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FORM NO. 678
(7-73)

CONFIDENTIAL

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

POLICY REVIEW COMMITTEE

PRC/C/75-6

July 7, 1975

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DFC POLICY PAPER

Attached please find the 'DFC Policy Paper' prepared by the Development Finance Companies Department. The paper is due to be considered by the Executive Directors on September 23, 1975. Also attached is a draft revision of Operational Policy Memorandum 2.64 on DFCs.

The staff level review of the paper was held on June 23, 1975; minutes of the meeting are attached (PRC/s/M/75-6a dated June 27, 1975). A Policy Review Committee meeting on the paper may be scheduled if the Chairman so desires; notification of the time and date will then be announced.

Frank Vibert
Secretary
Policy Review Committee

Distribution:

PRC Members
Mr. von Hoffman
Mr. Alter
Mr. Gustafson

Department Directors - IBRD/IFC

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

POLICY REVIEW COMMITTEE

PRC/s/M/75-6a

June 27, 1975

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DFC POLICY PAPER

STAFF REVIEW - MINUTES

Attendance:
Messrs. Alter (Chairman), Acharya, Chanmugan, Colaco, Fuchs, Glaessner, Gulhati, Gustafson, Hablutzel, Haq, Hidalgo, Hyde, P. Jacob, Karaosmanoglu, Kavalsky, Knotter, Loeschner, Mistry, Picciotto, R.L.Powell, Sekse, van der Bijl, van der Tak, Vita, Whitesell, Vibert (Secretary)

1. A staff review of the 'DFC Policy Paper' was held on Monday, June 23, 1975.

2. The Chairman noted that the policy paper originated as a response to recent questions raised by some Executive Directors in connection with the presentation of DFC loans. He proposed that the discussion focus on four topics: the policy to be followed in phasing out lending to established DFCs; the level of on-lending rates; the sector objectives in DFC lending; and the approach to lending to public DFCs. It was explained that the draft OPM attached to the paper would be detached when the paper went to the Board and would be issued subsequently reflecting further discussion.

Phasing-Out of Bank Lending to Established DFCs

3. The points made by the authors concerning the considerations (summarized in para. 62 of the paper) having to do with the length of time over which Bank support for a particular DFC was justified, were accepted in the discussion. It was also said that, while essential institution building objectives had often been achieved after a series of Bank loans to a particular DFC, lending to well-established DFCs in particular cases enabled the Bank to make an impact on important industrial sector objectives. It was felt that this justification for continued lending could be brought out more clearly in the paper.

Level of On-Lending Rates

4. Some discussants felt that a prescription of a real interest rate target level of 5-6% over the life of the loan, to be used when market rates of interest were not available as benchmarks, might be too restrictive. It was difficult to establish realistic benchmarks in cases where no comparable market rates exist for medium- to long-term lending and

any judgment about a particular level of real interest rates was inextricably linked to an assessment of expectations in the country for the medium- and long-term trend of inflation. In response, it was pointed out that in practice such assessment cannot be avoided under a fixed interest rate system. Others felt that the real interest rate target should be higher, particularly since the Agricultural Credit Paper had suggested that the cost of mobilizing credit was at least 8% in real terms, to which an appropriate spread should be added. The authors responded that what evidence there was suggested that the actual costs of mobilizing resources over long periods of time was lower than 8% in real terms; this, along with the other considerations mentioned, suggested that real interest rate target should be pointed at a lower level if it were to be taken seriously. Finally, it was suggested that in the version of the Paper going to the Board, the actual target numbers should be deleted but retained in the OPM.

Sector Objectives in DFC Lending

5. There was general agreement that in lending to DFCs, the Bank should aim to look beyond institution building concerns to achieve broader objectives in the industrial and financial sector. It was said that to date, the Bank had not been very successful in achieving these broader objectives through DFC lending, or through other means. Even though individual DFCs often account for a relatively small share of total financing of new industrial development in a given country, lending to DFCs could, however, provide a point at which the Bank could give operational expression to the conclusions reached in financial and industrial sector work. In relation to harmonizing the Bank's DFC operations with the Bank's approach to industry lending, it was agreed that DFCs be sensitized to the exploration of alternative technologies in appraising industrial projects and that the relationship between DFCs and institutes for technology be strengthened. It was also noted that the problem of assistance to small-scale industry through DFC lending may well require more systematic attention in the Bank through new organizational arrangements to ensure a coordinated approach.

Lending to Public DFCs

6. The proposed flexible approach to lending to public DFCs was endorsed, and it was noted that both direct and indirect lending to such institutions had been found useful in particular circumstances.

7. It was agreed that the paper would take into account the comments made before being sent to the Policy Review Committee.

Frank Vibert
Secretary
Policy Review Committee

dd
cc: Those Attending
Vice President - IFC
Department Directors -
IBRD/IFC

DFC POLICY PAPER

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DFC Policy Paper

SUMMARY

i. Bank Group financing of development finance companies (DFCs) has been the Bank's major mechanism for financing medium scale productive enterprises in member countries. Total financing of almost $3 billion has been provided to about 70 DFCs in 47 countries, including 3 regional banks. In many cases the Bank Group has provided catalytic support for either the creation or major reorganization of the DFCs it has assisted plus providing considerable ongoing technical assistance.

ii. Up to 1969 the Bank Group financed only DFCs that were privately controlled, although most of these institutions in fact were cooperative ventures between private shareholders and governments, which provided financial support to the DFCs in a variety of forms. Consequently, these institutions had a mix of objectives. Their professional inputs into project development and evaluation were intended to result in improved resource allocation and a distinct developmental impact. Over time it was expected that they could broaden their sources of funds and contribute to domestic capital market development. Because of these broad objectives the Bank has emphasized overall institutional development, not just the effective utilization of the Bank's stream of resources to a particular DFC.

iii. In 1969 the Bank widened its options by agreeing to finance government-controlled DFCs that were, or could be, effective development agents. Since that time about half of total Bank Group DFC financing has gone to government-controlled DFCs. The Bank is, therefore, in a position to examine a variety of ownership options when requested by member governments for institution building assistance in the DFC area. The Bank Group has now financed a wide variety of DFCs including mixed commercial and development banks; apex banks that pass funds onto a network of intermediaries; large government banks that undertake a sizeable range of programs on behalf of the government; banks that specialize in the finance of state enterprise; and multi-sector institutions that also perform not only a banking function but a promoter/holding company function as well.

iv. The approach of the Bank to DFC financing has, however, retained a common theme, which is reflected in a series of questions asked when DFC operations are considered. Are the sectors served by the DFC important in the development process in the country? Are sector policies conducive to growth? Is there a financing gap? Are the DFC's policies, procedures, decision rules, financial structure, and programs soundly based and effective? Moreover, questions concerning the contribution of DFCs to innovative activity in the sectors in which they operate have assumed increasing importance as the Bank has attempted to sharpen its analysis of the developmental role of DFCs and its dialogue with institutions in this area.

Economic Returns on DFC Projects

v. Recently an attempt to better define the economic impact of DFC lending was undertaken in a series of detailed studies of a group of older DFCs. The studies focused on the actual economic results of sub-projects financed as well as other contributions of the DFCs. These studies were combined with educational efforts to introduce all Bank-financed DFCs to appropriate economic appraisal tools. DFCs in India, Iran, Korea, Tunisia, Turkey and Columbia were studied. About 160 completed projects were studied and the weighted average economic rate of return of these projects was about 23% with a fairly wide spread ranging from negative to highly positive returns, although about three-fourths of the projects had economic returns over 10%. While the results are favorable, and indicate that the financial appraisal tools being applied resulted in sound projects in a majority of cases, economic analysis at the appraisal stage would have screened out some, but by no means all, low return projects as well as helped to provide signals to DFCs for the need for project modification or the examination of sector policy problems. Work continues with DFCs in developing appraisal skills to improve their resource allocation. It is also clear that the Bank should try to ensure that criteria being applied by government and DFC decision makers in the sectors served by the DFC are reasonably consistent.

Employment and DFC Projects

vi. In many countries where there is an active DFC program, unemployment is a serious problem and the question arises as to the impact of DFC financing on employment. The studies noted above attempted to examine in part this complex question. The first few studies were inconclusive on the problem. Direct employment created as measured in terms of capital cost per job ranged country to country ($7,000 in Colombia to $13,200 in Korea) and within countries this ratio did not turn out to be a good indicator of the overall economic return of particular projects. In the Colombia study, attempts were made to refine the analysis by looking at direct and indirect employment of DFC-financed projects. It became clear that direct employment was an important factor in the overall employment equation and affected the total employment figure in both positive and negative ways depending on the particular project. However, the adjusted employment/capital ratio was not found to be a good proxy for economic returns. Consequently the employment aspect must largely be considered by DFCs through appropriate factor pricing in the economic analysis done on projects. It is also important to sensitize DFCs to keep in view what they can do in project formulation by examining production options which have different factor proportions. Finally, more efforts could be made to support study efforts in member countries that seek to adjust technologies to better fit local conditions.

Small Enterprise Financing

vii. The role of Bank and DFCs in financing small scale enterprise has been the subject of increasing discussion. While a study of a large sample of Bank-associated DFCs and the 5,000 enterprises they financed in the 1970-72 period indicates that 50% of these sub-projects were with firms that had assets, after project completion, of less than $300,000, and 30% had fixed assets below $100,000, it was also the case that only about 5-10%

of these DFCs' total lending (by value) was to enterprises with assets below $100,000. In fact in the great majority of cases, the institutions reviewed were not set up to give concentrated assistance to small borrowers.

viii. However, small enterprises are pervasive, their employment is substantial, they provide balance to the ownership distribution of productive assets and in many cases their needs are neglected. The Bank, therefore, is directing more energy to this sector. In some cases this may involve using an existing DFC to undertake special small enterprise programs. In other cases more diffusive vehicles will be appropriate. It is also likely that special efforts will be needed to provide technical assistance since this seems to be an even more critical element than finance in helping small enterprises. Effective delivery systems for this technical assistance have rarely been developed and much needs to be learned in this area. Different approaches will be necessary in different countries as the nature and abilities of small scale entrepreneurs varies widely. The Bank has thus recently embarked on a range of schemes in Colombia, Nigeria, Cameroon, Ivory Coast, India, Korea and Philippines that, when operating, will provide a good base of experience to help refine judgments on the importance of such projects and the means to carry them out effectively. These operations should be closely evaluated and the lessons applied in the other 10 to 15 countries where it is hoped to develop small enterprise projects in the next few years. Continued liaison with UNIDO and ILO in this sector is also important to maximize the Bank's effectiveness.

Interest Rate Issues

ix. Interest rate questions are clearly vital to a DFC as they determine how it can mobilize resources, the risks it can take and the level of administrative costs it can bear. Low rates are often difficult to justify because if credit charges are not used to balance credit demand and supply, other mechanisms (often collateral) are used and leakages of credit in such situations can frustrate other policy objectives. Moreover, low rates may not be an efficient tool for steering investment while at the margin they encourage the use of capital as opposed to labor. Also, industrial borrowers are frequently high on the income curve and, since most governments face many claims on their resources, subsidized industrial credit is usually difficult to justify.

x. Interest rate issues need to be examined in the country context, taking into account the country's savings and investment strategies and needs, and the relationship of interest rates to those objectives. In many cases it will take a period of time to achieve progressive rationalization of interest rate structures. In addition to a review of the overall framework of rates and how they relate to policy objectives, the question arises as to the appropriateness of the DFC concerned being able, over time, to mobilize resources in the market. Consequently the first benchmark for measuring the adequacy of relending rates is the price a DFC would need to pay to mobilize funds, plus a reasonable spread. If such indices are not available, an alternative is to posit target real rates of 5-6%. This is based on estimates of rates required to mobilize capital, which are seldom less than 3-4% in real terms, plus a spread to cover intermediation costs.

In cases where high or volatile inflation exists, indexing or variable rate lending may be required to achieve this objective.

xi. Interest rate issues cannot be divorced from how foreign currency risks on external borrowings are handled. Generally, DFC sub-borrowers are in a position to cover such risks and, as a practical matter, governments may agree to this while not accepting domestic interest rates that approximate market rates. In other cases the government may assume all or part of these risks at an appropriate fee, although in practice it is difficult to calculate what is the appropriate level of the fee required to cover possible losses.

DFCs Dependency on Bank Funds

xii. Directly related to the above discussion is the question of how long the Bank should finance a given DFC. As noted, DFCs have often been frustrated in resource mobilization efforts by government interest rate and capital market policies. Even in cases where the Bank has ceased to lend to more established DFCs, these institutions have often continued to depend, to some extent, on special public funds. The state of international capital markets combined with country creditworthiness issues has also, in some cases, closed access to foreign funds for some DFCs which, on their own strength, might otherwise have been suitable borrowers. In determining how long the Bank should finance a particular DFC, two sets of questions need to be addressed. The first concerns the country's need for capital; the DFC's need for capital; and the effective use of such capital by the DFC in relation to other priorities for Bank financing in the country concerned. The second set revolves around the Bank's judgment concerning other options the DFC has for mobilizing resources and its pursuit of these options, the appropriateness of policy changes in the country to widen these options and possibilities for directly assisting DFCs to mobilize resources.

xiii. Concerning financial sector policies, it is clear that DFCs usually are only a relatively small part of the financial infrastructure; often they are not well integrated into that structure. It is, therefore, important to address the problem of a DFC's lending rates in concert with general financial sector policies. There is scope for improving the Bank's work in this area. One of the near term tasks is to develop a better framework for approaching this problem in the context of specific countries and work along these lines is underway.

xiv. Concerning direct efforts to help DFCs mobilize funds, the Bank Group can facilitate commercial borrowing by DFCs by (i) having IFC arrange financing packages, portions of which are covered by commercial lenders; and, (ii) by allowing DFCs to blend shorter-term commercial funds (usually 3-5 years money) with longer-term Bank funds so that, overall, the DFC has the right mix of maturities needed for its long-term lending. These options should be explored in the Bank Group's relations with each of its better established DFCs.

DFCs and Broader Development Functions

xv. Aside from efficient allocation of resources to economically viable projects, DFCs should be searching for areas where their contribution of

finance or effort is of catalytic importance. These tasks may relate to improvement of project design or implementation; special efforts to reach relatively new classes of entrepreneurs; regional development; acceleration of the development of export oriented projects; reviews of important subsectors; project promotion; financial sector development; and review of particular sector policy issues. While there are exceptions, and the pattern is changing, one tendency has been for DFCs to take a rather conservative view of their role which resulted in a weighting of their activity toward the relatively strong enterprises in their economies.

xvi. Consequently, in its dealings with each DFC, the Bank should encourage a dialogue over the spectrum of tasks the DFC can undertake where it can make a catalytic contribution. Definition of near-term strategies for DFCs which set out their operational plans in this regard is one method of giving focus and importance to these issues. The innovative impact of any DFC will, however, also largely depend on the quality and vision of the management of the institution; given this, there is no ready-made formula or model that will easily produce dynamic promotional DFCs.

xvii. An issue related to the DFC's innovative role concerns the need to better integrate the Bank's country economic and industrial sector work with DFC operations in order to provide better focus on policy issues of relevance to the Bank's DFC lending operations. Here there is scope for better use of the venue of DFC lending for analyzing subsector or policy questions and improving the roles of DFCs as credible spokesmen on sector policy issues. Sector work of relevance to DFC lending therefore needs to be done in close liaison with regional DFC staff.

Criteria for Lending to Government DFCs

xviii. In financing an increasing variety of institutions, the Bank has found that institutional criteria relevant in one case may not be relevant in others. In financing new types of institutions with a variety of ownership patterns the Bank has, case by case, attempted to determine the relevant criteria. One area where there is clearly a difference between government and private DFCs is in the owner's profit expectations. However, in financing government DFCs, the Bank normally looks at the following criteria and asks itself whether each criterion is appropriate given the context of the particular operation, how the DFC measures against the relevant criterion, and, if it is deficient in important respects, how these deficiencies can be corrected. The basic areas of examination are:

(a) the quality of management and the level of professional skills;

(b) the policy orientation of the DFC;

(c) the decision rules used in selecting projects;

(d) relending terms;

(e) supervision and administrative capacity;

(f) financial controls and verification of accounts;

(g) financial structure, financial planning and creditworthiness;

and

(h) the soundness of the overall operations program of the DFC.

xix. In some cases lending to government DFCs require difficult judgments as to the appropriate degree of autonomy for the institution and the necessity for it to follow financial policies normally applied to commercial intermediaries. The key elements in these judgments involve a determination of the degree of administrative and financial autonomy that allow the institution to achieve in an efficient manner its agreed policy objectives.

Future Dimensions of DFC Lending

xx. In the FY 76-80 period DFC lending is expected to reach $3.1 billion as compared with $1.7 billion in the preceeding 5 years. This represents about 8% of Bank/IDA financing in the two respective periods. About 20 new DFC borrowers will be added to the Bank's rolls during this period and 6 to 8 DFCs formerly financed by the Bank will be phased out of the lending program. The regional areas that are likely to see the highest growth rate in DFC lending volume are Latin America and East and West Africa. These areas have received the lowest share of DFC financing historically and the increasing pace of DFC operations in these areas reflects increasing options and potentials in those Regions for the financing of medium scale enterprise.

I. HISTORICAL PERSPECTIVE

Past DFC Lending and its Objectives

1. Bank Group financing of development finance companies (DFCs) commenced in 1950 with a loan of $2 million to the Development Bank of Ethiopia. By the end of FY1975, Bank Group finance extended to such intermediaries will have reached almost $3 billion to 67 DFCs in 45 countries, including 3 regional DFCs serving the East Africa Community, Africa and Latin America. A summary of all such lending appears in Annex 1. The great bulk of these funds have been Bank loans although about 8% of the total has been from IDA; IFC has provided $93 million ($73 million in loans, including participations, and $20 million in purchases of shares) for 28 of the 67 DFCs. Currently, Bank Group financing of DFCs is running on the order of 20 operations per annum for $500-600 million. In the next 5 years it is projected that about 10% of all Bank Group lending will be of this type, approximately the same percentage that has gone to such projects in the last decade.

2. In many member countries the Bank has come to the conclusion that assistance to enterprises in the manufacturing (and sometimes tourism) sector is of considerable importance in assisting the growth process, that not only the largest enterprises in such economies but the medium and smaller-sized ones as well require capital and that to deal efficiently with great numbers of relatively small enterprises intermediaries were required. DFC lending has been the principal vehicle for such lending. While there have been shifts in emphases over time and refinement of the objectives of such lending and how performance would be measured, there has been and there generally remains, a three-pronged objective in DFC lending. First, the Bank Group wants to have a favorable impact on the manufacturing sector in those countries where the judgment has been reached that this sector represents an important element in the economy.1/ Second, in many such cases the Bank Group has decided that it should try to reach not only the largest enterprises but more moderately-sized units as well. When project costs fall below $5-15 million, the Bank needs to work with institutions within member countries to decentralize the appraisal process and move it closer to the point of implementation. Third, the Bank is intent on helping to build strong and effective institutions that have the capacity to secure, and then to allocate, resources into efficient and productive investment and to have an innovative and developmental impact on the sectors in which they are involved. Consequently the Bank Group has provided catalytic support in terms of providing the basic institutional design to be followed, or the basis for a major reorganization, for about half of the DFCs which it has assisted. Moreover, with respect to all its DFC clients, the Bank has continuously tried to sharpen and expand its expectations concerning the developmental objectives of these DFCs as they grew in stature.

1/ While a few Bank-financed DFCs specialize in tourism, the overwhelming bulk of Bank Group DFC lending has been in the manufacturing sector. This, of course, does not mean that the DFC approach is not viable for other sectors. There is, for example, a large overlap between the institutional aspects of agricultural credit and DFC operations, although this paper does not attempt to review policy issues involved in the latter (see Bank Report on Agricultural Credit dated August, 1974). Moreover, DFC-type operations have been developed that have mining and contractors as their target groups. The use of credit intermediaries to reach particular sub-sectors or types of borrowers has obvious potential in a number of sectors.

3. Bank Group DFC activity has grown rapidly over the last 25 years, although there have been important shifts in the geographical orientation as well as the varieties of institutions assisted. The pace of Bank Group DFC financing is indicated in Table I below:

Table I

Bank Group DFC Assistance (FY)

	1950-54	1955-59	1960-64	1965-69	1970-74	1975	Total
No. of DFCs Assisted	3	4	17	23	54	15	70
Amt. of Bank Group financing($m)	20	25	246	641	1,415	507	2,854

While the most rapid period of growth of Bank Group DFC financing in percentage terms was in the 1960-69 period, DFC lending has continued to grow in the 1970-74 period in line with the rapid overall growth of Bank Group activity.

4. Geographically there have also been shifts in DFCs in the past 10 years as the Latin American Region and East and West Africa have increased their relative position (see Annex 2).

Table II

Total Bank Group Financing of DFCs at Year-End

	EMENA	LAC	EAP	S. ASIA	E&W AFRICA	TOTAL
1964	77 (26%)	6 (2%)	32 (11%)	170 (59%)	5 (2%)	290 (100%)
1969	376 (40%)	77 (8%)	112 (12%)	354 (39%)	12 (1%)	931 (100%)
1975	1206 (41%)	299 (10%)	477 (18%)	731 (26%)	141 (5%)	2854 (100%)

The low level of operations in Latin America resulted from the Bank Group's pre-1969 policy of financing only privately controlled DFCs. While a number of private financieras existed in Latin America, few could obtain governmental support (in terms of guarantees) for Bank financing. Moreover, the Inter-American Development Bank and US AID were active in financing both private and public development institutions in the LAC Region. In Africa, manufacturing activity was at its earliest stages and in many cases in the pre-1969 period it proved either impossible or inappropriate to create privately controlled DFCs. Low interest rate policies in parts of Africa in the late sixties also often resulted in DFCs there being dependent on low interest rate bilateral loans.

The Private DFC Model

5. In pursuing a policy of financing privately controlled DFCs the Bank in fact created hybrid institutions that represented a cooperative venture between the Bank Group, foreign investors (usually international commercial banks), the government and domestic investors (usually financial intermediaries and/or manufacturing enterprises or business associations). This design meant that the DFC was expected to follow a mix of commercial and developmental objectives. In some cases these objectives tended to pull in different directions and allowances were often made by all partners to achieve the right balance of objectives and policies. Private institutional investors often settled for lower returns on their DFC investments than they would have normally expected from alternative equity investments. Governments often gave subsidies to DFCs not generally available to other financial institutions in order to support institutions they believed would make a worthwhile contribution to development. Consequently, the benchmarks for measuring a DFC's suitability were broad. DFCs were not to be a source of long-term funds on more favorable terms than other lenders but rather their involvement in projects, sector development issues or policy issues was to lead to a unique developmental contribution. The expectations placed on them from the outset in terms of their defined policy objectives made it clear that their approach was not based on a single focus of profit maximization. Nevertheless, they had to be concerned about earnings because an increased equity base over time was essential for growth. Managerial and decision making autonomy was also considered important in such institutions, although the DFC was expected to have open communication with government on the latter's policies and objectives and to hold the confidence of the government. In this connection the Bank sought a high level of professionalism in the DFCs it financed; i.e., they were to have or were to develop capable analytical staff and clear and acceptable decision rules. Finally, these DFCs were never intended to be wards of the World Bank. It was hoped that they would broaden their funding base over time and that they would play a role in the development of domestic capital markets.

6. Given these broad and demanding objectives it is clear that the Bank's DFC work has been characterized by an institutional focus. The Bank was not so much concerned that its particular funds found their way to projects that met agreed criteria, but rather the Bank strove to help develop associated DFCs into strong, self-reliant institutions capable of making a growing contribution to development, and which would have the ability to evolve to meet changing environments.

Widening Options: 1969-1975

7. The purpose of this background is not to evaluate the relative success of the Bank Group's pre-1969 model. The OED Evaluation Report (Sec. M74-529 dated July 26, 1974) goes into this subject in great detail. Rather it is to point out that by 1968 three basic lessons had been learned. First, the institutional focus was a valid one as many Bank associated DFCs had in fact developed into institutions of stature. Second, while all of the DFCs assisted by the Bank Group up to that time enjoyed varying degrees of financial success and recognition as professional institutions, the model was simply not applicable in many countries.[1] In these countries the model did not fit with government

1/ The very first DFC assisted by the Bank (the government-owned Development Bank of Ethiopia) encountered serious problems and eventually went out of business.

wishes for developing public sector institutions, or the factors necessary to bring forth private capital for such an endeavor simply were not present, or the functions to be carried out were such that a market level of profitability could not be achieved without undue subsidies. Third, the Bank had become well aware that what mattered more than who held the shares of a DFC or its particular institutional design, were the processes, policies and degree of professionalism applied in the DFC's work which in turn often reflected the calibre and vision of DFCs' senior management and staff. While institutional design may in many cases play an important role in determining the kind of leadership and staff a DFC has, there has been ample evidence that, irrespective of ownership arrangements, the specific leadership of a DFC is a major factor in explaining relative dynamism among DFCs.

8. It was in recognition of these and other factors that the Bank modified its policy at the end of FY1968 to enable it to consider financing government-owned or controlled DFCs serving the private sector. Subsequently, it was also agreed that the Bank would be open to both public and private DFCs, financing government-owned enterprise if this appeared appropriate in the circumstances and if sound decision rules were applied to the public enterprises to be financed. This latter change in policy enables the Bank to try to come to grips with medium-size public sector enterprises through DFCs which is a particularly important option to have in countries where the state is heavily involved in industry. Nevertheless, the great bulk of lending through both government and private DFCs has been to privately-controlled enterprise at the sub-project level. (About 95% through FY75 and on the order of 85-90% in the next five-year period.)

9. After the change in policy toward government-controlled DFCs, the financing of such DFCs by the Bank has become pronounced. While 32 new DFC borrowers were added to the Bank Group's books in the 1969-75 period, only 7 of these were privately controlled DFCs.[1] The reason for this ratio was not a preference *per se* for government-controlled DFCs but rather that the Bank Group had exhausted, relatively speaking, the opportunities where the private DFC approach was feasible. Overall Bank Group lending to public as opposed to private DFCs has developed over the last five years as follows:

Table III.

Bank Lending to Public and Private DFCs FY71-75
($ million)

	FY71		FY72		FY73		FY74		FY75		TOTAL	
	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.
Public DFCs	3	24	10	156	4	120	8	139	8	292	33	731
Private DFCs	9	230	6	96	10	215	10	207	6	214	41	962
Total	12	254	16	252	14	335	18	346	14	506	74	1693

1/ Excluding 4 rather *sui generis* Yugoslav mixed commercial/investment banks.

10. The Bank has been pragmatic in its choice of institutions since 1969. When Bank assistance to create new DFCs has been requested by member governments the Bank has explored alternative ownership patterns and, taking into account the member government's preferences, has tried to adopt an approach and design which, given the total environment, would have the greatest chances of working effectively. Annex 3 gives some basic parameters of DFCs assisted to date by the Bank Group.

11. However, of greater interest, in the past 5 years or so, is the increasing variety of types of DFCs now assisted by the Bank Group. While most of the DFCs financed in the pre-1969 period shared many common characteristics, subsequent lending is marked by the diversity of institutions assisted and while many government-owned DFCs have a capital structure, role, policies and a sub-project profile not unlike their private counterparts, many others do not.

12. First, the Bank has commenced lending to a number of mixed banks in Yugoslavia, Egypt, and Pakistan, i.e., banks carrying on a large volume of commercial banking activity as well as providing significant long-term project finance. The Development Bank of Singapore moved in this direction subsequent to a Bank loan and this mixed banking approach has been recommended by the Bank but rejected in at least two other cases. In some economies the institutional set-up already includes banks that handle both short-term commercial business alongside long term investment and creating a new specialized institution may not make sense particularly if there are strong constraints on managerial skills in the country. Such mixed banks also have opportunities for resource mobilization by means of deposits, although such opportunities do not necessarily lead to higher savings at the margin. Such banks also have the possibility of being in a close supervisory position with clients as they often handle the day to day banking needs of their clients. However, in many cases the facts will argue that to tackle the variety of functions and issues most DFCs are engaged in will require the attention and focus of a specialized institution providing loans and equity finance and other services to productive enterprises.

13. Second, in a number of cases the Bank has decided to finance institutions which in turn passed Bank funds on to a network of financing institutions (India, Colombia, Brazil, Mexico, Philippines). In such cases an important objective was to get the Bank's primary borrower to take on the supervisory and institution-building role vis-a-vis subsidiary borrowers in the same fashion as the Bank normally does with its direct DFC borrowers.

14. Third, the Bank has financed some very large, government-owned, multipurpose institutions which carry on a wide variety of financial, investment and service functions. Examples of this are the Korea Development Bank, the Industrial Development Bank of India, and the Development Bank of the Philippines. In some such cases these institutions are the mechanism for carrying out specific government programs that arise from time to time for which the government requires an agent or intermediary. Such institutions find themselves in a closer interface with the day-to-day operations of government than do other DFCs.

15. Fourth, as noted earlier, the Bank has had the opportunity to evaluate and finance government institutions which have as their target public sector industrial activities (Tanzania, Pakistan, Turkey,and Algeria). If in some cases, but by no means all, public sector industrial investment activity confronts many difficult issues, the potential benefits of a strong institution capable of establishing financial disciplines, guiding investment decisions

and encouraging efficient project supervision and implementation are great and this is an option opened up by the flexibility in Bank policies on ownership issues.

16. Fifth, the Bank has been able to finance and otherwise assist, particularly in Africa, DFCs that perform a wide variety of financing functions. These include institutions that provide both agricultural and industrial credit (AIDB in Ethiopia), or in addition to this consumer and housing finance plus short-term credit (BCD in Cameroon and ICC in the Ivory Coast) and also institutions that have acted as a vehicle for government promotion, participation or ownership of various types of enterprises (AIDB in Ethiopia and BDC in Botswana).

17. The breadth of institutions now served is, consequently, very wide as Annex 3 indicates. Bank assisted DFCs now range in size from the Liberian DFC (total assets $3 million) to the Korea Development Bank (which has total assets of about $3 billion). The Liberian DFC (LBDI) has had a recent average loan size of $91,000; the Korean DFC (KDFC) an average size of $570,000; and IMDBI, Iran, an average loan size of $2,300,000. The Turkish DFC (TSKB) has by and large stuck to the manufacturing sector; the Irish DFC (ICC) has financed shipbuilding, trade and services as well as manufacturing. The Ethiopian DFC (AIDB) has financed farmers as well as acted as caretaker for a number of large government-owned manufacturing plants. Some DFCs have been active in hotel financing and others have decided not to finance such projects. These variations are considerable, even among private DFCs, and therefore the DFC umbrella covers an extremely broad range of institutional forms and underlying types of business being done.

The Consistency of Approach

18. While the variety of institutions served and the nature of their clientele have differed widely, the approach of the Bank Group to DFC financing has had a consistent core. First, in undertaking such operations the Bank has tried to assure itself that the policies pursued by the government to stimulate investment and growth in the sector or sectors served by the DFC are reasonably conducive to support economic investment in those sectors. A DFC, whether private or government-controlled, cannot go far in counteracting the distorting effects of seriously unsound government policies in its investment decision processes. Similarly the sectors served by the DFC should be of demonstrable economic importance in the country to give this type of project appropriate priority in the Bank's lending program. Bank loans to DFCs are not usually sector loans since they normally cover an extremely wide variety of sub-sectors and their focus is the institution, its capacities, decision rules, etc. as opposed to an in-depth analysis by the Bank of a specific sub-sector's needs, the policy framework for that sub-sector and an overall plan to deal with the issues arising therefrom. However they can have a sub-sector focus if the government, the Bank and the institution see an important need for and have developed a policy framework to develop a specific sub-sector which requires specific support and attention. Moreover, DFC loans provide one important potential venue for Bank discussion of general industrial sector policies that have been analyzed by the Bank and if the DFC has the right kind of staff it can undertake work to help examine some sector issues. It is clear, however, that such discussions must be integrated into the Bank's overall dialogue on economic policies with member governments.

19. Second, the Bank is concerned with examining the extent to which additional funds are necessary to meet investment demands in the sectors concerned and the resulting impact Bank financing can have both in assisting productive investment and in meeting the financial gap of the DFC involved.

20. Third, the Bank focuses on the specific characteristics of the DFC - its strengths and weaknesses. The broadest concern is the institution's own policy orientation. Is its policy consistent with the government's policy orientation and are the DFC's objectives consistent with the Bank's objectives in the country concerned? This analysis not only reviews the DFC's general policy objectives and analysis of the characteristics of its investment activity but also more difficult judgments concerning what the institution is adding to the development process in the way of innovation of new approaches or ideas relevant to its clientele and the sectors it serves.

21. The next group of questions is simply the capacity of the institution to use capital effectively. This implies competent management and staff, effective appraisal procedures, appropriate financial and economic decision rules, thorough follow-up and reporting systems and effective communication between the DFC, the business community it serves, and between the DFC and government.

22. The final level of concern the Bank addresses in evaluating DFCs is their financial viability in the context of the financial systems in which they operate. The Bank has not financed DFCs on the basis of simply maximizing the Bank's probability of getting repaid irrespective of the DFC's overall financial fortunes. The objective is to establish policies and procedures so that the intermediary will remain solvent, creditworthy and capable of growth throughout both the peaks and valleys in the economic health of its sectors it serves. Consequently, the areas of concern normally include the quality of the DFC's portfolio, the adequacy of its equity base given the nature of its business and the risks it is exposed to, its financial planning, liquidity and debt service capacity and its ability to maintain an appropriate level of administrative costs while at the same time earning returns in line with its self-financing needs and its public or private owners' expectations.

23. In the pursuit of these objectives the Bank has played an important part in the development of about 70 institutions that this year will disburse some $3.25 billion in long-term industrial capital. Essentially all of these have established sound portfolios and the capacity to weather economic downturns; most enjoy a rate of growth higher than that of the sectors they finance and many have had the ability to adjust to fairly basic shifts in their working environment.

24. Given the variety of DFCs now financed and the variation in their environments which range from highly centralized planning to highly market oriented economies, financial or policy guidelines appropriate in one case will not always be appropriate in others and thus the task of evaluation of standards and policies appropriate for a particular DFC has steadily become more complex. Moreover, expectations as to what constitutes a developmental contribution have changed over time and this requires new responses and ways of looking at and dealing with DFCs. Attention is now, therefore, directed to a number of issues the Bank repeatedly confronts in its DFC lending activity in order to help further define and clarify the current approach of the Bank in this field of lending.

II. CURRENT OBJECTIVES AND ISSUES IN DFC LENDING

A. Economic Returns of DFC Lending

25. During the 1960s the Bank Group's emphasis in its DFC lending was to develop institutions with strong professional skills in the areas of financial, marketing, technical and managerial evaluation. When the Bank surveyed the landscape for institutions which competently looked deep and hard into prospective projects, it often found that such skills were lacking and thus it is not surprising that the Bank Group was simply passing onto its DFC clients the tools and criteria it had used in its own work as a development bank in the industrial sector. This is not to say that the economic characteristics of projects were ignored. Indeed there were a number of cases where the Bank and DFCs engaged in dialogue over projects with questionable economic characteristics. However, there was no systematic attempt by most DFCs to determine quantitatively the economic efficiency of projects.

26. There was, consequently, increasing concern that in many countries normal financial return signals could give quite misleading results if one relied on them as a proxy for indicating economic efficiency. Various distortions in the pricing system due to protectionist policies, subsidies, inappropriately priced factor inputs, etc. raised two major issues for the Bank to deal with. First, how severe were the price distortions and had DFCs been financing a lot of inappropriate projects in terms of their having inferior economic returns relative to other Bank-financed projects? Second, how could the Bank Group develop and heighten sensitivity to economic appraisal skills in DFCs?

27. Work proceeded on both fronts. Concerning economic yields, five DFCs were chosen for an intensive review of sub-projects already financed and where there had been at least a year's production experience so that the research could be done with fairly hard data. The five DFCs studied were ICICI in India, IMDBI in Iran, KDFC in Korea, BDET in Tunisia, and TSKB in Turkey. These DFCs were chosen in order to give indicators for a wide variety of economies and because they accounted for about 40% of all Bank Group disbursements at the time the studies commenced. All five institutions were long-time Bank borrowers, and all, with perhaps the exception of BDET, had enjoyed continuity of management and quite highly qualified senior staff. Subsequently, another set of institutions, namely the financieras in Colombia, were studied from somewhat the same perspective. None of the institutions chosen were from the new ranks of DFCs financed in the post 1969 period as Bank experience with these new borrowers was too early to generate actual sub-project data.

28. For each of the six countries, the sample of projects studied in depth was representative of the types of industry the DFC normally financed. A total of 160 sub-projects were studied. The input of staff time was considerable as it required an average of 3 manweeks per project to evaluate using actual data and determining the basic adjustments for the appropriate pricing of labor, exchange rates, etc. The summarized results are indicated below.

Table IV

Economic Rates of Return (ERR) of DFC-financed Projects

	ICICI India	IMDBI Iran	KDFC Korea	BDET Tunisia	TSKB Turkey	Colombia	Total	%
No. of Projects studied	42	32	11	23	23	29	160	100
No. of Projects with:								
Negative ERRs	1	3	2	-	4	1	11	7
ERRs 0-10%	8	5	1	3	3	4	24	15
ERRs of 10-25%	13	14	-	3	8	4	42	26
ERRs of over 20%	20	10	8	17	8	20	83	52
Weighted Average ERR	19	17	31	36	11	32	23	
(Weighted Average Financial RR)	(17)	(14)	(29)	(11)	(16)	(18)	16	

29. With a weighted average ERR of 23% for the 160 projects, and with three-fourths and one half of the projects showing ERRs over 10% and 20% respectively, the results were encouraging and perhaps even surprising given the view that in almost all the countries studied there was thought to be a fairly aggressive important substitution, protection-based, industrial development strategy. Moreover, given the fact that the DFCs were not employing at the time the sub-projects were selected any sophisticated economic analysis tools, the conclusions showed that normal financial tests employed by the DFCs did,overall,lead to a favorable allocation of resources in terms of economic returns. However, individual projects did show weak or negative economic returns but good financial returns and to some extent this could have been anticipated by proper economic analysis at the time of project appraisal.

30. The studies focussed heavily on the economically unattractive projects to see whether any useful lessons could be learned that could be applied in the future. Poor economic returns measured ex post 1/ can, of course, be the result of a number of factors. While one cause may simply be that a project is basically uneconomic, other causes are misjudgments about markets and competence of management. Projects economically viable in concept can fail in implementation. Unfortunately no simple general answers emerged. The projects that performed poorly did so for a wide variety of reasons. Most commonly, the market for project output did not develop in the way anticipated. In some cases unforeseen technical difficulties arose. Hindsight suggests that some of these problems could reasonably have been anticipated through more careful appraisal of a conventional sort; by a deeper probing into such things as market potential, engineering soundness and managerial competence. It was also difficult to judge with certainty how many of these unattractive projects might have been screened out had the DFCs concerned been applying reasonably rigorous economic analysis at the time the project was selected. In a few cases a major factor in the poor performance of a project was the wide disparity between domestic and international prices. Economic rate of return analysis would have highlighted this problem.

1/ The analysis was based on actual capital cost data and actual operating cost data for historic periods. For the remainder of the economic life of the projects, the analysis was based on latest estimates for revenues and costs.

31. The overall conclusions that can be distilled from the studies are the following:

(a) By and large the overall economic returns earned in the past on DFC-financed sub-projects are attractive.

(b) There have, however, been some very weak (in economic terms) projects financed that could have been screened out by appropriate economic analysis.

(c) The importance of applying rigorous ERR analysis is greatest in those countries where there are wide discrepancies between domestic and international prices.

(d) The ERR tool applied in the appraisal stage when difficult assumptions concerning domestic and international prices need to be made is not useful for making finely tuned distinctions between projects of varying degrees of acceptability, but it can be used as an indicator to weed out the seriously deficient projects. While it is certainly feasible for DFCs to use this tool and a serious educational effort is being made to help DFCs develop their skills in this area, in some types of projects, e.g., non-tradeable goods or multi-product ventures, it is more difficult to apply.

(e) Good economic analysis is feasible only on the basis of good project analysis based on traditional approaches and it is still at the stage of applying traditional project tests that many mistakes are made.

(f) Economic analysis applied early on in the project cycle can also occasionally be useful to help DFCs adjust projects to make them more efficient in economic terms.

32. Turning to the Bank's approach to sensitizing DFCs to these issues, in late 1969 it was almost universally the case that DFCs operated within the constraints of a framework of government policies that usually contained a variety of fiscal incentives to promote manufacturing investments and systems that judged projects only against a rough list of indicators, e.g., How much foreign exchange is saved or earned? How many jobs will be created? Where is it located? Is it on government's priority list of investments? Few governments, even in cases where there is licensing or where incentives are handed out on a project by project basis, have data or skills required to subject the project to a serious economic cost/benefit analysis.

33. In this context in 1969 the Bank began working with a number of DFCs to develop useable economic analysis tools. Given the facts that most lines of credits to DFCs are to finance scores of projects in a wide variety of subsectors and that the projects are not yet appraised or perhaps not even identified, Bank staff could not carry out economic rate of return analysis at the time it appraised a DFC for a loan. In line with its normal institution building objective, the alternative was to have the DFC making the appropriate analysis

when detailed information was available on the sub-projects. As a first step a number of DFCs were introduced to effective rate of protection calculations which compared value added in domestic prices with value added in terms of international prices in the first full year of capacity operation. Subsequently the Bank issued guidelines to its DFCs for economic rate of return calculations. In those cases where it is important to apply economic rate of return analysis the Bank has had to undertake an education effort with the staff of the DFCs 1/. This is done using individual projects as points in case, seminars in the field with DFC staff, and training here in Washington for the staff of DFCs both in the Bank Group proper and in the EDI Industrial Projects and the Development Banking Courses.

34. One of the by-products of DFCs' use of ERR analysis has been to occasionally place the DFC at odds with specific government objectives. It has happened on a number of occasions that DFCs (both private and public) have encountered specific projects which, according to the DFC's analysis had poor economic prospects but which nevertheless had strong government backing because of perceived priorities within the government. The DFC is thus placed in a difficult position, particularly if the project meets financial but not economic tests. What such a case can provide, regardless of how the individual case is disposed of, is an opportunity for the DFC to open a dialogue with the government on the policy issues raised by such situations. It is therefore also important that the Bank, in reviewing manufacturing sector policies and investment incentive and selection tools used by governments, try to insure that the criteria being applied by government and DFC decision makers are consistent.

B. Employment and DFC Lending

35. Within the general concern of the economic impact of DFC lending, the employment impact of industrial activity has generated considerable interest. In particular, in those countries where there is a serious unemployment problem, it is important to consider the employment impact of project decisions. How does DFC lending affect employment problems? Can employment effects of such projects be improved?

36. In the six countries where DFCs were studied in depth, supplementary data was calculated on the direct employment generation attributable to the sub-projects, although it was recognized that this was only a preliminary approach to analyzing the employment impact. Such data is also now being collected *ex post* and *ex ante* on DFC lending generally and thus one finds situations on capital cost per direct job created ranging from $7,000 in Colombia to $48,000 in Greece. The projects of the DFCs in the six countries studied in depth revealed the following pattern.

1/ DFCD, Guidelines for Calculation of Economic Rates of Return on DFC Sub-Projects, mimeo, IBRD, June 7, 1974. The Guidelines attempt to demonstrate a pragmatic approach to economic project analysis and present two stages of approximation for ERR calculations. The Guidelines were sent to all DFCs for application to projects. The economic merits of smaller projects are gauged by simpler indicators such as the domestic resource cost per unit of foreign exchange saved or earned (Bruno ratio).

Table V

Fixed Investment per Employee in DFC Projects

	ICICI India	IMDBI Iran	KDFC Korea	BDET Tunisia	TSKB Turkey	Colombia	Total
Number of projects	42	32	11	23	23	29	160
Fixed assets/employee:							
Less than $10,000	30	14	5	12	13	19	93
$10,000 - $20,000	8	10	2	9	7	4	40
$20,000 - $30,000	1	7	1	1	3	-	13
$30,000 or more	3	1	3	1	-	6	14 1/
Average cost/job ($'000)	9.0	12.1	13.2	11.0	11.6	7.0	10.2

The studies showed an average cost per direct job of about $10,000 for the 160 projects, of which almost two-thirds were below this average. It was also demonstrated that the investment per job increases with the size of projects. It is difficult to draw conclusions from the employment data generated by the six studies in comparison with similar indices for the manufacturing sector as a whole in these countries. If anything, the sample average of $10,000 per job created may be taken as representative for the capital/labor mix of medium-sized projects. On the other hand, a comparison of the projects' direct employment data did demonstrate, as would be expected, that if capital cost per direct job was taken as a critical indicator and projects were rejected that had high capital cost/job this would have led to the rejection of numerous projects which were both financially and economically sound within the context of appropriate prices being applied for the value of foreign exchange, labor costs, etc. Similarly there were projects with low capital cost/direct job created ratios that were distinctly uneconomical.

37. Given the inconclusiveness of the data concerning employment in the studies noted above, the Bank undertook a study of DFC lending in Colombia to see whether more meaningful conclusions or guidelines could be developed on the employment question. In particular, attempts were made to look at the indirect employment impact as well as the direct. The preliminary data indicates three major points. First, the Colombia project sample show that the indirect employment creation was about 50% of the direct employment generation. Second, individual projects had widely divergent employment impacts as between direct employment and direct plus indirect employment, thus highlighting the unreliability of the direct cost/job ratio as a meaningful indicator in isolation. (In 5 of the 29 projects studied the inclusion of the indirect employment impact moved the projects from a positive aggregate employment position to a negative overall effect on total employment.) Third, using the refined data on both direct and indirect employment impact it was found that using the cost of total employment generated as an indicator for economic returns was not feasible as there was poor correlation between the two (see Annex 4). While it is likely that

1/ Includes 6 projects with no or negative direct employment generation.

industrial projects will have a lower employment impact per unit of investment than projects in some other sectors, the aggregate employment impact of DFC financed projects is sizeable. Extrapolating from the data from the studies noted above, it is likely that the total job opportunities created by DFC-financed projects in countries where the Bank has an active DFC financing program is about 800,000 in 1975. This represents about 6% of the new industrial employment created in a majority of these countries and over 12% of the increment in one-third of them.

38. While much remains to be learned about the employment creating aspects of industrial development, the work to date on DFC lending suggest that there is not yet any easy indicator or cut-off tool emphasizing employment that can be applied to industrial project selection by DFCs. The direct employment creation data can even be misleading as to overall employment impact. The pragmatic ways of dealing with this is to:

(a) Ensure that factor pricing in the ERR analysis done by DFCs captures the employment aspect of the equation by giving labor, capital, foreign exchange, etc. their proper values given the supply/scarcity situation of the economy.

(b) Endeavor to sensitize DFCs in labor surplus economies to keep in view what can be done within their project promotion or project evaluation processes to insure that when there are options for improving a project's employment impact by use of alternative technologies or designs, that they continuously question themselves about such possibilities. This comes down to developing the breadth, focus, and expertise of DFCs' engineering staffs and encouraging them to be alert to alternative technologies.

(c) Support efficient study efforts in borrowing countries that seek to adjust technologies to make them more appropriate for local conditions.

C. DFCs and Small Scale Enterprise

39. A related issue that often arises in connection with DFC lending activity is the size spectrum of borrowers assisted by DFCs and whether DFCs have had, or should have, an impact on small scale firms. One of the first problems in evaluating this matter in a specific country context is how to define what is meant by small scale enterprise activity. There is no common definition by asset size, employment or turnover and thus what might be labeled small-scale in one economy is perhaps medium or large scale in another. Thus one needs to exercise care in determining what scale of enterprise is being financed in a particular setting. For example, in the 1970-72 period the average loan size of IMDBI (Iran) was about $1.25 million and the median size of firms assisted was about $2.00 million in assets. In Liberia (LBDI) the similar figures were about $12,000 and $30,000, respectively. Nevertheless, this type of data does not tell one much about the relative effectiveness of the two institutions, how appropriate their policies toward small scale enterprise have been, or whether they should be doing more small enterprise financing.

40. A study undertaken of a large sample of Bank associated DFCs in the 1970-72 period indicated that of about 5,000 enterprises financed by the respondent DFCs, about 50% (by number) had fixed assets after project

completion of less than $300,000; about 30% had fixed assets below $100,000. About 30% of the enterprises financed had assets over $1,000,000. The distribution of the asset size of sub-borrowers among DFCs was, of course, quite wide, and only about 5-10% of the total volume of DFC lending was to enterprises with assets below $100,000.

41. While the above data indicates that Bank assisted DFCs finance considerable numbers of relatively small manufacturing enterprises, it is also true that in almost all cases these institutions are not expected to tackle the problems of the smallest entrepreneurs in their countries. There were only a few cases where the DFC financed artisanal activity in the informal sector. Basically their areas of activity were considered to be the modern sector and the type of lending that required substantial technical assistance was not normally put under their responsibility. Problems of assisting very small firms were not addressed by the Bank or most of its DFCs.

42. Given the lack of focus on smaller firms it is not surprising that in an effort to redress the balance particular DFCs have been criticized for not shifting their lending operations toward smaller borrowers, i.e., say, enterprises with assets below $150,000. However, the problems and potential of financing small enterprise should be addressed more systematically. In some cases DFCs which have been financed by the Bank can and should play a direct role in financing small enterprise and special programs can be developed under their auspices. This has happened for example in the case of Mauritius (DBM) and a number of other DFCs are exploring this area. However, it may often be the case that other approaches involving more diffusive institutions, specialized focus and financial support and special technical assistance will be more effective, although perhaps more difficult to set up, than pressing DFCs to dramatically shift the size distribution of their lending.

43. What may be of more general relevance in DFC financing than the size distribution of projects financed are the issues mentioned in paragraphs 68 and 69; namely, to what extent the DFC concerned is using its energies and resources in financing firms that do not really need its help at the expense of foregoing projects which are more dependent on the DFC's counsel and resources. The division of effort between various classes of borrowers is an area of creative tension in which the conscientious development banker must live as he steers a course between backing viable productive projects and taking risks.

44. What is clear, however, is that the Bank has not, until the last year or two made significant efforts to try to deal with the size of enterprises falling outside the range served by DFCs in many member countries. Such enterprises are pervasive in most economies, they employ substantial numbers of people and they provide balance to the ownership distribution of productive assets. While such enterprises are not always operated by people falling low in the income distribution curve, they are usually some distance from the entrepreneurial class which has a heavy involvement in larger scale industry. Issues on which the Bank is trying to find some substantive answers are the marginal impact and cost of assisting small enterprise, how assistance should be packaged to optimize its impact, and how critical this sector is in the growth equation in developing countries. Some preliminary insight to the complexity of the latter problem are noted in Annex 5 concerning the study of DFCs in Colombia (See paragraphs 85-88 for discussion on future activities re small scale enterprise.)

D. DFC Interest Rate Policies

45. The relending terms of DFCs touch on complex issues of critical importance to the DFC as well as basic government policies in the area of resource mobilization and credit allocation. There are a number of issues that converge at the point of decision on relending rates.

(a) From the outset of its DFC lending activity the Bank had expressed the view that normally it was interested in building institutions that would develop, over time, the capacity to mobilize resources from other sources and thereby reduce their dependency on the Bank.

(b) Nevertheless, in the majority of cases DFCs are required to lend at rates below what it would cost them to mobilize funds either in domestic or foreign markets. Governments often use interest rates as an incentive and also undertake to capture for government account, a large portion of the saving stream. Although capital is scarce governments often deliberately price it at levels not truly reflective of that scarcity.

(c) The rapid acceleration of inflation in many countries in the last year or two, and uncertainty on exchange rate adjustment questions, have led to even greater difficulty in forging positions on the appropriate relending terms for DFCs.

(d) Divergence in the nature of the economies and DFCs served by the Bank have further complicated the picture. The pattern of environments range from market-oriented financial systems, to systems that, while basically market-determined, also contain substantial privileged credit circuits; to economies with centrally directed and managed financial systems.

(e) Interest rate questions are often vital for DFCs. They determine how the DFC can mobilize resources, the risks to which it exposes itself, and the level of administrative costs it can bear.

Given the confluence of all these forces, how should the Bank's policies on relending rates be defined? What are the appropriate objectives?

46. In reviewing the appropriateness of the on-lending charges of a DFC the Bank must make basic judgments about government interest rate policies.[1] In general, it is the Bank's objective that borrowers from DFCs pay interest and other charges which approximately reflect the cost of mobilizing capital both at home and abroad and the opportunity cost of capital in the country. This will normally mean that sub-borrowers over the longer term will be paying real, positive rates of interest. Such rates will facilitate the mobilization of capital and the efficient allocation of capital within the concerned sectors. They also permit adequate earnings by DFCs, enhancing their ability to attract equity capital and to bear the costs and risks of an active promotional role.

1/ Annex 6 contains current relending rates of DFCs currently borrowing from the Bank.

47. The underlying rationale for this general posture is that direct allocative measures that seek to provide long-term credit to the industrial sector which run counter to market signals are difficult to manage and are likely to be ineffective. Other tools must, as a result, be imposed to balance credit demand with supply and this may mean that collateral or social standing become important criteria, thereby blocking access to credit by non-prime borrowers. Leakages of credit in administered systems can often lead to frustration of policy objectives. Second, interest rates are not often an efficient incentive device for steering investment to particular areas or activities. Interest costs are a relatively small part of total costs for most DFC clients. Interest subsidies discriminate in favor of those activities which are capital-intensive, and only if the industrial strategy of a country calls for justified encouragement to these sectors is an interest rate subsidy logical. Third, industrial borrowers are often at the highest end of income earners in developing countries. Governments have many claims on their resources, and use of these resources to subsidize such borrowers may not be easy to justify. Finally, institutions which are unable to lend at market rates will be largely dependent on credit facilities obtained on their behalf by the government. This can potentially affect overall resource mobilization in an economy; at a minimum it means the DFC involved will be a captive of its government's financial decisions.

48. While the above represents a general posture, each particular operation must be viewed in the specific country context. The starting point of the analysis of such issues is the current financial situation of the country. What is the overall savings performance in the country, and within the total, how adequate is the level and structure of financial savings, since the evidence suggests that the interest rate is of importance mainly with regard to financial savings? Are interest rates policies consistent with the country's objectives concerning the role of financial intermediation? To the extent that the level and the pattern of flows of financial savings into the financial intermediaries are considered satisfactory, there is less of a case for interest rate modification from a savings perspective, although in such cases the cost to the government of subsidizing certain credit streams may still not be justified given higher priority claims on the government's revenues. However, it is more often the case that the Bank faces situations where the government's fiscal system is weak, overall savings are low, and there are high priority competing claims on government revenues. On the allocation side, it is necessary to consider whether the pricing of capital reflects scarcities in the economy. While privileged credit circuits for particular activities may in some cases be an integral part of an effective plan to induce high priority investment, in other cases they may be more symbolic than effective. When price can no longer be used to balance credit demand with supply other rationing devices must be found and stringent collateral requirements and risk reduction through lending to only the most well established firms may result.

49. The next area of examination is a review of interest rates in the context of the DFC's capacity to mobilize resources in domestic and foreign markets. In some cases the question might be irrelevant if (i) the government by choice determines that it wishes to mobilize all resources for the DFC; (ii) international market conditions together with country conditions rule out significant non-governmental borrowing; and/or (iii) domestic capital markets are at a stage where medium or long-term resource mobilization by the DFC is simply not feasible. In such cases one is thrown back to the consideration of the preceding paragraph when reviewing the adequacy of interest rates; although

for many Bank-financed DFCs total dependence on government cannot be contemplated indefinitely, and in others, as a matter of institutional strategy, increasing capacity to directly mobilize resources may be an important objective.

50. The problem of the adequacy of interest rates is particularly acute in the context of the high rates of inflation which most countries have experienced over the past two years. While many LDCs have made small upward adjustments in the level of interest rates, it is apparent that current rates of inflation are well above interest rates on deposits in almost all countries, and sometimes above interest rates on loans as well. In determining the appropriate interest rate for medium and long-term lending by DFCs, however, this is not the only criterion. The benchmark for measuring the appropriateness of a DFC's lending rates will be what the DFC would have to pay to borrow medium- or long-term funds in domestic or foreign markets plus a reasonable spread. This is feasible when there are reasonably competitive markets open to the DFC, similar institutions, or the government. In most LDCs, however, the markets for medium- and long-term capital are not well developed, so that some approximation of the cost of mobilizing such resources must be used. This is most usefully expressed in terms of real interest rates, i.e., the nominal interest rate adjusted for the expected rate of inflation over the life of the deposit or loan. Historical analysis based on some of the developed countries, and the experience of the LDCs themselves during the past decade, suggests that the interest rates needed to mobilize capital are seldom less than 3 - 4% in real terms, although the data base for this conclusion is narrow. Adding a reasonable spread to this base would suggest relending rate targets of 5 - 6% in real terms. Given the fact that many LDCs presently have interest rates which are below, or at least very little above, even the expected rate of inflation over the life of the sub-loans, it would seem appropriate for the Bank to seek that DFCs charge minimal real interest rates of 5 - 6%. This would provide DFCs with an adequate spread over the approximate cost of mobilizing capital. On a more theoretical plane, rates at these levels are below the opportunity cost of capital, generally estimated to be a minimum of 8 to 10% in most LDCs, the difference permitting a reasonable return to marginal enterprises.

51. Three other observations are in order. First interest rates cannot be viewed in isolation from how the foreign exchange risk on foreign credits is handled. DFCs are not able to cover foreign exchange risks. Generally, one would expect sub-borrowers to be able to assume the exchange risk or to compensate through a premium to the interest rate, the government, central bank or other institution which is prepared to accept fully or partially the exchange risk on their behalf. A fair premium is difficult to calculate and is sometimes rejected by governments because it may establish undesirable expectations. Having the exchange risk borne by sub-borrowers obviates the need to forecast or justify a particular premium and, as a practical matter, governments have frequently been prepared to accept the transfer of the foreign exchange risk to the ultimate borrower, even when they are reluctant to accept reasonable approximations to market rates of interest on term loans repayable in local currencies. One particular problem of Bank loans (unlike bilateral credits to DFCs) is that DFCs are unable to tell sub-borrowers in advance what currencies they will receive and, after they are determined, in what order they will be recalled. In countries of severe foreign-exchange control, sub-borrowers will not be discouraged by such conditions as access to freely convertible hard currencies will offset the problem. In other countries it can prove a very difficult negotiating point between DFCs and their customers and here there is the possibility of sharing risks between the government and sub-borrowers by having the latter assume the risk in a single major currency used by the Bank, or denominating sub-loans in currencies of procurement, and having the residual risk assumed by the government (at a fee if appropriate).

52. Second, in countries with high and variable rates of inflation and infrequent but large exchange rate adjustments, it of course becomes difficult to anticipate with assurance inflation rates over a 7-10 year period. One solution has been complete or partial indexing of debt service payments to international price levels. Another alternative, variable-rate lending along lines followed in recent years in many term loans on the eurodollar market, also suggests itself as a practical response to this problem. This course has not yet been adopted by any Bank-associated DFCs but deserves increasingly serious consideration in some cases.

53. Third, in some centrally planned economies where the industrial sector is largely state-owned, interest rates may play an insignificant role in resource mobilization or allocation. If the system is as closed as implied, the Bank need not be concerned with the overall interest rate structure of DFCs, although if Bank capital were to be channeled to industrial enterprises in such economies at what, by international comparison, would be low rates, special justification would be needed to establish why the enterprise assisted should not bear the full costs of the foreign borrowing. However, interest in decentralization and the use of intermediaries in resource mobilization and the decision-making process is not uncommon in highly socialized economies. Yugoslavia provides such an example.

54. In the final analysis interest rate decisions must be judged in terms of the adequacy of the country's overall financial strategy and against the background of the Bank's major objective in lending through DFCs in the specified country. In many cases major objectives can only be served by a close approximation to interest rates established in accordance with the criteria presented above. In other cases, the margin is greater. However, in most countries it is to be expected that over time, as financial markets become less fragmented, and better organized, interest rates charged by credit institutions serving the industrial sector will be established on the basis outlined above, and that the progressive rationalization of interest rates, including rates charged the industrial sector, will itself contribute to the better organization of financial markets.

E. Reliance of DFCs on Bank Financing

55. A question closely related to the interest rate issues discussed above concerns Bank policy for the diversification of DFC financing and the eventual elimination of Bank lending to a particular DFC. In a number of cases the Bank has provided eight or more loans to a DFC. Is this consistent with the Bank's desire to build institutions?

56. As noted earlier, the Bank has wanted to build institutions that would develop the capacity to mobilize resources and not remain dependent on the Bank. In line with this objective the Bank has not normally provided, over time, more than half the resources required by the DFCs it finances. Moreover, in a number of cases it has agreed on a specific program of reducing, over time, a DFC's dependency on the Bank.

57. Recent cases where the Bank has had a declining role in DFC resource provision have been in Morocco, Tunisia, Philippines, Iran, Finland, and Greece. Nevertheless, the record of DFCs directly mobilizing funds in domestic or foreign markets has been rather meagre. As Annex 3 indicates, some of the most developed DFCs continue to be highly dependent on Bank funds. Moreover, the balance of their resources have often largely been governmental or quasi-governmental official funds with a concessional element.

58. Of the DFCs where the Bank Group clearly has had an important promotional role, the cases where the Bank lending has not remained a predominant source of funds are: IVK in Austria, IFF in Finland, NIDB in Nigeria, CDC in China, MIDF in Malaysia, CAVENDES in Venezuela, IMDBI in Iran and NIBID in Greece. The Austrian, Venezuelan, Finnish, Greek, Nigerian and Iranian DFCs represent cases where the Bank Group made a clear cut judgment that on country and project grounds continued Bank Group lending to the DFCs was inappropriate and a phasing out program was agreed with the DFCs involved. What is of interest is that to some extent all of these DFCs have subsequently continued to grow, but practically all of them still rely to some extent on official funding. Market borrowing by these DFCs, to the extent it has taken place in domestic or foreign markets, has been supported by borrowings from governments at moderately subsidized rates. In short, while they no longer depend on the Bank, most do not yet "stand on their own feet" in market terms.

59. CDC in China and MIDF in Malaysia are somewhat different cases. CDC was cut off from Bank funds rather suddenly when the Bank's program expired. MIDF found alternative funds on more attractive terms. Both institutions prospered after the Bank stopped lending as their respective governments became their major source of funds, normally on terms below what market borrowing would have entailed.

60. The reasons for continued dependency on official funds by the above-mentioned DFCs are one or more of the following: (a) Interest rate regimes imposed by governments that require DFCs to lend at rates below what it would cost to mobilize and to lend funds at a positive spread; (b) underdeveloped capital markets where sales of long-term debt instruments in meaningful quantities are not feasible and where the DFC is not in a position to mobilize deposits at all or on terms long enough to be useful; (c) government regulations giving various government securities priority in terms of mobilizing what long-term domestic savings are available for investment in debt instruments; and (d) conditions in international capital markets that closed entry to many potential borrowers plus, in some cases, government prohibitions or taxes on foreign borrowing by DFCs due to balance of payments problems and concern over the terms of such borrowing (i.e., variable rate or short-term funds that exposed the DFC to too high risks).

61. Turning to the long-term DFC borrowers still heavily dependent on Bank funds, the reasons for this dependency are essentially one or more of those listed above. However, there has been an additional problem in that in some cases these DFCs exist in countries where, on country grounds, there was little real possibility for significant borrowings by the DFCs due to overall country creditworthiness issues. Reduction of Bank lending in such cases would simply mean a decline in the institution's impact.

62. Given this landscape of issues, it is not possible to lay out precise rules concerning the length of time over which Bank support for a particular DFC is justified. Two sets of questions need to be addressed when facing this issue. The first set involves the country's need for capital; the DFCs's need for capital; and the effective use of such capital by the DFC, in relation to other actitivies perceived by the country and the Bank to be of priority for Bank financing. Bank financing of mature DFCs can provide an opportunity for the Bank to achieve important sectoral objectives in consort with the DFC that otherwise might not be achieved. The second set revolves around the Bank's judgment as to the other options open to the DFC for mobilizing funds, its effective pursuit of these sources and the desirability of policy changes which

would open up options for resource mobilization. In any case, methods of directly assisting DFCs to diversify resources should be undertaken when feasible.

63. In a number of cases, commercial banks have considered lending to the more established DFCs associated with the Bank Group. Loans of five years are typical, although in some cases 7-year loans are also feasible. Floating interest rates are usually proposed although fixed rates can sometimes be arranged at a premium. For the DFC wishing to tap these funds the essential problems that need to be resolved are: (a) whether the floating rate can be passed on to sub-borrowers; (b) whether, after tax considerations are taken into account, the cost of money is acceptable (often a 10-20% withholding tax on foreign interest is levied): (c) how the foreign exchange risk can be handled; and (d) how shorter-term loans can be utilized as the DFC's average term of sub-loans may considerably exceed that of the commercial credit.

64. There are two possibilities for the Bank Group to be of direct help to the DFCs in such cases.1/ One way is for the Bank to adapt the amortization and disbursement of its loans to accommodate, or blend with, shorter-term commercial loans by picking up with Bank funds the later maturities of sub-loans. The Bank would in effect lengthen the grace period. In such cases the DFC would establish direct relationships with commercial creditors and would have to resolve the issues noted above.

65. The second possibility is an IFC loan and the sale of participations in that loan. Here also the earlier maturities of a loan with a fixed amortization schedule could be sold to participating banks. Three advantages accrue to the recipient DFC in such operations: IFC lines up the lenders and puts the deal together, IFC's immunity from withholding tax on interest (if any) paid may enable the DFC to obtain the funds at a lower cost, and the loan will normally be in a single currency. The recent IFC and Bank loans to TSKB (Turkey) provide a relevant example: both the blending of Bank funds and direct IFC mobilization efforts were undertaken to assist TSKB in mobilizing and utilizing commercial funds.

66. The above discussion relates to helping DFCs to tap foreign commercial markets. This is only useful in those cases where additional foreign commercial borrowing can be supported on country grounds. It is also important to stress that Bank Group support for policies that open possibilities for domestic resource mobilization can be of even more important help to a particular DFC. Finally, the Bank should continue to cooperate with other bilateral or regional sources of credit for DFCs to facilitate the flow of funds from such lenders to DFCs.

1/ Within the Bank Group, the policy has been that the Bank does the lending to DFCs while IFC takes equity positions, although it will lend to the DFC if a guarantee is not, for acceptable reasons, forthcoming. The rationale for this was that the size of the DFC lending program was beyond IFC's capacity and given the Bank's concern to minimize the cost of debt to many countries, the Bank's interest rate was more appropriate. While this policy in general is still valid there are some situations, described in the following paragraphs, where an IFC loan is appropriate even if a government guarantee would be available for a Bank loan.

F. Broader Objectives of DFC Lending - DFCs as Development Agents

67. While the economic profile of sub-projects financed by DFCs appears to have been favorable and the Bank can try to ensure that this is enhanced in the future by helping to improve the use of economic tools by DFCs, the more difficult question to answer is what should a particular DFC be doing, besides backing viable projects, that will represent a unique contribution to the development effort in its area of operations. While in some cases the preponderant job of the DFC will be to receive large numbers of proposals and, by good project selection, ration scarce resources to them and in the process facilitate the implementation of projects being pursued by a dynamic entrepreneurial community, the more normal case will be one where the DFC is expected to fulfill a broader mandate, where its institutional posture should not only be that of one which reacts, but also one which initiates. Clearly the greatest developmental impact of DFCs will be things that happen largely as a result of a contribution they made, whether it is to the development or implementation of a specific project, an institutional innovation, or a policy improvement.

68. This is one of the most difficult issues facing the Bank and the boards and managers of DFCs. How does the DFC carve out areas of innovation for itself and how can the Bank help in this process? DFCs have a variety of developmental tasks that they might conceivably perform. At the most basic level is a contribution by making financing decisions based on sound project appraisal standards. The next level is the improvement of a project's design or its financial structure. A DFC's effectiveness in this respect depends on the nature of its clientele and the stage at which it gets involved in projects. If it restricts itself to the strongest firms in a given situation, then it is unlikely to be in a position to contribute significantly to project design. On the other hand, if it makes efforts to finance entrepreneurs who are not of the blue chip variety, the potential for a developmental contribution by the DFC at the margin is heightened. While there are exceptions, and the pattern is now changing somewhat, one general tendency of DFCs has been the directing of much of their lending to the relatively strongest entrepreneurs and enterprises in their economies. While this is understandable given: (a) the incentives to build up good portfolios; (b) imposed lending rates that often do not allow differentiation according to risks; (c) the need to allocate scarce capital to projects with high probabilities of success; and (d) in some cases the absence of other sources of long-term funds to which "prime" borrowers have access within or outside the country; it is, nevertheless, appropriate that the Bank and a given DFC continuously examine the DFC's policies in this area.

69. Other areas where the DFC can sometimes make differences at the margin are in its dialogue with government on industrial and financial policies or in the design and implementation of special programs dealing with specific development problems in sub-sectors, the financial sector, regionalization issues, etc. Finally, there may be potentials for some DFCs to play a basic entrepreneurial function in the generation of new project ideas and in taking a lead in the implementation of those ideas.

70. In its dealings with each DFC the Bank should be encouraging a dialogue to determine where in the above spectrum of tasks (or others not listed) the DFC can be making special efforts to expand its horizons and how that can be accomplished. One useful recommendation coming out of the OED study of DFC operations is that DFCs be asked to articulate their near term strategies,

objectives and the areas in which they intend to make or expand special developmental efforts. This has considerable utility in many cases for providing focus to this dialogue.

71. In focussing on the innovative characteristics of DFCs, one factor looms large: namely the caliber and vision of the DFC's management and staff. The relative success of a DFC charting an increasingly innovative role is closely linked with the personality and capabilities of the management of the institution. Innovative institutions are almost always led by innovative managers who attract staff which has an interest in, and a capacity for, unusual developmental contributions. The history of Bank-DFC relations provides ample confirmation of this notion. The growth process means working with available resources and developing them over time. This is true of human and institutional resources and given this basic element there is no easy formula or model that will produce dynamic, promotional DFCs.

G. Criteria to be Applied in Lending to Public DFCs

72. Given the increased variety of government-controlled development banks to which the Bank has lent or to which it is considering lending, the following question arises: To what extent are the criteria developed over a 20-year period of lending to privately-controlled development banks appropriate to government-owned banks?

73. In some cases the answers are fairly straightforward in that the DFC, although government-owned, is set up as a completely separate financial institution with clearly stated objectives, a relatively autonomous financial structure and an expectation that the DFC will operate as a commercial entity much like its private counterparts. Examples of this are numerous in the Bank's experience. The one major difference between such DFCs and their privately-controlled counterparts is expectations with respect to returns on net worth. Government shareholders usually do not expect their DFCs to generate market related earnings. This may give them the luxury of relatively wider administrative budgets or a higher risk portfolio which in some cases enables them to undertake developmental expenditures a privately controlled DFC could not, although the reduction or elimination of the profit tests calls for a rigorous approach to budgeting, expenditure control and program review to insure that funds are well spent by the DFC.

74. Consequently, in reviewing government-owned DFCs, the Bank has generally attempted to evaluate the DFC with the following general criteria in mind:

(a) Is the quality of management and the level of professional skills in the organization suitable?

(b) Are resource allocation criteria and the autonomy allowed the institution in its decision-making processes appropriate? Are the decision rules clear, do they fit the economy and are they followed with due diligence?

(c) Are the institution's overall policy guidelines and objectives in line with what the Bank considers appropriate for the situation? Are relending terms appropriate?

(d) Does the institution adhere to professional standards in the areas of investment administration, procurement, disbursement, collateral requirements? Does it supervise its portfolio aggressively and take effective action to deal with problem projects?

(e) Does the institution submit itself to the discipline of a thorough, professional, independent audit? Can the value of its assets be clearly established?

(f) Are financial standards maintained that allow the institution to present a strong financial posture toward creditors? Does it follow policies on budgeting, debt and liquidity management, capital structure, and diversification of risk that reflect its role as a financial intermediary?

(g) Does it have an operations program that, in its entirety, is sensible and developmentally sound?

Institutions have been considered suitable for Bank lending if they reasonably passed the sort of tests noted above. Of course, different DFCs pass them with varying degrees of quality but if in any of the above areas the DFC clearly failed, the Bank endeavoured to get the situation corrected in connection with its lending operations. This approach has proven to be sound and should be maintained.

75. However, the Bank has also encountered government development banks that depart from the more traditional concepts. Such an entity may not operate as an autonomous unit in all or even most of its financing programs. It may assume financial exposures which would clearly be considered imprudent for a private entity. It may not undergo a thorough independent audit. It may be that its own financial standing cannot be clearly separated from the government purse. It may have relatively weak rights as a creditor and poor capacity for project supervision and its roles as a banker and holding company for industrial subsidiaries might be blurred. Can such an institution be considered a relevant vehicle through which to provide credit to productive enterprises?

76. The Bank can weight its approach in financing productive enterprises in a variety of ways. It may endeavor to develop a specific sub-sector program, it may pursue the establishment of a sound intermediary or it may seek to blend the two objectives. At one end the Bank may undertake direct appraisal of sub-sector conditions including policy problems, market needs, production typologies, organizational means for developing and implementing new production capacities, locational issues, and the economic and financial characteristics of the sub-sector program. Such an approach places the Bank at the center of decisions required to implement a given set of sub-projects in a given sector. When this is the case the institution involved may largely be an agent to undertake administrative functions to deliver the Bank's contribution. In such cases the Bank may be justified in limiting its concern to the institution's capacity to undertake the narrow functions assigned to it, although some institution building will probably be required in the process. At the other end, the Bank may follow a heavy institutional path characterized by a transfer to the institution of the major responsibility for appraisal, selection, implementation and supervision of the lending program and the judgment that overall the intermediary is following appropriate policies and procedures.

77. The Bank would thus attempt to define for the institution what in principle would be appropriate in order to enable it to perform its role as a development agent more effectively. (This presumes it is agreed that it should have such a function.) It is this approach that normally should be applied in DFC lending. If the Bank is to have maximum institutional impact in such cases, the basic problems of the institution's overall role, policies and procedures should normally be addressed. This means looking at the criteria described in paragraph 74 and deciding in the country context which are relevant (i.e. the importance of each criterion in enhancing the institution's developmental contribution), rejecting those that are not relevant and focussing on programs to move the institution to the point where it can meet the relevant criterion. If the Bank were to focus only on its own stream of finance to such institutions and not address broader institutional issues, problems of double standards would emerge and, more importantly, the impact of such operations would be reduced in scope. While deviations from this approach are not inconceivable they should be subject to very special scrutiny and justification.

78. In dealing with cases that present unusual features, which may lead to serious questions concerning the role, policies, and financial condition of particular DFCs, the question of indirect lending to the DFC has emerged. In 3 cases to date the Bank used this approach in DFC lending.[1/] (Once in the Philippines and twice in Pakistan.) The Pakistan cases involved a privately-controlled and a government-controlled DFC which were generally considered to be acceptable intermediaries but which were not financially sound for the moment due to unresolved questions concerning large amounts of unrealizeable assets in Bangladesh. In the Philippines it was a situation where a large government bank which had been in rather hazardous financial condition had embarked on a serious effort to correct its financial position although the visible fruits of these efforts were a year or two away. It was judged that the Bank could contribute more by moving forward with a relationship with the DFC rather than waiting for two years. In these cases lines of credit were made to the governments for on-lending to the DFCs. By doing so the Bank was essentially saying that the governments but not the DFCs were creditworthy at that point in time. This approach was adopted in the expectation that the problems would be resolved and that a normal and direct credit relationship would be feasible for subsequent loans.

79. Is there a significant difference if the government, or an entity wholly owned by the government, signs the loan agreement? The indirect loan signifies that the institution concerned has problems to be resolved before it can be judged creditworthy. Second it reinforces the concept that the Bank basically looks to its borrower's performance and financial condition; not a general underpinning that government will see to it that its entities survive. While an indirect lending approach is useful to handle cases where the Bank wishes to make a loan for a project or sub-sector that has been subject to normal analysis by the Bank but where the intermediary does not meet minimum Bank standards, or for special situations (such as those encountered in the Philippines and Pakistan or where movement to reform is of an uncertain pace), it should normally be a temporary device and should not be used as a way to provide, over extended periods of time, lines of credit to institutions which do not meet the Bank's standards. In many cases it will be more productive to withhold lending until corrective steps have been taken.

1/ In some cases Bank DFC-loans have for legal or other valid reasons been passed to the DFC through another agency which has performed no more than a "post office" function.

80. In lending to some government DFCs there will be difficult judgments required on the degree of effective and appropriate autonomy for the institution as well as the necessity for it to follow financial policies that would normally be applied to other commercial-type intermediaries. The larger the scope and contribution of government-owned DFCs the more critical role they perform as instruments to effect implementation of government policy. Consequently, it is not a question of the need for government DFCs to be immune from government influence but rather whether the institution is allowed to function in a way that allows it to achieve its policy and objectives in an efficient manner. What is unacceptable is an institution that has its decision-making process frustrated or overruled in a way that results in its financing and assuming risks on operations that do not meet its normal criteria or that result in an erosion of the institution's professional competence. The key elements in arriving at the appropriate Bank response in such situations is to clearly establish the objectives of the institution both in a developmental and financial sense, to judge whether these are compatible with the Bank's objectives, and to see whether the policies it follows give adequate support to those objectives.

III. FUTURE DFC LENDING

Volume and Characteristic of Future Lending

81. In the FY76-80 period DFC lending is expected to reach an order of magnitude of $3.1 billion as compared with $1.7 billion in the preceding 5 years. This represents about 8% of total Bank/IDA lending in the two respective periods. The geographic pattern of lending to DFCs expected to be as follows ($million):

	EMENA	LAC	AFRICA	S.A.	E.A.P.
1971-75	795	182	88	314	316
1976-80	750	880	300	500	700

In relative terms, the two areas that have historically lagged will secure the largest increase in DFC lending as compared with the 1971-75 period: namely Latin America and East and West Africa. This is a continuation of the trend noted earlier in the paper.

82. Roughly 70% of this lending will be to institutions with which the Bank had commenced a relationship before FY74. However, it is expected that approximately 20 new DFC borrowers will be added to the Bank's rolls during this period. The overwhelming bulk of these new borrowers will be government-controlled DFCs although the beneficiaries at the sub-project level of DFC lending will continue to be predominantly private sector enterprises. Simultaneously with this growth of operations, 6 to 8 DFCs formerly financed by the Bank will cease to be borrowers.

83. During the next five years the variety, by type, of intermediaries financed will continue to increase requiring new dimensions of appraisal and performance criteria in the Bank Group's work with such intermediaries. It is also probable that the DFC lending approach will increasingly be applied to sectors other than manufacturing and tourism. The forthcoming operation with the Ghana Housing and Construction Bank for road contractors is an example and projects in the urban housing sector may also follow this approach. Finally, lending to large multi-sector and multi-purpose institutions is likely to increase moderately as is lending to institutions that combine facilities for commercial short-term lending and longer-term project finance.

84. The areas where special efforts will be made in the coming years to enhance that contribution have already been referred to in the previous section. They include a greater effort to deal with new and small entrepreneurs, better linkages of DFC operations with broader issues concerning sub-sectors being financed and attempts to seek a better integration of DFC operations with financial sector issues.

Small Scale Enterprise

85. An area that will be subject to increasing experimentation is the provision of financial and technical assistance to small scale enterprise.

It will be important to examine the effectiveness of various approaches utilized and to evaluate more deeply than has been feasible to date, the economic and perhaps social pay-offs resulting from such projects. It is by no means clear at this juncture whether the most effective small scale enterprise financing programs will be through credits broadly diffused through the banking system; specialized credit agencies focussing on the small scale sector; special programs sponsored by existing development banks or other approaches. Different approaches will no doubt be required from country to country. Just as important a question, if not more so, is the design of effective delivery systems for technical assistance to smaller entrepreneurs. It is likely that widely different approaches in different environments will be required. What is sensible in the Cameroon is not necessarily appropriate in Colombia. Consequently a special effort should be scheduled in three years or so to undertake a review of small enterprise projects financed by the Bank where there has been some operating experiance developed in order to distill the results of such financing at that time. The programs recently financed, or soon to be financed by the Bank in the Ivory Coast, Nigeria, Cameroon, Korea, Philippines, India, and Colombia will provide a good base for evaluating experience.

86. In the period up through FY1975 the Bank had financed 5 projects aimed specifically at small enterprises. Three of those projects were financed in FY1975 (Philippines, Colombia, and Cameroon). In addition to continued financing of these programs, the Bank will undertake such projects in 10 to 15 other countries plus working with some existing DFCs to initiate or improve small enterprise financing programs under their auspices. The review noted in the above paragraph may provide the basis for a more accelerated approach as more experience is gained with this type of project.

87. It will also be important for the Bank to liaise with other agencies, bilateral and multi-lateral, which are endeavoring to develop projects in this field. UNIDO is expending considerable manpower in this sector and a close working relationship with this body will be maintained as with the ILO, which also has experience in this field. At the same time, given the relatively high manpower input per productive assets financed that typifies these projects, it is important that in selecting countries in which the Bank wishes to develop such projects that (a) the countries be those where there appears to be an important gap in the services for small business; (b) that there not be serious overlaps with the efforts of other international or bilateral development agencies (in some countries several agencies are simultaneously trying to do the same thing); and (c) that monitoring systems be developed that will facilitate the analysis of the impact of such lending. This latter point is particularly important as there is extremely little "hard data" available on which to base judgments concerning the relative priorities of special efforts to deal with small businessmen in countries at different levels of development and the pay-offs of such programs.

88. Internal organizational rationalization is also required if there is to be effective attention paid to small scale enterprise financing. At present there is no focus of expertise on this matter in the Bank Group.

DFCs and Sector Issues

89. The industrial sector in most of the Bank's member countries involves an exceedingly wide variety of activity. This heterogenity makes it particularly difficult to analyze the sector as a whole. It is also a sector where a wide range of basic economic and political issues converge, e.g. trade policy and balance of payments issues; financial management, public vs. private sector issues, foreign vs. domestic investment considerations, etc. Individual DFCs often account for a relatively small share of the total financing of new industrial investment (usually less than 10%) and thus while they can select and develop important projects, such project decisions will not have a sweeping impact in the sub-sectors financed if basic policies are not congenial to the rational development of those sub-sectors. This underlines the need for an integrated Bank approach to the industrial sector.

90. Operationally this requires integration of the Bank's country economic work and industrial sector work in order to focus on problems of relevance to DFC lending, particularly in those cases where such lending forms an important part of the Bank's program in a country. Another facet of this is that there is scope for encouraging and helping many DFCs to take on greater responsibilities in analyzing sub-sector issues and to take a larger voice in discussion with governments in the dialogue on sector policies. These institutions are often well placed to observe the impact of policies at the level of the investing enterprise and thus their potential contribution is considerable. Obviously the capacity and credibility of institutions vary widely and not all will be in a position to play effective roles in influencing policy makers but there is scope for enhancement of many DFCs' contribution in this area.

91. Within the Bank Group efforts are continuing to ensure proper coordination among Regional Offices, the DFC Department, Industrial Projects and other units responsible for industrial aspects of development in the borrowing member countries. Recent DFC operations, including four for small-scale industry, were linked in about a dozen countries to sector work undertaken by Industrial Projects and Regional Offices. Currently, six to seven industrial sector studies are planned annually and detailed prior consultations have been or are being scheduled as sector missions are mounted. Joint staffing is attempted whenever appropriate and feasible. Although it is not always possible to link policy improvements in a developing country with specific DFC operations, an important purpose of detailed coordination in planning industrial sector work is to explore the extent to which sector studies can address specific issues at the subsector and enterprise levels which are relevant to achieving the objectives of DFC operations. In this context, avenues are also being explored to increasingly tap a DFC's experience and assessment or to directly involve the DFC in the mission's work, whenever it has special expertise to contribute.

92. Furthermore, there is scope for increased cooperation between DFCs and Institutes of Technology, Universities, and R & D Institutes in borrowing member countries. Within the overall framework of factor endowments of a

given country,there is an obvious need to utilize project designs which are in line with the relative scarcities of production factors. Nevertheless, significant differences in factor proportions between industrial subsectors are often appropriate and even within a given subsector there are usually many options for various types of technology and associated equipment. In this context the ties between DFCs and technological institutes can be of considerable importance. Where institutional capabilities for technological advice exist, DFCs have established such ties, usually on an informal basis. These ties can be strengthened, however, and in countries where technological institutes do not exist or are not adequately developed, the DFCs or the Bank can play a role in their creation or expansion. The Bank is encouraging efforts in these directions, for instance in planning the next financiera operation in Colombia, to supplement industrial DFC lending with technological development.

93. Concerning financial sector issues, DFCs are normally a small part of the financial infrastructure in a developing country. It is not unusual to find that they are not very well integrated into that system but remain a sort of privileged credit circuit, often along with other specialized credit agencies. Second, as noted earlier, interest rate issues arise in almost every DFC operation (and agricultural credit operation as well). This issue is part of the broader question of the efficient mobilization and allocation of savings throughout an economy. This in turn is related to fundamental strategies adopted by governments for resource management. It is often impossible and sometimes counter-productive to address the problem of a single institution's relending rates in isolation from general financial sector policies. Like industrial policies, these fundamental sector issues are broad, complex, and at the heart of basic economic strategies followed by governments. Given the increasing need to generate investment funds in most developing countries, these policies take on an even more critical dimension.

94. More work, therefore, is needed to try to evaluate and establish dialogues with countries over their financial sector policies. DFC lending is one element in the middle of this picture and while the Bank has not often attempted to look at the financial sector as a whole this is becoming more necessary if the Bank is to speak with authority on general questions of development of financial markets in developing countries. One of the near-term tasks is to develop a better methodology and framework for approaching these broader questions and then applying it in a few countries to see what benefits can be obtained. Work along these lines is underway.

95. Finally, in order to sharpen the Bank's dialogue with DFCs on their role and impact in the industrial and financial sectors a number of operational refinements are now being tested. First in providing general lines of credit to DFCs the Bank is asking, in most situations, that the DFC articulate its near-term plans for promoting development of the sectors it serves. This is not simply a financial projection as much as an indicator of the special initiatives the DFC intends to pursue to increase its effectiveness as a development agent. The formulation of these "strategies" will provide some focus and an opportunity for improved dialogue between the Bank and the DFC it is financing and can also be linked with issues turned up in the Bank's sector work.

96. A related action is the determination in a more digestible form of the impact of DFC financing through systematic sub-project monitoring systems. The review of the data generated by such systems as well as performance in relation to the objectives periodically set by DFC managers should prove helpful in refining judgments on performance of DFCs and identifying areas where improvements are desirable and feasible.

97. The DFC financing program has proven to be an effective tool for building what, by and large have been, competent, professional institutions capable of assisting the development of projects that make an impressive contribution to growth. More importantly most of these institutions show the capacity to adapt to changing needs and expectations and are responsive to constructive initiatives that can lead to an enhanced developmental contribution. It is in this framework that the Bank can continue to play a role in the development of effective development financing institutions.

Bank Group DFC Financing
Approved through FY'75
($'000)

Country	DFC	# Loans	# Equity Investment	Bank	IDA	IFC	Total
Africa							
Cameroon	BCD	1	-	-	3,000	-	3,000
Ethiopia	AIDB	1	-	-	11,000	-	11,000
"	DBE	2	-	4,000	-	-	4,000
Nigeria	NIDB	2	1	16,000	-	1,400	17,400
Ivory Coast	BIDI	-	1	-	-	204	204
Liberia	LBIDI	2	1	5,000	-	249	5,249
Zaire	SOFIDE	3	1	-	25,000	750	25,750
Africa	SIFIDA	-	1	-	-	500	11,500
Mauritius	DBM	2	-	5,000	3,500	-	8,500
E. Africa	EADB	1	-	8,000	-	-	8,000
Sudan	IBS	1	-	-	4,000	-	4,000
Kenya	IDB	1	-	5,000	-	-	5,000
Tanzania	TIB	1	-	-	6,000	-	6,000
Senegal	SOFISEDIT	1	1	3,000	-	209	3,209
Botswana	BDC	1	-	4,000	-	-	4,000
	Total	19	6	50,000	52,500	3,312	105,812
East Asia & Pacific							
China	CDC	4	-	48,000	5,000	-	53,000
Philippines	PDCP	5	1	95,000	-	15,205	110,205
"	DBP	1	-	50,000	-	-	50,000
Malaysia	MIDF	1	1	8,000	-	818	8,818
Thailand	IFCT	2	2	14,500	-	384	14,884
Korea	KDFC	4	2	95,000	-	1,058	96,058
"	KDB	1	-	60,000	-	-	60,000
Singapore	DBS	1	-	5,000	-	-	5,000
New Zealand	DFCNZ	1	-	8,000	-	-	8,000
Indonesia	BAPINDO	2	-	50,000	10,000	-	60,000
"	PDFCI	1	1	-	10,000	483	10,483
	Total	23	7	433,500	25,000	17,948	476,448
South Asia							
India	ICICI	11	-	435,000	-	-	435,000
"	IDBI	1	-	-	25,000	-	25,000
Pakistan	PICIC	9	2	209,000	-	486	209,486
"	IDBP	1	-	-	20,000	-	20,000
"	NDFC	1	-	-	30,000	-	30,000
Sri Lanka	DFCC	3	-	7,000	4,000	-	11,000
	Total	26	2	651,000	79,000	486	730,486
EMENA							
Algeria	BAD	1	-	35,000	-	-	35,000
Turkey	TSKB	13	4	198,000	35,000	37,098	270,098
"	DYB (SIB)	1	-	40,000	-	-	40,000
Austria	IVK	3	-	24,765	-	-	24,765
Iran	IMDBI	8	-	280,200	-	-	280,200
"	ICB	1	-	25,000	-	-	25,000
Morocco	BNDE	7	1	151,500	-	1,496	152,996
"	CIH	2	-	25,000	-	-	25,000
Spain	BANDESCO	-	2	-	-	585	585
Finland	IFF	4	1	63,000	-	159	63,159
Israel	IDBI	4	-	95,000	-	-	95,000
Greece	NIBID	5	1	97,500	-	719	98,219
Tunisia	SNI	5	2	49,000	-	1,205	50,205
Ireland	ICC	1	-	10,000	-	-	10,000
Cyprus	CDB	1	-	3,000	-	-	3,000
Afghanistan	IDBA	1	1	-	2,000	250	2,250
Egypt	BOA	1	-	-	15,000	-	15,000
Yugoslavia	SBS	1	-	28,000	-	-	28,000
"	PBS	1	-	22,000	-	-	22,000
	Total	60	12	1,146,965	52,000	41,512	1,240,477

Country	DFC	# Loans	# Equity Investment	Bank	IDA	IFC	Total
Latin America & Caribbean							
Colombia	Colombiana	-	1	-	-	2,023	2,023
"	Nacional	-	1	-	-	2,042	2,042
"	Caldas	-	1	-	-	701	701
"	5 Financieras	4	-	102,500	-	-	102,500
"	Norte	-	1	-	-	432	432
"	Valle	-	1	-	-	432	432
"	Col. Financieras(8)	1	-	60,000	-	-	60,000
"	CFP	1	-	5,500	-	-	5,500
Venezuela	CAVENDAS	2	1	-	-	13,836	13,836
Ecuador	COFIEC	-	2	-	-	305	305
"	COFIEC & CFN	2	-	28,000	-	-	28,000
Brazil	BNB	1	-	25,000	-	-	25,000
Regional	ADELA	1	-	-	-	10,000	10,000
Trinidad & Tobago	TTDFC	2	-	7,000	-	-	7,000
Mexico	FONEI	1	-	35,000	-	-	35,000
Bolivia	BISA	1	-	-	6,200	-	6,200
	Total	16	8	263,000	6,200	29,771	298,971
	GRAND TOTAL	144	35	$2,544 m.	215 m.	93 m.	2,852 m.

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Annex 2

Bank Group Assistance to DFCs by Geographic Area

	FY1950-54	FY1955-59	FY1960-64	FY1965-69	FY1970-74	FY1975	Total FY1950-75
EMENA							
No. of DFCs Assisted	1	1	6	8	16	5	19
No. of Countries Involved	1	1	6	8	12	5	15
No. of Loans/Cr./Inv.	2	1	10	23	30	6	72
Amt. of Loans/Credits/Inv.	$18.0 m	$10.8 m	$49.1	$298.4	$649.3	$215 m	$1,241
No. of Maj. Govt. Controlled DFCs					8	1	9
Amt. of Loans to Govt. Controlled DFCs					$168 m	$35 m	$203 m
LAC							
No. of DFCs Assisted	-	-	4	7	13	2	14
No. of Countries Involved	-	-	2	3	8	2	8
No. of Loans/Cr/Inv.	-	-	4	7	11	2	24
Amt. of Loans/Cr/Inv.	-	-	$6.1 m	$71.1 m	$211.2 m	$10.5 m	$298.5 m
No. of Govt. Controlled DFCs					4	2	5
Amt. of Loans to Govt. Controlled DFCs					$74 m	$10.5 m	$84.5 m
EAP							
No. of DFCs Assisted	-	-	4	3	9	3	11
No. of Countries Involved	-	-	4	3	7	3	8
No. of Loans/Cr/Inv.	-	-	7	6	14	3	30
Amt. of Loans/Cr/Inv.	-	-	$31.7 m	$80.7 m	$224.0	$140	$477
No. of Maj. Govt. DFCs					3	2	4
Amt. of Loans to Govt. Controlled DFCs					$68 m	$110	$178 m
S. Asia							
No. of DFCs Assisted	-	2	2	3	5	3	6
No. of Countries Involved	-	2	2	3	3	3	3
No. of Loans/Cr/Inv.	-	2	9	7	7	3	28
Amt. of Loans/Cr/Inv	-	$14.2 m	$155.4 m	$184.1 m	$243 m	$134 m	$731
No. of Govt. Controlled DFCs					3	2	4
Amt. of Loans to Controlled DFCs					$215 m	$130 m	$345
Africa							
No. of DFCs Assisted	1	-	2	3	12	2	15
No. of Countries Involved	1	-	2	3	12	2	14
No. of Loans/Cr/Inv.	1	-	2	3	17	2	25
Amt. of Loans/Cr/Inv	$2.0 m	-	$3.4 m	$6.5 m	$87 m	$7 m	$106 m
No. of Govt. Controlled DFCs					7	1	8
Amt. of Loans to Govt. DFCs					$46.5 m	$3 m	$49.5 m
Total							
No. of DFCs	2	3	18	24	55	15	65
No. of Countries	2	3	16	20	42	15	48
No. of Loans/Cr/Inv.	3	3	32	46	79	16	179
Amt. of Loans/Cr/Inv.	$20 m	$ 25 m	$246 m	$641 m	$1,415 m	$506.5	$2,854
No. of Govt. Controlled DFCs	-	-	-	-	25	8	30
Amt. of Loans to Controlled DFCs					$571.5	$288.5	$860

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Basic DFC Profile Data

(1) Country	(2) Name of DFC	(3) % Govt. Ownership	(4) % IFC Ownership	(5) Cumulative Bank Group Financing ($m)	(6) Total Assets ($m)	(7) Bank Group Loans Outstanding as % of Total Liabilities	(8) No. of Professional Staff	(9) Medium or Long-term Loan + Equity Approvals by DFC in Last FY of DFC ($m)	(10) No. of Projects Financed by Column (9)	(11) Average Size (9/10) ($'000)
East Africa										
1. Botswana	BDC	100	0	4	9	0	17	2	12	167
2. Ethiopia	AIDB	100	0	11	82	13	81	9	160	56
3. Kenya	IDB	100	0	5	5	100	8	7	11	627
4. Mauritius	DBM	100	0	12.5	17	11	18	4	14	312
5. Nigeria	NIDB	25	25	17.5	54	21	44	24	21	1,157
6. Sudan	IBS	100	0	4	8	3.	30	1	15	93
7. Tanzania	TIB	100	0	6	22	0	23	14	27	514
8. Zambia	DBZ	60	0	0	12	0	21	12	18	676
9. E. African Community	EADB	92	0	8	30	1..	30	8	12	700
West Africa										
10. Liberia	LBDI	25	25	5	8	17	7	5	53	91
11. Senegal	SOFISEDIT	46	8	3.2	n.a.	0	7	n.a.	n.a.	n.a.
12. Ivory Coast	BIDI	27	7	0.2	46	0	18	14	45	320
13. Ivory Coast	CCI	75	0	9.7	61.	0	23	28	772	36
14. Zaire	SOFIDE	25	19	25.8	23	48	18	17	31	532
15. Cameroon	BCD	75	0	0	49	0	17	15	1,904	8
East Asia & Pacific										
1. China	CDC	10	0	48	103	24	57	20	110	190
2. Indonesia	BAPINDO	100	0	69	223	5	307	48	52	930
3. "	PDFCI	25	8	10	21	0	13	4	4	1,110
4. Korea	KDB	100	0	60	2,908	0	554	341	1,330	280
5. "	KDFC	0	14	96	91	89	44	33	58	570
6. Malaysia	MIDF	41	0	8	99	2	59	41	240	170
7. Philippines	DBP	100	0	83	1,225	3	1,055	44	18,572	20
8. "	PDCP	0	0	99	106	60	99	29	64	460
9. Singapore	DBS	47	0	5	791	2.2	95	119	74	610
10. Thailand	IFCT	16	5	15	56	0	88	36	43	840
South Asia										
11. India	ICICI	72	0	426	394	40	154	82	166	500
12. "	IDBI	100	0	25	692	0	300	320	3,306	75
13. Pakistan	PICIC	45	4	208	278	34	113	42	38	1,100
14. "	IDBP	100	0	22	241	5	124	41	144	290
15. "	NDFC	100	0	30	33	0	21	33	33	1,000
16. Sri Lanka	DFCC	25	0	12	12	32	12	2	7	200
EMENA										
1. Afghanistan	IDBA	15	8	2	10	0	12	2	6	330
2. Egypt	BOA	100	0	15	1,676	1.	692	23	143	156
3. Finland	IFF	29	0	63	200	21	35	65	185	350
4. Greece	NIBID	0	1	99	235	21	62	63	81	780
5. Iran	IMDBI	2	0	278	740	17	97	293	126	2,300
6. "	ICB	100	0	25	244	0	88	122	n.a.	n.a.
7. Ireland	ICC	100	0	0	103	7	64	69	205	330
8. Israel	IDBI	3	0	70	514	8	89	126	360	285
9. Morocco	BNDE	38	15	142	150	40	48	112	67	1,700
10. "	CIH	54	0	25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
11. Tunisia	BDET	22	20	50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
12. Turkey	DYB	100	0	40	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
13. "	TSKB	0	11	306	265	41	116	67	82	820
14. Yugoslavia	PBS	0	0	22	2,228	0	n.a.	128	377	333
15. "	SBS	0	0	59	1,714	0.5	n.a.	310	307	1,000
Latin America & Caribbean										
1. Bolivia	BISA	0	0	5	8	0	14	3	46	66
2. Brazil	BNB	74	0	25	991	2	n.a.	130	152	852
3. Ecuador	COFIEC	7	7)	28	40	12	20	16	n.a.	n.a.
4. "	CV-CFN	100	0)		58	16	n.a.	11	n.a.	n.a.
5. Mexico	FONEI	(Trust Fund)	0	35	28	52	n.a.	38	27	1,400
6. Trinidad & Tobago	TTDFC	94	0	7	7	34	7	3	28	120

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PARTIAL INDICATORS OF ECONOMIC RETURNS

In the studies done to date several potential indicators were isolated to test their effectiveness as being descriptive of overall project efficiency. The results are shown below from the India and Colombia studies. This indicates the high degree of unreliability of using partial indicators as a substitute for overall ERR analysis.

Correlation of Indicators with ERR

Partial Indicators	ICICI India		Colombian Financieras	
	Correlation Coefficient (R)	Determination Coefficient (R^2)	Correlation Coefficient (R)	Determination Coefficient (R^2)
Investment/Employment	- 0.21	0.04	- 0.34	0.12
Valued Added/Investment	0.32	0.10	0.34	0.12
Gross Profits/Investment	0.14	0.02	0.29	0.08
Export/Sales	0.05	0.01	N.A.	N.A.
Domestic Cost/Foreign Exchange generated	- 0.60	0.36	- 0.55	0.30

The last indicator (Bruno ratio) shows the relatively best correlation with ERRs, but it explains only about one-third in the variation of economic returns. Further correlations were calculated between ERRs and the size of projects or sponsoring enterprises, but they too were statistically insignificant. Even a combination of partial indicators (multiple regression analysis) could explain the variation of ERRs only up to 50%. Finally, the partial indicators showed poor correlation among themselves.

Most of the results are as one would have expected although it is surprising how poorly some partial indicators are correlated with the absolute values of economic returns. They are therefore unreliable for the purpose of project ranking. Nevertheless, the studies also showed that a few partial indicators (including financial returns and Bruno ratio) did not do too badly, overall, to indicate projects with unattractive economic merits.

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COMPARISONS BETWEEN FIRMS OF DIFFERENT SIZES

(Some Conclusions from the 1974/75
Colombian Study on DFC Financing)

The 1974/75 study on financiera lending in Colombia contained, into alia, a comparison between projects sponsored by firms of different sizes.

One set of questions concerned the observable differences in financial and economic efficiency between projects sponsored by large firms (assets over $12 million), medium firms, and projects sponsored by smaller firms (assets below $2 million). Whereas differences in the financial and economic returns of projects sponsored by small, medium and large firms could be observed, the differences did not stand the test of statistical significance. The averages, for each size group indicated that projects in all size categories showed attractive financial and economic characteristics. The size criterion would thus have been a weak indicator of project selection.

Concerning the impact on employment generation it is interesting to note that the much larger impact by small firms was primarily due to their capacity to generate employment indirectly. With similar investment/employment ratios for direct job creation,[1] the difference in the total employment generation impact was not due to more labor-intensive production processes by small firms; through a lower share of inputs from abroad and through a different structure of domestic inputs, the small firms were found to achieve a more favorable impact than large firms in terms of indirect employment generation.

On income distribution, the Colombian Study represented an attempt in the Bank's DFC work to quantify the distributional effects of sub-projects financed with Bank funds. On the basis of all 29 projects in the sample it was found that domestic owners received 19% of net economic benefits generated by the projects compared to 9% received by workers. A priori this might suggest an aggravation of income disparities as between the two groups. However, through direct and indirect taxes, government received the largest share (57%) of the net benefit stream and thus the overall distributional impact of the projects depends squarely on the spending pattern of government revenues. Since there is some evidence that this pattern has some (but no large) impact in reducing income disparities , it can be concluded that financiera-assisted projects effected little, if any, change on the distribution of income in Colombia.

1/ A comparison by size of project (rather than by size of sponsoring firm) shows some differences, however: the investment needed to create a direct job amounted to $4,800 for relatively small projects (total investment cost below $250,000), $7,200 for medium projects and $8,000 for large projects (investment over $2 million). More pronounced differences were observed in India where ICICI found, on the basis of a sample of 126 projects, that the investment/job varied from $2,500 for small projects (total cost below $1.3 million) to $30,000 and above for large projects (with investments over $13 million). However, the projects were generally much larger than in the Colombian sample.

A comparison of projects sponsored by small and large firms showed that the former generated relatively large shares of income in the hands of unskilled workers (22%, compared to 7% for large firms) and the government (76%, compared to 54% for large firms). From an income distribution point of view, if income to workers and to the government can be valued more highly than income in the hands of owners, projects sponsored by small firms had a more positive distributional impact than others. On the other hand, a comparison by size of project (rather than by size of sponsoring firm) showed that large projects had somewhat better distributional effects than small projects.

While all these results are from the Colombian experience and there is no basis for generalizing from them, they point up the complexity of the problem and the need for more analysis on these issues in the context of specific operations.

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Medium and Long Term DFC Lending Rates
December 31, 1974

	DFCs	Nominal Interest Rate: Local Currency	Nominal Interest Rate: On Foreign Credit Lines	Fee Paid to Government	Who Takes Exchange Risk on Latest WBG Loans	Historical 1/ Exchange Rate Adjustment	Historical 2/ Rate of Inflation	Recent 3/ Rate of Inflation	
	Eastern & Western Africa								
(1)	BDC (Botswana)	10.5	10.5	-	Sub-borrower or Government 4/	n.a.	n.a.	n.a.	(1)
(2)	AIDB (Ethiopia)	9.5/10.5	9.5/10.5	-	Government	-1.5	4.3	8.8	(2)
(3)	BIDI (Ivory Coast)	10.25	10.25	-	Government	8.9	7.1	15.9	(3)
(4)	IDB (Kenya)	9.5	10/10.5	-	Sub-borrower or Sub-borrower & Government 5/	3.2	7.7	15.9	(4)
(5)	LBDI (Liberia)	11.5	11.5	-	Sub-borrower	3.2	n.a.	n.a.	(5)
(6)	DBM (Mauritius)	9.5	9.5	-	Sub-borrower	2.8	9.4	30.7	(6)
(7)	NIDB (Nigeria)	9.0	9.0	-	Sub-borrower	4.9	10.6	13.3	(7)
(8)	SOFISEDIT (Senegal)	10.5	10.0	-	Sub-borrower or Government	0.9	6.7	15.3	(8)
(9)	IBS (Sudan)	8.5/9.5	8.5/9.5	-	Sub-borrower	3.2	8.5	27.6	(9)
(10)	TIB (Tanzania)	10.0	10.0	-	Sub-borrower 6/	3.2	9.0	28.1	(10)
(11)	SOFIDE (Zaire)	10.5	10.5/11.5	1.0	Sub-borrower or Government 7/	3.2	14.7	29.3	(11)
	Asia								
(1)	CDC (China)	14.75	11.0	-	Sub-borrower	1.2	13.2	34.9	(1)
(2)	ICICI (India)	8.5/10.25	9.5/10.5	-	Sub-borrower	3.7	11.8	31.1	(2)
(3)	IDBI (India)	8.5/12	10.5/11	-	Government	3.7	11.8	31.1	(3)
(4)	BAPINDO (Indonesia)	15.0	15.0	8/	Government	7.3	18.1	34.4	(4)
(5)	PDFCI (Indonesia)	15.0	15.0	8/	Government	7.3	18.1	34.4	(5)
(6)	KDFC (Korea)	15.5	11.0	-	Sub-borrower	9.1	12.6	26.7	(6)
(7)	MIDF (Malaysia)	10.0	9.0/10.0	0.25	Central Bank and MIDF 9/	-2.9	6.7	16.0	(7)
(8)	IDBP (Pakistan)	12.5/13.5	8.5	0.50	Sub-borrower 10/	18.4	12.1	n.a.	(8)
(9)	PICIC (Pakistan)	12.5/13.0	9.5	-	Sub-borrower 10/	18.4	12.1	n.a.	(9)
(10)	DBP (Philippines)	12.0	12.0	0.75	Shared between Government and Sub-borrower 11/	14.1	16.7	36.2	(10)
(11)	PDCP (Philippines)	12.0	12.0	-	Sub-borrower	14.1	16.7	36.2	(11)
(12)	DBS (Singapore)	10.0/11.5	10.0/11.5	0.25	Government	-3.0	9.9	13.5	(12)
(13)	DFCC (Sri Lanka)	10.5	10.5	-	Government	4.7	7.3	12.4	(13)
(14)	IFCT (Thailand)	10.5	9.5	0.25	Shared between IFCT and Government 12/	1.5	8.1	25.4	(14)
	Europe, Middle East & North Africa								
(1)	IDBA (Afghanistan)	10.0	10.0 13/	-	Sub-borrower	-2.9	n.a.	n.a.	(1)
(2)	CDB (Cyprus)	8.3/8.8	8.3/8.8	-	Shared between Central Bank and CDB 14/	-1.3	7.3	17.7	(2)
(3)	BOA (Egypt)	9.5	9.5	-	Government	.1	4.0	7.1	(3)
(4)	IFF (Finland)	8.5/10.0	8.5/10.0	-	Sub-borrower or Government 15/	-.1	8.7	15.4	(4)
(5)	NIBID (Greece)	11.5	11.5	-	Bank of Greece	2.2	10.2	16.5	(5)
(6)	ICB (Iran)	8.5/11.5	8.5/11.5	-	Government	.1	7.2	13.0	(6)
(7)	IMDBI (Iran)	10.0	10.0 16/	-	Sub-borrower or IMDBI 17/	.1	7.2	13.0	(7)
(8)	ICC (Ireland)	14.25/15.5	14.25/15.5 18/	-	Government	2.8	10.8	20.0	(8)
(9)	IDBI (Israel)	8.0/10.0/12.0	8.0/12.0	-	Government 19/	7.5	17.6	48.0	(9)
(10)	BNDE (Morocco)	9.0	9.0	-	Central Bank	-1.5	5.5	13.7	(10)
(11)	CIH (Morocco)	8.8	8.8	-	Central Bank	-1.5	5.5	13.7	(11)
(12)	BDET (Tunisia)	8.0	8.0	-	Central Bank	-1.5	3.5	5.0	(12)
(13)	DYB (Turkey)	12.5	12.5	-	Government	11.7	11.9	24.7	(13)
(14)	TSKB (Turkey)	14.0	14.0	-	Sub-borrower	11.7	11.9	24.7	(14)
(15)	SBS, PBS (Yugoslavia)	4.0/12.0	9.0/12.0	-	Sub-borrower	7.3	17.0	23.8	(15)
	Latin America & Caribbean								
(1)	BISA (Bolivia)	13.0	12.0 20/	-	Sub-borrower	13.5	19.9	44.0	(1)
(2)	Caldas (Colombia)	25.0	10.75	14.25	Sub-borrower or Central Bank 21/	11.2	15.3	19.5	(2)
(3)	Colombiana (Colombia)	"	"	"	" "	"	"	"	(3)
(4)	Nacional (Colombia)	"	"	"	" "	"	"	"	(4)
(5)	Norte (Colombia)	"	"	"	" "	"	"	"	(5)
(6)	Valle (Colombia)	"	"	"	" "	"	"	"	(6)
(7)	CFN (Ecuador)	12.0	13.0	1.75	Government	9.2	11.2	22.8	(7)
(8)	COFIEC (Ecuador)	12.0	13.0	1.75	Government	9.2	11.2	22.8	(8)
(9)	FONEI (Mexico)	11.0	11.0	22/	Government	3.2	9.8	21.8	(9)
(10)	TTDFC (Trinidad & Tobago)	10.0	10.0	-	Government	2.8	10.1	23.2	(10)

See page 2 for footnotes.

1/ Average annual percentage rate of change over the past five years in the exchange rate is based on International Financial Statistics trade conversion factors (1969-1974). A positive change expresses depreciation of local currency. An average is calculated as the midpoint of changes with respect to US Dollars and Japanese Yen.

2/ The average annual percentage rate of change of prices over the past five years is based on the Consumer Price Index from International Financial Statistics (1969-1974).

3/ The recent rate of change of prices is from the 4th quarter of 1973 to the 4th quarter of 1974, or over the last 5 quarters for which figures are available. Data is as of the March 1975 International Financial Statistics.

4/ Normally sub-borrowers will assume the risk but in the case of small foreign exchange loans (less than $75,000) the Government will assume the exchange risk at no charge.

5/ In cases where IDB will not be able to pass the entire exchange risk to its clients, the foreign exchange risk on the Bank's loan to IDB will be shared between Government and IDB's borrowers. This will be accomplished by IDB having its borrowers assume the risk of exchange fluctuations between the Kenya shilling and the US dollar, and the Government the risk on any fluctuation between US dollars and the currencies in which the Bank loan was disbursed. There is no charge for this cover.

6/ Sub-borrower assumes dollar exchange risk in case of IDA credit.

7/ In cases where it is not possible for sub-borrower to take risk, SOFIDE charges 11.5% and the increased 1.0% margin on IDA funds goes to the Government as a foreign exchange risk coverage fee. In the case of small enterprises where the Government takes the risk without fee, they are charged 10.5%.

8/ Government assumes foreign exchange risk and receives the excess of any spread over 4% between the rate charged to the DFC and rate received by the DFC.

9/ MIDF assumes the exchange risk up to 3% on either side of the rate guaranteed by the Central Bank. The Central Bank assumes for a ½% per annum fee the exchange risk outside 3% on either side of the guaranteed rate.

10/ Sub-borrower assumes the exchange risk on all sub-loans. For the period when funds are repaid to the DFC but are not yet repaid to IDA the Government assumes the exchange risk.

11/ Sub-borrower assumes risk in currency of country of procurement, while Government assumes risk between procurement currencies and currencies used by IBRD. The fee for this to DBP is 3/4%.

12/ (i) IFCT shall pay into a "Claim Account" in the name of the Ministry of Finance ½% per annum of its outstanding foreign debt; (ii) IFCT shall set aside to a Provision for Exchange Risk 1% per annum of its outstanding debt; (iii) if a net loss occurs owing to a realignment of currencies, the loss shall be charged: first, against the Provision for Exchange Risk (up to 75% of the balance of that Provision), and secondly, the balance if any, against the Claim Account; (iv) in the event that the loss exceeds the sum of the charges so made, the Ministry of Finance shall reimburse IFCT the amount of the excess; and (v) IFCT shall repay the Ministry of Finance this reimbursement at the rate of Bt. one million per annum, irrespective of the numbers of such reimbursements made to IFCT by the Ministry of Finance.

13/ For enterprises where equipment and its installation cost less than $1000,000 the sub-borrower pays 8% for local or foreign currency (IDBA receives 10% interest and the Government rebates 2% to the sub-borrower).

14/ The Central Bank assumes the exchange risk on the principal while CDB takes the risk on interest while establishing provisions at the rate of 0.5% per annum on the principal outstanding.

15/ The Government has agreed to bear the foreign exchange risk for any sub-loan granted to small or medium sized enterprises up to Fmk 500,000. For any amount of an individual loan over this limit, the foreign exchange risk is passed on to the sub-borrower.

16/ IMDBI may charge an additional 1% if IMDBI assumes the foreign exchange risk.

17/ IMDBI's foreign exchange exposure arose from three major operations, 35 million dollars of Eurodollar borrowings in 1972 to prepay Loan 602-IRN, conversion of 36.1 million dollars of Eurodollar borrowings into Rials to meet its local currency needs, and conversion of DM 60 million bond issue in 1973 to Eurodollars as required by the German Monetary Authorities. IMDBI will protect itself from loss in addition to possible arranging guarantees, purchasing forward cover, etc., by establishment of a specific provision to cover possible exchange losses and the limiting of the exposure to a prudent level in relation to the provision. The relation between exposure and the provision is determined by the composition of the exposure, i.e. the number and relative importance of the currencies in the exposure. A review of IMDBI's exposure as of September 1973, established that a prudent level would be up to seven times the provision. The provision would be made up of realized and unrealized profits made on the exposure (offset by realized and unrealized losses) and of allocations from income. For tax and audit reasons the provision is not specifically identified in the Balance Sheet, and allocations from income are not made directly.

18/ Base rate 14½ - 15½%. Actual rate now 16 - 17%.

19/ Government takes up the excess of any spread over 1.75%.

20/ 12% + 2% commission.

21/ In the case where exchange risk is assumed by Central Bank, a 14.25% fee is charged to the sub-borrower.

22/ .125% for the first $40 m., .0625% thereafter.

DFCD
June 13, 1975

Record Removal Notice

File Title	Barcode No.
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Document Date	Document Type
7/2/1975	Operations Policy Memoranda

Correspondents / Participants

Subject / Title
O. P. M. No. 2.64 Development Finance Companies

Exception(s)
Corporate Administrative Matters

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Bertha F. Wilson	March 28, 2017

FORM NO. 678
(7-73)

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

POLICY REVIEW COMMITTEE

PRC/s/M/75-6a

June 27, 1975

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DFC POLICY PAPER

STAFF REVIEW - MINUTES

Attendance:
Messrs. Alter (Chairman), Acharya, Chanmugan, Colaco, Fuchs, Glaessner, Gulhati, Gustafson, Hablutzel, Haq, Hidalgo, Hyde, P. Jacob, Karaosmanoglu, Kavalsky, Knotter, Loeschner, Mistry, Picciotto, R.L.Powell, Sekse, van der Bijl, van der Tak, Vita, Whitesell, Vibert (Secretary)

1. A staff review of the 'DFC Policy Paper' was held on Monday, June 23, 1975.

2. The Chairman noted that the policy paper originated as a response to recent questions raised by some Executive Directors in connection with the presentation of DFC loans. He proposed that the discussion focus on four topics: the policy to be followed in phasing out lending to established DFCs; the level of on-lending rates; the sector objectives in DFC lending; and the approach to lending to public DFCs. It was explained that the draft OPM attached to the paper would be detached when the paper went to the Board and would be issued subsequently reflecting further discussion.

Phasing-Out of Bank Lending to Established DFCs

3. The points made by the authors concerning the considerations (summarized in para. 62 of the paper) having to do with the length of time over which Bank support for a particular DFC was justified, were accepted in the discussion. It was also said that, while essential institution building objectives had often been achieved after a series of Bank loans to a particular DFC, lending to well-established DFCs in particular cases enabled the Bank to make an impact on important industrial sector objectives. It was felt that this justification for continued lending could be brought out more clearly in the paper.

Level of On-Lending Rates

4. Some discussants felt that a prescription of a real interest rate target level of 5-6% over the life of the loan, to be used when market rates of interest were not available as benchmarks, might be too restrictive. It was difficult to establish realistic benchmarks in cases where no comparable market rates exist for medium- to long-term lending and

any judgment about a particular level of real interest rates was inextricably linked to an assessment of expectations in the country for the medium- and long-term trend of inflation. In response, it was pointed out that in practice such assessment cannot be avoided under a fixed interest rate system. Others felt that the real interest rate target should be higher, particularly since the Agricultural Credit Paper had suggested that the cost of mobilizing credit was at least 8% in real terms, to which an appropriate spread should be added. The authors responded that what evidence there was suggested that the actual costs of mobilizing resources over long periods of time was lower than 8% in real terms; this, along with the other considerations mentioned, suggested that real interest rate target should be pointed at a lower level if it were to be taken seriously. Finally, it was suggested that in the version of the Paper going to the Board, the actual target numbers should be deleted but retained in the OPM.

Sector Objectives in DFC Lending

5. There was general agreement that in lending to DFCs, the Bank should aim to look beyond institution building concerns to achieve broader objectives in the industrial and financial sector. It was said that to date, the Bank had not been very successful in achieving these broader objectives through DFC lending, or through other means. Even though individual DFCs often account for a relatively small share of total financing of new industrial development in a given country, lending to DFCs could, however, provide a point at which the Bank could give operational expression to the conclusions reached in financial and industrial sector work. In relation to harmonizing the Bank's DFC operations with the Bank's approach to industry lending, it was agreed that DFCs be sensitized to the exploration of alternative technologies in appraising industrial projects and that the relationship between DFCs and institutes for technology be strengthened. It was also noted that the problem of assistance to small-scale industry through DFC lending may well require more systematic attention in the Bank through new organizational arrangements to ensure a coordinated approach.

Lending to Public DFCs

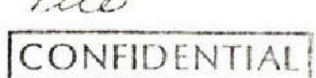
6. The proposed flexible approach to lending to public DFCs was endorsed, and it was noted that both direct and indirect lending to such institutions had been found useful in particular circumstances.

7. It was agreed that the paper would take into account the comments made before being sent to the Policy Review Committee.

Frank Vibert
Secretary
Policy Review Committee

dd
cc: Those Attending
Vice President - IFC
Department Directors -
IBRD/IFC

Form No. 630
(4-73)



INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

POLICY REVIEW COMMITTEE

PRC/s/C/75-6

June 13, 1975

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DFC POLICY PAPER

Attached please find the 'DFC Policy Paper' prepared by the Development Finance Companies Department. Also attached is a draft revision of Operational Policy Memorandum 2.64 on DFCs. A meeting to discuss the paper is tentatively scheduled for June 23; confirmation of the date and notification of the time and place will be sent out shortly.

Peter R. Jacob
Acting Secretary
Policy Review Committee

DISTRIBUTION

Attendance

Messrs.
Alter (Chairman)
Adler, Hans
Baneth
de Azcarate
de Vries
Fuchs
Gill (IFC)
Glaessner
Goodman
Gulhati
Gustafson
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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

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POLICY REVIEW COMMITTEE

PRC/s/M/75-6

June 17, 1975

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CONFIRMATION OF MEETING

DFC POLICY PAPER

This will confirm that the meeting to discuss the 'DFC Policy Paper' will be held on Monday, June 23, at 3 p.m., in Conference Room D-556. The paper (dated June 13, 1975; number PRC/s/C/75-6) was distributed earlier this week.

Peter R. Jacob
Acting Secretary
Policy Review Committee

DISTRIBUTION

Attendance

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Alter (Chairman)
Adler, Hans
Baneth
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de Vries
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Glaessner
Goodman
Gulhati
Gustafson
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Hasan, P.
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DFC POLICY PAPER

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Economic Returns on DFC Projects

v. Recently an attempt to better define the economic impact of DFC lending was undertaken in a series of detailed studies of a representative group of DFCs. The studies focused on the actual economic results of sub-projects financed as well as other contributions of DFCs. These studies were combined with educational efforts to introduce all Bank-financed DFCs to appropriate economic appraisal tools. DFCs in India, Iran, Korea, Tunisia, Turkey and Columbia were studied. About 160 completed projects were studied and the weighted average economic rate of return of these projects was about 23% with a fairly wide spread ranging from negative to highly positive returns, although about three-fourths of the projects had economic returns over 10%. While the results are favorable, and indicate that the financial appraisal tools being applied resulted in sound projects in a majority of cases, economic analysis at the appraisal stage would have screened out some, but by no means all, low return projects as well as helped to provide signals to DFCs for the need for project modification or the examination of sector policy problems,and work continues with DFCs in developing appraisal skills to improve their resource allocation. It is also clear that the Bank should try to ensure that criteria being applied by government decision makers and DFC decision makers in the sectors served by the DFC are reasonably consistent.

Employment and DFC Projects

vi. In many countries where there is an active DFC program, unemployment is a serious problem and the question arises as to the impact of DFC financing on employment. The studies noted above attempted to examine in part this complex question. The first few studies were inconclusive on the problem. Direct employment created as measured in terms of capital cost per job ranged country to country ($7,000 in Colombia to $13,200 in Korea) and within countries this ratio did not turn out to be a good indicator of the overall economic return of particular projects. In the Colombia study, attempts were made to refine the analysis by looking at direct and indirect employment of DFC-financed projects. It became clear that the indirect employment was an important factor in the overall employment equation and affected the total employment figure in both positive and negative ways depending on the particular project. However, the adjusted employment/capital ratio was not found to be a good proxy for economic returns. Consequently the employment aspect must largely be considered by DFCs through appropriate factor pricing in the economic analysis done on projects. It is also important to sensitize DFCs to keep in view what they can do in project formulation by examining production methodology options which have different factor proportions. Finally, more efforts could be made to support technological study efforts in member countries that seek to adjust technologies to better fit local conditions.

Small Enterprise Financing

vii. The role of Bank and DFCs in financing small scale enterprise has been the subject of increasing discussion. While a study of a large sample of Bank-associated DFCs and the 5,000 enterprises they financed in the 1970-72 period indicates that 50% of these sub-projects were with firms that had assets, after project completion, of less than $300,000, and 30% had fixed assets below $100,000, it was also the case that only about 5-10%

of these DFCs' total lending (by value) was to enterprises with assets below $100,000. In fact in the great majority of cases, the institutions reviewed were not set up to give concentrated assistance to small borrowers.

viii. However, small enterprises are pervasive, their employment is substantial, they provide balance to the ownership distribution of productive assets and in many cases their needs are neglected. The Bank, therefore, is directing more energy to this sector. In some cases this may involve using an existing DFC to undertake special small enterprise programs. In other cases more diffusive vehicles will be appropriate. It is also likely that special efforts will be needed to provide technical assistance since this seems to be an even more critical element than finance in helping small enterprises. Effective delivery systems for this technical assistance have rarely been developed and much needs to be learned in this area. Different approaches will be necessary in different countries as the nature and abilities of small scale entrepreneurs varies widely. The Bank has thus recently embarked on a range of schemes in Colombia, Nigeria, Cameroon, Ivory Coast, India, Korea and Philippines that, when operating, will provide a good base of experience to help refine judgments on the importance of such projects and the means to carry them out effectively. These operations should be closely evaluated and the lessons applied in the other 10 to 15 countries where it is hoped to develop small enterprise projects in the next few years. Continued liaison with UNIDO and ILO in this sector is also important to maximize the Bank's effectiveness.

Interest Rate Issues

ix. Interest rate questions are clearly vital to a DFC as they determine how it can mobilize resources, the risks it can take and the level of administrative costs it can bear. Low rates are often difficult to justify because if credit charges are not used to balance credit demand and supply, other mechanisms (often collateral) are used and leakages of credit in such situations can frustrate other policy objectives. Moreover, low rates may not be an efficient tool for steering investment while at the margin they encourage the use of capital as opposed to labor. Also, industrial borrowers are frequently high in the income curve and, since most governments face many claims on their resources, subsidized industrial credit is not easy to justify.

x. Interest rate issues need to be examined in the country context, taking into account the country's savings and investment strategies and needs, and the relationship of interest rates to those objectives. In many cases it will take a period of time to achieve progressive rationalization of interest rate structures. In addition to a review of the overall framework of rates and how they relate to policy objectives, the question arises as to the appropriateness of the DFC concerned being able, over time, to mobilize resources in the market. Consequently the first benchmark for measuring the adequacy of relending rates is the price a DFC would need to pay to mobilize funds, plus a reasonable spread. If such indices are not available, an alternative is to posit target real rates of 5-6%. This is based on estimates of rates required to mobilize capital which are seldom less than 3-4% in real terms, plus a spread to cover intermediation costs.

In cases where high or volatile inflation exists, indexing or variable rate lending may be required to achieve this objective.

xi. Interest rate issues cannot be divorced from how foreign currency risks on external borrowings are handled. Generally, DFC sub-borrowers are in a position to cover such risks and, as a practical matter, governments may agree to this while not accepting domestic interest rates that approximate market rates. In other cases the government may assume all or part of these risks at an appropriate fee, although in practice it is difficult to calculate what is the appropriate level of the fee required to cover possible losses.

DFCs Dependency on Bank Funds

xii. Directly related to the above discussion is the question of how long the Bank should finance a given DFC. As noted, DFCs have often been frustrated in resource mobilization efforts by government interest rate and capital market policies. Even in cases where the Bank has ceased to lend to more established DFCs, these institutions have often continued to depend, to some extent, on special public funds. The state of international capital markets combined with country creditworthiness issues has also, in some cases, closed access to foreign funds for some DFCs, which on their own strength, might otherwise have been suitable borrowers. In determining how long the Bank should finance a particular DFC, two sets of questions need to be addressed. The first concerns the country's need for capital; the DFC's need for capital; and the effective use of such capital by the DFC in relation to other priorities for Bank financing in the country concerned. The second set revolves around the Bank's judgment concerning other options the DFC has for mobilizing resources and its pursuit of these options, the appropriateness of policy changes in the country to widen these options and possibilities for directly assisting DFCs to mobilize resources.

xiii. Concerning financial sector policies, it is clear that DFCs usually are only a relatively small part of the financial infrastructure; often they are not well integrated into that structure. It is, therefore, important to address the problem of a DFC's lending rates in concert with general financial sector policies. There is scope for improving the Bank's work in this area. One of the near term tasks is to develop a better framework for approaching this problem in the context of specific countries and work along these lines is underway.

xiv. Concerning direct efforts to help DFCs mobilize funds, the Bank Group can facilitate commercial borrowing by DFCs by (i) having IFC arrange financing packages, portions of which are covered by commercial lenders; and, (ii) by allowing DFCs to blend shorter-term commercial funds (usually 3-5 years money) with longer-term Bank funds so that, overall, the DFC has the right mix of maturities needed for its long-term lending. These options should be explored in the Bank Group's relations with each of its better established DFCs.

DFCs and Broader Development Functions

xv. Aside from efficient allocation of resources to economically viable projects, DFCs should be searching for areas where their contribution of

finance or effort is of catalytic importance. These tasks may relate to improvement of project design or implementation; special efforts to reach relatively new classes of entrepreneurs; regional development; acceleration of the development of export oriented projects; reviews of important subsectors; project promotion; financial sector development; and review of particular sector policy issues. While there are exceptions, and the pattern is changing, one tendency has been for DFCs to take a rather conservative view of their role which resulted in a weighting of their activity toward the relatively strong enterprises in their economies.

xvi. Consequently, in its dealings with each DFC, the Bank should encourage a dialogue over the spectrum of tasks the DFC can undertake where it can make a catalytic contribution. Definition of near-term strategies for DFCs which set out their operational plans in this regard is one method of giving focus and importance to these issues. The innovative impact of any DFC will, however, also largely depend on the quality and vision of the management of the institution; given this, there is no easy formula or model that will easily produce dynamic promotional DFCs.

xvii. An issue related to the DFC's innovative role concerns the need to better integrate the Bank's country economic and industrial sector work with DFC operations in order to provide better focus on policy issues of relevance to the Bank's DFC lending operations. Here there is scope for better use of the venue of DFC lending for analyzing subsector or policy questions and improving the roles of DFCs as credible spokesmen on sector policy issues. Sector work of relevance to DFC lending therefore needs to be done in close liaison with regional DFC staff.

Criteria for Lending to Government DFCs

xviii. In financing an increasing variety of institutions, the Bank has found that institutional criteria relevant in one case may not be relevant in others. In financing new types of institutions with a variety of ownership patterns the Bank has, case by case, attempted to determine the relevant criteria. One area where there is clearly a difference between government and private DFCs is in the owner's profit expectations. However in financing government DFCs, the Bank normally looks at the following criteria and asks itself whether the criterion is appropriate given the context of the particular operation, how the DFC measures against the relevant criterion, and, if it is deficient in important respects, how these deficiencies can be corrected. The basic areas of examination are:

(a) the quality of management and the level of professional skills;

(b) the policy orientation of the DFC;

(c) the decision rules used in selecting projects;

(d) relending terms;

(e) supervision and administrative capacity;

(f) financial controls and verification of accounts;

(g) financial structure, financial planning and creditworthiness; and

(h) the soundness of the overall operations program of the DFC.

xix. In some cases lending to government DFCs require difficult judgments as to the appropriate degree of autonomy for the institution and the necessity for it to follow financial policies normally applied to commercial intermediaries. The key elements in these judgments involve a determination of the degree of administrative and financial autonomy that allow the institution to achieve in an efficient manner its agreed policy objectives.

Future Dimensions of DFC Lending

xx. In the FY 76-80 period DFC lending is expected to reach $3.1 billion as compared with $1.7 billion in the preceeding 5 years. This represents about 8% of Bank/IDA financing in the two respective periods. The regional areas that are likely to see the highest growth are in DFC lending volume are Latin America and East and West Africa. These areas have received the lowest share of DFC financing historically and the increasing pace of DFC operations in these areas reflects increasing options and potentials in those Regions for the financing of medium scale enterprise. About 20 new DFC borrowers will be added to the Bank's rolls during this period and 6 to 8 DFCs formerly financed by the Bank will be phased out of the lending program.

I. HISTORICAL PERSPECTIVE

Past DFC Lending and its Objectives

1. Bank Group financing of development finance companies (DFCs) commenced in 1950 with a loan of $2 million to the Development Bank of Ethiopia. By the end of FY1975, Bank Group finance extended to such intermediaries will have reached almost $3 billion to 67 DFCs in 45 countries, including 3 regional DFCs serving the East Africa Community, Africa and Latin America. A summary of all such lending appears in Annex 1. The great bulk of these funds have been Bank loans although about 8% of the total has been from IDA; IFC has provided $93 million ($73 million in loans, including participations, and $20 million in purchases of shares) for 28 of the 67 DFCs. Currently, Bank Group financing of DFCs is running on the order of 20 operations per annum for $500-600 million. In the next 5 years it is projected that about 10% of all Bank Group lending will be of this type, approximately the same percentage that has gone to such projects in the last decade.

2. In many member countries the Bank has come to the conclusion that assistance to enterprises in the manufacturing (and sometimes tourism) sector is of considerable importance in assisting the growth process, that not only the largest enterprises in such economies but the medium and smaller-sized ones as well require capital and that to deal efficiently with great numbers of relatively small enterprises intermediaries were required. DFC lending has been the principal vehicle for such lending. While there have been shifts in emphases over time and refinement of the objectives of such lending and how performance would be measured, there has been and there generally remains, a three-pronged objective in DFC lending. First, the Bank Group wants to have a favorable impact on the manufacturing sector in those countries where the judgment has been reached that this sector represents an important element in the economy.1/ Second, in many such cases the Bank Group has decided that it should try to reach not only the largest enterprises but more moderately-sized units as well. When project costs fall below $5-15 million, the Bank needs to work with institutions within member countries to decentralize the appraisal process and move it closer to the point of implementation. Third, the Bank is intent on helping to build strong and effective institutions that have the capacity to secure, and then to allocate, resources into efficient and productive investment and to have a catalytic and developmental impact on the sectors in which they are involved. Consequently the Bank Group has provided catalytic support in terms of providing the basic institutional design to be followed, or the basis for a major reorganization, for about half of the DFCs which it has assisted. Moreover, with respect to all its DFC clients, the Bank has continuously tried to sharpen and expand its expectations concerning the developmental objectives of these DFCs as they grew in stature.

1/ While a few Bank-financed DFCs specialize in tourism, the overwhelming bulk of Bank Group DFC lending has been in the manufacturing sector. This, of course, does not mean that the DFC approach is not viable for other sectors. There is, for example, a large overlap between the institutional aspects of agricultural credit and DFC operations, although this paper does not attempt to review policy issues involved in the latter (see Bank Report on Agricultural Credit dated August, 1974). Moreover, DFC-type operations have been developed that have mining and contractors as their target groups. The use of credit intermediaries to reach particular sub-sectors or types of borrowers has obvious potential in a number of sectors.

3. The amount of Bank Group activity has grown rapidly over the last 25 years, although there have been important shifts in the geographical orientation as well as the varieties of institutions assisted. The pace of Bank Group DFC financing is indicated in Table I below:

Table I

Bank Group DFC Assistance (FY)

	1950-54	1955-59	1960-64	1965-69	1970-74	1975	Total
No. of DFCs Assisted	3	4	17	23	54	15	70
Amt. of Bank Group financing($m)	20	25	246	641	1,415	507	2,854

While the most rapid period of growth of Bank Group DFC financing in percentage terms was in the 1960-69 period, DFC lending has continued to grow in the 1970-74 period in line with the rapid overall growth of Bank Group activity.

4. Geographically there have also been shifts in DFCs in the past 10 years as the Latin American Region and East and West Africa have increased their relative position (see Annex 2).

Table II

Total Bank Group Financing of DFCs at Year-End

	EMENA	LAC	EAP	S. ASIA	E&W AFRICA	TOTAL
1964	77 (26%)	6 (2%)	32 (11%)	170 (59%)	5 (2%)	290 (100%)
1969	376 (40%)	77 (8%)	112 (12%)	354 (39%)	12 (1%)	931 (100%)
1975	1206 (41%)	299 (10%)	477 (18%)	731 (26%)	141 (5%)	2854 (100%)

The low level of operations in Latin America resulted from the Bank Group's pre-1969 policy of financing only privately controlled DFCs. While a number of private financieras existed in Latin America, few could obtain governmental support (in terms of guarantees) for Bank financing. Moreover, the Inter-American Development Bank and US AID were active in financing both private and public development institutions in the LAC Region. In Africa, manufacturing activity was at its earliest stages and in many cases in the pre-1969 period it proved either impossible or inappropriate to create privately controlled DFCs. Low interest rate policies in Africa in the late sixties also often resulted in DFCs there being dependent on low interest rate bilateral loans.

The Private DFC Model

5. In pursuing a policy of financing privately controlled DFCs the Bank in fact created hybrid institutions that represented a cooperative venture between the Bank Group, foreign investors (usually international commercial banks), the government and domestic investors (usually financial intermediaries and/or manufacturing enterprises or business associations). This design meant that the DFC was expected to follow a mix of commercial and developmental objectives. In some cases these objectives tended to pull in different directions and allowances were often made by all partners to achieve the right balance of objectives and policies. Private institutional investors often settled for lower returns on their DFC investments than they would have normally expected from alternative equity investments. Governments often gave subsidies to DFCs not generally available to other financial institutions in order to support institutions they believed would make a worthwhile contribution to development. Consequently, the benchmarks for measuring a DFC's suitability were broad. DFCs were not to be a source of long-term funds on more favorable terms than other lenders but rather their involvement in projects, sector development issues or policy issues was to lead to a unique developmental contribution. The expectations placed on them from the outset in terms of their defined policy objectives made it clear that their approach was not based on a single focus of profit maximization. Nevertheless, they had to be concerned about earnings because to grow an increased equity base over time was essential for growth. Managerial and decision making autonomy was also considered important in such institutions, although the DFC was expected to have open communication with government on the latter's policies and objectives and to hold the confidence of the government. In this connection the Bank sought a high level of professionalism in the DFCs it financed; i.e., they were to have or were to develop capable analytical staff and clear and acceptable decision rules. Finally, these DFCs were never intended to be wards of the World Bank. It was hoped that they would broaden their funding base over time and that they would play a role in the development of domestic capital markets.

6. Given these broad and demanding objectives it is clear that the Bank's DFC work has been characterized by an institutional focus. The Bank was not so much concerned that its particular funds found their way to projects that met agreed criteria, but rather the Bank strove to help develop associated DFCs into strong, self-reliant institutions capable of making a growing contribution to development, and which would have the ability to evolve to meet changing environments.

Widening Options: 1969-1975

7. The purpose of this background is not to evaluate the relative success of the Bank Group's pre-1969 model. The OED Evaluation Report (Sec. M74-529 dated July 26, 1974) goes into this subject in great detail. Rather it is to point out that by 1968 three basic lessons had been learned. First, the institutional focus was a valid one as many Bank associated DFCs had in fact developed into institutions of stature. Second, while all of the DFCs assisted by the Bank Group up to that time enjoyed varying degrees of financial success and recognition as professional institutions, the model was simply not applicable in many countries.[1/] In these countries the model did not fit with government

1/ The very first DFC assisted by the Bank (the government-owned Development Bank of Ethiopia) encountered serious problems and eventually went out of business.

wishes for developing public sector institutions, or the factors necessary to bring forth private capital for such an endeavor simply were not present, or the functions to be carried out were such that a market level of profitability could not be achieved without undue subsidies. Third, the Bank had become well aware that what mattered more than who held the shares of a DFC or its particular institutional design, were the processes, policies and degree of professionalism applied in the DFC's work which in turn often reflected the calibre and vision of DFCs' senior management and staff. While institutional design may in many cases play an important role in determining the kind of leadership and staff a DFC has, there has been ample evidence that, irrespective of ownership arrangements, the specific leadership of a DFC is a major factor in explaining relative dynamism among DFCs.

8. It was in recognition of these and other factors that the Bank modified its policy at the end of FY1968 to enable it to consider financing government-owned or controlled DFCs serving the private sector. Subsequently, it was also agreed that the Bank would be open to both public and private DFCs, financing government-owned enterprise if this appeared appropriate in the circumstances and if sound decision rules were applied to the public enterprises to be financed. This latter change in policy enables the Bank to try to come to grips with medium-size public sector enterprises through DFCs which is a particularly important option to have in countries where the state is heavily involved in industry. Nevertheless, the great bulk of lending through both government and private DFCs has been to privately-controlled enterprise at the sub-project level. (About 95% through FY75 and on the order of 85-90% in the next five-year period.)

9. After the change in policy toward government-controlled DFCs, the financing of such DFCs by the Bank has become pronounced. While 32 new DFC borrowers were added to the Bank Group's books in the 1969-75 period, only 7 of these were privately controlled DFCs.[1] The reason for this ratio was not a preference per se for government-controlled DFCs but rather that the Bank Group had exhausted, relatively speaking, the opportunities where the private DFC approach was feasible. Overall Bank Group lending to public as opposed to private DFCs has developed over the last five years as follows:

Table III.

Bank Lending to Public and Private DFCs FY71-75
($ million)

	FY71		FY72		FY73		FY74		FY75		TOTAL	
	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.
Public DFCs	3	24	10	156	4	120	8	139	8	292	33	731
Private DFCs	9	230	6	96	10	215	10	207	6	214	41	962
Total	12	254	16	252	14	335	18	346	14	506	74	1693

1/ Excluding 4 rather sui generis Yugoslav mixed commercial/investment banks.

10. The Bank has been pragmatic in its choice of institutions since 1969. When Bank assistance to create new DFCs has been requested by member governments the Bank has explored alternative ownership patterns and, taking into account the member government's preferences, has tried to adopt an approach and design which, given the total environment, would have the greatest chances of working effectively. Annex 3 gives some basic parameters of DFCs assisted to date by the Bank Group.

11. However, of greater interest, in the past 5 years or so, is the increasing variety of types of DFCs now assisted by the Bank Group. While most of the DFCs financed in the pre-1969 period shared many common characteristics, subsequent lending is marked by the diversity of institutions assisted and while many government-owned DFCs have a capital structure, role, policies and a sub-project profile not unlike their private counterparts, many others do not.

12. First, the Bank has commenced lending to a number of mixed banks in Yugoslavia, Egypt, and Pakistan, i.e., banks carrying on a large volume of commercial banking activity as well as providing significant long-term project finance. The Development Bank of Singapore moved in this direction subsequent to a Bank loan and this mixed banking approach has been recommended by the Bank but rejected in at least two other cases. In some economies the institutional set-up already includes banks that handle both short-term commercial business alongside long term investment and creating a new specialized institution may not make sense particularly if there are strong constraints on managerial skills in the country. Such mixed banks also have opportunities for resource mobilization by means of deposits, although such opportunities do not necessarily lead to higher savings at the margin. Such banks also have the possibility of being in a close supervisory position with clients as they often handle the day to day banking needs of their clients. However, in many cases the facts will argue that to tackle the variety of functions and issues most DFCs are engaged in will require the attention and focus of a specialized institution providing loans and equity finance and other services to productive enterprises.

13. Second, in a number of cases the Bank has decided to finance institutions which in turn passed Bank funds on to a network of financing institutions (India, Colombia, Brazil, Mexico, Philippines). In such cases an important objective was to get the Bank's primary borrower to take on the supervisory and institution-building role vis-a-vis subsidiary borrowers in the same fashion as the Bank normally does with its direct DFC borrowers.

14. Third, the Bank has financed some very large, government-owned, multi-purpose institutions which carry on a wide variety of financial, investment and service functions. Examples of this are the Korea Development Bank, the Industrial Development Bank of India, and the Development Bank of the Philippines. In some such cases these institutions are the mechanism for carrying out specific government programs that arise from time to time for which the government requires an agent or intermediary. Such institutions find themselves in a closer interface with the day-to-day operations of government than do other DFCs.

15. Fourth, as noted earlier, the Bank has had the opportunity to evaluate and finance government institutions which have as their target public sector industrial activities (Tanzania, Pakistan, Turkey, and Algeria). If in some cases, but by no means all, public sector industrial investment activity confronts many difficult issues, the potential benefits of a strong institution capable of establishing financial disciplines, guiding investment decisions

and encouraging efficient project supervision and implementation are great and this is an option opened up by the flexibility in Bank policies on ownership issues.

16. Fifth, the Bank has been able to finance and otherwise assist, particularly in Africa, DFCs that perform a wide variety of financing functions. These include institutions that provide both agricultural and industrial credit (AIDB in Ethiopia), or in addition to this consumer and housing finance plus short-term credit (BCD in Cameroon and ICC in the Ivory Coast) and also institutions that have acted as a vehicle for government promotion, participation or ownership of various types of enterprises (AIDB in Ethiopia and BDC in Botswana).

17. The breadth of institutions now served is, consequently, very wide as Annex 3 indicates. Bank assisted DFCs now range in size from the Liberian DFC (total assets $3 million) to the Privredna Banka Sarajevo in Yugoslavia (total assets of about $2 billion). The Liberian DFC (LBDI) has had a recent average loan size of $91,000; the Korean DFC (KDFC) an average size of $570,000; and IMDBI, Iran, an average loan size of $2,300,000. The Turkish DFC (TSKB) has by and large stuck to the manufacturing sector; the Irish DFC (ICC) has financed shipbuilding, trade and services as well as manufacturing. The Ethiopian DFC (AIDB) has financed farmers as well as acted as caretaker for a number of large government-owned manufacturing plants. Some DFCs have been active in hotel financing and others have decided not to finance such projects. These variations are considerable, even among private DFCs, and therefore the DFC umbrella covers an extremely broad range of institutional forms and underlying types of business being done.

The Consistency of Approach

18. While the variety of institutions served and the nature of their clientele have differed widely, the approach of the Bank Group to DFC financing has had a consistent core. First, in undertaking such operations the Bank has tried to assure itself that the policies pursued by the government to stimulate investment and growth in the sector or sectors served by the DFC are reasonably conducive to support economic investment in those sectors. A DFC, whether private or government-controlled, cannot go far in counteracting the distorting effects of seriously unsound government policies in its investment decision processes. Similarly the sectors served by the DFC should be of demonstrable economic importance in the country to give this type of project appropriate priority in the Bank's lending program. Bank loans to DFCs are not usually sector loans since they normally cover an extremely wide variety of sub-sectors and their focus is the institution, its capacities, decision rules, etc. as opposed to an in-depth analysis by the Bank of a specific sub-sector's needs, the policy framework for that sub-sector and an overall plan to deal with the issues arising therefrom. However they can have a sub-sector focus if the government, the Bank and the institution see an important need for and have developed a policy framework to develop a specific sub-sector which requires specific support and attention. Moreover, DFC loans provide one important potential venue for Bank discussion of general industrial sector policies that have been analyzed by the Bank and if the DFC has the right kind of staff it can undertake work to help examine some sector issues. It is clear, however, that such discussions must be integrated into the Bank's overall dialogue on economic policies with member governments.

19. Second, the Bank is concerned with examining the extent to which additional funds are necessary to meet investment demands in the sectors concerned and the resulting impact Bank financing can have both in assisting productive investment and in meeting the financial gap of the DFC involved.

20. Third, the Bank focuses on the specific characteristics of the DFC - its strengths and weaknesses. The broadest concern is the institution's own policy orientation. Is its policy consistent with the government's policy orientation and are the DFC's objectives consistent with the Bank's objectives in the country concerned? This analysis not only reviews the DFC's general policy objectives and analysis of the characteristics of its investment activity but also more difficult judgments concerning what the institution is adding to the development process in the way of innovation of new approaches or ideas relevant to its clientele and the sectors it serves.

21. The next group of questions is simply the capacity of the institution to use capital effectively. This implies competent management and staff, effective appraisal procedures, appropriate financial and economic decision rules, thorough follow-up and reporting systems and effective communication between the DFC, the business community it serves and between the DFC and government.

22. The final level of concern the Bank addresses in evaluating DFCs is their financial viability in the context of the financial systems in which they operate. The Bank has not financed DFCs on the basis of simply maximizing the Bank's probability of getting repaid irrespective of the DFC's overall financial fortunes. The objective is to establish policies and procedures so that the intermediary will remain solvent, creditworthy and capable of growth throughout both the peaks and valleys in the economic health of its sectors it serves. Consequently, the areas of concern normally include the quality of the DFC's portfolio, the adequacy of its equity base given the nature of its business and the risks it is exposed to, its financial planning, liquidity and debt service capacity and its ability to maintain an appropriate level of administrative costs while at the same time earning returns in line with its self-financing needs and its public or private owners' expectations.

23. In the pursuit of these objectives the Bank has played an important part in the development of about 70 institutions that this year will disburse some $3.25 billion in long-term industrial capital. Essentially all of these have established sound portfolios and the capacity to weather economic downturns, most enjoy a rate of growth higher than that of the sectors they finance and may have had the ability to adjust to fairly basic shifts in their working environment.

24. Given the variety of DFCs now financed and the variation in their environments which range from highly centralized planning to highly market oriented economies, financial or policy guidelines appropriate in one case will not always be appropriate in others and thus the task of evaluation of standards and policies appropriate for a particular DFC has steadily become more complex. Moreover, expectations as to what constitutes a developmental contribution have changed over time and this requires new responses and ways of looking at and dealing with DFCs. Attention is now, therefore, directed to a number of issues the Bank repeatedly confronts in its DFC lending activity in order to help further define and clarify the current approach of the Bank in this field of lending.

II. CURRENT OBJECTIVES AND ISSUES IN DFC LENDING

A. Economic Returns of DFC Lending

25. During the 1960s the Bank Group's emphasis in its DFC lending was to develop institutions with strong professional skills in the areas of financial marketing, technical and managerial evaluation. When the Bank surveyed the landscape for institutions which competently looked deep and hard into perspective projects, it often found that such skills were lacking and thus it is not surprising that the Bank Group was simply passing onto its DFC clients the tools and criteria it had used in its own work as a development bank in the industrial sector. This is not to say that the economic characteristics of projects were ignored. Indeed there were a number of cases where the Bank and DFCs engaged in dialogue over projects with questionable economic characteristics. However, there was no systematic attempt by the Bank or by most DFCs to determine quantitatively the economic efficiency of projects.

26. There was, consequently, increasing concern that in many countries normal financial return signals could give quite misleading results if one relied on them as a proxy for indicating economic efficiency. Various distortions in the pricing system due to protectionist policies, subsidies, inappropriately priced factor inputs, etc., raised two major issues for the Bank to deal with. First, how severe were the price distortions and had DFCs been financing a lot of inappropriate projects in terms of their having inferior economic returns relative to other Bank-financed projects? Second, how could the Bank Group develop and heighten sensitivity to economic appraisal skills in DFCs?

27. Work proceeded on both fronts. Concerning economic yields, five DFCs were chosen for an intensive review of sub-projects already financed and where there had been at least a year's production experience so that the research could be done with fairly hard data. The five DFCs studied were ICICI in India, IMDBI in Iran, KDFC in Korea, BDET in Tunisia, and TSKB in Turkey. These DFCs were chosen in order to give indicators for a wide variety of economies and because they accounted for about 40% of all Bank Group disbursements at the time the studies commenced. All five institutions were long-time Bank borrowers, and all, with perhaps the exception of BDET, had enjoyed continuity of management and quite highly qualified senior staff. Subsequently another set of institutions, namely the financieras in Colombia, were studied from somewhat the same perspective. None of the institutions chosen were from the new ranks of DFCs financed in the post 1969 period as Bank experience with these new borrowers was too early to generate actual sub-project data.

28. For each of the six countries, the sample of projects studied in depth was representative of the types of industry the DFC normally financed. A total of 160 sub-projects were studied. The input of staff time was considerable as it required an average of 3 manweeks per project to evaluate using actual data and determining the basic adjustments for the appropriate pricing of labor, exchange rates, etc. The summarized results are indicated below.

Table IV

Economic Rates of Return (ERR) of DFC-financed Projects

	ICICI India	IMDBI Iran	KDFC Korea	BDET Tunisia	TSKB Turkey	Colombia	Total	%
No. of Projects studied	42	32	11	23	23	29	160	100
No. of Projects with:								
Negative ERRs	1	3	2	-	4	1	11	7
ERRs 0-10%	8	5	1	3	3	4	24	15
ERRs of 10-25%	13	14	-	3	8	4	42	26
ERRs of over 20%	20	10	8	17	8	20	83	52
Weighted Average ERR	19	17	31	36	11	32	23	
(Weighted Average Financial RR)	(17)	(14)	(29)	(11)	(16)	(18)	16	

29. With a weighted average ERR of 23% for the 160 projects, and with three-fourths and one half of the projects showing ERRs over 10% and 20% respectively, the results were encouraging and perhaps even surprising given the view that in almost all the countries studied there was thought to be a fairly aggressive important substitution, protection-based, industrial development strategy. Moreover, given the fact that the DFCs were not employing at the time the sub-projects were selected any sophisticated economic analysis tools, the conclusions showed that normal financial tests employed by the DFCs did overall lead to a favorable allocation of resources in terms of economic returns. However, individual projects did show weak or negative economic returns but good financial returns and this could have been anticipated by proper economic analysis at the time of project appraisal.

30. The studies focussed heavily on the economically unattractive projects to see whether any useful lessons could be learned that could be applied in the future. Poor economic returns measured ex post 1/ can, of course, be the result of a number of factors. While one cause may simply be that a project is basically uneconomic, other causes are misjudgments about markets and competence of management. Projects economically viable in concept can fail in implementation. Unfortunately no simple general answers emerged. The projects that performed poorly did so for a wide variety of reasons. Most commonly, the market for project output did not develop in the way anticipated. In some cases unforeseen technical difficulties arose. Hindsight suggests that some of these problems could reasonably have been anticipated through more careful appraisal of a conventional sort; by a deeper probing into such things as market potential, engineering soundness and managerial competence. It was also difficult to judge with certainty how many of these unattractive projects might have been screened out had the DFCs concerned been applying reasonably rigorous economic analysis at the time the project was selected. In a few cases a major factor in the poor performance of a project was the wide disparity between domestic and international prices. Economic rate of return analysis would have highlighted this problem.

1/ The analysis was based on actual capital cost data and actual operating cost data for historic periods. For the remainder of the economic life of the projects, the analysis was based on latest estimates for revenues and costs.

31. The overall conclusions that can be distilled from the studies are the following:

(a) By and large the overall economic returns earned in the past on DFC-financed sub-projects are attractive.

(b) There have, however, been some very weak (in economic terms) projects financed that could have been screened out by appropriate economic analysis.

(c) The importance of applying rigorous ERR analysis is greatest in those countries where there are wide discrepancies between domestic and international prices.

(d) The ERR tool applied in the appraisal stage when difficult assumptions concerning domestic and international prices need to be made is not useful for making finely tuned distinctions between projects of varying degrees of acceptability, but it can be used as an indicator to weed out the seriously deficient projects. While it is certainly feasible for DFCs to use this tool and a serious educational effort is being made to help DFCs develop their skills in this area, in some types of projects, e.g., non-tradeable goods or multi-product ventures, it is more difficult to apply.

(e) Good economic analysis is feasible only on the basis of good project analysis based on traditional approaches and it is still at the stage of applying traditional project tests that many mistakes are made.

(f) Economic analysis applied early on in the project cycle can also occasionally be useful to help DFCs adjust projects to make them more efficient in economic terms.

32. Turning to the Bank's approach to sensitizing DFCs to these issues, in late 1969 it was almost universally the case that DFCs operated within the constraints of a framework of government policies that usually contained a variety of fiscal incentives to promote manufacturing investments and systems that judged projects only against a rough list of indicators, e.g., How much foreign exchange is saved or earned? How many jobs will be created? Where is it located? Is it on government's priority list of investments? Few governments, even in cases where there is licensing or where incentives are handed out on a project by project basis, have data or skills required to subject the project to any sort of economic cost/benefit analysis.

33. In this context in 1969 the Bank began working with a number of DFCs to develop useable economic analysis tools. Given the fact that most lines of credits to DFCs are to finance scores of projects in a wide variety of subsectors not yet appraised or perhaps not even identified, Bank staff could not carry out economic rate of return of analysis at the time it appraised a DFC for a loan. In line with its normal institution building objective, the alternative was to have the DFC making the appropriate analysis

when detailed information was available on the sub-projects. As a first step a number of DFCs were introduced to effective rate of protection calculations which compared value added in domestic prices with value added in terms of international prices in the first full year of capacity operation. Subsequently the Bank issued guidelines to its DFCs for economic rate of return calculations and in those cases where it is important to apply economic rate of return analysis the Bank has had to undertake an education effort with the staff of the DFCs 1/. This is done using individual projects as points in case, seminars in the field with DFC staff, and training here in Washington for the staff of DFCs both in the Bank Group proper and in the EDI Industrial Projects and the Development Banking Courses.

34. One of the by-products of DFCs' use of ERR analysis has been to occasionally place the DFC at odds with specific government objectives. It has happened on a number of occasions that DFCs (both private and public) have encountered specific projects which, according to the DFC's analysis had poor economic prospects but which nevertheless had strong government backing because of perceived priorities within the government. The DFC is thus placed in a difficult position, particularly if the project meets financial but not economic tests. What such a case can provide, regardless of how the individual case is disposed of, is an opportunity for the DFC to open a dialogue with the government on the policy issues raised by such situations. It is therefore also important that the Bank, in reviewing manufacturing sector policies and investment incentive and selection tools used by governments, try to insure that the criteria being applied by government decision makers and DFC decision makers are consistent.

B. Employment and DFC Lending

35. Within the general concern of the economic impact of DFC lending, the employment impact of industrial activity has generated considerable interest. In particular, in those countries where there is a serious unemployment problem, it is important to consider the employment impact of project decisions. How does DFC lending affect employment problems? Can employment effects of such projects be improved?

36. In the six countries where DFCs were studied in depth, supplementary data was calculated on the direct employment generation attributable to the sub-projects, although it was recognized that this was only a preliminary approach to analyzing the employment impact. Such data is also now being collected *ex post* and *ex ante* on DFC lending generally and thus one finds situations on capital cost per direct job created ranging from $7,000 in Colombia to $48,000 in Greece. The projects of the DFCs on the six countries studied in depth revealed the following pattern.

1/ DFCD, *Guidelines for Calculation of Economic Rates of Return on DFC Sub-Projects*, mimeo, IBRD, June 7, 1974. The Guidelines attempt to demonstrate a pragmatic approach to economic project analysis and present two stages of approximation for ERR calculations. The Guidelines were sent to all DFCs for application to projects. The economic merits of smaller projects are gauged by simpler indicators such as the domestic resource cost per unit of foreign exchange saved or earned (Bruno ratio).

Table V

Fixed Investment per Employee in DFC Projects

	ICICI India	IMDBI Iran	KDFC Korea	BDET Tunisia	TSKB Turkey	Colombia	Total
Number of projects	42	32	11	23	23	29	160
Fixed assets/employee:							
Less than $10,000	30	14	5	12	13	19	93
$10,000 - $20,000	8	10	2	9	7	4	40
$20,000 - $30,000	1	7	1	1	3	-	13
$30,000 or more	3	1	3	1	-	6	14 1/
Average cost/job ($'000)	9.0	12.1	13.2	11.0	11.6	7.0	10.2

The studies showed an average cost per direct job of about $10,000 for the 160 projects, of which almost two-thirds were below this average. It was also demonstrated that the investment per job increases with the size of projects. It is difficult to draw conclusions from the employment data generated by the six studies in comparison with similar indices for the manufacturing sector as a whole in these countries. If anything, the sample average of $10,000 per job created may be taken as representative for the capital/labor mix of medium-sized projects. On the other hand, a comparison of the projects' direct employment data did demonstrate, as would be expected, that if capital cost per direct job was taken as a critical indicator and projects were rejected that had high capital cost/job this would have led to the rejection of numerous projects which were both financially and economically sound within the context of appropriate prices being applied for the value of foreign exchange, labor costs, etc. Similarly there were projects with low capital cost/direct job created ratios that were distinctly uneconomical.

37. Given the inconclusiveness of the data concerning employment in the studies noted above, the Bank undertook an in-depth study of DFC lending in Colombia to see whether more meaningful conclusions or guidelines could be developed on the employment question. In particular, attempts were made to look at the indirect employment impact as well as the direct. The preliminary data indicates three major points. First, the Colombia project sample show that the indirect employment creation was about 50% of the direct employment generation. Second, individual projects had widely divergent employment impacts as between direct employment and direct plus indirect employment thus highlighting the unreliability of the direct cost/job ratio as a meaningful indicator in isolation. (In 5 of the 29 projects studied the inclusion of the indirect employment impact moved the projects from a positive aggregate employment position to a negative overall effect on total employment.) Third, using the refined data on both direct and indirect employment impact it was found that using the cost of total employment generated as an indicator for economic returns was not feasible as there was poor correlation between the two (See Annex 4). While it is likely that

1/ Includes 6 projects with no or negative direct employment generation.

industrial projects will have a lower employment impact per unit of investment than projects in some other sectors, the aggregate employment impact of DFC financed projects is sizeable. Extrapolating from the data from the studies noted above, it is likely that the total job opportunities created by DFC-financed projects in countries where the Bank has an active DFC financing program is about 800,000 in 1975. This represents about 6% of the new industrial employment created in a majority of these countries and over 12% of the increment in one-third of these countries.

38. While much remains to be learned about the employment creating aspects of industrial development, the work to date on DFC lending suggest that there is not yet any easy indicator or cut-off tool emphasizing employment that can be applied to industrial project selection by DFCs. The direct employment creation data can even be misleading as to overall employment impact. The pragmatic ways of dealing with this is to:

(a) Ensure that factor pricing in the ERR analysis done by DFCs captures the employment aspect of the equation by giving labor, capital, foreign exchange, etc. their proper values given the supply/scarcity situation of the economy.

(b) Endeavor to sensitize DFCs in labor surplus economies to keep in view what can be done within their project promotion or project evaluation processes to insure that when there are options for improving a project's employment impact by use of alternative technologies or designs, that they continuously question themselves about such possibilities. This comes down to developing the breadth, focus, and expertise of DFCs' engineering staffs and encouraging them to be alert to alternative technologies.

(c) Support efficient technological study efforts in borrowing countries that seek to adjust technologies to make them more appropriate for local conditions.

C. DFCs and Small Scale Enterprise

39. A related issue that often arises in connection with DFC lending activity is the size spectrum of borrowers assisted by DFCs and whether DFCs have had, or should have, an impact on small scale firms. One of the first problems in evaluating this matter in a specific country context is how to define what is meant by small scale enterprise activity. There is no common definition by asset size, employment or turnover and thus what might be labeled small-scale in one economy is perhaps medium or large scale in another. Thus one needs to exercise care in determining what scale of enterprise is being financed in a particular setting. For example, in the 1970-72 period the average loan size of IMDBI (Iran) was about $1.25 million and the median size of firms assisted was about $2.00 million in assets. In Liberia (LBDI) the similar figures were about $12,000 and $30,000, respectively. Nevertheless, this type of data does not tell one much about the relative effectiveness of the two institutions, how appropriate their policies toward small scale enterprise have been or whether they should be doing more small enterprise financing.

40. A study undertaken of a large sample of Bank associated DFCs in the 1970-72 period indicated that of about 5,000 enterprises financed by the respondent DFCs, about 50% (by number) had fixed assets after project

completion of less than $300,000; about 30% had fixed assets below $100,000. About 30% of the enterprises financed had assets over $1,000,000. The distribution of the asset size of sub-borrowers among DFCs was, of course, quite wide, and only about 5-10% of the total volume of DFC lending was to enterprises with assets below $100,000.

41. While the above data indicates that Bank assisted DFCs finance considerable numbers of relatively small manufacturing enterprises, it is also true that in almost all cases these institutions are not expected to tackle the problems of the smallest entrepreneurs in their countries. There were only a few cases where the DFC financed artisanal activity in the informal sector. Basically their areas of activity were considered to be the modern sector and the type of lending that required substantial technical assistance was not normally put under their responsibility. Problems of assisting very small firms were not addressed by the Bank or most of its DFCs.

42. Given the lack of focus on smaller firms it is not surprising that in an effort to redress the balance particular DFCs have been criticized for not shifting their lending operations toward smaller borrowers, i.e., say, enterprises with assets below $150,000. However, the problems and potential of financing small enterprise should be addressed more systematically. In some cases DFCs which have been financed by the Bank can and should play a direct role in financing small enterprise and special programs can be developed under their auspices. This has happened for example in the case of Mauritius (DBM) and a number of other DFCs are exploring this area. However, it may often be the case that other approaches involving more diffusive institutions, specialized focus and financial support and special technical assistance will be more effective, although perhaps more difficult to set up, than pressing DFCs to dramatically shift the size distribution of their lending.

43. What may be of more general relevance in DFC financing than the size distribution of projects financed are the issues mentioned in paragraphs 68 and 69; namely, to what extent the DFC concerned is using its energies and resources in financing firms that do not really need its help at the expense of foregoing projects which are more dependent on the DFC's counsel and resources. The division of effort between various classes of borrowers is an area of creative tension in which the conscientious development banker must live as he steers a course between backing viable productive projects and taking risks.

44. What is clear, however, is that the Bank has not, until the last year or two made significant efforts to try to deal with the size of enterprises falling outside the range served by DFCs in many member countries. Such enterprises are pervasive in most economies, they employ substantial numbers of people and they provide balance to the ownership distribution of productive assets. While such enterprises are not always operated by people falling low in the income distribution curve, they are usually some distance from the entrepreneurial class which has a heavy involvement in larger scale industry. Issues on which the Bank is trying to find some substantive answers are the marginal impact and cost of assisting small enterprise, how assistance should be packaged to optimize its impact, and how critical this sector is in the growth equation in developing countries. Some preliminary insight to the complexity of the latter problem are noted in Annex 5 concerning the study of DFCs in Columbia.

D. DFC Interest Rate Policies

45. The relending terms of DFCs touch on complex issues of critical importance to the DFC as well as basic government policies in the area of resource mobilization and credit allocation. There are a number of issues that converge at the point of decision on relending rates.

(a) From the outset of its DFC lending activity the Bank had expressed the view normally that it was interested in building institutions that would develop, over time, the capacity to mobilize resources from other sources and thereby reduce their dependency on the Bank.

(b) Nevertheless, in the majority of cases DFCs are required to lend at rates below what it would cost them to mobilize funds either in domestic or foreign markets. Governments often use interest rates as an incentive and also undertake to capture for government account, a large portion of the saving stream. Although capital is scarce governments often deliberately price it at levels not truly reflective of that scarcity.

(c) The rapid acceleration of inflation in many countries in the last year or two, and uncertainty on exchange rate adjustment questions, have led to even greater difficulty in forging positions on the appropriate relending terms for DFCs.

(d) Divergence in the nature of the economies and DFCs served by the Bank have further complicated the picture. The pattern of environments range from market-oriented financial systems, to systems that while basically market-determined also contain substantial privileged credit circuits, to economies with centrally directed and managed financial systems.

(e) Interest rate questions are often vital for DFCs. They determine how the DFC can mobilize resources, the risks to which it exposes itself, and the level of administrative costs it can bear.

Given the confluence of all these forces, how should the Bank's policies on relending rates be defined? What are the appropriate objectives?

46. In reviewing the appropriateness of the on-lending charges of a DFC the Bank must make basic judgments about government interest rate policies.1/ In general, it is the Bank's objective that borrowers from DFCs pay interest and other charges which approximately reflect the cost of mobilizing capital both at home and abroad and the opportunity cost of capital in the country. This will normally mean that sub-borrowers over the longer term will be paying real, positive rates of interest. Such rates will facilitate the mobilization of capital and the efficient allocation of capital within the concerned sectors. They also permit adequate earnings by DFCs, enhancing their ability to attract equity capital and to bear the costs and risks of an active promotional role.

1/ Annex 6 contains current relending rates of DFCs currently borrowing from the Bank.

47. The underlying rationale for this general posture is that direct allocative measures that seek to provide long-term credit to the industrial sector which run counter to market signals are difficult to manage and are likely to be ineffective. Other tools must, as a result, be imposed to balance credit demand with supply and this may mean that collateral or social standing become important criteria, thereby blocking out access to credit by non-prime borrowers. Leakages of credit in administered systems can often lead to frustration of policy objectives. Second, interest rates are not often an efficient incentive device for steering investment to priority sectors. Interest costs are a relatively small part of total costs for most DFC clients. Interest subsidies discriminate in favor of those activities which are capital-intensive, and only if the industrial strategy of a country calls for justified encouragement to these sectors is an interest rate subsidy logical. Third, industrial borrowers are often at the highest end of income earners in developing countries. Governments have many claims on their resources, and use of these resources to subsidize such borrowers may not be easy to justify. Finally, institutions which are unable to lend at market rates will be largely dependent on credit facilities obtained on their behalf by the government. This can potentially affect overall resource mobilization in an economy; at a minimum it means the DFC involved will be a captive of its government's financial decisions.

48. While the above represents a general posture, each particular operation must be viewed in the specific country context. The starting point of the analysis of such issues is the current financial situation of the country. What is the savings performance in the economy and are interest rate policies consistent with savings objectives and needs? To the extent that overall savings performance is good there is less of a case for interest rate modification from a savings perspective, although in such cases the cost to the government of subsidizing certain credit streams may still not be justified given higher priority claims on the government's revenues. However, it is more often the case that the Bank faces situations where the government's fiscal system is weak, overall savings are low, and there are high priority competing claims on government revenues. On the allocation side, it is necessary to consider whether the pricing of capital reflects scarcities in the economy. While privileged credit circuits for particular activities may in some cases be an integral part of an effective plan to induce high priority investment, in other cases they may be more symbolic than effective. When price can no longer be used to balance credit demand with supply other rationing devices must be found and stringent collateral requirements and risk reduction through lending to only the most well established firms may result.

49. The next area of examination is a review of interest rates in the context of the DFC's capacity to mobilize resources in domestic and foreign markets. In some cases the question might be irrelevant if (i) the government by choice determines that it wishes to mobilize all resources for the DFC; (ii) international market conditions together with country conditions rule out significant non-governmental borrowing; and/or (iii) domestic capital markets are at a stage where medium or long-term resource mobilization by the DFC is simply not feasible. In such cases one is thrown back to the consideration of the preceding paragraph when reviewing the adequacy of interest rates; although for many Bank-financed DFCs, total dependence on government cannot be contemplated indefinitely, and in others, as a matter of institutional strategy, increasing capacity to directly mobilize resources will be an important objective.

50. The benchmark for measuring the appropriateness of a DFC's lending rates will be what the DFC would have to pay to borrow medium- or long-term funds in domestic or foreign markets plus a reasonable spread. This is feasible when there are reasonably competitive markets open to the DFC, similar institutions, or the government. If such indices are not available an alternative is to posit target rates of real interest at 5-6%.1/ This is based on estimates of interest rates to mobilize capital which are seldom less than 3-4% in real terms, even in countries which rely to a considerable extent on the fiscal system for transferable savings although adequate time series for equivalent data in developing countries is not yet available.

51. Three other observations are in order. First interest rates cannot be viewed in isolation from how the foreign exchange risk on foreign credits is handled. DFCs are not able to cover foreign exchange risks. Generally, one would expect sub-borrowers to be able to assume the exchange risk or to compensate through a premium to the interest rate,the government, central bank or other institution which is prepared to accept fully or partially the exchange risk on his behalf. A fair premium is difficult to calculate and is sometimes rejected by governments because it may establish undesirable expectations. Having the exchange risk borne by sub-borrowers obviates the need to forecast or justify a particular premium and, as a practical matter, governments have frequently been prepared to accept the transfer of the foreign exchange risk to the ultimate borrower, even when they are reluctant to accept reasonable approximations to market rates of interest on term loans repayable in local currencies. One particular problem of Bank loans (unlike bilateral credits to DFCs) is that DFCs are unable to tell sub-borrowers in advance what currencies they will receive and, after they are determined, in what order they will be recalled. In countries of severe foreign-exchange control, sub-borrowers will not be discouraged by such conditions as access to freely convertible hard currencies will offset the problem. In other countries it can prove a very difficult negotiating point between DFCs and their customers and here there is the possibility of sharing risks between the government and sub-borrowers by having the latter assume the risk in a single major currency used by the Bank, or denominating sub-loans in currencies of procurement, and having the residual risk assumed by the government (at a fee if appropriate).

52. Second, a serious problem arises in assessing interest rates in countries with high and variable rates of inflation and infrequent but large exchange rate adjustments. One solution has been complete or partial indexing of debt service payments to internal price levels, although only countries with long records of inflation seem prepared to consider this course. Another alternative is variable-rate lending along lines followed in recent years in many term loans on the eurodollar market. This course has not yet been adopted by any Bank-associated DFCs but deserves serious consideration in some cases.

53. Third, in some centrally planned economies where the industrial sector is largely state-owned, interest rates may play an insignificant role in resource mobilization or allocation. If the system is as closed as implied, the Bank need not be concerned with the overall interest rate structure of DFCs, although if Bank capital were to be channeled to industrial enter-

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1/ In some respects the World Bank's own relending rate is one relevant index. If, as has sometimes been asserted by potential borrowers and their governments, the DFC is unable to relend Bank funds in foreign exchange with a reasonable margin, one must examine carefully whether there is in fact a capital gap to justify DFC lending. It can be presumed that the Bank is securing capital on the most advantageous terms in international markets, and if such capital with 2-3 points added to it is not attractive to industrial users in a capital-importing country, the case for Bank lending to fill financial gaps in the industrial sector is severely weakened.

prises in such economies at what, by international comparison, would be low rates, special justification would be needed to establish why the enterprise assisted should not bear the full costs of the foreign borrowing. However, interest in decentralization and the use of intermediaries in resource mobilization and the decision-making process is not uncommon in highly socialized economies. Yugoslavia provides such an example.

54. In the final analysis interest rate decisions must be judged in terms of the adequacy of the country's overall financial strategy and against the background of the Bank's major objective in lending through DFCs in the specified country. In many cases major objectives can only be served by a close approximation to interest rates established in accordance with the criteria presented above. In other cases, the margin is greater. However, in most countries it is to be expected that over time, as financial markets become less fragmented, and better organized, interest rates charged by credit institutions serving the industrial sector will be established on the basis outlined above, and that the progressive rationalization of interest rates, including rates charged the industrial sector, will itself contribute to the better organization of financial markets.

E. Dependency of DFCs on Bank Financing

55. A question closely related to the interest rate issues discussed above, concerns Bank policy for the diversification of DFC financing and the eventual elimination of Bank lending to a particular DFC. In a number of cases the Bank has provided eight or more loans to a DFC. Is this consistent with the Bank's desire to build institutions?

56. As noted earlier, the Bank has wanted to build institutions that would develop the capacity to mobilize resources and not remain dependent on the Bank. In line with this objective the Bank has not normally provided, over time, more than half the resources required by the DFCs it finances. Moreover, in a number of cases it has agreed on a specific program of reducing, over time, a DFC's dependency on the Bank.

57. Recent cases where the Bank has had a declining role in DFC resource provision have been in Morocco, Tunisia, Philippines, Iran, Finland, and Greece. Nevertheless, the record of DFCs directly mobilizing funds in domestic or foreign markets has been rather meagre. As Annex 3 indicates, some of the most developed DFCs continue to be highly dependent on Bank funds. Moreover, the balance of their resources have often largely been governmental or quasi-governmental official funds with a concessional element.

58. Of the DFCs where the Bank Group clearly has had an important promotional role, the cases where the Bank lending has not remained a predominant source of funds are: IVK in Austria, IFF in Finland, NIDB in Nigeria, CDC in China, MIDF in Malaysia, CAVENDES in Venezuela, IMDBI in Iran and NIBID in Greece. The Austrian, Venezuelan, Finnish, Greek, Nigerian and Iranian DFCs represent cases where the Bank Group made a clear cut judgment that on country and project grounds continued Bank Group lending to the DFCs was inappropriate and a phasing out program was agreed with the DFCs involved. What is of interest is that to some extent all of these DFCs have subsequently continued to grow, but practically all of them still rely to some extent on official funding. Market borrowing by these DFCs, to the extent it has taken place in domestic or foreign markets, has been supported by borrowings from governments at moderately subsidized rates. In short, while they no longer depend on the Bank, most do not yet "stand on their own feet" in market terms.

59. CDC in China and MIDF in Malaysia are somewhat different cases. CDC was cut off from Bank funds rather suddenly when the Bank's program expired. MIDF found alternative funds on more attractive terms. Both institutions prospered after the Bank stopped lending as due to the fact their respective governments became their major source of funds, normally on terms below what market borrowing would have entailed.

60. The reasons for continued dependency on official funds by the abovementioned DFCs are one or more of the following: (a) Interest rate regimes imposed by governments that require DFCs to lend at rates below what it would cost to mobilize and to lend funds at a positive spread; (b) Underdeveloped capital markets where sales of long-term debt instruments in meaningful quantities are not feasible and where the DFC is not in a position to mobilize deposits at all or on terms long enough to be useful. (c) Government regulations giving various government securities priority in terms of mobilizing what long-term domestic savings are available for investment in debt instruments. (d) Conditions in international capital markets that closed entry to many potential borrowers plus, in some cases, government prohibitions or taxes on foreign borrowing by DFCs due to balance of payments problems and concern over the terms of such borrowing (i.e.,variable rate or short-term funds that exposed the DFC to too high risks).

61. Turning to the long-term DFC borrowers still heavily dependent on Bank funds, the reasons for this dependency are essentially one or more of those listed above. However, there has been an additional problem in that in some cases these DFCs exist in countries where, on country grounds, there was little real possibility for significant borrowings by the DFCs due to overall country creditworthiness issues. Reduction of Bank lending in such case would simply mean a decline in the institution's impact.

62. Given this landscape of issues, it is not possible to lay out precise rules concerning the length of time over which Bank support for a particular DFC is justified. Two sets of questions need to be addressed when facing this issue. The first set involves the country's need for capital; the DFC's need for capital; and the effective use of such capital by the DFC, in relation to other activities perceived by the country and the Bank to be of priority for Bank financing. The second set revolves around the Bank's judgement as to the other options open to the DFC for mobilizing funds, its effective pursuit of these sources and the desirability of policy changes which would open up options for resource mobilization. Finally, methods of directly assisting DFCs to diversify resources should be undertaken when feasible.

63. In a number of cases, commercial banks have considered lending to the more established DFCs associated with the Bank Group. Loans of five years are typical, although in some cases 7-year loans are also feasible. Floating interest rates are usually proposed although fixed rates can sometimes be arranged at a premium For the DFC wishing to tap these funds the essential problems that need to be resolved are: (a) whether the floating rate can be passed on to sub-borrowers, (b) whether, after tax considerations are taken into account, the cost of money is acceptable (often a 10-20% withholding tax on foreign interest is levied); (c) how the foreign exchange risk can be handled; and (d) how shorter-term loans can be utilized as the DFC's average term of sub-loan may considerably exceed that of the commercial credit.

64. There are two possibilities for the Bank Group to be of direct help to the DFCs in such cases.1/ One way is for the Bank to adapt the amortization and disbursement of its loans to accommodate, or blend with, shorter-term commercial loans by picking up with Bank funds the later maturities of sub-loans. The Bank would in effect lengthen the grace period. In such cases the DFC would establish direct relationships with commercial creditors and would have to resolve the issues noted above.

65. The second possibility is an IFC loan and the sale of participations in that loan. Here also the earlier maturities of a loan with a fixed amortization schedule could be sold to participating banks. Three advantages accrue to the recipient DFC in such operations: IFC lines up the lenders and puts the deal together, IFC's immunity from withholding tax on interest (if any) paid may enable the DFC to obtain the funds at a lower cost and the loan will normally be in a single currency. The recent IFC and Bank loans to TSKB (Turkey) provide a relevant example: both the blending of Bank funds and direct IFC mobilization efforts were undertaken to assist TSKB in mobilizing and utilizing commercial funds.

66. The above discussion relates to helping DFCs to tap foreign commercial markets. This is only useful in those cases where additional foreign commercial borrowing can be supported on country grounds. It is also important to stress that Bank Group support for policies that open possibilities for domestic resource mobilization can be of even more important help to a particular DFC. Finally, the Bank should continue to cooperate with other bilateral or regional sources of credit for DFCs to facilitate the flow of funds from such lenders to DFCs.

F. Broader Objectives of DFC Lending - DFCs as Development Agents

67. While the economic profile of sub-projects financed by DFCs appears to have been favorable and the Bank can try to ensure that this is enhanced in the future by helping to improve the use of economic tools by DFCs, the more difficult question to answer is what should a particular DFC be doing, besides backing viable projects, that will represent a unique contribution to the development effort in its area of operations. While in some cases the preponderant job of the DFC will be to receive large numbers of proposals and, by good project selection, ration scarce resources to them and in the process facilitate the implementation of projects being pursued by a dynamic entrepreneurial community, the more normal case will be one where the DFC is expected to fulfill a broader mandate, where its institutional posture should not only be that of one which reacts, but also one which initiates. Clearly the greatest developmental

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1/ Within the Bank Group, the policy has been that the Bank does the lending to DFCs while IFC takes equity positions although it will lend to the DFC if a guarantee is not, for acceptable reasons, forthcoming because: (a) the size of the DFC lending program was beyond IFC's capacity; (b) given the Bank's concern to minimize the cost of debt to many countries, the Bank's interest rate was more appropriate. While this policy in general is still valid there are some situations, described in the following paragraphs, where an IFC loan is appropriate even if a government guarantee would be available for a Bank loan.

impact of DFCs will be those things that happen as a result of a contribution they have made, whether it is to the development or implementation of a specific project, an institutional innovation, or a policy improvement.

68. This is one of the most difficult issues facing the Bank and the boards and managers of DFCs. How does the DFC carve out areas of innovation for itself and how can the Bank help in this process? DFCs have a variety of developmental tasks that they might conceivably perform. At the most basic level is a contribution by making financing decisions based on sound project appraisal standards. The next level is the improvement of a project's design or its financial structure. A DFC's effectiveness in this respect depends on the nature of its clientele and the stage at which it gets involved in projects. If it restricts itself to the strongest firms in a given situation, then it is unlikely to be in a position to contribute significantly to project design. On the other hand, if it makes efforts to finance entrepreneurs who are not of the blue chip variety, the potential for a developmental contribution by the DFC at the margin is heightened. While there are exceptions, and the pattern is now changing somewhat, one general tendency of DFCs has been the directing of much of their lending to the relatively strongest entrepreneurs and enterprises in their economies. While this is understandable given: (a) the incentives to build up good portfolios; (b) imposed lending rates that often do not allow differentiation according to risks, or (c) the need to allocate scarce capital to projects with high probabilities of success; and (d) in some cases the absence of other sources of long-term funds to which "prime" borrowers have access within or outside the country; it is nevertheless appropriate that the Bank and a given DFC continuously examine the DFC's policies in this area.

69. Other areas where the DFC can sometimes make differences at the margin are in its dialogue with government on industrial and financial policies or in the design and implementation of special programs dealing with specific development problems in sub-sectors, the financial sector, regionalization issues, etc. Finally, there may be potentials for some DFCs to play a basic entrepreneurial function in the generation of new project ideas and in taking a lead in the implementation of those ideas.

70. In its dealings with each DFC the Bank should be encouraging a dialogue to determine where in the above spectrum of tasks (or others not listed) the DFC can be making special efforts to expand its horizons and how that can be accomplished. One useful recommendation coming out of the OED study of DFC operations is that DFCs be asked to articulate their near term strategies, objectives and the areas in which they intend to make or expand special developmental efforts. This has considerable utility in many cases for providing focus to this dialogue.

71. In focussing on the innovative characteristics of DFCs, one factor looms large: namely the caliber and vision of the DFC's management and staff. The relative success of a DFC charting an increasingly innovative role is closely linked with the personality and capabilities of the management of the institution. Innovative institutions are almost always led by innovative managers who attract staff which has an interest in, and a capacity for, unusual developmental contributions. The history of Bank-DFC relations provides ample confirmation of this notion. The growth process means working with available resources and developing them over time. This is true of human and institutional resources and given this basic element there is no easy formula or model that will produce dynamic, promotional DFCs.

G. Criteria to be Applied in Lending to Public DFCs

72. Given the increased variety of government-controlled development banks to which the Bank has lent or to which it is considering lending, the following question arises: To what extent are the criteria developed over a 20-year period of lending to privately-controlled development banks appropriate to government-owned banks?

73. In some cases the answers are fairly straightforward in that the DFC, although government-owned, is set up as a completely separate financial institution with clearly stated objectives, a relatively autonomous financial structure and an expectation that the DFC will operate as a commercial entity much like its private counterparts. Examples of this are numerous in the Bank's experience. The one major difference between such DFCs and their privately-controlled counterparts is expectations with respect to returns on net worth. Government shareholders usually do not expect their DFCs to generate market related earnings. This may give them the luxury of relatively wider administrative budgets or a higher risk portfolio which in some cases enables them to undertake developmental expenditures a privately controlled DFC could not, although the reduction or elimination of the profit tests calls for a rigorous approach to budgeting, expenditure control and program review to insure that funds are well spent by the DFC.

74. Consequently, in reviewing government-owned DFCs, the Bank has generally attempted to evaluate the DFC with the following general criteria in mind:

(a) Is the quality of management and the level of professional skills in the organization suitable?

(b) Are resource allocation criteria and the autonomy allowed the institution in its decision-making processes appropriate? Are the decision rules clear, do they fit the economy and are they followed with due diligence?

(c) Are the institution's overall policy guidelines and objectives in line with what the Bank considers appropriate for the situation? Are relending terms appropriate?

(d) Does the institution adhere to professional standards in the areas of investment administration, procurement, disbursement, collateral requirements? Does it supervise its portfolio aggressively and take effective action to deal with problem projects?

(e) Does the institution submit itself to the discipline of an in-depth, professional, independent audit? Can the value of its assets be clearly established?

(f) Are financial standards maintained that allow the institution to present a strong financial posture toward creditors? Does it follow policies on budgeting, debt and liquidity management, capital structure, and diversification of risk that reflect its role as a financial intermediary?

(g) Does it have an operations program that, in its entirety, is sensible and developmentally sound?

Institutions have been considered suitable for Bank lending if they reasonably passed the sort of tests noted above. Of course, different DFCs pass them with varying degrees of quality but if in any of the above areas the DFC clearly failed, the Bank endeavoured to get the situation corrected in connection with its lending operations. This approach has proven to be sound and should be maintained.

75. However, the Bank has also encountered government development banks that depart from the more traditional concepts. Such an entity may not operate as an autonomous unit in all or even most of its financing programs. It may assume financial exposures which would clearly be considered imprudent for a private entity. It may not undergo a thorough independent audit. It may be that its own financial standing cannot be clearly separated from the government purse. It may have relatively weak rights as a creditor and poor capacity for project supervision and its roles as a banker and holding company for industrial subsidiaries might be blurred. Can such an institution be considered a relevant vehicle through which to provide credit to productive enterprises?

76. The Bank can weight its approach in financing productive enterprises in a variety of ways. It may endeavor to develop a specific sub-sector program, it may pursue the establishment of a sound intermediary or it may seek to blend the two objectives. At one end the Bank may undertake direct appraisal of sub-sector conditions including policy problems, market needs, production typologies, organizational means for developing and implementing new production capacities, locational issues, and the economic and financial characteristics of the sub-sector program. Such an approach places the Bank at the center of decisions required to implement a given set of sub-projects in a given sector. When this is the case the institution involved may largely be an agent to undertake administrative functions to deliver the Bank's contribution. In such cases the Bank may be justified in limiting its concern to the institution's capacity to undertake the narrow functions assigned to it, although some institution building will probably be required in the process. At the other end, the Bank may follow a heavy institutional path characterized by a transfer to the institution of the major responsibility for appraisal, selection, implementation and supervision of the lending program and the judgment that overall the intermediary is following appropriate policies and procedures.

77. The Bank would thus attempt to define for the institution what in principle would be appropriate in order to enable it to perform its role as a development agent more effectively. (This presumes it is agreed that it should have such a function.) It is this approach that normally should be applied in DFC lending. If the Bank is to have maximum institutional impact in such cases, the basic problems of the institution's overall role, policies and procedures should normally be addressed. This means looking at the criteria described in para. 74 and deciding in the country context which are relevant (i.e. the importance of each criterion in enhancing the institution's developmental contribution), rejecting those that are not relevant and focusing on programs to move the institution to the point where it can meet the relevant criterion. If the Bank were to focus only on its own stream of finance to such institutions and not address broader institutional issues, problems of double standards would emerge and, more

importantly, the impact of such operations would be reduced in scope. While deviations from this approach are not inconceivable they should be subject to very special scrutiny and justification.

78. In dealing with cases that present unusual features, which may lead to serious questions concerning the role, policies, and financial condition of particular DFCs, the question of indirect lending to the DFC has emerged. In 3 cases to date the Bank used this approach in DFC lending. (Once in the Philippines and twice in Pakistan.) The Pakistan cases involved a privately-controlled and a government-controlled DFC which were generally considered to be acceptable intermediaries but which were not financially sound for the moment due to unresolved questions concerning large amounts of unrealizeable assets in Bangladesh. In the Philippines it was a situation where a large government bank which had been in rather hazardous financial condition had embarked on a serious effort to correct its financial position although the visible fruits of these efforts were a year or two away. It was judged that the Bank could contribute more by moving forward with a relationship with the DFC rather than waiting for two years. In these cases lines of credit were made to the governments for on-lending to the DFCs. By doing so the Bank was essentially saying that the governments but not the DFCs were creditworthy at that point in time. This approach was adopted in the expectation that the problems would be resolved and that a normal and direct credit relationship would be feasible for subsequent loans.

79. Is there a significant difference if the government, or an entity wholly owned by the government, signs the loan agreement? The indirect loan signifies that the institution concerned has problems to be resolved before it can be judged creditworthy. Second it reinforces the concept that the Bank basically looks to its borrower's performance and financial condition; not a general underpinning that government will see to it that its entities survive. While an indirect lending approach is useful to handle cases where the Bank wishes to make a loan for a project or sub-sector that has been subject to normal analysis by the Bank but where the intermediary does not meet minimum Bank standards, or for special situations (such as those encountered in the Philippines and Pakistan or where movement to reform is of an uncertain pace), it should normally be a temporary device and should not be used as a way to provide, over extended periods of time, lines of credit to institutions which do not meet the Bank's standards. In many cases it will be more productive to withhold lending until corrective steps have been taken.

80. In lending to some government DFCs there will be difficult judgments required on the degree of effective and appropriate autonomy for the institution as well as the necessity for it to follow financial policies that would normally be applied to other commercial-type intermediaries. The larger the scope and contribution of government-owned DFCs the more critical role they perform as instruments to effect implementation of government policy. Consequently, it is not a question of the need for government DFCs to be immune from government influence but rather whether the institution is allowed to function in a way that allows it to achieve its policy objectives in an efficient manner. What is unacceptable is an institution that has its decision-making process frustrated or overruled in a way that results in its financing and assuming risks on operations that do not meet its normal criteria

or that result in an erosion of the institution's professional competence. The key elements in arriving at the appropriate Bank response in such situations is to clearly establish the objectives of the institution both in a developmental and financial sense, to judge whether these are compatible with the Bank's objectives, and to see whether the policies it follows give adequate support to those objectives.

III. FUTURE DFC LENDING

Volume and Characteristic of Future Lending

81. In the FY76-80 period DFC lending is expected to reach an order of magnitude of $3.1 billion as compared with $1.7 billion in the preceding 5 years. This represents about 8% of total Bank/IDA lending in the two respective periods. The geographic pattern of this lending is expected to be as follows:

	EMENA	LAC	AFRICA	S.A.	E.A.P.
1971-75	795	182	88	314	316
1976-80	750	880	300	500	700

In relative terms, the two areas that have historically lagged will secure the largest increase in DFC lending as compared with the 1971-75 period: namely Latin America and East and West Africa. This is a continuation of the trend noted earlier in the paper.

82. Roughly 70% of this lending will be to institutions with which the Bank had commenced a relationship before FY74. However, it is expected that approximately 20 new DFC borrowers will be added to the Bank's rolls during this period. The overwhelming bulk of these new borrowers will be government-controlled DFCs although the beneficiaries at the sub-project level of DFC lending will continue to be predominantly private sector enterprises. Simultaneously with this growth of operations, 6 to 8 DFCs formerly financed by the Bank will cease to be borrowers.

83. During the next five years the variety, by type, of intermediaries financed will continue to increase requiring new dimensions of appraisal and performance criteria in the Bank Group's work with such intermediaries. It is also probable that the DFC lending approach will increasingly be applied to sectors other than manufacturing and tourism. The forthcoming operation with the Ghana Housing and Construction Bank for road contractors is an example and projects in the urban housing sector may also follow this approach. Finally, lending to large multi-sector and multi-purpose institutions is likely to increase moderately as is lending to institutions that combine facilities for commercial short-term lending and longer-term project finance.

84. The areas where special efforts will be made in the coming years to enhance that contribution have already been referred to in the previous section. They include a greater effort to deal with new and small entrepreneurs, better linkages of DFC operations with broader issues concerning sub-sectors being financed and attempts to seek a better integration of DFC operations with financial sector issues.

Small Scale Enterprise

85. An area that will be subject to increasing experimentation is the provision of financial and technical assistance to small scale enterprise.

It will be important to examine the effectiveness of various approaches utilized and to evaluate more deeply than has been feasible to date, the economic and perhaps social pay-offs resulting from such projects. It is by no means clear at this juncture whether the most effective small scale enterprise financing programs will be through credits broadly diffused through the banking system; specialized credit agencies focussing on the small scale sector; special programs sponsored by existing development banks or other approaches. Different approaches will no doubt be required from country to country. Just as important a question, if not more so, is the design of effective delivery systems for technical assistance to smaller entrepreneurs. It is likely that widely different approaches in different environments will be required. What is sensible in the Cameroon is not necessarily appropriate in Colombia. Consequently a special effort should be scheduled in three years or so to undertake a review of small enterprise projects financed by the Bank where there has been some operating experience developed in order to distill the results of such financing at that time. The programs recently financed, or soon to be financed by the Bank in the Ivory Coast, Nigeria, Cameroon, Korea, Philippines, India, and Colombia will provide a good base for evaluating experience.

86. In the period up through FY1975 the Bank had financed 5 projects aimed specifically at small enterprises. Three of those projects were financed in FY1975 (Philippines, Colombia, and Cameroon). In addition to continued financing of these programs, the Bank will undertake such projects in 10 to 15 other countries plus working with some existing DFCs to initiate or improve small enterprise financing programs under their auspices. The review noted in the above paragraph may provide the basis for a more accelerated approach as more experience is gained with this type of project.

87. It will also be important for the Bank to liaise with other agencies, bilateral and multi-lateral, which are endeavoring to develop projects in this field. UNIDO is expending considerable manpower in this sector and a close working relationship with this body will be maintained as with the ILO, which also has experience in this field. At the same time, given the relatively high manpower input per productive assets financed that typifies these projects, it is important that in selecting countries in which the Bank wishes to develop such projects that (a) the countries be those where there appears to be an important gap in the services for small business; (b) that there not be serious overlaps with the efforts of other international or bilateral development agencies (in some countries several agencies are simultaneously trying to do the same thing); and (c) that monitoring systems be developed that will facilitate the analysis of the impact of such lending. This latter point is particularly important as there is extremely little "hard data" available on which to base judgments concerning the relative priorities of special efforts to deal with small businessmen in countries at different levels of development and the pay-offs of such programs.

88. Internal organizational rationalization is also required if there is to be effective attention paid to small scale enterprise financing. At present there is no focus of expertise on this matter in the Bank Group.

DFCs and Sector Issues

89. The industrial sector in most of the Bank's member countries involves an exceedingly wide variety of activity. This heterogenity makes it particularly difficult to analyze the sector as a whole. It is also a sector where a wide range of basic economic and political issues converge, e.g. trade policy and balance of payments issues; financial management, public vs. private sector issues, foreign vs. domestic investment considerations, etc. Individual DFCs often account for a relatively small share of the total financing of new industrial investment (usually less than 10%) and thus while they can select and develop important projects, such project decisions will not have a sweeping impact in the sub-sectors financed if basic policies are not congenial to the rational development of those sub-sectors. This underlines the need for an integrated Bank approach to the industrial sector.

90. Operationally this requires integration of the Bank's country economic work and industrial sector work in order to focus on problems of relevance to DFC lending, particularly in those cases where such lending forms an important part of the Bank's program in a country. Another facet of this is that there is scope for encouraging and helping many DFCs to take on greater responsibilities in analyzing sub-sector issues and to take a larger voice in discussion with governments in the dialogue on sector policies. These institutions are often well placed to observe the impact of policies at the level of the investing enterprise and thus their potential contribution is considerable. Obviously the capacity and credibility of institutions vary widely and not all will be in a position to play effective roles in influencing policy makers but there is scope for enhancement of many DFCs' contribution in this area.

91. Concerning financial sector issues, DFCs are normally a small part of the financial infrastructure in a developing country. It is not unusual to find that they are not very well integrated into that system but remain a sort of privileged credit circuit, often along with other specialized credit agencies. Second, as noted earlier, interest rate issues arise in almost every DFC operation (and agricultural credit operation as well). This issue is part of the broader question of the efficient mobilization and allocation of savings throughout an economy. This in turn is related to fundamental strategies adopted by governments for resource management. It is often impossible and sometimes counter-productive to address the problem of a single institution's relending rates in isolation from general financial sector policies. Like industrial policies, these fundamental sector issues are broad, complex, and at the heart of basic economic strategies followed by governments. Given the increasing need to generate investment funds in most developing countries, these policies take on an even more critical dimension.

92. More work, therefore, is needed to try to evaluate and establish dialogues with countries over their financial sector policies. DFC lending is one element in the middle of this picture and while the Bank has not often attempted to look at the financial sector as a whole this is becoming more

necessary if the Bank is to speak with authority on general questions of development of financial markets in developing countries. One of the near-term tasks is to develop a better methodology and framework for approaching these broader questions and then applying it in a few countries to see what benefits can be obtained. Work along these lines is underway.

93. Finally, in order to sharpen the Bank's dialogue with DFCs on their role and impact in the industrial and financial sectors a number of operational refinements are now being tested. First in providing general lines of credit to DFCs the Bank is asking, in most situations, that the DFC articulate its near-term plans for promoting development of the sectors it serves. This is not simply a financial projection as much as an indicator of the special initiatives the DFC intends to pursue to increase its effectiveness as a development agent. The formulation of these "strategies" will provide some focus and an opportunity for improved dialogue between the Bank and the DFC it is financing and can also be linked with issues turned up in the Bank's sector work.

94. A related action is the determination in a more digestible form of the impact of DFC financing through systematic sub-project monitoring systems. The review of the data generated by such systems as well as performance in relation to the objectives periodically set by DFC managers should prove helpful in refining judgments on performance of DFCs and identifying areas where improvements are desirable and feasible.

95. The DFC financing program has proven to be an effective tool for building what, by and large have been, competent, professional institutions capable of assisting the development of projects that make an impressive contribution to growth. More importantly most of these institutions show the capacity to adapt to changing needs and expectations and are responsive to constructive initiatives that can lead to an enhanced developmental contribution. It is in this framework that the Bank can continue to play a role in the development of effective development financing institutions.

Bank Group DFC Financing
Approved through FY'75
($'000)

Country	DFC	# Loans	# Equity Investment	Bank	IDA	IFC	Total
Africa							
Cameroon	BCD	1	-	-	3,000	-	3,000
Ethiopia	AIDB	1	-	-	11,000	-	11,000
"	DBE	2	-	4,000	-	-	4,000
Nigeria	NIDB	2	1	16,000	-	1,400	17,400
Ivory Coast	BIDI	-	1	-	-	204	204
Liberia	LBIDI	2	1	5,000	-	249	5,249
Zaire	SOFIDE	3	1	-	25,000	750	25,750
Africa	SIFIDA	-	1	-	-	500	11,500
Mauritius	DBM	2	-	5,000	3,500	-	8,500
E. Africa	EADB	1	-	8,000	-	-	8,000
Sudan	IBS	1	-	-	4,000	-	4,000
Kenya	IDB	1	-	5,000	-	-	5,000
Tanzania	TIB	1	-	-	6,000	-	6,000
Senegal	SOFISEDIT	1	1	3,000	-	209	3,209
Botswana	BDC	1	-	4,000	-	-	4,000
	Total	19	6	50,000	52,500	3,312	105,812
East Asia & Pacific							
China	CDC	4	-	48,000	5,000	-	53,000
Philippines	PDCP	5	1	95,000	-	15,205	110,205
"	DBP	1	-	50,000	-	-	50,000
Malaysia	MIDF	1	1	8,000	-	818	8,818
Thailand	IFCT	2	2	14,500	-	384	14,884
Korea	KDFC	4	2	95,000	-	1,058	96,058
"	KDB	1	-	60,000	-	-	60,000
Singapore	DBS	1	-	5,000	-	-	5,000
New Zealand	DFCNZ	1	-	8,000	-	-	8,000
Indonesia	BAPINDO	2	-	50,000	10,000	-	60,000
"	PDFCI	1	1	-	10,000	483	10,483
	Total	23	7	433,500	25,000	17,948	476,448

Country	DFC	# Loans	# Equity Investment	Bank	IDA	IFC	Total
South Asia							
India	ICICI	11	-	435,000	-	-	435,000
"	IDBI	1	-	-	25,000	-	25,000
Pakistan	PICIC	9	2	209,000	-	486	209,486
"	IDBP	1	-	-	20,000	-	20,000
"	NDFC	1	-	-	30,000	-	30,000
Sri Lanka	DFCC	3	-	7,000	4,000	-	11,000
	Total	26	2	651,000	79,000	486	730,486
EMENA							
Algeria	BAD	1	-	35,000	-	-	35,000
Turkey	TSKB	13	4	198,000	35,000	37,098	270,098
"	DYB (SIB)	1	-	40,000	-	-	40,000
Austria	IVK	3	-	24,765	-	-	24,765
Iran	IMDBI	8	-	280,200	-	-	280,200
"	ICB	1	-	25,000	-	-	25,000
Morocco	BNDE	7	1	151,500	-	1,496	152,996
"	CIH	2	-	25,000	-	-	25,000
Spain	BANDESCO	-	2	-	-	585	585
Finland	IFF	4	1	63,000	-	159	63,159
Israel	IDBI	4	-	95,000	-	-	95,000
Greece	NIBID	5	1	97,500	-	719	98,219
Tunisia	SNI	5	2	49,000	-	1,205	50,205
Ireland	ICC	1	-	10,000	-	-	10,000
Cyprus	CDB	1	-	3,000	-	-	3,000
Afghanistan	IDBA	1	1	-	2,000	250	2,250
Egypt	BOA	1	-	-	15,000	-	15,000
Yugoslavia	SBS	1	-	28,000	-	-	28,000
"	PBS	1	-	22,000	-	-	22,000
	Total	60	12	1,146,965	52,000	41,512	1,240,477

Country	DFC	# Loans	# Equity Investment	Bank	IDA	IFC	Total
Latin America & Caribbean							
Colombia	Colombiana	-	1	-	-	2,023	2,023
"	Nacional	-	1	-	-	2,042	2,042
"	Caldas	-	1	-	-	701	701
"	5 Financieras	4	-	102,500	-	-	102,500
"	Norte	-	1	-	-	432	432
"	Valle	-	1	-	-	432	432
"	Col. Financieras(8)	1	-	60,000	-	-	60,000
"	CFP	1	-	5,500	-	-	5,500
Venezuela	CAVENDAS	2	1	-	-	13,836	13,836
Ecuador	COFIEC	-	2	-	-	305	305
"	COFIEC & CFN	2	-	28,000	-	-	28,000
Brazil	BNB	1	-	25,000	-	-	25,000
Regional	ADELA	1	-	-	-	10,000	10,000
Trinidad & Tobago	TTDFC	2	-	7,000	-	-	7,000
Mexico	FONEI	1	-	35,000	-	-	35,000
Bolivia	BISA	1	-	-	6,200	-	6,200
	Total	16	8	263,000	6,200	29,771	298,971
	GRAND TOTAL	144	35	$2,544 m.	215 m.	93 m.	2,852 m.

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Bank Group Assistance to DFCs by Geographic Area

	FY1950-54	FY1955-59	FY1960-64	FY1965-69	FY1970-74	FY1975	Total FY1950-75
EMENA							
No. of DFCs Assisted	1	1	6	8	16	5	19
No. of Countries Involved	1	1	6	8	12	5	15
No. of Loans/Cr./Inv.	2	1	10	23	30	6	72
Amt. of Loans/Credits/Inv.	$18.0 m	$10.8 m	$49.1	$298.4	$649.3	$215 m	$1,241
No. of Maj. Govt. Controlled DFCs					8	1	9
Amt. of Loans to Govt. Controlled DFCs					$168 m	$35 m	$203 m
LAC							
No. of DFCs Assisted	-	-	4	7	13	2	14
No. of Countries Involved	-	-	2	3	8	2	8
No. of Loans/Cr/Inv.	-	-	4	7	11	2	24
Amt. of Loans/Cr/Inv.	-	-	$6.1 m	$71.1 m	$211.2 m	$10.5 m	$298.5 m
No. of Govt. Controlled DFCs					4	2	5
Amt. of Loans to Govt. Controlled DFCs					$74 m	$10.5 m	$84.5 m
EAP							
No. of DFCs Assisted	-	-	4	3	9	3	11
No. of Countries Involved	-	-	4	3	7	3	8
No. of Loans/Cr/Inv.	-	-	7	6	14	3	30
Amt. of Loans/Cr/Inv.	-	-	$31.7 m	$80.7 m	$224.0	$140	$477
No. of Maj. Govt. DFCs					3	2	4
Amt. of Loans to Govt. Controlled DFCs					$68 m	$110	$178 m

Bank Group Assistance to DFCs by Geographic Area

	FY1950-54	FY1955-59	FY1960-64	FY1965-69	FY1970-74	FY1975	Total FY1950-75
S. Asia							
No. of DFCs Assisted	-	2	2	3	5	3	6
No. of Countries Involved	-	2	2	3	3	3	3
No. of Loans/Cr/Inv.	-	2	9	7	7	3	28
Amt. of Loans/Cr/Inv	-	$14.2 m	$155.4 m	$184.1 m	$243 m	$134 m	$731
No. of Govt. Controlled DFCs					3	2	4
Amt. of Loans to Controlled DFCs					$215 m	$130 m	$345
Africa							
No. of DFCs Assisted	1	-	2	3	12	2	15
No. of Countries Involved	1	-	2	3	12	2	14
No. of Loans/Cr/Inv.	1	-	2	3	17	2	25
Amt. of Loans/Cr/Inv	$2.0 m	-	$3.4 m	$6.5 m	$87 m	$7 m	$106 m
No. of Govt. Controlled DFCs					7	1	8
Amt. of Loans to Govt. DFCs					$46.5 m	$3 m	$49.5 m
Total							
No. of DFCs	2	3	18	24	55	15	65
No. of Countries	2	3	16	20	42	15	48
No. of Loans/Cr/Inv.	3	3	32	46	79	16	179
Amt. of Loans/Cr/Inv.	$20 m	$ 25 m	$246 m	$641 m	$1,415 m	$506.5	$2,854
No. of Govt. Controlled DFCs	-	-	-	-	25	8	30
Amt. of Loans to Controlled DFCs					$571.5	$288.5	$860

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Basic DFC Profile Data

(1) Country	(2) Name of DFC	(3) % Govt. Ownership	(4) % IFC Ownership	(5) Cumulative Bank Group Financing ($m)	(6) Total Assets ($m)	(7) Bank Group Loans Outstanding as % of Total Liabilities	(8) No. of Professional Staff	(9) Medium or Long-term Loan + Equity Approvals by DFC in Last FY of DFC ($m)	(10) No. of Projects Financed by Column (9)	(11) Average Size (9/10) ($'000)
East Africa										
1. Botswana	BDC	100	0	4	9	0	17	2	12	167
2. Ethiopia	AIDB	100	0	11	82	13	81	9	160	56
3. Kenya	IDB	100	0	5	5	100	8	7	11	627
4. Mauritius	DBM	100	0	12.5	17	11	18	4	14	312
5. Nigeria	NIDB	25	25	17.5	54	21	44	24	21	1,157
6. Sudan	IBS	100	0	4	8	3	30	1	15	93
7. Tanzania	TIB	100	0	6	22	0	23	14	27	514
8. Zambia	DBZ	60	0	0	12	0	21	12	18	676
9. E. African Community	EADB	92	0	8	30	1	30	8	12	700
West Africa										
10. Liberia	LBDI	25	25	5	8	17	7	5	53	91
11. Senegal	SOFISEDIT	46	8	3.2	n.a.	0	7	n.a.	n.a.	n.a.
12. Ivory Coast	BIDI	27	7	0.2	46	0	18	14	45	320
11. Ivory Coast	CCI	75	0	9.7	61	0	23	28	772	36
14. Zaire	SOFIDE	25	19	25.8	23	48	18	17	31	532
15. Cameroon	BCD	75	0	0	49	0	17	15	1,904	8
East Asia & Pacific										
1. China	CDC	10	0	48	103	24	57	20	110	190
2. Indonesia	BAPINDO	100	0	69	223	5	307	48	52	930
3. "	PDFCI	25	8	10	21	0	13	4	4	1,110
4. Korea	KDB	100	0	60	2,908	0	554	341	1,330	280
5. "	KDFC	0	14	96	91	89	44	33	58	570
6. Malaysia	MIDF	41	0	8	99	2	59	41	240	170
7. Philippines	DBP	100	0	83	1,225	3	1,055	44	18,572	20
8. "	PDCP	0	0	99	106	60	99	29	64	460
9. Singapore	DBS	47	0	5	791	0.2*	95	119	74	610
10. Thailand	IFCT	16	5	15	56	0	88	36	43	840
South Asia										
11. India	ICICI	72	0	426	394	40	154	82	166	500
12. "	IDBI	100	0	25	692	0	300	320	3,306	75
13. Pakistan	PICIC	45	4	208	278	34	113	42	38	1,100
14. "	IDBP	100	8	22	241	5	124	41	144	290
15. "	NDFC	100	0	30	33	0	21	33	33	1,000
16. Sri Lanka	DFCC	25	0	12	12	32	12	2	7	200
EMENA										
1. Afghanistan	IDBA	15	8	2	10	0	12	2	6	330
2. Egypt	BOA	100	0	15	1,676	1	692	23	143	156
3. Finland	IFF	29	0	63	200	21	35	65	185	350
4. Greece	NIBID	0	1	99	235	21	62	63	81	780
5. Iran	IMDBI	2	0	278	740	17	97	293	126	2,300
6. "	ICB	100	0	25	244	0	88	122	n.a.	n.a.
7. Ireland	ICC	100	0	0	103	7	64	69	205	330
8. Israel	IDBI	3	0	70	514	8	89	126	360	285
9. Morocco	BNDE	38	15	142	150	40	48	112	67	1,700
10. "	CIH	54	0	25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
11. Tunisia	BDET	22	20	50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
12. Turkey	DYB	100	0	40	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
13. "	TSKB	0	11	306	265	41	116	67	82	820
14. Yugoslavia	PBS	0	0	22	2,228	0	n.a.	128	377	333
15. "	SBS	0	0	59	1,714	0.5	n.a.	310	307	1,000
Latin America & Caribbean										
1. Bolivia	BISA	0	0	5	8	0	14	3	46	66
2. Brazil	BNB	74	0	25	991	2	n.a.	130	152	852
3. Ecuador	COFIEC	7	7)	28	40	12	20	16	n.a.	n.a.
4. "	CV-CFN	100	0)		58	16	n.a.	11	n.a.	1,400
5. Mexico	FONEI	(Trust Fund)	0	35	28	52	n.a.	38	27	120
6. Trinidad & Tobago	TTDFC	94	0	7	7	34	7	3	28	

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PARTIAL INDICATORS OF ECONOMIC RETURNS

In the studies done to date several potential indicators were isolated to test their effectiveness as being descriptive of overall project efficiency. The results are shown below from the India and Colombia studies. This indicates the high degree of unreliability of using partial indicators as a substitute for overall ERR analysis.

Correlation of Indicators with ERR

Partial Indicators	ICICI India		Colombian Financieras	
	Correlation Coefficient (R)	Determination Coefficient (R^2)	Correlation Coefficient (R)	Determination Coefficient (R^2)
Investment/Employment	- 0.21	0.04	- 0.34	0.12
Valued Added/Investment	0.32	0.10	0.34	0.12
Gross Profits/Investment	0.14	0.02	0.29	0.08
Export/Sales	0.05	0.01	N.A.	N.A.
Domestic Cost/Foreign Exchange generated	- 0.60	0.36	- 0.55	0.30

The last indicator (Bruno ratio) shows the relatively best correlation with ERRs, but it explains only about one-third in the variation of economic returns. Further correlations were calculated between ERRs and the size of projects or sponsoring enterprises, but they too were statistically insignificant. Even a combination of partial indicators (multiple regression analysis) could explain the variation of ERRs only up to 50%. Finally, the partial indicators showed poor correlation among themselves.

Most of the results are as one would have expected although it is surprising how poorly some partial indicators are correlated with the absolute values of economic returns. They are therefore unreliable for the purpose of project ranking. Nevertheless, the studies also showed that a few partial indicators (including financial returns and Bruno ratio) did not do too badly, overall, to indicate projects with unattractive economic merits.

DFCD
June 13, 1975

COMPARISONS BETWEEN FIRMS OF DIFFERENT SIZES

(Some Conclusions from the 1974/75 Colombian Study on DFC Financing)

The 1974/75 study on financiera lending in Colombia contained, into alia, a comparison between projects sponsored by firms of different sizes.

One set of questions concerned the observable differences in financial and economic efficiency between projects sponsored by large firms (assets over $12 million), medium firms, and projects sponsored by smaller firms (assets below $2 million). Whereas differences in the financial and economic returns of projects sponsored by small, medium and large firms could be observed, the differences did not stand the test of statistical significance. The averages, for each size group indicated that projects in all size categories showed attractive financial and economic characteristics. The size criterion would thus have been a weak indicator of project selection.

Concerning the impact on employment generation it is interesting to note that the much larger impact by small firms was primarily due to their capacity to generate employment indirectly. With similar investment/employment ratios for direct job creation,[1] the difference in the total employment generation impact was not due to more labor-intensive production processes by small firms; through a lower share of inputs from abroad and through a different structure of domestic inputs, the small firms were found to achieve a more favorable impact than large firms in terms of indirect employment generation.

On income distribution, the Colombian Study represented an attempt in the Bank's DFC work to quantify the distributional effects of sub-projects financed with Bank funds. On the basis of all 29 projects in the sample it was found that domestic owners received 19% of net economic benefits generated by the projects compared to 9% received by workers. A priori this might suggest an aggravation of income disparities as between the two groups. However, through direct and indirect taxes, government received the largest share (57%) of the net benefit stream and thus the overall distributional impact of the projects depends squarely on the spending pattern of government revenues. Since there is some evidence that this pattern has some (but no large) impact in reducing income disparities , it can be concluded that financiera-assisted projects effected little, if any, change on the distribution of income in Colombia.

1/ A comparison by size of project (rather than by size of sponsoring firm) shows some differences, however: the investment needed to create a direct job amounted to $4,800 for relatively small projects (total investment cost below $250,000), $7,200 for medium projects and $8,000 for large projects (investment over $2 million). More pronounced differences were observed in India where ICICI found, on the basis of a sample of 126 projects, that the investment/job varied from $2,500 for small projects (total cost below $1.3 million) to $30,000 and above for large projects (with investments over $13 million). However, the projects were generally much larger than in the Colombian sample.

A comparison of projects sponsored by small and large firms showed that the former generated relatively large shares of income in the hands of unskilled workers (22%, compared to 7% for large firms) and the government (76%, compared to 54% for large firms). From an income distribution point of view, if income to workers and to the government can be valued more highly than income in the hands of owners, projects sponsored by small firms had a more positive distributional impact than others. On the other hand, a comparison by size of project (rather than by size of sponsoring firm) showed that large projects had somewhat better distributional effects than small projects.

While all these results are from the Colombian experience and there is no basis for generalizing from them, they point up the complexity of the problem and the need for more analysis on these issues in the context of specific operations.

DFCD
June 13, 1975

Medium and Long Term DFC Lending Rates
December 31, 1974

	DFCs	Nominal Interest Rate: Local Currency	Nominal Interest Rate: On Foreign Credit Lines	Fee Paid to Government	Who Takes Exchange Risk on Latest WBG Loans	Historical 1/ Exchange Rate Adjustment	Historical 2/ Rate of Inflation	Recent 3/ Rate of Inflation	
	Eastern & Western Africa								
(1)	NDC (Botswana)	10.5	10.5	-	Sub-borrower or Government 4/	n.a.	n.a.	n.a.	(1)
(2)	AIDB (Ethiopia)	9.5/10.5	9.5/10.5	-	Government	-1.5	4.3	8.8	(2)
(3)	BIDI (Ivory Coast)	10.25	10.25	-	Government	0.9	7.1	15.9	(3)
(4)	IDB (Kenya)	9.5	10/10.5	-	Sub-borrower or Sub-borrower & Government 5/	3.2	7.7	15.9	(4)
(5)	LBDI (Liberia)	11.5	11.5	-	Sub-borrower	3.2	n.a.	n.a.	(5)
(6)	DBM (Mauritius)	9.5	9.5	-	Sub-borrower	2.8	9.4	30.7	(6)
(7)	NIDB (Nigeria)	9.0	9.0	-	Sub-borrower	4.9	10.6	13.3	(7)
(8)	SOFISEDIT (Senegal)	10.5	10.0	-	Sub-borrower or Government	0.9	6.7	15.3	(8)
(9)	IBS (Sudan)	8.5/9.5	8.5/9.5	-	Sub-borrower	3.2	8.5	27.6	(9)
(10)	TIB (Tanzania)	10.0	10.0	-	Sub-borrower 6/	3.2	9.0	28.1	(10)
(11)	SOFIDE (Zaire)	10.5	10.5/11.5	1.0	Sub-borrower or Government 7/	3.2	14.7	29.3	(11)
	Asia								
(1)	CDC (China)	14.75	11.0	-	Sub-borrower	1.2	13.2	34.9	(1)
(2)	ICICI (India)	8.5/10.25	9.5/10.5	-	Sub-borrower	3.7	11.8	31.1	(2)
(3)	IDBI (India)	8.5/12	10.5/11	-	Government	3.7	11.8	31.1	(3)
(4)	BAPINDO (Indonesia)	15.0	15.0	8/	Government	7.3	18.1	34.4	(4)
(5)	PDFCI (Indonesia)	15.0	15.0	8/	Government	7.3	18.1	34.4	(5)
(6)	KDFC (Korea)	15.5	11.0	-	Sub-borrower	9.1	12.6	26.7	(6)
(7)	MIDF (Malaysia)	10.0	9.0/10.0	0.25	Central Bank and MIDF 9/	-2.9	6.7	16.0	(7)
(8)	IDBP (Pakistan)	12.5/13.5	8.5	0.50	Sub-borrower 10/	18.4	12.1	n.a.	(8)
(9)	PICIC (Pakistan)	12.5/13.0	9.5	-	Sub-borrower 10/	18.4	12.1	n.a.	(9)
(10)	DBP (Philippines)	12.0	12.0	0.75	Shared between Government and Sub-borrower 11/	14.1	16.7	36.2	(10)
(11)	PISCP (Philippines)	12.0	12.0	-	Sub-borrower	14.1	16.7	36.2	(11)
(12)	DBS (Singapore)	10.0/11.5	10.0/11.5	0.25	Government	-3.0	9.9	13.5	(12)
(13)	DFCC (Sri Lanka)	10.5	10.5	-	Government	4.7	7.3	12.4	(13)
(14)	IFCT (Thailand)	10.5	9.5	0.25	Shared between IFCT and Government 12/	1.5	8.1	25.4	(14)
	Europe, Middle East & North Africa								
(1)	IDBA (Afghanistan)	10.0	10.0 13/	-	Sub-borrower	-2.9	n.a.	n.a.	(1)
(2)	CDB (Cyprus)	8.3/8.8	8.3/8.8	-	Shared between Central Bank and CDB 14/	-1.3	7.3	17.7	(2)
(3)	BOA (Egypt)	9.5	9.5	-	Government	.1	4.0	7.1	(3)
(4)	IFF (Finland)	8.5/10.0	8.5/10.0	-	Sub-borrower or Government 15/	-.1	8.7	15.4	(4)
(5)	NIBID (Greece)	11.5	11.5	-	Bank of Greece	2.2	10.2	16.5	(5)
(6)	ICB (Iran)	8.5/11.5	8.5/11.5	-	Government	.1	7.2	13.0	(6)
(7)	IMDBI (Iran)	10.0	10.0 16/	-	Sub-borrower or IMDBI 17/	.1	7.2	13.0	(7)
(8)	ICC (Ireland)	14.25/15.5	14.25/15.5 18/	-	Government	2.8	10.8	20.0	(8)
(9)	IDBI (Israel)	8.0/10.0/12.0	8.0/12.0	-	Government 19/	7.5	17.6	48.0	(9)
(10)	BNDE (Morocco)	9.0	9.0	-	Central Bank	-1.5	5.5	13.7	(10)
(11)	CIH (Morocco)	8.8	8.8	-	Central Bank	-1.5	5.5	13.7	(11)
(12)	BDET (Tunisia)	8.0	8.0	-	Central Bank	+1.5	3.5	5.0	(12)
(13)	DYB (Turkey)	12.5	12.5	-	Government	11.7	11.9	24.7	(13)
(14)	TSKB (Turkey)	14.0	14.0	-	Sub-borrower	11.7	11.9	24.7	(14)
(15)	SBS, PBS (Yugoslavia)	4.0/12.0	9.0/12.0	-	Sub-borrower	7.3	17.0	23.8	(15)
	Latin America & Caribbean								
(1)	BISA (Bolivia)	13.0	12.0 20/	-	Sub-borrower	13.5	19.9	44.0	(1)
(2)	Caldas (Colombia)	25.0	10.75	14.25	Sub-borrower or Central Bank 21/	11.2	15.3	19.5	(2)
(3)	Colombiana (Colombia)	"	"	"	" "	"	"	"	(3)
(4)	Nacional (Colombia)	"	"	"	" "	"	"	"	(4)
(5)	Norte (Colombia)	"	"	"	" "	"	"	"	(5)
(6)	Valle (Colombia)	"	"	"	" "	"	"	"	(6)
(7)	CFN (Ecuador)	12.0	13.0	1.75	Government	9.2	11.2	22.8	(7)
(8)	COFIEC (Ecuador)	12.0	13.0	1.75	Government	9.2	11.2	22.8	(8)
(9)	FONEI (Mexico)	11.0	11.0	22/	Government	3.2	9.8	21.8	(9)
(10)	TTDFC (Trinidad & Tobago)	10.0	10.0	-	Government	2.8	10.1	23.2	(10)

See page 2 for footnotes.

1/ Average annual percentage rate of change over the past five years in the exchange rate is based on International Financial Statistics trade conversion factors (1969-1974). A positive change expresses depreciation of local currency. An average is calculated as the midpoint of changes with respect to US Dollars and Japanese Yen.

2/ The average annual percentage rate of change of prices over the past five years is based on the Consumer Price Index from International Financial Statistics (1969-1974).

3/ The recent rate of change of prices is from the 4th quarter of 1973 to the 4th quarter of 1974, or over the last 5 quarters for which figures are available. Data is as of the March 1975 International Financial Statistics.

4/ Normally sub-borrowers will assume the risk but in the case of small foreign exchange loans (less than $75,000) the Government will assume the exchange risk at no charge.

5/ In cases where IDB will not be able to pass the entire exchange risk to its clients, the foreign exchange risk on the Bank's loan to IDB will be shared between Government and IDB's borrowers. This will be accomplished by IDB having its borrowers assume the risk of exchange fluctuations between the Kenya shilling and the US dollar, and the Government the risk on any fluctuation between US dollars and the currencies in which the Bank loan was disbursed. There is no charge for this cover.

6/ Sub-borrower assumes dollar exchange risk in case of IDA credit.

7/ In cases where it is not possible for sub-borrower to take risk, SOFIDE charges 11.5% and the increased 1.0% margin on IDA funds goes to the Government as a foreign exchange risk coverage fee. In the case of small enterprises where the Government takes the risk without fee, they are charged 10.5%.

8/ Government assumes foreign exchange risk and receives the excess of any spread over 4% between the rate charged to the DFC and rate received by the DFC.

9/ MIDF assumes the exchange risk up to 3% on either side of the rate guaranteed by the Central Bank. The Central Bank assumes for a ½% per annum fee the exchange risk outside 3% on either side of the guaranteed rate.

10/ Sub-borrower assumes the exchange risk on all sub-loans. For the period when funds are repaid to the DFC but are not yet repaid to IDA the Government assumes the exchange risk.

11/ Sub-borrower assumes risk in currency of country of procurement, while Government assumes risk between procurement currencies and currencies used by IBRD. The fee for this to DBP is 3/4%.

12/ (i) IFCT shall pay into a "Claim Account" in the name of the Ministry of Finance ½% per annum of its outstanding foreign debt; (ii) IFCT shall set aside to a Provision for Exchange Risk 1% per annum of its outstanding debt; (iii) if a net loss occurs owing to a realignment of currencies, the loss shall be charged: first, against the Provision for Exchange Risk (up to 75% of the balance of that Provision), and secondly, the balance if any, against the Claim Account; (iv) in the event that the loss exceeds the sum of the charges so made, the Ministry of Finance shall reimburse IFCT the amount of the excess; and (v) IFCT shall repay the Ministry of Finance this reimbursement at the rate of Bt. one million per annum, irrespective of the numbers of such reimbursements made to IFCT by the Ministry of Finance.

13/ For enterprises where equipment and its installation cost less than $1000,000 the sub-borrower pays 8% for local or foreign currency (IDBA receives 10% interest and the Government rebates 2% to the sub-borrower).

14/ The Central Bank assumes the exchange risk on the principal while CDB takes the risk on interest while establishing provisions at the rate of 0.5% per annum on the principal outstanding.

15/ The Government has agreed to bear the foreign exchange risk for any sub-loan granted to small or medium sized enterprises up to Fmk 500,000. For any amount of an individual loan over this limit, the foreign exchange risk is passed on to the sub-borrower.

16/ IMDBI may charge an additional 1% if IMDBI assumes the foreign exchange risk.

17/ IMDBI's foreign exchange exposure arose from three major operations, 35 million dollars of Eurodollar borrowings in 1972 to prepay Loan 602-IRN, conversion of 36.1 million dollars of Eurodollar borrowings into Rials to meet its local currency needs, and conversion of DM 60 million bond issue in 1973 to Eurodollars as required by the German Monetary Authorities. IMDBI will protect itself from loss in addition to possible arranging guarantees, purchasing forward cover, etc., by establishment of a specific provision to cover possible exchange losses and the limiting of the exposure to a prudent level in relation to the provision. The relation between exposure and the provision is determined by the composition of the exposure, i.e. the number and relative importance of the currencies in the exposure. A review of IMDBI's exposure as of September 1973, established that a prudent level would be up to seven times the provision. The provision would be made up of realized and unrealized profits made on the exposure (offset by realized and unrealized losses) and of allocations from income. For tax and audit reasons the provision is not specifically identified in the Balance Sheet, and allocations from income are not made directly.

18/ Base rate 14½ - 15½%. Actual rate now 16 - 17%.

19/ Government takes up the excess of any spread over 1.75%.

20/ 12% + 2% commission.

21/ In the case where exchange risk is assumed by Central Bank, a 14.25% fee is charged to the sub-borrower.

22/ .125% for the first $40 m., .0625% thereafter.

DPCD
June 13, 1975