OFFICE OF INSPECTOR GENERAL

# AUDIT OF USAID/BULGARIA'S DEVELOPMENT CREDIT AUTHORITY

AUDIT REPORT NO. 9-183-06-002-P
OCTOBER 25, 2005

WASHINGTON, DC

*Office of Inspector General*

October 25, 2005

**MEMORANDUM**

**TO:** USAID/Bulgaria Director, Michael Fritz

**FROM:** IG/A/PA Director, Steven H. Bernstein /s/

**SUBJECT:** Audit of USAID/Bulgaria's Development Credit Authority (Report No. 9-183-06-002-P)

This memorandum transmits our final report on the subject audit. In finalizing our report, we considered your comments on our draft report and have included your response in its entirety in Appendix II. This report does not include any recommendations.

I want to express my sincere appreciation for the cooperation and courtesy extended to my staff 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 (see page 2).

This audit was conducted as an initial audit by the Office of Inspector General's Performance Audits Division—the first in a series of planned individual mission audits of USAID's Development Credit Authority. The objective of this audit was to determine whether USAID/Bulgaria managed its DCA guarantees to ensure that selected intended results were achieved (see page 3).

USAID/Bulgaria managed its DCA guarantees to ensure that selected intended results were achieved. The loans selected for review supported their intended strategic objectives, were made to qualified borrowers for qualified projects, and funded activities reflecting the intended purpose of the loans. Furthermore, the Mission achieved its aggregate utilization[1] projections for the fiscal year ending September 30, 2004 (see page 4).

This report does not include any recommendations. In response to our draft report, USAID/Bulgaria concurred with the observations made in the draft report. See page 8 for our evaluation of management comments.

Management comments are included in their entirety in Appendix II.

[1] Utilization refers to the number and/or dollar amount of loans disbursed by a partnering bank under a loan portfolio guarantee.

# 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. Guarantees typically cover up to 50 percent of a loan.[2]

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.

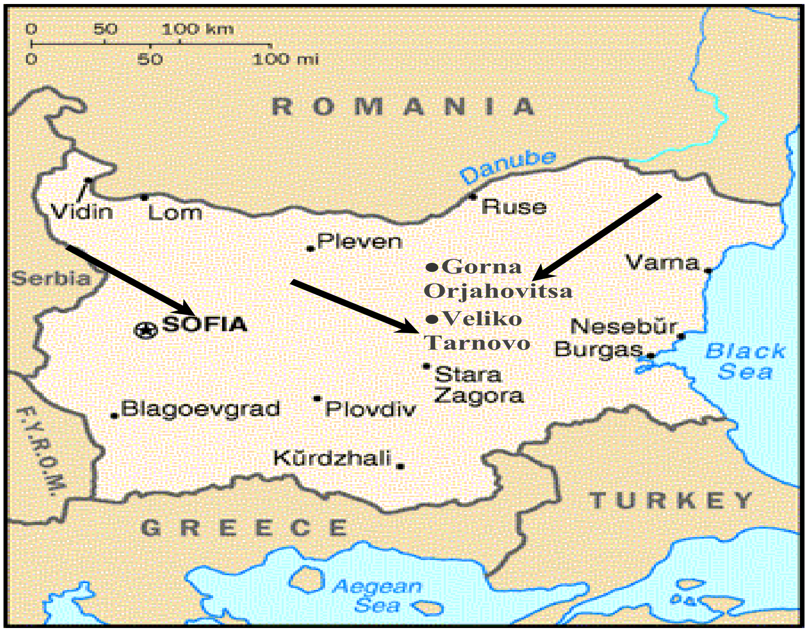
DCA credit guarantees are typically designed by USAID's overseas missions and managed jointly by the mission and USAID's Office of Development Credit (ODC). Missions are primarily responsible for developmental monitoring, while ODC is primarily responsible for financial monitoring. While four types of DCA guarantees are available, as of September 30, 2004, nearly 75 percent were loan portfolio guarantees.[3]

As of September 30, 2004, USAID had signed 114 DCA guarantees in 36 countries, making credit totaling nearly $856 million available, guaranteeing a maximum of approximately $335 million, with cumulative utilization amounting to nearly $193 million.[4] During this same period, USAID/Bulgaria had five DCA loan portfolio guarantees, making credit of $60 million available, while guaranteeing a maximum of $26.5 million. As of September 30, 2004, these five guarantees were responsible for 86 loans totaling over $41 million, representing over 20 percent of the dollar amount of loans guaranteed by USAID to date.

[2] Although USAID is also authorized to make direct loans under its DCA authority, as of September 30, 2004, it had not exercised this authority.

[3] In a loan portfolio guarantee, USAID signs an agreement with a partnering bank and agrees to partially guarantee individual loans made by the bank to borrowers meeting strict eligibility guidelines, such as type of borrower and project, projected positive cash flows, creditworthiness, and other factors.

[4] These figures are unaudited.




**Map[5] of Bulgaria, with arrows designating cities where the OIG audit team conducted site visits to projects funded with DCA loan guarantees.**

## AUDIT OBJECTIVE

This audit was conducted as an initial audit in a planned series of individual worldwide mission audits of USAID's Development Credit Authority, as part of the Office of Inspector General's (OIG) fiscal year 2005 audit plan. The audit was conducted to answer the following question:

- Did USAID/Bulgaria 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.

[5] This map is not to scale. It was adapted for report purposes from a map on the Lonely Planet website found at http://www.lonelyplanet.com/mapshells/europe/bulgaria/bulgaria.htm.

# AUDIT FINDING

USAID/Bulgaria managed its Development Credit Authority (DCA) guarantees to ensure that selected intended results were achieved. The loans selected for review supported their intended strategic objectives, were made to qualified borrowers for qualified projects, and funded activities reflecting the intended purpose of the loans. Furthermore, the Mission achieved its aggregate utilization projections for the fiscal year ending September 30, 2004.

Various forms of USAID guidance govern missions' responsibilities for managing DCA guarantees. Automated Directive System (ADS) 249, *Development Credit Authority*, states that missions are responsible for the developmental soundness of DCA activities and for implementing, overseeing, monitoring, and evaluating these activities. USAID's Office of Development Credit's (ODC) *Operations Manual* states that missions should conduct development monitoring and should assist ODC with financial monitoring,[6] including bank site visits.

USAID/Bulgaria had five loan portfolio guarantees as of September 30, 2004. In accordance with ADS 249, each guarantee agreement supported one or more of the Mission's strategic objectives. Additionally, each agreement targeted one of the Mission's development sectors. For example, the two agreements selected for detailed review supported the Mission's "Economic Growth and Increased Prosperity" strategic objective—one funded loans for municipal and company energy efficiency projects and the other funded loans for small and medium enterprise projects in competitive sectors. As part of its monitoring process, the Mission appropriately included its DCA guarantees in its annual strategic objective portfolio and activity reviews. Furthermore, the Mission described how its guarantees helped achieve the related strategic objective in the performance narrative of its fiscal year 2005[7] annual report submitted to USAID/Washington.

To ensure that loans made under a portfolio guarantee were used to achieve intended results, each agreement between USAID and the partnering bank specified loan eligibility guidelines. When a partnering bank approved and disbursed a loan and put it under guarantee, it notified the Mission by issuing a notification letter. USAID/Bulgaria used these letters to verify that both the borrower and the loan purpose met the eligibility guidelines in the agreement. In accordance with USAID guidance, the Mission also conducted semi-annual site visits to partnering banks, maintained regular contact with bank officials, and obtained the banks' annual audited financial statements.

USAID/Bulgaria's loan guarantees funded activities which reflected the intended purpose of the loans. For example:

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[6] According to the May 2002 version of the *Operations Manual*—which was available on ODC's website during the period of the audit through mid-August 2005—ODC is primarily responsible for financial monitoring. Missions' responsibility for financial monitoring is a support role. ODC maintains a database to which partnering banks submit semi-annual loan schedules. See page 7 of this report for a related discussion concerning project monitoring.

[7] USAID's fiscal year 2005 annual reports describe performance information from fiscal year 2004.

- One loan guarantee allowed a municipality to modernize its streetlights, creating sufficient energy savings to repay the loan. USAID's guarantee decreased the amount of collateral the municipality was required to provide the bank.


**Photograph taken June 15, 2005 by an OIG auditor of municipal, bank and Mission staff in front of a streetlight funded by a DCA loan guarantee in Veliko Tarnovo, Bulgaria.**

- A second loan guarantee allowed a small, family-run hotel to expand from just several rooms to 22 rooms—17 of which are suites—and to install energy-efficient lighting in the halls and suites. According to hotel staff, the hotel has been enjoying an average occupancy rate of 90 percent. USAID's guarantee gave the partnering bank confidence to lend in a sector to which it had not previously been willing to extend credit.

- Two loan guarantees allowed a taxi company to buy a fleet of new specially outfitted cars and to modernize the equipment in its service center. USAID's guarantees permitted the bank to make a larger loan to this company than it otherwise would have, due to collateral and capital requirements.

- Lastly, a loan guarantee allowed a company to double its energy efficiency by refurbishing and replacing its antiquated heat and power station. A company executive stated that it no longer had to buy power, but instead generated excess electricity and sold it to the municipality's grid.


**Photograph taken June 16, 2005 by a DCA beneficiary of OIG auditors and factory officials in the factory's command center. An official explained that a DCA loan guarantee funded generator number 2. The factory is located in Gorna Orjahovitsa, Bulgaria.**

One of the primary performance measures ODC used to evaluate whether DCA guarantees achieved their intended results on a worldwide basis was the dollar volume of cumulative utilization and the related percentage of this volume to the total available credit for approved DCA facilities. Correspondingly, USAID/Bulgaria's primary performance measure for its DCA guarantees was the utilization of its guarantees by the partnering banks. The indicator used to measure utilization was the dollar amount of loans made under its guarantee agreements.[8] The Mission obtained semi-annual projections from its partnering banks and forwarded these projections to ODC staff, who prepared an analysis of projected versus actual utilization. Based on their analysis, the Mission achieved its aggregate utilization projections for the fiscal year ending September 30, 2004—actual cumulative utilization totaled $41.6 million versus projected utilization of $39.9 million.

## Other Matters without Recommendations

During the course of our audit, we noted the following matters requiring follow-up during the individual mission audits to be performed during the first and second quarter of fiscal year 2006. This information is provided for informational purposes only. If appropriate, we will address these matters and make related recommendations in the summary audit report issued upon completion of this worldwide audit. This summary audit report is expected to be issued in the summer of 2006.

[8] The Mission reported the number and dollars of utilization in its fiscal year 2004 Joint Agency-State Mission Performance Plan.

**Claims Processing** — ADS 249[9] states that missions should be the focal point for lender claims under DCA guarantees and that mission staff should determine if a claim is valid and request that ODC process the claim. USAID/Bulgaria received its first DCA guarantee claim request from a partnering bank in April 2005 and submitted the $97,886 claim to ODC for verification and payment, without first determining the validity of the claim. USAID paid the claim in May 2005. During follow-up fieldwork performed at USAID/Washington, the audit team determined that ODC is in the process of revising the ADS to properly reflect that it is ODC's responsibility—not the missions'—to determine claim validity. As of the issuance date of this report, ODC was in the process of revising ADS 249. Therefore, no recommendation regarding this matter is considered necessary at this time.

**Project Monitoring** — Neither Federal regulations nor USAID guidance require monitoring by missions at the borrower level. Although missions are required to conduct periodic partner bank site visits, they are not required to perform borrower site visits.[10] According to USAID/Bulgaria staff, this is because USAID's contractual relationship is with the partner bank, not the borrower. In fact, one of the benefits of a DCA guarantee, as opposed to a grant or contract, is that the onus for borrower/activity monitoring is on the bank, not USAID.

Nevertheless, we believe that monitoring loan guarantees at the borrower or project level would help ensure that guaranteed loans are being used for their intended purpose and that they are funding projects that support specified strategic objectives. USAID guidance reinforces the importance of project site visits when managing grants and cooperative agreements. In April 2004, the ODC revised its *Operations Manual* to state that in conjunction with bank site visits, mission staff should, if possible, request at least one borrower site visit. We plan to further explore the feasibility of requiring missions to conduct periodic borrower site visits during the course of this worldwide audit.

**Marking Requirements** — On August 25, 2005, USAID's Administrator announced the issuance of new branding requirements for grants and cooperative agreements, effective January 2, 2006. This guidance is in addition to the Administrator's March 2005 letter directing contractors to begin using the new USAID identifier. This new Federal regulation requires that all USAID programs, projects, and activities be "marked' to clearly identify that the aid is, "From the American People." The new marking rules are part of a larger campaign to generate more positive perceptions about the United States in developing countries. We plan to determine whether these marking requirements apply to DCA guarantees.

[9] At the time of our audit, the most recent version of ADS 249 was dated June 14, 2002.

[10] According to the April 2004 revision of the *Operations Manual*, during its biennial reviews, the ODC requests at least one visit to a borrower who received a DCA-guaranteed loan.

# EVALUATION OF MANAGEMENT COMMENTS

In response to our draft report, USAID/Bulgaria concurred with the observations made in the report. The Mission pointed out that it is a graduation Mission with limited resources and thus it may not be feasible to monitor at the borrower or the project level.

No further action is needed. Appendix II includes management comments in their entirety.

# SCOPE AND METHODOLOGY

## Scope

The Office of Inspector General's (OIG) Performance Audits Division conducted this audit in accordance with generally accepted government auditing standards. This audit was the first in a planned series of mission audits to be conducted by the OIG. The audit was designed to answer this question: Did USAID/Bulgaria manage its Development Credit Authority (DCA) guarantees to ensure that selected intended results were achieved?

In planning and performing the audit, we assessed the effectiveness of internal controls related to DCA guarantees. We identified pertinent internal controls as (1) the Mission's procedures for managing and monitoring its DCA guarantees, (2) partnering banks' procedures regarding DCA loan approvals and payments, and (3) the Mission'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 May 2002 *DCA Operations Manual*.

There were no prior audit findings affecting the areas reviewed in this audit.

Our audit scope encompassed USAID/Bulgaria's five DCA loan portfolio guarantees as of September 30, 2004. These five loan portfolio guarantees made credit of $60 million available, while guaranteeing a maximum of $26.5 million. As of September 30, 2004, these five guarantees had generated 86 loans totaling over $41 million, representing over 20 percent of the dollar amount of DCA loan guarantees to date. USAID/Bulgaria's DCA guarantees represented over 4 percent of USAID's 114 guarantees and approximately 7 percent of the available credit reported by USAID in fiscal year 2004.

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

- Loans supported the strategic objective(s) specified in the documentation submitted by the Mission and approved by USAID's Credit Review Board.

- Loans were made to qualified borrowers for qualified projects as specified in the guarantee agreement between USAID and the partnering bank.

- Activities funded by the loan guarantees represented the intended loan purpose stipulated in the partnering banks' loan files.

- USAID/Bulgaria achieved its utilization projections for the dollar amount of loans generated by the guarantee portfolio, on an aggregate basis, as of September 30, 2004.

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

This report summarizes the results of our audit work. Preliminary fieldwork for this audit was performed at USAID/Washington from January through May 2005. Mission fieldwork was conducted at USAID/Bulgaria in Sofia and at various bank office locations and borrowers' sites within Bulgaria from June 2 through June 29, 2005. Follow-up fieldwork was conducted at USAID/Washington from July 5 through August 16, 2005.

## Methodology

To answer the audit objective, we performed detailed reviews of the two oldest and largest of USAID/Bulgaria's five DCA loan portfolio guarantees as of September 30, 2004. The two guarantees selected for review represented 92 percent of the dollar amount utilized under USAID/Bulgaria's guarantee portfolio. From these two guarantee agreements, we judgmentally selected a sample of loans for detailed loan file reviews and for borrower site visits.[11]

We interviewed mission 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 the Mission for all five guarantee agreements. We also interviewed selected borrowers and conducted site visits to observe the projects and activities funded by the selected loans. Additionally, we interviewed USAID officials in Washington D.C.

We did not determine materiality thresholds for the audit objective.

[11] The sample selected for loan file reviews comprised approximately 41 percent of the dollar volume of the two guarantees chosen for review and almost 38 percent of the total portfolio of USAID/Bulgaria DCA guarantees.

October 06, 2005

# A C T I O N   M E M O R A N D U M

To: IG/A/PA Director, Steven H. Bernstein

From: USAID/Bulgaria Mission Director, Michael Fritz /s/

Subject: USAID/Bulgaria Written Comments on Draft Report on Audit of USAID/Bulgaria's Development Credit Authority (DCA) (Report No 9-183-05-00X-P)

The Mission's Audit Management Officer (AMO), the DCA Energy and Environment Technical Officer and the Economic Growth Officer reviewed the subject report and IG memo.

Basically, the draft Audit report of USAID/Bulgaria's Development Credit Authority programs does not include any recommendations or findings to be addressed by the Mission.

We concur with the observations made in the report. With regard to revisions in process of ADS 249 and the ODC DCA Operations Manual related to the monitoring requirements for loan guarantees, we would like to point out that USAID/Bulgaria is a graduating Mission with limited resources, and thus it may not be feasible to monitor at the borrower or project level.

We would like to thank the audit team for their diligent efforts in performing this audit.

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