Audit of USAID/Bosnia-Herzegovina's Bosnian Reconstruction Finance Facility Program for the Period April 1 through September 30, 1998

Audit Report No. B-168-99-004-P

August 18, 1999

United States Agency for International Development
Office of the Regional Inspector General
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August 18, 1999

MEMORANDUM

TO: USAID/Bosnia-Herzegovina, Craig G. Buck

FROM: RIG/Budapest, James R. Bonnell

SUBJECT: Audit of USAID/Bosnia-Herzegovina's Bosnian Reconstruction Finance Facility Program for the Period April 1 through September 30, 1998

This is our final report on the subject audit. In preparing the report, we considered your comments on the draft and included them in Appendix II. Based on the results of our audit, we found that the loan volume during this six month period—$33.8 million in loans recommended—represented only 56 percent of the targeted amount. In addition, the $149.5 million in recommended loans from the inception of the program was also short of the targeted amount of $255 million due to a slow start as discussed in our earlier audit reports. During the period covered by the audit, we noted that there were various reasons for loan activity not meeting targets such as an increased emphasis on lending smaller amounts to smaller enterprises and the disruption caused by the contract expiration of the primary contractor. Development Alternatives, Inc. was replaced by the Barents Group who assumed responsibility for Business Finance on October 1, 1998.

One preliminary audit finding was issued for this reporting period on which the Mission took corrective action. This report makes no new recommendations; therefore, no action on the report is required by USAID/Bosnia-Herzegovina.

We appreciate the cooperation and assistance provided to the auditors on this assignment.

Background

Bosnia-Herzegovina declared its independence from the former Socialist Republic of Yugoslavia in March 1992, following the lead of Slovenia and Croatia which declared their independence in 1991. The move to independence precipitated a war in Bosnia-Herzegovina that lasted from 1992 until the signing of the Dayton cease-fire agreement on October 10, 1995. Following the cease-fire, Bosnia-Herzegovina was faced with keeping the peace and restructuring its war-torn economy. The Dayton Agreement viewed economic rehabilitation and reconstruction as an essential element in achieving peace. The Agreement negotiators believed that the people must have an economic stake in the process; therefore, economic reconstruction, economic institution building, and promotion of a market economy were deemed to be major factors in ensuring lasting peace.

In 1996, there were signs of economic recovery such as repairs to basic infrastructure. However, many key economic institutions and businesses were not fully functioning. The country's banking system was technically insolvent and burdened with non-performing loans. On March 29, 1996, the House Joint Resolution 170 (Public Law 104-122) appropriated $198 million for assistance to Bosnia-Herzegovina to address some of these concerns. These funds were to be used for economic revitalization ($145 million); police training and monitors ($45 million); demining ($5 million); and operating expenses ($3 million).

USAID became involved in May 1996 when the Assistant Administrator for the Bureau of Europe and the New Independent States authorized the five-year $278 million Bosnian Reconstruction Finance Facility (BRFF) program. These funds were to be used for financial support of post war reconstruction and economic revitalization, as well as for increasing employment of the general population, refugees, and demobilized soldiers. On May 7, 1996, a grant agreement was signed between the United States and Bosnia-Herzegovina to obligate the program's initial $27.5 million. This amount was transferred by USAID to Bosnia-Herzegovina in July 1996. As shown in the following table, USAID has transferred a total of $194.9 million to Bosnia-Herzegovina.

SUMMARY OF OBLIGATIONS AND FUNDS TRANSFERS
AS OF SEPTEMBER 30, 1998

OBLIGATING DOCUMENT	AMOUNT (millions)	DATE OF FUNDS TRANSFER
Grant Agreement	$27.5	July 1996
Amendment #1	12.5	November 1996
Amendment #2	19.5	May 1997
Amendment #3	40.0	September 1997
Amendment #4	30.0	April 1998
Amendment #5	65.4	September 1998
Total Obligated and Transferred	$194.9	

Audit Objective

The objective of this concurrent audit was to determine whether USAID/Bosnia-Herzegovina and the implementing contractors used economic revitalization assistance funds designated for the Bosnian Reconstruction Finance Facility Program for the purposes authorized under the Grant Agreement and Public Law 104-122.

The Office of the Inspector General has issued periodic reports on the Bosnian Reconstruction Finance Facility Program. This report is the seventh such report on the program.[1] Appendix I contains a discussion of the scope and methodology for the audit.

[1] See Audit Report Nos: B-168-97-002-P, dated March 26, 1997; B-168-97-006-P, dated June 27, 1997; B-168-98-001-P, dated October 10, 1997; B-168-98-004-P, dated March 26, 1998; and B-168-99-001-P, dated October 30, 1998. Also, see Memorandum Report No. B-168-98-003-S, dated July 21, 1998.

Audit Findings

Did USAID/Bosnia-Herzegovina and the Implementing Contractors Use Economic Revitalization Assistance Funds Designated for the Bosnian Reconstruction Finance Facility Program for the Purposes Authorized Under the Grant Agreement and Public Law 104-122?

For the items tested, USAID/Bosnia-Herzegovina and the implementing contractors were using the economic revitalization assistance funds designated for the Bosnian Reconstruction Finance Facility (BRFF) program for the purposes authorized under the grant agreement and Public Law 104-122.

BRFF Program—What can funds be used for?

Bosnia-Herzegovina's physical infrastructure sustained extensive damage during the war. Reconstruction requires financial resources and long-term credit for the rehabilitation and revitalization of Bosnian businesses, which could then offer sustainable employment opportunities for the general population, especially demobilized soldiers and refugees. In response to this requirement, USAID designed the BRFF program, a $278 million balance-of-payments initiative intended to "jump-start economic growth and generate employment opportunities for the general population." The program was officially initiated with the signing of the grant agreement on May 7, 1996. Of the planned $278 million available for the BRFF program through fiscal year 1998, $256 million was allocated for the loan program and $22 million for technical assistance, training, and support costs.

Loan Program. To implement the BRFF program, USAID signed a task order with Development Alternatives, Inc., (hereafter referred to as Development Alternatives) on May 16, 1996, to establish and operate Business Finance.[2]

As the primary implementor of the BRFF loan program, Business Finance, with offices in Sarajevo, Tuzla, Banja Luka, and Brcko, recommends loans to USAID/Bosnia-Herzegovina for approval. The task order set targets of $45 million in loan recommendations which were expected to create 6,750 jobs through December 31, 1996. After that time, USAID/Bosnia-Herzegovina expected Business Finance to recommend $10 million in loans per month, which would generate 1,500 jobs per month. These targets were formalized with Development Alternatives in a task order modification that became effective on May 1, 1997, and were continued in a subsequent contract with Development Alternatives that expired on September 30, 1998. Through the contract's expiration date, USAID expected a cumulative total of $255 million in Business Finance loan recommendations, resulting

[2] Formerly known as the On-Lending Management Unit.

in 38,250 new jobs. The Barents Group, the new contractor, assumed responsibility for Business Finance on October 1, 1998.

Technical Assistance. Development Alternatives' task order also provides for training of Bosnian commercial bankers to help strengthen the Bosnian banks' ability to meet the credit requirements of the emerging private commercial sector.

In addition to creating Business Finance, USAID also signed a task order on June 28, 1996, with The Recovery Group to provide assistance to businesses seeking loans from the BRFF and World Bank credit programs and to assist enterprises in achieving long-term viability. To meet its objectives, The Recovery Group established Business Consulting[3] which now has offices in Sarajevo, Tuzla, Banja Luka, and Brcko.

BRFF Status—What were funds used for?

Loan Program. Generally, borrowers are financing building reconstruction, equipment purchases, raw material acquisitions, and some operational expenses with the loan proceeds. Since the program's inception through September 30, 1998, USAID/Bosnia-Herzegovina approved 377 loans (totaling $138.1 million) of the 396 loans (amounting to $149.5 million) that Business Finance recommended. USAID/Bosnia-Herzegovina obligated and disbursed $194.9 million to the Government of Bosnia-Herzegovina to assist with their balance of payment needs. (See Appendix V for details on budgeted, obligated and disbursed amounts.) The Government of Bosnia-Herzegovina disbursed $101 million for 264 of the 377 approved loans.

The $149.5 million in loans that Business Finance recommended to USAID/Bosnia-Herzegovina since the beginning of the program fell short of the targeted amount of $255 million, which resulted in approximately 19,000 fewer estimated loan-generated jobs than expected.

During this six month period, Business Finance recommended 136 loans totaling $33.8 million, which was expected to create about 2,800 jobs. Business Finance fell short of the targets by approximately $26 million and 6,000 jobs.

In previous reporting periods, shortfalls were attributed to a systems and personnel restructuring intended to streamline loan production and a shortage of lending officers available to analyze and process applications. During this reporting period, Business Finance was unable to maintain the momentum of the prior six month period. Loan volume was significantly short of the six month

[3] Formerly known as the Bosnia Business Assistance Center.

target and, in fact, decreased from about $54.5 million in the previous six months to $33.8 million for this six month period. According to program personnel, this shortfall was the result of factors such as:

- Contract expiration and associated close-out activities that disrupted loan activities
- Reorganization of the Business Finance lending structure
- Increased emphasis on loan restructures and foreclosures
- Increased emphasis on lending smaller amounts to smaller enterprises.

Technical Assistance. According to Business Finance's September 30, 1998 training report, its training division sponsored 35 seminars and work shops in Tuzla, Sarajevo, and Banja Luka for 610 bankers, prospective borrowers, consultants and Business Finance staff during this six month period. Since the program began, Business Finance has sponsored 124 events for a total of 2,992 participants. The seminars included such courses as "Counting on Your Banker", "Managing the Loan Portfolio", and "Financing the Small Business." The Training Unit also presented workshops on loan monitoring to representatives of the agent banks and continued the "Senior Lending Associate Program" covering advanced credit analysis and loan structuring for in-house staff.

Business Consulting reported that since the inception of the program through September 30, 1998, it had prepared 517 diagnostics, formerly referred to as loan application supporting documentation. The organization also completed 519 performance improvement projects designed to help enterprises restart and strengthen operations and establish initial viability and direction. Business Consulting was achieving its targets for diagnostics and projects.

At the end of the last reporting period, Business Consulting also launched a turnaround consulting practice, designed to turnaround certain borrowers who were having problems in specific areas, e.g. marketing. Through September 30, 1998, Business Consulting reported that it completed 29 turnaround actions. Business Consulting closely coordinates its turnaround efforts with Business Finance.

As of September 30, 1998, Business Consulting completed its original contract period for the program. For the next six months, Business Consulting will operate under a "no-cost" extension period granted by USAID.

(See Appendix III for detailed information on the status of the BRFF program.)

Results of Audit Tests

Our audit this reporting period focused on the status of loan activities and assessed the adequacy of loan monitoring efforts. A sample of agent banks and borrowers in the Sarajevo, Tuzla, and Banja Luka areas were visited. In performing our audit, we also reviewed and tested the audit results of Business Finance's Internal Audit Unit. Satisfied with the auditors' qualifications and independence, we concluded that we could rely on the results of the auditors' work. The audit unit, consisting of an American audit manager and two Bosnian auditors, performs site visits to agent banks and borrowers, and reviews operations within the Business Finance organization. We believe that this unit is playing an important role in ensuring accountability for this USAID-funded program. (Appendix I contains a more detailed description of our audit scope and methodology.)

During this reporting period, Business Finance's Internal Audit Unit visited a judgmental sample of 46 borrowers; we visited 3 additional borrowers. Since the program began, 109 of the 254 borrowers have been visited; the Business Finance Internal Audit Unit conducted 60 visits and RIG/Budapest auditors made 49 visits. When appropriate, reconstruction work and equipment purchases funded by the loan proceeds at the borrowers' place of business were inspected. Also during this period, the Business Finance Internal Audit Unit visited two agent banks while RIG/Budapest visited one agent bank. These three banks handled 77 loans totaling $21.3 million.[4] Since the inception of the program, we have visited 19 of the 23 agent banks. Where appropriate, compliance with the loan procedures and the agreements with agent banks was tested. (Appendix IV contains more detail on the results of our site visits.)

Although some of the 49 borrowers visited were prospering in this high-risk emergency lending environment, others were experiencing problems. Anticipated market demand had not materialized or production activity was delayed or reduced for 16 of those borrowers. Other problems were also noted. For instance,

- 3 borrowers did not respect loan agreement covenants about additional debts
- 3 borrowers did not use loan funds according to agreed-upon plans

[4] In addition, Business Finance formed a team to conduct agent bank evaluations. Team members visited 30 banks (21 active, 6 inactive, 3 new) during the period. While noting numerous problems with the capabilities of the banks, the team recommended that most banks continue to participate in the program.

- 7 borrowers did not document loan fund usage as required
- 19 borrowers did not repay loan indebtedness on time.

The Business Finance Internal Audit Unit noted that more aggressive monitoring by Business Finance and the agent banks would have prevented or lessened some of these problems.

At the completion of our field work, we issued Report of Audit Finding No. 9 on March 5, 1999 which addressed the inadequate loan monitoring by Business Finance staff and the agent banks participating in the BRFF Program. Due to the significance of our preliminary finding, we have included the details in this section, along with a summary of the Mission's response as to the corrective actions being taken.

Loan Monitoring Problems. Although crucial monitoring tasks have been carried out by the Business Finance field associates and agent bank personnel, problems with loan monitoring in the BRFF Program continue. A Business Finance credit audit conducted in the summer of 1998 found that earlier loans received virtually no monitoring for up to a year after approval. Over the past year, efforts to address this problem have been inadequate.

In early 1998, Business Finance began hiring field associates to monitor agent banks and borrowers. Specifically, the field associates were to track the borrowers' use of loan proceeds by visiting sites; collecting from delinquent borrowers; and, working with agent banks through the review and grading of agent bank quarterly monitoring reports. In practice, however, the field associates' role shifted to include assisting the lending associates in generating loans. As of February 1999, Business Finance had 12 field associates operating under the guidance of lending teams.

The agreements between Business Finance and the participating agent banks assign bank personnel the task of loan origination and servicing. An important component of servicing is monitoring the loan to ensure that loan proceeds are used for the agreed-upon purposes and are repaid in accordance with the terms of the loan agreement. In practice, however, these monitoring efforts have been inconsistent and often ineffective. For example, a member of a Business Finance lending team noted that the role of the agent banks is to inform Business Finance about early warning signals of potential borrower problems, but in many cases banks chose not to—or even refused to—say anything about a misuse of funds.

An external evaluation conducted during the summer of 1998 reported that loan monitoring was ambiguous, and that there was a need for Business Finance and agent banks to generate more effective loan monitoring, follow-up, and intervention procedures within the limitations of available resources.

A December 1998 Business Finance monthly report noted the need to work better with the agent banks to improve disbursement procedures and quarterly monitoring. For example, the report referred to the case of a borrower where problems with invoice verification could have been avoided with better monitoring by both the agent bank and Business Finance staff.

The 1998 Business Finance credit audit found that site visitation reports by field associates were not widely read or analyzed by Business Finance staff. A February 1999 Business Finance internal audit memo noted that the quality and quantity of monitoring efforts needed considerable improvement in order to provide any real benefit to Business Finance. For instance, the memo stated that there were more visits to a particular borrower in the past few months, but the quality of the work was so poor that the visits provided little, if any, added value or benefit to Business Finance.

A June 1998 Business Finance memo noted that it was evident that many agent banks needed additional training in monitoring borrowers and completing monitoring reports. The Business Finance 1998 credit audit noted that the reliability of financial data varied in quarterly monitoring reports. For example, the credit audit report found that the quarterly monitoring reports neither initiated actions to correct the deficiencies noted, nor provided for follow-up. The credit auditors felt that the lack of early monitoring in the program and consistency in report information were the most serious deficiencies. The external consultants who evaluated the agent banks in the summer of 1998 also noted weaknesses in the quality of these reports. In February 1999, internal audit reports noted that the monitoring reports of Tuzlanska and IKB Banks were not timely and did not contain adequate analysis and/or useful information. Through our discussions and review of documents, we confirmed these observations.

Lack of Effective Supervision and Training in Loan Monitoring. According to program personnel, a significant cause of the inadequate monitoring in the BRFF program is the lack of effective supervision and training of the field associates and agent bank personnel. In contrast, the Business Finance Internal Audit Unit has performed 79 initial and repeat site visits using standard methodologies. Their knowledge and experience should be fully utilized to improve loan monitoring.

Program's Success At Risk. As shown below, we believe that a combination of more loans, in smaller amounts, and inadequate monitoring could lead to the collapse of the program unless these deficiencies are addressed immediately. For example, we observed a significant trend toward making smaller loans than earlier in the program . We found that the average amount recommended for approval from the start of the program until September 30, 1998, was $425,000. However, the average size in the fourth quarter of 1998 was $187,000. We also noted that delinquent loans have increased substantially since the program began. The delinquency rate was about 18 percent as of September 30, 1997, and increased to 35 percent a year later. The rate rose to 47 percent as of January 31, 1999, and grew to 50 percent by February 28, 1999.

Inadequate monitoring is likely to be a major contributing factor in the high delinquency rate. At a conference of micro lending institutions held in Sarajevo in February 1999, conference presenters stressed that most delinquencies are caused—not by bad borrowers—but by credit institutions that have not implemented an effective methodology (e.g., stringent monitoring of borrowers). Business Finance also noted in its 1998 fourth quarter progress report that constant monitoring of the borrower is vital to loan collection.

A group of external consultants visited and evaluated most of the agent banks in the summer of 1998. Their report noted that none of the banks they evaluated had the short-term capacity to double or triple its current Business Finance portfolio. Rapid portfolio growth would likely be accompanied by a deterioration in asset quality, as loans recommended to Business Finance are supported by less thorough analyses, and are monitored in an increasingly cursory manner. In addition, if the average loan size continues to fall, as expected with the introduction of the small loan program, agent bank responsibilities will increase substantially. The consultants' report concluded that none of the agent banks are prepared for such an expansion of responsibilities—especially monitoring. More loans in Business Finance's portfolio, under current conditions, would likely produce a greater risk level than that presently faced.

Our Preliminary Recommendations. In our preliminary finding, we recommended that USAID/Bosnia-Herzegovina ensure that Business Finance improves loan monitoring by rotating its field associates through the Business Finance Internal Audit Unit for supervision and training in monitoring, and by enhancing the quality and quantity of the agent bank monitoring efforts through intensive mentoring and training. We also recommended that USAID/Bosnia-Herzegovina suspends or drastically curtails approval of new loans until loan monitoring improves significantly.

Mission's Response. The Mission responded to our preliminary audit findings and recommendations by clarifying and tightening monitoring and risk management requirements. Specifically, the Mission advised us, in a memo dated March 19, 1999 that they were taking the following actions:

- With substantial input from Business Finance, the Mission developed a plan to immediately improve loan monitoring. The monitoring role of field associates will be upgraded and clarified. All field associates will undergo training, supervision, and periodic testing by the Business Finance Internal Audit Unit. In addition, Business Finance is coordinating a new monthly borrower contact monitoring program with Business Consulting.

- The new agent bank coordinator will prepare and implement a detailed plan for upgrading the monitoring efforts of the agent banks.

- With respect to our recommendation that the Mission suspends or drastically curtails the approval of new loans until loan monitoring significantly improves, the Mission advised us that it would not be in the best interests of the program to cease new loan activity. However, new loan production has been reduced, and will continue until the delinquency rate decreases. According to the Mission, the focus will be more on loan quality rather than quantity. Business Finance will keep the credit standards of new loan recommendations tight. They will limit proposals to a risk rating of five or better, and be very cautious about recommending startups. In addition, Business Finance seeks to improve the quality of existing loans by working on specific strategies for dealing with each of the 119 problem and potential problem loans in the portfolio.

As the Mission is taking appropriate corrective action in response to our preliminary recommendations, we have not included these recommendations in our formal recommendation tracking system. However, we will continue to review the adequacy of loan monitoring during our future audit work on this program.

Management Comments and Our Evaluation

USAID/Bosnia-Herzegovina officials agreed with the content of the report and their comments are included as Appendix II to this report. In its response, USAID/Bosnia-Herzegovina noted the specific actions being taken to significantly improve the monitoring of loans in this program. The Mission is clarifying and tightening monitoring and risk management requirements.

The new requirements include upgrading the monitoring role of the Field Associates as well as their training, supervision, and periodic testing by the Business Finance Audit Unit. Also included is an intensified focus on enhancing the quality and quantity of agent bank monitoring efforts through Business Finance targeted training and mentoring. The rate of new loan production has been reduced and significant program changes have been made to focus more on loan quality than quantity.

Scope and Methodology

Scope

The Office of the Regional Inspector General/Budapest is conducting a concurrent audit of USAID's Bosnian Reconstruction Finance Facility (BRFF) program activities in Bosnia-Herzegovina in accordance with generally accepted government auditing standards. We conducted the audit from June 1, 1998, through February 27, 1999, at the USAID office in Sarajevo, and at the Business Finance and Business Consulting offices in Sarajevo and Banja Luka. During this reporting period there were visits to 49 borrowers and 3 agent banks in areas around Sarajevo, Banja Luka, and Tuzla. Several were visited more than once. We visited three borrowers and one bank, while the Business Finance Internal Audit Unit conducted the balance.

In conducting our audit, we substantially utilized the work of the Business Finance Internal Audit Unit. In order to rely on their work, we reviewed the generally accepted government auditing standards pertaining to an auditor's reliance on the work of other auditors. In accordance with those standards, we were satisfied as to the auditors' competence and objectivity. We also evaluated and tested their work through inquiries and reviews of internal audit reports, working papers and audit methodologies.

We did not audit the three BRFF program bank accounts maintained by the Central Bank of Bosnia-Herzegovina (formerly the National Bank) during this period. Also, we did not audit the program's financial statements shown in Appendix V. We did perform limited work on The Recovery Group's Business Consulting activities.

Methodology

Audit methodology included file reviews, interviews, field visits and data analysis. We reviewed amendments to the Grant Agreement Between Bosnia-Herzegovina and the United States of America for Reconstruction Finance Facility; program documents; and contracts to determine BRFF program objectives and restrictions. We reviewed accounting records and tested compliance with the loan procedures and the agent bank agreements to assess whether internal control procedures were adequate and being followed. We interviewed USAID, contractor, and agent bank officials, as well as borrowers, about problems they experienced in the program, and the adequacy of actions taken to address these problems.

In the current reporting period, there was a judgmental selection of 49 first visits to borrowers and one repeat visit. We conducted three first visits. Of the 254 borrowers who have received loan disbursements since the inception of the program, 109 borrowers have been visited once and 24 have had repeat visits. We conducted 49 first visits and 5 repeat visits. (See table below.) The visits were conducted to verify the existence of the borrowers' businesses and their use of the loan proceeds. Equipment and raw material purchases and reconstruction efforts that were funded by the loan proceeds were observed during these visits.

	Current Period			**Cumulative**		
	First Visits	**Repeat Visits**	**Total**	**First Visits**	**Repeat Visits**	**Total**
RIG/ Budapest auditors	3	0	3	49	5	54
BF internal auditors	46	1	47	60	19	79
Total	49	1	50	109	24	133

Since the program began, we have visited 19 of the 23 agent banks that disbursed loans. When appropriate, documentation was reviewed to determine how the banks were monitoring the use of the proceeds, as well as the agent banks' internal records of receipt and disbursement of loan proceeds. There was also a selective review of invoices submitted by the borrowers for purchases made using loan proceeds.

USAID

United States Agency for International Development
Sarajevo, Bosnia and Herzegovina

July 26, 1999

MEMORANDUM

TO: James R. Bonnell, RIG/Budapest

FROM: Craig G. Buck, Mission Director /s/

SUBJECT: Audit of USAID/Bosnia-Herzegovina Bosnian Reconstruction Finance Facility Program (BRFF): for the period April 1, 1998 through September 30, 1998

Thank you for bringing to our attention your preliminary finding on the monitoring of loans in our BRFF program. It has provided us with an opportunity to scrutinize intensively the related monitoring acitivities of both our Business Finance (BF) and Business Consulting (BC) contractors.

Based on your findings we have clarified and tightened monitoring and risk management requirements, effective immediately, as summarized below. The new requirements include upgrading the monitoring role of the Field Associates as well as their training, supervision, and periodic testing by the BF Audit Unit. And they include an intensified focus on enhancing the quality and quantity of agent bank monitoring efforts through BF targeted training and mentoring. Targets will be based on specific needs identified by the Audit Unit and active relationship management by expatriate Team Leaders. Additionally, at its own initiative over the past several months, the BF has prepared specific strategies for each of the problem or potential problem loans. Thus we believe the range of monitoring activities to which the BF is committed will be adequate and covers every reasonable means available.

With respect to your preliminary recommendations, we had already reduced the rate of new loan production, and will continue at this reduced pace. We have also made significant program changes to focus more on loan quality rather than quantity. There is still room for improvement, but curtailing lending any further at this point could not only create program problems but might pose contractual problems as well.

Specifically, the Mission has informed the BF we will be holding them accountable for the primary monitoring activities summarized below as well as all others elaborated in a separate memorandum:

1. The monitoring role of Field Associates has been upgraded and clarified in detailed position descriptions along with separate position descriptions for Lending Associates that also include explicit monitoring responsibilities. All field Associates are being trained by the BF Audit Unit which also tests them periodically.

2. A detailed plan for upgrading the monitoring efforts of the agent banks was submitted by 3/31/99 and is being implemented.

3. Until further notice, the BF will keep the credit standards of new loan recommendations tight by limiting proposals to a risk rating of 5 or better while being very cautious about submitting any greenfield or startup recommendations.

4. With respect to the problem or potential problem loans for which strategies had been reviewed and established by 3/31/99, the BF has identified the most problematic cases not already under foreclosure/litigation for immediate action and related publicity.

5. The BF's new monthly borrower contact monitoring program is being closely coordinated with Business Consulting and reviewed weekly in a joint BF and BC meeting with Mission staff. Specific types of monitoring contacts by various levels of staff are now summarized and indicated in the BF's monthly reports.

6. The BF Chief of Party and Auditor now meet monthly with Mission staff to review monitoring efforts as well the status of BF audit findings.

We look forward to your continued review of our monitoring efforts.

Audited Status of the Bosnian Reconstruction Finance Facility *as of September 30, 1998*

The Bosnian Reconstruction Finance Facility (BRFF) program, a five-year, $278 million balance-of-payments initiative, approved by the Assistant Administrator for the Bureau of Europe and the New Independent States on May 3, 1996, is intended to "jump-start economic growth and generate employment opportunities for the general population, including refugees and demobilized soldiers." The BRFF grant agreement, signed on May 7, 1996, provides balance-of-payments assistance to Bosnia-Herzegovina to aid postwar reconstruction, provide credit to the industrial and commercial sectors, and generate employment.

On May 16, 1996, USAID signed a task order with Development Alternatives to establish and operate Business Finance[5] and provide intensive, in-country commercial banker training. Development Alternatives' team arrived in Sarajevo on June 13, 1996, to begin implementing the program. Their final contract expired September 30, 1998. The new contractor, The Barents Group, assumed responsibility for Business Finance on October 1, 1998.

Business Finance, composed of a team of experienced U.S. bankers, accountants, and Bosnian staff has its headquarters at the Central Bank of Bosnia-Herzegovina, and is the primary administrator of the BRFF program. Some of Business Finance's responsibilities include reviewing and recommending loan applications for approval; managing BRFF's lending operations; and monitoring and managing the flow of funds between the BRFF program, the borrowing enterprises, and the agent Bosnian commercial banks, which are licensed by the Central Bank. Agreements between the two allow the commercial banks to function as agents for Business Finance, and submit client loan applications. Business Finance also works with the Bosnian commercial banks to help educate them in market-oriented lending policies and credit evaluation techniques to assist in developing a capable financial sector.

In addition to creating Business Finance, USAID signed a task order on June 28, 1996, with The Recovery Group to help Bosnian businesses prepare and present proposals to Business Finance and

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[5] Formerly known as the On-Lending Management Unit.

to assist enterprises in restarting and strengthening their operations. To implement its objectives, The Recovery Group established Business Consulting[6] with headquarters in Sarajevo.

BRFF Program Plan

Although the BRFF program is a five-year program, its planned $278 million budget covers only a three-year period. According to the BRFF program authorization document, $278 million was budgeted through fiscal year 1998, with $256 million allocated for the lending program and $22 million for technical assistance and implementation costs.

The BRFF program also provides training for Bosnian commercial bankers concentrating on loan structuring and risk assessment. This training is intended to strengthen the Bosnian commercial banks' ability to meet the credit requirements of the emerging private commercial sector.

BRFF Program Status

Since the program's inception, $228 million of the $278 million budget has been obligated, and $224.3 million has been disbursed. Of the $228 million obligated, $194.9 million went toward loans, while the remaining $33.1 million was allocated for technical assistance and program implementation. (See Appendix V.)

Loan Program. Business Finance is responsible for reviewing and assessing credit risk on all loan applications and recommending viable loans to USAID/Bosnia-Herzegovina for approval. After USAID/Bosnia-Herzegovina approves the loan, it can be disbursed by the Central Bank of Bosnia-Herzegovina with USAID's approval. During the six month period ended September 30, 1998, Business Finance recommended 136 loans valued at $33.8 million to USAID/Bosnia-Herzegovina. These recommendations anticipated an increase of approximately 2,800 new jobs. The Central Bank disbursed funds for 103 loans, which totaled $31.4 million.

Since the BRFF program began, USAID/Bosnia-Herzegovina approved 377 loans totaling $138.1 million. The Central Bank disbursed $101 million for 264 of the approved loans. Loan proposals classified as "prospective" can potentially be recommended to USAID/Bosnia-Herzegovina for approval. Business Finance's cumulative lending activity is shown as follows:

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6 Formerly known as the Bosnia Business Assistance Center.

BRFF LOAN SUMMARY AS OF SEPTEMBER 30, 1998

Status of Loans	**Number of Loans**	**Amount[7] (millions)**
Applications		
Recommended by Business Finance[8]	424	$165.4
Prospective[9]	55	26.0
Rejected[9]	400	142.2
TOTAL	879	$333.6
Recommended by Business Finance[8]		
Approved by USAID/B-H	377	$138.1
Awaiting approval by USAID/B-H	19	11.4
	396	$149.5
Not Approved by USAID/B-H	28	15.9
TOTAL	424	$165.4
Approved by USAID/B-H		
Disbursed	264	$101.0
Not Yet Disbursed	113	37.1
TOTAL	377	$138.1

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[7] Loan amounts are recorded and disbursed in Deutsche Marks, a medium of exchange in Bosnia-Herzegovina. Loan totals were converted using a weighted average exchange rate of 1.6894 Deutsche Marks to $1.

[8] For discussion purposes in our report, we have considered loan recommendations by Business Finance to consist of those recommended loans which were approved or are awaiting approval. We have presented the loans not approved for information purposes only.

[9] Information obtained from Business Finance's September 30, 1998, report.

Development Alternatives' task order set targets of $45 million in loan recommendations which were expected to create 6,750 jobs through December 31, 1996. After that time, USAID/Bosnia-Herzegovina expected Business Finance to recommend $10 million in loans per month, which would generate 1,500 jobs per month. These targets were formalized with Development Alternatives in a task order modification that became effective on May 1, 1997, and were continued in a subsequent contract with Development Alternatives that expired on September 30, 1998. Through the contract's expiration date, USAID expected a cumulative total of $255 million in Business Finance loan recommendations, resulting in 38,250 new jobs. The Barents Group, the new contractor, assumed responsibility for Business Finance on October 1, 1998.

A comparison of the targets to actual results from inception through September 30, 1998 is shown in the following table.

	Targeted	**Actual**	**Shortfall**
Recommended Loans	$255 million	$149.5 million	$105.5 million
Associated Jobs	38,250	19,216	19,034

Business Finance recommended the approval of $149.5 million in loans, achieving only 59 percent of the targeted amount of $255 million, or falling short by 41 percent. The disbursed loans were expected to generate 19,216 jobs, or 50 percent of the targeted 38,250 jobs, leaving a shortfall of 50 percent.

In previous reporting periods, shortfalls were attributed to a systems and personnel restructuring intended to streamline loan production and a shortage of lending officers available to analyze and process applications. During this reporting period, Business Finance was unable to maintain the momentum of the prior six month period. Loan volume was significantly short of the six month target and, in fact, decreased from about $54.5 million in the previous six months to $33.8 million for this six month period. According to program personnel, this shortfall was the result of factors such as:

- Contract expiration and associated close-out activities that disrupted loan activities
- A Reorganization of the Business Finance lending structure
- An Increased emphasis on loan restructures and foreclosures
- An Increased emphasis on lending smaller amounts to smaller enterprises.

Business Finance sends monthly bills to both the borrowers and the agent banks. Borrowers make interest and/or principal payments to their agent bank which then wires the money to the Central Bank's Bank of America repayment account. The funds in the repayment account have been used for future lending. The interest and/or principal repayments are tracked and recorded by Business Finance. According to a Business Finance delinquency report as of September 30, 1998, 68 borrowers were delinquent—an increase of 22 from the March 31, 1998 report. Business Finance plans to review each borrower's situation and attempt to work out a solution or restructure the loan. Business Finance has formed a loan restructuring and workout group and has already restructured some loans to facilitate repayment.

Technical Assistance. Business Finance reported that a cumulative total of 124 seminars and workshops have been completed in Sarajevo, Tuzla, and Banja Luka for a total of 2,992 bankers, prospective borrowers, consultants, and internal staff. Topics included:

- Counting on Your Banker.
- Advanced Credit Seminar.
- Managing the Loan Portfolio.
- Financial Analysis and Business Planning.
- Financing the Small Business.

Audit Test Results

The chart below details visits to agent banks and borrowers. An asterisk (*) indicates organizations visited by RIG/Budapest. Except for the organizations visited by RIG/Budapest, information in "Comments/Exceptions Noted" was obtained from the Internal Audit unit.

Visits to Agent Banks[10]

Agent Bank	No. Of Loans	Total Loan Amount (millions)	Comments, If Applicable
1. Gospodarska	21	$ 6.2	
2. Kristal *	35	$ 10.3	Bank had not prepared quarterly monitoring reports as Business Finance had not provided any instruction. Subsequently, Business Finance provided a one day training session on the preparation of monitoring reports.
3. Export	21	$ 4.8	

[10] Actual records and documents reviewed did not always total the loan amount as many borrowers had not used all of the loan proceeds.

Visits to Borrowers

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
1.	Central Profit	591,926	Working capital, purchase of pharmaceutical equipment and reconstruction works for the production facility.	All equipment has been bought and reconstruction works have been completed. However, borrower has not respected loan agreement covenants. Without BF approval, borrower took out additional loans totaling about $2.6 million.
2.	Gospodarska	189,416	Purchase of equipment for a bakery.	New equipment has been delivered but part has been returned to supplier as it did not meet specifications; thus, production has not started yet.
3.	Central Profit	591,926	Purchase of equipment and reconstruction works for a sawmill.	All required equipment has been delivered; reconstruction works are in process. Borrower lacks market for products. Without BF approval, borrower took out additional loan to make BF loan repayments.
4.	Central Profit	532,734	Working capital, purchase of machines and reconstruction works for a clothing production facility.	Insufficient documentation to establish usage of loan funds. Liquidity problem exists as products are seasonal in nature; resorts to short-term loans to meet cash needs. Past due on principal and interest payments.
5.	Central Profit	591,926	Working capital and purchase of equipment for the production of sheep skin slippers, thread and blankets.	Cash is tied up in large amount of receivables and huge inventory. Past due on principal and interest payments.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
6.	Komercijalna	532,734	Purchase of fruit and vegetable processing equipment and construction works for a food processing and cold storage warehouse.	Equipment for juice production had not been delivered at time of visit so that production had not started yet.
7.	IKB	473,541	Working capital, purchase of equipment in the retreading of tires and construction works for the production facility.	Loan proceeds were used to reimburse the borrower for payments of raw materials, equipment and construction works; current on payments but may have future problems with repayment of loan due to customers' lack of liquidity and existence of other loans becoming due.
8.	Komerc	1,479,815	Working capital and purchase of equipment for the manufacture of auto parts.	Production is expected to start in a few months when the remaining equipment is delivered and installed; in the meantime, borrower might have short term cash flow problems.
9.	Komercijalna	355,156	Purchase of meat processing equipment and construction works for the slaughter house and production facility.	Most equipment has been delivered and the construction works are almost completed. Borrower past due on payments; loan has been restructured.
10.	Komercijalna	828,697	Working capital and purchase of equipment for the production of bread.	Some of the equipment had not been delivered at time of visit so production on those machines had not started yet.
11.	Komercijalna	414,348	Working capital, purchase of broiler and egg production equipment and reconstruction works for the production facilities.	No problems noted except for initial difficulty in marketing the borrower's products due to uncontrolled import of such products; protection measures have since been introduced by the government.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
12.	Komercijalna	177,578	Working capital and purchase of sawmill and wood processing equipment.	No problems noted except for possible future problem in procuring raw materials. Every shipment of logs would require the borrower to pay 100 percent in advance; if borrower has some cash flow problem, he might not be able to procure the raw materials which would halt production.
13.	Komecijalna	236,770	Working capital and purchase of equipment for the production of lumber, furniture and other wood products.	Awaiting delivery of balance of equipment. Has long term agreements for delivery of products.
14.	Komercijalna	591,926	Working capital, purchase of equipment and construction works for the production of livestock feed and grain.	Delay in equipment delivery which cost the borrower an additional amount as custom duties on imports of equipment increased. Grain production not started yet but borrower already repaid 20 percent of loan from flour sales. Construction costs appear overestimated.
15.	Komercijalna	514,976	Working capital, equipment, and building costs for the production of broilers, eggs, and fodder.	Factory partly complete. Formed new company and not making loan payments. Loan documents unavailable at visit.
16.	Komercijalna	887,889	Working capital and equipment costs for cement production.	Funds used as planned. Borrower is selling his cement and making timely loan repayments.
17.	Komercijalna	207,174	Working capital, purchase of logging and sawmill equipment and construction works for the sawmill facility.	Most equipment has arrived and is being installed. Documentation incomplete. Slipping behind on payments.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
18.	Komercijalna	224,932	Working capital, purchase of equipment and construction works for the manufacture of aluminum windows and door frames.	Equipment had arrived but had not been installed at time of visit so new production line had not begun. Funds used as planned and is current on payments.
19.	Komercijalna	272,286	Working capital, purchase of equipment and construction works for the production of cut lumber.	Noted poor maintenance of records and incomplete documentation for certain purchases made from the proceeds of the loan. Awaiting delivery of equipment after construction is completed.
20.	Komercijalna	414,348	Working capital and purchase of equipment for waffle production.	Borrower may face future difficulties in repaying the loan. Sales are low and competition is significant.
21.	Komercijalna	177,578	Purchase of equipment for the production of liquid detergents.	Equipment has been delivered but installation has not been completed.
22.	Komercijalna	144,430	Working capital and purchase of transportation equipment for the production of insulation materials.	Due to difficult business environment, borrower could not get any contract despite offering the most favorable terms. Plans to pay off loan when principal becomes due.
23.	Komercijalna	177,578	Working capital, purchase of equipment and construction works for the production of clothing.	No problems noted except that the borrower is engaged in low profitability jobs at time of visit and could have cash flow problems in the future.
24.	Komercijalna	207,174	Working capital, purchase of equipment in the production of eggs and construction works for the chicken farm.	Borrower requested additional loan to fund production of chicken food which comprises the bulk of production costs. By producing its own chicken food, borrower expects to reduce costs and be price-competitive. Slipping behind on principal and interest payments.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
25.	Komercijalna	621,522	Working capital, purchase of equipment for timber cutting, wood processing and production.	Borrower returned part of the loan because the agent bank refused to pay for equipment through a certain foreign trade company. As a consequence, borrower is requesting a new repayment schedule for the balance of the loan amount.
26.	Komercijalna	443,945	Working capital, purchase of equipment for the production of concrete and construction materials.	Borrower's premises were locked at time of visit. Equipment and raw materials have been purchased but appear to have not been delivered at time of visit as the borrower's property was empty. Additional visit confirmed that loan funds not used according to plan. Borrower is behind in payments. Foreclosure procedures have been initiated.
27. *	Kristal	414,348	Working capital, purchase of equipment and building improvements to a printing shop.	Partial delivery of equipment. Funds have been used as planned to date.
28. *	Kristal	118,385	Working capital, purchase of equipment and building renovations for the production of baked goods and ice cream.	Partial delivery of equipment. Funds have been used as planned to date.
29. *	Kristal	414,348	Working capital, purchase of equipment and building renovations for the fabrication of metal products.	Partial delivery of equipment. Funds have been used as planned to date.
30.	Komercijalna	41,435	Working capital, purchase of equipment and construction costs for the re-starting of broiler chicken production.	Funds have been used as planned. Making timely repayments of loan.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
31.	Komercijalna	56,233	Working capital, purchase of equipment and construction costs for the production of broiler chickens.	Documents unavailable as to usage of loan funds. Over half of funds not used one year after disbursement.
32.	Komercijalna	65,112	Working capital for the production of broiler chickens.	Funds used for working capital but documents unavailable as to specific usage. Minor amount used for construction repairs which was not as planned.
33.	Komercijalna	65,112	Working capital, purchase of equipment and construction costs for the production of broiler chickens.	Funds have been used as planned. Making timely repayments of loan.
34.	Vakufska	745,827	Working capital and construction costs for the manufacture of irrigation equipment.	Documents not available. Construction has been halted as borrower does not have proper permit.
35.	Komercijalna	65,112	Working capital, purchase of equipment and construction costs for the production of broiler chickens.	Funds are being used as planned. Borrower has requested authorization to reallocate a minor part of the funds.
36.	Komercijalna	769,504	Purchase of equipment to enable start up of a concrete plant.	Bank slow to disburse funds. Borrower willing to return entire loan if extension of grace period is not approved.
37.	Export	71,031	Working capital, purchase of equipment and construction costs for the manufacture of juice.	Funds spent according to plan. Borrower is selling juice and has made interest payments to date.
38.	Komercijalna	88,789	Working capital and the purchase of equipment for the manufacture of parquet and furniture.	Funds spent according to plan. Most equipment delivered and put into production. Timely interest payments made.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
39.	UPI	488,339	Working capital and the purchase of equipment for the production of paper.	Most funds have been spent according to plan. A small balance remains which will be spent shortly. Business is slow and borrower is slipping on payments.
40.	Komercijalna	76,950	Working capital, purchase of equipment and construction costs for the production of broiler chickens.	Funds have been spent according to plan. Borrower is current on payments.
41.	Universal	557,594	Working capital and the purchase of equipment for the processing of wood and furniture.	Part of the equipment and raw materials have been delivered. Borrower behind on payments. Borrower has taken on additional debt without BF approval. Bank has paid borrower interest on undisbursed funds.
42.	Privredna, Sarajevo	177,578	Working capital and the purchase of equipment for the production of concrete blocks.	Funds were spent according to plan. Business operating at less than 50 percent of capacity. Borrower behind in payments.
43.	UPI	591,926	Purchase of equipment for the production of bakery products.	Funds were spent according to plan. The wafer production line is not up and running now but payments are current due to other bakery goods.
44.	Sahinpasic	414,348	Working capital, purchase of equipment and construction costs for the production of flour and fodder.	Funds were spent according to plan except for a minor reallocation of funds to purchase additional wheat. Borrower is current with payments but would like a grace period extension due to a delay in factory start-up.
45.	Vakufska	2,308,512	Working capital, purchase of equipment and construction costs for the production of food.	Strong growth in borrower's business. Borrower is current on payments and would like additional loan to expand operations.

Borrower	Agent Bank	Loan Amt. $	Purpose of Loan	Comments/Exceptions Noted
46.	BH	248,609	Working capital, purchase of equipment and construction costs for the production of plastic products.	Funds were spent according to plan. Making timely interest payments to date.
47.	BH	562,330	Working capital and the purchase of equipment for general construction work.	Most funds have been spent as planned but equipment has not been delivered yet. Making timely interest payments to date.
48.	Privredna, Travnik	591,926	Working capital, purchase of equipment and construction costs for the production of shoes and boots.	Loan has been restructured after borrower fell behind in payments. Borrower in difficult financial situation due to cancellation of contracts.
49.	Privredna, Travnik	420,859	Working capital, purchase of equipment and construction costs for the processing of wood.	Bank delay in disbursement caused supplier cancellations. Equipment has been obtained but not yet installed. Current on interest payments to date.

Unaudited Bosnian Reconstruction Finance Facility Fund Accountability Statement *as of September 30, 1998*

The amounts that USAID/Bosnia-Herzegovina budgeted and obligated for the five-year Bosnian Reconstruction Finance Facility program are shown below; however, the program has a three-year budget. The amount obligated for the On-Lending Program represents the balance-of-payments support to Bosnia-Herzegovina. Of the $194.9 million transferred to Bosnia-Herzegovina, $101 million[11] has been disbursed as loans to borrowers. The disbursed implementation costs are amounts paid by USAID.

	3-Year Program Budget	Amount Obligated	Amount Disbursed
On-Lending Program	$256,000,000	$194,879,178	$194,879,178
Implementation Costs:			
Contractors	17,500,000	32,756,477	28,988,423
Audit, Program and Evaluation	1,500,000	0	0
Environmental Monitoring	600,000	0	0
USAID Program Management	0	388,096	385,933
Contingencies	2,400,000	0	0
Totals	$278,000,000	$228,023,751	$224,253,534

[11] Loans were disbursed in Deutsche Marks, a medium of exchange in Bosnia-Herzegovina. A total of 170.6 million Deutsche Marks were disbursed and converted using a weighted average exchange rate of 1.6894 Deutsche Marks to $1.