USAID

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*AGENCY FOR **INTERNATIONAL** DEVELOPMENT*
*OFFICE OF **THE REGIONAL** INSPECTOR **GENERAL/AUDIT***

CAIRO, EGYPT

Report No. 6-278-98-002-P
July 15, 1998

MEMORANDUM

TO: USAID/Jordan Director, Lewis W. Lucke

FROM: RIG/A/Cairo, Lou Mundy for Bruce Boyer

SUBJECT: Audit of Jordan Loan Guarantee Corporation's Implementation of USAID/Jordan's Loan Guarantee Activities

This is our report on the subject audit. In finalizing the audit report, we considered the Mission's comments on the draft report and have included them in Appendix II.

The report contains three recommendations to: (1) discuss with the Jordan Loan Guarantee Corporation (JLGC) the areas identified by the audit where JLGC appears to have gone beyond the terms of the written agreement and modify the agreement as deemed necessary, (2) assist the JLGC in evaluating its fee structure, and (3) assure that JLGC dividends based on USAID funds, but payable to the Central Bank of Jordan, remain invested in the JLGC. Recommendation No. 3 involves an efficiency savings of $420,800.

Based on the management decisions made by the Mission, Recommendation Nos. 1 and 2 are resolved. The documentation needed to close these recommendations is contingent upon the Mission's decision on whether to extend JLGC's agreement for one more year. Please advise M/MPI/MIC of the actions planned or taken to implement these two recommendations (see page 14). With regard to Recommendation No. 3, the Mission concurred in the efficiency savings of $420,800. Based on final action taken by the Mission, Recommendation No. 3 is closed upon report issuance.

We appreciate the cooperation and assistance provided to the auditors on this assignment both by the Mission and JLGC.

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EXECUTIVE SUMMARY

The Jordan Loan Guarantee Corporation (JLGC) was established in 1994 to take over implementation of a USAID/Jordan-supported project[1] which began in 1988 to provide guarantees for loans to micro and small businesses for activities that generate employment and earn or save foreign exchange. The JLGC has two lines of business, a domestic loan guarantee (domestic) program and an export credit guarantee (ECG) program.

The JLGC is a public shareholding company with public and private shareholders. Its share capital is JD[2] 10.0 million. The investment of the Central Bank of Jordan (Central Bank), JLGC 's largest shareholder, and the entity that provided leadership in creating JLGC, was reimbursed by project funds. Additionally, JLGC has 23 other shareholders, mainly banks, most of which participate in the guarantee programs.

The project originally targeted a narrower audience and it was expected that 1,650 loans would be guaranteed during its first four years. That level of demand did not materialize. Since JLGC took over as implementing entity, the target audience has been expanded. And, as of December 31, 1997, the cumulative number of loans guaranteed over the life of the project had reached 1,131.

The audit found that JLGC has established a control system which, if followed, would largely assure that USAID funds are used for project purposes and USAID policy restrictions are observed. However, under its ECG program all of the guarantees were to businesses too large to meet the project's small business definition and there were some instances of guarantees for textile exports to the U.S. without obtaining required written approvals from USAID/Jordan. Also, for the domestic program the range of eligible beneficiaries had been widened considerably and the loan limits increased without updating the written agreement with the Mission. We recommended that the Mission discuss the above issues with JLGC and decide whether the agreement should be modified (page 3).

The audit also found that JLGC has reached the level of being self-financing due to investment earnings on its substantial capital. However, JLGC incurs serious losses on the operating part of its business since its fees do not cover its present rate of default payouts, let alone its other costs. JLGC indicated that it would request USAID assistance in evaluating the actuarial soundness of its fee structure for both its domestic and ECG programs. We recommended that the Mission assist the JLGC in this matter (page 7). Related to JLGC's financial viability, the audit also noted that JLGC's financial statements for 1997 reflect dividends payable to the

[1]Loan Guarantee for Small Enterprise Development Project, Project No. 278-0255

[2]JD stands for Jordanian Dinar. The exchange rate at the time of the audit was about $1.42 per JD.

Central Bank of JD 296,340 ($420,800). JLGC apparently was not aware of an earlier agreement between the Government of Jordan and the Mission which requires that the earnings from USAID's donation be used for the implementing entity's operating expenses with any surplus being recycled into the loan guarantee fund. We recommended that the Mission inform the Central Bank of the agreement provision and assure the dividends remain in JLGC (page 9).

Lastly, the audit reported the opinions of-bankers from 13 of the 19 private banks participating in JLGC's programs regarding the demand for JLGC's loan guarantee programs and any problems and opportunities.

Certain banks had definite plans to increase their use of JLGC's guarantees or noted organizational changes that might increase demand for the guarantees, but by and large the banks had no definite plans to increase their business with JLGC. Significantly, the audit noted that JLGC's guarantees are marketed more from the standpoint of Jordan's social development than from a business standpoint, so in many cases the banks use JLGC's guarantees when they do not actually need them. We did not make a recommendation, but this is a matter that should be considered when assessing JLGC's fee structure as mentioned above (page 11).

As to problems and opportunities, several banks did not mention anything. Certain banks mentioned they would like to see JLGC raise the limits on its domestic and ECG programs. The banks that did mention problems generally were concerned about paperwork requirements or fees. We did not make a recommendation (page 12).

USAID/Jordan agreed with the contents of the audit report. The Mission's comments and our evaluation are presented in the section entitled "Management Comments and Our Evaluation" (see page 14 and Appendix II).

Office of Inspector General

Office of Inspector General
July 15, 1998

INTRODUCTION

Background

In 1988 USAID started a project[3] to help the Government of Jordan (GOJ) address problems of unemployment and an adverse foreign exchange situation. These problems were to be addressed by encouraging commercial banks to lend to micro and small productive[4] enterprises for activities that would generate employment and either earn or save foreign exchange. Micro and small businesses were targeted because such businesses have the greatest potential for job creation and the capital cost of jobs created is low.

The project created a fund to guarantee a percentage of the loan amount to the targeted micro and small businesses. Banks were encouraged to lend to these businesses based on their revenue potential and ability to repay, i.e., on their cash-flows, thereby reducing traditional collateral requirements for this sector. It was anticipated that within four years 1,650 loans would be guaranteed and that the loan guarantee program would become self-sustaining.

However, after three years of project implementation only 230 loans had been guaranteed and there was no strong evidence that banks had significantly reduced their collateral requirements or committed to lending based on an entity's cash-flow. Additionally, USAID and the original implementing entity, Jordan's Industrial Development Bank (IDB), had divergent views on project implementation. These problems led USAID to recommend to the GOJ that the project be terminated.

The GOJ instead proposed that a new public shareholding company be formed to continue the project under the supervision of the Central Bank of Jordan (Central Bank). This new corporation, the Jordan Loan Guarantee Corporation (JLGC), was formed in April 1994. The JD 4.2 million[5] in net assets of the loan guarantee fund implemented by the IDB were transferred to the JLGC: JD 3 .O million as the Central Bank's shares investment, and the remainder as a reserve to cover outstanding loan guarantees at the time of transfer. Additionally, 23 other organizations, mainly banks, subscribed to JLGC's remaining shares of JD 4.0 million.

Under the IDB, and now the JLGC, the project's main line of business has been and remains a domestic loan guarantee program. This program guarantees loans to small businesses or to

[3] Loan Guarantee for Small Enterprise Development Project, Project No. 278-0255

[4] i.e., in the industry and non-trade service sectors

[5] JD stands for Jordanian Dinar. The exchange rate at the time of the audit was about $1.42 per JD. At this rate, the value of the net assets transferred from the old to the new implementing entity was about $6.0 million.

individuals for activities which may not involve exports directly. In 1997, JLGC established a new line of business, an export credit guarantee program, specifically for export transactions. This new program has two sublines of business, one to guarantee financing to produce the goods and the other to guarantee payment by the party that receives the exports (the importer). JLGC's capital was increased from JD 7.0 million to JD 10.0 million to support this undertaking with the Central Bank's share being reimbursed by USAID[6].

Through December 31, 1997, JLGC had made 799[7] loan guarantees under its domestic loan guarantee program, with a cumulative guaranteed amount of JD 8.1 million. Under its export credit guarantee facility, which was still in the start-up phase, JLGC had guaranteed six loans with a guaranteed amount of about JD 336,000.

The completion date for the project is August 30, 1998. However, USAID/Jordan requested that we review the project because the Mission is interested in the project's success beyond the period of USAID support and because it expects to have a continuing relationship with JLGC through other USAID projects.

Audit Objectives

At the request of USAID/Jordan, the Office of Regional Inspector General for Audit/Cairo conducted an audit of U&AID/Jordan's loan guarantee activities implemented by the Jordan Loan Guarantee Corporation. The audit sought to answer the following questions:

- Has the Jordan Loan Guarantee Corporation established control systems that assure USAID funds are used for project purposes and USAID policy restrictions are observed?

- Have the Jordan Loan Guarantee Corporation's credit guarantee programs reached the level of being self-financing?

- What are the views of the participating banks regarding the expected level of demand for the loan guarantee programs and any problems or opportunities?

Appendix I describes the audit's scope and methodology.

[6]The Central Bank invested JD 1,775,000 and USAID reimbursed the equivalent dollar amount, $2.5 million.

[7]Project records indicate that an additional 326 loans were guaranteed during the period the IDB managed the program.

REPORT OF AUDIT FINDINGS

Has the Jordan Loan Guarantee Corporation established control systems that assure USAID funds are used for project purposes and USAID policy restrictions are observed?

The audit found that the Jordan Loan Guarantee Corporation (JLGC) has established a control system which, if followed, would largely assure that USAID funds are used for project purposes and that USAID policy restrictions are observed. However, JLGC was not following certain program guidelines for its export credit guarantee (ECG) program, and its domestic loan guarantee program had been broadened in scope without updating the grant agreement.

JLGC's control system basically relies upon the completeness and veracity of the information contained in standard forms which must be filled out by banks or applicants seeking a guarantee. Based on the information, JLGC assesses whether the proposed guarantee qualifies under USAID's agreement restrictions. While the control system is a reasonable one, to a certain degree it is susceptible to circumvention by either intentional or unintentional misstatement of the basic information. However, we are not aware of any significant problems in this regard.

As regards JLGC observing the agreement's restrictions, however, we did note for its ECG program that all of the guarantees were to businesses larger than permitted under the agreement. Also, for the ECG program we noted that for 2 of the 12 guarantees made or approved through our audit cutoff date JLGC did not observe a restriction concerning exports of textiles to the U.S.

Further, for the domestic program, we noted that JLGC has considerably widened the range of eligible beneficiaries and increased program limits, but the written agreement has not been modified to reflect these changes.

Updating the Agreement to Reflect Current Activities and Any Loosening of Restrictions

The agreement for the project provides that within the broad definition of the project the project's elements may be changed by written agreement of the parties. The audit found that the written agreement does- not reflect the present scope of -activities under JLGC's domestic program, and that the business-size restriction and a prohibition regarding exports of textiles to the U.S. were not being adhered to for JLGC's ECG program. The Mission was aware of the changes to the domestic program and did not consider that the expanded activities were outside the scope of the project design. As regards the ECG compliance issues, JLGC considered the agreement to be too restrictive. The main impact of the above is that as the project's focus drifts it is likely that the project impact will be different than originally envisioned. For example, if there are "small" businesses within the project's current definition that need financing for export transactions, they are not currently being reached.

> **Recommendation No. 1: We recommend that USAID/Jordan discuss with the Jordan Loan Guarantee Corporation (JLGC) the areas identified by the audit where JLGC appears to have gone beyond the terms of the written agreement, and decide to what extent, if any, the agreement should be modified.**

Discussion

USAID's grant agreement with the Government of Jordan defines the general limits of the activities to be pursued under the project. The agreement further provides that the project elements may be changed by written agreement of the parties. Typically the written agreements to change a project's elements are in the form of Project Implementation Letters (PILs).

The basic grant agreement and PILs 1 through 9 were issued while the Industrial Development Bank (IDB) was still the project's implementing entity and lay out the agreement parameters regarding the project's domestic loan guarantee program. PIL No. 10 made the Central Bank of Jordan the implementing entity but otherwise did not significantly modify the agreement. The next PIL of interest was PIL No. 15 which laid out the parameters for JLGC's export credit guarantee (ECG) program.

Before JLGC took over implementation of the project, guarantees were to be for loans to micro and small enterprises in the industrial and non-trade services sectors, and the maximum loan that could be guaranteed was JD 20,000. Also, a small business was defined as having no more than 25 employees.

But when JLGC was established, its charter was broader in that it did not restrict JLGC's activities- to the industrial and non-trade sectors. Also the maximum loan that could be guaranteed was increased to JD 40,000 and the maximum number of employees to be considered a small business was raised to 50.

Although the general thrust of JLGC's domestic program is still micro and small businesses, the program now has been expanded to include: the service sector, e.g., professionals such as doctors, dentists and engineers; taxicab drivers, for the purchase of new vehicles (supports tourism); domestic or internal trade, e. g . , markets, boutiques, restaurants; and mortgage lending. Also, the maximum loan limit that can be guaranteed has been further raised to JD 100,000.

JLGC indicated that it may expand the program further in the future. It expressed that its current thinking is to support productive projects in any sector since ultimately any increase in

Jordan's productive base positively affects employment and foreign exchange. Still, up to the present JLGC does not provide guarantees for consumer loans.

The agreement for JLGC's ECG program is PIL No. 15. The PIL was the first to set limits on the value of assets a business could have and still be considered a small business. It also specified multiple USAID policy restrictions to be applied to the ECG. One of those restrictions was that loans must not be used for the export of textiles to the U.S. without the prior written approval of USAID.

Our audit tested 29 guarantees made under JLGC's domestic program and all 12 loan guarantees made or approved by JLGC under its ECG program through our audit cutoff date. Our basic objective was to determine whether the guarantees were made in accordance with the agreement's restrictions.

While the agreement with JLGC for the domestic program does not specify the assets a borrower may have and still qualify for the program, as a general observation we noted that 9 of the 29 loans (31 percent) reviewed were to persons or businesses which appeared to have significant asset levels, i.e., the assets or equity reflected in their guarantee applications exceeded JD 176,000 (the U.S. equivalent to $250,000). Several cases exceeded JD 1 .O million. Further, there were indications that the applications for guarantees did not always reflect all the borrower's assets. Some of the borrowers above exceeded the small business definition specified in PIL No. 15 for JLGC's ECG program.

In our testing of transactions under JLGC's ECG program, we noted that all 12 guarantees were to businesses that exceeded or appeared to exceed the limits for a small business as defined in PIL No. 15. All but one of the guarantees were to businesses that exceeded the asset limit[8] and four of the businesses exceeded the limit for the number of employees. Also, two of the guarantees were for loans which financed exports of textiles to the U.S. The agreement restricts such loans from participation in the program without the prior written approval of the Mission, but no such approval was requested.

JLGC stated that the Mission knew of its changes to the domestic program. The Mission agreed and stated that it considered that the expansion in scope of JLGC's domestic program was not restricted by the project design.

For its ECG program, JLGC stated that it is capitalized by both USAID and non-USAID funds and that activities restricted for USAID funds could be considered as having been funded by non-

[8]The one business that did not-exceed the asset limit apparently did exceed the -employee -limit. During our site visit to this business we were told that the owner employed 50 people at the site we were visiting plus he had another business in another location. We assume then that this businessman had more than 50 employees albeit split between two businesses. This businessman and another further stated that they employ more people when orders are received. Each of these points raises a question on the correct way to count the number of employees for purposes of determining whether a loan qualifies under the agreement.

USAID funds which do not have similar restrictions. Also, it considered that the PIL No. 15 definition of what constitutes a small business is too restrictive since small exporters are bigger than a typical small business.

In regard to the agreement restriction concerning exporting textiles to the U.S., JLGC stated that it had considered the word "textiles" in PIL No. 15 to refer only to fabric as opposed to clothing. So there was a misinterpretationof the restriction. However, JLGC noted that another U.S. program actually encourages the unrestricted export of goods, including clothing, to the U.S. from Qualified Industrial Zones in Jordan. Therefore it did not see the reasonableness of a restriction on the export of clothing to the U.S. JLGC stated that it would request a blanket waiver from the restriction because at this point in the marketing of the ECG program it wanted to minimize restrictions that might reduce business.

As a result of expanding to larger businesses and to sectors not within the definition of "productive" enterprises in the original project design, the project may not have as great an impact on the broad problems of unemployment and foreign exchange that the project was originally intended to address. For example, lending for mortgages on housing already built probably has a less direct effect on employment than a loan to expand a business, and lending for an internal trade activity such as a supermarket as likely as not could result in increased demands for imports, and thus negatively affect foreign exchange. Further, the fact that the ECG program is not presently reaching exporters of small size under USAID's definition in PIL No. 15 raises the question of whether there are businesses of that size which might be potential exporters but whose needs are not being addressed.

Nevertheless, any productive activities that JLGC's guarantees cause to happen, and which otherwise would not have happened, are an economic plus for Jordan. And, if there are no small exporters, as JLGC contends, then there will not be any demand for JLGC's ECG program if its activities are restricted to that group.

Considering the questions raised by JLGC with regard to restrictions on its ECG program and also the broad expansion of activities under the domestic program without updating the written agreement between USAID and the Government of Jordan--not to mention the fact that the period of the agreement will soon end--we believe that the time is opportune for the Mission and JLGC to discuss the activities that should be pursued and, if necessary, to make any last minute adjustments to the agreement before the period of USAID support ends.

Have the Jordan Loan Guarantee Corporation's credit guarantee programs reached the level of being self-financing?

JLGC's credit guarantee programs have reached the level of being self-financing. This positive situation is due to investment earnings on the substantial capital provided by its shareholders.

On the negative side, however, JLGC's fee structure for guarantees does not cover its current rate of payouts for defaults, let alone its other operating costs. We also noted that JLGC's financial statements reflect a dividend payable to the Central Bank of Jordan (Central Bank) of JD 296,340 ($420,800). However, the Central Bank's investment as a shareholder in the JLGC was completely reimbursed by USAID. Our interpretation of the agreement is that the dividends payable to the Central Bank should remain in the business and therefore not be paid to the Central Bank. These two issues are discussed further below:

Evaluating Jordan Loan Guarantee Corporation's Fee Structure

USAID generally expects the microfinance institutions it supports to charge high enough rates to cover the full long-run costs of their programs, including the opportunity costs associated with USAID's donation. In 1997, JLGC earned enough from its invested capital and fees to more than cover the full cost of its programs. However, it did so only because of the investment earnings on its substantial capital. If only fees are considered, JLGC is presently incurring serious losses. JLGC indicated that its fees were set without adequate analysis and that it is under pressure from its bank shareholders not to increase fees. Unless JLGC corrects its fee structure, it is likely to lose progressively more on its operations as they grow. Additionally, if interest rates in Jordan decline from their past levels, JLGC investment earnings will also decline, worsening its financial situation.

> **Recommendation No. 2: We recommend that USAID/Jordan assist the Jordan Loan Guarantee Corporation in evaluating the fee structure for its guarantee programs.**

Discussion

USAID's Microenterprise Development Policy Paper generally requires that USAID's support be restricted to microfinance institutions that provide financial services on an unsubsidized basis, that is, the interest and fees collected from clients should cover the institutions' full long-run costs, including the opportunity costs associated with funds donated by USAID[9]. USAID views financial sustainability not as an end in itself, but as a means to attain large-scale, growing, and sustainable program benefits to the target beneficiaries.

[9] The opportunity cost associated with donated funds is the difference between what the entity pays for the funds and what it would have had to pay if it had raised the funds on the market.

JLGC’s financial statements for 1997 show that it earned about JD 1.26 million against adjusted[10] expenses, provisions and reserves of about JD 642,000, meaning that JLGC had about JD 618,000 available to declare dividends or add to its retained earnings. Figuring in the opportunity cost associated with USAID's donation[11], the result is still positive, which leads to the conclusion that JLGC has reached the point of full financial sustainability.

However, the above figures do mask a serious problem. Almost all of JLGC’s revenues are from interest and dividends on its substantial invested capital. The operating part of its business incurs heavy losses vis-a-vis the fees that it charges. JLGC’s revenues from fees were only JD 124,000 which was insufficient to cover JLGC’s net payouts for loan defaults of JD 176,000, let alone its other expenses. If one excludes JLGC’s investment income from the equation, it would have lost on the order of JD 5 18,000 during 1997.

JLGC is well aware that its fees do not recoup its costs and considers fees to be a problem for both its domestic and ECG programs, but particularly for its ECG program which it said had been launched without adequate analysis. While there have not been any defaults under the ECG program, a recent technical assistance report funded by the Mission questioned the actuarial soundness of the program.

JLGC stated that fee setting is one of the ECG's shortcomings and that the fees as presently structured will not provide sufficient income to cover the program’s costs. It also stated that an actuarial study had not been done in setting up the ECG and that it wants to study the ECG further from a productivity, actuarial and business point of view. JLGC indicated that it would request USAID assistance in doing the study.

For its domestic program, JLGC explained that it had intended to establish somewhat higher fees, but its bank shareholders protested, leading it to settle for its present rates. JLGC expressed an interest in obtaining USAID assistance to assess the fees versus risk for its domestic program as well. JLGC noted that such assistance would be helpful in convincing the banks of the need for higher fees.

In the interim, JLGC indicated that it is thinking about studying its portfolio of defaulted loans to determine the causes of the defaults. With this information, JLGC will assess whether fees should be increased to certain banks or classes of borrowers based on risk.

We believe JLGC’s plan to study its defaulted loans to determine whether there is a discernable pattern of higher defaults from certain banks or types of borrowers is a prudent step on JLGC’s part and we support the setting of risk-based fees. We further realize that JLGC’s product is price sensitive and that the demand for JLGC’s guarantees likely will go down if it raises prices.

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[10] For purposes of our analysis, we adjusted JLGC’s provisions for loan defaults to the net cash payout for the year and we excluded an addition by JLGC to its “voluntary reserve”.

[11] The opportunity cost (at 9 percent) associated with donated USAID funds of about JD 6.0 million is JD 540,000.

Nevertheless, we believe this is a problem that JLGC needs to face if it is to become a viable business. As JLGC's fees are presently structured, it will only become less profitable as its business grows.

Retaining the Central Bank's Dividends in the Business

A written agreement reached early on in the project before the JLGC was formed requires that the earnings from the Government of Jordan funds invested in the project, as reimbursed by USAID, be used to cover the operating expenses of the project with any surplus recycled into the loan guarantee fund itself. Since JLGC's establishment in 1994, it has declared dividends on two occasions and its financial statements for 1997 reflect dividends of JD 296,340 ($420,800) payable to the Central Bank of Jordan (Central Bank), JLGC's biggest shareholder. However, the Central Bank's investment in JLGC was completely reimbursed from USAID funds. Therefore, per the agreement, the Central Bank's dividends should remain in JLGC. This issue has arisen apparently because JLGC was unaware of the earlier written agreement. However, unless USAID/Jordan intervenes, JLGC may still provide the dividends to the Central Bank.

> Recommendation No. 3: **We recommend that USAID/Jordan inform the Central Bank of Jordan of the agreement requirement that the earnings associated with USAID's investment in the project be used for the costs of project implementation with any surplus being added to capital, and that USAID/Jordan assure that such earnings remain in the business.**

Discussion

The design for the project has always been that the Government of Jordan (GOJ) would provide the Jordanian Dinar financing for the project's loan guarantee fund and that USAID would in turn reimburse the GOJ. The project design further envisioned that the fees associated with use of the guarantee facility and interest on guarantee funds would be used to cover the operating expenses of the project with any surplus recycled into the fund itself. This was all explained and mutually agreed to in Project Implementation Letter (PIL) No. 4 in 1989 when USAID agreed to reimburse the GOJ up to $5.5 million to establish the loan guarantee fund.

At the time of PIL No. 4, Jordan's Industrial Development Bank (IDB) was the implementing entity and a special account for the loan guarantee fund was established at the IDB.

When JLGC was established in 1994 its capital came from public and private shareholders, including the Central Bank, and all funds were commingled. The Central Bank's investment came from the residual assets left over from the loan guarantee fund as implemented by the IDB. Three years later, USAID reimbursed the Central Bank's further contribution to JLGC's capital to establish JLGC's export credit guarantee facility. So the Central Bank's capital contribution to the JLGC has been completely reimbursed by USAID.

Since JLGC was established, its Board of Directors has declared dividends on two occasions. Dividends to all the shareholders except those to the Central Bank were paid. However, the Central Bank's dividends have been carried on JLGC's books as dividends payable. JLGC's financial statements for 1997 show accumulated dividends of JD 296,340 ($420,800) still payable to the Central Bank.

We questioned JLGC why the Central Bank would be receiving dividends when the money for the Central Bank's investment had been reimbursed from project funds, and further asked why since dividends had been declared that Central Bank has not been given its dividends. JLGC agreed that as a matter of principle the Central Bank should not receive dividends from its investment in JLGC since the ultimate source of the Central Bank's investment is USAID funds. On the other hand, it stated that the Central Bank is a JLGC shareholder and that as a shareholder it is entitled to dividends when they are declared.

JLGC has withheld giving the dividends to the Central Bank because it was warned by a previous USAID/Jordan project officer that any dividends to the Central Bank should stay in JLGC. It indicated that the Central Bank had requested the dividend but JLGC advised the Central Bank to not take the dividend until after USAID's monitoring rights end. JLGC did not indicate any awareness of the mutual agreement evidenced in PIL No. 4, and when informed of it requested a copy.

After reviewing PIL No. 4, JLGC indicated that it is not in a good position to raise the matter of the dividends with the Central Bank and suggested that USAID raise the issue. JLGC suggested putting the funds into a special reserve account so that it will be clearly identified as coming from the Central Bank and not available as dividends to the other shareholders.

What are the views of the participating banks regarding the expected level of demand for the loan guarantee programs and any problems or opportunities?

The reason for this descriptive audit objective is basically to report our general observations after interviewing 13 of the 19 banks participating in JLGC's programs as of the end of 1997. Over the life of the project, the demand for. loan guarantees has not materialized to the extent originally expected even though the scope of JLGC's programs has been expanded substantially. So we were interested in getting the bankers' opinion on the expected future demand for JLGC's programs. Additionally, we were interested in any feedback regarding how the programs might be improved.

Expected Demand for the Loan Guarantee Programs

The information that we obtained through banker interviews did not provide us a basis to draw a conclusion on the overall demand for JLGC's programs. However, two banks visited indicated that they have plans to increase their business with JLGC on the order of JD 2.7 million during 1998, of which JD 2.0 million was in the mortgage area. Also, certain other banks indicated that they had undergone organizational changes which might lead to increased business with JLGC. However, most of the banks had no definite plans to increase their business with JLGC. This is not to say that JLGC, through-its marketing efforts, will not be able to further develop business with most banks or that other business-stimulating projects sponsored by USAID, other donors, or the Government of Jordan will not lead to greater demand beyond what the bankers are presently aware of.

While the above indicates some immediate potential for new business, we do have a concern regarding how solid JLGC's present business base is. In our opinion, JLGC's present level of business is based more on the Central Bank's supervisory position over Jordan's banking system and the Central Bank's desire to promote social development in Jordan than it is on the business merits of JLGC's programs. JLGC told us that most banks are interested in participating in JLGC's programs to show the Central Bank that they are serious about addressing the social development of the country. JLGC noted that marketing the program on this basis works.

However, a question needs to be asked as to whether a bank's participation in JLGC's programs means that the bank sees a business value in JLGC's guarantees. To be sure, the banks did identify situations where they saw a business value to JLGC's guarantees. However, these situations were at the margins of their business and it is not clear that all the JLGC guarantees the banks presently have in force were needed.

JLGC follows a practice of charging fees to a bank based on the guarantee ceiling allocated to the bank rather than its actual usage of guarantees. This charging policy on JLGC's part clouds the analysis of how much of the current level of loan guarantee usage by banks is for situations that made business sense for the banks. Because of this charging practice, one bank stated that it submitted all loans which met JLGC's program eligibility requirements for guarantees. The bank stated that very few of its loans submitted for guarantees actually needed to be guaranteed to make them acceptable to the bank, but that since the bank was already paying fees against its ceiling, it might as well submit the loans for guarantees.

Another bank which accepted a minimal allocated ceiling from JLGC was paying JLGC's fees but had never used any guarantees and explained that due to the nature of its business it does not foresee that it will ever use JLGC guarantees.

JLGC itself analyzed that 35 percent of all the loans it has guaranteed met the banks' traditional lending criteria and did not need JLGC's guarantees. But it stated that for the present it would accept such loans for guarantee in order to build its business. Based on our bank interviews, we consider the percentage could be even higher. However, even so JLGC's analysis does point out that in many cases the banks use JLGC's guarantees when the banks would be willing to make the loans without them.

While JLGC may be successful in marketing its programs based on Jordan's social development problems, we believe it is much more desirable to put JLGC's programs on a sound business footing so that lending guaranteed by the programs actually is additional lending that incrementally contributes to Jordan's social development.

We are not making a recommendation, but the solution would appear to lie in identifying the real demand for JLGC's guarantees and working from there. The identification of where the business demands are for JLGC's products is something that JLGC should consider in assessing its fee structure in any case.

Problems and Opportunities Noted by the Banks

Two banks mentioned that they would like to see the ceilings raised for JLGC's programs. One bank interested in the domestic program[12] suggested the ceilings for the domestic program might be raised to broaden the range of potential beneficiaries. As an initial step, the bank favored using the highest guarantee percentage available under the domestic program (75 percent) for all loans rather than just the lower value ones. The bank also suggested that the domestic program's current JD 100,000 ceiling amount for a single loan might be raised. The other bank, which was more interested in JLGC's ECG program, said it would like to see the ECG's ceiling loan amount raised from the current JD 100,000[13] to JD 500,000[14].

[12]The banker in this case was also a JLGC board member. He offered his comments as his personal opinion as a board member considering ways to create greater demand for JLGC's guarantees.

[13]The current ceiling for the ECG -program is JD -100,000 for a single loan. -However,. JLGC is willing to guarantee multiple loans to a single borrower up to JD 250,000.

[14]As a side note, we should mention that in our visits to the borrowers under JLGC's ECG program, the borrowers almost uniformly mentioned that they wanted higher loan limits. On the other hand, all the businesses were larger than what is allowed for under the current agreement.

We would consider the above to be more in the nature of opportunities than problems. As for problems, it should be noted that several banks did not mention any problems that concerned them. The bankers that did mention problems generally were concerned with the paperwork requirements or with fees.

As regards paperwork, the only specific suggestion for improvement was that the initial two forms submitted to JLGC for domestic guarantees should be combined into one. However, the more general complaint was that the paperwork requirements are too much. It appeared to us that the general complaint may be premised on the amount of management's time it takes to process an application for a guarantee through JLGC including doing the required analyses and obtaining the information requested in the standard forms.

For instance, one bank told us that it takes 10 days just to prepare the analyses JLGC requires. The bank's comment is not inconsistent with a previous survey done under a Mission-funded technical assistance contract where the survey respondents said it takes one to three hours to prepare a business plan and a day to a week to prepare JLGC's guarantee application. Since bank managers who deal with loans are usually quite busy, streamlining the programs' paperwork and analysis requirements to a level considered reasonable by the banks would be highly desirable.

The last problem mentioned by two banks is that the programs' fees are too high. While we note such comments run counter to the problem JLGC has in setting its fee structure high enough to recover its operating costs, we are discussing them anyway because they were mentioned by the banks.

One bank thought that its loans guaranteed by JLGC had much higher than the normal collateral requirements and therefore represented very little risk that the loan would not be repaid. It thought these over-collateralized loans should qualify for a lower guarantee fee. Our only comment is that it appears that such loans would be made without JLGC's guarantees and that JLGC's guarantees were not needed in these cases.

The second bank said it would like to see JLGC's fees reduced and would like to be charged based on the amount of guarantees used as opposed to its allocated ceiling. We noted that this bank charges JLGC's fees for guarantees in addition to the bank's normal lending rate. Therefore, we consider that the bank's comment shows its keen interest in minimizing its overhead costs, i.e., in this case the part of JLGC's fees not charged to the loans guaranteed.

We have already commented previously on the situation JLGC faces regarding its fees and the desirability of its programs being structured so that they are desirable to the banks as a business proposition. The above examples simply provide further information to be considered as JLGC prices its product.

Management Comments and Our Evaluation

USAID/Jordan agreed with the contents of the audit report. The Mission's comments and our evaluation are presented in the following paragraphs. The Mission's complete response is included in Appendix II.

In response to Recommendation No. 1, the Mission pointed out that while the project agreement was due to expire on August 3 1, 1998, they believed that there might be justification to extend the agreement for one more year. Accordingly, the Mission agreed to clarify to the management of JLGC the substance of the recommendation and to incorporate suggested amendments into the agreement should it be extended. With regard to Recommendation No. 2, the Mission intends to bring out a consultant to assist JLGC in assessing client risk and determining the appropriate fees for bearing such risk.

We agree with the management decision made by the Mission with regard to both these recommendations and thereby resolve Recommendation Nos. 1 and 2. The documentation needed to close these recommendations is contingent upon the Mission's decision to extend JLGC's agreement for one more year. Should the Mission decide to let the agreement expire on August 3 1, 1998, closure should be requested from M/MPI/MIC based on the fact that the recommendations are no longer relevant. Should the Mission decide to extend JLGC's agreement for one year, the Missions's request for closure to M/MPI/MIC should include a copy of the agreement amendment showing that the areas discussed in the audit report have been clarified for Recommendation No. 1 and a copy of the consultant's contract with the Mission for Recommendation No. 2.

As for recommendation No. 3, the Mission informed the Central Bank of Jordan of the requirement that they not take any of the dividends that have accrued from the investment in JLGC through project funds and requested that accrued dividends of $420,800 be credited to the reserves account of JLGC's owners' equity. The Mission concurred that this amounted to an efficiency savings of $420,800.

We agree with the Mission's management decision and note that it has already taken the final action recommended. Recommendation No. 3 is therefore resolved and closed upon issuance of this report.

SCOPE AND METHODOLOGY

Scope

We conducted our audit in accordance with generally accepted government auditing standards. Our fieldwork was conducted between February 22 and April 2, 1998 and was performed at USAID/Jordan, the Jordan Loan Guarantee Corporation (JLGC), participating banks, and at the sites of selected borrowers whose loans had been guaranteed under JLGC's programs. Audit fieldwork took place in Amman, Jordan except for site visits to certain borrower sites located outside Amman. The audit included reviews of files and documents at the Mission and JLGC as well as interviews of responsible personnel at the Mission, JLGC, and banks. Additionally we interviewed the borrowers selected for site visits.

The audit reviewed the Mission's project files back to the initial planning documents prepared for the project in 1987, but the main focus was on events that have taken place since JLGC was established in 1994.

Our audit generally was limited to a review of activities financed from JLGC's capital. We did not review commodities and technical assistance paid for directly by the Mission. USAID/Jordan has through the Central Bank of Jordan provided about JD 6.0 million to JLGC's capital and reserves. JLGC's total share capital at the end of 1997 was JD 9,875,000. It was subsequently increased to JD 10.0 million in March 1998.

From its inception through December 3 1, 1997, JLGC guaranteed 805 loans with a cumulative guaranteed amount of JD 8.1 million.

Methodology

Audit Objective No. 1

To determine whether JLGC has established control systems that assure USAID funds are used for project purposes and USAID policy restrictions are observed, we interviewed JLGC personnel and reviewed JLGC's operating procedures for its credit guarantee programs and then reviewed JLGC's files for selected guarantees and performed site visits to a sample of the borrowers to determine whether the control systems were in place and operating as intended.

Audit Objective No. 2

To determine whether JLGC's credit guarantee programs have reached the point of being self-financing according to the criteria in USAID's Microenterprise Development Policy Paper, we reviewed JLGC's financial statements for 1997 and analyzed the information making adjustments to eliminate certain items which did not affect JLGC's cash flow. We further adjusted the result to reflect the opportunity cost associated with USAID's donation.

Audit Objective No. 3

To determine the views of participating bank officials regarding the expected level of demand for JLGC's loan guarantee programs and any problems or opportunities, we interviewed managers at 13 of 19 banks participating in JLGC's programs as of the end of 1997.

USAID

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

OFFICE OF THE DIRECTOR

09 JUL 1998

MEMORANDUM

TO: RIG/A/Cairo, Lou Mundy

FROM: USAID Mission Director, Lewis Lucke

SUBJECT: Audit of Jordan Loan Guarantee Corporation's Implementation of USAID/Jordan's Loan Guarantee Activities (Report No. 6-278-98-00-P)

Thank you for your draft audit report dated June 10, 1998 covering the program audit of the Loan Guarantee Activities. We very much appreciate the useful suggestions and insight provided in the draft report. As to our comments on the findings and recommendations presented in the report, they are as follows:

Recommendation No. 1: ***We recommend that USAID/Jordan discuss with the Jordan Loan Guarantee Corporation (JLGC) the areas identified by the audit where JLGC appears to have gone beyond the terms of the written agreemertt, and decide to what extent, if any, the agreemertt should he modified.***

Comment: The economic benefits **provided** by providing access to credit to enterprises which otherwise might not have had such access are potentially very effective in a country such **as** Jordan. The principal problem for JLGC to date has been that the banks providing credit to private enterprises have not been forced to assess client risk in an effective manner since they have been relying on collateral in the form of liens on real properties as opposed to credit analysis of borrowers. When a bank places a lien on a property worth 150% of the value of the loan provided to the enterprise, it is not motivated to do any further analysis on the borrower.

As stated in the draft report, much of the banks' utilization of JLGC's guarantees to date has been to placate the Central Bank of Jordan. Despite this. we believe that the banks will soon realize the importance of JLGC's guarantees and start to utilize them to a much greater extent than now. This is due to economic reforms currently being undertaken which will cause the value of real estate to reflect true market conditions in this country. This expected decline in real estate value is going to force banks to rely less on collateral in the form of real estate and more on the analysis of the credit worthiness of their clients based on cash flow, etc.

Given the above, we have provided JLGC a certain degree of latitude in the interpretation of the project agreement in order to permit them co develop a track record before the demand for their

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product increases significantly, as we expect to happen quite soon. Despite this, we do not condone the use of the export credit guarantee facility for the financing of textile exports to the U.S. and we will clarify that to the management of JLGC during our upcoming discussions with them concerning your recommendation number 1.

The project agreement is due to expire on August 3 1,1998. We believe that there might be justification to extend the agreement for one more year. If the agreement is extended, we would incorporate the amendments to the agreement that you have suggested in recommendation number 1.

Recommendation No. 2: We *recommend that USAID/Jordan assist the Jordan Loan Guarantee Corporation in evaluating the fee **structure for** its guarantee programs.*

Comment: We very much appreciate this recommendation. This is really a problem at JLGC, and for the financial sector as a whole in Jordan. The fee structure should be based on the level of risk associated with the banks providing the loans. Risk analysis is something the Jordanian banks are very weak on. In order to address this problem, we intend to bring out a consultant to JLGC who will assist them in assessing client risk and determining the appropriate fee for bearing such risk. As you rightly point out in the report, the banks are complaining about the level of the fees right now, but when they realize the importance of a JLGC guarantee in lieu of real estate collateral, they will be more willing to pay for the risk cover they get from JLGC. This activity that we propose to do with JLGC will probably be the main reason for the extension of the agreement beyond its current end date.

Recommendation No. 3: *We recommend that USAID/Jordan inform the Central Bank of Jordan of the agreement requirement that the earnings associated with USAID's investment in the project be **used for** the costs ofproject implementation with any surplus being added to capital, and that USAID/Jordan assure that such earnings remain in the business.*

Comment: We have informed the Central Bank of Jordan of the requirement that they not take any of the dividends that have accrued to them from their investment in JLGC through project funds. We also requested that the accrued dividends of JD 296,340 be credited to the reserves account of JLGC's owners' equity in order to allow for the coverage of any possible future losses from their guarantee activities. We also requested that the Central Bank not withdraw any dividends in the future, and to keep adding such amounts to the company's reserves.

We concur that there has been an efficiency savings of $420,800.