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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

POLICY REVIEW COMMITTEE

PRC/M/73-9

October 3, 1973

POLICY PAPER ON
THE WORLD BANK AND DEVELOPMENT FINANCE COMPANIES:
STAFF REVIEW

The revised date set for the staff review of the paper, "The World Bank and Development Finance Companies," prepared by the Development Economics Department, is Wednesday, October 31, 1973, at 3:30p.m. in Conference Room C. 310 Please inform this office if you cannot attend.

Frank Vibert
Acting Secretary
Policy Review Committee

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THE WORLD BANK AND DEVELOPMENT FINANCE COMPANIES

August 1973

Prepared by:
Development Economics Department

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The World Bank and Development Finance Companies

The World Bank and Development Finance Companies

A. Introduction

1. The focus of this paper is on Bank Group support to development finance companies (DFCs) operating predominantly in the industrial sector. These DFCs became key instruments for transferring Bank Group funds to industry in the 1950s and 1960s, with lending growing from $11 million in FY1951 to $252 million in FY1972. During the period FY1966-1970, lending through DFCs accounted for 45% of Bank Group lending to industry and 10.5% of total Bank Group lending of all types. If program loans are excluded, the share of DFCs in total Bank support to industry rises to 66%.

2. Until the late 1960s, Bank Group support for DFCs was predicated on the belief that private enterprise was the preferred way of securing industrial development. The willingness of governments to guarantee IBRD and IDA loans to DFCs made it possible to channel Bank Group credits to a large number of private industrial firms without requiring them to obtain government guarantees directly. The emphasis was on building well-managed, autonomous institutions that would take increasing responsibility in project selection and in raising funds in capital markets. To do that a DFC had to be solvent; furthermore it had to achieve a financial position and earnings capability which would attract funds on a commercial basis. A major change in policy took place in 1968 when government-owned DFCs became eligible for IBRD/IDA financing. Whether private or public, the DFC had to be autonomous and financially viable to qualify for Bank support. "..., the ability of a government-owned DFC to borrow on its own credit will do much to strengthen its resistance to political intervention..." (O.M. 2.64). Since then a rapid growth in the support of DFCs in the public sector has taken place. The Bank

has tended to apply more or less the same standards to these government-owned intermediaries as to the earlier generation of private sector DFCs. Both were expected to adopt a commercial orientation, to improve their financial standing, to reduce the incidence of defaults or arrears, to raise their efficiency, etc. The number of DFCs financed by the WBG has risen from 28 in 1968 to 47 in 1973; of the additional 19 DFCs 16 are government-owned. Lending to government DFCs accounted for 34% of all credits to DFCs in the period FY1970-72; the remaining 66% went to DFCs in the private sector.

3. DFCs associated with the Bank have made an appreciable contribution to industrial growth and the spread of modern business practices. Frequently, they are the premier "project institutions" in the country surpassing planning commissions and industry ministries in their ability to formulate or evaluate specific industrial investment proposals. By applying systematic project analysis, DFCs have helped avoid gross errors in resource allocation of the kind associated with suppliers credit financing. They have expanded the supply of term-finance, particularly that available for financing the foreign exchange component of industrial investment. Most DFCs have won the confidence of the business community. They enjoy a well-earned reputation for honest dealing and fair practice.

4. Despite these achievements, DFC operations have attracted a large measure of criticism in recent years. Records of Board meetings of the Bank, during the last two years, were reviewed to identify the main issues. Underlying these discussions was the fear that there might be an inconsistency between the profit-oriented behavior of privately owned DFCs and the development aims of societies in which they operated. More specifically, some Executive Directors pointed out that,

(i) DFCs have financed industrial projects heavily protected by government import policy,

(ii) DFCs have financed capital-intensive projects where the investment cost per job created was excessively high.

(iii) DFCs have mainly supported well-established industrial elite groups.

(iv) DFCs have remained heavily dependent on their governments for domestic funds and on the World Bank for foreign exchange financing. They have failed to exploit the capital market or to develop its potential.

5. The President of the Bank expressed his anxiety when he asked the staff to explain why it was not possible to estimate the economic rate of return on a DFC loan as was the custom in most other Bank operations. A program of special studies was undertaken to measure the economic payoff of investments financed through selected DFCs. The scope of these studies embraced many aspects related to the developmental impact of these institutions. The preliminary results of three of these studies are now ready; they are used in this paper to examine the validity of the criticisms levelled at DFCs. TSKB in Turkey is the subject of one case study. It is one of the oldest DFCs associated with the Bank and received its first loan in FY1951. Altogether, this private DFC has obtained $187 million, including an equity investment by IFC. The second case study is on ICICI in India which came into existence in 1955, as a result of Bank promotional activity. It has borrowed $335 million from the Bank. Conceived and operated as a private company for many years, ICICI became a public-sector institution following the government's decision to nationalize major commercial banks and insurance companies which are sizeable stockholders of this DFC. The third case study is on KDFC in Korea

which came into being in 1968; another product of Bank Group promotional effort. This private institution has received nearly $96 million from the Bank Group, including an equity investment by IFC. The three case studies are on DFCs which account for about 32% of overall Bank Group funding of such institutions.[a/]

6. The specific findings for TSKB, ICICI and KDFC will not apply, of course, to the 42 other institutions associated with the Bank Group. They are a wide assortment in terms of their size and age, the stage of development of the economies in which they operate and management styles. Yet, the experience analyzed in the three case studies allows us to generalize broadly about problems and potentials of the group of DFCs that came into being or were reorganized in the 1950s and 1960s, largely as a result of Bank initiative. This group has enjoyed a very special relationship with the Bank reflected in a large volume of financial support and technical assistance. Many of the policies and practices of these DFCs have been influenced heavily by the Bank Group.

B. Principal Conclusions[b/]

7. To summarize, the main conclusion of the case studies is that the criticisms levelled against DFCs are not without foundation. There are many projects supported by them which are heavily protected by government import policy. Some of these investments are inefficient from an economic standpoint, although they yield handsome financial returns to the sponsors. The staggering range of protection - from over 1000% to highly negative - encountered in practice cannot be justified on the basis of any conceivable notion of indus-

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a/ Similar studies on SNI (Tunisia) and IMDBI (Iran) have been carried out by the Operations Evaluation Department.

b/ A more detailed version of these conclusions can be found in the Annex.

trial strategy. Probably, the extreme values result from happenstance and reflect the uncoordinated nature of policy formulation by governments of developing countries. The capital intensity of DFC projects varies enormously depending on the activity, the type of project (expansion or new) etc. The investment cost per job created ranges all the way from less than $1,000 to infinity (where employment diminished in expansion projects). The record is not easy to interpret. It is certainly true that industrial development has generated inadequate job opportunities, that distortions in factor prices make it financially attractive for project sponsors to adopt excessively capital-intensive techniques and that DFCs have done little to explore the feasibility of alternative production methods. Given these distortions in factor and commodity markets, financial signals were an unreliable guide to resource allocation. The weighted average pre-tax financial return on total capital was about 30% in the TSKB sample. These financial returns exceeded the economic pay-off to society in more than two-thirds of the projects and in several cases the differential was very large. Despite these misleading signals, the large majority of DFC projects earned economic returns above 10%. Even so, nearly a quarter to a third of the projects earned low or negative economic returns. DFCs could have avoided supporting many projects which turned out to be mistakes by screening project applications on an economic basis.

8. The bulk of DFC operations were directed at relatively large, well-established and sophisticated firms. Development banks failed to broaden the entrepreneurial class by facilitating the entry of newcomers or assisting small entrepreneurs to expand their business. DFCs have exhibited a marked aversion for bearing risks and for catering to the needs of borrowers who require a heavy dose of technical assistance and auxilliary services.

9. Many DFCs are simply windows for official funds; primarily from governments and the Bank. Many factors are responsible for this situation; the most important are the significantly higher cost of borrowing from the domestic private market and government restraints on the undertaking of foreign debt on hard terms. DFC lending rates are regulated by governments and kept at levels no higher (and sometimes lower) than interest rates for short-term loans charged by commercial banks and considerably lower than what DFCs would have to pay if they borrowed in the domestic capital market. Therefore, market borrowing means a sharp reduction in DFC profitability. Governments have made available to DFCs large sums on concessional terms and thus the low-interest regime has been perpetuated. The result is to deepen the dualism in the market for loanable funds; a low-cost privileged sector coexisting with a very high cost unorganized sector.

10. There is a sense in which the criticisms, mentioned above, are unfair to DFCs. These institutions came into being a decade or two ago to carry out certain tasks considered to be important by member governments and the Bank. They are now being evaluated on the basis of priorities and perceptions which are quite different; reflecting a measure of hindsight and a keener appreciation of the development process. The purpose of this evaluation is not to apportion blame but to learn from past experience. Two questions need to be answered:

(i) How should the Bank deal with the group of DFCs it helped create in the 1950s and 1960s?

(ii) What kinds of institutions should the Bank be building in the next decade for further industrial development?

C. The Bank and Existing DFCs

11. The Bank intends to lend \$3 billion to the industrial sector of developing countries during FY1972-76; about \$1.4 billion through intermediary instituions.[a] This is the planning framework within which the first of the questions listed above is addressed. It is important to achieve these lending targets and at the same time remedy defects in operations of existing DFCs, outlined above. The reforms should have three objectives:

(i) to avoid the financing of economically inefficient subprojects and to upgrade the auxilliary services of DFCs necessary for improving the design and implementation of industrial projects supported by them.

(ii) to reorient policies and procedures of DFCs aimed at expanding their assistance to small and/or new entrepreneurs as well as borrowers in backward regions of the economy.

(iii) to reduce the dependence of DFCs on concessional finance.

12. These reforms are not simply a matter of changing the internal policies and procedures of DFCs; they are intimately bound up with the economic policy frames of governments. The prospect for successful reform in any particular case depends not only on the attitude of DFC management but also on the receptiveness of governments to necessary changes in exchange rates, interest rates protection, etc. These are difficult issues and progress is unlikely to be very rapid. The Bank's posture needs to be defined in each individual case. What will be required in most instances is some judicious mixture of Bank efforts,

(i) to persuade governments to make policy changes which facilitate the DFC's task,

(ii) to persuade DFC management to change its program and procedure,

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a/ Sector Working Paper on Industry.

(iii) to negotiate covenants or side-conditions which make further Bank support conditional on new <u>controls</u> on DFC operations.

13. The concrete manifestations of the "persuasion" and "control" approaches in the context of the three objectives of reform are listed below.

<u>Objective 1: Avoid Uneconomic Projects and Improve Project Design</u>.

<u>The Persuasion Approach</u>:

(i) Demonstrate to governments the need to rationalize protection-cum-exchange rate regimes as well as structure of interest rates. These moves will diminish the need for DFCs to undertake economic analysis.

(ii) Demonstrate to DFC leadership and key staff the value of economic analysis for (a) improving project design, (b) negotiating contracts with multi-national corporations, (c) assessing the risk of sudden changes in government policy which can disrupt the cash flow of DFC supported projects and (d) contributing to the review of government economic policies.

(iii) Encourage public sector planning and project authorities as well as DFCs to define the methodology and criteria for project analysis so that investment proposals in both the public and private sectors can be screened consistently on the basis of uniform standards.

<u>The Control Approach</u>:

(i) Reduce the so called "Free Limit" (below which DFCs can draw down Bank funds without obtaining prior approval) and thereby expand the area over which Bank can exercise direct surveillance over DFC operations. The resort to this option will raise steeply the Bank's staff costs of supervising DFC operations.

(ii) Earmark the uses to which Bank lines of credit can be put on the basis of sectoral or other analysis carried out by Bank staff. The feasibility of this option turns on whether or not the Bank can bring about a very large improvement in the data base and the analytical quality of its economic-cum-sectoral work.

(iii) Insist on DFCs undertaking specified types of economic analysis and selecting projects eligible for Bank funds on the basis of criteria defined by the Bank.

<u>Objective 2: Expand DFC Assistance to Underprivileged Borrowers</u>

<u>The Persuasion Approach</u>:

(i) Demonstrate to governments the need for letting interest rates vary according to the cost of intermediation and/or devising subsidy, risk guarantee as well as insurance schemes aimed at enhancing the attractiveness to DFCs of assisting small and/or new entrepreneurs as well as borrowers in backward regions.

(ii) Demonstrate to DFCs the need for them to re-think their own role in society in the light of changing national priorities.

<u>The Control Approach</u>:

(i) Specify ceilings beyond which DFCs cannot lend Bank funds to well-established large firms as in the recent loan to Colombian financieras.

(ii) Specify targets for DFC assistance to underprivileged borrowers funded by Bank loans.

<u>Objective 3: Reduce the Dependence of DFCs on Concessional Finance.</u>

<u>The Persuasion Approach</u>:

(i) Demonstrate to governments the need for raising interest rates in the modern financial sector, for allowing DFCs to charge higher lending rates and thereby making it possible for those intermediaries to raise funds in the private domestic market.

(ii) Demonstrate to DFCs that their long-run viability rests on the ability to mobilize resources from private sources on a commercial basis. Encourage them to improvise second-best solutions of the type discussed in the Annex (paras. 26-34).

The Control Approach:

(i) Specify targets for equity issues, commercial borrowing, underwriting, et.al. and make withdrawal of Bank loan conditional on satisfactory progress by DFC in line with these targets. Recent loans to TSKB and the Colombian financieras incorporated such features for the first time in Bank history.

14. Whether or not the three objectives for DFCs, listed above, are mutually compatible depends on what is assumed regarding reforms in government policies, particularly the level and structure of interest rates. Given the present regime of low interest rates, there is a conflict between Objectives 1 and 2 which require significant increases in administrative costs of DFCs and Objective 3 which implies a rise in their borrowing costs. The simultaneous pursuit of all three objectives would quickly erode DFC profitability and also impose a burden on its scarce managerial resources. It is probably wise to admit that performance on the resource mobilization front cannot improve very much without government action on interest rates. If such reform is not expected, then it is best to downgrade Objective 3 and concentrate instead on Objectives 1 and 2. This means the Bank should revise its expectations about DFCs achieving financial viability and commercial autonomy under these conditions.

15. The Bank's posture vis-a-vis each existing DFC should have a time perspective. Initially, we should emphasize the "persuasion approach" but define a time span, of say five years, during which well-specified results are expected. If these results do not materialize, the emphasis should shift to the "control approach" or the Bank should withdraw support altogether.

16. The "persuasion approach" has much to commend it. It is consistent with the aims of institution-building. It treats DFCs as organizations capable of exercising mature judgement, shouldering responsibility and making innovations in the social milieu in which they operate. By contrast, the "control approach" has a much narrower aim, i.e. to assure that Bank funds are utilized according to our sense of priorities. It implies a considerable reduction in the scope of decision-making entrusted to DFCs. Instead of helping them to upgrade their problem-solving and policy-formulating skills, the Bank tells DFCs what to do, at least so far as Bank funds are concerned.

17. The "persuasion approach" may take longer to produce results but these will be much more far reaching than under any conceivable control regime. For example, once a DFC is convinced of the value of economic analysis and appreciates what it is all about, there is willingness to apply it not only to projects using Bank funds but to all projects. Furthermore, the DFC staff is frequently able to adapt the analytical technique to local conditions. Pains are taken in assembling required data and checking its validity. Under favorable circumstances, DFCs might even be able to transmit their know-how to other financial intermediaries or to appropriate government agencies. By contrast, the imposition of controls by the Bank will be construed as an element of pressure exercised by the creditor. Some DFCs may respond by turning to alternative sources of funds (IDB, ADB, KFW, et.al), and others may resort to "window-dressing" operations in order to meet Bank conditions.

D. New Institutions for the 1970s.

18. One of the objectives of reform of existing DFCs is to enhance their capacity to assist underprivileged borrowers - i.e. small operators, potential entrants into the ranks of entrepreneurs with good ideas but little experience or financial strength and industrialists wishing to set-up facilities in backward regions. Whether or not such attempts to graft social orientation on "old style" DFCs will succeed remains to be seen. Therefore, in considering the establishment of new institutions, the Bank should place this objective at the center of the picture and design the structure accordingly. This emphasis on the underprivileged and their needs should exercise a dominating influence in deciding what kind of an entity to create - public vs. private, orientation and professional composition of staff, financial structure, subsidy required, etc. Research is underway aimed at defining the characteristics of institutions which can fulfill this mandate.

19. Apart from the priority need to create or strengthen institutions of this kind there are two other issues which deserve consideration. The first concerns the quantitative role of Bank assisted DFCs. Many of the institutions in the present Bank portfolio play a rather small part in the financing of industrial investment. The question is whether or not it is worthwhile to invest a great deal of staff time studying, making loans, extending training or technical assistance facilities to DFCs who are marginal and who will remain marginal in the context of the industrial sector. By contrast, if we establish a relationship with the apex industrial financing institution in the economy we can not only realize economies of scale on Bank staff-input but also hope to engage the attention of government on matters of industrial policy. Recently,

the Bank has made moves in this direction by lending to the Industrial Development Bank of India and to the Banco de la Republica in Colombia.

20. Secondly, the Bank should reconsider the importance it attaches to DFCs operating in member countries of a common market. So far the Bank has lent to only one such institution - the East African Development Bank. A number of other opportunities of this kind - in Central America and the Caribbean - are being processed in the normal course. There is little awareness of the special role that a development bank can play in the context of regional integration experiments. In fact, the Bank has not yet defined a clear policy on the subject of regional integration. A paper is planned on this topic by the Development Research Center.

E. Recommendations

21. The Bank should carry out a reform of existing DFCs,

(i) to avoid the financing of economically inefficient sub-projects and to upgrade the auxilliary services of DFCs necessary for improving the design and implementation of industrial projects supported by them.

(ii) to reorient policies and procedures of DFCs aimed at expanding their assistance to small and/or new entrepreneurs as well as borrowers in backward regions of the economy.

(iii) to reduce the dependence of DFCs on concessional finance.

22. Lending through DFCs is similar to program loans in that the end-result of such lending depends critically on the government's policy frame. The Bank should upgrade the quality of macro-economic and sectoral studies of member countries to provide a base for carrying out reforms of DFC operations.

23. The Bank should define its posture vis-a-vis each of the existing DFCs in some time perspective, say the next five years. The aim should be to specify,

(i) the objectives of reform,

(ii) the relative priority of each objective and

(iii) what can be achieved through the "persuasion" or "control" approaches with respect to each objective.

24. Where there is a serious conflict between the objective of resource mobilization and the objective of expanding a DFC's capability for rendering assistance in different phases of the project cycle, the latter objective should receive priority.

25. The Bank should withdraw its support from existing DFCs where one or more of the following conditions apply:

(i) the government policy frame is intolerable and there is no prospect for early improvement,

(ii) the orientation of DFC Board and management rules out essential reforms,

(iii) funds from commercial sources are available on terms that are reasonable both from the institutional and national viewpoints.

26. The Bank must make a concerted effort to avoid creating new DFCs in the image of old ones. New institutions should have the capability of serving under-privileged borrowers in the industrial sector. It is also important to expand relations with apex industrial financial institutions and DFCs serving member countries of common markets.

Annex: Conclusions of DFC Case Studies

I. Resource Allocation

A. The Policy Environment and Its Impact

1. Industrialists who borrow from DFCs are mostly private parties whose investment behavior is governed mainly by the cost-price-profit mechanism. Government policies - protection, taxes, interest rates, etc. - influence private decisions by changing the relationship of market prices. In addition, governments deploy non-price instruments such as licensing and controls which further circumscribe or redirect private business activity. Accordingly, portfolios of DFCs are not only heavily influenced by the structural characteristic of economies in which they operate but also by the impact of government policies. In as much as the Bank has serious reservations about industrial policies followed by member governments, there is reason to fear that assistance to DFCs will lead to waste and inefficiency. The Bank view of industrial policy in Turkey and India has been a very critical one but this has not stood in the way of supporting DFCs in these countries. By contrast, Bank economists have admired the spectacular achievements of Korean industry and reservations about government policy have not been so severe.

2. What these policy-frames meant in practice became clear through the case studies. These focused on projects approved by DFCs during the later 1960s and which had operated commercially for at least a year. There were 141 such projects in TSKB, 27 in KDFC and 208 in ICICI. A sample of these projects were studied intensively to answer (amongst others) the following questions;

(i) how much protection do they receive?

(ii) how capital-intensive are they?

(iii) how profitable are they on a financial basis?

(iv) how profitable are they on an economic basis (i.e. from the standpoint of society)?

3. There is no simple answer to the first question. On the one hand, a sizeable proportion of projects in each of the three DFCs have negative or zero effective protection. (See Table 1). In KDFC this proportion is 45% while in the other two it is about a quarter. On the other hand, a significant portion of projects are heavily protected. The magnitude of the protection in some cases is colossal; exceeding 1000% in a Turkish plastic project, 900% in a project producing agricultural discs in India and 300% in a Korean textile project. High protection is usually a sign of project inefficiency but this is not always the case. There are a number of projects which are earning attractive economic returns and at the same time enjoying a subsidy from society in the form of high protection. An example is a Turkish light bulb project with an economic return of 48%, an effective rate of protection of 118% and a handsome financial return of 63%. The protection afforded this enterprise is clearly unnecessary and probably not a deliberate government decision; it has the unintended effect of raising private profit to an absurd level.

4. The staggering range of protection - from over 1000% to highly negative - encountered in the three case studies cannot be justified on the basis of any conceivable notion of industrial strategy or overall economic policy. The extreme values probably result from happenstance and reflect the historical evolution of tariffs on a piece-meal basis. The rationalization of protection regimes by governments can have major consequences for projects supported by DFCs; either enhancing their financial profitability and debt servicing capacity or undermining it by the stroke of a pen. At present most

Table 1: EFFECTIVE RATES OF PROTECTION FOR DFC PROJECTS

Effective Rates of Protection (%) /b	Percentage Distribution of Investment in Sample			Percentage Distribution of Number of Projects in Sample		
	TSKB Turkey	KDFC Korea	ICICI India	TSKB (Turkey) %	KDFC (Korea) %	ICICI (India) %
0 to -100% /a	19.8	24.7	16.6	26.1	45.4	23.8
0.1 to 50%	23.4	32.6	33.7	26.1	27.3	23.8
50.1 to 100%	18.1	37.8	5.2	8.7	9.1	14.3
100.1 to + %	38.7	4.9	44.5	39.1	18.2	38.1
Total	100.0	100.0	100.0	100.0	100.0	100.0

/a Projects which involve negative rates of more than 100 percent have been classified into the fourth group (100.1 +).

/b Measured in year of full capacity utilization. The underlying exchange rate is TL/$ = 15, Won/$ = 400 and Rs/$ = 7.50.

DFCs are not aware of the way in which their portfolio of projects will be affected by changes in major government policy instruments such as protection. They ought to acquire this knowledge and reinforce their capacity to manage their investments.

5. The second question relates to capital intensity and the underlying concern is that DFC operations are not creating enough job opportunities. It is easy enough to summarize available data on this score (see Table 2). The investment cost per job created varies widely in the three project samples. For example, the range in the case of ICICI is from a low of $840 for textile projects to a high of $28,000 for petrochemicals. New projects had considerably higher investment/labor coefficients than expansion projects in the same industrial branch. On the whole, the Korean sample turn out to be more capital-intensive than the Turkish or the Indian. In two Korean projects there was a reduction in employment. How should this record be interpreted? Would it be useful to apply a simple rule of thumb and reject projects where the investment-job coefficient exceeds a prescribed ceiling, as has been urged by some Executive Directors? There is strong evidence that project selection on this basis would have led DFCs to approve projects with unacceptably low economic returns and to reject others which are attractive from an economic standpoint.

6. While it is not easy to devise a simple rule of thumb that DFCs can apply in project selection, the basic point that industrial development has generated inadequate employment opportunities is valid in both Turkey and India. (In this context, the Korean situation of more or less full employment is exceptional and should be treated as such). This is not the place to discuss policies necessary to accelerate job creation in industry - realignment of factor prices, research into intermediate technology, management of the demand pattern for industrial goods, etc. However, it is possible for DFCs to play a modest role

Table 2: CAPITAL LABOR RATIOS OF DFC PROJECTS

Capital/Labor Ratios /a /b (000 of dollars per job)	TSKB (Turkey)		KDFC (Korea)		ICICI (India)	
	Number of Projects Percent	Share of Investment Percent	Number of Projects Percent	Share of Investment Percent	Number of Projects Percent	Share of Investment Percent
up to 10	60.0	29.7	40.0	23.6	71.4	42.6
10.1 to 20	35.0	51.7	10.0	13.8	19.1	33.0
20.1 to 30	-	-	20.0	40.6	2.4	1.8
30.1 to 40	5.0	18.6	-	-	7.1	22.6
Total	100.0	100.0	100.0 /c	100.0 /c	100.0	100.0
Mean	$12,000		$13,220		$15,104	
Median	8,000		16,500		6,490	

/a The capital labor ratios for TSKB refer to the operations of firms. For several of the TSKB projects, though not for all of them, the project and firm are identical. The KDFC and ICICI figures refer to projects. In several cases, the latter are also identical with firms.

/b The estimates apply to full capacity operation and refer to fixed investment only. Rates of exchange used for converting local currency into dollars were: Rs/$ = 11.25, TL/$ = 15. The Won/$ rate applied was the constant dollar conversion factor for the year in which the respective investment was made. This was 270, 280, 310 and 340 respectively for the years 1968, 1969, 1970 and 1971, and represents an average of the quarterly sliding rates.

/c Two out of ten firms in the Korean sample reduced the size of their labor force after the investment. For another firm, employment data was unavailable.

drawing the attention of their clients to relatively labor-intensive technologies during the project appraisal process. Most DFCs do not look at projects from this standpoint.

7. The third question concerned the financial success of DFC projects. A measure of this was the pre-tax financial rate of return on total capital (equity-plus debt). The calculations were based on actual investment outlays and actual records of operation for one or more years. However, it was necessary to use estimates of future demand, prices, etc. to derive returns over the entire life of the project investment. The results are summarized in Table 3. Handsome returns were realized on the vast majority of DFC projects particularly in Turkey and Korea. The weighted mean return of these two project samples was about 30%. Financial results in India were pitched at a relatively modest level, although the range was wide.

Table 3: ECONOMIC AND FINANCIAL RETURNS ON DFC PROJECTS

Rate of Return	Economic (%) a/			Financial (%) a/		
	TSKB Turkey	KDFC Korea	ICICI India	TSKB Turkey	KDFC Korea	ICICI India
Negative - 0.0	22	20	2	0	10	0
0.1 to +10%	13	10	21	9	0	21
10.1 to 30%	43	10	53	52	30	60
Above 30%	22	60	24	39	60	19
Median	14	46	20	29	41	15
Mean c/	12	26	17 b/	31	30	17

a/ Percent of total number of projects in sample; for distribution by size of investment see Table 4 at the end of the Annex.
b/ Excludes one extreme value; if included mean would be 8%.
c/ Weighted by investment cost of projects.

8. Of course, the large majority of equity investors in DFC projects earned financial returns higher than the overall pay-off to capital. They had access to borrowed funds both from DFCs and commercial banks at effective interest rates well below the median or weighted mean financial return shown in Table 3. Even in Korea, where commercial bank rates were pitched at levels above 20% during the period under consideration, equity holders in most KDFC projects secured a sizeable spread on borrowed funds. The Indian level of interest rates was quite low (9-11%); except for ICICI projects in the bottom quintile, equity holders secured substantial leverage on debt financing.

9. Financial returns earned by owners of capital differed widely from the economic pay-off to society. The former exceeded the latter in more than two-thirds of sample projects in Turkey. In some instances, the constrast was conspicuous; in one ceramic project a high level of effective protection generated a 100% financial return although the economic return was negative. In Korea, the discrepancy between financial and economic return was not as great; however, there was at least one case in the sample where high protection enabled a lamp manufacturer to secure a 66% financial return although economic return was below 10%. The result for India was unexpected; economic returns exceeded financial ones in the majority of the sample. This was so for a number of technical reasons related to individual projects spelled out in the ICICI Special Study Report. One reason which applied in a number of cases was that domestic prices were controlled by Government at relatively low levels.

10. The most interesting result on the three case studies concerns the average level of economic returns. The median economic yield of KDFC projects - 46% - is extremely attractive by any standard. It is much higher than ex-ante

economic returns calculated on Korean projects in a variety of fields (transport, livestock, irrigation) which have been financed directly by the Bank in recent years.[a/] Similarly, the median economic pay-off of ICICI projects - 20% - exceeds expectations on directly financed Bank projects in manufacturing, shipping, power, telecommunications and irrigation. By contrast, TSKB does not appear in a favorable light. Its median economic return of 14% is a modest one and falls far below ex-ante calculations for directly financed Bank projects in livestock, transport, power, telecommunications and manufacturing.

11. Equally instructive is the range and scatter of economic returns on DFC projects. The proportion of projects yielding an economic pay-off above a critical minimum (say 10%) is quite high - 77% for ICICI, 70% for KDFC and 65% for TSKB. On the whole, this is a reassuring result; the large majority of DFC projects pass the grade, so to speak. This is so despite high protection barriers that governments have constructed and despite the bias introduced by government incentives in favor of capital-intensive methods of production. Although market signals have been grossly misleading in many instances, the overall resource allocation picture that emerges is not all that bad. The fact that the DFC portfolio is not as bad as some have feared is hardly cause for jubilation. More, to the point was the conclusion that DFCs could have avoided financing many of the bad investments. They did not do so because it was not their practice to screen projects from an economic standpoint. DFC staff analyzed proposals from an engineering and financial angle but they stopped short of the economic dimension. Till recently, DFCs did not consider it their business to scrutinize projects in terms of their contribution to the economy,

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a/ Admittedly these comparisons are extremely crude and should be recognized as such. They do not allow for differences in technique of estimation and they ignore the question of whether or not inter-sectoral comparisons are respectable from a conceptual standpoint.

except in so far as this was embodied in engineering-cum-financial analysis. They felt that Governments should determine the policy and priorities and that DFCs should function within this framework.

B. DFC Impact on Project Design and Investment Promotion

12. It would be a mistake to say that the development impact of a DFC is measured by the average economic rate of return realized by sub-projects it has financed. If the DFC has simply waited for project applications and then financed them passively, it would be clearly wrong to attribute to the intermediary the economic pay-off of such projects. These would have been executed in much the same form without the intervention of the DFC. At the opposite end of the spectrum a DFC might identify, formulate and promote many of the investments it finances; these might never materialize without the initiative of the intermediary. The economic return of such projects might well be attributed to the DFC in large part.

13. Some idea of the magnitude and character of DFC involvement in project design can be obtained from the ICICI Study. In nearly 25% of the sample of projects, ICICI did not feel the need to (or could not) introduce substantial changes. In 66% of the sample, ICICI modified the investment proposal significantly - mostly by revising cost estimates, changing the capital structure of the borrower firm or by reassessing the market prospect and thereby the scale as well as timing of operation. In 8% of the sample, changes introduced as a result of ICICI intervention amounted to a drastic overhaul of the project submission. While it is possible to describe the impact exercised by DFCs on projects, there is no easy way to quantify the net result on resource allocation. What is involved is not simply the project appraisal process, although this is a central feature. Also relevant is the DFC's project supervision activity, how it responds to problems arising during the implementation

the firm." (Report No. 109-KO). The selection procedure is biased in favor of firms which have healthy cash flows.

16. DFCs have exhibited a marked aversion towards bearing risks. In addition, they have deliberately avoided accepting clients who are inexperienced and unsophisticated in the industrial world. To cater to the needs of such borrowers would have required DFCs to provide a heavy dose of technical assistance and auxiliary services. There is only a limited extent to which the extra costs of such services can be recovered from clients. For these reasons, development banks have failed to broaden the entrepreneurial class by facilitating the entry of newcomers or assisting small entrepreneurs to make the quantum jump to the ranks of industrialists. The difficulty they would face if they endeavored to follow a vigorous promotional policy cannot be ignored:

(a) Promotion is risky as well as expensive; it requires scarce entrepreneurial talent which most development finance companies do not possess.

(b) Redesigning projects requires professional talent which is scarce and expensive. Development banks have limited leverage vis-a-vis their clients who may turn to alternative sources of credit.

17. The conflict between profit maximization and promotional activities is inherent in a dynamic business situation, but it is generally exacerbated in the case of a development finance company by fixed interest rates. A development finance company which could charge different interest rates according to the cost of intermediation could afford to take higher risks and undertake more promotion. Alternatively, DFCs could be encouraged to innovate by allowing them to recoup from government higher than average intermediation costs, and by risk guarantee and insurance schemes.

Kreditanstalt, reducing its reliance on the World Bank to 58%. TSKB has recently concluded its first private commercial borrowing abroad.

(b) Governments provide most of the domestic currency resources: 62% in the case of KDFC and about 70% for TSKB and ICICI. For KDFC and TSKB, the reminder has been provided by shareholders. ICICI sold bonds to the extent of 12% of its domestic currency resources, but they were purchased largely by public sector intermediaries on the basis of special considerations.

21. The three development finance companies thus remain heavily dependent on Governments for domestic funds and on the Bank for foreign exchange. Many factors underlie this situation; the most important are the significantly higher borrowing cost in tapping funds from the private market and government restraints on borrowing from foreign private sources. As DFC lending rates are regulated by Governments, market borrowing would generally mean a sharp reduction in profitability.

A. Interest Rate Policies

22. The dilemma could be resolved if government could be persuaded to change their interest rate policies. A variety of motivations lead governments to keep interest rates low. The list includes: some notion of a "normal" level of interest rates as they prevail in developed economies; a desire to encourage investment by reducing its cost, a desire to encourage competitiveness of industry; a belief that savings are not sensitive to interest rates. Not only is the whole structure of interest rates kept low (relative to inflation rates in the economy) but the long-term lending rate is set at a particularly low level. For the three DFCs under review, lending rates were no higher (and sometimes lower) than interest rates for short-term loans from commercial banks

to consider measures that the DFC might take to reduce dependence on government funds without any change in the interest rate structure. Implementation of these techniques will absorb scarce managerial resources and diminish the financial spread available to DFCs. In this sense, the adoption of these techniques competes with measures aimed at expanding the auxiliary services and promotional activities of the DFC. How this conflict should be resolved will depend on the specific circumstances in each case.

(i) Share Capital Expansion

27. Shareholders of DFCs have earned a rate of return that compares favprably with what is available on other financial investments in the country, taking account of risk differentials. ICICI has earned a net profit after tax at an average rate of 12.3% of equity in the last four years. This compares favorably with the average profitability (11% on share capital) of 158 companies in which ICICI has an equity investment and with the average dividend yield on preference shares in India (9-10%). The comparable rate of profit of ICICI's 543 clients was 10.8% in 1969/70 and 12.6% in 1970/71. TSKB has earned an after tax return of 17.4% on equity during 1968-1971, compared to 14% earned by its 245 clients. The return on TSKB's portfolio of equity investments is also 14%. KDFC has earned an average after tax return of 19.6% on equity during the first four years since its establishment. Interest rates in Korea have been falling rapidly during this period, from about 26% to 15%, and KDFC's shareholders appear to be satisfied with their earnings rate.

28. The rate of return on equity and the stability of the dividend yield make DFC equity quite attractive to financial investors, especially in view of the small supply of good equity in the capital markets of most developing countries. Indeed, many DFCs have exploited this situation to obtain sizeable increases in

capital, thereby alleviating shortages of domestic funds. For instance, TSKB has been able to increase its equity base by an average of 17% per year over the last 16 years.

29. The ceiling on lending rates, however, does place a limit on the potential expansion of equity. Since the required yield on equity capital is higher than interest rates on government loans or on foreign debt, an increased reliance on equity raises the average cost of capital for the DFC unless it can also raise low cost debt at the same time. The benefit of the high spread between the lending rate and low interest rates on government loans has to be distributed over a larger amount of share capital. This makes increases in share capital undesirable to existing shareholders. This reluctance is reinforced if increases in share capital also mean increases in the number of shareholders. Control of ownership is cherished because it gives power over the lending activities of DFCs. Where government policy holds the DFC lending rate at artificially low levels, the power of ownership is even greater because lending carries with it a subsidy to the borrower.

30. Under these circumstances, it is no wonder that existing shareholders are reluctant to exploit fully possibilities of raising more resources by issuing more share capital. Where shareholders are industrialists who are themselves in need of long-term finance for investment, as in KDFC, the conflict is most obvious. Where shareholders are financial institutions, as in TSKB, the conflict is less severe but may not be altogether absent. To offset these tendencies, the Bank has emphasized the need to expand the equity base of DFCs and this should be continued. It may be useful also to devise criteria for evaluating the structure of DFC ownership and the role played by different interest groups.

(ii) Negative Spread Borrowing

31. A DFC can increase its long-term, domestic currency resources despite the constraints imposed by the interest rate structure if it is willing to borrow at an interest rate higher than its lending rate. Obviously, this will reduce profits but increase the supply of long-term funds to sub-borrowers. It can only be undertaken to a limited extent, depending on the necessary negative spread and the reduction in the rate of profit that shareholders are willing to tolerate. For instance, the concessional element available in existing loans could have been used by TSKB to borrow an estimated TL 160 million in 1972, a 23% increase in its domestic currency resources (including equity and quasiy-equity). TSKB's shareholders would have continued to earn the rate of return that they had over the period 1950-1972.

(iii) Underwriting Securities

32. The DFC can guarantee and underwrite the issue of bonds by sub-borrowers as a substitute for direct loans. The advantage of this approach is that it does not absorb any debt resources of the DFC and yet performs a very useful and innovative intermediation function, providing sub-borrowers with funds. The scope for bond guarantees is not affected by any restriction on the DFC lending rate and can be successful even in relatively undeveloped capital markets, although it could also be subject to government regulation. Where the stock market is better developed, there may also be some scope for underwriting new issues of share capital. Both ICICI and TSKB have used this technique with considerable benefit to their clients. KDFC played a vital role in establishing an investment finance corporation in Korea (KIFC) which aims at facilitating the marketing of corporate financial instruments. However, KDFC

has been reluctant to start underwriting activities for a variety of reasons; one of them being a fear that its own scarce domestic currency resources would be consumed if the issue was not taken up by the public.

(iv) Indirect Mobilization

33. DFCs have tended to finance the entire foreign exchange cost of projects but only a small proportion of the local currency component. The DFC can insist that a high proportion of the local currency expenses of an investment is financed by the sub-borrower from his own funds. This increases the total amount of funds over which the DFC exercises some influence. One cannot say with much assurance that aggregate savings or even aggregate financial savings in the economy will increase as a result of such action. By encouraging self-finance of investment, the allocative function of the capital market is by-passed and too rigid an adherence to such criteria may have the harmful effect of turning away good projects because the entrepreneur is not rich enough. Applied with discretion, the policy can be beneficial. A study of 30 clients of KDFC showed that KDFC's insistence on additional share capital led to an increase of at least 1 billion won above that originally proposed by project sponsors, compared to the 4.8 billion won of KDFC's direct commitment to these same borrowers.

(v) Linked Debentures

34. When foreign exchange is scarce, the DFC can exploit its market power by requiring sub-borrowers to lend domestic currency to it in return for a foreign exchange loan. This is exactly the same as a commercial bank requiring compensating deposits from a customer. This arrangement is a technically feasible way of increasing domestic resource mobilization in an environment where more conventional methods do not yield adequate results. If consistently applied, this scheme will not only provide the DFC with domestic funds but can also reduce distortions caused by an over-valued exchange rate.

C. Foreign Borrowing

35. Dependence on a single source for foreign funds may injure the health and stability of a DFC. Apart from uncertainties resulting from possible changes in creditor policy, official loans are frequently tied to specific sources for procurement. Diversifying loans from bilateral sources, therefore, has the immediate benefit of increasing the purchase options available to sub-borrowers. However, diversification may also impose costs on the DFC. Different creditors may have conflicting requirements regarding appraisal techniques and loan administration. The need to negotiate with many creditors may lead both to higher administrative expenses and longer delays. In encouraging diversification, account must be taken of these costs and benefits. An additional consideration is government's desire to "manage" access to various official, foreign aid agencies. For example, KDFC was discouraged from seeking loans from the Japanese Government and the Asian Development Bank as the Korean Government had earmarked these sources for other purposes.

36. Additional opportunities for diversifying sources of foreign borrowing arise from the increased availability of funds in the Euro-currency market for those development finance companies which,

(i) are mature, have established an international reputation and can raise funds commercially from international lenders,

(ii) can tolerate increased borrowing costs without jeopardizing developmentally important intermediary services, and consistently with acceptable profitability,

(iii) operate in economies whose balance of payments and debt servicing capacity prospects do not rule out resorting to international borrowing on a commercial basis.

37. Private foreign loans are more expensive than official loans, and some special benefit must be perceived before they are encouraged. Unlike domestic private borrowing, private overseas borrowing by the DFC does nothing to help the domestic capital market. It is justified only when the country's balance of payments prospects are good, especially if the DFC cannot meet its foreign exchange requirements from official sources.

38. Foreign private borrowing is usually available only for short to medium-term maturities and sometimes only at a variable interest rate, expressed as a fixed premium on a specified money market rate in a developed country. The maturity problem can be relieved by blending private loans with longer term lending by IFC or the Bank so that the DFC does not face a severe amortization problem. Where the loan is at a variable interest rate, the interest rate risk is best borne by the DFC,with a compensating higher lending rate (if permissible by government regulation).

Table 4: ECONOMIC AND FINANCIAL RETURNS ON DFC PROJECTS - IN TERMS OF SHARE OF INVESTMENT /a

Rates of Return (%)	Economic (%)			Financial (%)		
	TSKB Turkey	KDFC Korea	ICICI India	TSKB Turkey	KDFC Korea	ICICI India
Negative to 0	23.5	42.8	11.3	0.0	2.6	0.0
0.1 to 10	27.4	0.0	9.5	18.6	0.0	25.5
10.1 to 30	30.0	3.0	68.7	62.8	46.4	62.2
30.1 plus	19.1	54.2	10.5	18.6	51.0	12.3
Total	100.0	100.0	100.0	100.0	100.0	100.0

/a The figures in the body of the table represent the share of total project investment in the three samples in each of the four groupings.

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CONFIDENTIAL

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

POLICY REVIEW COMMITTEE

PRC/M/73-9a

November 12, 1973

"THE WORLD BANK AND DEVELOPMENT FINANCE COMPANIES"
MINUTES OF STAFF REVIEW

Attendance: Messrs. Stern (Chairman), Diamond, Fuchs, Gulhati, Gustafson, Haq, Knox, Mathew, Qureshi, van der Tak, Votaw, Willoughby, Dosik, Hattori, Hughes, Humphrey, Nowicki, Pollan, Wood, Vibert (Secretary).

1. A staff level PRC review was held on October 31, to discuss the paper "the World Bank and Development Finance Companies" prepared by the Development Economics Department.

2. There was widespread criticism of the analysis and conclusions of the paper as well as the way in which the arguments were presented. Among the comments made on the analysis were the following;

: the distinction made in the paper between the so-called "persuasion" and "control" approach was artificial;

: the analysis was based on case studies of three DFCs and more caution should be shown in generalising from the results;

: the analysis should be more evenly balanced and assess the achievements of DFCs as well as their shortcomings;

: the analysis should take more account of recently created DFCs which are different from the earlier DFCs;

: the analysis should be placed in the context of the general Bank aims in the industrial sector of a particular country of which lending to DFCs is only one aspect.

3. As far as the conclusions and recommendations of this paper were concerned, the meeting argued against trying to generalise recommendations across all DFCs. DFCs serve different purposes in different countries. In particular, it was felt that the case studies on which the paper was based, as well as the case studies in the Operations Evaluation Department report, did not support any general conclusion that "the Bank should carry out a reform of existing DFCs". Thus, with regard to the recommendation that DFCs should emphasise small entrepreneurs,

it was suggested that in some cases different institutions may be needed for this purpose rather than trying to adjust existing DFCs which in many cases were purposely designed to meet the needs of middle or large sized enterprises which also had financing requirements. Different institutions were needed at different levels of industrialisation of developing countries.

4. While both the Operations Evaluation Department report and the policy paper being discussed were agreed in advocating a more promotional role for DFCs, this had led the Operations Evaluation report to be not unduly concerned by the access of DFCs to domestic sources of concessional finance. Such finance might be necessary for the DFCs to carry out a promotional role. Thus the recommendation in the paper under review that DFC dependence on concessional finance be reduced was not generally accepted. In addition, it was suggested that the recommendation that DFCs improve the design and appraisal of projects from the point of view of their economic justification was given undue emphasis. A more pertinent observation was with regard to the need for the Bank to scrutinise DFC strategic objectives in the economy including the degree to which the DFC should be integrated into the general financial structure of the economy. It was suggested that clearer Bank and DFC focus on these broader aspects would result in a strengthening of the economic justification of their lending at the project level. If this broader approach were accepted the Bank would need to pay more attention in future to influencing the broad policy framework set by government policies.

Frank Vibert
Acting Secretary
Policy Review Committee

Cleared with and cc: Mr. Stern

cc: Those listed above
Policy Review Committee Members