

**Audit of USAID/Bosnia-Herzegovina's
Bosnian Reconstruction Finance Facility Program
for the Period
October 1, 1998 through March 31, 1999**

**Audit Report No. B-168-00-004-P
February 25, 2000**



**United States Agency for International Development
Office of the Regional Inspector General**

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February 25, 2000

MEMORANDUM

TO: USAID/Bosnia-Herzegovina, Edward L. Kadunc, Jr.

FROM: RIG/Budapest, James R. Bonnell

SUBJECT: Audit of USAID/Bosnia-Herzegovina's Bosnian Reconstruction Finance Facility Program for the Period October 1, 1998 through March 31, 1999

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. Although target figures for loan volume differ, we found that, regardless of which target figure is used, loan activity was significantly behind schedule. During the next reporting period we plan to pursue the issue of differing target figures.

During the period covered by the audit, we noted that there were various reasons why loan activity did not meet targets—increased emphasis on loan quality and monitoring, making smaller loans to smaller enterprises, and a new primary implementing contractor. The Barents Group replaced Development Alternatives, Inc., the original implementing contractor, on October 1, 1998.

We issued three preliminary audit findings 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 promoting 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 for Europe and the New Independent States (now called the Bureau for Europe and Eurasia) 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 \$232.9 million to Bosnia-Herzegovina.

**SUMMARY OF OBLIGATIONS AND FUNDS TRANSFERS
AS OF MARCH 31, 1999**

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
Amendment #6	58.0	February 1999
Total Obligated and Transferred	\$232.9	

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 eighth 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; B-168-99-001-P, dated October 30, 1998; and B-168-99-004-P, dated August 18, 1999. 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?

USAID/Bosnia-Herzegovina and the implementing contractors generally 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. However, six of the nine borrowers visited during this period used loan funds for purposes that were not allowed, and two of the 12 agent banks visited have not fulfilled their responsibility under agreements.

Although BRFF has experienced some problems with borrowers and banks, USAID/Bosnia-Herzegovina has taken corrective action against the borrowers and the banks including civil actions.

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, \$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., on May 16, 1996, to establish and operate Business Finance. The task order also set targets of \$45 million in loan recommendations that were expected to create 6,750 jobs through December 31, 1996. 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. USAID/Bosnia-Herzegovina formalized performance targets—the dollar volume of loan recommendations and the number of jobs to be generated monthly—with Development Alternatives, Inc., in a task order modification and a subsequent contract that expired on September 30, 1998.

When the Barents Group assumed responsibility for Business Finance on October 1, 1998, USAID set similar performance targets. According to the terms of Barents' contract, a volume of \$10 million worth of recommendations on the average, with an associated employment impact of 1,500 jobs is expected each month during the contract period. Applying the contract terms to the six months ending March 31, 1999, Business Finance would be expected to increase loan recommendations by \$60 million resulting in 9,000 new jobs. The cumulative figures would be \$315 million in loan recommendations and 47,250 jobs.

However, as Mission officials pointed out, \$256 million is the total authorized on-lending program and is the only target mentioned in the program assistance approval document. Furthermore, there was no mention of any specific employment targets in the approval document. Because the original contractor offered an employment target based on experience, USAID/Bosnia-Herzegovina included it as a target in the task order and subsequent contractual documents.

Technical Assistance. The Barents Group's contract also provides for training to (1) enable Bosnian bankers to offer a range of financial services to private sector companies and undertake responsibility for a portion of the lending activity and (2) prepare Bosnian counterparts to eventually assume responsibility for the management of the program.

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 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 March 31, 1999, USAID/Bosnia-Herzegovina approved 426 loans (totaling \$141.8 million) of the 432 loans (amounting to \$143.7 million) that Business Finance recommended. USAID/Bosnia-Herzegovina obligated and disbursed \$232.9 million to the Government of Bosnia-Herzegovina to assist with their balance of payment needs. (See Appendix IV for details on budgeted, obligated and disbursed amounts.) The Government of Bosnia-Herzegovina disbursed \$114.2 million for 345 of the 426 approved loans.

The \$143.7 million in loans that Business Finance recommended to USAID/Bosnia-Herzegovina since the beginning of the program fell short of the program targeted amount of \$256 million.

In previous reporting periods, shortfalls were attributed to systems and personnel restructurings intended to streamline loan production, a shortage of lending officers available to analyze and process applications and a change in contractors. During this reporting period, Business Finance experienced a decrease in loan

volume from the prior six month period—from about \$33.8 million to \$12.5 million for 64 loans. According to program personnel, this shortfall was the result of factors such as:

- ! Increased emphasis on loan quality and loan monitoring
- ! Increased emphasis on lending smaller amounts to smaller enterprises
- ! New primary implementing contractor

Technical Assistance. During this six month reporting period, Business Finance conducted seminars and workshops for bankers, prospective borrowers, consultants and Business Finance staff. The seminars covered the credit application process, the quarterly monitoring report, and the environmental aspects of the lending program. Workshops were held for the lending associates and the internal audit group conducted site visit training for the benefit of the field and lending associates. To further strengthen banks' capabilities, USAID is in the process of developing a new bank training program.

Business Consulting reported that since the inception of the program through March 31, 1999, it had prepared 563 diagnostics, formerly referred to as loan application supporting documentation. The organization also completed 926 performance improvement projects designed to help enterprises restart and strengthen operations and establish initial viability and direction. Business Consulting was achieving its targets for almost all of its activities.

Business Consulting has continued to operate a turnaround consulting practice, assisting borrowers who were having problems in specific areas, e.g. marketing. Through March 31, 1999, Business Consulting reported that it completed 68 turnaround actions. Business Consulting closely coordinates its efforts with Business Finance.

As of September 30, 1998, Business Consulting completed its original contract period for the program. For this six month reporting period, Business Consulting operated 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 the adequacy of agent bank and loan monitoring efforts. As in previous reporting periods, in carrying out our audit work 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. As previously reported, 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 9 borrowers. Since the program began, auditors have visited 115 of the 345 borrowers. The Business Finance Internal Audit Unit conducted 66 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 performed 15 visits to 12 agent banks responsible for servicing most of the loans in the program. Since the inception of the program, RIG/Budapest and Business Finance auditors have visited 18 of the 24 agent banks actively participating in the program and representing over 95% of the loan volume. Where appropriate, compliance with the loan procedures and the agreements with agent banks were tested.

Borrower visits by Business Finance's internal auditors focused on visits to borrowers suspected of possible improprieties. Six of the borrowers visited had used some of the loan funds for purposes not originally intended. For instance, one borrower bought a luxury car instead of a pickup truck as planned. Due to pressure from Business Finance, this borrower returned the loan funds used to purchase the luxury car. Business Finance is pursuing claims against borrowers who have not used the loan funds for the agreed-upon purposes. As of March 31, 1999, Business Finance was actively pursuing 17 court cases involving criminal, litigation and foreclosure actions.

Bank visits by the Business Finance internal auditors highlighted several problem areas. All banks need improvement in their monitoring of the loans and in their disbursement verification procedures although some banks are more competent than others. Business Finance classified the 12 primary agent banks visited this reporting period in one of five categories ranging from superior to unacceptable. Only one bank was satisfactory; four were considered acceptable but in need of improvement. Five banks were rated unacceptable and in need of significant improvement. Two of the banks were considered below acceptable and are the subject of one of our findings discussed below.

At the completion of our fieldwork, we issued three Reports of Audit Findings (RAF) on August 17, 1999 that addressed the following:

- RAF No.10, the conduct of the agent banks,

- RAF No. 11, the issue of purchases made in Serbia, and
- RAF No. 12, the cash flow management of the BRFF accounts.

We have included the details of these findings in this section, along with a summary of the Mission's response as to the corrective actions being taken.

Agent Bank Problems. RAF No. 10 focused on two agent banks in the BRFF program that have committed repeated serious violations of their responsibilities under their agency agreements. Civil and possible criminal cases against both banks are being pursued aggressively by USAID and Business Finance. Due to the sensitivity of this issue, the names of the banks and borrowers are not included in this report.

Instances of deceptive and inappropriate actions by one bank are illustrated below in the four examples of BRFF loans made to borrowers.

- Loan funds were disbursed directly to the account of the first borrower without any supporting invoices. A month later, the funds were transferred back to the bank. The bank then began to make short term loans to this borrower.
- In submitting the loan application to Business Finance, the bank deliberately concealed the actual status of its own short term loans to the second borrower. The BRFF loan funds were used mostly to repay the bank's own loans rather than for the purposes intended.
- In submitting the loan application to Business Finance, the bank deliberately concealed the actual status of its own short term loans to a third borrower. The BRFF loan funds were used mostly to repay the bank's own loans rather than the purposes intended. The borrower stated that the bank blackmailed him into taking a short-term bank loan in order to obtain a BRFF loan.
- In submitting A construction company, the fourth borrower, did not use the loan funds as intended but rather used the funds to repay existing debts. The bank transferred loan funds to the equipment suppliers who then transferred the funds back to the borrower. The fourth borrower used most of the funds to repay various debts, including debts previously owed to the bank.

Instances of deceptive and inappropriate actions by the other bank are illustrated below in the three

examples of BRFF loans to borrowers shown below.

- The first borrower instructed the bank to make a loan repayment on the BRFF loan. The bank seized the payment and applied it to their own loan with the borrower. A bank official stated that “. . .the Bank has acted in accordance with its right to help itself.”
- The bank used BRFF loan funds to pay off its own short term loans, and required a second borrower to purchase bank stock. The bank hid the actual use of over half the loan funds with dubious invoices and submitted monitoring reports to Business Finance that presented an unrealistically positive picture.
- The bank never filed a mortgage to perfect Business Finance’s collateral interest in the third borrower’s real property. It was the borrower who eventually filed a mortgage on behalf of Business Finance but only after another bank’s mortgage had been filed first, thus placing Business Finance in a subordinate position.

We recommended that, after consulting with Business Finance on legal strategy, USAID/Bosnia-Herzegovina terminate the agency agreements with these banks as soon as possible.

The Mission responded that despite serious attempts by the Business Finance contractor to get the two banks to remediate their practices and adhere to their detailed agency agreements, additional investigations revealed highly improper activities by each bank which jeopardized the probability of full and timely repayment of several loans. For both banks, detailed strategies were prepared and recommended by Business Finance, with active Mission consultation, to (1) recover and/or safeguard the program’s loaned assets through appropriate legal action; (2) inform and involve the Federation Banking Agency (Bosnia-Herzegovina’s banking supervision authority); (3) provide the authorities with evidence of improper banking conduct and possible criminal activity; and, (4) formally sever the Business Finance agency agreements with each bank once USAID’s interests under the first three categories had been secured. These strategies are currently being implemented.

Purchases From Serbia. RAF No. 11 addressed the issue of borrowers in the Republika Srpska using loan proceeds to purchase items from Serbia. For instance, Business Finance internal audit testing at two agent banks noted that about 20 percent of the purchases at one bank and about 30 percent of the purchases at another bank were made from Serbia. According to the program grant agreement between Bosnia-Herzegovina and the United States, the grant excludes the use of loan proceeds for the purchase of goods or services which are shipped from or produced in several countries, one of which is Serbia.

We recommended that USAID/Bosnia-Herzegovina take immediate action to resolve this issue by enforcing the exclusion or modifying the agreement so that the exclusion is no longer applicable. As Serbia has been

an integral part of the Balkans economy, USAID and its legal counsel concluded that restricting financed enterprises from purchasing needed supplies and equipment from Serbia using BRFF funds would impede the recovery of these enterprises. Therefore, USAID has clarified this issue by amending the agreement with the Government of Bosnia-Herzegovina to permit purchases from Serbia.

Cash Flow Management. RAF No. 12 questioned the cash flow management of the program. The Government of Bosnia-Herzegovina maintains two Deutschmark accounts at the Bank of America that are dedicated for use by the BRFF program. Both accounts have balances which are excessive to the current needs of the program. For instance, at July 31, 1999, the accounts held about \$135 million which we considered excess to the program needs for the next three months. The increase of funds in the program accounts during the past year occurred due to a slowdown in new loans and a reallocation of resources to focus attention on loan monitoring and problem loans.

Although the funds are used for the loan program, the grant agreement states that the amounts obligated are “in support of the balance of payments needs of the State of Bosnia and Herzegovina”. USAID noted that this balance of payments support is the primary objective of the program and that the secondary purpose is to provide credit to the productive sector in order to jump-start the economy after the four-year civil war.

We recommended that USAID follow U.S. Treasury policies and match disbursements with the lending needs of the program. USAID replied that they will take all necessary steps to comply with our recommendation while still honoring the spirit and intention of the Grant. However, USAID officials noted that, as part of a multi-donor effort to assist Bosnia’s economy, their primary objective is not to tie disbursements to the lending needs of the program but to help the Government of Bosnia-Herzegovina meet their foreign exchange requirements.

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 conduct of the agent banks 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, Mission management described the specific actions being taken to address each of our three preliminary findings—the improper conduct of two agent banks, the issue of purchasing supplies and equipment shipped from or produced in Serbia, and the cash flow management of the BRFF accounts. A summary of the Mission’s comments on each preliminary finding follows:

USAID/Bosnia-Herzegovina officials agreed that the two agent banks violating their agency agreement should be removed from the program. Mission officials explained that despite serious attempts by Business

Finance to get the banks to correct their practices and adhere to their agreements, further investigations showed highly improper activities by each agent bank. Therefore, Business Finance, in consultation with the Mission, prepared detailed strategies for addressing deficiencies at the two banks. The Acting USAID Mission Director approved the detailed strategies on August 19, 1999. In both cases, the agent bank relationship was terminated and civil and legal lawsuits were prepared against both banks.

Regarding the issue of goods made in or shipped from Serbia, in the early days of the BRFF program, Mission officials and legal counsel in Washington concluded that restricting USAID-financed businesses from purchasing needed supplies and equipment from Serbia would hinder recovery of the businesses. USAID/Bosnia-Herzegovina issued Program Implementation Letter Number 12, dated September 8, 1999, clarifying its policy of encouraging BRFF borrowers to diversify and to reduce or eliminate their dependence on Serbia as a source or market.

Finally, regarding cash flow management of the BRFF accounts, the Mission's response addressed this issue in depth. Referring to specific articles in the grant agreement, the Mission summarized its position by reiterating that the amounts pledged by the U. S. Government were intended to help the Government of Bosnia-Herzegovina and the private sector meet their foreign exchange requirements, and to meet higher U. S. Government objectives. Therefore, it was not USAID's primary objective to tie disbursement to the lending needs of the program. USAID/Bosnia-Herzegovina officials explained how they attempted to match disbursements with the lending needs of the program—while honoring the spirit and intention of the grant agreement—by estimating the demand for the funds based on the best information available at the time initial disbursement took place.

<p>Scope and Methodology</p>

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. From July 1996 through March 1999, USAID/Bosnia-Herzegovina obligated and disbursed \$232.9 million through BRFF to the Government of Bosnia-Herzegovina to assist with their balance of payment needs. Of the \$232.9 million transferred to the Government of Bosnia-Herzegovina \$114.2 million has been disbursed as loans. During the period of this audit from October 1998 through March 1999, USAID/Bosnia-Herzegovina obligated and disbursed \$38 million. We conducted the audit from July 13 through August 7, 1999, at the USAID, Business Finance and Business Consulting offices in Sarajevo.

In conducting our audit, as in prior reporting periods, 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 although we did review the cash management of those accounts. Also, we did not audit the program's financial statements shown in Appendix IV. We did perform limited work on The Recovery Group's Business Consulting activities.

Methodology

Audit methodology included file reviews, interviews 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 about problems they experienced in the program, and the adequacy of actions taken to address these problems.

In the current reporting period, Business Finance auditors made a judgmental selection first-time visits to six borrowers and three repeat visits; RIG/Budapest did not conduct any of the visits. Of the 345 borrowers who have received loan disbursements since the inception of the program, 115 borrowers have been visited once and 27 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.

BORROWER VISITS

	Current Period			Cumulative		
	First Visits	Repeat Visits	Total	First Visits	Repeat Visits	Total
RIG/Budapest auditors	0	0	0	49	5	54
BF internal auditors	6	3	9	66	22	88
Total	6	3	9	115	27	142

During this reporting period, Business Finance auditors performed 15 visits to 12 agent banks which are responsible for servicing most of the loans in the program. Since the program began, RIG/Budapest and Business Finance auditors have visited 21 agent banks. (See table below.) There have been visits to 18 of the 24 agent banks that are currently active participants in the program (representing over 95 percent of the loan volume). Subsequent to our visits to an additional three banks, their participation in the program was terminated. 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.

AGENT BANK VISITS

	Current Period			Cumulative		
	First Visits	Repeat Visits	Total	First Visits	Repeat Visits	Total
RIG/Budapest auditors	0	0	0	19	12	31
BF internal auditors	2	13	15	2	18	20
Total	2	13	15	21	30	51



United States Agency for International Development
Sarajevo, Bosnia and Herzegovina

December 10, 1999

MEMORANDUM

TO: James R. Bonnell, RIG/Budapest

FROM: Erna Kerst, Acting Mission Director

SUBJECT: Concurrent Audit of USAID/Bosnia-Herzegovina Bosnian Reconstruction Finance Facility (BRFF) Program for the Period October 1, 1998 through March 31, 1999

Thank you for bringing to our attention three preliminary audit findings related to BRFF agent banks, procurement and cash flow management of BRFF accounts in your memorandum of August 17, 1999. The Mission continues to value highly the concurrent audit efforts of your office as we implement this complex program. I will address each of your preliminary findings in order.

1. In preliminary BRFF audit finding number 10, you indicated that agent banks in flagrant violation of their agency agreements should be removed from the program. We agree. As your memorandum pointed out, USAID and Business Finance (BF) are aggressively pursuing civil and possible criminal cases against two agent banks. [Due to the sensitivity of these issues and the need to honor business confidentiality, we shall refer to them as M bank and K bank in this unclassified memorandum.] These banks were audited by the BF audit team in January and March 1999 respectively. On a four-point scale, the M bank was found to be 1 (Unacceptable) while the K bank was rated 2 (Below Acceptable - Needs Significant Improvement).

Despite serious subsequent attempts by the BF contractor to get the two banks to remediate their practices and adhere to their detailed agency agreements, additional investigations revealed highly improper activities by each bank which jeopardized the probability of full and timely repayment of several BF loans. In June 1999 a formal demand letter was sent to the M bank, and an outside attorney was retained to evaluate several suspicious loans made through the K bank to see if valid criminal cases existed under Bosnian law.

For both banks, detailed strategies were prepared and recommended by BF, with active Mission consultation, to (1) recover and/or safeguard the program's loaned assets through appropriate legal action, (2) inform and involve the Federation Banking Agency (the banking supervision authority), (3) provide the

authorities with evidence of improper banking conduct and possible criminal activity, and (4) formally sever the BF agency agreements once USAID's interests under the first three categories had been secured. The Acting USAID Mission Director approved these detailed strategies for the two banks on August 19, 1999.

Both strategies are on track and continue to be implemented aggressively. In both cases, the agent bank relationship has been terminated. There has been full cooperation and coordination with the Federation Banking Agency including the sharing of indications of improper or illegal activity on the part of the banks. In the case of M bank where we demanded appropriate repayment or guarantees related to three disputed loans, the bank has already paid off two of the three demands in full. We continue to negotiate a guarantee for the third loan. Civil and legal lawsuits have been prepared against both banks as negotiations continue. We will continue keep you apprised of the further implementation of the actions against both of these banks as they unfold.

It should be kept in mind that these strategies are designed to meet the objectives stated above without unnecessarily collapsing either of the two banks. However, if protecting the interests of the BRFF program funds provided by the U.S. taxpayers happens to lead to the demise of one or both of these agent banks, it will have been caused by their own actions. Such concerns will not diminish the aggressiveness with which we implement the approved strategies.

2. In preliminary BRFF audit finding number 11, you recommend that the Mission take immediate action to resolve the issue related to the procurement by BRFF loan recipients of goods from Serbia. This was done formally with the issuance of Program Implementation Letter (PIL) Number 12, dated September 8, 1999, a copy of which has been provided to you.

In the early days of the BRFF in mid-1996, USAID/B-H, and its legal counsel in Washington, came to the conclusion that restricting financed enterprises from purchasing needed supplies and equipment from Serbia from BRFF funds would impede the recovery of these enterprises. We have, however, encouraged borrowers to diversify to the extent possible, and to reduce or eliminate their dependence on Serbia as a source or market. The referenced PIL clarifies this issue for the record.

3. In preliminary BRFF audit finding number 12, you indicated a need for improved cash flow management of BRFF accounts. This is a particularly important subject worth addressing in depth.

Background: According to Article I of USAID Grant Agreement Number 168-L-601, which was signed between the Government of the United States and the Government of the State of Bosnia-Herzegovina in May 1996, the amounts obligated are “in support of the balance of payments needs of the State of Bosnia and Herzegovina.” Furthermore, Article II of the Agreement, Disbursement of the Grant, states that “at such times as the Parties may mutually agree, and upon satisfaction each such time of the conditions

precedent set forth in sections 2.1, 2.2, and 2.3 of this agreement, USAID will deposit, from Grant proceeds, a disbursement in the bank account or accounts designated by the Grantee, pursuant to section 2.1 c in the amounts agreed by USAID.”

Discussion: From the outset of the BRFF program, as stated in Article I of the grant agreement, its clear primary objective has been to provide balance of payments assistance to the Government of Bosnia-Herzegovina. Its secondary purpose is to provide credit to the productive sector in order to jump-start the economy following the 4-year civil war. In so doing, USAID contributes, as part of a multi-donor effort, to the Government’s effort to meet its reserve and monetary requirements in accordance with the IMF and World Bank agreements and estimates of the required financing gap. This is also clearly indicated by the Program Authorization Document, including Section III (b), "Goal and Purpose."

Therefore, the amounts pledged by the U.S. Government each and every year since 1996 were intended to help the Government and the private sector meet their foreign exchange requirements, and to meet higher-level USG objectives. Thus it was not USAID's primary objective to tie disbursements to the lending needs of the program.

Notwithstanding the primary objective of the program, and keeping in mind the principles of prudent forward funding and US Treasury policy, USAID sought to meet both conditions while preserving the primary intent and purpose of the Grant. We have done so by estimating the demand for these funds based on the best information available at the time initial disbursements (i.e., from US Treasury to the Grantee bank account) took place. However, given the high degree of uncertainty in terms of the political and economic situations, the supply (Grant disbursements to the Grantee’s account) and demand (disbursements to borrowers) did not always coincide. For example, following disbursement of the last tranche in early 1999, USAID, in consultation with RIG, decided to reduce the rate of new loans in order to focus on loan monitoring. This slowed down not only disbursement of existing loans, but also reduced the number of new loans under consideration, thus contributing to the buildup in the pipeline of un-disbursed funds.

Conclusions: The foremost and clear objective of the BRFF program is to provide the Government of Bosnia and Herzegovina with balance of payments assistance, with disbursements linked to the Government meeting specific conditionalities and to the USG honoring its financial commitment, as enunciated at pledging conferences. The timing of the disbursements to the Government accounts is part of a multi-donor effort to jump-start Bosnia’s war-torn economy, and is based on high-level political commitment.

That having been said, the Mission continues to take all necessary steps to match disbursements with the lending needs of the program while honoring the spirit and intention of the Grant as outlined above.

**Audited Status of the
Bosnian Reconstruction Finance Facility
*as of March 31, 1999***

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 (now called the Bureau for Europe and Eurasia), 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 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 in an effort to assist the banks to develop 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 to assist enterprises in restarting and strengthening their operations. To implement its objectives, The Recovery Group established Business Consulting 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, \$264.4 million of the \$278 million budget has been obligated, and \$256.5 million has been disbursed. Of the \$264.4 million obligated, \$232.9 million went toward loans, while the remaining \$31.5 million was allocated for technical assistance and program implementation. (See Appendix IV.)

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 March 31, 1999, Business Finance recommended 64 loans valued at \$12.5 million to USAID/Bosnia-Herzegovina. These recommendations anticipated an increase of approximately 700 new jobs. The Central Bank disbursed funds for 84 loans, which totaled \$14.3 million.

Since the BRFF program began, USAID/Bosnia-Herzegovina approved 426 loans totaling \$141.8 million. The Central Bank disbursed \$114.2 million for 345 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 in the table below:

BRFF LOAN SUMMARY AS OF MARCH 31, 1999

Status of Loans	Number of Loans	Amount ² (millions)
Applications		
Recommended by Business Finance ³	483	\$174.9
Prospective ⁴	48	21.6
Rejected ³	<u>440</u>	<u>152.1</u>
TOTAL	<u>971</u>	<u>\$348.6</u>
Recommended by Business Finance ²		
Approved by USAID/B-H	426	\$141.8
Awaiting approval by USAID/B-H	<u>6</u>	<u>1.9</u>
	432	\$143.7
Not Approved by USAID/B-H	<u>51</u>	<u>31.2</u>
TOTAL	<u>483</u>	<u>\$174.9</u>
Approved by USAID/B-H		
Disbursed	345	\$114.2
Not Yet Disbursed	<u>81</u>	<u>27.6</u>

² 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 1.7073 Deutsche Marks to \$1.

³ 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.

⁴ Information obtained from Business Finance's March 31, 1999, report.

TOTAL 426 \$141.8

In previous reports we provided information comparing actual results for recommended loans and associated jobs against targets. However, discussions with Mission officials and a review of program and contractual documentation revealed that there are different target amounts for the recommended loans and no agreement on the target amount for associated jobs. For example, USAID program documentation indicates that the target amount for recommended loans was \$256 million for the on-lending program while contractual documents (contracts and task orders) indicate a figure of \$315 million through March 31, 1999. In the case of associated jobs targets there is no target figure contained in the original program documentation. Contractual documents indicate that \$10 million in recommended loans per month would generate 1,500 jobs per month.

During the next reporting period we plan to pursue the issue of differing target figures in more detail. In the meantime, for this reporting period, we will use the approved program amount of \$256 million in comparing actual recommended loans against a performance target, but we will not provide information on associated jobs against targets. As of March 31, 1999, Business Finance recommended the approval of \$143.7 million in loans, achieving 56 percent of the program targeted amount of \$256 million, or falling short by 44 percent.

In prior reporting periods, shortfalls were attributed to systems and personnel restructuring intended to streamline loan production, a shortage of lending officers available to analyze and process applications and a change in contractors. During this reporting period, Business Finance experienced a decrease in loan volume from the prior six month period. In fact, loan volume decreased from about \$33.8 million in the previous six months to \$12.5 million for this six month period. According to program personnel, this decrease was the result of factors such as:

- ! Increased emphasis on loan quality and loan monitoring
- ! Increased emphasis on lending smaller amounts to smaller enterprises
- ! Transition to a new primary implementing contractor

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 March 31, 1999, 114 borrowers were delinquent—an increase of 46 from the September 30, 1998 report. The delinquency rate has grown from 35 percent to 48 percent during this six-month reporting period. For a fuller discussion of this issue, refer to Audit Report No. B-168-99-004-P dated August 18, 1999. Business Finance has stepped up monitoring efforts in response to our concerns. In addition, Business Finance's loan restructuring and workout group reviews each borrower's situation and attempts to work out a solution or restructure the loan in order to facilitate repayment.

Technical Assistance. During this six month reporting period, Business Finance conducted seminars and workshops for bankers, prospective borrowers, consultants and Business Finance staff.

The seminars covered the credit application process, the quarterly monitoring report and the environmental aspects of the lending program. Workshops were held for the lending associates and the internal audit group conducted site visit training for the benefit of the field and lending associates. To further strengthen bank capabilities, USAID is in the process of developing a new bank training program.

Unaudited Bosnian Reconstruction Finance Facility Fund Accountability Statement as of March 31, 1999

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 \$232.9 million transferred to Bosnia-Herzegovina, \$114.2 million⁵ has been disbursed as loans to borrowers. The disbursed implementation costs are amounts paid by USAID.

	3-Year Program Budget (millions)	Amount Obligated (millions)	Amount Disbursed (millions)
On-Lending Program	\$256.0	\$232.9	\$232.9
Implementation Costs:			
Contractors⁶	17.5	31.0	23.1
Audit, Program and Evaluation	1.5	0	0
Environmental Monitoring	.6	0	0
USAID Program Management	0	.5	.5
Contingencies	2.4	0	0
Totals	<u>\$278.0</u>	<u>\$264.4</u>	<u>\$256.5</u>

⁵ Loans were disbursed in Deutsche Marks, a medium of exchange in Bosnia-Herzegovina. A total of 194.9 million Deutsche Marks were disbursed and converted using a weighted average exchange rate of 1.7073 Deutsche Marks to \$1.

⁶ USAID is not including the Business Consulting contract in the BRFF program budget. Additional obligations and disbursements under that contract total \$18.2 million and \$15.5 Million, respectively.