OFFICE OF INSPECTOR GENERAL

AUDIT OF THE OFFICE OF DEVELOPMENT CREDIT'S COMPLIANCE WITH FEDERAL REGULATIONS AND GUIDANCE

AUDIT REPORT NO. 9-000-14-003-P
August 19, 2014

WASHINGTON, D.C.

Office of Inspector General

August 19, 2014

MEMORANDUM

TO: E3/DC, Director, Michael Metzler

FROM: Assistant Inspector General for Audit, Nathan Lokos //s

SUBJECT: Audit of the Office of Development Credit's Compliance With Federal Regulations and Guidance (Report No. 9-000-14-003-P)

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

This report contains seven recommendations to help strengthen USAID's oversight of the Development Credit Authority program. Management decisions are pending on all seven recommendations.

Please provide written notice within 30 days of any actions planned or taken to implement these recommendations and target dates for completion of final action.

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

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SUMMARY OF RESULTS

According to USAID's Development Credit Authority (DCA), banks in many developing countries do not lend money easily. Instead, they invest much of their money in low-risk government bonds. However, when they do lend money, they typically lend it to established customers and impose high collateral requirements. As a result, many creditworthy borrowers who are not established customers or do not have access to high collateral cannot borrow money.

In 1998, Congress gave USAID the general authority to provide credit assistance for any of the development purposes specified in the Foreign Assistance Act of 1961. The following year, the Office of Management and Budget (OMB) certified USAID to administer credit assistance through DCA. Congress has renewed DCA every year since then.

DCA enables USAID's missions to issue partial credit guarantees to banks and financial institutions, particularly for loans in local currency that are backed by the U.S. Treasury. It promotes private sector investment by encouraging financial institutions to lend large reserves of private capital for projects benefitting long-term growth. Additionally, DCA builds the capacity of domestic financial institutions by reducing the risk of extending credit into new sectors. As a result, through the DCA, financial institutions can reduce collateral requirements, lengthen loan periods, and explore new markets with the safety of a credit guarantee. The guarantees cover debt transactions including term-loans, financial leases, wholesale loans, and a variety of other debt instruments. The guarantees typically cover up to 50 percent of the risk in lending to projects that advance USAID's development objectives.

DCA's partial guarantees make funds available to encourage local economic growth and encourage risk-averse financial institutions to lend to creditworthy, but underserved borrowers. By getting working capital to promising entrepreneurs and financing small farmers and others, DCA seeks to prove the commercial viability of underserved markets so that lending and investment continue long after USAID leaves a country.

From 1999 through the end of fiscal year (FY) 2012, USAID issued 378 guarantees worth $3.23 billion in 69 countries. The lenders that received the guarantees had in turn utilized or lent nearly $1.13 billion, or almost 34 percent. DCA guarantees have gone to entities in agriculture, water, energy, health, and microfinance, and to micro, small, and medium-size enterprises (MSMEs).

DCA is managed by the Office of Development Credit, and it issues four types of guarantees: bond, loan, loan portfolio, and portable.[1] Table 1 lists the number of each type of guarantee issued, the number of loans made through the different guarantees, the maximum amount that the lenders could distribute, and the actual amounts guaranteed since DCA started.

[1] A bond guarantee enables financial institutions, corporations, and other entities to issue bonds. A loan guarantee is used when the borrower, lender, and loan uses are known. A loan portfolio guarantee provides financial institutions with partial coverage of a portfolio of loans they provide to borrowers. A portable guarantee provides a potential borrower with a letter of guarantee that they can then present to lenders. It is then converted into a loan or bond guarantee.

Table 1. Distribution of Guarantees, 1999 Through FY 2012 (Audited)

Guarantee Type	Guarantees Issued	Total Loans	Planned Distribution ($ Million)	Utilization ($ Million)
Bond	12	7	233	122
Loan	47	41	188	129
Loan Portfolio	319	131,653	2,559	877
Portable	NA[1]	NA	248[2]	0
Total	**378**	**131,701**	**3,228**	**1,128**

[1] Portable guarantees are issued after they are converted into a loan or bond guarantee. Thus, issued portable guarantees are included in the loan or bond guarantee totals above.
[2] Planned distribution amount is the total of eight terminated or expired and seven active portfolio guarantees that were never actually issued as loan or bond guarantees.

This audit focused on loan portfolio guarantees because that category represents nearly 84 percent of all guarantees and almost all loans issued.

The Office of Inspector General (OIG) conducted this audit to determine whether the Office of Development Credit complied with federal regulations and guidance pertaining to credit loan guarantees. These regulations and guidance call for agencies to establish certain internal controls and comply with specific requirements, which the office did. For example, the office established the internal controls listed below that refer to and meet federal regulations and guidance for its partial credit guarantee program:

- A credit review board to review and approve guarantee packages prepared by the office.
- A financial management and reporting system.
- A process to calculate subsidy costs and perform annual reestimates.
- A risk assessment procedure for all proposed guarantee agreements.
- Guidance to review and approve claims, recoveries, and other related activities to ensure consistent work practices through the operations manual, portfolio monitoring guide, and plans to monitor guarantees.

Moreover, the office complied with specific requirements in federal regulations and guidance, such as the need to assess the risk posed by its guarantees. The office used guidance in its handbook to calculate the country, borrower, lender, and transaction risk scores in order to determine the overall risk score for its guarantees. The risk score was also used to calculate the subsidy cost (that missions pay), and origination and utilization fees (that banks pay). In addition, the office's risk assessment charged riskier borrowers more than those that pose less risk.

In addition, the office implemented actions on four recommendations issued in OIG's September 25, 2006, "Audit of USAID's Development Credit Authority" (Report No. 9-000-06-009-P). OIG had recommended that the office issue policies and procedures to verify the eligibility of loans,

clarify additionality[2] requirements for loans, clarify roles and responsibilities related to establishing and monitoring guarantee utilization rates, and issue guidance that missions review their unused subsidies as part of the ongoing monitoring process. The Office of Development Credit also has collaborated and consulted with mission officials and lenders consistently, as shown in the office's biennial reports, progress reports, trip reports, and monitoring reports. Mission officials said they were pleased with the office's support. Finally, in addition to the efforts of the office, USAID has issued agency-wide guidance concerning credit guarantees in its Automated Directives System (ADS). Specifically, USAID has two ADS chapters that apply to credit programs: ADS 249, "Development Credit Authority," and ADS 623, "Financial Management of Credit Programs."

Notwithstanding the program's positive aspects, the audit found certain areas for improvement.

- Banks did not utilize all available guaranteed amounts (page 5). In fact, many banks with active and expired loan portfolio guarantee agreements had not made any loans. This resulted in missions' subsidies being locked up and not available for other uses.

- The office did not always define or differentiate among micro, small, and medium-size enterprises (page 8). As a result, there may be greater risk that some small borrowers, such as microenterprises, would receive loans larger than they can successfully manage

- The office's 2009 operations manual did not include a section on audits, which had discussed the oversight options of performing on-site visits and conducting independent audits (page 9). The omission of this section may reduce the likelihood that these tools are fully considered when further oversight of a guaranteed party is required.

- The office did not properly document borrower and lender risk weightings and the bases for those ratings (page 9).

To address the above issues, the audit recommends that the Office of Development Credit:

1. Revise loan portfolio guarantee target utilization rates to reflect historical data, and incorporate them into its operations manual and portfolio monitoring guide (page 7).

2. Implement an action plan to encourage banks to meet loan portfolio guarantee target utilization rates and require them to include utilization guidelines in on-boarding documents for bank partners (page 7).

3. Confirm and document that partner banks have clear and acceptable utilization strategies before finalizing guarantees (page 8).

4. Establish guidelines on when to amend, modify, or terminate a guarantee for insufficient use (page 8).

5. Coordinate with missions to define what constitutes a micro, small, and medium-size enterprise in the host country and consistently insert those definitions into its legal agreements directed at such enterprises (page 8).

6. Revise its operations manual and portfolio monitoring guide to require that it or the mission

[2] A project is "additional" if it would not go forward without the support of a DCA guarantee.

conduct on-site reviews and/or commission an independent auditor, when warranted (page 9).

7. Implement a procedure to clearly document the weighting of the risk factors in guarantees packages and the bases for adjusting or not adjusting those risk weightings (page 10).

Detailed findings are in the following section. The audit's scope and methodology are described in Appendix I. OIG's evaluation of management comments is on page 11, and the full text of management comments appears in Appendix II.

AUDIT FINDINGS

Banks Did Not Use All Guaranteed Amounts

The Office of Development Credit's 2009 operations manual states that the portfolio management team ensures "DCA guarantees are actively and correctly utilized." The office defines utilization broadly "as the extent to which the Guaranteed Party [lender or bank] has disbursed DCA-guaranteed loans."

The office and the mission are jointly responsible for identifying and addressing utilization problems through semiannual portfolio reviews. In doing so, they assess utilization rates because utilization is the office's primary quantitative measure of a guarantee's success. According to the manual, guarantees should reach the following target utilization rates: 10 percent after Year 1; 30 percent after Year 2; 60 percent after Year 3; 80 percent after Year 4; 87 percent after Year 5; 97 percent in Year 6; and 100 percent from Year 7 through Year 10. Additionally, the office is charged with analyzing and updating these rates at least once every 2 years as the DCA portfolio matures.

The office's 2004 operations manual[3] stated that the office should work with the mission to discuss low utilization with the lender if the following conditions were met:

1. If no loans were guaranteed by the end of first reporting period, which typically is 6 months after the guarantee agreement was signed.

2. If the cumulative utilization rate reported in the credit managing system (CMS)[4] is less than 10 percent of maximum cumulative disbursements (MCDs) by the second reporting period (typically 1 year after the agreement was signed).

3. If the cumulative utilization rate reported in CMS is less than 50 percent of MCD by the midpoint of the guarantee's term.

Many guarantees are not meeting their targeted utilization rates.[5] Additionally, 18 active pre-FY 2011 guarantees have an average age of 3 years and average utilization of not quite 4 percent—much less than the expected 10 percent utilization rate at the end of the Year 1 reporting period—at the end of FY 2012.

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[3] The office's 2004 operations manual is referenced in this report because the audit team's samples for utilization rates, claims checks, and testing of legal agreements for MSMEs included guarantees that were monitored using conditions and specifications in that manual.

[4] CMS stores and processes data related to Agency credit programs. It provides information related to loans under USAID guarantee coverage. The system is used to exchange information between financial institutions and USAID to accelerate fees and claims processing, and to avoid data entry duplication. CMS centralizes loan monitoring by allowing banks to provide guarantee program status.

[5] The audit team analyzed active and expired guarantees. Expired guarantees provide information on utilization trends that can shed light on the utilization rates of active guarantees.

Table 2 shows the number of active guarantees issued from 2007 to 2011 that met the utilization rates specified in the 2009 operations manual. For example, only 46 of 114 guarantees—or 40 percent—met the target rate of 10 percent utilization for Year 1. As further depicted in the table, the number of active guarantees meeting the target rates for subsequent years was even lower.

Table 2. Utilization Rates for Active Guarantees Issued From 2007 to 2011 (Audited)

Year	Loan Portfolio Guarantees	Year (Target Rate)				
		1 (10%)	2 (30%)	3 (60%)	4 (80%)	5 (87%)
2007	11	2	0	0	2	3
2008	28	11	7	5	6	
2009	18	4	5	8		
2010	33	20	18			
2011	24	9				
Total	**114**	**46**	**30**	**13**	**8**	**3**
Guarantees Meeting Target Rate		**40%**	**33%**	**23%**	**21%**	**27%**

In addition to the active guarantees above, we also analyzed the Office's expired guarantees. Only 43 of 77 expired guarantees (56 percent) met targeted utilization rates.[6] Taken as a whole, these active and expired guarantees have been significantly underutilized as compared to the target utilization rates. Finally, an analysis of terminated guarantees that were not fully utilized revealed that 40 terminated guarantees had no utilization (0 percent) and were active for an average of 2.34 years before being terminated (in contrast, the target utilization rate at Year 2 is 30 percent). Twenty additional terminated guarantees had an average utilization rate of 16 percent and were active for 3.8 years before being terminated (in contrast, the target utilization rate at Year 3 is 60 percent).

The office provided the following reasons as to why the use of guarantees fell short of targeted rates.

- Banks did not have clear guarantee implementation strategies. Sometimes banks are eager to sign the agreements and begin collaborating with USAID without having thought through how they will actually use the guarantee.

- A bank's management or ownership structure changed, which slowed down the lending process and, subsequently, guarantee utilization. Similarly, new shareholders may wish to modify the bank's strategy or refocus lending activities.

- Guarantees from other sources made the DCA guarantee less competitive. Alternatively, banks realized that they did not need USAID's guarantee to lend to the targeted sector.

- Banks had difficulty identifying good projects and may not have had the required in-house expertise to undertake the necessary credit analyses.

[6] The office also had four terminated guarantees that were fully utilized, which means that those guarantees could not be used to cover further loans.

- Banks did not market their guarantees to potential borrowers properly.

- The host country's central bank did not recognize USAID's guarantee. This can adversely affect loan classification as well as reserve and collateral requirements, making the guarantee less attractive than originally envisioned.

- Banks' officers may not have completely understood the constraints, such as the country's central bank's lending restrictions.

- Banks signed guarantees in anticipation of regulatory changes that never materialized.

- Weaknesses in the legal and regulatory environment may have hindered lending to certain borrowers. For example, lending to municipalities may have been hampered without legislation giving municipalities the authority to borrow or pledge their assets.

In addition to the above, while the Office of Development Credit put the onus on participating missions to get the banks to meet targeted utilization rates by Year 4, it did not communicate the target utilization rates to banks when the guarantees were being designed. Moreover, the legal guarantee agreements between USAID and the banks did not always cite the utilization rates that banks were supposed to meet. Since knowing desired targets is an important factor in developing and implementing strategies to achieve those targets, we believe that the failure to consistently present banks with target utilization rates may also have played a role in DCA guarantees falling short of target utilization rates.

In the office's opinion, utilization rates are not a rigid metric for measuring guarantees; instead they act as guides to determine when USAID needs to investigate further and intervene to increase utilization. It also said that utilization rates are the result of the type of guarantee, the number of years it has been active, the availability of technical assistance, and the partner bank's desire to see the guarantee work. The office further indicated that if the guarantee's utilization rate was less than 10 percent after the first year, it reviewed the bank's strategy, loans placed under coverage, and proposed loans to determine whether to intervene. Finally, office staff said that if they suspect utilization of a guarantee would not increase, they would discuss ways to improve utilization rates, such as outreach, and would then work with the mission to provide training to banks and potential borrowers.

That being said, a significant number of guarantees are still being underutilized in comparison with the target utilization rates. As a result, funds remain obligated in underperforming guarantee agreements that might be used more productively elsewhere. Accordingly, we are making the following recommendations to help address the underutilization of guarantees.

> ***Recommendation 1.*** *We recommend that the Office of Development Credit revise loan portfolio guarantee target utilization rates to reflect historical data, and incorporate them into its operations manual and portfolio monitoring guide.*

> ***Recommendation 2.*** *We recommend that the Office of Development Credit implement an action plan to encourage banks to meet loan portfolio guarantee target utilization rates and require them to include utilization guidelines in on-boarding documents for bank partners.*

__Recommendation 3.__ We recommend that the Office of Development Credit confirm and document that partner banks have clear and acceptable utilization strategies before finalizing guarantees.

__Recommendation 4.__ We recommend that the Office of Development Credit establish guidelines on when to amend, modify, or terminate a guarantee for insufficient use.

Office Did Not Always Define or Differentiate Among Micro, Small, and Medium-Size Enterprises

ADS 596, "Management's Responsibility for Internal Control," states that Agency managers are responsible for ensuring that "internal controls are incorporated into strategies, plans, guidance, and procedures that govern programs and operations." Furthermore, the agency managers should ensure that "internal control standards are maintained in the implementation of activities to achieve Agency program goals and objectives."

Defining and differentiating among MSMEs is an important internal control that helps to reduce the risk that borrowers will receive significantly larger loans than they can successfully manage. Nevertheless, only 10 of 19 DCA legal agreements examined that were targeted at MSMEs defined MSMEs using the definition applied by the country where the guarantees were being executed.

Staff in the Office of Development Credit said they did not always define MSMEs for five reasons:

1. The office is not a bank.

2. Countries define MSMEs differently.

3. Defining MSMEs would constrain DCA.

4. Defining MSMEs would be duplicative, office staff said, since legal agreements contain a section called "Qualifying Borrower and Maximum Loan Size."

By not defining MSMEs in all agreements targeted at MSMEs, the Office of Development Credit is not effectively using a basic internal control that could benefit the program, its lenders, and its borrowers. Moreover, there may be greater risk that some small borrowers, such as microenterprises, would receive loans larger than they can successfully manage. Therefore, we make the following recommendation.

__Recommendation 5.__ We recommend that the Office of Development Credit coordinate with missions to define what constitutes a micro, small, and medium-size enterprise in the host country and consistently insert those definitions into its legal agreements directed at such enterprises.

Office's 2009 Operations Manual Did Not Include Section on Audits

ADS 596.2.I states that Agency managers are responsible for making sure that internal controls are incorporated into strategies, plans, guidance, and procedures that govern programs and operations. Furthermore, Agency managers are required to confirm that internal control standards are followed when activities are implemented.

The office's 2004 operations manual, a type of internal control, had a section called "Audits" which indicated that the results of nominal, subsidy, and portfolio checks could prompt an internal review of the lender's transaction reports and qualifying loan schedules. This section also cited other explicit oversight actions that could be taken, such as performing on-site visits and, in the case of irregularities, an audit by an experienced, independent auditor.

In contrast, the 2009 updated operations manual no longer contained a section on audits. Instead, the section addressing claims simply stated that if any two criteria from the nominal, subsidy, and portfolio checks are met, then the regional manager should consider the possibility of a more thorough review of the lender's reports and review a sample of the loan file. There is no longer explicit discussion of on-site visits and independent audits as oversight tools, as there was in the prior version of the manual.

Although the office did not indicate why the language regarding on-site visits and independent audits had been omitted from the 2009 version of the operations manual, we believe that omitting mention of these oversight options may reduce the likelihood that these tools are fully consideration when further oversight of a guaranteed party is required. Therefore, we make the following recommendation.

> ***Recommendation 6.*** *We recommend that the Office of Development Credit revise its operations manual and portfolio monitoring guide to require that it or the mission conduct on-site reviews and/or commission an independent auditor, when warranted.*

Office Did Not Properly Document Borrower and Lender Risk Weightings

The U.S. Government Accountability Office's "Standards for Internal Control in the Federal Government" notes that all transactions and other significant events need to be clearly documented. Since DCA is meant to increase credit and to be used when the risks of default may be reasonably estimated and managed, it is important that USAID's assessment of those risks be clearly documented.

The risk assessment process calculates the borrower's risk score within a weight range of 10 to 30 percent. We examined 25 guarantee packages. In those packages, the risk analysts noted that borrowers in 13 packages posed risks, and those in the other 12 did not. Nevertheless, the risk analysts assigned the same standard weight of 15 percent to 24 of the packages for credit review board, without clearly documenting in the packages why the risks identified in the 13 packages did not merit an adjustment to that standard weight.

Some of the borrower risks identified in the guarantee packages prepared for the credit review board are listed below.

- Weak or limited managerial skills and financial sophistication
- Limited internal cash generation to finance business growth
- Lack of a credit history
- Limited collateral
- Poor business management skills and unsophisticated levels of corporate governance

Similarly, 11 of the guarantee packages identified lender risks. However, the average score for those lenders was almost the same as lenders without risk. Moreover, the impact of these risks on the weighting of the lender was not clearly documented in the packages. Some of those lender risks are detailed below.

- Bank has many nonperforming loans and write-offs; bank has recorded a loss each year of the last 3 years; and the quality of bank's portfolio has deteriorated.
- Small and medium-size enterprise loans are monitored poorly or bank is not experienced in lending to small and medium-size enterprises.
- The types of loans the bank will provide under the guarantee are not typical of what the bank normally offers; bank has only 1 year of experience lending in sector and has a small loan portfolio compared with the size of the guarantee
- Bank is not operationally sustainable or it is not doing as well as similar-sized banks and it is weaker than its parent bank.

While it is not clear why the bases for adjusting or not adjusting risk weightings were not always clearly documented in the guarantee packages, an official stated that the office would in the future include language indicating the weightings that were used for all transactions. Nevertheless, we believe that it is also important to clearly document the reasons behind the weightings used. Accordingly, we are making the following recommendation.

> ***Recommendation 7.*** *We recommend that the Office of Development Credit implement a procedure to clearly document the weighting of the risk factors in guarantees packages and the bases for adjusting or not adjusting those risk weightings.*

EVALUATION OF MANAGEMENT COMMENTS

Recommendation 1. The office agreed with this recommendation. The office stated that it has revised its utilization targets based on data through FY 2011. Furthermore, the office stated that it will incorporate the revised targets into its operations manual and portfolio monitoring guide. The office expects to complete this action in FY 2014. However, since the office did not specify a target date for completion of this action, a management decision has not been made on Recommendation 1.

Recommendation 2. The office partially agreed with our draft recommendation, in that it noted that it implements a detailed monitoring plan for each guarantee, which indicates how utilization is to be tracked, reported and encouraged. In addition, the office stated that as part of its FY 2013 annual performance goals, the office strengthened how it manages its portfolio by introducing new processes and procedures to better monitor utilization levels, including quarterly outreach to financial institution partners. The office noted its intent to institutionalize these performance management improvements in its FY 2014 update of the Development Credit Authority operations manual.

The office, however, disagreed with the second part of our draft recommendation, where we recommended that it require partners to commit in writing to meet set utilization rates before approving a loan portfolio guarantee. It asserted that the bank's payment of origination and utilization fees on the guarantee served to demonstrate the importance of the guarantee to the bank's core business and its intent to use it. The office also noted that forcing financial institution partners to agree to legally binding targets could result in adverse consequences that could inhibit USAID's development efforts in the mobilization of private capital for development, such as banks making questionable loans under changing market conditions.

While paying origination and utilization fees may be one way that a bank demonstrates the importance of the guarantee to its core business operations and its intent to utilize it, as depicted in Table 2, many guarantee agreements still did not meet the office's utilization targets. We do recognize, however, that there may be unintended consequences of legally requiring banks to meet utilization targets. Having utilization guidelines included in on-boarding documents for bank partners, as mentioned above, would serve to ensure that partner banks are aware of the utilization targets and could properly incorporate those targets into their implementation of the guarantee program. Therefore, we have modified our recommendation to address the inclusion of utilization guidelines in on-boarding documents for bank partners.

We believe that the office's plans to strengthen its monitoring of utilization combined with the inclusion of target rates in on-boarding documents will help to encourage increased utilization of guarantees. Given that this recommendation has been revised in response to management's comments, it does not have a management decision at this time. A management decision may be reached on Recommendation 2 when the office details its response to this revised recommendation and provides a target date for completion of any actions to be taken to implement the recommendation.

Recommendation 3. The office agreed with our draft recommendation that it perform the risk analysis, develop the action package, and write the legal agreement for lenders with acceptable utilization strategies, and stated that it already did so. Moreover, the office stated that under no circumstance would it put in place a guarantee without a utilization strategy that was realistic, transparent, and acceptable to both USAID and its partner financial institution. Yet, one of the reasons that the office provided for guarantee utilization falling short of targets was that some banks did not have clear guarantee implementation strategies. Additionally, according to the office, sometimes banks are eager to sign the agreements and begin collaborating with USAID without having thought through how they will actually use the guarantee. We have refined the recommendation to focus on the necessity for a clear and acceptable guarantee implementation strategy. A management decision is pending on Recommendation 3. A management decision may be reached on this recommendation when the office details its response to the revised recommendation and provides a target date for completion of any actions to be taken to implement the recommendation.

Recommendation 4. The office partially agreed with our draft recommendation, although it expressed concern regarding setting hard deadlines across countries that have diverse, underdeveloped, and unpredictable credit markets. The office noted its support for strong, formal, and published guidelines and that it will insert general guidelines on when to amend, modify, or terminate a guarantee in its operations manual and portfolio monitoring guide in FY 2014. Based on the office's response and planned action, we have modified our recommendation and acknowledge that the office's planned actions meet the thrust of the recommendation. However, since the office did not specify a target date for final action, a management decision has not been made on Recommendation 4.

Recommendation 5. The office agreed with the draft recommendation to the extent it suggested that DCA guarantees should be based on the applicable mission's definition of "Micro, Small and Medium Enterprises (MSMEs)." However, it also noted that when an operating unit did not specifically define MSMEs, the office followed suit in the guarantee.

We believe that it is important to define MSMEs, especially in guarantees that are directed to such entities and have revised our finding and recommendation to focus on this issue. The office has not reached a management decision on Recommendation 5. A management decision may be reached on this recommendation when the office details its response to the revised recommendation and provides a target date for completion of any actions to be taken to implement the recommendation.

Recommendation 6. The office agreed with the intent of the draft recommendation, which it understood to be that it revise its procedures to require that the office or the mission conduct site reviews and commission an independent auditor, when warranted. The office indicated that it will update its operations manual and portfolio monitoring guide to specifically require the Portfolio Management Team to determine whether conducting site reviews or commissioning an independent auditor is appropriate if two or more of the criteria established are met. However, since the office did not specify a target date for final action, a management decision has not been made on Recommendation 6.

Recommendation 7. In response to our draft recommendation, the office stated that it had a procedure to confirm whether the risk analyst appropriately weighted the risk factors in guarantees that identified borrower and lender risks. However, the office also noted that going forward, it would document the weightings used for all transactions in the Project Information Sheet of the action package. While documenting the risk weightings is important, another key

element is maintaining clear documentation of the bases for those risk weightings. Such documentation would allow interested parties to confirm whether the risk analyst correctly weighted the risk factors when assessing a guarantee that posed borrower and/or lender risks. Accordingly, the office has not reached a management decision on Recommendation 7.

SCOPE AND METHODOLOGY

Scope

OIG's Performance Audits division conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions in accordance with our audit objective. We believe that the evidence obtained provides that reasonable basis.

The objective of the audit was to determine whether the Office of Development Credit complied with federal regulations and guidance pertaining to credit loan guarantees. Specifically, the audit determined whether the office complied with the following:

1. OMB Circular No. A-129, the Federal Credit Reform Act of 1990, the Federal Claims Collection Act of 1966, as amended pertaining to internal controls.

2. The establishment of a credit review board and a financial management and reporting system.

3. A process to calculate subsidy costs and annual reestimates, which is a risk assessment procedure.

4. Guidance to review and approve claims, recoveries, and other related activities to ensure consistent work practices.

Finally, we also determined whether the office wholly implemented actions that it agreed to perform from four recommendations issued in "Audit of USAID's Development Credit Authority."

We performed the audit at the Office of Development Credit at USAID/Washington from October 26, 2011, through April 16, 2013. Our fieldwork covered the period from FY 1999 through FY 2012.

In planning and performing the audit, the audit team assessed the management controls the office used to manage the program and ensure that it provided adequate oversight. The team reviewed OMB Circular No. A-129, the Federal Credit Reform Act, and the Federal Claims Collection Act, and compared their requirements to controls established in ADS 219, 249, 596, 623, and "Microenterprise Development: A Mandatory Reference for ADS Series 200."

In addition, we reviewed the following documents:

- Microenterprise for Self-Reliance and International Anti-Corruption Act of 2000

- Microenterprise Results and Accountability Act of 2004

- The Government Accountability Office's *Microenterprise Development*, November 17, 2003

- 2009 and 2010 DCA year in review reports, 2011 DCA portfolio review, and USAID's Microenterprise Results Reporting Annual Report to Congress, FY 2011
- 2004 and 2009 operations manuals
- 2006 risk assessment handbook
- 29 guarantee legal agreements and standard terms and conditions
- 25 guarantee action packages, and summary of 39 FY 2011 guarantees and weighted average risk factor scores
- Minutes from 4 credit review board meetings. These meetings occurred in December 2009, August 2010, January 2011, and July 2011.
- 2009 portfolio monitoring guide
- Agreement monitoring plans, biennial reviews, subsidy reestimates, and progress and trip reports
- Program evaluation guidelines, including evaluations and impact briefs
- 2008-2012 CMS spreadsheets
- 55 termination letters

Methodology

To answer the audit objective we interviewed officials at the Office of Development Credit and the Office of the Chief Financial Officer. We reviewed documents the office gave us to understand the policies and procedures pertaining to (1) risk assessments, (2) calculation and re-estimation of subsidy costs, (3) utilization rates, (4) claims and recoveries, and (5) biennial reviews. Our discussions and the office's documents covered areas like program background, organizational structure, governing acts, procedures manuals, and management and staff responsibilities specified in the operations manual.

"Audit of USAID's Development Credit Authority" identified two areas needing management attention and made four recommendations. We assessed the actions the office implemented to resolve the recommendations and determined that all four were addressed properly.

We used OMB Circular No. A-129, the Federal Credit Reform Act, and the Federal Claims Collection Act to evaluate the adequacy of significant controls in USAID's ADS and in the office's procedures and guidance manuals.

To analyze utilization rates, we used close-of-fiscal-year CMS data from 2008 to 2012 that the office provided. For our analyses on utilization rates, we separated active, expired, and terminated guarantees. We analyzed utilization rates of active guarantees from 2007 to 2011 to determine their end-of-year utilization using CMS data from 2008 to 2012. This enabled us to track 5-year utilizations for 2007 guarantees, 4-year utilizations for 2008 guarantees, and so

forth. We then analyzed expired guarantees' utilizations to inquire whether the expired guarantees met their rates and determined the variance from the rates.

We performed two types of tests to evaluate how the office monitored claims. The first consisted of tabulating claims and bank fees for each year from 1999 for active and expired guarantees. For the second test, we analyzed whether the office performed its claim trigger checks consistently.

We used the office's prescribed claim checks to test whether two of three conditions were being met that would prompt further action from the office. During this testing, we learned that the office had dropped its audit checks and had not performed any audits on guarantees with large claims.

To confirm whether the office properly estimated and managed the risks of default, we tested the expected default rates for active and expired guarantees to calculate the expected default and net claims. In addition, we assessed whether the bank fees and subsidy costs for guarantees with claims exceeded the claims. From 25 action packages we extracted the weights the office used for the country, borrower, lender, and transaction risks to (1) confirm the weighted average risk score and (2) determine the borrower standard weights the office used.

We used the office's 2012 CMS data to separate microenterprise guarantees and small and medium-size enterprises guarantees. We then separated them by active and expired guarantees, and divided the cumulative distribution by the total number of loans to arrive at an average loan amount. We separated these average loan amounts to compare loans to microenterprises with loans to small and medium-size enterprises.

Finally, we judgmentally selected 29 legal agreements and determined whether they were issued to MSMEs and whether MSMEs were defined as the host country defined them. The sample was chosen to include a reasonable number of agreements from different sectors. Its results, however, cannot be projected to the entire population of loan portfolio guarantees. In the agreements that defined MSMEs as the host country did, we determined their utilization rates. We augmented this analysis by assessing 25 guarantee packages approved by the credit review board between FY 2007 and FY 2011 where the office estimated the number of subloans and the average amount of subloans for MSMEs.

MANAGEMENT COMMENTS

Date: October 15, 2013

To: Steven Ramonas
Director of Performance Audits
Office of Inspector General
U.S. Agency for International Development

From: Ben Hubbard
Director of the Office of Development Credit
Bureau for Economic Growth, Education, and Environment
U.S. Agency for International Development

Subject: USAID's Response to the Office of Inspector General (OIG) Report "Audit of the Office of Development Credit's Compliance with Federal Regulations and Agency Policies (Report No. 9-000-12-00X-P)"

Dear Mr. Ramonas:

The Office of Development Credit (ODC) appreciates the significant OIG effort required over the past two years to review the Development Credit Authority (DCA) program. Unlike grants or contracts, the DCA guarantee is a complex mechanism that required the OIG auditors to become familiar with a unique operating model.

This unique model has led to over a decade of positive results, including an overall default rate of 1.8% and more than $1 billion in financing disbursed to developmentally important sectors in more than 70 countries. The success and sustainability of the DCA model is based on several core principles, including but not limited to:

- Partnering with private financial institutions that are commercially driven;
- Utilizing 50% risk-sharing with lenders to support mutually agreed-upon sectors and/or market segments;
- Relying on lenders to make credit decisions using their own commercially-oriented credit criteria;
- Requiring lenders to exhaust reasonable recovery efforts before claims are submitted; and
- Coupling DCA guarantees with technical assistance wherever possible.

The ability of a DCA guarantee to achieve its goals is therefore highly dependent on financial institution expertise, complementary technical assistance, and evolving market conditions. In addition, each DCA guarantee needs to be compliant with USG and Office of Management and Budget (OMB) credit policies. As such, specific DCA policies and procedures have been drafted in consultation with OMB.

While ODC recognizes that the DCA model is unique and nuanced, the office has concerns regarding portions of the audit recommendations and findings. A number of the examples, narratives and data used to support the final recommendations are confusing and, in some cases, inconsistent with the recommendations. Moreover, in some instances, the office has already taken the recommended course of action.

Nevertheless, ODC stands ready to take whatever actions it can to improve its processes, and appreciates any actionable insight OIG can provide. ODC appreciates the opportunity to provide management comments on each of the seven recommendations.

Audit Recommendation 1: *We recommend that the Office of Development Credit revise loan portfolio guarantee utilization rates to reflect historical data, and incorporate them into its operations manual and portfolio monitoring guide.*

Management Response: ODC fully concurs with this recommendation. The office has revised its utilization targets based on data through FY2011 and will incorporate the revised targets into its operations manual and portfolio monitoring guide. ODC expects to complete this action in FY2014.

Audit Recommendation 2: *We recommend that the Office of Development Credit implement an action plan to encourage banks to meet loan portfolio guarantee utilization rates and require them to make written commitments to meeting those rates before guarantees are approved.*

Management Response: ODC is already complying with the first part of this recommendation and does not concur with the second part.

With regard to utilization action plans, the office, in conjunction with the mission, implements a detailed monitoring plan for each guarantee, which indicates how utilization will be tracked, reported and encouraged. Through these action plans, financial institutions are already being encouraged to meet their utilization targets. As a result of this audit, ODC will revise its procedures for new guarantees during FY2014 to ensure that utilization guidelines are included in on-boarding documents for bank partners.

In addition, as part of its FY2013 annual performance goals, the office strengthened its portfolio management efforts with a particular emphasis on increasing utilization. ODC's portfolio management team introduced new processes and procedures to better monitor utilization levels, including quarterly outreach to financial institution partners to review current utilization levels. Portfolio management improvements will be formalized and captured in the office's FY2014 update of the DCA Operations Manual.

With regard to requiring partners to provide written commitments to meet set utilization rates before guarantee approval, the office disagrees and believes it is based upon a fundamental misunderstanding of how the office operates and how its guarantees are viewed by its private sector partners.

As referenced in the beginning of this letter, guarantees are market-based financial products designed to encourage private capital lending to developmentally important sectors. As such, USAID cannot and should not dictate to a private lender when and how much to use the guarantee. These decisions should be based upon commercial considerations and underlying markets conditions. ODC and USAID missions spend a great deal of time understanding those conditions before designing guarantees to make certain the guarantee is aligned with the bank's commercial strategy and USAID's development priorities. Furthermore, the bank is required to pay origination and utilization fees on the guarantee. This serves to demonstrate the importance of the guarantee to the bank's core business operations and its intent to utilize it. Such market-based assurances are sufficient to demonstrate the financial institutions' commitment to full use of the guarantee over time.

Going beyond fees to require legally binding utilization targets on a financial institution partner would unnecessarily and unnaturally bind that partner to targets that may not make commercial sense.

ODC believes that forcing financial institution partners to agree to such targets would result in one of several negative consequences that would severely inhibit USAID's development efforts in the mobilization of private capital for development:

- ODC's partners would simply refuse to enter into a guarantee agreement with USAID, rendering useless what is currently the Agency's most effective and catalytic tool for mobilizing private capital;
- ODC's partners would begin making questionable loans under changing market conditions because the new requirement would essentially force them to rapidly disburse funds regardless of whether a loan made sense economically; or
- ODC's partners would be forced to continue to lend under the guarantee (and pay for it) even if they have become convinced that there is a commercially viable opportunity to lend to the targeted sector without the need of a guarantee.

While forcing financial institution partners to agree to prescribed utilization targets seems like a quick and easy way to increase utilization rates, it is not. Accordingly, ODC believes the better approach is to continue enhancing its existing methods to encourage and reach better utilization rates. These methods include, but are not limited to: working with lenders to review and amend guarantee agreements, reducing facility sizes, recommending training or technical assistance for borrowers and lenders, and terminating guarantees in cases where it was clear that utilization will not increase.

Audit Recommendation 3: *We recommend that the Office of Development Credit perform the risk analysis, develop the action package, and write the legal agreement for lenders with acceptable utilization strategies.*

Management Response: ODC concurs with this recommendation because the office already does this with each guarantee it issues. Under no circumstance would the office put in place a guarantee without a utilization strategy that was realistic, transparent and acceptable to both

USAID and its partner financial institution. As a result, every risk analysis conducted, action package developed, and legal agreement written is done with an acceptable utilization strategy in place.

Prior to each guarantee transaction being closed, USAID has determined that the use of a guarantee a) makes sound development sense, b) is aligned with USAID's priorities, c) supports a core commercial strategy of the guaranteed party, d) is based on terms and conditions acceptable to all parties, and e) is based on a clear utilization expectations shared by all parties. To demonstrate their commitment to the guarantee and its use, financial institution partners are required to pay both origination and utilization fees. These commercial commitments clearly demonstrate that the financial institution partner intends to utilize the guarantee and finds the utilization strategy developed for the transaction with ODC acceptable. Otherwise, it would simply not pay for the guarantee.

Audit Recommendation 4: *We recommend that the Office of Development Credit set a limit on the amount of time allowed to elapse before the office amends, modifies, suspends, or terminates agreements that are not meeting utilization rates.*

Management Response: ODC partially concurs with this recommendation. The office recognizes a need to limit the total amount of time an underutilized guarantee remains in the portfolio without being amended, modified or suspended. As a result, it will set guidelines on when to amend, modify or terminate a DCA guarantee for lack of use. General guidelines will be included in the 2014 revision to DCA's Operations Manual and Portfolio Monitoring Guide.

That said, ODC cannot set *hard* limits when such actions must be taken. USAID implements guarantees in markets that are extremely diverse, underdeveloped and unpredictable. In every case in which a guarantee is being underutilized, ODC works closely with missions to determine the exact cause of underutilization and the appropriate corrective action. This case-by-case approach is not unique to ODC, as it is routinely taken across USAID's entire platform, whether a program is being implemented through a contract, cooperative agreement, grant or loan guarantee. This flexibility is critical to most efficiently respond to significant and often unforeseen changes on the ground that are beyond the control of USAID's financial (or implementing) partners to influence or control (*e.g.*, macroeconomic shocks). Setting a hard deadline without taking into consideration and responding to the underlying drivers of underutilization is an inefficient way to structure guarantees, is not consistent with the way USAID deploys other implementing mechanisms, undermines USAID's attempts to affect lasting behavioral change in the marketplace and could force DCA to terminate guarantees at exactly the moment when they are needed most from a development perspective. This is why the office supports strong, formal and published guidelines but stops short of developing hard limits.

Audit Recommendation 5: *We recommend that the Office of Development Credit coordinate with missions to define what constitutes a micro, small, and medium-size enterprise in the host country and insert the definitions into its legal agreements.*

Management Response: ODC concurs with this recommendation, to the extent it suggests that DCA guarantees should be based on the applicable mission's definition of "Micro, Small and Medium Enterprises (MSMEs)." To the extent that is the recommendation, this is exactly what ODC already does. Each guarantee the office develops is in response to a development need identified by a mission (or a USAID/Washington operating unit) and supports an existing program implemented by that mission. As such, those existing programs are being implemented under established definitions of MSMEs appropriate to the local context. When ODC designs a guarantee, it does so based upon those definitions and includes those definitions in its legal agreements. If operating units decide not to define MSMEs narrowly or specifically, ODC follows suit within the guarantee. The office does not develop its own definitions, nor does it impose standard definitions on missions. The main concern embedded in the audit finding appears to be that operating units do not use consistent definitions of MSMEs across the USAID platform. If so, ODC believes this audit finding is misplaced in an audit of DCA credit guarantees and should be directed more broadly at the Agency.

Audit Recommendation 6: *We recommend that the Office of Development Credit revise its operations manual and portfolio monitoring guide to require that it or the mission conduct site reviews, and commission an independent auditor to determine whether there are irregularities in claims when two or more of the criteria established are met.*

Management Response: ODC understands that the intent of this recommendation is for ODC to revise its procedures to require that it or the mission conduct site reviews and commission an independent auditor *when warranted*, which may or may not be the case when two or more of the criteria established are met. ODC agrees with the intent of this recommendation. As discussed below, ODC already complies with the intent and will continue to do so.

ODC currently complies with the intent of this recommendation because it considers many different options when reviewing claims made by guaranteed parties, including site visits and independent audits. ODC's Portfolio Management Team ensures the health of the DCA portfolio, including that only credible, legally-complaint claims are paid. The Portfolio Management Team has sufficient capacity and expertise to review claims as they come in and determine how to most efficiently handle those claims. This process involves carefully reviewing original loan documentation, including the original loan approval/agreement, proof of disbursement, amortization schedule, borrower payment history, final demand letter, and explanation for default. As part of that process, the Portfolio Management Team has conducted site visits and has considered whether an independent audit was warranted.

As a result of this recommendation, ODC will update its operations manual and portfolio monitoring guide to specifically require the Portfolio Management Team to determine whether conducting site reviews or commissioning an independent auditor is appropriate if two or more of the criteria established are met. The update will encourage the Portfolio Management Team to consider many factors when making this determination, including the cost of such activities in comparison to the claim amounts and whether the information already provided to the Agency by the guaranteed party is sufficient to support the claims made.

Audit Recommendation 7: *We recommend that the Office of Development Credit implement a procedure to confirm whether the risk analyst appropriately weighted the risk factors in guarantees that identified borrower and lender risks.*

Management Response: ODC already complies with this recommendation. Under the office's current risk assessment methodology, which complies with the Federal Credit Reform Act (FCRA) of 1990 and has been approved by OMB, risk analysts have some prescribed flexibility in adjusting risk weightings if the particular circumstances of a transaction call for such an adjustment. Before an analyst adjusts these weightings, however, he/she must consult and gain the approval of the Agency's Chief Risk Officer (CRO). Furthermore, those adjustments must be explicitly addressed in the risk assessment report presented to the Credit Review Board (CRB) and highlighted in the risk analyst's oral presentation to the board. Thus, if the weights are adjusted by an analyst, those changes must be explicit and affirmatively agreed to by the CRO and CRB. Going forward, ODC will include language in the Project Information Sheet of the Action Package indicating the weightings that were used for all transactions. This will ensure that the weighting decision is always documented.

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