OFFICE OF INSPECTOR GENERAL

AUDIT OF USAID REGIONAL DEVELOPMENT MISSION/ASIA'S DEVELOPMENT CREDIT AUTHORITY

AUDIT REPORT NO. 5-440-06-004-P
MAY 11, 2006

MANILA, PHILIPPINES

Office of Inspector General

May 11, 2006

MEMORANDUM

TO: Regional Development Mission/Asia Director, Timothy T. Beans

FROM: RIG/Manila, Catherine M. Trujillo /s/

SUBJECT: Audit of USAID Regional Development Mission/Asia's Development Credit Authority (Report No. 5-440-06-004-P)

This memorandum transmits our final report on the subject audit. In finalizing the report, we considered your comments to the draft report and included the comments in Appendix II.

This report contains six recommendations to improve USAID Regional Development Mission/Asia's oversight of its Development Credit Authority loan portfolio guarantees. Based on your comments, management decisions have been reached on all six recommendations. The Regional Development Mission/Asia should coordinate final actions on these recommendations with the Audit, Performance and Compliance Division of USAID's Office of the Chief Financial Officer.

I want to thank you and your staff for the cooperation and courtesy extended to us during the audit.

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SUMMARY OF RESULTS

The Development Credit Authority (DCA) is a broad financing authority that allows USAID to use credit to pursue any of the development purposes specified under the Foreign Assistance Act of 1961, as amended. The DCA is designed to overcome lending obstacles encountered in the commercial banking sector, which is often unwilling to lend funds to a particular sector or borrower(s). USAID's DCA credit guarantees encourage commercial banks to finance targeted development projects that otherwise would most likely not be funded. They also encourage local private-sector lending and stimulate the development of local capital markets. Guarantees typically cover up to 50 percent of a loan. (See page 2.)

This audit was one in a series of worldwide audits of USAID's Development Credit Authority. The objective of this audit was to determine whether USAID's Regional Development Mission/Asia (RDM/Asia) managed its DCA guarantees to ensure that selected intended results were achieved. (See page 3.)

RDM/Asia managed its DCA guarantees to ensure that selected intended results were achieved; however, not all selected intended results were achieved. RDM/Asia's three DCA loan portfolio guarantees supported the Mission's "Transition to an Open, Market-Based Economy Accelerated" strategic objective. The Mission was not able to utilize its student loan portfolio guarantee, and as a consequence, the loan guarantee only met one selected intended result of supporting its strategic objective. Despite the obstacles of Vietnam's emerging private sector, RDM/Asia's two Small and Medium Enterprises (SME) loan portfolio guarantees funded activities that reflected the intended purposes of the loans, kept utilization fees current, and funded activities that expected positive financial rates of return. (See page 4.) However, RDM/Asia did not fully monitor its DCA loan portfolio guarantees. (See page 5.) This occurred because the Mission did not establish certain procedures to more proactively detect and promptly resolve compliance or performance issues. As a result, (1) after two years, no loans had been issued under the student loan portfolio guarantee and the two SME loan portfolio guarantees fell short of their performance goals, (2) two of 12 loans did not qualify for loan guarantee coverage, and (3) partnering banks did not understand certain aspects of the loan portfolio guarantees they were implementing. (See pages 6, 7, 9 and 10.)

This report makes six recommendations to improve RDM/Asia's oversight of its DCA loan portfolio guarantees. (See pages 7, 9, and 10.) Based on RDM/Asia's comments, management decisions have been reached on all six recommendations. (See page 11.) RDM/Asia's comments are included as Appendix II to this report. (See page 14.)

BACKGROUND

The Development Credit Authority (DCA) is a broad financing authority that allows USAID to use credit to pursue any of the development purposes specified under the Foreign Assistance Act of 1961, as amended. The DCA is designed to overcome lending obstacles encountered in the commercial banking sector, which is often unwilling to lend funds to a particular sector or borrower(s). USAID's DCA credit guarantees encourage commercial banks to finance targeted development projects that otherwise would most likely not be funded. They also encourage local private-sector lending and stimulate the development of local capital markets. One way credit guarantees encourage lending is by guaranteeing up to 50 percent of a loan.

Congress gave USAID the general authority to provide loan and bond guarantees in the Appropriations Act for Fiscal Year 1998. In April 1999, the Office of Management and Budget certified USAID's capacity to properly manage credit programs—to accurately assess risk and to operate viable financial management and accounting systems. Subsequently, USAID began to exercise its DCA authority.

DCA credit guarantees are typically designed by USAID's overseas missions and managed jointly by the missions and USAID's Office of Development Credit (ODC). Missions are solely responsible for development monitoring, while the ODC and missions are both responsible for financial monitoring. Four types of DCA guarantees are available, including loan portfolio guarantees.[1] As of September 30, 2005, USAID had signed 153 DCA guarantees, making credit totaling nearly $1.1 billion available, with cumulative utilization amounting to nearly $317 million.[2]

USAID's Regional Development Mission/Asia (RDM/Asia), which opened in Bangkok, Thailand in June 2003, manages regional and country-specific programs in mainland Southeast Asia (Burma, China, Laos, and Vietnam). Of these countries, RDM/Asia established DCA loan portfolio guarantees only in Vietnam. As shown in Table 1 on the next page, RDM/Asia established three loan portfolio guarantees with two banks in Vietnam in September 2003.

[1] A loan portfolio guarantee covers a pool of new loans from one financial institution to multiple borrowers in an area or sector specified by USAID. USAID shares the risk of default on the portfolio of loans to those borrowers.

[2] These numbers are unaudited. Cumulative utilization is the total dollar amount of loans placed under guarantee coverage.

TABLE 1: RDM/ASIA'S DCA LOAN PORTFOLIO GUARANTEES IN VIETNAM[3]

Partnering Bank	DCA Loan Portfolio Guarantee	Maximum Credit Available	USAID Guarantee Ceiling
Asia Commercial Bank	Small and Medium Enterprises	$5,000,000	$2,500,000
	Student Loan	500,000	250,000
Eastern Asia Commercial Bank	Small and Medium Enterprises	5,000,000	2,500,000
	Totals	**$10,500,000**	**$5,250,000**

The two Small and Medium Enterprises loan portfolio guarantees end in 2008, and the one student loan portfolio guarantee ends in 2011. As of September 30, 2005, these loan guarantees had generated 54 loans totaling over $3.4 million, and neither partnering bank had made claims for delinquent loans against the $1.7 million that had been guaranteed by USAID.

AUDIT OBJECTIVE

This audit was one in a series of worldwide audits of USAID's Development Credit Authority, conducted as part of the Office of Inspector General's fiscal years 2005 and 2006 annual audit plans. The audit was conducted to answer the following question:

- Did USAID's Regional Development Mission/Asia manage its Development Credit Authority guarantees to ensure that selected intended results were achieved?

Appendix I contains a discussion of the audit's scope and methodology.

[3] The figures in the table are unaudited.

AUDIT FINDING

Did USAID's Regional Development Mission/Asia manage its Development Credit Authority guarantees to ensure that selected intended results were achieved?

USAID's Regional Development Mission/Asia (RDM/Asia) managed its Development Credit Authority (DCA) guarantees to ensure that selected intended results were achieved; however, not all selected intended results were achieved.

RDM/Asia's three DCA loan portfolio guarantees supported the Mission's "Transition to an Open, Market-Based Economy Accelerated" strategic objective by addressing key obstacles facing Vietnam's emerging private sector. More specifically, the DCA loan portfolio guarantees were established to increase loans to financially viable small and medium enterprises and to encourage promising business leaders to obtain higher education in economics and business management.

As discussed on page 6 of this report, the Mission was not able to utilize its student loan portfolio guarantee, and as a consequence, the loan guarantee only met one selected intended result—that of supporting the Mission's strategic objective. Despite the obstacles of Vietnam's emerging private sector, RDM/Asia's two Small and Medium Enterprises (SME) loan portfolio guarantees funded activities that reflected the intended purposes of the loans. For example:

- A company that manufactures tarpaulin used its loan to build a newer, larger manufacturing plant. This increased capacity allowed the company to begin exporting its product, which is used for various purposes such as temporary shelters, canopies, and greenhouse covers.

- A second company used its loan to purchase additional equipment and raw materials for manufacturing high-density polyethylene pipes used in drainage and irrigation systems. A company spokesman explained that the partnering bank had rejected the company's previous loan application because of insufficient collateral, but the rejected loan application was subsequently approved under the DCA loan portfolio guarantee.

Moreover, SME utilization fees were current as of September 30, 2005, and activities funded by the SME loan guarantees expected positive financial rates of return.[4]

[4] Partnering banks pay semiannual utilization fees to USAID based on the average outstanding principal under guarantee during the semiannual period.

OIG photograph of a tarpaulin factory in Binh Duong Province, Vietnam. RDM/Asia's SME loan guarantee helped the borrower build the factory and expand his business. (October 2005)

However, as described in the next section, better monitoring by RDM/Asia could help its loan portfolio guarantees achieve all their intended results.

Better Monitoring Could Improve Loan Portfolio Guarantee Performance

Summary: According to USAID's DCA *Operations Manual*, RDM/Asia is solely responsible for development monitoring, while USAID's Office of Development Credit (ODC) and RDM/Asia are both responsible for financial monitoring. However, RDM/Asia did not fully monitor its loan portfolio guarantees at partnering banks. This occurred because the Mission did not establish certain procedures to more proactively detect and promptly resolve compliance or performance issues. As a result, (1) after two years, no loans had been issued under one loan guarantee and two others fell short of their performance goals, (2) two of 12 loans did not qualify for loan guarantee coverage, and (3) partnering banks did not understand certain aspects of their loan guarantees.

According to USAID's DCA *Operations Manual,* RDM/Asia is solely responsible for development monitoring, while the ODC and RDM/Asia are both responsible for financial monitoring. To carry out its monitoring responsibilities, RDM/Asia included a monitoring plan in its DCA Action Package that was approved by USAID's Chief Financial Officer on June 5, 2003. The monitoring plan stated that RDM/Asia would meet with bank management, clarify how issues are to be resolved, monitor the status of the project, and determine if there are compliance or performance issues. The plan also required RDM/Asia to make semiannual visits to the partnering banks during the first year of a loan guarantee and annual visits thereafter.

RDM/Asia did perform some activities outlined in its monitoring plan. During fiscal year 2005, the Mission conducted annual visits to its partnering banks, acted as liaison between the banks and the ODC, and maintained contact with the banks by e-mail and telephone. In addition to the required visits, RDM/Asia together with the ODC conducted four other site visits from February 2004 to August 2005.

However, program performance was hampered because the RDM/Asia did not proactively monitor certain aspects of its loan portfolio guarantees to identify and promptly resolve compliance and performance issues. For example, RDM/Asia did not have procedures to (1) promptly resolve problems identified during site visits that were affecting loan guarantee performance, (2) set utilization targets or regularly use utilization targets as a tool for monitoring, (3) test whether loans issued by partnering banks met eligibility requirements, and (4) provide sufficient technical assistance to the partnering banks. Additionally, the Mission did not have a full-time and dedicated economic growth officer in place until March 2005, and as one ODC official put it: “this program has likely suffered” as a result.

Consequently, certain intended results were not achieved and partnering banks did not fully understand the loan guarantees they were charged with implementing. To better ensure that its DCA loan guarantees achieve all their intended results, RDM/Asia should address the following issues.

Student Loan Portfolio Guarantee Not Utilized – After two years the partnering bank had not issued any loans under this loan guarantee. Because almost no credit was available for educational financing in Vietnam, RDM/Asia, on September 12, 2003, established this eight-year loan guarantee to provide up to $500,000 in loans to students seeking higher education in economics and business management. The partnering bank did not issue student loans because RDM/Asia did not proactively monitor the partnering bank.

For example, RDM/Asia, in conjunction with the ODC, did not establish utilization targets for this loan guarantee. As a result, the partnering bank did not have a goal that it could strive to achieve and RDM/Asia did not have a baseline against which it could measure the bank’s progress in promoting this loan guarantee. The DCA *Operations Manual* requires missions to provide feedback to determine whether the use of DCA guarantees has out-performed or under-performed planned utilization.

Additionally, although RDM/Asia made site visits to the partnering bank, it did not take timely action to resolve problems identified during those visits. For example, Mission and/or ODC staff visited the bank in February, July and October of 2004. All three trip reports reported that no loans were being issued and all cited the bank’s collateral policies as a problem.

For instance, the July trip report noted that, despite USAID agreeing to guarantee 50 percent of each loan, the bank was requiring potential student borrowers to provide collateral at a level similar to that required under the bank’s regular loan programs, which were not supported by loan guarantees. The trip report concluded that there was a need to better inform the bank of student loan program concepts and review the bank’s risk assessment policy. In his October trip report, an ODC official cited the collateral problem and noted that measures needed to be taken to cancel the loan guarantee, move it to another bank, or make it successful.

However, there was no evidence that RDM/Asia took remedial action to resolve the collateral problem after any of these site visits. This occurred, in part, because the Mission did not have a system to document, track and promptly resolve problems identified in site visits that were affecting loan guarantee performance.

In April 2005, RDM/Asia began to address the lack of loans by establishing a task force to better coordinate efforts between the partnering bank and the schools. In September 2005, as part of the task force's marketing strategy, RDM/Asia awarded a grant to the Hanoi School of Business with the purpose to make student loans accessible to needy students and to increase awareness, understanding, and benefits of educational funding. The key outcome indicators were to generate at least 30 loan applications and award 10-15 loans within one year. However, the task force was not charged with addressing cumulative utilization targets or promptly resolving problems identified in trip reports.

Because six years remain on the partnering bank's loan guarantee agreement, there is time for the Mission to invigorate the student loan guarantee; therefore, we are making the following recommendations to contribute to the success of the student loan portfolio guarantee.

> *Recommendation No. 1: We recommend that USAID's Regional Development Mission/Asia, in conjunction with the Office of Development Credit, establish cumulative utilization targets in dollars for its student loan portfolio guarantee, and that the Regional Development Mission/Asia develop and implement procedures to regularly report on whether the guarantee out-performed or under-performed planned utilization.*

> *Recommendation No. 2: We recommend that USAID's Regional Development Mission/Asia develop and implement procedures to document, track and promptly resolve significant problems affecting loan guarantee performance identified in site visits.*

SME Loan Portfolio Guarantees Did Not Meet Utilization Targets – RDM/Asia's two SME loan guarantees did not meet their most recent cumulative utilization targets. Cumulative utilization is the total dollar amount of loans placed under guarantee coverage at a point in time. The monitoring and evaluation of cumulative utilization is one method that USAID uses to determine whether DCA loan portfolio guarantees achieve their intended results.

Based on financial data provided by RDM/Asia's partnering banks, the ODC established semiannual cumulative utilization targets for the two loan guarantees. As shown in Table 2, the loan guarantees fell significantly short of their cumulative targets for the period ending September 30, 2005.

TABLE 2: CUMULATIVE UTILIZATION PERFORMANCE[5]
(As of September 30, 2005)

Partnering Bank	Loan Portfolio Guarantee	Cumulative Utilization		Actual As a Percentage of Target
		Target	Actual	
Asia Commercial Bank	Small and Medium Enterprises	$2,700,000	$1,700,000	63%
Eastern Asia Commercial Bank	Small and Medium Enterprises	$3,800,000	$1,700,000	45%

[5] The figures in the table are unaudited.

For the period ending March 31, 2005, both loan guarantees exceeded their cumulative utilization targets. Based on this performance, ODC officials set cumulative utilization targets for the period ending September 30, 2005, at twice the actual cumulative utilization that the two loan guarantees had achieved from their inception in September 2003 through March 2005. Given the loan guarantees past performance and the private-sector environment in Vietnam, the September 2005 targets might have been too ambitious.

Nevertheless, RDM/Asia could have more proactively monitored cumulative utilization. Specifically, RDM/Asia did not regularly use established targets to monitor and evaluate the performance of its partnering banks. For example, RDM/Asia did not compare monthly cumulative utilization reports from partnering banks to the semiannual targets to gauge progress. Trip reports from site visits also did not address actual versus targeted performance.

As noted earlier, the DCA *Operations Manual* requires missions to provide feedback on whether DCA guarantees are exceeding or falling short of planned utilization. Regular monitoring of targets is important because it enables a mission to take timely remedial action if a loan guarantee is not meeting its semiannual targets. In this case, staff from both banks stated that it was increasingly difficult to issue new loans because borrowers had to repay the loans within the time remaining on the banks' loan guarantee agreements—a period of time that decreases daily. This issue might have surfaced sooner had RDM/Asia regularly monitored cumulative utilization.

Further, regular monitoring of actual performance against targets can be used to identify opportunities to put DCA subsidies to better use.[6] According to the DCA *Operations Manual*, a mission can deobligate its subsidy funds if it determines that all or a portion of the funds will not be used. The deobligated funds can then be used for other DCA guarantees, either in the same country or in other countries.

For its two SME loan guarantees, RDM/Asia had $535,000 in subsidy funds, some of which the Mission may be in a position to put to better use because of both partnering banks cumulative utilization performance. As shown in Table 2 (See page 7.), each partnering bank had actual cumulative utilization of $1,700,000 at September 30, 2005. This represents 34 percent of each bank's maximum available credit (See Table 1 page 3.) As mentioned above, partnering banks were having increasing difficulty issuing new loans. Consequently, there might have been an opportunity to reduce the amount of subsidy funds set aside to cover claims because the partnering banks might not utilize all their available credit, thus reducing the amount that USAID will need to guarantee and the amount of subsidy funds needed.

RDM/Asia was considering extending the life of its two SME loan guarantees to improve cumulative utilization performance. Nonetheless, RDM/Asia can better monitor the performance of its partnering banks by regularly comparing actual performance against utilization targets. There might also be an opportunity for RDM/Asia to put subsidy funds to better use.

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[6] DCA subsidies are funds that have been obligated (set aside) to cover bank claims against DCA loan guarantees because borrowers could not repay their loans.

Recommendation No. 3: We recommend that USAID's Regional Development Mission/Asia develop and implement procedures to regularly use established cumulative utilization targets to monitor and evaluate the performance of its loan portfolio guarantees.

Recommendation No. 4: We recommend that USAID's Regional Development Mission/Asia examine its Small and Medium Enterprises loan portfolio guarantees to determine if subsidy funds can be deobligated and put to better use.

Nonqualifying Loans Under SME Loan Portfolio Guarantees – Two of twelve loans sampled should not have been included in SME loan guarantees because they did not meet eligibility requirements. To ensure that loans were used to achieve intended results, each agreement between RDM/Asia and its two partnering banks contained standard loan eligibility terms. One term restricted the maximum cumulative principal amount that could be loaned to a borrower to the local currency equivalent of $500,000.

However, as shown in Table 3 partnering banks exceeded the $500,000 loan limit for two loans.

TABLE 3: NON-QUALIFYING LOANS[7]

Borrower	Partnering Bank	Cumulative Amount Loaned	Maximum Cumulative Principal Amount Allowed	Excess Amount Loaned
A	Asia Commercial Bank	$535,703	$500,000	$35,703
B	Eastern Asia Commercial Bank	$2,016,638	$500,000	$1,516,638

In part, this occurred because RDM/Asia's monitoring plan lacked a specific review component to test the eligibility of loans issued by partnering banks. Had Mission staff tested loan eligibility during site visits, they would have detected that the two borrowers had received more monies than was permitted. Generally, Mission staff relied on partnering banks' "Certification of Qualifying Loan" reports for proof of eligibility. From the partnering banks perspective, Eastern Asia Commercial Bank employees did not fully understand the eligibility term, and Asia Commercial Bank employees described their error as an oversight and failed to correct it. Subsequent to our audit fieldwork, the ODC removed these two loans from guarantee coverage. Nonetheless, there is still the need for a review process to ensure the partnering banks are meeting loan eligibility requirements.

Recommendation No. 5: We recommend that USAID's Regional Development Mission/Asia develop and implement procedures to periodically review eligibility of loans under its loan portfolio guarantees.

[7] The figures in the table are unaudited.

Partnering Banks Need More Technical Assistance – Both partnering banks did not understand certain aspects of their loan portfolio guarantees. This unfamiliarity contributed to the compliance and performance issues discussed in previous sections of this report. As mentioned earlier, Eastern Asia Commercial Bank did not fully understand the terms in its SME loan guarantee agreement and, as a result, issued a nonqualifying loan. Similarly, the Asia Commercial Bank was not able to utilize its student loan guarantee, in part, because it did not understand the concepts behind a loan guarantee. Further, in April 2005 the Asia Commercial Bank replaced the bank officer in charge of its SME loan guarantee with another officer who did not have experience with or knowledge about DCA loan guarantees.

The ODC did provide training to RDM/Asia's partnering banks in February 2004 on how to submit their loan schedules through the ODC's Credit Management System website. However, the partnering banks have had no formal training since then.

RDM/Asia has recognized that partnering banks needed more technical assistance. For example, a February 2004 trip report noted that the partnering banks needed technical assistance and training. A July 2004 trip report noted that there was a need to better inform the Asia Commercial Bank of the concepts of a loan guarantee. Finally, in its fiscal year 2005 annual report, RDM/Asia reported that it would provide training to its partnering banks. However, the planned training did not materialize in FY 2005 because of scheduling conflicts between the partnering banks.

During our audit, RDM/Asia indicated that it would provide technical assistance, in collaboration with the ODC, in fiscal year 2006 through selected training courses. It is important that RDM/Asia provides the needed technical assistance.

> *Recommendation No. 6: We recommend that USAID's Regional Development Mission/Asia establish a plan of action that identifies the areas where its partnering banks need technical assistance and includes milestones to provide the needed technical assistance.*

EVALUATION OF MANAGEMENT COMMENTS

USAID Regional Development Mission/Asia's written comments on the draft report are included in their entirety as Appendix II to this report.

The Regional Development Mission/Asia agreed with Recommendation Nos. 1, 2, 3, 4, 5 and 6, and it detailed the actions it has taken or plans to take to implement the recommendations, including target completion dates where applicable. Based on our review of the detailed actions, we consider that management decisions have been reached on all six recommendations. The Mission should coordinate final actions on these recommendations with the Audit, Performance and Compliance Division of USAID's Office of the Chief Financial Officer.

SCOPE AND METHODOLOGY

Scope

The Regional Inspector General/Manila conducted this audit in accordance with generally accepted government auditing standards. The purpose of the audit was to determine whether USAID's Regional Development Mission/Asia (RDM/Asia) managed its Development Credit Authority (DCA) guarantees to ensure that selected intended results were achieved. Audit fieldwork was conducted at RDM/Asia's country representative office in Vietnam and at various bank office locations and borrowers' sites within Vietnam from October 4 through October 21, 2005.

In planning and performing the audit, we assessed the effectiveness of internal controls related to DCA guarantees. We identified pertinent internal controls such as (1) RDM/Asia's procedures for managing and monitoring its DCA guarantees, (2) partnering banks' procedures regarding DCA loan approvals and payments, and (3) RDM/Asia's annual self-assessment of internal controls in accordance with the Federal Managers' Financial Integrity Act. Relevant criteria included USAID's Automated Directives System 249 and USAID's Office of Development Credit's *DCA Operations Manual*. There were no prior audit findings affecting the areas reviewed in this audit.

Our audit scope encompassed RDM/Asia's three DCA loan portfolio guarantees as of September 30, 2005. These three loan portfolio guarantees made credit of $10.5 million available, while guaranteeing a maximum of $5.25 million. As of September 30, 2005, these three guarantees had generated 54 loans totaling over $3.4 million.

The intended results related to RDM/Asia's DCA loan portfolio guarantees selected for review included determining whether:

- Guarantees supported the strategic objective(s) specified in the documentation submitted by RDM/Asia and approved by USAID's Credit Review Board.

- Loans were qualified loans and satisfied the terms and conditions specified in the guarantee agreement between USAID and the partnering bank.

- Activities funded by the loan portfolio guarantees reflected the intended loan purposes stipulated in the partnering banks' loan files.

- RDM/Asia achieved its utilization projections for the dollar amount of loans generated by its loan portfolio guarantees as of September 30, 2005.

- Loan portfolio guarantee utilization fees were current.

- Activities funded by the loan portfolio guarantees expected positive financial rates of return.

Our audit scope did not include DCA guarantee macro-level results, such as impact on unemployment, job creation, or other economic growth indicators.

Methodology

To answer the audit objective, we performed detailed reviews of all three loan portfolio guarantees from the two partnering banks of USAID's Regional Development Mission/Asia. We judgmentally selected 12 of 54 loans for detailed loan file reviews and made borrower site visits for 6 of 12 loans reviewed. The 12 loans represented 80 percent of the total dollar amount utilized under RDM/Asia's loan portfolio guarantees as of September 30, 2005.

We interviewed RDM/Asia staff and management and loan officers of the two partnering banks—including officers at bank headquarters as well as those in selected branch offices. For the loans selected for audit, we performed detailed loan file reviews at the banks' offices and reviewed supporting documentation maintained by RDM/Asia for all three loan portfolio guarantee agreements. We also interviewed selected borrowers and conducted site visits to observe the projects and activities funded by the selected loans. Additionally, we communicated with USAID officials in Washington D.C.

We did not determine materiality thresholds for the audit objective.

MANAGEMENT COMMENTS

USAID | ASIA
FROM THE AMERICAN PEOPLE

MEMORANDUM

TO:	Catherine M. Trujillo	**DATE:**	May 8, 2006
FROM:	Peter Hubbard, Acting Mission Director /s/ Regional Development Mission/Asia (RDM/A)		
SUBJECT:	Audit of USAID Regional Development Mission/Asia's Development Credit Authority (Report N. 5-440-06-00X-P)		

Dear Ms. Trujillo,

Thank you for sharing with us the draft report of RDM/A's DCA audit. The draft report is informative and generally well-documented. We find the recommendations useful and take them as helpful for achieving more effective results in the future. We request resolution of all recommendations on issuance of the report. Below are our specific responses to each of the recommendations in the draft report which you noted the RDM/A should address.

Student Loan Portfolio Guarantee Not Utilized:

Recommendation No. 1: We recommend that USAID's Regional Development Mission/Asia, in conjunction with the Office of Development Credit, establish cumulative utilization targets in dollars for its student loan portfolio guarantee, and that the Regional Development Mission/Asia develop and implement procedures to regularly report on whether the guarantee out-performed or under-performed planned utilization.

The Mission concurs with the audit recommendation, and notes that the Vietnam Office has taken to resolve issues and problems with the credit programs. The Action Memo on SME loan and Student Loan Guarantee dated July 24, 2003 and June 5, 2003, was not clear as to who (EGAT/DC or RDM/A Vietnam Program office) had primary responsibility of setting up the utilization targets. In December 2004 the RDM/A Vietnam Program office took the lead in urging EGAT/DC to come to Vietnam to address the lack of targets and performance issues. EGAT/DC visited Vietnam in August 2005.

Following the EGAT/DC visit and in-depth discussions with all parties, the entire student loan strategy and business plan were reviewed in further discussions with the partner bank and participating schools. It was agreed that the bank's loan terms and risk-sharing arrangements with participating schools needed to be significantly revised for all parties, including students, to have adequate incentives to utilize the proposed loan facility.

Also after the EGAT/DC visit RDM/A established utilization targets for the student loan portfolio guarantee. The Student Loan Promotion grant to Hanoi School of Business (HSB) [the grant was approved last August and commenced in last October], set forth the targets as key outcome indicators of the program. Specifically:

> "Upon completion of the project in 12 months (by October 2006):
> - Minimum 30 loan applications completed for lending by Asia Commercial Bank (ACB);
> - 10-15 loans made to students from at least 3 different training institutions."

These "indicators may be subject to revision after 6 months of program operation upon discussion with, and formal approval, of USAID/Vietnam". In this context, the task force for student loans was set up as mechanism for better coordinating efforts between the bank and the schools. The draft audit report states that this task force was charged with addressing utilization targets or promptly resolving problems as noted in the draft report that was not the intent. RDM/A Vietnam Program office will monitor and report on utilization semi-annually.

In the recent visit by EGAT/DC staff in January 2006, the technical staff of RDM/A Vietnam program office, EGAT/DC, the bank, and four participating schools all jointly defined a new pilot program to determine the viability of this student loan facility in Vietnam's culture where the predominant method of payment is family cash/savings, and there is a historical aversion to commercial borrowing. A new and more attractive loan product has recently been designed and approved by the Board of the bank; a new business and risk sharing arrangement is currently being negotiated between each participating institution and the bank; and new and more feasible goals/indicators have been set to test the new program. Accordingly, the original HSB targets and implementation schedule have been revised to take these new initiatives into account.

There is no question that a need exists for effective student loan access in Vietnam. While the DCA program evokes a lot of interest on the part of the bank and schools to fulfill this perceived need, the challenge remains to design a facility in a commercially sustainable way supporting more effective borrowing and lending for higher education. By establishing this new pilot guarantee facility, RDM/A is helping bridge the credit gap – and in parallel – trying to trigger a change of mindset and habit that makes student loans attractive, given Vietnam's institutional and cultural environment.

We do agree that this pioneering activity has taken much longer time than expected. The banks and schools have been on a learning curve in what was, and continues to be a pioneering type activity.

While RDM/A and EGAT/DC have worked hard to solve the problem, part of the initial shortcoming was with the partnering bank, which assigned ineffective staff to carry out the program. Both RDM/A and EGAT/DC recognized this weakness, took the initiative to discuss it with the bank and proactively attempted to solve the problem as promptly as practical. EGAT/DC promised to send either a US banker or a technical staff from USAID/Panama's DCA student loan program to work in the bank to provide hands-on technical assistance and experience to ACB's staff. To date, EGAT/DC is planning to send a very capable banking expert to work with ACB on the student loan program in April 2006. We have asked the bank's management to adhere to the bank's commitment to the set new targets for the redesigned pilot program.

Based on the actions described above we request that recommendation 1 be resolved on issuance of the audit report. The Mission will establish dollar value targets in the near future, and procedures to regularly report on performance, and will request closure of this recommendation at that time.

Recommendation No. 2: We recommend that USAID's Regional Development Mission/Asia develop and implement procedures to document, track and promptly resolve significant problems affecting loan guarantee performance identified in site visits.

As stated above although there were problems early in the program, RDM/A Vietnam Program and Economic Growth Offices have been working actively to resolve problems affecting the loan guarantee programs. The staff now has a good awareness of the situation and has been proactive in dealing with it. Based on the information presented above the Mission believes it now has in place procedures to work towards resolution of problems affecting loan guarantee programs. RDMA/Vietnam will continue to monitor the program. Depending on performance of this plan and targets, we will make a determination whether to continue, modify or close the program. Modification might include de-obligating the unutilized subsidy funds or moving the facility to another bank which has proven to be an excellent partner in another project. In response to the audit recommendation RDMA/Vietnam will clearly articulate in writing procedures to document, track and promptly resolve significant problems affecting loan guarantee performance. Based on this agreement we request resolution of this recommendation.

SME Loan Portfolio Guarantees Did Not Meet Utilization Targets:

Recommendation No. 3: We recommend that USAID's Regional Development Mission/Asia develop and implement procedures to regularly use established cumulative utilization targets to monitor and evaluate the performance of its loan portfolio guarantees.

We concur with this recommendation. However the Mission plans to make this a participatory process. EGAT/DC set utilization targets based on its monitoring plan or in reliance on the banks' utilization projections. This has resulted in unrealistic targets which banks failed to meet. The banks were overly optimistic about their capacity to disburse the facilities and set too ambitious targets. One partnering bank (East Asia Commercial Bank - EAB) blamed the underutilization on management's moving priority from the DCA program to other donor's credit program. In the context of loan portfolio guarantee with two private financial institutions, the banks have found it difficult to link the operational and financial activities of borrowers to particular target indicators. It would likely be possible and beneficial to assume some potential target areas of business (the bank's client/sector focus) and try to link relevant bank lending activities with our DCA indicators.

To respond to this recommendation, RDM/A, EGAT/DC and the partner banks will coordinate more closely in their activities for setting up realistic utilization targets based on the banks' performance and operation, and managing utilization targets as a performance measure. We then will communicate with the banks' management on the progress, document their responses and take appropriate action for any shortfall. These reports and communications together with semi-annual site visits will better track utilization.

RDM/A Vietnam Program office and EGAT/DC, in consultation with the banks, will continue to establish utilization targets on a semiannual basis. This process will incorporate realistic expectations for use of the guarantees based on more in-depth discussions with the partner banks.

The Mission request resolution of recommendation 3. RDMA/Vietnam will clearly articulate in writing procedures to regularly use established cumulative utilization targets to monitor and evaluate the performance of its loan portfolio guarantees, and request closure of the recommendation upon submission of that document.

Recommendation No. 4: We recommend that USAID's Regional Development Mission/Asia examine its Small and Medium Enterprises loan portfolio guarantees to determine if subsidy funds can be deobligated and put to better use.

The Mission concurs with this recommendation. The Mission has examined its Small and Medium Enterprise loan portfolio and believes it is premature to consider deobligation of the subsidy funds. While resolution of the difficulties experienced to date with the program has taken time, the guarantees should not be limited to free up the subsidy funds as long as there is still potential that they will be fully used. From discussions with the banks, we believe that this potential still exists. Within six months, based on performance the Mission will revisit the issue, and write a memorandum detailing the analysis and decision process. The Mission requests that recommendation 4 be resolved upon issuance, and closed with the completion of the follow-up analysis and memo.

Non-qualifying Loans Under SME Loan Portfolio Guarantees

Recommendation No.5: We recommend that USAID's Regional Development Mission/Asia develop and implement procedures to periodically review eligibility of loans under its loan portfolio.

The Mission concurs with this recommendation. The Mission notes that the guarantee agreement establishes specific parameters for qualifying loans after which the banks are the entity with the primary responsibility to adhere to these parameters, and conduct due diligence to place eligible loans under coverage without USAID notice of approval. Measures are in place by EGAT/DC during the claim review process to ensure that claims will not be reimbursed in case of default, if indeed the loan is ineligible for the guarantee. RDM/A staff is in frequent communications with the banks, which routinely send RDM/A Vietnam Program office a copy of CQL whenever a loan was made. The Mission will use this information it currently receives to perform a semi-annual review of the loans in the guarantee to check for eligibility. In addition, RDM/A annual site visits will include more specific reviews of loan eligibility, in addition to loan eligibility checks by EGAT/DC biennial reviews.

Based on this agreement we request the recommendation be resolved on issuance. Documentation on the procedures to be implemented will be included with recommendation 2 procedures. Closure will be requested when the documentation of the planned procedures is complete.

Partnering Banks Needs More Technical Assistance

Recommendation No. 6: We recommend that USAID's Regional Development Mission/Asia establishes a plan of action that identifies the areas where its partnering banks need technical assistance and includes milestones to provide the needed technical assistance.

The Mission concurs with this recommendation. The action plan for technical assistance for FY2006 is in place. After the recent EGAT/DC visit in January 2006, we have contracted Dickerson Knight Group (DKG) to deliver two training courses for ACB's executive and mid-level management on two subjects: SME Customer-Based Marketing and SME Credit Risk Management. The training represents effective cost-sharing with 60% funded by ACB and 40% funded by EGAT/DC. The first training course will take place from April 3-8, 2006 (6 days) and the second course will be held during April 25 to May 4, 2006 (7 days). Each course will accommodate 28 participants and will be held in Ho Chi Minh City. While the other partner bank (EAB) had asked for training for their staff, it declined USAID's offer for training citing that the bank has recently received similar training from another donor. Moreover, EGAT/DC is now planning to send one US expert on student loan to come to work with ACB on student loan program in April 2006. Technical assistance for partnering banks relies on EGAT/DC, which has again confirmed its commitment to provide technical assistance to our partner banks within the planned timeframe.

Based on the information described above, we request that this recommendation be resolved upon issuance. We will request closure on submission of a formal action plan.

Finally, I would like to express our thanks for the recommendations as well as the thorough review and the hard work of RIG auditors during their assignment in RDM/A.

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