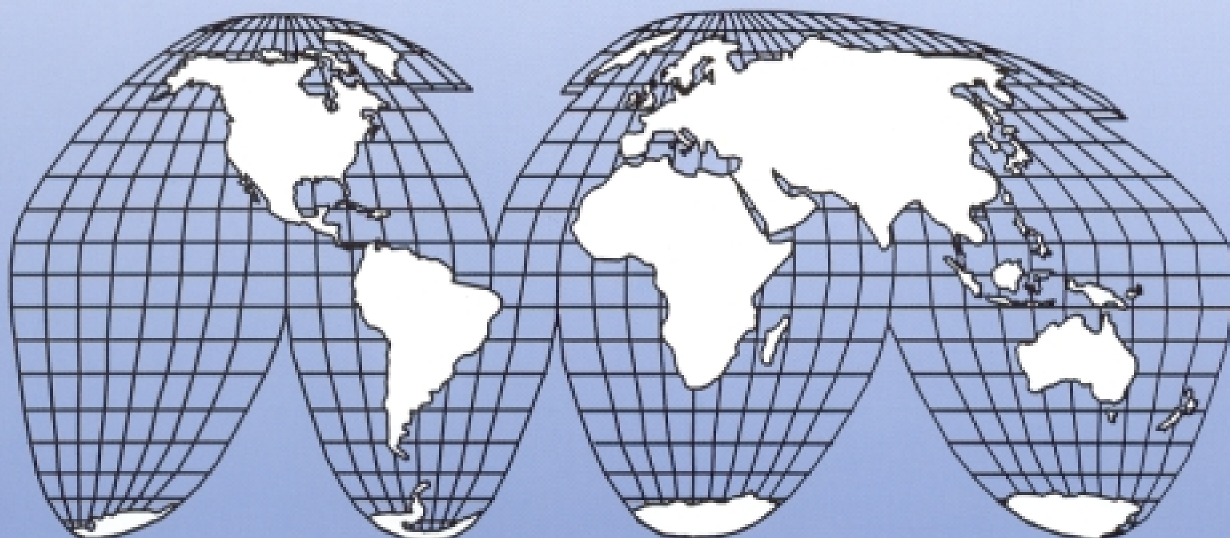
USAID

OFFICE OF INSPECTOR GENERAL

Audit of USAID's Bureau for Asia and the Near East Monitoring of the Government of Pakistan's Compliance with the Provisions of USAID Grant No. 391-K-005

Audit Report No. 0-000-03-001-F

January 7, 2003



Washington, D.C.

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January 7, 2003

MEMORANDUM

FOR: DAA/ANE, Mr. Gordon West

FROM: IG/A/FA, Alvin A. Brown

SUBJECT: Audit of USAID's Bureau for Asia and the Near East (ANE) Monitoring of the Government of Pakistan's Compliance with the Provisions of USAID Grant No. 391-K-005 (Report No. 0-000-03-001-F)

This memorandum is our final report on the subject audit. In finalizing this report, we considered your comments on our draft report and have included your response as Appendix II

This report includes three recommendations for your action. Based on your written comments, a management decision has been reached on Recommendation No. 2. Information related to your final action on this recommendation should be provided to USAID's Office of Management Planning and Innovation.

Recommendation Nos. 1 and 3 do not yet have a management decision. Please contact us, within 30 days, of any actions planned or taken to reach a management decision on these recommendations.

The OIG appreciates the cooperation and courtesies extended to our staff during the audit.

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Summary of Results

"Did USAID's Bureau for Asia and the Near East (ANE) monitor the grant activity of the Government of Pakistan to ensure its compliance with the terms of Grant No. 391-K-005 (the grant) to be used as reimbursement of debt paid, and service of debt, to the U.S., World Bank, Asian Development Bank or International Monetary Fund?"

The OIG has determined that USAID/ANE did not design the grant to allow for effective oversight and did not effectively monitor the Government of Pakistan's compliance with certain provisions of the grant. Specifically, the OIG has determined that;

- USAID/ANE officials did not secure authorizations from the Government of Pakistan to have loan records released by each of the Government of Pakistan's creditors to corroborate loan payment data provided by the Government of Pakistan (see p. 5);

- USAID/ANE officials did not obtain timely required reports from the Government of Pakistan on the use of the separate dollar funds and the status of the Separate Dollar Account, as required by the agreement (see p. 7);

- USAID transferred grant funds into an interest-bearing account at the Federal Reserve Bank of New York, although Article V, Section 5.1 of the agreement requires grant funds to be deposited into a non-interest-bearing account (see p. 10). ANE also did not establish procedures to ensure that interest earned was returned to USAID.

These conditions existed largely because ANE did not fully consider its monitoring requirements prior to the grant award or during the Government of Pakistan's use of the award. As a result, ANE officials had no assurance that the grant funds were used in accordance with the terms of the grant agreement, until after the Government of Pakistan expended the funds.

ANE had not monitored, in a timely way, the Government of Pakistan's compliance with Section 5.2(a) of the grant agreement (see p. 9). Section 5.2(a) requires the Government of Pakistan to transfer budget resources to the poverty reduction and social development program in an amount commensurate to the amount of the grant during the fiscal year ended June 2002. According to the Government of Pakistan's own records, submitted to ANE in April 2002, the Government of Pakistan budgeted only about 14 billion Rupees (approximately $230 million or 38 percent of the grant funds) on these sectors during the fiscal year ended June 2002.

Despite these issues, the OIG found no evidence that grant funds were not used for debt relief, and the Government of Pakistan was very cooperative in responding to USAID/ANE's varied requests for access to its loan payment information at each of its creditors, and to its banking records related to the grant account at the Federal Reserve Bank of New York.

Background

On September 18, 2001, the 107th Congress enacted Public Law 107-38 making emergency supplemental appropriations for fiscal year 2001 for additional disaster assistance for anti-terrorism initiatives, for assistance in the recovery from the tragedy that occurred on September 11, 2001, and for other purposes.

On November 15, 2001, the Administration provided a $600 million cash transfer to the Islamic Republic of Pakistan, a key front-line coalition partner in our global campaign against terrorism. The money was to be used for the (1) reimbursement of loan payments made by the Government of Pakistan between September 11, 2001 and November 15, 2001 and (2) loan payments to each of several of the Government of Pakistan's creditors identified in the agreement. Grant funds were to be used by the Government of Pakistan to meet foreign exchange needs, pursuant to Article II of the agreement, to service its debt owed to the Government of the United States of America, World Bank, Asian Development Bank, or International Monetary Fund and for other purposes or uses as agreed to in writing between the United States and Pakistan. In any case, no grant proceeds were to be used to finance, reimburse for, or service debts related to, the purchase of military or police equipment and other ineligible uses outlined in subsequent guidance. Therefore, the grant was to free the Government of Pakistan's domestic revenues for spending on its poverty reduction and social development program as outlined in section 5.2 of the agreement.

Audit Objective

Our review addressed the following question:

"Did USAID's Bureau for Asia and the Near East (ANE) monitor the grant activity of the Government of Pakistan to ensure its compliance with the terms of Grant No. 391-K-005 (the grant) to be used as reimbursement of debt paid, and service of debt, to the U.S., World Bank, Asian Development Bank or International Monetary Fund?"

Appendix I provides a complete discussion of the scope and methodology for this audit.

Audit Findings

"Did USAID's Bureau for Asia and the Near East (ANE) monitor the grant activity of the Government of Pakistan to ensure its compliance with the terms of Grant No. 391-K-005 (the grant) to be used as reimbursement of

debt paid, and service of debt, to the U.S., World Bank, Asian Development Bank or International Monetary Fund?"

ANE did not effectively monitor the Government of Pakistan's compliance with certain provisions of the agreement until after the Government of Pakistan had expended the funds, primarily because of design shortcomings related to the instrument and because monitoring procedures were not fully implemented. Most of the deficiencies can be corrected in the future through the establishment of agreements that provide for effective USAID oversight, and through the implementation of grant monitoring procedures. Accordingly, the OIG makes three recommendations to address these deficiencies.

The Grant Award to Pakistan was not Designed Effectively

USAID/ANE did not monitor or compare, in a timely and effective way, banking and creditor activity associated with the $600 million cash transfer to the Government of Pakistan. USAID/ANE did not monitor this activity effectively because it did not design the grant to require authorizations to access Government of Pakistan creditor and banking records as a condition of the agreement. ANE officials did not ultimately receive these authorizations until after our audit began. As a result, until our audit fieldwork was completed, ANE officials had no assurance that the funds were used in accordance with the terms of the agreement.

On November 19, 2001, USAID's Office of Financial Management funded a grant account with $600 million at the Federal Reserve Bank of New York for the purpose of holding and disbursing funds to specific creditors, as indicated in USAID Grant Number 391-K-005 issued on November 15, 2001. Grant funds were transferred to this account under the condition that the Government of Pakistan provides USAID/ANE with regular statements on the account's activity. However, USAID/ANE did not receive this information in a timely manner and, even after its receipt, could not compare Government of Pakistan creditor records with Federal Reserve Bank of New York account records because ANE did not secure proper authorizations to review this information.

The OIG could not reconcile Federal Reserve Bank of New York account information with payment records provided by the Government of Pakistan because the activity identified in the Government of Pakistan payment records did not resemble the activity identified in the Federal Reserve Bank of New York records in any way. Activity within the grant account at the Federal Reserve Bank of New York represented transfers of large sums of money - not individual payments as indicated in the Government of Pakistan records provided to ANE.

For example, an analysis of Federal Reserve Bank of New York account activity indicated that $531.2 million was transferred from Pakistan's grant account to Pakistan's general (PakGen) Federal Reserve Bank of New York account -

predominantly *after* the Government of Pakistan indicates that it had expended USAID grant funds. The Federal Reserve Bank of New York records further showed that the Government of Pakistan only made $74.4 million of fund payments or account transfers directly to any of the creditors identified in the agreement. Since the Government of Pakistan was paying its loans without significant Federal Reserve Bank of New York account activity, USAID/ANE officials could have reasonably concluded that Government of Pakistan was using another source of funds to pay its creditors, prompting ANE to question whether or not grant funds had been commingled (see last paragraph in this section). USAID/ANE officials were not aware of this, however, until October 2002. Had ANE obtained current account information as required in the agreement, it could have asked the Government of Pakistan and the Federal Reserve Bank of New York for an explanation of much of the activity in the account.

Several of the Government of Pakistan's creditors would not release information to USAID without specific authorization from the Government of Pakistan. Therefore, on September 13, 2002, ANE requested that the Government of Pakistan provide such authorizations. ANE received authorizations for release of Asian Development Bank (ADB) and Federal Reserve Bank of New York information on October 5, 2002, but authorization for the release of World Bank information was not received until October 29, 2002. The release of these authorizations were delayed due to several misunderstandings ANE had with respect to what information each individual creditor required from ANE in its request. As a result, the World Bank and ADB confirmations were not received until November 2002.

Because ANE did not receive authorizations to review creditor and banking records, it also was not aware that the Government of Pakistan had possibly not complied with Section 5.1 of the agreement, which disallowed the commingling of grant funds with funds from any other sources. Section 5.1 of the agreement states, "The Grantee agrees to establish a separate, non-interest bearing dollar account in the Federal Reserve Bank of New York (the 'Separate Dollar Account') for the deposit of the Grant, and shall not commingle the Grant with funds from any other source."

As mentioned earlier, the OIG determined that the Government of Pakistan did not comply with the agreement when it transferred $531.3 million (89 percent) of the grant funds between the Federal Reserve Bank of New York grant account and PakGen account. These transfers made it impossible for us to confirm payments to the Government of Pakistan's creditors using banking records. Had USAID/ANE required authorizations to access Federal Reserve Bank of New York records as a condition of the grant, it could have identified account activity that did not comply with the agreement on a timely basis, including the transfer of funds to the PakGen account - the details of which USAID has no information.

Recommendation No. 1: We recommend that USAID's Bureau for Asia and the Near East implement procedures to obtain third party authorizations necessary to monitor its cash transfer grant awards to the Government of Pakistan and all other foreign government grantees.

ANE Monitoring of Pakistan Grant Agreement was not Timely

USAID/ANE did not receive:

- timely loan information from the Government of Pakistan's creditors,
- timely loan payment documentation from the Government of Pakistan, or
- useful account information from the Federal Reserve Bank of New York, where the grant funds were held (see previous finding).

This condition existed because ANE did not implement procedures to monitor the grant on an ongoing basis. The OIG noted that USAID/ANE had taken steps, throughout the grant period, to monitor the Government of Pakistan's compliance with the agreement, but that many issues were left unresolved until after the funds were expended. At the time our fieldwork was completed in October 2002, ANE could not fully determine if the Government of Pakistan complied with Article II of the agreement or if the Government of Pakistan used USAID grant funds to service debt owed to the World Bank and the Asian Development Bank - representing, according to the Government of Pakistan, about 78 percent of the grant funds expended to service debt payments.

According to Article II of the agreement, "… grant proceeds will be used to: (a) Service debt payment to the Grantee which are owed to the Government of the United States of America, World Bank, Asian Development Bank, or International Monetary Fund; (b) Reimburse for debt payments by the Grantee between September 11, 2001 and the date of this Agreement to the Government of the United States of America, World Bank, Asian Development Bank, or International Monetary Fund…."

Section 5.4 of the agreement states that "… the Grantee shall provide USAID with quarterly reports on the uses of Separate Dollar Account funds and the status of the Separate Dollar Account until the funds are fully disbursed for the purposes specified in Article II, including all dollar deposits into and disbursements from the account. Each report shall include copies of monthly bank statements pertaining to the account."

When the OIG began the audit on May 21, 2002, it discovered that, ANE had not yet received the information identified in Section 5.4. Therefore, in order to obtain initial information on the Government of Pakistan's grant activity to begin the audit, the OIG requested that ANE obtain loan payment information from the

Government of Pakistan, as required by the agreement. ANE formally requested this information on May 31, 2002, and received it on June 28, 2002. A summary of the loan payment information provided by the Government of Pakistan is as follows:

Payments Made Prior to November 15, 2001

Creditor	Amount
Asian Development Bank (ADB)	$113,829,422
World Bank (WB)/International Development Association (IDA)	$ 19,508,948
WB/International Bank for Reconstruction and Development (IBRD)	$ 80,277,855
Total	$213,616,225

Payments Made on or Subsequent to November 15, 2001

Creditor	Amount
ADB	$ 96,465,384
WB/IDA	$ 41,710,723
WB/IBRD	$120,091,872
IMF	$114,593,983
U.S. Government	$ 13,521,813
Total	$386,383,775

In accordance with the agreement, and as noted previously, all loan payments made by the Government of Pakistan between September 11, 2001 and November 15, 2001 were to be reimbursed directly to the Government of Pakistan. Remaining grant funds were to be used specifically to make payments against existing loans with each of the Government of Pakistan's identified creditors. As a result of this debt relief, the Government of Pakistan, during its fiscal year ending June 30, 2002, was to transfer budget resources to its poverty reduction and social development programs in an amount commensurate with the amount of the grant, as indicated in Section 5.2 of the agreement. According to the Government of Pakistan records summarized above, Pakistan disbursed all $600 million by April 15, 2002. The reimbursement on the loan payments (those loan payments identified by the Government of Pakistan as having been paid between September 11, 2001 and November 15, 2001) amounted to $213,616,225. Loan payments made after November 15, 2001, amounted to $386 million.

At the time it was awarded, the $600 million grant was equal to approximately 36.6 billion rupees (Rs). The Government of Pakistan's own budget records showed that, as a result of the USAID award, an additional Rs.14 billion (38 percent of the grant funds) would be spent on social sectors during the fiscal year ended June 30, 2002, with the balance of Rs.22.6 billion (62 percent of the grant funds) to be used for budgetary support. This would not be in compliance with Section 5.2 of the agreement, which requires an amount equivalent to 100 percent of the grant funds to be spent on social sectors (including poverty reduction and social development). Because the OIG could not confirm whether or not the Government of Pakistan used these funds for such programs within Pakistan - or how the Government of Pakistan defines "budgetary support" - it focused the audit on confirming the Government of Pakistan's loan payment records with those of its creditors. As of the completion of our fieldwork in October 2002, the OIG had no information that ANE had contacted the Government of Pakistan for an explanation of its information. In December 2002, USAID/ANE officials provided us with additional information it had received from the Government of Pakistan related to its fiscal year 2002 program expenditures, and USAID/ANE officials intend to continue to monitor program activity within Pakistan.

As mentioned in the previous section, loan payment information from the Government of Pakistan's creditors was not immediately available because ANE did not secure proper authorizations from each of the identified creditors in a timely manner. This information would have provided corroborating information required to successfully monitor the grant's performance and could have been reconciled to records provided by the Government of Pakistan. USAID/ANE ultimately received some type of confirmation from the following creditors:

- U.S. Department of Agriculture/Commodity Credit Corporation
- Export-Import Bank of U.S.
- USAID
- International Monetary Fund
- World Bank Group
- Asian Development Bank

Although the payment information from the Government of Pakistan and the payment information from each of its creditors did not match exactly, each of these creditors indicated that the Government of Pakistan is current on its loan payments, and the OIG found no evidence that grant funds were not used for debt relief. Also, the Government of Pakistan was very cooperative in responding to ANE's varied requests for access to its loan payment information at each of its creditors.

Recommendation No. 2: We recommend that USAID's Bureau for Asia and the Near East implement procedures to monitor its grant agreements on an ongoing basis.

Accumulated Interest from the Separate Dollar Account was not Collected

In meetings conducted with the Ministry of Finance officials in January and May 2002, ANE requested that the Government of Pakistan comply with the reporting requirements of the agreement and also sent written requests for these documents. However, the Government of Pakistan did not initially comply with ANE's attempts to acquire this information. Consequently, USAID/ANE did not monitor, in a timely manner, the Separate Dollar Account in the Government of Pakistan's name at the Federal Reserve Bank of New York. As a result, although aware of the nature of the account, ANE did not obtain information on interest accumulated within the account until ten months after the grant was awarded. This condition existed because ANE did not initially realize the level of monitoring that was required to ensure the Government of Pakistan's compliance with the agreement. As of October 8, 2002, over $4 million remained in the account even though the Government of Pakistan's records indicate that the entire $600 million had been disbursed.

USAID's Financial Management Division transferred the grant funds into a separate account established by the Government of Pakistan at the Federal Reserve Bank of New York. This account was interest bearing, and not in compliance with Section 5.1 of the agreement because the Federal Reserve Bank of New York does not allow funds to be deposited and remain idle in a non-interest-bearing account. According to one Federal Reserve Bank of New York official, idle account funds at the Federal Reserve Bank of New York are either used to purchase short-term Treasury securities or are invested in overnight instruments that allow the account to accumulate interest nightly. Therefore, it was difficult for the Government of Pakistan to comply with Section 5.1 of the agreement as designed. This highlighted the need for USAID to make arrangements in advance of the award to ensure that interest was not earned in an account designated for grant funds.

Section 5.4 of the agreement requires the Government of Pakistan to provide USAID with quarterly reports on the uses of the Separate Dollar Account funds and the status of the Separate Dollar Account until the funds are fully disbursed for the purposes specified in Article II, including all dollar deposits into, and disbursements from, the account. Each report was to include copies of monthly bank statements pertaining to the account.

USAID/ANE officials believed the account would be open and closed within a short period of time and also believed that the Government of Pakistan would make only a few large payments to liquidate the account. ANE officials therefore concluded that accounting for a small amount of interest would not be worth a considerable effort. However, since the account was open almost ten months longer than anticipated, at least $4.3 million of interest was earned (see following paragraphs).

USAID/ANE did not receive Federal Reserve Bank of New York statements that would show disbursement from, deposits to, and interest accumulated within the until account ten months after the grant was awarded. The information that the Federal Reserve Bank of New York ultimately provided ANE only included individual transactions with no opening or closing balances. As a result, the OIG was unable to determine the exact amount of interest earned in the account and the closing balance of the Separate Dollar Account. A separate analysis performed by ANE in October 2002 determined that approximately $5 million of interest accumulated in the account. However, as mentioned previously, had ANE been receiving timely reporting information, it could have monitored account activity that was not in compliance with the agreement on an ongoing basis and resolved these issues earlier.

Article VI Section 6.2 of the agreement states, “In the case of any utilization of the Grant which is not supported by valid documentation in accordance with this Agreement, or which is not made or used in accordance with this Agreement, USAID may require the Grantee to refund the amount of such disbursement in U.S. dollars to USAID within sixty (60) days after receipt of request therefore.” The OIG considers the accumulated interest held in the account to meet the definition of an unauthorized use of funds referred to in this section.

As mentioned earlier, an October 2002 ANE analysis determined that approximately $5 million of interest accumulated in the account since its inception. During the same period, ANE worked with Government of Pakistan and Federal Reserve Bank of New York officials to collect $4.3 million from the account in two separate installments during October 2002. Yet, ANE has not determined the reason for the difference between the $4.3 million of interest collected and the $5 million of interest that ANE determined had accumulated in the account.

Recommendation No. 3: We recommend that USAID’s Bureau for Asia and the Near East identify and collect the difference between interest remitted by the Government of Pakistan and total interest earned in the Separate Dollar Account associated with USAID Grant Number 391-K-005.

Management Comments and Our Evaluation

In its response, USAID's Bureau for Asia and the Near East accepted the three recommendations in the draft report.

Recommendation No. 1 stated that USAID's Bureau for Asia and the Near East should implement procedures to obtain third party authorizations necessary to monitor its cash transfer grant awards to the Government of Pakistan and all other foreign government grantees. In response to Recommendation No. 1, ANE stated that it will include provisions in future agreements which will require the grantee to seek the timely submission of information from third parties that may be necessary for USAID to monitor ANE grant awards to the Government of Pakistan and all other foreign government grantees, as appropriate to U.S. foreign policy considerations. Also, on January 6, 2003, USAID/ANE issued a memorandum to its Office Directors related to the implementation of procedures for cash transfer agreements. The OIG has considered this memorandum in our evaluation of the ANE comments to our draft report.

In its response, ANE refers to the implementation of a requirement for grantees to seek information from third parties, as necessary. In its January 6, 2003 memorandum, ANE outlined procedures to be completed before determining whether it will require third party authorizations from its grantees in future cash transfer grant agreements. The OIG agrees that the procedures to be implemented by USAID/ANE represent a step in the right direction and will help to avoid future problems related to USAID's access to third party information. However, since the recommendation refers to cash transfer grant awards at *all* foreign government grantees, a management decision has not yet been reached. To reach a management decision ANE must ensure that USAID's Office of Policy, Planning, & Coordination (PPC) accepts these procedures for all of USAID. Once the procedures are accepted by PPC for cash transfers made to all foreign government grantees, a management decision will be reached.

Recommendation No. 2 stated that USAID's Bureau for Asia and the Near East should implement procedures to monitor its grant agreements on an ongoing basis. In response to Recommendation No. 2, ANE stated that it will implement procedures to enforce, on an ongoing basis, its cash transfer grant requirements. Also, in its January 6, 2003 memorandum to its Office Directors, ANE stated its intentions to enforce the requirements of its cash transfer grant agreements over the life of each agreement.

Since ANE has agreed to implement procedures to monitor *its* cash transfer grant agreements on an ongoing basis, a management decision is reached on Recommendation No. 2. Once the procedures are accepted by

PPC and implemented throughout USAID, they should be forwarded to USAID's Office of Management Planning & Innovation for final action.

Recommendation No. 3 stated that USAID's Bureau for Asia and the Near East should identify and collect the difference between interest remitted by the Government of Pakistan and total interest earned in the Separate Dollar Account associated with USAID Grant Number 391-K-005. In response to Recommendation No. 3, ANE indicated that it has collected more than the $4.3 million referred to in our audit, and that a further reconciliation was forthcoming. ANE stated that it has instructed USAID/Islamabad to identify and collect the difference between interest remitted by the Government of Pakistan and total interest earned in the Separate Dollar Account of USAID Grant Number 391-K-005.

In addition to the above actions, ANE will need to (1) identify the specific amount of the difference between interest earned and interest remitted to USAID, and (2) agree to collect any additional amount due before a management decision is reached.

We have also made certain revisions and clarifications to language in the draft report suggested by ANE, as appropriate.

The complete text of management comments is contained in Appendix II. ANE also provided seven attachments with their comments that are not included.

Scope and Methodology

Scope

This audit was conducted in accordance with generally accepted government auditing standards to determine whether USAID/ANE effectively monitored the Government of Pakistan's compliance with USAID Grant No. 391-K005. The OIG obtained an understanding of the grant agreement, the roles of ANE and Government of Pakistan in the contract and the laws related to the implementation of the grant.

The audit started on May 21, 2002, and the fieldwork ended on October 28, 2002. Because of the urgency associated with this report, the scope was limited. The OIG relied on the information provided by USAID/ANE, the Government of Pakistan, and confirmation requests to Pakistan's creditors. However, the scope was limited to the requirements identified in the grant agreement and the OIG did not verify the accuracy of the Quarterly Reports received from the Government of Pakistan, which reflect changes in the planned and actual budgets and transfer of funds for poverty reduction and social development programs within Pakistan. The OIG also did not audit the significant management controls of USAID's Bureau for Asia and the Near East.

Methodology

In accomplishing our audit objectives, the OIG reviewed PL 107-38, the Presidential Determination No. 2001-28, the grant agreement, the Pakistani Quarterly Reports, grant records at financial institutions, and information from creditors of the Government of Pakistan.

The OIG reviewed the records associated with the grant account, confirmed that the opening balance was equal to the grant amount, and attempted to follow transactions into and out of the account. The OIG examined the list of Pakistan's creditors paid from the grant and ensured that it is in compliance with the agreement and identified any exceptions. The OIG also verified disbursements made to each organization via confirmation requests, and reviewed correspondence between the Government of Pakistan and the United States government.

Management Comments

TO: AIG/A/FA, Alvin A. Brown

FROM: SDAA/ANE, Gordon H. West

SUBJECT: Response to the Audit of USAID/ANE Monitoring of the Government of Pakistan's (GOP) Compliance with the Provisions of USAID Grant No. 391-K-005 (Report No. 0-000-03-001-F)

Summary

USAID/ANE management accepts the OIG draft recommendations. With regards to Recommendation No. 1, ANE will include provisions in future agreements which will require the grantee to seek the timely submission of information from third parties that may be necessary for USAID to monitor ANE grant awards to the Government of Pakistan and other foreign government grantees, as appropriate to U.S. foreign policy considerations. With regard to Recommendation No. 2, ANE will implement procedures to enforce on an ongoing basis its cash transfer grant requirements. With regard to Recommendation No. 3, ANE has instructed USAID/Islamabad to identify and collect the difference between interest remitted by the Government of Pakistan and total interest earned in the Separate Dollar Account of USAID Grant Number 391-K-005.

The Importance of this Grant Agreement

Pakistan has been and continues to be a critical frontline state in the war against terrorism. The Government of Pakistan (GOP) has cooperated fully with the US-led efforts to defeat terrorism and in doing so has carried a substantial economic and political burden. In its effort to assist the GOP, the U.S. Government signed the Program Assistance Grant Agreement (No. 391-K-005) on November 15, 2001, little more than two months after the terrorist attacks of September 11. The decision to provide this type of assistance to the GOP furthered U.S. foreign policy as indicated by the U.S. Department of State and was clearly in our best interests. The Grant Agreement provided emergency economic assistance in a timely manner assisting the GOP in maintaining political stability and providing relief to the Pakistani people.

The grant served its purpose. The GOP used the funds to service debt payments of which over $13.5 million went toward debts to U.S. Government agencies. The remainder was used to pay down debts with the World Bank, the International Monetary Fund, and the Asian Development Bank. The grant provided by the U.S. Government enabled the GOP to re-allocate funds within its budget in order to protect the budgeted levels for specific social sector and poverty reduction programs during the Government of Pakistan's FY 2001–2002. The GOP continues to be cooperative in providing information as part of the Grant Agreement. Documentation provided by the Ministry of finance indicated that over $1.6 billion was spent on qualified poverty reduction and social development programs as specified in the Grant Agreement.

<u>The Grant Agreement Design and Implementation</u>

The ANE Bureau took care in the design and implementation of this Grant Agreement. The bureau went so far as to send a memo from the ANE Assistant Administrator to the IG requesting the OIG's assistance during the development stages of the agreement back in October 2001.

The complexity of the situation immediately after the terrorist attacks of September 11, helped drive the process for crafting, signing and implementing the Grant Agreement. U.S. Foreign Policy requirements accelerated the grant making process including the manner in which the grant funds were disbursed. One of the features the ANE Bureau built into the design--the requisite non-interest bearing account--was meant to facilitate the establishment of a repository for the funds in an expedited manner. Though receiving assurances that this condition had been met, upon discovery to the contrary, the ANE Bureau quickly raised the issue with the GOP in December 2001 (PIL no. 4) and again in November 2002 (PIL no. 7)(Tab I).

With regard to the grant design and the OIG's recommendation on third party authorizations, Sec. 5.3 of the Grant Agreement requires that the grantee make available documents that support deposits and expenditures from the Separate Dollar Account. This implies that account statements (which initiate from a third party--in this case the Federal Reserve Bank of New York) be made available to USAID. Additionally, Sec. 5.4 of the Grant Agreement indicates that further reporting requirements would be established in Program Implementation Letters (PILs). PIL no. 3 further refined those requirements to state:

> Financial records should, at a minimum, include sufficient information to document the deposit, withdrawal and disposition of dollar funds from the separate special account and permit USAID to track the dollars to their final uses, if necessary.

While the Grant Agreement did not require third party authorizations as a condition precedent, the language of the agreement and PIL no. 3, enabled the ANE Bureau to request authorization from the grantee in order to verify and track their final uses.

Finally, monitoring activities did occur in spite of the contention by the OIG to the contrary. The design of the Grant Agreement while not identifying specifically the types of documents that would be required in order to effectively monitor the agreement, did allow the ANE Bureau to request and obtain the documentation necessary for monitoring and providing information for this audit. Though time consuming, the third party authorizations eventually obtained, verified banking records as well as information obtained from the GOP's creditors.

Monitoring Activity during the Life of the Grant Agreement

Monitoring the Grant Agreement was handled primarily through the U.S. Embassy in the early stages of implementation. To refute the OIG's remarks "that ANE had not received any of the information listed in Sec. 5.4 as of May 2002," reports were submitted to the Embassy in Islamabad in December and January of 2002 (Tab II). Though these reports were not complete, ANE worked with Embassy staff to encourage the GOP to comply fully with reporting requirements (Tab III). During this time discussions were held between the U.S. Embassy and Ministry of Finance. Monitoring trips were conducted on the ground in Pakistan by Embassy staff to look at the effectiveness of the Grant Agreement before the OIG Audit began. This was reported between Embassy staff in a memo dated May 8, 2002 (Tab IV).

The Department of State cable issued prior to the OIG Audit (see Tab V) indicated that there had been regular discussions between the Embassy in Islamabad and GOP officials from November 2001 when the agreement was signed until April 2002 when the cable was sent. The cable went on to report progress on a number of different aspects of the grant. It further indicated that monitoring efforts would continue, though at the time the Embassy was experiencing monitoring problems due to security constraints.

In January 2002, U.S. Embassy staff along with an ANE Bureau representative were able to meet with the Ministry of Finance in Islamabad and followed up on monitoring issues including the issue of interest earned on the grant proceeds in the Separate Dollar Account (Tab III). Further talks in Islamabad in May 2002 pressed the Ministry of Finance for delinquent quarterly reports, FRBNY account statements and inquired about actual expenditures for eligible social sector programs (Tab III). Further reports from the GOP were submitted to the ANE Bureau in April (again before the OIG began its audit) and June of 2002. Two additional reports were sent in August of 2002 (Tab II).

In monitoring activities there was clearly a high level of effort on the part of the ANE Bureau that included contact with the GOP through telephone conversations, e-mails, meetings and through PILs. Furthermore the ANE Bureau in conjunction with the Embassy exhibited a willingness to elevate monitoring activities by enlisting the assistance of the Ambassador to call on her counterparts in the GOP when necessary (Tab VI).

Just as Embassy staff were constrained in their activities to monitor the Grant Agreement in Pakistan, the ANE Bureau's effectiveness to conduct monitoring activities was also constrained by security and other issues.

<u>The Constraints on Managing this Activity</u>

In the early stages of monitoring this Grant Agreement, ANE encountered a number of constraints some outside of the bureau's control that in part, made monitoring difficult.

The USAID mission closed in 1995 and Pakistan remained a "non-presence" country until July 15, 2002. On that date USAID officially re-opened its bilateral program in Islamabad. At the time the Grant Agreement was signed and during the early period of implementation, no USAID staff were on the ground in Pakistan. Due to security restrictions, requests by USAID/Washington staff (FM Controller, GC Lawyer and ANE Program Officers) to travel to Islamabad in order to carry out final grant design negotiations with the GOP and to establish monitoring procedures were denied. All activities to support the Grant Agreement originated from the USAID offices in Washington in consultation with the U.S. Department of State and U.S. Embassy in Islamabad. Monitoring was handled through the use of Program Implementation Letters (PILs). In all, seven PILs have been issued to the GOP Ministry of Finance since November 2001, providing guidance to the grantee and requesting information in order to implement and perform monitoring under the grant (Tab I). At no time prior to the signing of the agreement was anyone from USAID permitted to travel to Islamabad to meet directly with Ministry of Finance.

In the ANE Bureau, key personnel normally in place in a bureau to manage these kinds of activities, had not yet been assigned as Pakistan was still a non-presence country. Simultaneously there was a major increase in workload placed upon Bureau staff to handle activities for Afghanistan. The Bureau has been steadily staffing up throughout this year in an effort to handle the new bilateral programs in both Pakistan and Afghanistan. The Desk Officer for Pakistan in Washington was in position by June of this year.

In the Mission the Mission Director arrived at post in July of this year and the mission has been staffing up since that time. The Financial Controller arrived at post on December 13, 2002. Prior to his arrival, most financial matters for the mission in Pakistan were handled by the Financial Controller in Manila.

Issues related to the Grant Agreement could not be addressed directly to the MOF but had to go through the Pakistan Embassy here in Washington, which then relayed information on to the GOP counterparts in Islamabad. In essence there was no one from USAID based on the ground in Pakistan to engage in monitoring until July of this year when the Mission Director arrived.

In mid-August the ANE Bureau arranged to have the services of a full-time FSO Controller (on family medical leave from her post in USAID/New Delhi) via USAID's CFO. Her time was focused primarily on reconciling Separate Dollar Account transactions, interest earnings and interest remittances due on the Pakistan cash transfer. During the next two months, she was able to pursue documentation and/or authorizations from the Federal Reserve Bank in New York (FRBNY), the GOP (with assistance from USAID/Islamabad), and all GOP qualifying creditors under the agreement. The authorizations allowed USAID to confirm that debt payments were made per the guidance provided in PIL nos. 4 and 7 (Tab I). In part because of those efforts, the ANE Bureau was able to collect more than US$4.3 million in earned interest from the GOP. Final reconciliation of interest due will be done by the recently arrived Controller in Islamabad.

<u>Government of Pakistan's Compliance with the Grant Agreement</u>

The ANE Bureau was able to determine (with a significant amount of effort on the part of the Bureau and the Mission) that the GOP had complied with Art. II of the Grant Agreement. The GOP made eligible debt service payments amounting to US$600 million. Additionally, the GOP submitted a schedule of total expenditures for social sector programs of approximately US$1.6 billion during the GOP FY 2001-2002 (see Tab VII). This information (August 2002) was provided in support of Sec. 5.2(a)--illustrating expenditures by the GOP on poverty reduction and social development programs in an amount in excess of the amount of this grant. It confirms the previously reported budget allocation of approximately US$1.3 billion reported to USAID on eligible social sector spending programs reported as part of Condition Precedent 4.1(c) (15 Nov 2001).

By complying with this Grant Agreement the GOP was able to meet its debt service payments and redirect funds to provide assistance to its people. Through this Grant Agreement the U.S. Government was able to further foreign policy directives at a crucial time in our history.

Attachments (not included):

Tab 1 – Summary of Program Implementation Letters
Tab 2 – SENSITIVE BUT UNCLASSIFIED Summary of ANE Monitoring Activities Under Grant Agreement – No. 391-K-005
Tab 3 – E-mail from Del McCluskey to Andrew Katsaros (19 Nov 2001)
Tab 4 – Unclassified Memo from Naheed Aslam to Andrew Haviland (08 May 2002)
Tab 5 – SENSITIVE BUT UNCLASSIFIED Cable from US State Department PDAS Sison (April 2002)
Tab 6 – E-mail from Andrew Haviland to Del McCluskey (27 Jun 2002)
Tab 7 – Social Sector Program Spending Report from GOP to Mark Ward (19 Aug 2002)