge and stated that bank C2 should separately identify the costs of the technical assistance for which the additional funds would be used. As stated above, officials of both bank C1 and bank C2 advised us that they provided very little technical assistance. The charge was instituted in 1968, but, at the time of our review in April 1970, the Mission was unable to provide us with information relative to the amount of technical assistance provided by bank C2 in justification of the charge.

Officials of bank C1 advised us that, though they have engaged in some promotional activities, they have not really been active in putting projects together. However, bank C2 has been active in this area and has promoted a number of projects.

Although the first AID loan to bank D1 provided that up to $100,000 of the funds would be used to finance technical assistance, no use was made of these funds; they were ultimately used by the bank, with AID approval, to make additional loans. Bank officials advised us that this money was not used because most intermediaries had the capability to provide such assistance.

We visited five intermediaries making loans of bank D1 funds and were advised by officials that, for the most part, they do not provide technical assistance to their borrowers. Bank D1 by law cannot operate directly with borrowers and therefore cannot do promotional work. Promotion is left to the intermediaries. Officials of the intermediaries informed us that they do not actively seek out and promote new investment opportunities.

Bank E1 does not provide technical assistance. Its officials are of the opinion that such services should be obtained from an independent activity. When the bank believes that a project will require technical assistance, it requests the borrower to obtain such services, sometimes as a prerequisite to approval of the loan. Bank E2 does not offer technical assistance to its borrowers.

AID, in addition to supporting the two development banks, supported an automonous development agency established by country E in 1962. Since 1962 AID has made grants totaling about $2 million to this agency. Country E has contributed another $2 million.

The objectives of this development agency are (1) to increase production and lower costs in existing industrial plants through productivity consultations, (2) to promote the expansion of existing industries, (3) to make feasibility and market studies for new industries, particularly those processing agricultural raw materials, and (4) to promote investment in new industry.

During the period 1962 to 1967, this development agency prepared 48 feasibility studies, 15 domestic market studies, two external market studies, and two small industry studies. Also its productivity division, established in 1965, completed 116 technical assistance projects.

AID has stated that this development agency is a part of an integrated industrial development effort and, as such, is directly related to other AID projects, including assistance to the development banks. We did not review the operations of the development agency; however, both bank E1 and bank E2 provided funds to finance projects initiated by this agency.

Agency comments and our evaluation

AID stated that technical assistance is normally provided for in most AID loans and will be used if borrowers agree.

None of the AID loans reviewed provided for technical assistance to the banks' borrowers, although provision was made in most cases for technical assistance to the banks. The clients served by the banks by and large are not those requiring such assistance. The smaller firms--those which have little or no alternative sources of long-term financing and need technical assistance most--are not well represented among the banks' clients.

AID stated also that promotion is very expensive and has thus far not proven feasible for a development bank to perform. It has been left for host governments to provide promotional services through specialized subsidized institutions. AID stated, however, that consideration will be given in negotiations of future loans for development banks to forms of incentives which will permit them to engage in promotional activities.

We have no idea as to the cost of promotional activity which the AID manual order states that development banks should be encouraged to do. We did, however, note that the bank C2 has done some promotional work.

STIMULATION OF HIGH-PRIORITY INVESTMENT

Conformance with national development plans

There is a general absence of national development plans specifying industrial priorities and providing guidance for development banks.

Although country A has prepared a draft of a national development plan, the Mission advised us that it is a rather innocuous document and is not used. We reviewed the draft plan and found that it is general and does not detail specific industrial priorities.

Country B also has prepared a draft of a national development plan. AID officials advised us that it is only used for discussion purposes and does not set forth specific industrial priorities.

There is no operational development plan setting forth industrial priorities in country C.

The Government of country D has prepared a national development plan but it does not specify industrial priorities.

Country E has had two 5-year industrial development plans. One plan, covering the period 1964 to 1968, placed emphasis on specific import substitution industries, and the second plan, covering the period 1969 to 1973, stressed both specific export-oriented industries and import substitution industries. Government officials advised us that the first 5-year plan had been extremely successful and that a total of $80 million had been invested in priority projects identified in the plan. They stated that this investment also had resulted in the creation of 7,842 new jobs. Both bank E1 and bank E2, in approving projects, generally adhered to the priorities specified in the development plan.

AID agreements on priority activities

The AID loan agreements generally did not provide the development banks with sufficiently detailed guidance on priority activities to be financed. Most agreements permitted the banks to finance almost any proposed project.

In April 1965 AID granted the Government of country A a $5 million loan to establish bank A1, a private investment fund within the country's central bank. The purpose of the loan was to finance the dollar and peso costs of projects in the private sector to increase the production of agriculture, industry, mining, and transportation in accordance with the following priorities.

1. Diversification and promotion of exports.
2. Elimination of production bottlenecks.
3. Import substitution.

This purpose was later expanded to include loans for commercial hotel improvements and medical facilities in the private sector.

AID granted the Government of country A a follow-on loan of $8 million in March 1970 for use by bank A1. This loan was to be used for the same purposes as the first loan and to process domestic raw materials and to manufacture products for domestic consumption.

In May 1968 AID granted a $5 million loan to bank A2, a private development finance company established in March 1968. The loan was to finance loan and equity investments in the private sector for the creation, expansion, modernization, and consolidation of manufacturing, agriculture, mining, transport, services, and other facilities.

The purposes of the first AID loan to bank B1 were to assist in making loans to promote the creation or expansion of private industrial enterprise and to enable the bank to engage in limited refinancing operations, to participate in equity financing, and to finance technical assistance related to the improvement of its operations and the appraisal of loans and equity participations.

A second AID loan in the amount of $4 million was agreed to in October 1966. It was made for the same purposes as the first AID loan but also provided that bank B1 use its best efforts to find and finance projects that would increase exports.

The first AID loan to bank C1 was for $3 million and was dated May 25, 1965. The purpose of the loan was to assist the bank in promoting the creation, expansion, or more effective operation of private industrial enterprise. A second loan to bank C1 for $5 million was made in September 1966 for the same purpose as the initial loan.

The first AID loan to bank C2 was for $4 million and was dated December 23, 1964. The purpose of the loan was to assist bank C2 (1) to promote the creation, expansion, or more effective operation of privately owned industrial enterprises and (2) to execute and finance feasibility studies related to investment opportunities.

The second loan to bank C2, dated October 23, 1967, was for $5 million.

The objective of this loan was:

"*** to stimulate and facilitate industrial promotion and development activities and the financing of new high risk private enterprise, as well as to allow Borrower to build its financial position to a point where such activities may be continued without recourse to borrowing on concessional terms or Government subsidy."

In December 1964 AID provided the central bank with a $10 million loan for use by bank D1. The loan was to be used to finance high-priority projects in the areas of export promotion, import substitution, and elimination of production bottlenecks. The loan agreement required that at least 60 percent of the total value of all principal made available by bank D1 each year to intermediaries be utilized to assist in financing loans whose principal purpose was to promote the increase of exports. We found that approximately 70 percent of this AID loan was used by bank D1 to make loans justified on the basis of increasing exports.

In December 1969 AID provided bank D1 with a follow-on loan of $10 million. The purpose of this loan was to make dollars available to finance industrial and agroindustrial projects in the private sector. The bank loans made with these funds are to be directed toward (1) diversification and promotion of exports, (2) elimination of production bottlenecks, and (3) import substitution.

On July 20, 1962, AID granted a $5 million loan to an autonomous Government agency of Country E which in 1964 became E1. The purpose of the loan was to finance the procurement of equipment, materials, and services for the establishment and expansion of industrial enterprise in country E and to assist small handicraft industries.

In January 1966 AID granted a $3 million loan to bank E2, a private development bank. The purpose of the loan was to assist bank E2 in making medium- and long-term subloans, short-term working-capital loans, and equity investments to meet the need for medium- and long-term credit and for working capital by private enterprises whose creation, expansion, and more effective operation would contribute to the country's economic development.

Agency comments and our evaluation

In its comments on our draft report, AID stated that we did not attempt to determine whether those banks which agreed with AID to concentrate their financing in certain high-priority industries did in fact do so. As indicated above we found that only one AID loan agreement, that relating to the first loan to bank D1, established what could be considered a specific priority area--at least 60 percent of the loan should be used for financing increased exports--and that this was complied with.

AID stated that it will, in every case, review with the host governments and banks the specific priority activities to be financed with AID loan funds.

Development bank criteria

Of the six banks located in countries not having national development plans specifying priority industrial activities, only bank C2 had its own selective development criteria. The others either did not have their own criteria or adopted criteria which were so broad as to permit them to finance almost any project proposed.

Bank A1 has no development criteria of its own. Bank A2 officials advised us that, because of a lack of demand for credit, they have not applied development criteria.

The AID Mission stated that bank B1 has not used formal economic development criteria in reviewing loan applications. Bank B1 officials stated that profitability is their major consideration in making loans.

Bank C1 does not use development criteria. The major consideration in making loans is the financial strength of the applicant and the potential profitability of the project.

Bank C2 has established a list of preferred industries and has used general development criteria in making its loans. We found that, for the most part, bank C2's loans conformed to this listing.

Bank D1 is guided by a resolution of the Government of country D which establishes diversification and promotion of exports, elimination of shortages of food and services, and import substitution as broad general priority areas.

Bank E1 and bank E2 do not have their own development criteria. Instead, as noted previously, both institutions have generally financed the specific priority activities identified in the National Development Plan.

Employment

A large part of the banks' loans have gone to firms in capital intensive industries.

We used the previously explained methodology (see p. 13) and prepared the following schedule which shows for each bank the distribution of its industrial loan portfolio as to the capital or labor intensity of the borrowers.

	Loan amounts classified (millions)	Percent of total loan amounts classified
Country A:		
Bank A1:		
Capital intensive	$ 7.3	50
Labor intensive	7.2	50
	$14.5	
Bank A2:		
Capital intensive	$ 1.4	42
Labor intensive	1.9	58
	$ 3.3	
Country B:		
Bank B1:		
Capital intensive	$ 4.9	60
Labor intensive	3.2	40
	$ 8.1	
Country C:		
Bank C1:		
Capital intensive	$ 1.5	45
Labor intensive	1.8	55
	$ 3.3	
Bank C2:		
Capital intensive	$ 3.5	47
Labor intensive	4.0	53
	$ 7.5	

	Loan amounts classified (millions)	Percent of total loan amounts classified
Country D:		
Bank D1:		
Capital intensive	$61.6	72
Labor intensive	23.9	28
	$85.5	
Country E:		
Bank E1:		
Capital intensive	$12.0	49
Labor intensive	12.6	51
	$24.6	
Bank E2:		
Capital intensive	$ 6.6	50
Labor intensive	6.6	50
	$13.2	

Exports

Development bank assistance to firms which exported at least some part of their production has been limited.

Mission officials advised us that, of the approximately 150 industrial firms granted loans by bank A1, only about five exported. These five exporters received approximately $1.2 million, or 8 percent, of the $15.6 million in total loans. According to officials of bank A2, they have not made loans to firms which export.

AID assistance strategy for country B for fiscal years 1969 and 1970 had as one of its focal points the development of projects involving the increase of exports. Our analysis of bank B1's loan portfolio indicated that, of 150 loans, only 13 went to firms which exported; these 13 loans to exporting firms amounted to $0.7 million, 6 percent of the $11.6 million in total loans.

We found that 20 loans amounting to $2.9 million made by bank C1 were made to firms that exported and that 50 loans amounting to $2.9 million went to companies having no reported export sales. At bank C2, 31 loans amounting to $4.2 million went to firms having some export sales whereas 24 loans amounting to $1.4 million went to companies having no indicated exports.

AID auditors, in a 1969 review of 70 bank D1 local currency loans financed with AID counterpart funds provided prior to the first AID dollar loan, found that the exports of the borrowers actually increased from $4.2 million in 1964 to $20.6 million in 1968. We found that approximately 70 percent of the first $10 million AID loan to bank D1 was used to make loans justified on the basis of increasing exports.

Bank E1 and bank E2 officials advised us that until recently they had concentrated on providing assistance to import substitution industries. The reasons cited for such concentration were (1) the banks initially depended on local businessmen to recommend desirable projects and invariably they chose import substitution types since they had the greatest profit potential and involved the least risk and (2) both the first industrial development plan and the development laws favored import substitution projects. Analysis of about $9 million of bank E1's total disbursements of $32 million showed that less than 1 percent went to firms which export. A similar analysis of $7 million of bank E2's total disbursements of $22 million showed that about $1.7 million or 24 percent went to export-oriented industries.

Agency comments and our evaluation

AID criticized us for using rigid criteria of what constitutes high-priority investment. AID was referring to our use of exports and employment as criteria. As indicated in chapter 2, the main reason we reviewed exports and employment was that there was little in the way of specific guidance on priority activities in national development plans, AID loan agreements, or the banks' own loan criteria.

AID stated that stimulation of employment through greater labor intensity may contradict the goal of expanding exports. Although this is a possibility, we believe that the experiences of Hong Kong, Taiwan, Korea, and Japan show that labor intensity and export orientation need not be incompatible.

AID also commented that a determination of secondary employment effects--the impact on employment in industries supplying or purchasing from a particular industry--should be made to assess the employment effect of capital intensive industries. Capital intensive industries may generate a high volume of secondary employment. We agree and urge AID to undertake such analysis. Secondary employment effects, however, may be no less or perhaps may be even greater for labor intensive industries.

AID stated that a determination as to how much investment is geared to expanding exports must include a determination as to the modernization and improved efficiency of those industries which supply and service exporters and therefore play a major role in reducing costs and improving the overall competitiveness of export products. We agree and we urge AID to consider such industries in determining the priority activities to be financed with AID loans to development banks.

COLLATERAL REQUIREMENTS

The banks' collateral requirements are generally quite high.

Bank A1 channels its funds through intermediaries, mainly commercial banks. The intermediaries underwrite the credit risks involved in making subloans. Bank A1 assumes no credit risk. Officials of AID and bank A1 advised us that, prior to approving loans, the intermediaries generally seek a virtual guarantee of repayment. The collateral requirements were categorized as being "substantial."

Bank A2 officials advised us that, although collateral requirements vary among loan applicants, they usually acquire a secured interest in the borrower's assets and generally require sufficient collateral to cover one and one-half times the requested loan amount. The officials stated that they initially look to the liquidity of the borrower's assets to ensure repayment of the loan should a situation arise wherein the borrower's ability to repay becomes questionable. In some instances bank A2 has required the personal guarantee of a surety.

For country B the AID Mission stated that:

"*** [bank B1's] loan security has probably been somewhat more conservative than many would deem desirable in development banking where a certain element of risk taking is implied. ***"

Further, in reply to a question as to whether the balance between security on loans and stimulation of new activities was satisfactory, the Mission indicated that the emphasis was on security.

A bank C1 official advised us that the collateral required of borrowers is at least 100 percent of the loan amount and in some cases as high as 200 percent. We also noted that AID requires that bank C1 obtain collateral of at least 100 percent of a loan.

At bank C2 AID requires that collateral of at least 130 percent be obtained. In addition, the Mission stated that it believes that insistence by both bank C2 and AID on large collateral and low risk projects may be inhibiting investment. They indicate that it is difficult to see how a truly new investment can get support.

At bank D1 collateral requirements are at least 100 percent of the loan amount and at times 200-300 percent.

The collateral required of borrowers by banks E1 and E2 consists chiefly of mortgages, frequently complemented with additional collateral, and personal guarantees. Bank E1 officials generally require collateral of 125 percent of the loan, and bank E2 officials require collateral of 150 percent.

Agency comments and our evaluation

AID maintained that we did not evaluate appraisal banking. "Appraisal banking" is defined as concentration on the ability of the entrepreneur and the prospects of the projects, rather than on high collateral and quick repayment. We evaluated two major aspects of appraisal banking--collateral requirements and the development criteria used by the banks in evaluating the prospects of proposed projects.

CHAPTER 4

INSTITUTION BUILDING

One position taken in defense of a development bank's placing its loan funds with large firms having highly profitable projects is that this enables the bank to establish itself and become a viable development institution. The assumption is that, by servicing the large, financially strong credit applicant, the bank will, within a reasonable period of time often referred to as the institution building period, become profitable and will establish a sound financial reputation and thus enable it to shift attention to the smaller firms requiring greater assistance. Although there is little information regarding the duration of time involved in achieving institution building, a U.S. economist was of the opinion that it would extend for as long as 3 years.[1]

We recognize that a better assessment of institution building can be made over a longer period but feel that a 3-year interval is sufficient to allow at least a tentative assessment. To determine if the banks reviewed did shift emphasis after being in existence for at least 3 years,[2] we compared their aggregate performance in meeting four previously discussed development criteria during the first year they received AID assistance with that of the most current year for which information was available. The criteria used were (1) investment stimulation, i.e., loans to firms unable to obtain financing elsewhere, (2) size of loans, (3) size of borrowers, and (4) employment (labor intensity).

The following graph shows the results of our analysis and indicates no significant shift in emphasis.

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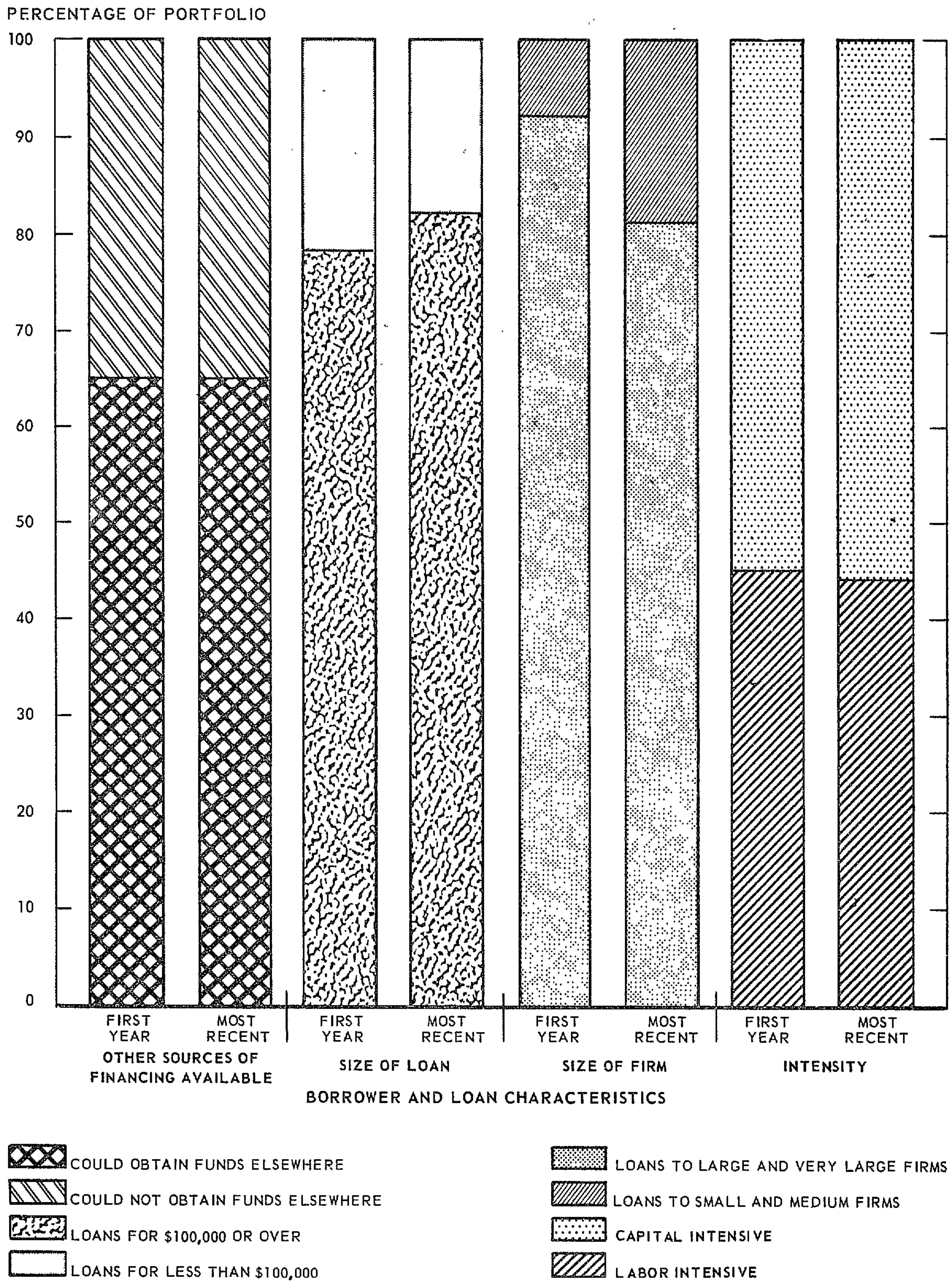
[1] Philip Perera, Development Finance (Praeger, 1968), p. 193.

[2] Of the institutions covered in this report, only bank A2 had not been in existence and making loans for at least 3 years from the time AID assistance began. Bank A2 had been making loans for approximately 18 months.

BORROWER AND LOAN CHARACTERISTICS DURING THE FIRST YEAR OF U. S. ASSISTANCE AND IN THE MOST RECENT YEAR



Agency comments and our evaluation

AID stated that, when our study was completed, $28 million,or about 39 percent, of the $72 million of total AID dollar loan assistance to the banks had been available less than 3 years and that 56 percent had been available less than 5 years. Thus the amount of the AID-provided funds available long enough to permit a meaningful study of the evolution of development bank lending policies was relatively small.

In our view a tentative assessment of the evolution of bank lending only requires that the banks be making loans for at least 3 years from the time AID assistance began, regardless of source of funding. As previously indicated, our analysis was not confined to loans made with AID funds; we looked at all loans wherever possible. Of the banks reviewed, only bank A2 had not been in existence and making loans for at least 3 years.

CHAPTER 5

AID REVIEW AND MONITORING

AID involvement in development bank operations has generally been restricted to approval of larger loans as specified in loan agreements.

Mission reviews of bank loans were primarily concerned with administrative matters and not with the effectiveness of the institutions. In only one instance, that of a recent review of the first AID dollar loan to bank D1, did we find that the review was of a comprehensive nature. For example, this report points out that 76 percent of all bank D1 funds committed were for individual loan amounts exceeding $300,000 and that four loans accounted for 58 percent of the AID loan funds committed. We also found that Mission reviews were not conducted on a periodic basis and generally were performed anywhere from 3 to 5 years after the loan had been granted and at a time when the bulk of the funds had been disbursed.

In view of the observations cited in chapter 3, we are of the opinion that closer AID monitoring of U.S. assistance to development banks would be desirable. AID recognizes this need and has indicated that it is currently reviewing its monitoring procedures.

TWO-STEP LOANS

As indicated in appendix I, eight of the 13 AID dollar loans provided to the banks reviewed were two-step agreements. Under this arrangement, the loan is negotiated with the bank but the host government is afforded the opportunity of assuming responsibility for repayment to AID. If the host government exercises its option, it repays AID over a longer period of time and at a lower rate of interest than the development bank is required to repay the host government. For example, whereas the host government might be required to repay AID over 40 years with interest at 2 percent, the development bank would be required to repay the host government over 20 years with interest at 4 percent. The two-step loan therefore results in substantial sums accruing to the host governments.

The loan agreements and underlying documentation generally did not set forth the reasons for using the two-step arrangement or the rationale for the specific terms. Further, in a number of instances there was no provision for AID control of the funds accruing to the governments.

ROLL-OVER FUNDS

Most of the loan agreements did not make provision for AID control over the banks' use of roll-over funds, i.e., funds obtained from repayments of loans made by the banks from the initial AID credit and held by the banks before repayment to AID or their governments. Without such control, the banks are free to use these funds without restriction and AID's ability to influence the banks' lending practices is lessened.

CHAPTER 6

AID ASSISTANCE FOR SMALL BUSINESS FIRMS

In addition to providing assistance to development banks, AID has provided a very limited amount of funds for lending programs to small business firms and artisans. As AID stated during its 1969 evaluation of development banks, AID assistance for small industry financing is small.

AID has supported two programs to assist small business in country A. Two local commercial banks received local currency to establish revolving funds to be used to make loans to small businesses. The money provided was local currency which was generated under an AID dollar loan granted to the Government of country A in June 1967 and was held in a special account in the country's central bank.

The first fund was established with a local bank in June 1966. Under an agreement with the bank, country A, and AID, $100,000 was made available to provide supervised credit to individuals and small firms that could not otherwise obtain financing. The agreement also provided that $10,000 would be made available to meet the costs of advisors who would assist and advise the bank's borrowers. Loans were to be repaid within 72 months; however, the bank could grant an initial grace period of 12 months before the first payment of principal. Loans made from the fund were not to be less than $500 nor more than $7,500, and as a general rule the bank was to try to obtain an average for loans of less than $4,000. Interest was to be 8 percent.

In June 1969, by mutual consent of the parties, the agreement with the above bank was terminated and all monies generated were required to be returned to the special account as received by the bank. As of this time the bank had made 52 loans and had disbursed approximately $90,000. Mission documentation indicated that the responsibility for the termination action must be borne jointly by AID and the bank. AID stressed that the loans from the fund were to be essentially "character" loans, and it became impatient when the bank wished to apply regular lending criteria. Therefore the bank lowered its lending standards.

The bank, bearing no credit risk, did not make a full effort at collecting and did not provide adequate technical assistance. Through August 1969 the bank had collected approximately 67 percent of the outstanding small business loans.

In September 1968 a new agreement was reached with country A, AID, and a second local bank whereby the latter would establish and administer an Artisan and Small Business Trust Fund similar to that operated by the previous bank. Under this agreement $300,000 was provided from the special account for loans and technical assistance to individuals and firms that could not otherwise obtain financing. This agreement also set aside the original character-loan concept and required that loan recipients provide adequate guarantees and/or a guarantor.

As a result of the difficulties encountered with the first bank, an eight-page annex, which detailed the specific objectives of the program and a system of formal procedures designed to maximize the possibility of obtaining these objectives, was made a part of the agreement with the second bank. The terms of the loans to be made by the second bank were to be the same as those made by the first bank.

Through March 1970 the second bank had made 76 loans to small business firms and artisans and had disbursed $349,586.

In 1965 a pilot project to provide assistance to small private enterprise was started in country B. Under an agreement with bank B1, AID, and a nonprofit private organization, a revolving fund with initial capitalization of $20,000 was established. AID and bank B1 contributed $10,000 each, and the operation was managed by the nonprofit private organization.

Individual loans were not to exceed $3,000, and interest was to be at 7 percent a year on the unpaid balance. Loans were to be repayable in 30 monthly installments with maximum grace periods of 6 months; however, this was subsequently amended to allow loans to be repaid in 36 months with maximum grace periods of 6 months.

In February 1970 bank B1 made another contribution of $10,000 to the small business fund.

As of March 1970 the private nonprofit organization under this program had made 45 loans to small business firms and had disbursed approximately $64,000. There were no significant collection problems.

In October 1967 AID granted a $2 million loan to a government credit institution in country C for use in a program of assistance to small urban businessmen. In addition, the credit institution contributed $3.3 million. The objective of the program is to provide short- , medium- , and long-term credit, along with technical assistance, to small industries, artisans, and merchants.

The loan agreement provides for both working-capital loans and fixed-investment-type loans and sets maximum loan amounts of $3,571 and $7,142, respectively. Working-capital loans can be made for periods up to 5 years and in exceptional cases for 10 years. The interest rate on both types of loans is 8 percent plus a 1-percent commission.

Our review of the bank's records indicated that 7,422 loans, amounting to about $3.8 million, had been made during 1969. This averages about $510 per loan. There were 7,380 loans made for periods of 18 months or less and 42 loans made for longer periods.

A review of the capital assistance paper for the AID loan indicates that, along with making credit available to small businessmen, a major requirement of the program is to provide technical assistance to subborrowers. During our discussions with officials at the bank's Division of Small Enterprises, however, we were advised that this aspect of the program was being neglected due to a lack of capable personnel and inadequate funding.

Under the terms of the AID loan to bank E1, $350,000 was reserved for a special lending program to artisans and to small business. Bank E1 transferred the funds to another bank for program administration, and the entire amount was disbursed during the period July 1965 to November 1966. Upon disbursement of the funds, the lending program terminated and repayments of the loans were required to be returned to bank E1.

The bank made 504 loans under the program and experienced no delinquency or collection problems.

As a follow-up to the above program, AID, in July 1970, was considering a loan of $5.2 million to country E to be used for small business development. Under this program country E will distribute the funds through intermediary financial institutions to meet small business needs. It is also expected that the participating institutions will reserve a part of their own resources for small business loan purposes and that, as a result, the total resources available will amount to about $9.6 million.

The project is intended to facilitate, through the establishment of a special fund at the central bank, the growth and the influence of the small business community enabling it to contribute more significantly to the country's development. An amount of $400,000 has been set aside for technical assistance needs, and the Mission estimates that about 1,000 small enterprises will obtain assistance under this program. Further they estimate that 5,000 new job opportunities will be created. The project is designed to increase productivity, reduce unit costs, and enable country E's small business to compete more favorably in the forthcoming Andean Common Market.

We did not make a review of AID assistance to small enterprises and artisan funds. We did, however, visit a number of AID's borrowers in country B and country C and found that they were small operations which had marginal credit ratings and which, we believe, would not have been able to obtain financing from other sources.

CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

This chapter summarizes our principal observations and sets forth our conclusions and recommendations for improving the effectiveness of U.S. assistance to development banks.

SUMMARY OF OBSERVATIONS

The institutions reviewed received AID dollar loans of $72 million, or 40 percent of such assistance to development banks in Latin America. These loans were provided at concessionary interest rates--it cost the United States more to obtain the funds than it will eventually receive from the borrowers. The additional cost to the United States for the $72 million in loans will amount to about $74 million; in return for this subsidy, AID expects the banks to perform certain development functions.

The banks have, to some extent, assisted in the economic development of the countries involved, because most of their loans were of medium term and long term and were made to the private sector. In addition a number of banks were successful in attracting non-AID foreign funds.

In the following areas, however, the banks' performance fell short of AID criteria and could be improved.

> Size of firm--large firms received 75 percent of available funds.
>
> Size of loan--over 80 percent of available funds were for loans in excess of $100,000.
>
> Stimulation of investment--over 75 percent of the banks' funds went to firms which could have obtained the necessary financing for their investments elsewhere, and therefore GAO believes that the banks stimulated relatively little new investment.
>
> Capital markets--the banks had done little to establish and broaden capital markets.

Technical assistance--the banks had provided little technical assistance to borrowers.

Promotion--the banks did little to search out and promote new investment opportunities.

In general, investment priorities had not been established, and AID's monitoring of the development bank program by design was limited.

Eight of the 13 loan agreements reviewed were two-step arrangements whereby the host government received repayment from the development bank and assumed responsibility for final repayment to AID. In such instances the host government repays AID over a longer period of time and at a lower rate of interest than the development bank is required to repay the host government. Substantial sums thus are made available for use by the host government. GAO found that none of the loan agreements or underlying documentation set forth the reasons for using the two-step arrangement or the rationale for the terms and that not all agreements provided for AID control of the funds generated.

Most of the AID loan agreements did not make provision for AID control over the banks' use of roll-over funds, i.e., funds obtained from repayments of loans made by the banks from the initial AID credit and held by the bank before repayment to AID or the host government. As a result, upon the banks' initial disbursement of AID funds, AID's ability to influence the banks' lending practices is lessened.

CONCLUSIONS AND RECOMMENDATIONS

We recommend that AID monitor more closely its assistance to development banks through periodic analyses to determine whether the banks

--emphasize loans to small- and medium-size firms,

--stress moderate-size loans,

--consider the applicant's ability to obtain the necessary financing from other sources so that there is greater assurance that new investment is stimulated,

--establish and broaden capital markets,

--provide technical assistance to borrowers, and

--search out and promote new investment opportunities.

We also recommend that:

--AID, in conjunction with the host country, establish the specific priority activities to be financed with AID funds.

--In those instances where AID assistance is to be provided under the two-step arrangement, AID document the reasons for its use and establish controls over the amount and use of the funds generated.

--AID make provision in its loan agreements for control of roll-over funds.

Agency comments and our evaluation

AID stated that it felt that on balance its support for the development banks had achieved a significant degree of success in strengthening the channels for the investment of private sector funds for Latin American development purposes. AID recognized, however, the continuing need for improvement in the program. We believe that our recommendations, if implemented, will assist in this endeavor.

Regarding our recommendation for closer monitoring, AID stated that it is currently reviewing its monitoring procedures with respect to both disbursement and postdisbursement phases. AID stated also that it will review with the host government and borrower in every case the specific priority activities to be financed with AID loan funds.

AID disagreed with the recommendation on two-step loans and stated that most such loans do provide for AID and host government agreement on the use of local currency payments. The two-step option is offered to all host governments which qualify for AID's most concessional loan terms. Its purpose is to provide the host country with maximum balance-of-payments support and external debt relief and, at the same time, to lend to revenue-producing entities on terms which reflect their ability to repay without unjustified subsidization.

We found that none of the AID loan papers and loan agreements relative to the eight two-step loans included in this review documented the reasons for the use of such arrangements. Further, none explained the rationale for the particular terms of the bank-host government repayment arrangement and three of the eight loans did not provide for setting aside the local currency repayments for mutually agreed-upon development purposes.

AID disagreed with our recommendation on roll-over funds and stated that such a requirement was unnecessary and would be excessive. Most loan agreements provide that any major change in the policies of the borrower must be approved by AID. Any monitoring of loans, however, should be limited to the initial disbursement of the AID loan. AID also stated that the length of roll-over period and the fungibility of loan recoveries (i.e., commingling of AID funds with those from other sources) would make following AID monies impossible and following the total portfolio impracticable.

In our view control of roll-over funds is necessary to ensure that a development bank becomes or remains development oriented. Our review showed that the present limited monitoring of development banks is insufficient to ensure that the banks perform the development functions expected. Without some control of roll-over funds, AID, following initial disbursement of its funds, has little leverage with which to influence the bank in its lending practices.

Control of roll-over funds may be accomplished by including a provision in loan agreements which would give AID the right to review the total loan portfolio of a bank, regardless of source of funds. AID could then, by use of sampling, readily ascertain at frequent intervals the extent a bank was development oriented.

If AID were to sample the total portfolio of a bank at frequent intervals, the length of the roll-over period would not be a problem. Under our suggested procedure of looking at the total portfolio, keeping separate track of AID loans would be unnecessary; hence, there would not be a fungibility problem.

Country and bank	Loan number	Date of agreement	Amount (millions)	Term of loan: Grace period: Government	Term of loan: Grace period: Bank	Term of loan: Number of years (including grace): Government	Term of loan: Number of years (including grace): Bank	Interest rate: Grace period: Government	Interest rate: Grace period: Bank	Interest rate: Nongrace period: Government	Interest rate: Nongrace period: Bank
Nicaragua:											
CNI (note a)	524-L-010	5-25-65	$ 3.0	10	5	40	20	1%	2-1/2%	2-1/2%	2-1/2%
CNI (note a)	524-L-016	9-27-66	5.0	10	5	40	20	1	5-1/2	2-1/2	5-1/2
INFONAC (note a)	524-L-009	12-23-64	4.0	10	10	40	25	3/4	2	2	2
INFONAC (note a)	524-L-018	10-23-67	5.0	10	5	40	25	1	3-1/2	2-1/2	3-1/2
Dominican Republic:											
FIDE	517-L-007	4-12-65	5.0	10	10	40	40	1	1	2-1/2	2-1/2
FIDE	517-L-023	3- -70	8.0	10	10	40	40	2	2	3	3
FDSA (note a)	517-L-018	5-28-68	5.0	10	5	40	20	1	2-1/2	2-1/2	2-1/2
Panama:											
DISA	525-L-006	12-23-63	5.1	-	5	-	20	-	2	-	2
DISA	525-L-014	10-19-66	4.0	-	5	-	20	-	3	-	3
Ecuador:											
CV/CFN (note a)	518-L-014	7-20-62	5.0	10	5	40	20	3/4	5-3/4	3/4	5-3/4
COFIEC	518-L-026	1-31-66	3.0	-	5	-	20	-	2-1/2	-	2-1/2
Colombia:											
PIF (notes a and b)	514-L-040	12-23-64	10.0	10	5	40	20	3/4	5-1/2	2	5-1/2
PIF (note a)	514-L-057	12- -69	10.0	10	5	40	20	2	5-1/2	3	5-1/2
Total AID dollar loans			$72.1								

[a]Two-step loans.

[b]PIF also received about $59.5 million in U.S.-controlled counterpart local currency generated by program loans and a loan of $1.6 million in local currency generated by Public Law 480 sales.

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

June 11, 1971

Mr. Oye V. Stovall
Director
International Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Stovall:

We have completed our review of the draft report entitled "Development Performance of A.I.D.-Assisted Industrial Development Banks in Latin America" which was transmitted with your letter of February 24, 1971. Enclosed is a memorandum to the Auditor General from Mr. Herman Kleine, the Assistant Administrator of the Latin America Bureau, which constitutes the Agency's consolidated response to this report.

Sincerely yours,

Charles G. Haynes

Charles G. Haynes
Deputy Auditor General

Enclosure: a/s

3 JUN 1971

MEMORANDUM

TO : AG, Edward F. Tennant

FROM : AA/LA, Herman Kleine

SUBJECT: GAO Draft Report Entitled "Development Performance of AID-Assisted Industrial Development Banks in Latin America"

We have reviewed with interest the draft of the GAO's report on industrial development banks in Latin America and have obtained analyses and comments from the USAIDs in the five Latin American countries which were visited by the GAO in connection with this examination.

[See GAO note 1.]

GAO note 1: The deleted comments pertain to material presented in the draft report which has been revised or not included in the final report.

MEMORANDUM

[See GAO note 1, p. 63]

The GAO's rigid criteria of what constitutes high priority industrial investments are difficult for us to accept. For example, the GAO feels that the industrial development banks should give priority consideration to investments in both export industries and labor intensive industries. Not only does the GAO's analysis of what constitutes investments for export industries appear to be incomplete, but the goal of investing in labor intensive industries may well prove to be inconsistent with that of investing for the stimulation of exports. Moreover, the discussion in the draft report with regard to labor intensive industries appears to rest on debatable grounds.

The GAO auditors also attempted to determine the degree of success of the industrial development banks in stimulating new investment. They appear to have arrived at their conclusions by means of a subjective determination of the amount of investment that "went to firms whose financial characteristics were such, that we believe they would have undertaken their investments regardless of the assistance of the banks." The conclusion reached by the GAO is inconsistent with the analyses that were made to support AID's

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assistance for the industrial development banks. Generally it was found that the non-availability of equity capital or long or medium credit facilities on reasonable terms was a bottleneck in the development of the private sectors in the countries visited by the GAO auditors.

The possibility that sub-borrowers might have obtained credit elsewhere is not conclusive unless it can be shown that the other possible sources offered credit on the same terms as the industrial development banks. The test for stimulating new investment is not merely whether it occurs, but whether it is economically viable. If the GAO had shown that the sub-borrowers could have made investments although borrowed at the harder terms charged by non-industrial development bank lenders and still have carried out successful and profitable ventures, the GAO's conclusions would be more persuasive.

We feel that on balance AID's support for the industrial development banks has achieved a significant degree of success in strengthening the channels for the investment of private sector funds for Latin American development purposes. We recognize the continuing need for improvement in this program, particularly toward refining the investment priorities of the banks. We continue to review the performance of the AID-supported institutions in providing appraisal banking services and in responding to the effective demands for medium and long term credit and equity financing.

In the attachment you will find a further discussion of these matters, as well as more detailed comments with regard to each of the GAO's conclusions and recommendations.

If there is any additional information that we can provide at this time, please do not hesitate to let me know.

Attachment [See GAO note 2.]

GAO note 2: The applicable comments contained in the attachment to the above memorandum and our evaluations have been included in the appropriate sections of this report.

Copies of this report are available from the U. S. General Accounting Office, Room 6417, 441 G Street, N W., Washington, D.C., 20548.

Copies are provided without charge to Members of Congress, congressional committee staff members, Government officials, members of the press, college libraries, faculty members and students. The price to the general public is $1.00 a copy. Orders should be accompanied by cash or check.