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Operational - Development Banks - Essays on Policy and Operations

BNDE/MIT JOINT DEVELOPMENT BANK TRAINING  
AND RESEARCH PROJECT

OBSERVING MANAGEMENT STRENGTH IN  
DEVELOPMENT FINANCE INSTITUTIONS

by

George Farris, Dan Nyhart  
Jack Rockart, Fabio Erber

GTM BNDE/MIT WP 13

GRUPO DE TRABALHO MISTO

WORKING PAPER

BANCO NACIONAL DO DESENVOLVIMENTO ECONOMICO  
MASSACHUSETTS INSTITUTE OF TECHNOLOGY

The Grupo de Trabalho Misto is the working entity carrying on the goals of the BNDE/MIT Joint Development Bank Training and Research Project. The Project was created in 1967 with the support of a Ford Foundation grant. It is providing training, technical assistance, and action research designed to increase the capability of development finance institutions serving as BNDE financial agents in Brazil. The members of the Grupo de Trabalho Misto are:

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is obtained from everyone on questions which have been chosen as important to ask.

Written questionnaires are usually the most systematic and structured way of gathering information about characteristics of an ongoing social system. Typically, not only are specific questions asked, but also the kind of answer a person can give is also restricted. For example, a person asked, "How involved are you in your work?", is likely to average his feelings of involvement over a period of time and report them on a scale ranging from "not very involved" to "completely involved." He is not able to say that he feels very involved every day but Friday, when his anticipation of the weekend diminishes his involvement to nil. While questionnaires restrict the number of things you can ask about, they have the great advantage of providing quantitative information on factors deemed to be important. Such quantitative information is readily subjectible to statistical analyses in order to determine the range of answers, the relationships of answers to various questions (for example: salary and satisfaction), and the significance or importance of a particular factor.

Questionnaires can and should ask about factors which we expect to change during the course of the project. For example, we probably would predict improved communication between the member banks and BNDE, a greater acceptance of modified BNDE procedures, and a feeling of greater influence on BNDE by the members of the regional banks.

#### Suggested Procedure in Visits

1. Use the basic questionnaire. We urge that the basic pencil and paper questionnaire be applied wherever possible by the field teams when they visit banks. The basic questionnaire will provide more pre-

cise information on factors which are obtained than the less precise manner in the observations and questioning. The factors include such things as communication, motivation, influence patterns, control procedures, and ideas about the development banker. This more precise information obtained from the basic questionnaire will allow comparisons to be made on identical questions between the various regional banks which are visited. Comparisons can also be made with other organizations within Brazil and outside the country, including organizations in which the factors studied have been related to effective operations. It is suggested that two questionnaires be administered fairly late in the visit after trust has developed between members of the regional banks and the visitors.

2. Complete the Profile of Organizational Characteristics. This one-page profile provides a fast, convenient way to record observations of management characteristics.. See Appendix A.

3. Use the List of Questions as a guide. A number of specific suggestions for points to observe or ask are listed in Appendix B. They are useful in helping the observer learn about management characteristics, and they provide examples of ways to learn about the areas on the Profile in Appendix A.

4. Study the stated and real decision-making procedures in a particular case. In addition to the use of these techniques, a fairly intensive study of a particular case should be conducted and followed by flow-charting of the case and questions about the actual encounters among the various decision-makers involved. From a relatively full understanding of a particular case, a better understanding of the organization's decision-making processes, goal setting, communications, in-

fluence patterns, motivation, and leadership processes can be obtained.

It is suggested that the person visiting the organization read the Profile (Appendix A) and the questions (Appendix B) before the visit to familiarize himself with the important areas in which to seek information and possible ways of obtaining this information. He should talk to people about the bank, study a case, and administer the basic questionnaire. At the close of the visit, he should complete the Organizational Profile with his best estimate of the answers to each of the questions and record any observations he feels are of particular importance.



# Appendix A

## PROFILE OF ORGANIZATIONAL CHARACTERISTICS

	SYSTEM 1	SYSTEM 2	SYSTEM 3	SYSTEM 4	Item no.
LEADERSHIP	None	Condescending	Substantial	Complete	1
	How much confidence is shown in subordinates?				
	Not at all	Not very	Rather free	Fully free	2
	How free do they feel to talk to superiors about job?				
MOTIVATION	Seldom	Sometimes	Usually	Always	3
	Are subordinates' ideas sought and used, if worthy?				
	1, 2, 3, occasionally 4	4, some 3	4, some 3 and 5	5, 4, based on group	4
	Is predominant use made of 1 fear, 2 threats, 3 punishment, 4 rewards, 5 involvement?				
COMMUNICATION	Mostly at top	Top and middle	Fairly general	At all levels	5
	Where is responsibility felt for achieving organization's goals?				
	None	Little	Some	Great deal	6
	How much cooperative teamwork exists?				
DECISIONS	Downward	Mostly downward	Down and up	Down, up, and sideways	7
	What is the direction of information flow?				
	With suspicion	Possibly with suspicion	With caution	With a receptive mind	8
	How is downward communication accepted?				
GOALS	Often wrong	Censored for the boss	Limited accuracy	Accurate	9
	How accurate is upward communication?				
	Know little	Some knowledge	Quite well	Very well	10
	How well do superiors know problems faced by subordinates?				
CONTROL	Mostly at top	Policy at top, some delegation	Broad policy at top, more delegation	Throughout but well integrated	11
	At what level are decisions made?				
	Not at all	Occasionally consulted	Generally consulted	Fully involved	12
	Are subordinates involved in decisions related to their work?				
CONTROL	Nothing, often weakens it	Relatively little	Some contribution	Substantial contribution	13
	What does decision-making process contribute to motivation?				
	Orders issued	Orders, some comments invited	After discussion, by orders	By group action (except in crisis)	14
	How are organizational goals established?				
CONTROL	Strong resistance	Moderate resistance	Some resistance at times	Little or none	15
	How much covert resistance to goals is present?				
	Highly at top	Relatively highly at top	Moderate delegation to lower levels	Quite widely shared	16
	How concentrated are review and control functions?				
CONTROL	Yes	Usually	Sometimes	No----same goals as formal	17
	Is there an informal organization resisting the formal one?				
	Policing, punishment	Reward and punishment	Reward, some self-guidance	Self-guidance, problem-solving	18
	What are cost, productivity, and other control data used for?				

## Appendix B

### Suggested Questions and Observations

#### LEADERSHIP

1. How much of the time is management actually at the bank?  
-- Full? Half?  
-- How many other activities are they engaged in?
2. Do managers demonstrate personal knowledge of the technicians' names, backgrounds, family situation, etc.?
3. Are successors being trained or readied for each top management post?
4. Does top management recognize its problems? Do they articulate them to you?
5. Do people underneath speak well of their bosses?
6. What do outsiders think of the management?
7. Does management appear to anticipate problems, as opposed to react to crises?
8. How long has management been there, how long are they going to be there?
9. Does top management understand where and who its potential entrepreneur-borrowers are? Is it making plans to reach these entrepreneurs? Can they produce hard data, e.g., surveys, etc., as to their market?
10. Does the team get a feeling that top management has an awareness of the real forces at work in the organization?

#### MOTIVATION

1. Ask interviewees to relate especially satisfying and dissatisfying experiences they have had in the bank.
2. Ask people if they think they are contributing as much as they could be contributing to the overall work of the bank.
3. Check on the turnover rate. Has anybody been fired in the last year?

One reason for asking this question is that turnover up to a certain point indicates both that the management is constantly trying to upgrade the personnel and that it also is in a position to clear out deadwood. This practice in turn frequently increases the motivation and the esprit of the workers, who do stay as part of the continuing organization. Other possible reasons for turnover are dissatisfaction with bad management and better opportunities in other institutions. The team will need to distinguish among forces.

## COMMUNICATIONS

1. Nature and frequency of meetings between management and technical levels.
  - a. For what kinds of purposes are meetings called?  
For example, to exchange information, to make decision, to announce decisions, to solve problems.  
(Team ought to try to answer these questions by either following the course of a project through its file or by asking direct questions of the people they are interviewing.)
  - b. Is there a high degree of informal communication, facilitated by such things as technicians working together in the same room, apparent easy access of subordinates to superiors' offices, social contacts outside working hours?
  - c. Who is involved in the meetings?
  - d. How much preparation is there for the different meetings?

2. Communications among peers and between subordinates and superiors.  
(The following questions should be asked regarding both the communications between subordinates and superiors, and among people at the same level.)

- a. Frequency?
- b. Who initiates?
- c. How hard are the people to see?
- d. What is the degree of openness and trust in these communications?

Things to look for:

Team can ask different people the same question in order to check accuracy of communications.

Where are the meetings held? Where do people talk?

Do parties put on a coat or otherwise change demeanor when dealing with a superior as opposed to dealing with a peer?

Do parties go through secretaries when dealing with each other and with superiors?

How much is the telephone used for communications?

What are the different forms of written communication?

How much is face-to-face communication used as opposed to written or telephone communication?

3. In general, compare the communication styles between peers and between different levels.

4. Are corrective processes established and used, bringing actual progress in line with what is desired?
5. Are the best people in the best jobs? It is frequently a sign of bad management if good people are in bad jobs.

### INFLUENCE

The project team should try to find out who really has influence and power within the institution. What is the relative influence or power of the technical level, the department heads, the directors, the president? The following suggestions provide some ideas for getting at this.

1. Who talks to whom, how often? Do a sociometric diagram. That is a diagram showing the frequency with which different people talk to each other.
2. How do procedures for project evaluation get changed? In other words, what is the process by which existing procedures are changed? Do the technical level have any say in effecting changes within the bank?
3. Where and when does the bank really decide on a project? Before the appraisal is even started? Before it is completed? At the technical level? At the department head level? Etc.
4. Who signs the processes at the different levels and how much work does he do in the process of signing?  
How often does he:
  - a. Check with the man below?
  - b. Disagree or reject the decision of the man below?How much time does the process stay at each level?

DRAFT  
WDiamond  
July 31, 1967

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Some Aspects of Policy and Operation  
of  
Development Finance Companies

Six Essays and An Address

by

E. T. Kuiper, Douglas Gustafson, P.M. Mathew and David Grenier

With an Introduction and Notes by William Diamond

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## Introduction

In October 1965, the chief executives (or their deputies) of 18 development finance companies met at the headquarters of the World Bank in Washington. Together with a few staff members and consultants of the International Finance Corporation, they spent three days discussing in depth some of the specific and difficult problems they meet in managing the institutions they head.

This was not the first Conference of Development Finance Companies sponsored by the World Bank group. The first occurred in May 1958. In the interval of more than seven years, the number of development finance companies financed by the World Bank group grew from 5 to 21; its financial involvement in them grew from \$43 million to \$445 million; the impact of the older of the institutions on the economies of the countries in which they operate became evident and widely acknowledged.

Unlike the 1958 meeting, the 1965 Conference was limited to the 21 companies financed by the World Bank and the IFC.<sup>1/</sup> Several of the 21 had been promoted by the Bank or the IFC, and bore the imprint of common parenthood; all of them had received some finance from the Group and thus had to have an outlook and a policy congenial to it. As a result, the companies invited, although widely different in many ways, shared a common philosophy and often a common financial structure and policy, which made it easier to sit down together to discuss common problems. The Conference of 1965 was thus a family affair, as the Conference of 1958 was not.

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<sup>1/</sup> There are now, in mid-1967, 25 of them.

The familial character of the companies, reflected in similarities of outlook, rested on two underlying facts: All of them were established to promote and to finance the expansion of private economic activity; and they were set up as shareholder-owned and -controlled finance companies. These two facts imposed upon each of the institutions the necessity of operating on the basis of financial, economic and technical criteria rather than on the basis of political criteria. And they imposed the discipline of having to operate in a prudent and profitable way, so as to promise shareholders a reasonable return on their investment. This is a vitally important discipline which, more than any other single factor, is responsible for such success and effectiveness as the institutions have had.

Of the 21 institutions invited to the Conference, 18 came. Four came from Europe (from Finland, Spain, Austria, Turkey); four, from Africa (from Morocco, the Ivory Coast, Liberia, Nigeria); four, from Latin America (three from Colombia and one from Venezuela); and six, from Asia (from China, India, Iran, Israel, Pakistan, the Philippines). Of the 18 institutions, only three existed when the 1958 Conference took place, and only the Industrial Development Bank of Turkey and the Pakistan Industrial Credit and Investment Corporation participated in it.

The representatives of these institutions were all top executives: Presidents, Vice Presidents, Managing Directors, General Managers or their Deputies. In addition, the four men who represent IFC on the Boards of several development finance companies also participated in the Conference. The level of participation assured



a fruitful discussion by persons able to speak authoritatively on the problems and policies of the institutions they represented.

The Agenda of the Conference was drawn up in consultation with the development finance companies associated with the World Bank group, and reflected their specific and immediate concerns. It is remarkable, but not surprising, how common those concerns are. Whether in Finland or in Thailand, in Pakistan, Spain or Colombia, boards and managements struggle with questions involving the promotional and entrepreneurial role of their companies; with the problems of establishing a constructive relationship with the enterprises they promote or finance; with such difficult questions of financial policy as how much to borrow in relation to equity, and how much of profits to pay out as dividends and how much to retain in the company; with the task of resisting governmental pressure yet being sufficiently responsive to governmental policy to justify the official financial support without which most companies would not have the resources to do their jobs; with developing an effective staff. Not all companies are troubled by all these problems; those that are, are affected to differing extents. Yet the overwhelming majority of them placed these problems, issues, questions and tasks at, or near, the top of the subjects that cause them the greatest concern.

The discussion was too diverse and too complex to be susceptible to summarization or synthesis, certainly not in a way which would do justice to its range and flavor. Conclusions were not reached. It would, indeed, have been impossible to do so, for the

time available was too short to exhaust the flow of ideas, and the subjects were not in any event of the kind where discussion could lead to concrete conclusions. The participants in the Conference did not expect to receive answers to the problems they faced or to the questions they asked; they sought, and hopefully found, some enlightenment from the experience of others, which could be helpful in finding their own answers and new approaches to their problems.

One clear consensus did, however, emerge from the Conference. The problems faced by the 18 companies were complex and diverse, reflecting the differing size, history, resources and state of economic development of the 16 countries in which they were located. Nevertheless, although details differed, there was substantial similarity in the basic problems they faced. The difference in details and the widely different environments suggested that similar problems would have to be dealt with in many varying ways and would find varying solutions from one country to the next. At the very least, the exchange of views on many questions sharpened the questions themselves, suggested options not previously thought of, and thus opened the way to useful solutions tailored to the particular situation of each of the companies represented.

It is not possible, unfortunately, to make available to other development finance companies and to a wider public the experiences laid out and the views expressed at the Conference. It was fundamental to the usefulness of the discussion that the participants speak frankly, and this was possible only in the knowledge that the discussion would be confidential.

In place of "proceedings", there is presented here an essay on each of six subjects discussed at the Conference.<sup>1/</sup> It is a personal essay, the work of its individual author, reflecting his views. Perhaps no participant in the Conference would find himself in full agreement with all the views expressed in the essay. Nevertheless each essay has been written by a person with experience in the work of development finance companies, who participated in the Conference or who observed it, and who has had the opportunity to reflect on the discussion that took place. In addition, an address by one of the essayists has been included, which he delivered at a luncheon attended by the participants and by the Boards and senior staff of the World Bank group.

All the essayists are associated with the World Bank group. E. T. Kuiper has been associated with it, in one capacity or another, for a decade and has been involved in investment banking for an even longer time. He has been chief executive of the Industrial Bank of Indonesia, the Pakistan Industrial Credit and Investment Corporation, the Development Bank of Ethiopia and Malaysian Industrial Development Finance Limited. He has taken on various special assignments for the World Bank group and now represents the IFC on the boards of directors of development finance companies in Greece, Morocco and Tunisia.

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<sup>1/</sup> One item on the Agenda, the training of personnel and the use of expatriate staff, was not discussed because of shortage of time.

P.M. Mathew has been a staff member of the staff of the IFC since 1962 and is now Deputy Director of the Development Finance Companies Department. Douglas Gustafson is also a member of the staff of the IFC. Both men have had advisory assignments with development finance companies in Nigeria. David Grenier was a staff member of IFC until 1967.

William Diamond

August 1967

THE PROMOTIONAL ROLE OF A DEVELOPMENT

FINANCE COMPANY

[all in italics]

Note:

The first subject on the Agenda of the Conference concerned promotional activity. The provision of capital is the hard core of the function of a development finance company. Does it have an entrepreneurial role to play, as well as a financial one? What are the circumstances and the ways in which a development finance company can appropriately and prudently take the initiative and the leadership in conceiving and fashioning proposals for new enterprises, organizing the finance for them, and carrying them out? What are the costs and risks of such activity?

A variety of views were expressed on these questions, views which tended in general to reflect the level of economic development in the country concerned. Those who were most reluctant to take the lead in promoting enterprises were from countries in which there was already a large and

active entrepreneurial class, while those that stressed most vigorously the need for promotional activity came from countries where investment opportunities existed but where entrepreneurs to grasp these opportunities were conspicuously absent or were hard to convince of the merits of new proposals in new fields.

Yet even the managers of companies in the more underdeveloped countries considered that the primary function of their institutions was to provide finance and to organize the provision of finance. There was a general reluctance to take the primary responsibility for the formulation and execution of a project and an awareness of the moral as well as financial risks involved, of the danger of spreading staff capacities too thinly, and of the seductive effects of promotion on staff, which tended to find promotion much more exciting than the more pedestrian activity of appraising the projects of applicants. Some criteria emerged from the discussion, to cope with these risks and dangers. For instance, promotion should be undertaken only in industries which are of national importance and should involve operations which were large enough to make the considerable risks worthwhile.

Mr. N.M. Uquaili, then Managing Director of the Pakistan Industrial Credit and Investment Corporation, and now Finance Minister of Pakistan, chaired the discussion of promotional activity. In summing up his reaction to the discussion, he said that the main functions of development finance companies, with respect to promotion, were to suggest improvements in projects submitted to them for approval, to assist in finding technical and entrepreneurial partners, to assist in finding funds for large projects, to arrange for the preparation both of industrial surveys and of feasibility

studies for specific projects, and to make equity investments and carry out underwriting operations and thereby attract other private investors. Since development finance companies were primarily financial institutions, their promotional role had to be limited. But sometimes the objective situation called for promotional activity. The cost should be borne by the sponsors of the project which emerged from the promotion, that is by the new enterprise itself, although such expenses might also be shared by development finance companies, national governments and friendly foreign governments.



- 11 -

An Essay on Promotional Activity, by E.T. Kuiper

What is Promotion?

One of the primary responsibilities of a banker is concern for security and interest margins. He is expected to be conservative and to look with a certain suspicion on untried ideas. A development finance company, on the other hand, must create for itself the image of an activist institution, interested in development and unafraid of change and fully aware that there can be no development without new ideas. This approach involves the development finance company in a variety of activities which may be bundled together under the name of "promotion".

In looking at applications for finance, a banker will not look only at security and the creditworthiness of the sponsor. He will look primarily at the project, and will try to suggest improvements in it. This is the minimum activity that falls under the name of promotion. At the other end of the spectrum, maximal promotional activity involves a development finance company in a project from its conception; in the extreme case, the development finance company originates the idea, transforms it into a financeable project, perhaps with the help of consultants, arranges the financing, organizes the company and, if only for a time, manages the new enterprise.

Between their minimum and maximum roles, there is a wide range of possibilities, of promotional activities which a development finance company can undertake. Among them are:

- (1) arranging for general industrial surveys and feasibility studies for special projects;

- (2) formulating specific proposals for new enterprises;
- (3) assisting in finding technical and entrepreneurial partners for local clients or for foreign investors;
- (4) investing in share capital and underwriting securities, in order to attract other investors;
- (5) arranging mergers, in order to create more economic industrial units;
- (6) developing a capital market by trying to broaden ownership and by other devices; and
- (7) encouraging the acceptance of new ideas in the economic sector.

Development finance companies are, of course, not the only promoters in the underdeveloped countries. They should always realize that their activities are part of a general urge to change a stagnant situation, and their activities should be coordinated with those of other institutions and individuals (and the government) devoted to the same end.

#### How Does a Promotor Work?

How does a promotor, whether private individual, development finance company, government agency, or business enterprise, go about "promoting"?

The promotor will first identify a project that appeals to him, perhaps the manufacture within the country of an article currently imported or the processing for export of a primary product that presently leaves the country as a raw material. He will next formulate the project; he will make studies to establish the economic, financial and technical feasibility of the venture. The studies must answer the following questions: Can we

produce it? Can we sell it? Can we make a profit? If a project of importance is involved, the promotor will - at this crucial stage in the project - almost always have to seek expert assistance. If the venture passes this critical stage of formulation, the promotor may then pass to the phase of initiation. In this stage, technical know-how is engaged, partners, agents and distributors are found, a capital structure is determined and technical plans are blueprinted. Finally, the project passes to the stage of execution; financing is arranged, sites are acquired, tenders are solicited, contracts are closed, machinery is ordered. And so forth.

Whether or not he is aware of it, every entrepreneur goes through these stages in preparing and executing a new venture. And whether or not he is aware of it, every banker, in considering an application, systematizes his investigation along somewhat similar lines.

A development finance company may contribute to the success of a venture at any one of these stages of project development. In the initial stage of identification, it may have a broader or more balanced perspective than the individual entrepreneur can have of the practicability of an idea, or it may be better equipped to carry out a market survey at home or abroad. During the crucial stage of project formulation, the development finance company may have better access, through its international contacts, than the entrepreneur to more reliable information and to expert consultants abroad. Previous experience in project appraisal and international contacts can also be of crucial importance in the more advanced stages of project initiation and execution.

While a development banker will be the first to admit that he has learned much of his business from his client, his client will concede that

he owes more than capital to his banker. There is only a thin line between "financing only" and "promotion". For effective appraisal involves a careful scrutiny of each of the factors involved in promotion. Moreover every project for which financing is sought must be reviewed from the point of view of economic development, because ventures that do not in some way contribute to the growth of the economy will, in a dynamic situation, sooner or later prove to be bad projects from a financial point of view. It is therefore essential that the development banker keep an eye on future prospects in a growing economy. The difference between assuming long-term financial commitments, on the one hand, and promoting, on the other, reflects mainly the development finance company's degree of initiative and the margin of risk it is willing to assume. Of course, it is the profitability of the project itself that determines whether or not a "secured" loan will, in the long run, prove more or less risky than an investment in survey and research or an equity investment. Trust in tangible assets as "security" for loans and for equity is more deeply rooted than justified.

#### Why Should a Development Finance Company Engage in Promotional Activities?

If "promotion" is broadly defined, it will be difficult to find a development finance company that does not engage in some form of promotion. But promotion by development finance companies is a much rarer phenomenon if, as is customary, one regards it as taking the initiative for arranging general industrial or agricultural surveys or feasibility studies for particular projects, formulating the venture itself and capitalizing an enterprise - in short, when the development finance company does not limit itself to stimulating others but itself assumes entrepreneurial functions. When we view promotion in this light, the question should not be "Why does a

development finance company engage in promotional activities?" but rather "When is a development finance company inclined or bound to do so?" Both attitudes appear among development bankers.

One development finance company associated with the World Bank group was organized after World War II to assist in the rehabilitation of a country with an impressive pre-war industrial history, which had greatly suffered from the War. This development finance company felt no need to engage in promotion, for the simple reason that the country had an ample supply of entrepreneurial talent and of technical and commercial experience. The company was kept fully engaged in investigating interesting and ready projects, and its principal problems were the recruitment and training of a staff capable of handling applications and finding the capital to satisfy all credit applicants.

Quite different is the case of another development finance company organized in the late fifties in a newly independent country with no industrial experience at all and with a small entrepreneurial class interested mainly in commerce and real estate. This finance company, which had a dynamic management, felt that it must supply the propulsive force. It therefore became the effective promoter, organizing surveys, engaging consultants and preparing projects that, for lack of outside interest, it financed fully or partly and, in many cases, staffed and managed. After some years of such activity, the management of the company justifiably felt that it had done something significant for the country. But the company was now suffering from its excess of zeal, because much of the institution's capital had been invested in the currently unsalable stock of industrial enterprises, some of which will eventually prosper, but others of which

may fail. The company is now in the process of reorganization, new capital is being injected and a new policy is being formulated.

Between these extremes there lies a whole range of variations in orientation and approach.

It is interesting to note that the attitudes of the development finance companies associated with the World Bank group toward promotional activities reflects the stage of economic development of their respective countries. The institutions most reluctant to engage in promotional activities are those in countries with a large and active entrepreneurial class. Although these companies do occasionally inform their clients of promising projects and advise on project preparation and possible improvements, their preoccupation is not with industrial promotion but rather with finding funds, stimulating the capital market, attracting foreign investment, and strengthening their staffs, in order to deal more effectively with their many applications.

The relatively passive role of the development finance companies in the more advanced of the underdeveloped countries is a phase of their history. After all, the largest, most active and most prosperous development finance companies are located in New York, London and Paris, where they play a vital role in arranging mergers, attracting international investment, financing the reorganization or modernization of existing enterprises and underwriting. The more economically advanced of the underdeveloped countries will in due course mature and their institutional structure will grow. As this happens, their development finance companies, which now concentrate on medium- and long-term lending and are reluctant to enter the promotional field, will begin to follow with increasing enthusiasm, the patterns of

activity of their counterparts in Europe and the United States. On the other hand, it is the development finance companies of countries with a shortage of entrepreneurs that stress the need for and the rewards from promotional activity. They rightly believe that, although they may have a sizable lending business, their countries have opportunities which neither local nor foreign businessmen are grasping. And they consider that one of their legitimate functions is to step into the breach. In doing so, they face many problems.

#### Ideas: the Beginning of Promotion

Although the general public usually regards development finance companies primarily as sources of financing, those who sponsor the establishment of such institutions - and national governments are prominent among the sponsors - are often convinced that it is developmental activities that should be stressed. Whatever the thought of the sponsors, the managements of development finance companies are inclined to feel that promotion is perhaps the most important, certainly the most difficult and often the most costly of all their operations.

There are, however, a number of so-called promotional activities that do not, in fact, involve a company in risk and may, for a time, have little direct effect on the profit and loss account. Such activities involve ideas - proposing new ideas.

All promoting starts with an idea. If a development finance company is development-oriented, it will constantly be coming up with new ideas. Such an orientation is more important for the success of a development finance company than the amount of capital at its disposal. For if a development finance company combines a dynamic approach with sound judgment

and persistent endeavor, the necessary capital is likely, in the long run, to be forthcoming provided, of course, that the opportunities for investment exist and that the political climate is favorable for economic growth.

Ideas for development may vary widely, and may be oriented toward government as well as toward private initiative. Once a development finance company has reached some conclusions about the appropriate direction for national economic development, it may approach the government with suggestions for projects that might be incorporated into the national plan or, if they are already in the plan, might be given a higher priority. Or it may come up with ideas on a more effective orientation of investment policy. It is true that many privately managed development finance companies have not found governmental planning authorities very receptive to their suggestions. Yet the counsel of others has been sought by governments on questions of investment codes, taxation, foreign exchange allotments and various financial matters; and unsolicited advice has sometimes been well received. There are no two countries in which the relationship between the government and a privately managed development finance company is identical. As will be noted in a later essay, a developmental orientation and successful operation are bound to result, sooner or later, in a fruitful and effective reciprocal relationship.

The real test, however, of the development finance company's effectiveness as a promoter of ideas lies in its contacts with private entrepreneurs, both foreign and domestic. Close and continuing contact with the private business community is crucial. A development banker who does not meet frequently with the community he serves is not in business; a man



without ideas for economic growth should not be the executive of a development finance company.

Through its day-to-day contact with the business community, a development finance company can make its knowledge and experience available to others, and bring them to bear on the investment proposals of others. A development finance company with good international connections is in a particularly advantageous position to bring the experience of other countries to bear upon the local situation. Since most development finance companies are located in countries which are relatively stagnant economically because of their traditional orientation to agriculture and to trade, the primary need is often, not for its capital, but for its ideas and for the new techniques of production and sales to which it can open its clients' minds.

A development finance company can help bring men who have new ideas or technical knowledge together with men who have capital; the two are not always found together. The function of negotiating such a marriage is particularly important in bringing foreign and domestic businessmen together. A development finance company should have a sound knowledge of the capabilities and limitations of various industries, in relationship to their market prospects. It may thus be in a favorable position to promote cooperation, coordination and mergers among enterprises in the same field, in order to take advantage of opportunities and situations of which the individual entrepreneur may not be aware, with advantage to the economy of the country. The only limit to the possibilities of a development finance company to promote new ideas is the availability of businessmen who can listen intelligently.

A development finance company can also act naturally and effectively as a liaison between the government generally and the national planning authorities in particular, on the one hand, and the investing community, on the other. The company can play an essentially pragmatic and common-sense role, choosing between projects that can be implemented at once because their profitability is assured and projects whose execution must be deferred until the economic situation evolves. In helping to coordinate the studies of the planning authorities with the decisions of businessmen, and to make the studies objective as well as realistic, and to relate the investment decisions to general economic objectives, the development finance company plays a critical role.

It should be noted again that none of these activities engages the finance of a development finance company. They engage, rather, its philosophy and the time of its management and staff. Development finance companies that cannot yet invest any funds in equity investment or do not yet have a margin of income for expenditure on surveys and research, can nevertheless be active and effective in influencing others, both government and private businessmen.

#### Backing Ideas with Capital

Promotion starts with the generation of ideas. It would be naive to think, however, that the catalytic function of a development finance company will go very far if the company is not prepared or is not in a position to back ideas with capital. The capital need not be its own. The development finance companies associated with the World Bank group have had a variety of experiences in putting up and in finding capital to support the ideas they have germinated.

If initial inquiries regarding the idea for a project suggest that systematic investigation will lead to concrete results, the development finance company must hire consultants to survey the field or to help formulate a specific financeable proposal - or drop the matter without further ado. Good consultants are neither cheap nor easy to find. A company's foreign and international shareholders and creditors, both of which are usually deeply interested in the welfare of the company, will be able to help find appropriate expertise. In some countries, governments have established funds to finance industrial surveys or project studies, to which development finance companies may have access. It has often also been possible to obtain grants from foreign governments, international agencies, foreign foundations and universities.

Because the development finance company is a profit-oriented institution, it can rarely afford to contribute substantially to such studies, even though it may have initiated them. It will be able, and prepared, to do so only if it can clearly visualize the prospect of recovering its outlay later on, in the process of executing the project. Such a prospect is more likely if the study or survey is narrowly focussed. A general economic survey is the least likely to pay off; a study of a specific project is the most hopeful. A survey of a range of projects in a particular field (such as the cement or sugar industry, wood-processing, or mechanical industry) falls somewhere between. The narrower the focus of a study, the more precisely directed it is to a specific project or to a clear-cut group of such projects, the better the possibility that a development finance company can usefully contribute to it from its specialized experience or from its financial resources. So restricted outlays for

research and study can sometimes prove fruitful and profitable, and in the process create attractive new investment possibilities and business clients for the development finance company.

Some Latin American development finance companies have sponsored "study funds". They have formed groups with other financiers and industrialists (especially foreign ones) for further study of a specific project or of an entire sector. The study group (or "promotion company", as it is often called) retains consultants and receives and considers all the pertinent information. If the studies are favorable, the members of the group either finance and carry out the project themselves, or sell the studies at a profit. In either case, the development finance company will have created a client.

It is characteristic of less developed countries that natural resources are insufficiently mapped and that possibilities for their exploitation and marketing have not been properly explored. Governments have the primary responsibility in this sector; but although many planning authorities make such studies with enthusiasm and diligence, they are rather general in character. The business community is occasionally disappointed with the results because it fails to find in "the plan" answers to its practical problems. This is not surprising, for planners must deal at a fairly general level and cannot readily put themselves in the position of the entrepreneur who must risk his capital on the basis of his assessment of a market.

Development finance companies can act as a link between the entrepreneurial class and the planners by translating the planners' ideas into the concrete specifics required by the entrepreneurs and into a

language the entrepreneurs understand. They are strategically placed to undertake this kind of promotional activity; this may well prove the most fruitful branch of the promotional tree for development finance companies.

#### Thoughts on the Promotion of New Companies

Development bankers would generally be content to restrict their promotion to the activities discussed thus far: advising, suggesting, helping locate technical and financial partners, arranging for general surveys and for the study of specific projects. Such a posture would enable a development finance company to exercise a helpful influence on the economy as a whole and on the company's applicants in particular, with benefit to the company's loan portfolio and without much financial risk. As a rule, however, such an attitude succeeds only in an environment that is well supplied with private entrepreneurial talent or in which the development finance company enjoys a virtual monopoly in the supply of foreign exchange for long-term capital investment in private industry. Such a situation, however, does not always exist. Where there is not a plentiful supply of entrepreneurs working to exploit investment opportunities and seeking capital to finance them and where the development finance company has no special advantages over competitive institutions, it must sooner or later wet its feet in the treacherous waters of company promotion.

The same may also be true of development finance companies more advantageously placed. One development finance company which has had 15 years of operation in a country with a good entrepreneurial environment and which has always had a position of strength in the financial field, has called attention to a cyclical movement in its promotional activities. During boom periods, it received so many applications for financing apparently

viable projects that it could not afford to spend time on promotion and found little need to do so. But in periods of relative depression, applications for loans fell substantially; and the company took up old files on development projects and opened new investigations. This company found that, in normal times and on the average, ten per cent of staff time was devoted to promoting new companies but that in slack times there was no such limit to the efforts staff could devote to such activities.

Other development finance companies, which feel unable to study new projects in present conditions of demand for their finance, may note this experience. A development finance company requires a skilled and experienced staff. It would be regrettable if this asset, created with so much difficulty and expense, were not kept in effective use in slack times.

Company promotion may be particularly important where a development finance company is not in a monopoly position. Some countries have several such companies. Often they are sponsors or co-sponsors of most of the important new undertakings in the countries concerned. There is a danger that not all may find sufficient business to build a sound organization and to make a profit. Yet, generally speaking, there is room in a developing country for all promotion-oriented financial institutions that prove themselves efficient; some competition among development finance companies so oriented stimulates industrial activity.

The classical approach is for a development finance company to begin with ordinary medium- and long-term loans. As its work proceeds, it considers other ways of financing, such as by convertible loans or debentures or equity investments. It then advances to the more complex forms of promotional activity, such as promoting companies independently. As the

staff becomes more experienced and as the portfolio of the development finance company is seasoned, there will be a more solid base for promotional work. In the newly emerging countries, however, many development finance companies cannot follow this classical pattern. The sponsors of the company may have been correct in assuming that there were favorable development opportunities and the company would have a capable staff. Nevertheless the flow of applications may be disappointing in the first years; in such circumstances, one must promote through "pump-priming". Unless the sponsors of the development finance company have made a serious mistake, there will be projects that can be studied by the staff; instead of learning from clients who have not appeared, the staff will learn its business by trial and error and through contacts with more experienced foreign companies.

It should be borne in mind that promotion is a long-term activity; many ideas and only partly studied investment possibilities may be re-studied in the light of new developments, as chances for attracting financing appear to have improved, or as the staff has more time to devote to the projects being promoted, rather than to those being offered.

It is a good rule for a development finance company that service to clients should normally take precedence over the company's own promotional activities and that when sufficiently knowledgeable businessmen show an interest in a project that has been promoted by the company for its own account, the company should share its findings with these entrepreneurs. Yet even development finance companies that follow this admirable counsel of self-denial cannot expect always to escape the charge that they are competing with the business community and neglecting the interests of their clients when they themselves take up promotional activities. In addition,

in every country there are business and political groups that resent any promotional activity by a development finance company because they suspect that funds and attention are being diverted from matters which interest them. Conversely, for example, in an ex-colonial country, one development finance company with overseas shareholders felt impelled to take the initiative in promoting new industrial ventures in order to dispel the impression that the company was a foreign organization.

When promoting new enterprises for their own account, development finance companies differ in one vital respect from the private entrepreneur. The individual businessman usually intends that he or his group shall own and control the venture for a long time to come, whereas development finance companies have no desire to create enterprises that they must control; they expect to divest themselves of ownership and control in due course and at a profit commensurate with the initial work and risk as well as with the performance and outlook of the enterprise created.

The role of a development finance company in stimulating the capital market will be discussed elsewhere. Suffice it to say here that the same type of activity may be required, and crucial, in company promotion.

The development finance companies that operate in countries in which a capital market already exists or is in the process of developing, find that they can assist in floating new industrial ventures by underwriting part of the share capital required for offering on the stock exchange. This, of course, can be done only when the development finance company is thoroughly acquainted with the project and is confident of its ultimate success. Thus, the development finance company becomes both a partner in the promotion and a co-sponsor of the project. In view of the



thinness of the capital market in underdeveloped countries, a development finance company engaging in an underwriting should be prepared to become a substantial investor; for it is more likely than not to be made to sell all of the securities it underwrites. A somewhat similar role is played by the financial institution that forms a syndicate or finds equity capital privately for a new venture; many development finance companies in developing countries perform a useful function in this manner. The exercise need not be limited to equity; the development finance company may prepare an over-all financial plan and use its connections and specialized knowledge to arrange a package deal to provide all the finance required for the project, in whatever form.

Foreign investors, as well as national governments, usually prefer a form of joint enterprise in which part of the equity is owned by nationals of the country in which the venture will operate. At the inception of a project, it is often difficult to interest local owners of capital; in these circumstances, a development finance company may, for some time, fill the gap. This has the added advantage of giving the foreign investor confidence that, during the sometimes difficult early years of his enterprise, his partner is not an uncertain and perhaps impatient group of individuals, but is rather a far-sighted institution of prestige.

In any group promotion, there is bound to develop among the partners a division of functions. Thus the technically more knowledgeable assume responsibility for ordering and installing machinery, commercial people prepare markets, while the development finance company draws up budgets, calculates costs, prices and cash flow, arranges financing and probably, in the end, underwrites not only medium- and long-term loans,

but also a substantial part of the equity risk. In several countries, the government has put a substantial amount of money under the management of privately owned and managed development finance companies in the form of an "equity fund", out of which equity participations in enterprises sponsored by the development finance companies could be financed in part. This may prove a very sound procedure and one of the best devices for a government that wants to stimulate economic growth and has decided against an increase in government-owned and government-managed enterprises. In many countries, as experience grows and the private sector becomes more competent and sophisticated, the policy of government has gradually shifted away from the wish to do everything itself and towards indicative planning and policy control, and towards encouraging private enterprise to carry out specific actual projects. Development finance companies may be instrumental in instigating this change in attitude and can offer their services in the process.

The extent to which a development finance company may assume the functions that are normally those of the individual entrepreneur depends on two factors, apart from the entrepreneurial environment and the presence of potential projects: capital structure and staff. So far as capital structure is concerned, promotion cannot prudently be carried out with borrowed funds. A substantial equity and a willingness to wait for a return on it, are vital if company promotion is to loom significantly in the activity of a development finance company. On the staff side, a development finance company will have to attract for its management and senior positions people who combine the alertness of the promotor with a prudent approach to commercial and financial problems. Common sense and the

wit to recognize what one does not know are more important for the financier than specialized knowledge. If a development finance company cannot attract a few people with these characteristics, it would be wise to abstain from the more advanced and risky promotional activities.

And if it can find such people, there is another type of risk. One of the dangers of promotion for a development finance company is that both management and staff may begin to find such satisfaction in promotional work that they may become overly involved. This may result in their doing too many promotional jobs, in a relative loss of objectivity, or in their favoring "pet projects", with possible adverse effects on the soundness of the ventures and consequent risks to the reputation of the development finance company. Experience suggests that the best way to avoid the danger of over-involvement is to associate others in the preparation and the execution of projects as soon as practicable.

#### Costs and Risks of Promotion

In the long run, the success or failure of the promotional efforts of a development finance company will be judged by its own Profit and Loss Account and its own Balance Sheet. There should be no misunderstanding about this. No development finance company strives to maximize its profits only in order to pay large dividends to shareholders or large bonuses for its directors. Since the lack of capital is one of the main impediments on the road to economic development, a loss of capital resources is always detrimental to progress. Financial institutions that cannot build up reserves, cannot declare reasonable dividends and cannot show promising profit prospects for the future, will be unable to attract capital and will therefore fail to pull their weight in the march forward. The crux of the

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matter is that development finance companies must try to combine profit-making with a developmental orientation.

The simple fact is that promotion is both costly and risky, and the management of a development finance company engaged in promotion must keep an ever-vigilant eye on both the costs and the risks.

The costs of promotion are, first, the salaries of personnel devoted to promotional work, plus part of the salaries of the executive staff, general office expenses, etc., and, secondly, out-of-pocket expenses for services supplied by consultants, travel, laboratory research, etc.

The costs of personnel are partly hidden and may therefore be higher than the development finance company realizes. Even if the project promoted is successful, it is often difficult to recover these costs from the sponsors who carry out the venture. But the older and more experienced development finance companies have learned they may not do too much work on a scheme unless they are confident that they will ultimately receive a fair return from the exercise, in the form of a profitable loan operation, underwriting commissions or an equity participation.

The costs of outside services can be more easily ascertained. They can readily be passed on in full to the client of the development finance company or, in the case of a new promotion, to the new company.

Many development finance companies receive substantial support in both categories of expense from their governments and sometimes from foreign aid funds. One such company associated with the World Bank group receives an annual grant from its government to cover a major portion of the salaries of specialized staff devoted to promotion. In general, such arrangements have worked fairly well and the governments have not attempted to exert undue

influence on the type of study undertaken or on the choice of entrepreneur for project implementation.

The costs of study and research may often run into high figures. But while the project is still under study, losses can be cut in time if the promotion shows no promise, and financial involvement may be limited if there is danger that the amount budgeted for the study will be exceeded. All the same, more than one development finance company has incurred losses in dead-end studies and has learned from the experience.

The major financial consequences of a promotion, whether favorable or unfavorable, derive not from the studies undertaken but from the equity investment in the project which the development finance company has decided to back. This is the real risk, even if the equity investment is camouflaged as a "secured loan". (In the case of a new enterprise, sponsored by persons new to the industrial field, there may be little difference between an investment in share capital and an investment in the form of a loan.) But such risks must be taken. They can be avoided, and should be, if studies backed up by business judgment suggest that the risks are not justified, but if everything has been done to establish and to strengthen the inherent soundness of a project, a development finance company may be more to blame for not showing the courage of its conviction than for taking a well-considered equity risk.

Taking such risks does not mean ignoring their existence. Most development finance companies have adopted policies to limit the size of each such equity risk (to a given percentage of net worth) and to limit their aggregate total (to net worth itself). Such a restriction helps safeguard the liquidity and viability of the development finance company. There may be justification for feeling that such investments in equity will, in due course, be profitable; but the time that is likely to elapse before dividends are paid and shares can

be sold may exceed the period for which the participating development finance company can afford to forego the income and lock up funds. Another useful device for restricting commitments is to avoid taking a controlling position in an enterprise. Such a posture could well result in additional financial exposure, and certainly have the effect of taking up management time.

The greatest non-financial risk of promotion is over-involvement, which has already been referred to. There is a conceptual parallel between financial liquidity on the one hand and, on the other, staff objectivity and flexibility. "Pet projects" often go wrong. Over-devotion to promotions may result in under-devotion to clients. Both may result in loss of the respect and confidence of the business community - without which a development finance company cannot survive. One manager of a development finance company associated with the World Bank family has said that the promotional action which caused him the greatest concern was the sale to the general public of shares in ventures he had promoted, without being able to guarantee that the shares would be profitable or that they would remain in strong and sympathetic hands. His personal sensitivity on these crucial issues was a more effective caution against the risks of promotion than any formal policy declaration could provide.

In general, there seems little doubt that in promotion one may incur considerable losses not only for a development finance company but also for its partners and for the public which it has enticed into investment. It is encouraging, however, that practically all the development finance companies associated with the World Bank group have thus far avoided most of the pitfalls, and some have done fairly well in the field and are confident of their ability to expand these operations in the future.

An Address on the Role of Development Finance Companies, by E.T. Kuiper

My experience with development finance companies is, in fact, rather limited, because I have worked in only four of them and studied the situation in respect of the problems connected with industrial finance in a few other countries. Many members of your staff have a much broader field of observation, because IFC and the Bank are now in constant touch with more than 20 development finance companies over the world. Yesterday and today I have been listening to presentations and discussions by my colleagues concerning the various aspects of principles and of techniques of our trade, and if I have learned anything, it is how great the variety of problems and solutions is and how general opinions are influenced by the experience gained under circumstances in specific countries. I do not doubt that, similarly, my own opinions are conditioned by the experience I had in Indonesia, Pakistan, Ethiopia and Malaysia, where I have been acting as chief executive of development finance companies and by the observations I made in the few Middle East countries which I visited to investigate the possibilities for industrial finance. My experience is not only limited geographically but also materially, because I have been mainly active in industrial finance and I specially value my term of office in Ethiopia, because as Managing Director of the Development Bank of Ethiopia I have been confronted with the challenge of agricultural development finance. I often wonder why there are not more development finance companies that specialize in the extension of financial assistance to the bigger farmers in African and Asian countries.

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Delivered to the Executive Directors and senior staff of the World Bank and International Finance Corporation, and to the participants in the Conference of Development Finance Companies at a luncheon on Tuesday, October 12, 1965.

I do not propose to talk about failures and achievements of the four institutions I have managed, because their present chief executives are better qualified to give information; but, although I do not think I can contribute any new observation to a subject that has, for a number of years, been so thoroughly discussed in this building, I would like to say something about my own thoughts concerning the general role a development bank can play in the economy of the new nations.

One can look upon these institutions mainly as vehicles for the transfer of loan capital from the richer to the poorer nations and state that where the services of a development bank are not available, it is difficult to find a proper channel to reach the small entrepreneurs. Development finance companies certainly perform a function in this respect, also because they offer a valuable alternative to suppliers' credit which, as we are all aware, often proves a very undesirable form of finance. Because, with only one or two exceptions, all the emerging nations suffer from more or less severe balance-of-payments difficulties, the fact that a development finance company can be a useful source of foreign exchange on reasonable terms will for a long time remain one of the principal attractions of such an institution for the country concerned. It should, however, be realized that against the total amount of loan and investment capital that flows from the richer to the poorer nations the turnover of all the development finance companies combined is very small indeed, and, if there were no other purpose in the establishment of development finance companies, one could wonder why you here in Washington, and many other people all around the world, spend so much time and effort on the subject.



Development finance companies can also perform some useful function in the creation or stimulation of national capital markets, for instance, by offering attractive and diversified investment and thus stimulating saving. There are other institutional devices, however, that offer similar services to the community, and I do not think development finance companies in Asia and Africa have so far made really important contributions in this respect, although some of them have achieved something in channeling non-entrepreneurial saving into privately managed industrial ventures.

The establishment of development finance companies is also advocated on the ground that they could contribute to the flow of private foreign investments into the developing world. A development finance company can, indeed, sometimes, be of some value in this respect; but experience shows that foreign entrepreneurs or international investors, like IFC, can usually find their way, and the necessary local support, also without a national development finance company.

In my opinion, the principal object and main function of a development finance company lies in a somewhat different direction and is connected with the general approach to development. It is perhaps inevitable that in the primary period after the end of a colonial era, in the early years of what is often called a "national revolution", governments want to be everything to all people. I think that this is as it should be, because this is -- I am speaking in a general way -- what the majority of the population expects and it is not for us to criticize, although we may have our doubts about the effectiveness of governmental activity in the industrial sector. There are, however, apart from the obvious hazards to government finances, two dangers:

- (i) In the first place, the approach of a government official, or a planning board, or another committee, to the problems of industrial development, is often not commercial; profit motive and capital formation are neglected in favor of consideration of size and prestige. The result is that the country becomes poorer instead of richer.
- (ii) Still more important, however, is the reaction of the private entrepreneurs to this over-extension of governmental activity in the economic sector. The men who do not wish to become government officials, who want to be their own bosses, who like to take risks and responsibilities, become discouraged and withdraw into traditional pursuits such as trade and real estate speculation.

Now you will, I think, all agree with me that the most important assets of a nation are not in material wealth, but in the genius of the population. And I think that in this context we have to look for the main usefulness of a development finance company as a rallying point for private entrepreneurs. The staff of a development finance company and the friends of such an institution abroad talk the language of the private entrepreneur; a language they may, for some time, not have heard in official quarters at home. I think this is very important, because it may save and further stimulate the activity of a very valuable human asset in the country. When you would ask me how many millions of dollars have been invested by the development finance companies I have managed, I would not be able to give you a direct answer, and even if I could I am afraid you would not be impressed. But I do remember vividly that we have put a great number of first-class people in

a position to put their ideas into bricks and mortar, and I feel this human element is very important because it has a lasting impact on the social structure.

Should a development finance company be active or passive? We spent the better part of yesterday's meeting on the subject of promotional activities, and although there were many different views on how far a development finance company can go in taking responsibility or committing funds for the study or execution of specific projects, we were all agreed that a development finance company should be active in the promotion of ideas for new development and in the stimulation of correct attitudes in matters of research, project appraisal and cost-price calculations; in short, in those fields where, also through contacts with friends in the more developed countries, we have something tangible to offer.

I hope I have made it clear that when I talk about "we" and "us", I am referring to chief executives of finance companies in the developing world. As you will observe from the list of participants in our conference, the overwhelming majority of them are now nationals of the country their company serves, and we are looking forward to the time that the same can be said of all the professional staff. International talents in this field should, I think, be concentrated in IFC and other organizations that like to be associated with development finance companies in various parts of the world.

If one looks at the impressive list of development finance companies already in business in various countries, one is led to the conclusion that the more promising prospects have all been filled, and that new propositions coming up will mostly be marginal or worse. It is

not for me to say which attitude should be adopted toward such propositions, because I will not be responsible for the money that may be lost if the new development finance company is established unwisely or prematurely, but my own inclination would be to err on the side of audacity, taking a calculated risk on a prospect in a country where it looks reasonably probable that government will for some time be willing to stimulate private enterprise.

PROMOTING BROADER OWNERSHIP OF PRIVATE SECURITIES

[all in italics]

Note:

Virtually all the development finance companies associated with the World Bank group have the objectives of promoting the broader ownership of enterprise by encouraging the distribution of private securities. Explicitly or initially, they are supposed to stimulate the growth of the capital market in the countries in which they operate: to find ways of mobilizing savings, to facilitate the flow of those savings by devising types of securities which will be both suitable to the enterprise that needs financing and at the same time attractive to the investor who has the savings, and by encouraging the investor to transform his savings into those securities.

Mr. James Raj, then General Manager of the Nigerian Industrial Development Bank and now Vice President of IFC, led the discussion on this

subject. He organized the discussion under four broad headings. The first was developing institutional arrangements needed for the growth of a capital market. There must be some method and marketplace for buying and selling before security ownership can be expanded to any significant extent. The second problem to be faced was developing different types of securities to fit the particular conditions of the country. This depended on the demand and supply of funds and the requirements of investors; various types of securities needed to be designed to fit their specific needs. The third problem was that of developing an orderly market for securities in order to build public confidence in their ownership. This related to assuring reasonable stability in the market, once shares are widely distributed. The fourth problem concerned the participation of development finance companies in these activities without undue risk. This involved the question of the role of development finance companies in underwriting.

In his reflections on the discussion, Mr. Raj identified several points on which there seemed to be general agreement. First, before wide distribution of stocks and expanding ownership was possible, there must be a basic company law, acceptable and qualified accounting, honesty in public disclosure and so forth, which existed in the more developed countries. It was generally felt that development finance companies could play a useful role, if only by requiring such standards from their own clients. The second point was that, before a wide capital market could be established, the government's monetary and fiscal measures must be recognized as avoiding hyperinflation. Once the individual investor developed confidence in the value of his money, liquidity and debt instruments

suited to the particular environment could be developed. A third matter concerned competition between government and private enterprise for funds in the capital market. In some countries, there was a question as to how far the government was prepared to tolerate competition from private enterprise for funds which the government wanted. A final point of agreement, and a vital one, was that in helping maintain an orderly market, a development finance company must not go against the market. There was a case for making a market and, to some extent, being a buyer or seller of last resort, but there was not a case for supporting prices.



An Essay on Expanding Security Ownership, by Douglas Gustafson

The development finance companies associated with the World Bank group are commonly expected to make an important contribution to the development of the capital markets in the countries in which they operate. Stated in such general terms, however, this objective is rather vague. To give it concrete meaning in a specific environment, three questions need to be answered. Why should the widespread ownership of securities be promoted? What are the factors limiting this development? What is the legitimate role of a development finance company in the realization of this objective?

Reasons for Encouraging Security Ownership

There are a number of reasons why wider-spread ownership of securities is important in the less developed countries. First, it may be of economic importance to open up new investment possibilities for the savings of the community. Investment capital is a critical component of economic growth and if the availability of industrial securities means that capital can be mobilized and diverted from less productive investment in such things as real estate into more productive investment in industrial assets, the economy will be better served. In the absence of publicly held securities, the only alternatives for mobilizing and channeling savings into productive investment are by way of the banking system or by the government's gaining access to savings by means of taxation, and investing them in industry. If, however, decentralization of the ownership of assets and a healthy private sector are also objectives,

then it is imperative to encourage the widespread ownership of securities and the growth of a capital market. If avoidance of an excessive concentration of power in the hands of the government is an objective, a related goal will no doubt be the avoidance of the concentration of wealth and economic power in the hands of a small private group. The only alternative to these two extremes is widespread individual ownership of assets.

A similar problem may arise in an agrarian society where the equivalent to securities is land ownership. If land is controlled by relatively few people, attaining a more equitable distribution of it will be an important policy matter. In a country that is undergoing some degree of industrialization (even if land ownership is broadly based), as commercial enterprise and industry become more important, citizens will find themselves unable individually to own and control industries as easily as they might be able to own land; their only way of participating directly in the ownership, control and returns of industrial property will be to own, directly or indirectly, their securities. Widespread security ownership by individuals or by the institutions to which they have entrusted their savings, is thus basic to a reasonable distribution of wealth, income and power.

In countries where foreign enterprises play an important role in industrial development, widespread participation in the ownership of industry may be even more important politically than in countries where industry is controlled by strong local groups. A foreign presence always has some negative aspects, either materially or psychologically, and this becomes more critical as the visibility of the foreign sector increases

along with its control of a country's industry. An effective way to deal with this problem, from the viewpoints both of the foreign investor and the local community, is for the foreign concern to open its ownership to participation by private local individuals and institutions. Such a move may be important not only in mobilizing savings for productive investment and achieving a more equitable distribution of wealth, but also in facilitating cooperation between foreign investors and the local community. In fact, the favorable impression created by such a move and the fact that it may result in better cooperation between the parties involved, may be the most important benefit to foreign investors who offer shares of their overseas subsidiaries to local investors.

Unless such objectives as these are valid and accepted in a country, there will be no basic reason or motivation for stimulating the widespread ownership of securities; and a development finance company will find it difficult, if not impossible, to make any progress in this direction.

#### Factors That Limit the Broadening of Securities Markets

In countries where securities ownership is not common, a development finance company's role in promoting such ownership will be affected, and may be determined, by the characteristics of the environment in which the company operates. The extent to which the company can deal successfully with these barriers depends on the skills of its management as reflected in the company's stature and influence in the community. In some countries, it may be the acknowledged and accepted leader in promoting a local capital market, whereas in others, its influence may be smaller due to the existence of other private or public agencies engaged in the

same task. Because it is a difficult area of operations, it may be given a low priority; but because of the challenges it offers, a development finance company's contribution in this field can be very important to the economy as well as rewarding to its shareholders and management.

The basic condition that must be met if the ownership of securities is to be popularized is that the financial returns must be attractive to the potential investors, taking into account considerations of risk, relative to other forms of investment in the community (or even returns from investments abroad, if investors are accustomed to sending their savings overseas). Often land speculation and investment in commerce are not only the more familiar forms of investment but also the more profitable types of investment. As long as this condition exists, in actuality or in investors' minds, it will be difficult to market industrial securities. Of importance here is how the existing or potential investor evaluates investment alternatives. Is he interested in assured income streams or in capital appreciation? Does he need visible evidence of ownership in real assets as opposed to a "piece of paper"? How important is liquidity? These factors will affect the type of security that will be marketable and the nature, form and methods of communication by the company to its shareholders. Innovation in security types and marketing procedures will often be required to generate investor interest.

In some cases, legal restrictions may not permit the form of security that appears to be the most suitable for a given situation. If, for example, investors require an immediate return on an investment, a straight equity issue by a new company will not be very attractive, and a possible alternative would be a convertible debenture that has a fixed

income combined with an option to convert at a later date into ordinary shares at a specific price. The legal status of convertible debentures may, however, be in doubt or they may not be permitted. If securities are to be sold, they must fit local requirements and this may require modifications of the law.

Of course, a basic influence on the returns accruing to investors holding industrial securities will be the nature and performance of the economy, and it is unlikely that a development finance company will be able to affect this directly, although it can be influential in pressing for changes in policies if such changes appear to be necessary and realistic. A high rate of inflation can curb any interest on the part of the public in investing in securities, particularly those with a fixed income. This problem is out of the hands of the development finance company, but the company must take inflationary factors into consideration when it designs security types and when it makes recommendations to investors. Apart from inflation, a tight money market may make it impossible to sell securities when the promise of a reasonable return is in the distant future or when the long-term return is unattractive relative to other forms of investment. In a number of countries, widespread use of consumer financing in a tight-money situation may result in high yields on finance company paper, outstripping all other available yields and thereby channeling a sizable proportion of investible funds into consumer finance at the expense of investment in industry.

Tax policies affect the popularity and form of security ownership. This is another point at which a development finance company may be able to exert some influence. Of particular importance are the

regulations affecting institutional investors such as insurance companies, private pension funds and government provident funds. In many countries, these institutions may be fairly well developed while the capital market, as far as industrial securities are concerned, is in its infancy. As a result, these investors often represent the most important market for securities, although there may be impediments in the form of tax and legal restraints on their investments, particularly in equities. Also they may not be familiar with new types of investments and the seller of industrial securities may have to educate them.

Taxation is also a very important factor in the investment decisions of individuals. In a number of countries, governments are hard pressed for funds and in order to attract savings the interest rates and tax features of government securities are designed to give them a competitive edge over private securities. The taxation of capital gains relative to normal income is also an important determinant of investors' attitudes.

Even if all these conditions are such as to make investment in the securities of private concerns relatively attractive at the initial stages of security ownership, a very large educational effort may be required, first to inform investors of these new alternatives and then to convince them that they are really suitable. This is a long process. But if the institutions promoting widespread security ownership do an effective job, the response can be surprisingly great, even in very unsophisticated capital markets.

Perhaps one of the most important considerations in broadening a capital market is the business ethics of a society and their influence on

security ownership. Because such matters are cultural matters, their modification can be achieved only over a long period of time. Consequently it is commonly foreign enterprises, which are accustomed to high auditing and accounting standards and to public disclosure, that first offer their securities successfully to the public in countries where security ownership is relatively new. They may be motivated by a government requirement for a local ownership component of foreign firms, a desire to raise capital, a gesture to indicate their willingness to identify themselves with the interests of the local community, or a combination of these. Whatever the motivation, their issues often serve as a starter for security ownership, and provide useful examples for local firms to follow.

Another vital requirement for the development of widespread ownership of industrial securities is the existence of some type of orderly market for trading in securities. Investors are unlikely to tie up their funds in an investment if there is considerable uncertainty about their ability to liquidate their investment. It is, of course, true that two individuals can make a market; but unless there is some specific place where buyers can, in effect, meet sellers, the development of the capital market will be restricted. Without a marketplace for trading and price determination, each individual must act as his own agent and the market in private securities will be chaotic. Because of the considerable differences in knowledge, sophistication and ethics among the individuals in any community, some form of controlled market, with competitive selling and buying, is necessary if fraudulent transactions are to be avoided and investment in industrial securities is to be encouraged.

The Role of the Development Finance Company

The question facing a development finance company's management is what activities can it reasonably undertake in order to promote ownership of securities issued by private companies. In countries where there is little or no market for securities, it is likely that a development finance company will be in a unique position to take the lead in the development of a capital market. Often these development finance companies are established with international cooperation and thus have access to a significant pool of experience; they are operated in accord with high financial standards; their staffs represent sources of unique knowledge as far as industrial development in their respective countries is concerned; and they often assume a stature of some importance in the private and public sectors of their countries. The facilitation of industrial development will almost always, by definition, include the promotion of the widespread ownership of industrial securities; and most managements of development finance companies consider this as an important area in which their companies can be active and can have a significant influence on the developmental process.

Marketing Its Own Shares and Debentures

A common objective in establishing many development finance companies is the distribution of their own securities as a means of activating a capital market. In some cases, they may be able to sell their own share capital or debentures to the public and to channel the funds so raised into private industry. Here the companies act as financial intermediaries between private investors and industry. To date, however, this intermediary role has not been an important one for most of the development



finance companies associated with the World Bank group. With the exception of BANDESCO in Spain, which has raised most of its resources directly from the public through its own debentures, the others have raised the bulk of their funds either through international lending agencies or through their national governments. To the extent that national government funds are considered savings of the local community, the development finance company is a vehicle for the investment of the country's savings in private industry. But this mechanism does not increase security ownership by individuals and private companies, nor does it stimulate a more active capital market. Although public sale of the shares or debentures of development finance companies have not yet been a common device for promoting the development of a capital market, it could become one in the future, for the more mature development finance companies. Their progress in this area will depend on the volume of savings available, on the willingness of governments to allow these institutions to raise funds locally, and the attractiveness of the securities offered in relation to alternative investment opportunities.

Nevertheless, even for relatively young companies operating in countries where public interest in security ownership is new, there are a number of areas in which the companies can make an effective contribution to broadening the capital market. One is in the general upgrading of business and financial practices. Another is in developing a mechanism, if none exists, for effective marketing and trading in securities or improving the existing mechanism. A third is by expanding the number of private securities available for public subscription and trading. Fourth, they can often have a direct hand in expanding the number of institutions

and individuals interested in investing in securities. Finally, there may be some situations in which development finance companies can play a role in maintaining an orderly market for securities. The extent to which any of these roles is practicable depends on the institutional and economic environment. It would be unusual if an effective development finance company did not have a contribution to make in at least one of these areas.

#### Upgrading Business Practices

In some countries, the standards of business practices are such that it is difficult or impossible to establish companies with outside ownership and management, with the result that widespread security distribution cannot be achieved. This is often the case if the local business community is composed primarily of family concerns, which are the typical organization of business in a traditional economy. In such cases, financial data are usually closely guarded against outsiders, including the tax collector. In fact, bookkeeping and accounting procedures and standards within the enterprise may be so fragmentary that even the "insiders" may not know exactly what the firm's financial condition and performance are. If this is the accepted pattern of business operation, there will be a strong prejudice against widespread ownership of a company and disclosure of important financial data outside the family group; and potential investors will be wary of putting their money where they do not directly oversee the operation and where their control is diluted. Absentee ownership might be considered unthinkable. Auditing of accounts may be unknown, or at best inaccurate, and there may not be a local accounting profession that can be relied upon. Even if competent local or foreign accounting

services are available, it may be difficult to persuade the local businessmen to subject their operations to such scrutiny.

Without fairly full and honest disclosure to the public and a business ethic whereby management senses its responsibilities to all shareholders or groups of shareholders, companies will not wish to open up their ownership to outsiders and investors will consider investment in private securities hazardous. These two forces may stand quite firmly in the way of developing widespread security ownership and in some countries these problems are clearly the major obstacles to the promotion of security ownership. And these problems may be compounded if business ethics are low. Such an environment will have to be modified if a climate conducive to the development of a capital market is to come into being.

A development finance company can have a direct hand in improving such a situation. By setting high standards of performance in its own operations, by observing high standards of accounting, by observing thorough control procedures, and by making meaningful reports available to its shareholders and the public, it can serve as a model. If it works closely with its clients both at the appraisal and follow-up stages, the company will be able to educate and influence its clients to upgrade their practices, though this may prove a long-range undertaking. There is, of course, the danger that it may become too rigid in its requirements and frighten business off; if this happens, no one benefits. Thus judgement is required as to the speed with which it should press for changes in a client's operations and procedures. Sometimes the development finance company will be able to make a start toward upgrading business practices by imposing auditing and reporting requirements on its clients. It may

also perform a service by encouraging, or perhaps requiring, clients to use corporate forms of business organization.

The development of modern business practices is sometimes hampered by the absence of a sound accounting and auditing profession, either because qualified accountants are lacking or because their standards are low. A development finance company can assist in upgrading practices, first by example, and then by supporting accounting firms that do have high standards. In one case, a development finance company associated with the World Bank group assisted in the formation of a new accounting firm, with the understanding that if the firm would follow international accounting standards, the finance company would, in turn, underwrite the accounting firm's business until its operations were profitably established. The firm was an almost immediate success and is helping to establish a new norm for accounting practices in the country concerned.

Often the laws and legal practices of a country may be archaic when viewed in the light of modern business practice. Typical of this are security arrangements on loans and complications in matters of trusteeship. Legal traditions and customs may be difficult to modify, particularly if a significant amount of legislation is involved and the legislature is not business-oriented. By virtue of its operations, a development finance company will be aware of the areas in which financial operations are needlessly restricted by legislation and legal practices and it will be in a position, along with other interested parties, to suggest appropriate changes. Often development finance companies have good access to the legal experience and practices of other countries, and this can add to the effectiveness of their recommendations.

Developing a Trading Mechanism

In most countries, there is some mechanism whereby the holders of various types of financial paper can liquidate their holdings. In some, bearer shares that require no registration of transfer are permitted, and there is considerable trading in these securities, although it may be neither efficient nor without substantial risk of fraud. In other countries, there may be small quantities of registered shares held by investors but no formal market, and thus all transfers are effected individually between buyer and seller. In still other countries, trading in securities may be limited to government securities at a price pegged by the government (normally by having the Central Bank buy and sell at par); in such cases, there is an exchange mechanism although it cannot be considered a real trading mechanism, since the price is fixed. In a few countries, security ownership may not exist at all and there are consequently no procedures for exchanging either public or private securities.

Where no exchange exists or where the trading procedures are very rudimentary, a development finance company may play a role, often in cooperation with other institutions, in developing a trading mechanism. Some banks have been responsible for drafting legislation, establishing the regulations pertaining to an exchange mechanism and establishing a share registration system. In such situations, the development finance company may even become a dealer and broker on the exchange and assist in its direction and management. Such activities are certainly of a developmental nature and any financial returns from these efforts will be indirect and will probably come only in the long run.

In a very small market, a useful first step may be merely the creation of some type of clearing house where individuals wishing to buy or sell can register their intent and the price at which they wish to do business; here could be kept records of transactions and the prices at which they were consummated. As trading increases, it may be necessary to establish a more formal exchange, with a daily or weekly call-over of listed securities; this would involve the legal establishment of the exchange, regulations for listing and requirements as to who may act as brokers.

There are a number of countries with established stock exchanges that list and trade only a few securities. Existing mechanisms may have become discredited in the eyes of the public as a result of improper supervision or speculative or fraudulent practices. Here the role of a development finance company might be the promotion of reforms in order to increase the effectiveness of the exchange and to restore the confidence of the investing public in the exchange itself and in investment in securities in general. In countries where the mechanism for trading securities is moribund or discredited, remedies will be a prerequisite to broadening the capital market.

Of course, the existence of a formal stock exchange does not necessarily mean that the market will be orderly and that practices will be ethical. In fact, it may at times not be necessary nor desirable to establish a stock exchange in the formal sense. Yet before there can be an effective expansion of a young capital market, some mechanism is needed to bring buyers and sellers together to trade in good faith with one another. The basis for the development of securities ownership is mutual

trust and confidence among those involved. If this element is missing or if it is called into question by fraudulent trading practices, the development of the capital market will be severely circumscribed.

#### Expanding the Number of Securities Available

Another way in which a development finance company may play an important role is by increasing the number of private securities available in the local capital market, thereby diversifying investment alternatives. In countries where industrial development is in its earliest stages and in which foreign investment plays the predominant role in industrial development, the finance company may be in a position to encourage some of the existing or new foreign firms to offer some of their shares to the public and, if there is a stock exchange, to list such shares on the exchange. Although many foreign investors prefer to hold one hundred per cent of the shares of the companies they have established, it is in the interest of both the country and the foreign investor that industry be closely identified with the local economy, and through a combination of government pressure and self-interest, foreign investors may often agree. Sometimes it will be not the capital it can thereby mobilize that will lead a foreign-held firm to offer its shares locally, but rather the psychological effect and the resulting improved "image".

Industry may be controlled by relatively small groups of local citizens, thus creating an unhealthy concentration of industrial wealth. Here an objective may be to get the local firms to open their ownership to the public. This may be considered important enough to motivate a government to require that a certain percentage of all increased capitalizations be offered to the public. This has happened in Pakistan, which

requires that sixty per cent of all capital increases of existing firms, or capitalizations of new firms, be offered to the public.

A development finance company's ability to press for public issues will depend on its bargaining power vis-a-vis industrialists. It may be, for example, an important source of debt funds for these companies, and thus be in a position to make loans conditional on the issuance of shares to the public or to itself, with the understanding that it will later sell its portion of the shares to the public. If the development finance company's clients have confidence in its intentions, they may be more willing to make at least a gesture to outside participation in their firms by selling their shares to the development finance company. In some situations, the development finance company will have to exercise care when it "rolls over" its portfolio, in order that the ownership of a company not be altered in such a way as to create instability. More often, unless it holds a considerable proportion of the total share capital in a single firm, the development finance company should, after holding the investment for a time, aim at selling it to the public. In some countries, the current owners may be anxious to buy back the shares held by the development finance company, and here a decision must be made by management as to which is more important, the owners' retention of one hundred per cent control or a wider distribution of shares.

Occasionally a development finance company may not be able to find any industrial concerns in which it considers it suitable for investors to participate on a minority basis. This might be the case, for example, if the standards of business practices are low and the management of existing firms cannot be counted upon to operate in a responsible fashion



with respect to minority shareholders. This is an extreme situation, but it does occur. And when it does, there may be some justification for engaging in the promotion of new companies and hand-picking its major groups of shareholders in such a way as to give confidence that the management will deal forthrightly and honestly with all shareholders. The shares of such companies could be offered to the public with some confidence, either at the outset or at a later date, when the companies are well established. The trouble here is that it may be difficult and costly for the development finance company first to put together such projects; and the process may also result in a prolonged tie-up of its funds and more managerial responsibilities than it would normally wish to assume.

An unsophisticated investing public will need to rely on the recommendations and examples of a development finance company. If that company can project itself in the eyes of the public as a competent and trustworthy institution, the fact that it is participating in an enterprise may be sufficient recommendation to private investors. Consequently, particularly at the early stages in the development of a capital market, it is very important that a development finance company be careful in the choice of the share issues it will support, in order to build confidence in its judgements. Some poor choices, early in its career, can do lasting damage to a development finance company's capacity to make an impact on the capital market.

#### Widening the Market for Securities

A development finance company can have a direct role in expanding the ownership of securities by undertaking public issue work and underwriting

on its own. In countries that already have a number of securities brokers and issuing houses, a development finance company may find that this is not an area of activity in which it can profitably engage. In many countries, however, the company is in a position to take the lead in putting new securities before the public. At first, because of limitations of financial resources and the primitive condition of the capital market, it may not be able to underwrite industrial securities. Nevertheless, the company can make a start by offering to market industrial securities on a best efforts basis. This will involve it in the legal groundwork necessary to set up a public issue, the preparation of a prospectus, and the advertising and marketing of the shares. Occasionally the development finance company will have to operate entirely on its own, whereas in other cases, it may be able to join forces with other financial institutions in undertaking public issues. At times it has been found feasible to use the commercial banking system or the insurance companies as intermediaries in reaching the investing public.

Public issue work is certainly different from the direct investment activities that development finance companies undertake, for it is primarily a marketing function. Consequently, it requires specialized skills different from those of the development finance company's regular staff, and for this reason it may be advisable to establish a separate group within the company or even a subsidiary company to specialize in the marketing of securities.

An effective sales machine is a prerequisite to successful public issues and the problem is how to establish it. In the early stages of security ownership, the volume of sales and the brokerage income are likely

to be marginal, so that the sales effort by banks and insurance companies will be motivated more by a spirit of public service than by the expectation of profit. This is particularly true if these institutions view the securities as eating into their own sources of funds from the public.

It is important that the sales effort be of high standard. When only a few people or institutions are involved, practices can be controlled by the self-discipline of the group, but as the system expands, it will be necessary to institute training and licensing procedures for dealers in securities and restrictions on who may sell them, as well as to regulate commissions. Here again the development finance company may take part in training and in designing controls to ensure the soundness of the issuing and dealing system.

Another step in broadening the market for securities is underwriting. In a relatively narrow capital market, this can involve considerable risk; for it will often be the newly established firms or new subsidiaries of existing firms that will seek to raise capital by way of public issues, and it will be the marginal share or debenture issues that will seek underwriting. Because of this narrowness, the underwriting function in less developed countries may be somewhat different from that in developed countries. In a broad and competitive capital market, with large amounts of funds coming into the market daily, an underwriting that is not fully sold indicates to the underwriting firm that the issuing price was wrong. The underwriter in this situation will not hold onto the security but will readjust his price in order to market the issue. The basic underwriting skill is proper pricing. In a very thin market, however, the unsold portion of an underwriting operation may be not an

indication of an unreasonable price, but rather of a market so narrow that it cannot absorb the entire issue at a reasonable price.

Of course, anything can be sold if the price is right; but in a narrow market the price necessary to sell a security may be unreasonably low, merely because the normal market for the security has absorbed all that it can. If this is the case, it may not be at all advisable to reduce the price in order to attract an entirely new and unexpected class of investor. The required skill, in such a situation, may not be in pricing but rather in estimating absolute levels of investible funds. A development finance company must therefore be prepared to operate as an investor as well as an underwriter. It will almost certainly have to absorb into its own portfolio a large portion of a share or debenture issue. Knowledge that it will have to do so, will help impose a prudent caution on its underwriting decisions.

As the market for securities develops in volume, however, an underwriter may make pricing mistakes; by taking up the unsold balance for its own portfolio, the underwriter may be covering its error, and thereby penalizing its own shareholders. Its shareholders' interests should perhaps be the criterion for the development finance company's decision with respect to an unsold portion of an underwriting commitment. Are its shareholders best served by selling the issue at a reduced price or by holding on to it and selling it later at a better price? Although a development finance company may combine underwriting and investment, basically these functions require different skills. An underwriter is a merchandiser, whereas an investor is a buyer of values. While it is better

to separate the two activities completely, practical circumstances often dictate that development finance companies combine the two.

Because of the risks of underwriting in thin markets, many development finance companies may have to do the bulk of their public issue work on a best-efforts basis. It may be possible for them to arrange sub-underwriting for an issue in advance of their own commitment; in this way, although they will have underwritten the issue, buyers will have been assured beforehand.

The brokerage and underwriting fees in the countries in which the development finance companies associated with the World Bank group operate, range from 2% to 4% for underwriting and brokerage is about 1-1/2%. Because of the risk involved, these fees may not be realistic, but they are often fixed by the government, and the development finance company, as well as other underwriters, can only press for what they feel are reasonable rates. Rates too low to compensate for the risks will inhibit the growth of a capital market, rather than stimulate it.

Occasionally development finance companies have helped to establish some type of unit trust or mutual fund, the advantage of which is that it offers the investor a diversified portfolio and professional management, even though he may make only a small investment. Whether or not it makes sense to establish a unit trust probably depends on the number of securities available in a market and the opportunities for spreading risk. Governments often support such funds as a way of encouraging savings and may even give the funds tax advantages, thereby providing an additional benefit. What is important is to ensure competent and trustworthy management of the fund, sound sales methods and realistic charges.

In most cases, legislation will be needed to establish proper controls. A decision will also have to be made as to whether these funds should be private, based on making a profit for their owners, or government-controlled. Control should be determined by selecting the type of organization whose management will be the most effective in maximizing the interests of the fund's investors. There are serious pitfalls in establishing a fund or trust which has poor management or is considered to be a tool of public policy, subject to political pressures; such intermediaries cannot, in the long run, prove helpful in broadening a capital market.

When the question of unit trusts or mutual funds arises, a development finance company will generally have an interest in seeing to the establishment of sound institutions and the legislation relating to them, but depending on the environment it may or may not want to become directly involved in their formation and operations.

#### Sales out of Portfolio

The pricing problem is especially important to a developing finance company in rolling over its investments, if the company is to achieve its three objectives of promoting security ownership, profit-taking and generating funds for further equity operations. The most straightforward method is to offer individual securities in the market at going prices or, if there is no market price, at the best available estimate of a market price. Variations in this method of marketing include giving first rights for purchase to the development finance company's shareholders or selling blocks of its equity portfolio, made up of a combination of shares. The problem in any sales maneuver, if the sales are not clearly priced according to the market, is that the institution exposes itself to

possible unfairness to some or all of its shareholders, or to the purchasers of the shares. If its shareholders are given an option to buy at a lower than market price, only those in a position to buy will benefit, unless the rights are salable at market prices. If an effort is made to sell a package of shares to third parties, then price determination is extremely important so that advantage is taken of neither the purchasers nor the shareholders of the development finance company. Tricks to sell shares or to use sales out of portfolio to benefit only some of the company's shareholders will not, in the long run, be helpful. If, however, pricing is done as fairly as possible, package sales or sales to shareholders may be a useful way of stimulating public interest in purchasing portions of a development finance company's portfolio and in creating interest in its own shares.

#### Maintaining an Orderly Market

Another aspect of promoting a capital market is the stabilization or maintenance of a market for securities, in order to avoid widely fluctuating prices. Where security ownership is not common, building up the confidence of the investing public in the investment of its savings in industrial securities is a prerequisite to expanding the number of investors and the volume of funds coming to the market. If market prices are erratic and the investor runs a considerable risk of not being able to liquidate his investment in a reasonable amount of time and at a reasonable price, investment in securities will be difficult to encourage. In very thin markets, there is a possibility of sharp fluctuations in prices as a result of rapidly changing conditions of supply and demand. The difficulty is that attempts to maintain an orderly market border on price maintenance

of security values and this is something about which development finance companies should be extremely careful.

The important variable in the role of a development finance company in trading securities is the size of the market. In a market of significant size, it is impossible for an institution with moderate resources to stabilize or fix the price of a given security at a level other than that established by the market. It might be able to do so temporarily, very briefly, but even this may be difficult. If a development finance company tries to hold the price of a security above the price the market is prepared to pay, the company will penalize its own shareholders; for the individual shareholders could buy the security at a lower price than their company is paying. It is their funds that are being used to pay the premium.<sup>1/</sup>

If, however, the number of shares traded and the volume of trading are low, and the number of shares of a given company in the hands of the public is relatively small, a good case can be made for the development finance company to maintain a pool of funds from which it is willing to sell and for which it is willing to buy to temper wide price fluctuations. This involves an element of price stabilization because the company must make a decision as to the price it is willing to pay and the price at which it is willing to sell the securities it is stabilizing. These decisions involve a significant risk. However, such activity can be very important for small industrial shareholders who may want to sell their \$50-100 investments on short notice. For them, a buyer prepared to take their

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<sup>1/</sup> This is illustrated in the underwriting activities of investment banks in the developed countries. If underwriters have overpriced an issue and do not lower their price to a level at which the security will be bought up, they are in effect making their shareholders pay the difference. Thus, if an underwriting is mispriced, the underwriters will adjust the price to meet the market price.



shares at a price reflecting a realistic assessment of the position and prospects of the company whose shares they hold, is vital. There is, however, a clear line between maintaining a market and maintaining a price. A development finance company can usefully maintain a market. But it should not support a security at a price that is unjustified in terms of the performance and prospects of the company involved. To do so would be to build a false confidence in the market, for the value of a security cannot be guaranteed. When considering "stabilization", a finance company must make a basic decision between its own profitability (and the interests of its shareholders) and its responsibility to the public and to the development of the securities market.

Another reason for a development finance company to deal in the market is that in a small market a relatively few people can set the price. In fact, if a development finance company is the most important broker, or perhaps the only broker, it may find itself in a position where buyers and sellers look to it for advice about a reasonable price for a given security. This situation is quite different from that in a developed capital market, where the opinions of many brokers and individual investors determine the market. In a narrow capital market, a broker may be dealing with both the buyer and the seller without the benefit of substantial outside sales to help him determine a market price. This places a great responsibility on the broker, but until a capital market reaches a size at which it is financially feasible for a number of people or institutions to engage in brokerage, the problems arising from such a narrow market will have to be dealt with by the management of development finance companies.

In countries with fairly well developed securities markets, such as India and Pakistan, the development finance company may not play a broker's role and these problems may not be relevant. On the other hand, in countries where capital markets are in their infancy, a development finance company may be called upon to do things that, though not orthodox in a broader and more fully developed capital market, are useful and necessary in generating the growth of the market. An example of this type of activity concerns extremely inexperienced investors; here there may even be an argument for a development finance company to issue shares to the public with an agreement to repurchase all or part of the issue from private investors within a given time at a stipulated price. Such an arrangement should be carefully considered and the development finance company should not assume undue risk, but it could be a useful device for getting "people's feet wet" in the market.

From the foregoing, it is clear that there are no general rules for "stabilizing" a market, for establishing an "orderly market". Before engaging in such activity, a development finance company must consider the interests of its shareholders and must avoid supporting something that is economically unsupportable.

#### The Extent of Equity and Underwriting Activity

The main financial policy question relating to a development finance company's equity operations concerns the level of equity and underwriting operations. At present, most such companies restrict their equity acquisitions to an amount equivalent to their paid-in share capital and retained earnings. Underwriting commitments in excess of this are accepted if, in the management's view, the company will not have to take up the

remains of an issue, which would put its equity holdings over its total aggregate worth. Some development finance companies have not found this guideline restrictive, for they have found it difficult to engage in equity operations because of the nature of the economies in which they operate and the prevailing structure of business. But others have gone more heavily into this field and have found that an equity limit equivalent to net worth tends to restrain their equity investments and underwriting operations. Thus the question arises as to whether this limit should be expanded or reduced.

This is a question to which there is no "right" answer. The limitation of equity investments to the development finance company's own net worth is based on the assumption that equity operations are risky and uncertain of liquidation in emergency, and that a development finance company should therefore not use borrowed funds to make equity investments. In so doing, it would be undertaking a repayment obligation which might prove difficult to fulfill if the company were unable to liquidate equity investments at reasonable prices when cash was required for debt amortization.

It could in principle be argued that in some countries the capital market is so broad and buoyant that a finance company might, from time to time, consider it not only sound but advantageous to go into equities at a level exceeding its own net worth. By the same token, there might be situations in which the market and the risks were of such a nature that a development finance company would want to limit equity participations to something less than its own net worth. Neither should necessarily be a once-and-for-all policy; for market conditions and the risk inherent in equity operations can vary with a changing economic climate. It is a

question that needs to be related to the company's cash flow, and to the stage of development of the capital market of the country concerned. If the company were in a relatively tight cash position, there would be less reason for increasing equity participations that might involve tying up funds for a considerable length of time than for reducing equity participations, thereby freeing resources for more liquid operations. If the cash position were strong and the market for securities were broad enough to give such investments a fair degree of liquidity, a stronger case could be made for an aggregate equity portfolio's exceeding a development finance company's own net worth.

#### Conclusion

In summary, development finance companies are often expected to play an important role in the promotion of the widespread ownership of industrial securities. In many countries they are in a unique position in terms of their staff, experience and resources to play an important role of this kind. What role they actually take will be dependent on the environment in which they operate. For those countries where capital markets are almost non-existent, broadening the capital market will be a long, hard process and the development finance company operating in such a situation, although perhaps best placed among institutions to stimulate investment, should not be expected to achieve miracles overnight. There are a great many factors involved in determining whether or not conditions are conducive to the development of widespread security ownership and many of these are beyond the immediate control of the development finance company and the other financial institutions it works with. Whatever

the obstacles to an active security market may be, however, an effective development finance company will normally have some role to play in encouraging the widespread ownership of securities and can often undertake activities directed toward this goal to the benefit of both its shareholders and the economy as a whole. Some of the development finance companies associated with the World Bank group are already playing a pioneering role in this area of activity.

3

THE RELATIONSHIP BETWEEN A DEVELOPMENT FINANCE  
COMPANY AND THE MANAGERMENTS OF THE ENTERPRISES  
IT PROMOTES, SPONSORS OR FINANCES

(ALL IN ITALICS)

Note:

When a development finance company promotes, sponsors or finances an enterprise, it risks its capital and reputation; and it often influences others; both individuals and institutions, to risk their capital as well. This is a grave responsibility, which receives continuing vigilance on the part of the finance company.

That responsibility calls, in the first place, for the careful selection of investment proposals. No factor in selection is more important than a judgement regarding management, and a decision that that management is satisfactory in every way - technically, commercially, administratively, and honest. But satisfaction with management before the investment is made is not enough. Management must remain a matter of continuing concern thereafter. This is important when a development finance company has given a loan to the enterprise; it is critical when the enterprise is a promotion of the company.

Dr. Jose Gutierrez Gomez, President of the Corporacion Financiera Nacional of Colombia, who was chairman of the discussion, pointed out at least three aspects of this Agenda item. One concerned the financiera's problem of obtaining full and timely information on the affairs of his client; another

involved taking a seat on the board of directors of the client enterprise; a third was involvement in day-to-day decision making. On the first, there was no dissent on the fundamental importance of having at all times a current knowledge of the situation of a client enterprise and of establishing a close and constructive relationship with it. And on the third, there was a strong reluctance against participating in management. But on the taking of a board seat, opinions differed widely, from the completely negative through abstemiousness to a positive conviction that a board seat established a relationship not otherwise possible.

Dr. Gutierrez Gomez felt that conventional end-use, supervision and board representation could be equally effective in establishing the right kind of relationship between a development finance company and the management of its client enterprise. A director could do much effective missionary work, but a great deal depended on luck in the selection of a director and on the habits and procedures of the board on which he sat. Many participants shared his concern about the difficulty of finding qualified outside directors and the risks of taking directors from inside - risks of overburdening management, creating conflicts of interest, and compromising the future business of the development finance company. Then risks were magnified when a company took on managerial responsibilities. In general a tone of abstemiousness pervaded the discussion, despite recognition of the need to go the limit in cases of jeopardy and in some cases of promotion.



An Essay on Relationship with the Managements of Client Enterprises, by  
E. T. Kuiper

The relationship between those responsible for running a development finance company and their clients is not a matter of financial technique, which one can learn from textbooks. As in all human relations the banker will have to find his own way, through trial and error, but the experience of others can give some guidance.

It is often said that, in the less developed countries, where most of the development finance companies connected with the World Bank Group operate, there is an appalling lack of managerial ability, which is one of the principal difficulties in fostering industrial growth and constitutes a major risk for financiers of new industrial ventures. So general a statement as that needs qualification. In many of the countries that are now on the road to industrial development, there's no dearth of commercial know-how. What is even more important, from an organizational point of view, one finds in them a number of men who have a real talent for inspiring their associates. In Asian and African countries there are many families which have been in business for generations and have developed groups of people who work together in harmony under centralized, often more or less patriarchal leadership for a common purpose. In an organizational sense, this should be an invaluable asset, and one which is no longer so widely spread as it once was in Europe or the United States.

But the statement that there is a lack of managerial ability may still be justified. A community cannot depend for its industrial development exclusively on the few groups which have built up commercial organizations in the past. Moreover, these traditional businessmen sometimes find it

difficult to adapt their views and methods to the administrative requirements of large-scale modern industrial ventures. New attitudes towards management are needed because as an enterprise grows, capital has to be attracted from outsiders and new techniques may call for the employment of foreign technicians and managers.

Nevertheless, the staff of a development finance company, which is often oriented to modern organizational patterns, should always value the qualities of commercial acumen and organizational know-how that are present in the communities they serve. It is obvious that good management is the key to the success of any enterprise and the development banker would do well to recognize that there is more than one way to manage an industrial venture and he should be careful when trying to impose his own ideas on his clients. The relationship between development finance companies and their clients involves a two-way traffic; even the best qualified banker has to learn a lot before he can start to teach or to guide. The managers of the development finance companies associated with the World Bank Group recognize that, even where they have the power to force their views on their client companies, it is the latter which should in practically all circumstances remain fully responsible. Only if, after very careful consideration, there remains a basic incompatibility of views on important matters and the investment of the company is in jeopardy, ought the company use whatever powers it may have to replace management.

In this perspective, one can consider the three ways in which a development finance company maintains regular contact with its clients and gives advice to it under the following headings:

- a. obtaining information,
- b. representation on boards of directors, and
- c. taking responsibility for or participation in management.

### Obtaining Information

An essential difference between ordinary commercial banking on the one hand and development financing on the other is that the latter is not primarily concerned with tangible security that can easily be realized, but takes a long-term view of a venture's financial prospects. The personal and financial standing of the people sponsoring an enterprise is also, of course, of considerable importance.

Before a financial deal, whether a loan, a participation or an agreement to underwrite, is concluded, a project is carefully studied by the development finance company and forecasts are made in a joint exercise with the project's sponsors. This period of project preparation and financial negotiation usually presents suitable occasions to suggest improvements in many aspects of the venture, so that the development finance company may in effect play a crucial role in influencing its structure. It is at this stage that the banker and the client get to know each other better, and it is here that the relationship of mutual confidence should take shape. The foundation of confidences laid then, if it is well done, will assume a mutually beneficial relationship between a development finance company and the client after the transaction has been finalized and the banker's money is actually invested.

Strange as it may seem, it is a common experience that management and staff frequently devote much more time and effort to project preparation and loan negotiations than to keeping themselves well informed concerning the activities of clients in whose businesses their institutions' money is at risk. Yet it is extremely important to keep in close touch with clients. Personal contacts on the technical and policy levels are needed, but no less

important are more formal relationships, through regular audits and "end-use" inspections, i.e. frequent, periodic performance in construction of the project and in running the enterprise when construction is done. If this is to be done, provision must be made in the loan contract to give the development finance company the right to ask for information and to carry-out inspections and imposing on the borrower the obligation to supply all information required. The discrepancies between projection and performance, and the problems that come to light from the reports and during the inspections form a useful subject for discussion between the financiers and the client, and lead to opportunities for consultation about measures to improve the situation. Usually, but not always, the client himself knows his own business best, but the development finance company may have a broader range of experience from which helpful suggestions can be drawn to help a specific client.

Follow-up investigations are, generally, carried out by the staff of the development finance company, but it is often useful to enlist the services of independent consultants. It is usually a condition of a loan contract that the client must retain independent auditors satisfactory to the development bank that the auditors should be chosen from a panel presented by them to their customers. Such audits should be made available as a matter of routine; they with other detailed reports, create the foundation for a constructive relationship.

Every banker has much to learn from his clients; unless he is willing to learn more every day about the special intricacies of particular situations, he will soon find it impossible to maintain a relationship of

confidence. It also should constantly be realized that the managers of these enterprises remain responsible for its operations; unless they can be convinced that a suggestion makes sense, it is useless to try to force it upon them. The aim of the development banker should be to create such an atmosphere of confidence that his opinion and advice are asked and his suggestions are accepted in the knowledge that they are based on experience and common interest.

#### Representation on Boards of Directors

Development finance companies do not restrict themselves to loan operations. They often venture out into more entrepreneurial activities by participating in new or reorganized enterprises, by underwriting or by financing in one way or another a very substantial amount of the total cost of a venture. In these cases the matter of relationship with clients may take on new aspects. Information and inspection may not be sufficient. A seat on the board of directors may be called for.

Obtaining accurate and reliable information from a client and carrying out follow-up inspections are crucial. It is doubtful whether the position of a financial institution in this respect can be improved by taking a seat on the board of the enterprise. Experience shows that directors are often less well informed than are the bankers who take follow-up procedures seriously. Indeed, sometimes an institution tends to relax vigilance when it has a director on the board, and to rely mainly on board papers or on the views of the individual who happens to serve as its representative on the board.

Experience differs widely in this respect because no two boards operate in the same manner. For instance, some boards meet every week, and

others once a year. Sometimes board meetings are cut-and-dried affairs; sometimes listening to discussions in the board brings out certain facets of an operation that cannot be appreciated in another manner. What is important in this respect is the personal relations established between directors and managers and the candid opinions expressed during meetings which are usually not placed on record. Another advantage of a directorship involves the timeliness of information and of possible intervention. Audits, reporting and follow-up inspections are retroactive, in the sense that they inform after the event. On the other hand a board is normally informed of prospective decisions before they are taken; a development finance company represented on a board may often have a chance to put in a word at the most opportune moment, and then exercise an influence which follow-up, audits, and reports will not allow. When a financial institution puts a director on the board of a client enterprise it obtains for itself certain powers which go beyond those reserved in a loan contract. At the same time it assumes a measure of responsibility that may, especially in the case of an enterprise whose shares are held by the public, constitute an onerous burden. Newly floated companies, especially which a development finance company has promoted, sponsored or underwritten and whose shares it has helped market, may ask the company to go on its board because this enhances its standing. Indeed going on the board may be a measure required for effective sponsorship, promotion or underwriting. There is, however, understandable reluctance on the part of development finance companies to accept such nominations because they might in this manner be faced with a conflict of

interest, (for instance, on dividend policy) between that of the shareholding public and that of the financier. Some development finance companies have found that board representation has strengthened an otherwise tenuous relationship with a debtor company; others have felt it wiser to remain aloof so as to avoid being in a situation in which sides have to be taken with either of the factions one often finds fighting more or less openly in a board.

The situation appears in a different light when the finance company is itself an important shareholder and not simply a debtor. It is not only unusual, but in many countries it is illegal, for specific shareholders to procure for themselves privileges in the matter of information or otherwise; therefore a directorship may be the only way for the institution to keep itself informed and to try to influence management when that seems desirable.

Sometimes a development finance company is asked to go on the board of an enterprise where foreign and indigenous entrepreneurs each own a certain portion of the stock. This may not be an enviable position in every respect, but the finance company may have to take on the responsibilities of a "go-between" in order to help bring, and hold, together varying interests, especially if it took the initiative in bringing those interests together.

Clearly there are many pros and cons on the issue of putting representatives on boards of client enterprises. The finance companies

associated with the World Bank Group have widely differing views on the subject. In general, they seem agreed that they should be represented on boards when they owned an amount of stock large enough to justify such representation. But there was no concession on whether to take a seat on the board of a company to which a loan had been given. Some felt a finance company should never go on the board of a debtor company; other institutions invariably take the right to nominate a director, but exercise it sparingly. None seemed keen to put nominees on boards of debtor companies because this usually involved the financial institutions in responsibilities and conflicts of interest without giving it extra powers; but it was generally agreed that there is sometimes no suitable alternative to protect the interest of the institution, of the public or of a particular enterprise.

When it is decided to put a representative on the board, an appropriate person must be chosen. Who? Some development finance companies prefer to have their own staff on clients' boards, because they felt this strengthened the relationship. Others prefer qualified outsiders, because they would not so directly involve the development finance companies in responsibilities or differences of opinion. The latter group generally admit, however, that it was difficult to find qualified people who could and would take time to interest themselves sufficiently in the affairs of the client companies. One company expressed the opinion that qualified people should be found prepared to specialize in the



responsibilities of industrial directorship and should develop such specialization as a professional career.

Taking Responsibility for, or Participating in, Management

Development finance companies are, and have good reason to be, reluctant to take seats on boards of directors. It is not surprising that, as a rule, development banks refuse to be involved in management. There is sometimes only a thin line between a board seat and participation in management. The line is, nevertheless, there.

Firstly, there is the human angle. A good development banker should have some entrepreneurial and managerial qualities, but he is usually stronger on the financial, technical and administrative sides. More important still is the institutional aspect. A development finance company is set up to serve many clients in each of many fields of industrial activity, and it should not identify itself with the interest of one particular enterprise in one particular field; by doing so it risks compromise its position vis a vis other businesses in the same industry. Finally, there is the financial principle that a development bank should place its investments with prudence and with proper diversification. Involvement of a development finance company in the management of a company would mean that two functions are merging into one; the function of the entrepreneur who should go ahead, take risks, expand, and the function of the financier who should ask questions, restrain and urge caution.

Notwithstanding these sound arguments against involvement of a development finance company in managerial responsibilities, there are exceptional cases where such responsibilities should be undertaken. Three instances may be cited which are symptomatic of the cases when deviation

for an admirably sound principle are necessary.

As noted in the discussion of promotion, in some countries clients with constructive ideas and funds to back them are conspicuously absent, and the development finance company feels there are really promising possibilities. The company then has to take the responsibility for promoting; for if it does not do this, nobody else will. In such a situation, there is often no alternative to involvement in management if the promotion is to be successful. This is a risky business but sometimes an unavoidable one; it is a type of "priming" which contributes to the industrial development of the country. One finds in some countries enterprises that are now widely held which are still managed by men, who years earlier, were put into managerial posts by the development banks on whose staffs they worked. In another country, a development finance company has been asked to administer a portfolio of Government participations in industry. It may find that some of these enterprises need reorganization and that it is not in all cases possible to find qualified outside managers. In such instances the finance company may delegate one or more of its staff to form a management team, which is accountable to the company, and which will, hopefully, be replaced one day. Still another kind of case involves jeopardy. In the case of an investment gone sour, the taking over of management may offer the only alternative to outright loss. Thus, the development finance companies which have entered, directly or indirectly into the management of the client enterprise, have never done so lightly, and have done so in the conviction that there was no acceptable alternative and that the situation would be temporary.

### Conclusion

Good management is of crucial importance for the success of new enterprises, and one of the most important tasks for a development finance company is to encourage good management and to establish close and constructive contacts with its clients. The possession of reliable and up-to-date information is a prerequisite in this respect.

Responsibility for management should remain where it belongs - with the owners of the enterprise - and for this reason development finance companies are often reluctant to accept directorships and always reluctant to manage the industrial enterprise they finance. There may be cases, however, when a development bank has to go on a board, primarily when a share participation justifies such action, but also when it is felt that reliable information cannot be obtained otherwise or when the bank's interests need extra surveillance. Managerial responsibilities are also on rare occasions accepted but only when doing so is justified as a temporary measure for which there is no reasonable alternative.

PROBLEMS OF FINANCIAL POLICY OF  
DEVELOPMENT FINANCE COMPANIES

[all in italics]

Note:

The Agenda of the Conference called for a discussion of the financial policy of development finance companies. Included were such diverse matters as the level of debt a development finance company can prudently incur, policy towards the establishment of reserves to protect the company against specific expected losses, how much of profits should be paid out and how much retained, the effect of taxation on reserves policy and dividend payments, and interest rate policy. Thus "financial policy" was not "a subject", but a package of subjects.

It was also a complex and important package of subjects, especially for institutions which were approaching maturity - for they were fundamental to decisions on how the growth of development finance companies was to be financed. They were also subjects on which there

could be conflicts of interest among interested parties - certainly between shareholders and creditors; and perhaps also governments, if governments were providing important financial resources or incentives.

The chairman of the discussion of financial policy was Mr. H. T. Parekh, General Manager of the Industrial Credit and Investment Corporation of India. The largest part of the discussion concerned the level of debt. Mr. Parekh noted that, if a development finance company is to make satisfactory profits, its ratio of debt to equity must be weighted in favor of its shareholders. As a lender, he insisted that his borrowers maintain a 1:1 ratio, but as a borrower he preferred to have no limit. Such a stand was not defensible; there had to be some check. On the other hand, development finance companies could not afford to close their doors; business had to be increased. If so, they needed resources. Local currency funds had been relatively easy to raise, for governments were not bothered about debt/equity ratios. But the World Bank and other conventional lenders did ask questions which, while relevant, were sometimes disagreeable. In the past, the World Bank had been most helpful by relaxing the limitation, when the situation justified a relaxation. Still, financial institutions had to recognize that there were limits to the debt they could incur, even from the point of view of their own prudence. Mr. Parekh pointed out that part of the difficulty lay in the fact that raising equity capital was the most expensive form of financing and that it was difficult to go to the market for new capital until additional capital could be serviced without reduction of reserves.

On another aspect of financial policy, Mr. Parekh called attention to the difficulty of establishing a "right" balance between retention of earnings and payment of dividends. The former encouraged creditors, the latter encouraged investors. The former was needed for nationally financed growth; the latter for external financing. In either case the attitude of the shareholders was crucial: how and at what price did he want to finance the growth of the development finance company. A 50-50 distribution was a reasonable rule-of-thumb. Regarding interest spreads, the general feeling was that a spread of 2-1/2% to 3% was reasonable. As to whether the interest charged should be above or below the prevailing market rates, Mr. Parekh thought a lower interest might attract bad projects while a higher rate might adversely affect a development finance company's public image. On the question of taxation, Mr. Parekh considered it politically inexpedient to ask for total tax exemption, although a case could be made that, since a development finance company's operations involved large risks, profits put to reserve should not be taxed to the same extent as distributed profits and bond issues would benefit from tax exemption. Clearly, the crucial question which a development finance company would face over the years was that of raising resources to enable them to continue operations raising both loans and equity. Although financial assistance could be expected for some time from governmental sources and international institutions it would become necessary for a development finance company to go the market at some stage, and it was thus essential to gear financial policies to facilitate this objective.

The discussions and Mr. Parekh's summing up made it clear that there were no easy or universal answers to the questions that had been raised.



An Essay on Aspects of Financial Policy, by Douglas Gustafson

INTRODUCTION

The development finance companies associated with the World Bank Group are in many respects crossing uncharted territory. They are unique in most of the countries where they operate, in the kind of financing they do, in their appraisal and follow-up efforts, and in their methods of financing their operations. Although charged with a developmental function, they are also responsible for earning a return satisfactory to their shareholders. To achieve these goals, it has been necessary to develop new types of financial structures and policies. For many of these development finance companies, previous comparable experience, which could serve as a sound guideline for their operations, is simply not available in their countries; and even the older ones among them have an experience of only about 10 years or so, which, relatively speaking, is a very short history. Yet within this time some of these institutions have accumulated large resources and occupy an important position in the fabric of industrial and financial institutions in their countries. Because of their unique features and of the absence of institutional history, they have had to develop new financial policies determined, in many cases, by environment and circumstances, and in others, by intuition. This fact underlies the difficulty of trying to use an analytical approach in defining financial policy, particularly for a new type of company.

Unfortunately, some of the knottiest problems of financial policy are fundamental to the sound growth of a development finance

company. How much debt should a development finance company incur relative to the shareholders equity? On what terms should this debt be acquired, and how do these terms affect the overall acceptable level of debt? What interest spreads are required? How should losses and bad debt allowances be handled? What is the appropriate dividend and reserve policy in a given environment? These are basic questions of financial policy which must concern the shareholders, management and creditors of a private development finance company. Consequently, an important task of those associated with these companies is to sharpen the decision making process used in answering these questions.

#### Diversity in Capital Structures

Although there is similarity among the development finance companies associated with the World Bank Group, each operates in its distinctive environment and has its unique characteristics. Generalization is always difficult and sometimes impossible. For instance capital structure differs widely. Some companies have what might be called a World Bank "model" capital structure consisting of 100 units of share capital, a thirty-year interest-free loan of 150 units, subordinate to share capital, and an initial borrowing power of three times the sum of these, or 750 units. This borrowing power allows a maximum of nine units of debt capital for every unit of shareholders' equity. A variation of this is a company that has a share capital of 100 units, a thirty-year low-interest loan of 300 units, subordinate to other debt but ranking ahead of a paid-in share capital, and an initial borrowing power of three times the sum of these, or 1,200 units; this structure allows a maximum of fifteen units of debt to be mobilized for each unit of shareholders'

equity. Still other companies do not have subordinated loans but have been entrusted with the management of funds belonging to their governments, which they have invested in industry without risk and with a fixed income. Finally, some development finance companies associated with the World Bank Group have no subordinated loans or agency funds, and operate under government- or creditor-imposed borrowing limits ranging from 3.0 times to 6.6 times their own net worth.

#### Goals of Financial Policy

Although the capital structures of the twenty-odd companies associated with the World Bank Group are varied, the objectives of their respective financial policies are more uniform. In any private concern, the primary responsibility of the management is to the company's shareholders. Financial policies, like all policies, should be directed, in the first instance, toward earning a reasonable return for the shareholders and, second, toward the related goal of maintaining an organization capable of expanding its resources with a minimum of special concessions. The ability to expand resources is indicated by the ability of the company to raise additional equity capital as well as to obtain loan capital on suitable terms.

These basic objectives are somewhat clouded by the fact that private development finance companies are hybrid institutions, which, although distinctively private, are also involved in activities that are not reflected in their financial statements. These less easily measured secondary activities motivate both governments and private shareholders to provide funds on a broader basis than merely financial return. Governments often feel that the overall economic impact of a

development finance company warrants the provision of funds on non-market terms, if this is necessary to bring the company into existence and to sustain its activity. Occasionally shareholders realize benefits corollary to the financial return on their investment and they purchase shares in this knowledge. These factors are almost always of great importance during the formative stage of a development finance company; and there may, in fact, be companies for which such concessions are necessarily and justifiably a continuous feature of their operations. Nevertheless the managements of such companies feel that a company operating in the private sector must have as a goal the minimization of special concessions. For capital provided on concessional terms is more likely to result in undesirable restrictions on a management's freedom than funds that are obtained competitively in the market.

In order to be able to expand resources, a development finance company must maintain financial policies that will both attract private investors so that new share capital will be forthcoming when needed and leave creditors satisfied in order that loan capital will continue to be available. Obviously conditions vary greatly from country to country and subjective responses will influence the decisions of investors in share capital and of creditors, so that it is not possible to take a given company and formulate, on the basis of a completely rational analysis, a precise financial policy.

#### DEBT-EQUITY RELATIONSHIPS

Perhaps the most fundamental questions of financial policy related to achievement of a development finance company's objectives concerns the appropriate level of debt relative to equity and what the

terms of that debt should be. The complexity of this problem has often led to simplifications and rules of thumb that are based primarily on what has been done before rather than on an analysis of what is appropriate for a given company at a given time.

#### The Aims of Creditors and Shareholders

In practice, there are two distinct approaches to the determination of the relationship between debt and equity. Generally, shareholders are interested in maximizing the financial return on their investment; this viewpoint, in the case of a development finance company, leads to maximizing the number of units of "outside" capital (debt or managed funds) for every unit of equity whether in the form of paid-in share capital or of retained earnings. If given the choice, shareholders will always prefer to increase debt relative to equity (i.e., increase leverage) as long as they feel that the marginal net spread on new debt resources, after all charges, including losses, is positive. Take, for example, a company which earns a gross spread of  $2\frac{1}{2}\%$  on borrowed funds, whose administrative expenses and taxes at the margin take  $1\frac{1}{2}\%$  and whose expected annual losses on the company's portfolio are steady at  $\frac{1}{2}\%$ . The net spread on these funds would be  $\frac{1}{2}\%$ ; and shareholders would, in principle, like to expand debt relative to equity infinitely. If, for any number of reasons, increased debt were to produce no net margin or a negative one, shareholders would not, of course, want to incur the new debt.

Creditors, on the other hand, wish to maintain an expectation of repayment of their funds commensurate with the interest rates they charge. In short, creditors are concerned with risk. It is clear that the final decision as to what is appropriate involves a balance between the

views of the shareholder and those of the creditor. Moreover, because the evaluation of risk is such a difficult task, debt-versus-equity decisions are largely a matter of judgment based on what those involved are accustomed to. An analytical formulation of what is a "right" debt-equity policy is difficult, if not impossible.

The management of a development finance company, representing, as it should, the shareholders, may often use the following approach in determining a reasonable debt-equity policy. First, it establishes a minimum acceptable return on equity; then it imposes on this the spread earned on its resources. With these two conditions stipulated, the management then determines the leverage necessary to achieve the desired result. Arithmetically, this is a simple way of arriving at a decision. It is also helpful in that it indicates what may be necessary in a given situation to maintain a profitable operation. The fact, however, that a given relationship of debt to equity is necessary, given certain spreads, to make a development finance company reasonably profitable does not in any way indicate whether or not that debt-equity relationship is appropriate from a risk standpoint and therefore acceptable to creditors.<sup>1/</sup> The major concern of creditors is the measurement of their risk; this involves an analysis of their client's risk under what might be considered normal operating conditions and possible deviations from the normal. Such

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<sup>1/</sup> On the other hand, if a company operating under an established debt-equity relationship is earning returns that the market judges attractive, it is not reasonable to expect that creditors will be willing to increase their risk by increasing their exposure in the company, relative to shareholders' equity; they will want to be compensated in some way for the additional risk they thereby assume.

measurements probably constitute the most difficult of all financial problems.

The World Bank Model

The World Bank "model" capital structure for a development finance company, referred to above, provides a useful base for examining the problem. There was no experience by which to judge the proper relationship among shareholders' equity, subordinated loans and conventional loans for this new type of company. The initial ratios were determined, not by analytical findings as to what was reasonable in a particular economy for a particular company doing a particular kind of business, but rather by a feeling that the "model" capital structure was reasonable. The managements of many of these companies have not had to question the appropriateness of this initial debt-equity relationship; for the younger companies, the problem of the relative amounts of outside capital to shareholders' capital is not important, since it takes several years before a company's initial borrowing capacity is fully utilized. Experience to date with this capital structure has not been unfavorable. A number of companies operating with it have been reasonably profitable and their creditors have incurred no losses.

The Role of Subordinated Loans. Except in Colombia, Greece, Spain and Venezuela, subordinated loans or the managed funds that have been put at the disposal of development finance companies associated with the World Bank Group by local governments, or by the United States government at the request of local governments. This was done largely at the urging of the World Bank, which considered subordinated loans both appropriate and essential for the formation of these private companies.

The funds provide an initial earning base at little or no cost to the shareholders, as well as a base for considerable leverage. Although it is common among these companies to refer to their capital structures as having a debt-equity ratio of 3:1, this is not correct, because the potential ratio of real debt to equity, which reflects the actual leverage on shareholders' equity, is on the order of 9:1.

Another important aspect of some subordinated loans, from the shareholders' point of view, is that they usually give the shareholders additional protection; if the company goes into liquidation, the share capital ranks either ahead of, or pari passu with, the subordinated funds. In other cases, these funds rank ahead of share capital and are subordinated only to foreign debt. The relative ranking of subordinated funds, reserves and paid-in share capital is not material to the risk position of creditors who have supplied senior debt, because their exposure is determined by the total amount of funds which are junior to their loans. It is immaterial to them whether or not subordinated loans rank before, after or pari passu with share capital.

Requirements of Subordinate Lenders. The providers of subordinated funds have often made them available without a detailed consideration of their exposure and risk position in the borrowing company. Such loans have been made generally because the World Bank considers them a reasonable and necessary component of a development finance company's capital structure. As a practical matter, governments supplying funds to private development finance companies, have often given the World Bank Group the responsibility for overseeing a "proper" capital structure. They have been prepared to take the World Bank's advice even though it



involves them as subordinate lenders, in the greatest financial risk among all those who provide capital to the proposed company. In some cases, the only protection that a subordinated creditor has, apart from confidence in the management of the company and confidence in the World Bank's concern for the company's continuing stability, is a contractual provision that the company set aside a certain part of earnings in reserves. Such a provision gives some backstopping to a loan subordinated to paid-in share capital, for the subordinated loan usually ranks ahead of retained earnings in liquidation. On occasion, however, subordinated creditors have not required even this and have left the whole question of proper debt-equity relationships to the World Bank Group.

Theoretically, creditors making different classes of loan funds available to a development finance company should select a different debt-equity ratio for each type of debt. This does not, however, happen in practice; what has happened is that the World Bank has, on its own, selected the ratios of non-subordinated debt to shareholders' equity plus subordinated loans for most of the companies associated with it.<sup>1/</sup>

Problems of Maturity. Although relatively young development finance companies are not greatly concerned with debt-equity decisions, as they mature and press against their original borrowing limits and as they face the prospect of having to repay subordinated loan funds originally included as part of their borrowing base, the concern for establishing an appropriate capital structure becomes of major importance. In most cases there are pressures to redefine debt limitations so that the companies may take on additional debt. Illustrative of these pressures is the case

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<sup>1/</sup> In some cases, however, not all of the subordinated funds available to the company have been included in the borrowing base. Such a situation usually reflects, when it occurs, the non-analytical reliance on intuition referred to earlier.

of a company with a debt limitation of three times a borrowing base made up of net worth plus a subordinated loan, and an earnings spread, after financial charges and administrative expenses, of 2% on capital employed. This company might grow as follows:

	<u>Year A</u>	<u>Year B</u>	<u>Year C</u>	<u>Year D</u>
(a) Paid-in share capital	100	100	125	150
(b) Retained earnings	-	50	75	150
(c) Net worth	<u>100</u>	<u>150</u>	<u>200</u>	<u>300</u>
(d) Subordinated debt included in borrowing base	<u>150</u>	<u>150</u>	<u>75</u>	<u>-</u>
(e) Borrowing base	<u>250</u>	<u>300</u>	<u>275</u>	<u>300</u>
(f) Other debt (3 x e)	<u>750</u>	<u>900</u>	<u>825</u>	<u>900</u>
(g) Total capital	<u>1,000</u>	<u>1,200</u>	<u>1,100</u>	<u>1,200</u>
(h) Earnings (2% of total capital)	20	24	22	24
(i) Return on net worth	20%	16%	11%	8%
(j) Ratio of total debt to net worth (d + f/c)	9:1	7:1	4.5:1	3:1

The company's problems as it matures, can be summarized as follows:

- (1) Real leverage, i.e., the ratio of outside funds to shareholders' funds, declines between year A and year B as reserves increase, although all the subordinated funds remain intact.
- (2) This loss of leverage is accelerated when the subordinated debt is lost through repayment.
- (3) The result is a decline in the return on shareholders' equity.
- (4) As long as the earnings increment on new borrowed funds is positive, raising additional debt will be cheaper, from the existing shareholders' point of view, than increasing the paid-in share capital.

- (5) Furthermore, although this is not illustrated in the example, it is likely that low-interest funds become a smaller proportion of the total resources of a development finance company as it matures. Thus the average cost of its capital will increase and the average earnings spread on resources employed will drop. Whether or not there is an overall decline in the margin will depend on the movement of administrative expenses, as well as bad debt losses, relative to the resources employed.
- (6) In addition to these normal forces, there is always the possibility that market conditions and the company's operations are such that it may not be possible to go the market to sell new ordinary shares at a price that existing shareholders would consider reasonable.

It is clear that as this company nears its initial borrowing capacity and the time when it must begin to repay its subordinated loans, it faces an entirely new set of problems concerning the continuity of its earnings potential and the expansion of its resources. There is thus a strong motivation, from the shareholders' point of view, to have the borrowing limit relaxed in order to maintain actual leverage. Several of the development finance companies associated with the World Bank Group are in this situation, or approaching it.

The Case Where Subordinated Funds Predominate. Another interesting situation occurs when a company continues to receive local currency loans that are subordinated to foreign debt or when other unusual circumstances exist in which subordinate funds are very large, relative to the company's

own net worth. For example, the original capital structure of the Industrial Credit and Investment Corporation of India (ICICI) consisted of Rs. 50 million in paid-in share capital and Rs. 75 million in a long-term government loan subordinate to share capital and other debt. The World Bank limited ICICI's borrowing to three times the sum of these funds, allowing an effective leverage of 9:1. By the end of 1965, ICICI's net worth had increased to Rs. 94 million and, in addition to the original Rs. 75 million of subordinated debt, ICICI had obtained from the Government of India additional loans of Rs. 220 million; although not subordinated to share capital, these loans were subordinated to foreign debt. If the Rs. 220 million were included in the borrowing base along with the original government loan of Rs. 75 million, the total level of senior debt that this borrowing base allows would have been Rs. 1,556 million and the ratio of shareholders' funds to outside funds (all debt) at this limit would be on the order of 20:1. Even at this level of borrowing, the exposure of foreign creditors in ICICI would still be on the basis of a ratio of 4:1; from the viewpoint of their risk this would not be unreasonable. But would a ratio of debt to equity of 20:1 be a healthy situation for ICICI? The debt ranking above share capital but below senior debt was excluded from the borrowing base.

Similar is the case of the Industrial Development Bank of Turkey (IDBT). At no risk to itself, this company had been managing TL382 million in agency funds for the government. The company's own net worth amounted to approximately TL76 million and it had been borrowing, principally foreign currency funds, on the basis of a limit of four times its net worth. In 1966 the managed funds were turned over to TSKB in the

form of a long-term loan, subordinated both to other debt and to share capital. If this subordinated loan is included in TSKB's borrowing base on the 4:1 ratio, the company would be able to borrow funds, both subordinate and conventional debt, up to a total amount of almost twenty-eight times its net worth. Here again, the infusion of additional subordinated loan capital and the potentially high total ratio of debt to equity have not increased the risk to conventional creditors in case of default; it is clearly the junior creditor (i.e., the government) who assumes the additional risk.

#### The Establishment of "Proper" Ratios

The World Bank's attitude toward debt-equity relationships is broader than that of a normal creditor. The Group, as promotor, financial adviser, creditor and shareholder of private development finance companies, has a much wider responsibility and some governments rely on it to exercise this responsibility. The Bank's objective is twofold: that the company be solvent, profitable and eventually self-sustaining, and that the risk taken by creditors, including subordinated creditors, be at an acceptable level. Its first objective coincides with that of the company's management and shareholders. As for the second, the World Bank is, in effect, asked to decide the overall level and the terms of debt that are acceptable in order to avoid an excessive risk of insolvency. What are the risks? What level of risk are the creditors and shareholders willing to accept?

Any answer to these questions will be riddled with judgments. For an industrial concern, the rational approach to debt decisions is to evaluate the behavior of each major determinant of the company's cash flow (taking into account its realizable assets) in a recessionary period,

on the basis of the past experience of the company and of similar companies in the same industry during a business downturn. It is extremely difficult to forecast the severity and length of a recession and its impact on a company's sales and costs. This must nevertheless be done; critical judgment must be exercised in trying to quantify these forecasts. Shareholders and creditors alike must endeavor to make systematic analyses of cash flows in order to rationalize the decision-making process a step beyond the application of hunches and rules-of-thumb.

Similarly, in endeavoring to establish a reasonable debt-equity relationship for a development finance company, an attempt should be made to evaluate the company's operations under normal operating conditions and to forecast cash flows under adverse circumstances, assuming different levels of debt and equity and different terms for the various levels of debt. Conceptually, the approach is basically the same for a finance company as for an industrial concern. In undertaking this analysis, however, two important differences should be noted.

Firstly, for an industrial concern, the important variables are sales and costs. For a development finance company, expenses can be forecast with relative accuracy and the major variable determinant of the cash flow will be the estimated net defaults in a recessionary period (net defaults being gross defaults on interest and principal in a given period less cash recoveries by the realization of security during that period).

Secondly, if the development finance company is borrowing for periods longer than it is lending, the chances are that it can generate a large cash-flow surplus by making no new loans under normal operating circumstances. By stopping new operations, the excess of debt collection from its customers over debt repayments to its creditors will often

provide a significant margin of safety. Such a company, even if it has a higher debt-equity ratio, will have relatively more time to recover from a recessional impact before defaulting on any of its obligations, than will a company whose repayments of principal are closely tied to its collections of principal (as the World Bank when it lends). In one sense, the former company is safer than the latter as long as it is operating; but at the point of liquidation, the protection behind the creditor's funds, as measured by the ratio of its debt to shareholders' equity, is of course more favorable for the latter company. Thus, a company could be solvent as to cash flow, but insolvent if the value of its assets were insufficient to cover its liabilities at any given point, and under this definition, it would have failed. Consequently, in the establishment of debt policies, both the overall relation of debt to equity and the cash flow situation need to be appraised. This requires some understanding of the risks being taken by the company.

Evaluated and Unevaluated Risks. What this boils down to is risk evaluation. In their day-to-day operations, the managements of development finance companies are concerned with minimizing unevaluated risks. There is a difference between a management that takes risks without realizing it and one that takes risks knowingly. In a competitive situation, any development finance company (or any type of company, for that matter) is involved in risk-taking. Consequently, the objective of a development finance company's management is not to eliminate or even minimize risks, but to be in a position to make a sound judgment of precisely what risks are being taken and then to make a second judgment as to whether or not it should take this degree of risk.

There are several components in an estimate of a development finance company's risk under normal circumstances. Perhaps the key component is the ability of the staff to appraise projects. This is determined by the basic competence of the people employed, their thoroughness in evaluating investments and the effectiveness of subsequent follow-up. A second factor in evaluating risk is determined by the clientele served by the development finance company. There is a significant difference in the competence and level of sophistication of the business community dealt with by different development finance companies. Generally, the companies servicing the larger, more established industrialists take fewer risks than those whose clients are predominantly small and unproven businessmen. Another element is the diversity of investments; most development finance companies try to spread risks by avoiding concentrations of investment in individual firms or individual sectors of industry. The final element concerns the company's security requirements, the possibilities for the realization of security upon liquidation, and the ethics of the business community. Although the security on a loan may appear considerable, it might prove difficult to realize it in the event of liquidation; or it might be difficult to exercise mortgage rights, due to customs or title difficulties; or a combination of circumstances might make it more costly to try to realize the security on a loan than to write it off.

These are matters which managements deal with daily in their hiring and training programs, in their policies with respect to investment, and in with their practices with respect to security. In dealing with them, they are endeavoring to sharpen their ability to avoid uncalculated risk. Judgments as to their effectiveness in dealing with all these components of calculation are necessary to begin to evaluate the risks they are undertaking.



Measurement of Risks. The management of a development finance company and its creditors should have some sort of evaluation of the level of risk that they are undertaking. This is difficult for a young development finance company, whose loan and investment portfolio is unseasoned. As such a company matures, however, as a larger percentage of its loan portfolio represents operating projects, and as the number of projects that it has seen through from loan disbursement to loan repayment has increased, it becomes easier to evaluate meaningfully the normal operating risks undertaken by the company. The first and basic indicator is the default experience on loan interest and principal. This should probably be separated into two parts: one that deals with the problems of timing, resulting from optimistic forecasts, particularly during the construction stage, and another that deals with defaults due to basic difficulties in the client's operations, managerially, technically or financially. With respect to equities, the indicator is the value of the shares in the marketplace although where the market is very thin or nonexistent, this is difficult to find.

The record of defaults on interest as well as principal payments relative to total interest and principal payments due during a given period will indicate the general lag in collections; and the total funds outstanding on those projects in default related to the total loan portfolio will give some indication of the relative soundness of the portfolio. Some of these defaults may be merely temporary, with little risk of ultimate loss, whereas others will indicate more serious situations that might involve write-offs. When a development finance

company has established a record of operation over ten years or so, and if its management has been realistic in recognizing the cases that are likely to be permanent defaults (even before it is appropriate to write them off), some general observations can be made as to the probable element of loss under normal operating circumstances. Finally, when it is necessary to exercise security provisions, their effectiveness can be evaluated. A similar, continuous evaluation can be made for the equity portfolio.<sup>1/</sup>

The difficulty is that although defaults, write-offs and security recoveries are critical indicators, they are not popular statistics to deal with, with the result that they may not be handled in a way that makes them easy to analyse and evaluate by either management or creditors. The sensitivity of this area, however, is such that it should receive careful attention from management, particularly if management is interested in securing higher debt-equity ratios. A mature institution should be able to have a fairly clear idea of four parameters with respect to its loan and equity portfolio:

- (1) the percentage of payments of interest and principal that is due during a given period, but is unpaid;
- (2) the percentage of the loan portfolio that at any given time is likely to be in permanent default;
- (3) the percentage of uncollectables that is likely to be recovered as a result of security provisions;
- (4) The value of the equity portfolio relative to its cost.

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<sup>1/</sup> Some equities carried at cost will be worth less than cost, while others will be worth more; the evaluation should arrive at the net normal gain or loss on the value of the equity portfolio.

If these basic parameters of risk can be established under normal operating conditions, the problem becomes one of evaluating divergences from the normal risk. In practice this would mean trying to predict what would happen in business downturns. Experience in such situations is slim, but if debt-equity policy decisions are to be rational, some thought must be given to what would happen in such a situation. The following questions need to be asked. What percentage of the loan and equity portfolios would be in trouble in an expected recession? Of the projects in difficulty during a recession, what proportion could, given time, be revived? What part of the portfolio would be a complete loss and would have to be written off? Finally, of the part of the loan portfolio that must be written off, what could the development finance company hope to realize from its security? These questions, when asked in light of cash flow projections, can be helpful in determining whether a company is facing excessive risks of defaulting on its own obligations.

On the other hand, if, at any time, the value of a development finance company's assets is less than its liabilities, the company could theoretically be considered in a state of default, even though not defaulting on a cash basis. If this were viewed as a temporary situation, that is, if the company could recover itself before running into a cash deficiency, creditors would be wise to ride it out. Nevertheless, if a company's portfolio is valued at less than an amount sufficient to cover its debt, and there were some uncertainty about the future condition of the portfolio, the company would be in a serious situation, regardless of its cash flow. Thus creditors should not lose sight of the ratio of all the

debt incurred by a development finance company relative to its equity, regardless of its ranking, and should insist on a ratio which provides a cushion large enough to minimize the possibility that a development bank's assets might be inadequate to cover all its liabilities, senior or junior.

Thus creditors, like shareholders themselves, are concerned with the true ratio of debt to equity. All who are involved with a development finance company would be displeased should it find it necessary to default on any of its commitments. Even if subordinated debt is available ad infinitum, it would be prudent to maintain a balance between debt and equity which minimizes the risk of default to any of the company's creditors. Hence decisions on the debt-equity ratio should be based on a systematic and continuing evaluation of the risks in the company's portfolio and of its cash flow.

Summary. Decision-making on the relative amounts of conventional debt, subordinated debt, and equity in the capital structure of a development finance company has little experience to fall back on. The initial capital structures designed for many of the development finance companies associated with the World Bank was more or less taken as given. It has so far been a successful model to the extent that there does not yet appear to have been any excessive risks taken either by shareholders or by creditors. However, as companies reach their initial borrowing limits, there are forces at work which will lead to a desire on the part of the shareholders to maximize leverage and new decisions are required.

During this process the debt limits established by the World Bank have become quite widely accepted standards. However, in many cases these ratios do not indicate the real leverage on shareholders' capital,

which is the critical ratio both as far as profitability is concerned and also as far as the risk position of the company's creditors is concerned. Now that original borrowing limits have been reached for a number of development finance companies, more careful thought will have to be given to an evaluation of the risks involved in doing the type of business they are doing in the environments in which they are located, in order to establish more precisely the risk position of creditors so that their decision-making will be better informed. In doing this, it is necessary to analyze the cash flows of development finance companies and the quality of their portfolios as well as the underlying cushion of equity which should be required to maintain the value of its assets at least equal to its debts in predictable business downturns.

#### POLICIES REGARDING RESERVES AND RISK PROVISION

In discussing the financial policies of private development finance companies, the term "reserves" is often used in a generic sense. When so used, reserves are always considered important and "good", a sign of success; and it is commonly recommended that they be built up to the greatest extent possible. The rationale behind this, however, is sometimes unclear or at least unexplained. The word implies an extra cushion for shareholders as well as for creditors, and therefore has a positive connotation. This is indeed true to a large extent, because the accumulation of what are generally referred to as reserves indirectly implies a profitable operation as well as abstemiousness on the part of the company's shareholders, which is a reflection of their willingness

to continue and to increase their investment in the company. Reserves of the type that development finance companies have in mind are also an indication that the company's equity base has been enlarged and that this has been done over and above the shareholders' requirements for cash returns on their equity.

On the other hand, there is a mystique about development finance company reserves, which sometimes endows them with greater importance in the eyes of shareholders and creditors than they in fact have in the basic financial condition of the company. In order to establish an appropriate reserve policy for a development finance company, it is necessary, first, to be precise in definition and terminology, and second, to take a hard look at different types of reserves, at their purposes and at how these purposes coincide with the objectives of a particular company.

The term "reserves", is often used to refer to the retention of earnings and accumulated profits after all other charges against income have been levied, including the payment of taxes and distribution of dividends. A part of this retention may be labeled a "legal reserve", since many countries require that a certain percentage of net profits be so retained; but this still basically represents an increase of the shareholders' equity in the company. These are earnings that belong to the shareholders, which they have elected to keep in the company, thereby increasing their investment in the company. If the term "reserves" is used to represent funds generated out of the true net profits of the company, then a better term than "reserves" would be "retained earnings." The simple word "reserves" implies something "extra" and this is not necessarily the case.

An entirely different type of "reserve" is the allocation of funds to cover a specific risk. There is some confusion about what such provisions are, how to provide for them, if, in fact, they are different from retained earnings, and whether or not a development finance company need be concerned with them at all. Often this type of "reserve", which is a provision against risk, is used interchangeably with the "reserves" described in the preceding paragraph, i.e., with "retained earnings". Yet these two financial accounts are quite different. Part of the confusion in nomenclature arises from tax and legal requirements relating to development finance companies. Although legal requirements must, of course, be observed and the managements of development companies will wish to maximize tax advantages, these factors are secondary to the basic decisions of prudent financial policy and they should not be allowed to distort the underlying financial condition and objectives of the company. Considering, for example, an industrial concern that, under the tax code, is able to depreciate equipment at a much faster rate than the actual economic rate, thereby improving its tax position. That company will want to take advantage of this privilege. However, it will also recognize that such a depreciation is an accounting device that does not truly reflect the actual operations of the company and it will want to keep in view a realistic evaluation of assets at all times. Thus, in trying to define policies relating to the retention of earnings and the provision of specific protective reserves, it is best to ignore tax or legal implications in determining the basic objectives of the policies and then superimpose on these objectives the legal and tax factors.

### Protection against Losses

Protective reserves are provisions against possible losses on loans and investments. The rationale for these provisions is that one of the real costs of operation for most development finance companies is losses on loans and equity investments. One way of handling these costs (losses) is merely to wait until the loss is definite (has been incurred) and then to charge it against that period's income.<sup>1/</sup> Such a procedure might be suitable only when write-offs are infrequent and of negligible amount.

For most development finance companies, however, it would be prudent to anticipate these costs and to level their cyclical impact by charging annually against income an amount estimated to be the annual expense of the losses. This expense should be deducted from income before the calculation of net profits and should be carried as a provision in the balance sheet in the form of a reduction in the value of the portfolio. If it is determined on a realistic basis, this provision should not be considered a part of the shareholders' equity. When a loan or investment has to be written down or written off, it is charged against this provisional account.

The real problem, however, lies in the levels to which these provisions might, in principle, be built regardless of the tax code, although it might be advantageous, from the point of view of taxes, to build them up more rapidly. In Colombia, for example, the tax code allows finance companies to provide against possible losses up to 10 percent of their portfolios and the amounts charged to this account are

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<sup>1/</sup> One way that such costs should not be handled is to write them off out of retained earnings. If this were done, these costs would never be reflected in the income statements, and profits would be overstated.



tax-exempt until this level is reached. Consequently, for companies with rapidly expanding portfolios, there are times when their entire income, before provision for losses, can be charged to this account, thereby eliminating any tax liability at all; to take advantage of this tax provision, all earnings are so charged. From the financial point of view, however, it would probably not be correct to consider the whole amount set aside in this way as a provision against losses; certainly, a portion of it is retained earnings and should be considered part of the equity base of the company. On the other hand, it would be unsound to consider the entire provision as equity. Nevertheless, in practice it has often been the tax code that has determined the establishment of protective reserves and their size.

In countries that permit a tax free reserve as a provision against possible losses, the amounts so allowed generally range from 2 percent to 10 percent of portfolio. This range is quite wide. There will obviously be a great difference between the "paper" net profits of a company that charges no provision for losses against profits, and a company that charges an amount sufficient to maintain the reserve at, say, 8 percent of portfolio. Hence it is important to determine what is a proper provision for losses. Funds in excess of this provision should be considered equity and deficiencies should call for reduction in the equity indicated on the balance sheet.

For relatively young companies, it is difficult to determine precisely the provisions that are advisable. All the factors influencing

the level of risk need to be taken into account in fixing the size of such provisions. Managements should, as a first step, focus on the rationale of handling losses, make estimates of what they consider to be reasonable provisions, test these estimates under actual operating condiditons, and adjust them in the light of experience. What is clear is that retained earnings and provision for losses are far from synonymous and should be considered and dealt with separately.

#### Retention of Earnings and Dividend Payments

Once provision for specific risks has been made along with all the other charges against the company's income, a policy must be adopted for the retention of earnings vis-a-vis the distribution of cash dividends. Retained earnings per se do not necessarily make the capital structure basically sounder for conventional creditors nor stronger for shareholders.

Take the two following cases as examples.

	<u>Company A</u>	<u>Company B</u>
Paid-in share capital	100	100
Reserves	<u>25</u>	<u>50</u>
Net worth	<u>125</u>	<u>150</u>
Debt (4 x net worth)	<u>500</u>	<u>600</u>
Total resources	<u>625</u>	<u>750</u>

In both cases, equity backing amounts to 20 percent of total resources so that the faster build-up of reserves of Company B has not made it relatively safer than Company A. For every unit retained, the company can borrow four more units; retention of earnings has allowed Company B to expand its overall resources faster than Company A. Similarly, the shareholders' position is not necessarily "better" in Company B than in

Company A. It is true that the book value per share for the shareholders of Company B is larger than in Company A, but this may indicate merely that the shareholders of Company A have opted to take their return on investment in cash rather than in increased book values, preferring to add to the equity base by purchasing additional shares at a later date. Thus assuming that both companies want to expand continuously, the decision to retain or distribute is not so much a decision of which policy is "safer" as it is a decision concerning how the expansion of the company can best be financed. Retained earnings in these examples do not provide additional protection as long as they are considered part of the borrowing base. If they were not considered such, then the overall debt-equity ratio would decline and creditors would then have greater protection.

The position is modified in the case of companies with subordinated loans. There are three levels of subordination, so far as loans to development finance companies are concerned: (1) loans subordinate to paid-in share capital, (2) loans ranking pari passu with paid-in share capital, and (3) loans subordinate to senior debt (usually, foreign currency loans). Retention of earnings does have a "protective element" as far as subordinated lenders are concerned. Their risk is reduced as earnings are retained, due to the fact that in liquidation, the first line of defense will be the retained earnings of the company; consequently, a company with a higher level of retained earnings is a lesser risk to subordinated creditors than a company with relatively lower retained earnings, other things being equal. As far as conventional creditors are concerned, as long as the ratio of their loans to equity and junior debt to their loans remains fixed, the retention of earnings does not affect their basic exposure.

From the shareholders' point of view, their exposure in liquidation is increased by a retention of earnings if the subordinated funds they employ are of types (1) and (2) above, but if the subordinated funds are of type (3), their position is not affected by the level of retained earnings. It is thus the subordinated creditors who should normally have a special interest in the retention-of-earnings policies of their debtors. In practice, however, they have not often concerned themselves greatly with these policies and the question of retained earnings versus dividend distributions has been left to the development finance companies and the World Bank Group.

The policies of any company, including any development finance company, regarding retained earnings and dividends, are determined by a number of forces, some psychological and some financial. In theory, and assuming no tax, the decision to retain or distribute earnings should be determined by the rate of return on reinvested earnings as compared with the return shareholders could earn elsewhere on these funds, if they were paid-out in the form of dividends. Where shareholders are taxed on their dividend receipts, this formula would be modified; by retaining earnings, the company puts more cash to work for the investor than if he draws it out as a dividend and pays tax on it. Thus, conceivably, shareholders' financial interests might be maximized by a no-dividend policy, with all profits taken in the form of capital gains.

Dividend policies are, however, influenced by a number of other factors. This is true particularly for a development finance company, since many investors in these companies are not investing purely for the financial returns. Yet even if they were, and it could be shown that the action of earnings would maximize the returns on their investment, there would be strong pressures to pay regular dividends. First of all, over and above earnings-per-share performance, investors always seem to value a cash income.

Regular dividend payments are visible evidence of a profitable operation and may be an important determinant of the interest in, and the price paid for, the shares of a development finance company. Investors in the shares of financial institutions will be interested in the certainty of earnings and thus the dividend yield will be an important factor for them. In fact, the managements of many development finance companies use the dividend yields of other financial institutions, and even the return on fixed interest securities, as criteria for establishing the level of dividends their own companies should try to pay.

It is impossible to lay down precise rules for an appropriate pay-out ratio (dividends-to-net-profit). A common rule of thumb is that the retention of earnings will be at a reasonable rate, if about half of profits is paid in dividends. Yet in fact it is difficult to say that the pay-out ratio should be 30 percent or 50 percent or 70 percent, much depends on the situation and environment of a particular company and on whether and how it wants to finance additional growth. In normal operating conditions, the earnings of a development finance company are more predictable than are those of most industrial firms; thus, if stability of dividends is an important consideration, a development finance company could possibly have a higher pay-out ratio than an industrial firm, without undue risk of having to reduce its dividend. However, if the company's objective is to expand its equity base, then it must decide whether to pay out or to retain in the light of how best to achieve this objective. If shareholders value dividends, and will subscribe to additional shares if the dividend policy is generous, then a good argument could be made for a relatively high pay-out ratio. If the company feels that market conditions are such that the flotation of additional shares would be difficult, then it is likely to want to retain relatively more of its earnings to finance expansion. Thus a conservative dividend policy may or may not be the most effective way of increasing the equity of the company.

Aside from considerations of financing future growth, some development finance companies feel restricted in their dividend policies because they sense that, if dividends seem too attractive, the company will invite criticism from the government, particularly if the government has given significant concessions to the company. There could indeed be a basis for government criticism if dividend policy were directed toward reducing the shareholders' stake in the firm rather than toward encouraging investment in subsequent share issues. But if such criticism is based only on the fact that the dividends appear generous, it is ill-founded, for the distribution or retention of earnings is not in itself the best profit indicator. Profits before distribution are the criterion upon which the government should base its views. Two companies can have precisely the same level of profitability, yet one retain all its earnings and the other distribute all its earnings. The former is not necessarily the sounder and more responsible company, a fact which the management of a development finance company may have some difficulty in getting across.

Ultimately the stronger the performance of a development finance company, the less it will have to rely on long-term concessions. Such concessions as it may have, were given in the first place in order to make the company profitable. If these concessions were too generous and resulted in "excess" profitability for the private shareholders, there would be good cause for encouraging the company to stand more on its own. The criterion for such a judgment, however, should not be the Company's dividend policy, but rather profitability of the company and the objectives of its dividend policy.

Another factor affecting dividend policies, is that companies will be reluctant to reduce dividends because such action is likely to have an adverse effect on investors' attitudes, regardless of the real financial situation behind the decision.<sup>1/</sup> For this reason

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<sup>1/</sup> A cut in dividends might actually indicate the alternative of a high return on retained earnings and thus would theoretically represent an improvement in the shareholders' position, which would in turn be reflected in the price paid for the company's shares.

managements are also unlikely to increase a dividend if maintaining the new rate might be difficult. One way of dealing with this consideration is to pay a basic dividend plus an extra dividend, the former representing the normal dividend and the latter representing a fluctuating element related to movements in profitability. Also, issuing bonus shares, by capitalizing earnings, is one way of making a non-cash payment to shareholders which has sometimes been effective. This is, however, clearly a paper transaction; and if the cash dividend rate is to be maintained, a bonus share issue only postpones an increase in the actual cash distributions, since the existing dividend rate will be applied to a larger number of shares in the future.

There are usually no restrictions on the use of retained earnings by development finance companies. Some financial institutions, however, are required to invest all retained earnings in short-term liquid assets. Such a limitation has two effects on the financial position of a company. First, it increases the company's liquidity. Second, it reduces the risks in the overall portfolio for shareholders and creditors alike; for, with this higher liquidity, a smaller proportion of the company's assets is held in long-term risk investments. Because retained earnings have an opportunity cost that probably approaches the cost of new equity capital, such a policy would discourage shareholders, since it would require them to make relatively high-cost equity available for low-yield short-term securities. A restriction on the use of retained earnings is probably not a very useful policy. If such a restriction were desirable in order of increasing liquidity and reducing risk, these objectives would probably be better served by requiring a sound liquidity ratio, independent of the level of retained earnings, and by lowering the overall allowable debt-equity ratio, which is the point at

which the riskiness of the company's capital structure can be most effectively evaluated and controlled.

A final consideration arises when a development finance company is operating in an environment in which there is a risk of devaluation. It is not possible to say with assurance whether shareholders will be better protected by a relatively high retention of earnings. All depends on what the shareholder would have done with his dividends had they been distributed, as compared with their effective return when reinvested in the company's operations

Summary. What is generically referred to as reserves policies needs to be considered in two distinct categories: provisions for losses, which is an expense item, and retention of earnings, as opposed to distribution of net profits. Tax and legal considerations will, of course, affect what is actually done but these requirements should not distort the real economic condition or objectives of the company. Losses for most development finance companies are a cost of doing business, and orderly provision should be made for expensing these costs. The actual magnitude of provisions for losses is a matter of judgment which can be made only on the basis of experience and of a thoughtful evaluation of the risks being undertaken by a given development finance company.

To the extent that retained earnings are used as a base for additional borrowing, they should not be considered as inherently strengthening the company's capital structure. Such retentions are simply an enlargement of the capital base of the company and in this sense are similar to increases in the paid-in share capital. The decision as to the relative amounts of dividends and retentions should be based on a consideration of



the shareholders' interests as well as of how the expansion of the company can most effectively be achieved. This makes rules of thumb regarding appropriate pay-out ratios quite tenuous.

TAXATION IN THE OPERATIONS OF A DEVELOPMENT  
FINANCE COMPANY

Taxation is, of course, a very important element in the operation of a development finance company. It can also be a complicated one. Because of the great diversity in national tax procedures and policies, it is extremely difficult to compare the experience of one country with that of another and to generalize about the impact of taxation on the operations of their development finance companies.

The rate of taxation among the companies associated with the World Bank Group differs widely. The Industrial Finance Corporation of Thailand, for example, is completely exempt from all taxes. In India, ICICI is subject to an effective tax rate of 45% on its interest and dividend income and a 30% tax on capital gains, and it has no tax advantages for building provisions against losses. In addition, ICICI shareholders pay their normal rate of personal income tax on dividends distributed by the company. There are also important differences in level at which taxes are imposed. For instance, the first level of taxes imposed on a company usually comprises relatively small business and stamp taxes. These may, however, become quite important, as in the case of the China Development Corporation, which pays a business tax of 3.9% on its gross income. Although the corporate income tax rate in Taiwan, at 18%, may appear low in comparison with that of other countries, the business tax modifies this picture significantly. Another level of tax is normally that levied on the company's income. Here the rate is not the only factor of significance; not less so is the base on which the tax is computed. For example, how are the dividends

received and the capital gains realized by the development finance company taxed? Are there different rates depending on whether it distributes or retains its earnings? Are deductions allowed, such as for provision against possible losses, before the computation of the income tax? A third level of taxation, which is closest to the shareholder, is the tax for which he is personally liable. Is the dividend that he receives from the company subject to personal income tax or to some other tax? Does he receive a credit for taxes paid by the company? Are the capital gains he might realize from the sale of his shares taxable, and at what rate?

#### The Influence of Tax Policies on Operations

Taxes will have an important influence on the policies of a development finance company. As already noted, the size of provisions against possible losses will be heavily influenced by taxation. The taxation of dividends and capital gains will have a negative, neutral or positive effect on a company's willingness to invest in equities rather than straight loans. Tax on interest received from short-term investments will affect the level of liquidity sought by the company as well as the types of securities it holds.

It is impossible to generalize about how development finance companies should be taxed. One must analyze a specific situation to see if a given tax treatment is the most efficient from every angle. There is, however, one general question that is important. Given a country's tax policies and practices, should a development finance company be treated differently from other companies, and if so, how should it be treated? If an argument were made for treating the development finance company differently from other companies,<sup>1/</sup> it would have to be based either on a need to improve

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<sup>1/</sup> There might be cases where an argument could be made for changing tax policies toward all companies.

the company's after-tax profitability or on a desire to encourage certain activities of the development company by making them more worthwhile than alternative activities.

Tax Reductions to Improve Profitability. The objective of after-tax profitability is related to the question of the level of incentives necessary to assure effective operation of a development finance company and the most efficient way of providing those incentives. The original premise of any incentive given to a development finance company is that special treatment is justified by the corollary benefits to the economy as a whole derived from the company's existence and operations. The question then arises as to the level of incentives which are necessary. Both for those who provide the incentives and for the shareholders of the company, the objective ought to be to keep the incentive at the lowest level conducive to sound operations. If some form of incentive or concession is justified, in the opinions both of government and of shareholders, it does not follow that tax relief is necessary. Other devices are available, such as cheap, long-term, subordinated loans. Tax concessions might be as valuable and effective as a subordinated loan, or even more so. Yet a general argument that development finance companies should receive tax concessions because they are promoting economic development and in effect helping to broaden the tax base is not sufficient until some judgments are made with respect to the necessity and justification for such concessions in the interest of the profitable operation of the company.

Tax Policies to Encourage Specific Operations. The second justification for tax concession is to make some types of activity more attractive than others and thus to encourage them. To this end, one must consider, first, whether the existing tax code, given the relative before-tax return on interest income and on dividends, encourages one type of operation as

opposed to another and, second, whether there are clear reasons for modifying the tax. It is not possible to argue that development banks should be relieved of a capital gains tax because such a tax discourages them from making equity investments. It may be that even with a capital gains tax there is an incentive to invest in equities, or that even without the tax the earnings expectation from equities is inadequate to generate much interest in equities. From a private company's point of view, of course, no tax is always preferable to some tax, but that is not the question. The tax treatment of capital gains will also affect the policies of a development company in revolving its equity portfolio. In Spain, for example, the longer an industrial bank holds a share, the higher the rate of taxation that is levied on the capital gains resulting from the sale of that share.

Finally, from the point of view of the shareholder, the treatment of dividend income and capital gains from his investment in the company will be an important factor influencing the companies' policies towards paying dividends, retaining profits, and financing the growth of the company. If it is advantageous for shareholders to realize earnings by way of capital gains rather than by way of dividend income, they (and the company) will tend to prefer that the company's earnings be retained rather than paid out as dividends. If there is a tax advantage in dividend income, there will be an incentive to finance the growth of the company by larger dividend distributions and periodic share increases.

An important consideration for a development finance company that is trying to raise money in local capital market is that local currency funds are often provided by a government at interest rates acceptable to the company. When it provides such funds, the government is acting as an intermediary, channeling the country's savings to the development bank. In other

countries, it is not possible nor practicable to obtain loans from the government and the development finance company enters the market directly as a financial intermediary between savers and investors. The company must then try to raise funds through the sale of its own securities and this often poses a problem because of inadequate margins between the interest rate that the company will have to pay for funds and the rate at which it can lend, which in some cases may be fixed by other than market considerations. In such a case, the company's ability to raise funds can be enhanced by making the interest income from its bonds partially or completely tax-free to the bond holder. The government will have to consider how it wishes to channel the available savings and where the development finance company stands in the priorities established by the government. There is no doubt that tax exemptions of this kind can be very useful to the development bank; if it is doing an effective job, its bargaining power for attaining such concessions will be strengthened.

#### INTEREST SPREADS

The two final variables which together determine the profitability of a development finance company (as measured by the return on net worth) are the ratio of "outside" funds to shareholders' equity and the average margin on resources employed. For most development finance companies associated with the World Bank Group, particularly the more mature ones, the largest components in the profit and loss statements are interest income on loans and debentures, administrative costs and financial charges. These effectively determine the average margins earned by the companies. Unfortunately, management has control over them only to a very limited extent.

As for interest rates, in some cases governments prescribe the interest rate structure, and this must be observed by the company even though market conditions might indicate different rates. Even where no rate <sup>structure</sup> ~~is~~ set by government, a development bank may be under strong pressure to charge "reasonable" rates. Sometimes the existing structure of commercial bank rates will more or less determine the company's lending rate. Whatever the determinants, in most of the countries with development banks of the World Bank Group, the companies' lending rate is in the range of 7<sup>1</sup>/<sub>2</sub>% to 9%, and within this range 8% and 8<sup>1</sup>/<sub>2</sub>% are by far the most common rates.

It is important to remember that factors other than interest spread also affect the gross margin earned on a development finance company's resources. At all times, but particularly in the early years of a development finance company's life, it is likely to have a considerable amount of current assets. Careful husbandry of these assets can make a considerable difference in the overall margin earned by the company. An important task of management is thus the careful and imaginative investment of these resources in order to maximize the earnings from them. The return on equities can also be an important factor in the earnings of a development finance company, and should be kept in mind when interest spreads and earnings margins are being discussed. Investment-related activities such as underwriting, putting together of projects, and other services connected with lending and investment operations can be additional important sources of income.

Of the three determinants of net spreads, administrative costs are probably the most directly controllable by the management, although they too are heavily influenced by other factors, such as the nature of the company's clients, local wage levels and expatriate staff requirements. Even so, there is doubtless much that a cost-conscious management can accomplish

in controlling administrative expenses. Among the companies associated with the World Bank Group that have been in operation for five or more years, administrative expenses ranged from 0.5% to 1.5% of average total resources in the fifth year of operation.

Perhaps the least amenable among the determinants of average margin, to the action of management is financial charges. Many of the companies borrow a substantial part of their resources from the World Bank or other financial institutions and pay 5-6% for much of their debt. Many also had low-interest or interest-free loans from government when they began operations, but generally additional funds are not available at concessionary rates. As conventionally priced debt assumes a larger share of the company's total debt, the average cost of its resources increases. Thus the more mature companies are operating with a gross spread of only 2-3% on new debt resources. This does not leave much after administrative expenses are deducted, even if, at the margin, these expenses amount to less 1% of the new resources. The narrow, and narrowing, average spread is, of course, a major source of the pressure to relax borrowing limitations in order to increase leverage.

The rigidity of the principal factors determining profitability does not relieve a development finance company of responsibility of taking such actions and options as are open to it, to increase its earnings. On the expenditure side, it has a responsibility to keep them at a minimum consistent with effective operation. On the income side, a market rate should be the goal of interest rate policy; and no effort should be spared to make the most of other opportunities to increase income.

### CONCLUSION

Answers to the basic financial policy decisions facing the management of private development finance companies do not come easily, and in any event are not very precise. Judgment and experience are important in arriving at these decisions, but at the same time there is scope for more analytical thought in providing some basic parameters which can serve to guide the decision-making process. Rules of thumb, if used loosely, may not be very helpful, and may in fact be harmful.

In the early years of a development finance company's existence, its management will primarily be occupied with organizational and operational questions. However, as the company matures, policy questions relating to finance assume a more important role, particularly if the company is aiming toward standing on its own legs with a minimum of concessions from government. This will require re-thinking past policies and in some cases a significant redefinition of them. Hopefully new policies will be made, not simply by tuition and under pressure of circumstances, but with some analytical backing. This will not be an easy task, but will become the more necessary as a development finance company matures.



RELATIONS BETWEEN GOVERNMENTS AND  
DEVELOPMENT FINANCE COMPANIES

[all in italics]

Note:

Almost all the development finance companies associated with the World Bank Group have been sponsored, financed and otherwise supported by their governments. This fact places upon them a responsibility - even if their own objectives did not - to behave in the public interest as well as in the interest of their own shareholders. It also exposes them to the dangers of political pressures, which could severely inhibit their ability to act in the interest either of the general public or of their shareholders. What course of behavior will assure a smooth relationship with government within the framework of national policy and at the same time discourage or resist misguided governmental efforts to influence selection of personnel, administration and, most of all, particular investment decisions?

One conference participant noted, early in the discussion of this subject, the paradox that development finance companies were private institutions and yet were called upon to work for very much the same

objectives as governments with respect to economic development. The companies represented at the Conference that had government help desired to maintain their independence from government, not because they did not want to work with government but because otherwise a political color might be injected into their operations thereby making them inefficient. They thought it was important to make this distinction; otherwise the government would get the impression that a development finance company enjoyed the benefits of government assistance without having a sense of responsibility to it. Secondly, even though development finance companies had to align themselves with the general policies of the government, it ought not to become involved in the task of economic planning, otherwise it would become politically exposed and face interference. Thirdly, a government should not enter into unfair competition with a development finance company in regard to raising capital internally in a country. Lastly, the informal relations with government agencies were important; the development finance company could greatly influence government policy.

Underlying the discussion was the uneasy feeling that, in the words of one participant, most development finance companies were "basically quasi-governmental institutions" since, directly or indirectly, they received a substantial part of their resources from governments. One wondered whether they could long remain really private, if in fact they were private now; for in each instance the private capital and the capital received from the World Bank Group were small compared with the capital provided by government. This state of affairs was justifiable in the early years of a development finance company when it was necessary to protect an infant industry. But when would they be able to stand on their own feet and develop their independent sources of finance?

This was obviously a difficult and delicate subject. Mr. Felix Chang, President of the China Development Corporation, who led the discussion, concluded that relations with government were essentially a matter of give and take. In this continuing relationship, the development finance company had to maintain its independence. It could do so if it established a condition of mutual confidence with government (which close relations contacts with government officials and agencies would encourage) and if it worked over the years to decrease its reliance on government by building up alternative sources of finance.

An Essay on Relations with Governments, by P. M. Mathew

Basis for Cooperation

Development finance companies need to cooperate more with governments than other private companies, and vice versa. Companies that have built up a close relationship with the government and governments that do not substitute interference for cooperation have found their mutual relationship rewarding and beneficial in the fulfillment of their common, as well as separate, aims.

A finance company is not entirely like other private business institutions, whose all-important goal is the profit of their shareholders and whose concern with public aims is important only insofar as it contributes to its own self-interest; to a development company concern with development is an important objective in itself. Even where there is a conflict between the demands of development and self-interest, the finance company often willingly compromises its self-interest to a degree in order to foster development.

Recognizing the development banks' concern with and potential for promoting development, governments have given many of them various types of assistance.

In most countries, government development finance institutions exist side by side with private ones. One of the major problems of the private companies is to evolve a modus vivendi with the public agencies. Unless the roles and spheres of interest of the two types of institution are defined and coordinated, competition could develop between them to the disadvantage of both and to the serious detriment of the private institutions.

Development finance companies often need close contact with governments in order to serve their clients effectively. Many developing countries use measures such as licensing and control of foreign exchange and of capital issues to regulate industry or to direct investment into desired channels. Almost all governments provide incentives and concessions in varying degrees to promote desired forms of investment. Entrepreneurs, particularly foreign investors who do not have the contacts or the ability to obtain government concessions, often rely on development banks to negotiate and insure coordinated action for the issuance of permits.

Some development companies consider the need for cooperation with the government so vital to their success and viability that they have provisions, either in their charters or in their statements of general policy, requiring them so to cooperate. In some cases, these provisions have been suggested by the government that provided important financial support to the companies.

#### Public Economic Objectives

Like other private businesses, development finance companies live within the economic climate of their respective countries and are affected by it. Rarely do they assert their private nature to the extent of pursuing policies in opposition to government aims, but often work closely with governments in evolving the economic climate and the government policies that influence it.

With a view to quickening the pace of economic growth, many governments draw up economic development plans and programs. Even where these primarily concern government investment outlays, they almost invariably lay down private investment goals and propose public policies aimed at facilitating their achievement. Areas of priority are often indicated and incentives are offered. To what extent should a private development finance company become involved in shaping these targets and policies?

Development companies generally feel that too close an association with the government's planning machinery, which might involve them in responsibility for formulating government plans, is not one of the company's normal objectives. Many consider that too close an association with government thinking may result in their identification in the public mind with the government. In some countries, such an identification is enough to frighten prospective clients away. Moreover, excessive preoccupation with economic development might conflict with the company's duty to its shareholders to invest its resources, including staff time, to the best advantage. A development company has to marry its financing function and its development function, and the marriage should not be an unequal one.

Operating, as they do, at the core of the industrialization process, finance companies often acquire an intimate knowledge of the effects of government measures and policies on industrial investment, and are among the best sources of objective judgment about their soundness. They are also often the best informed agency in the private sector on the problems of industry. These advantages enable the companies to offer sound advice to governments and to have their advice taken seriously. It is not, therefore, surprising that the management and staff of development companies find themselves invited to sit on government committees concerned with public policy and plans. If kept within reasonable bounds, this association is of mutual

benefit. It gives the finance company important contacts, as well as an insight into government motivations and aims for the future. It enables the company not only to influence the investment climate, but also to acclimatize itself better to its environment and to make the best of it. On the other side, it enables the government to feel the pulse of the private industrial sector and to know in what way, and in what sectors, private resources are likely to be applied to development.

In the course of a study of its country's sugar industry, for example, one of the development companies found that existing government policies had the effect of driving the industry to virtual bankruptcy. The finance company proposed appropriate policy changes to the government; these the government accepted. The result was a spectacular recovery of the industry and new business for the finance company.

Many development companies consider formal statements of the country's investment programs and economic development plans very useful. These documents enable them to decide whether or not their own projects contribute to the country's sound economic development. Few among them would like to make an investment that they cannot so justify. If government policies are enforced through such administrative devices as licensing, exchange allocations and capital issue controls, the decision that a project has priority is ready-made in advance for the finance companies to act on.

Will too close an association with policy-making commit a development bank to implementing government programs, even if such a course is not in its own interest? Will management and staff become missionaries, losing the cautious and critical attitude essential for a banker? Will the company tend to neglect its primary function of financing, in the exhilaration of finding itself in the highest councils of the land? These are legitimate questions that worry some development finance companies and point up the



dangers of carrying contacts to excess. Caution and sound judgment are necessary.

#### Government Assistance

All but two of the twentyfive<sup>1/</sup> privately or predominantly privately-owned development companies with which the World Bank family is associated are under obligation to their respective governments or its agencies for important assistance in one form or another. Nineteen of these companies have public funds in their share capital, ranging from 4% to 44%. Fourteen have received loans on favorable terms, with long terms and grace periods, bearing little or no interest, and ranking equal or subordinate to share capital. The amount of these loans varies from two-thirds to seven times the original share capital.

Twenty of the twentyfive companies depend on loans from the government or its agencies or on discounting facilities with central banks for all or some of their local currency resources. Nineteen of them, which have received World Bank loans, have obtained government guarantees to cover the loans. Governments have also guaranteed loans by foreign governments to some of the companies. In many cases, the proportion of their funds derived independently of the government, is small indeed, relative to total resources.

Governments have supplied two of these companies with funds to manage for investment or reinvestment purposes, the amount ranging as high as 38% of the total portfolio of one company. In another, the ratio reached 50% until recently, when most of it was converted to a subordinated loan. One company also draws upon a public fund created for the special purpose of making equity investments for increasing domestic participation in enterprises.

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<sup>1/</sup> As of June 30, 1967

Governments have made it possible for several companies to obtain technical assistance free of cost or at reduced cost from friendly governments and international agencies. Eleven companies enjoy favorable tax treatment, either as a concession to each one individually, or to development finance companies generally; four companies are completely exempt from taxes on income earned and dividends paid.

To many of these companies, governments are an important or perhaps the only potential source of fresh domestic capital. To the government, they are important tools in the developmental effort. Are these institutions really private? To what extent are they subject to government influence? Is some measure of government influence justified? Where should one draw the line?

#### Government Influence

There can be no concensus as to what it is legitimate for a government to do vis-a-vis the private sector, in view of the differences in political systems, public aims and administrative traditions. Industrial licensing, exchange controls, interest rate restrictions and the like might be obnoxious in one country, but normal in another. Partnership with government might be frowned upon in one country, but welcome in another. What is legitimate government influence on a development finance company in a given country will depend on what is, on the whole, accepted by the private sector in that country as the normal role for government in the economy.

In view of the common interest of the government and the development bank in economic development, the government is likely to influence the company in achieving public goals. For example, a government may believe that cheap credit is an essential instrument for rapid growth and may try, by regulation or more often through persuasion, to inhibit the finance

company's freedom to charge an interest rate that the market will bear. Especially where the government has provided the finance company with cheap funds or facilitated the channeling of such funds into the company, it may feel that the company should limit itself to something below the market rate rather than the maximum possible rate. In some countries, a market rate for long-term funds other than that set by the finance company does not exist.

Restrictive government policies applied to interest rates can have a significant effect on the earnings of a development bank. It may be justified in charging something higher for its long-term financing than the prevailing commercial bank rate for short-term advances, but partly in deference to a government's expressed or anticipated wishes and partly because of its loyalty to the cause of development, it rarely charges rates equal to the best it can get. Some finance companies feel inhibited in undertaking the risks they are designed to take because they do not feel that they have the freedom to charge a price commensurate with the risk. Quite different is the case of one government, itself in the long-term lending business through public agencies, which persuaded a large private development finance company to increase its rates in line with an increase in government rates. The fact that most companies have contented themselves with a somewhat lower rate than the prevailing commercial rate, and have not protested too loudly against government pressures to keep rates low, might be taken to mean that, within bounds, they consider government influence on interest rates legitimate. It also probably indicates a responsible attitude on the part of most governments, which refrain from pushing a development company too hard in the direction of rates that are too low.

Some development companies are under pressure from governments to finance small scale enterprise. Because of the high cost of investigating and supervising small projects, and because of a feeling that small loans

are riskier, most finance companies shy away from small loans. In many countries there are special financial and promotional agencies to assist small enterprises. Typically, they are public and provide financing on concessional terms.

Pressure on development banks to involve themselves with small loans stems from various causes. Governments sometimes are unable to raise funds to support small enterprises, and, if they have financed private development finance companies, may ask them to set apart some of their funds for small enterprises, on lenient terms.

Because of the paucity of local entrepreneurs and capital in many developing countries, industry is dominated by foreigners. Nationals engage only in small business. Due to national sentiment, development finance companies feel obliged to assist local entrepreneurs, and an effective way to help them is by assisting small enterprises. Noting that much of the resources of private development companies is used to assist foreign-sponsored businesses, governments sometimes feel it desirable to ask the companies to interest themselves in supporting domestic entrepreneurs.

Similar to the financing of small enterprise is the financing of the less developed regions of a country. Most governments have the avowed purpose of quickening the growth of such districts and they devote public funds to the necessary promotional effort. Industries for such regions may not be attractive for private investors without special guarantees. They are also unattractive to a development finance company, except on special terms. Finance companies may be under pressure to assist such projects, particularly if they have themselves received government assistance. At least one finance company, which has to cooperate with the government's plans to offer low interest rates in an underdeveloped region, has arrangements with the government to be compensated for the differential between the

company's normal rates and the rate desired by the government. Depending on the circumstances, a measure of flexibility on the part of the development company in assisting such projects may result in a better alternative to the economy than the only other one usually available, namely, for the enterprise to be fully government-financed.

When development finance companies are called upon to undertake risky or unprofitable projects at the suggestion of the government, it is normal for them to expect compensation. Otherwise, they would be acting under duress and against their own interest. Some governments, however, have argued that if the companies have already received special governmental assistance in the form of low-cost, subordinated funds, it is their duty to finance the uneconomic and risky schemes in which the government is interested.

When granting financing and assistance to development companies, the government rarely intends to require in return that the companies undertake particular forms of uneconomic financing. Often the government is more likely to have based its concessions on the prospect of the general benefits to the economy from the assistance that the finance company was designed to provide. In some cases, the government's financing of a private development bank has reflected its failure to achieve certain results on its own. In these circumstances, the company is entitled to take for granted that governmental assistance will be available for all the kinds of operation envisaged when the funds were provided, and not for specific programs needing subsidy and identified only later. Finance companies would therefore be justified in assuming that if governments expect them to undertake, in the public interest, specific risks that are not normal to their operations, adequate compensation should be forthcoming. The compensation may take the form of an interest subsidy, a guarantee of the investment, or a promise by the government to buy the investment on pre-agreed terms.

The government's invitation to finance companies to branch out into areas or lines of activity beyond those originally contemplated may be flattering, but many companies prefer to be cautious and avoid undue risks, although they are willing to expand their role in response to their commitment to the developmental effort.

Finance companies using public funds sometimes receive requests for information from governments, in response to questions posed in parliament or by legislative committees. Most companies recognize that it is only legitimate that the government, having invested public funds in them, be in a position to account for the end-use of those funds, and they are therefore ready to supply the information. It is also proper, within limits, for a government to examine the operations and creditworthiness of a company in some detail before deciding to grant it assistance. It is generally agreed, however, that if supplying the information were to violate a client's confidence, the company would be justified in withholding the information.

Discussion in legislatures exposes finance companies to public criticism, without an opportunity to defend themselves. Most companies shun such publicity. At its worst, such a discussion can deteriorate into an occasion for officials and politicians to apply pressure on the company to act against its best judgment, or to reap public revenge for favors refused.

#### Government Interference

Most finance companies clearly recognize the line of separation between cooperation and interference. The government may seek the cooperation of a finance company in furthering its public aims, such as implementing government priorities for channeling investment, assisting particular sectors like small industry, giving special attention to projects sponsored by nationals, developing the technical and managerial skills of nationals, taking an interest in industrial promotion and attracting foreign

investment. In fact, in countries where the government controls many sectors of the economy, such cooperation is essential and in the interest of the finance company. Interference begins when the government goes beyond the general area of these policies and tries to influence or control the finance company's decisions with respect to internal administration, staffing and investments.

The general experience of finance companies is that they have been able to develop a cooperative relationship with the government without inviting interference, but there are a few instances of governmental attempts to influence decisions.

It is useful to distinguish between interference by the government, acting as a public body, and interference by individual members of the government, acting in their personal capacity. The former is often born of respectable motives. The government should, nevertheless, recognize the harm it can do by trying to impose its will on a company in matters that are strictly within the company's private domain.

Most often, interference arises from a feeling on the part of governments that since they contributed substantially to the resources of the finance companies, and were, in some cases, also the sponsors, they are entitled to take a close interest in all of the company's affairs. When domestic private ownership of the company is small and the government is the substitute therefor, and when foreign participation is large, governments seem to feel a special responsibility for keeping watch over and guiding the affairs of the finance company. Whatever the apparent justification, interference can, in the long run, do only harm.

When a finance company seeks a participation in its share capital or other benefits from the government, the company's relations with the government are often discussed in great detail. When interference occurs,

it is often because the government has lost sight of the relationship envisaged when the company was established. If, as has happened on rare occasions, governments were to treat private development finance companies as private only in form and as public corporations in reality, they would destroy the very basis on which the companies were founded, thereby undermining their effectiveness and usefulness.

Wise governments recognize that there are bound to be some differences in approach between them and the finance companies. They do not ask for conformity, but only for intelligent decisions that take into account the public interest as the government's representative explains it to the company. Wise finance companies have learned to respect the government's views; but they also realize that, if they were not to preserve their independence in decision-making, they would be selling out their character as a private agency.

The type of interference that finance companies resent and resist as best they can originates with individual officials and their henchmen. Resort to this, backed up with veiled or open threats of dire consequences, has the purpose of securing for officials' friends special and undeserved favors. Except in countries where corruption is so extensive as to be open, this type of interference seldom comes to the surface, but it has occasionally posed serious problems.

#### The Government Director

Financial assistance, either as share capital or as loans to a finance company, often obligates the company to have on its board one or more directors representing the government. In the interest of coordinating the development bank's activities with public agencies responsible for



investment or technical assistance, such agencies also may be represented on the board of the finance company, and vice versa. The government directors are an obvious and, to a certain extent, legitimate channel of government influence.

The role of a director of a finance company representing the government is threefold. In his personal capacity, he contributes to the company his general vision, experience and judgment. As the representative of his government, he makes sure that the company has correctly understood the government's developmental aims and policies. Again, as a government nominee, the director is often the channel through which the company sounds out and formally approaches the government when it needs a government ruling either for itself or for a client.

In addition to supplying the government director with normal information to which directors are entitled, companies are often obligated under loan contracts to supply the government with other specific information about their operations. Because of the sensitivity of some of their clients, some private development companies have been troubled about the extent of the information to be given the government. Clients sometimes fear that information supplied by them to the finance company will end up, via the government director, on the tax collector's desk. As a rule, however, managements do not feel seriously inhibited on this score.

Some finance companies believe that the presence of a government official on the company's board provides a point of too frequent contact with, and too close involvement of the government in, the company's affairs. For this reason, they would prefer to avoid government

representation on their boards. The extent of this feeling varies with the degree of the government's involvement in industrial and related sectors. In some newly independent countries, government participation and representation on the boards of finance companies, as well as in industrial enterprises, are often welcomed by the domestic as well as the foreign private sector as a factor in the stability of their investment.

#### Relationship with Public Financial Agencies

Reference has already been made to the need for coordination between the activities of private development finance companies, on the one hand, and of public financial and other related agencies, on the other. Where there is no coordination, a public financial agency could compete unfairly with a private company by applying inadequate standards of judgment to the soundness of projects seeking assistance and by offering assistance at below-market rates; public agencies, which often receive capital without cost or obligation to return a profit, can afford to be more liberal than private companies. Both methods are potentially harmful to the real interests of the economy. Industry at any cost is not necessarily better than no industry. If, as a result of inadequate appraisal, an unsound project goes ahead, it involves the economy in unnecessary costs that are often hidden. If a fundamentally viable project receives a subsidy, it unnecessarily fattens someone's purse at the expense of the taxpayer. If it becomes viable only because of the subsidy, the economy pays a price to support an uneconomic industry. It rarely happens that both the direct and indirect benefits derived by the economy from such industries adequately compensate for the visible and invisible costs to the economy.

It is, however, reasonable to assume that some uneconomic projects will somehow be financed in most developing countries, and that some of them will be subsidized. Governments sometimes conceive prestige projects, and private entrepreneurs can almost always be found, at a price, to implement them. Political considerations, the needs of underdeveloped parts of the country, a misconceived belief in industrialization at any cost, and prospects of personal gain to public officials are among the motivations for governmental adventures with uneconomic industrial investments. Granting that the pressures to finance such projects exist, many private finance companies feel it desirable that a public financial agency be available to absorb these pressures. Where there is no such public agency or it lacks the necessary resources, a private company may be subjected to severe pressure to finance prestige projects. If the private company received government funds at little or no interest, pressure is likely to be applied also for reduced interest rates for such projects.

When it becomes an important shareholder in a finance company, the International Finance Corporation has frequently negotiated an understanding with the government about the coordination of the private company with public financial agencies. Typically, this understanding provides that the public agency will not finance any project in which the private company is interested, that it will route all investment proposals initially received by it to the private company, and that the private company will not finance projects below, nor the public agency above, a certain level. Where no formal understandings are established in advance, they inevitably evolve through a period of co-existence. The understandings also

envisage joint operations of mutual advantage. Sometimes coordination is facilitated by representation for each company on the other's board.

If they have rejected projects as unsound, some private development finance companies feel that the financing of these by a public financial agency would represent unfair competition. This is perhaps an imaginary grievance. No private company can seriously complain if a project that it had had an opportunity to finance, but which it had turned down as unsound, were to end up in the government's lap. In the best of circumstances, a government's willingness to accept the findings of a private company about the soundness of a project and to desist from financing it will depend on the government's confidence in the technical ability of the staff and the judgment of the private company's management; the best of circumstances seldom exists, and it would be unrealistic to assume that governments are entirely motivated by undiluted economic criteria. The government's financing of projects that are considered unsound by private companies, the offer of below-market interest rates, and the relaxation of appraisal standards remain sources of irritation for several private finance companies.

Demarcating the fields of interest of public and private development finance institutions is a good negative way to avoid wasteful competition. On the other hand, the development of opportunities for joint operations is constructive co-existence. Public agencies that are obliged, as agents of the government, to finance projects needing special financial arrangements could, where the projects are sound, invite private agencies to undertake senior financing at market rates, while they themselves provide junior financing on appropriate soft terms.

If the resources of the public agency are large, it will be in the interest of the private company to cultivate the former in order to use it as a source of additional financing for its own projects. In this way, the private company can reduce its exposure and the consequent risk. Some private companies have found it advantageous to associate a public agency with them in order to facilitate the granting of the various government permits that clients require.

In some countries, government promotional-cum-financing agencies finance and organize feasibility studies, which they then turn over to private finance companies to implement. If it is the private company that adopts the project, it is useful to set aside a part of the financing for the public agency concerned, in order to maintain good will.

There are several public financial agencies that have developed competent staffs with a diversity of appraisal skills. Joint operations with such agencies provide the private company with the opportunity for a double check on its own conclusions. Setting up joint appraisal teams serves to minimize the time needed to complete appraisals of projects that interest both and to amalgamate the experience of both. When it is not practicable to set up joint teams, the circulation of studies among the interested parties is being adopted as a substitute for sharing views and experience.

#### Safeguarding Independence

The points of contact between the government and a development finance company are many. Every company is exposed at sometime or another to government's attempts to influence it. However, the real test of independence is not whether a company is faced with government pressure ,

but whether it has been able, in practice, to make its investment decisions, choose its staff and carry on its administration solely on the basis of its own best judgment. Judged by these criteria, many companies, even some in centrally run economies, are remarkably independent. This is a testimony no less to the good sense, abstemiousness and foresight of governments than it is to the strength and tact of the boards and managements of the companies themselves.

Nevertheless, safeguarding their independence, which is crucial to their effectiveness, is a matter which gives development finance companies continuous concern and calls for continuous vigilance. Many companies wish they did not have to concern themselves with this problem. But so long as they have to depend on governments for capital and other assistance, they cannot avoid exposure to governments' attempts to influence them. This dependence does not appear to be a short-term feature. The older finance companies associated with the World Bank group, after about ten years of operation, feel that they still cannot depend to any significant extent on the market for their resources. It will probably take them another decade to be able to stand on their own legs.

In some cases, the World Bank family has been able to play a part in maintaining the independence of a development finance company. An IFC subscription to share capital sometimes accompanied by its presence on the board of directors and almost always involving an intimate relationship, has on occasion provided a shield to government pressure. No less important has been the World Bank's insistence on operational independence as a condition for a Bank loan. The influence of the World Bank family stems not from legal arrangements but from the fact of its being a continuing, and often the most important, single source of finance for development finance companies.

The experience of the older, more effective development finance companies offers instructive guidelines for a successful relationship with government and for the avoidance of interference from Government. Such a company values a close relationship with the government. It welcomes opportunities to advise the government on economic and industrial policy, serving on government committees when invited, but avoiding responsibility for public planning. It equips itself adequately through study and research to act as a responsible representative of the private sector, and scrupulously avoids giving the impression that it is an arm of the government. It uses its contacts with government agencies to the best advantage for itself and for its clients. It gives all due information to the government, but jealously protects from exposure to public bodies the information given in confidence by its clients.

Such a company cooperates with the government as fully as it can in matters of policy, but stays at arm's length in matters of investment and administrative decisions. It builds a cooperative relationship with public agencies financing or otherwise assisting industry. To the extent it can, it joins in the promotional effort to get new industries started, to develop the capital market, to improve institutional arrangements to facilitate investment and to attract foreign investment. It does not forget that it is a developmental agency as well as a financial institution obligated to return a profit to its shareholders; and it makes a wise compromise when the two aims seem to conflict. It functions as an evolving mechanism in an evolving economy, as mindful of its responsibilities as it is watchful of its rights. When these attitudes of a

finance company are matched with those of a sensible government which recognizes, despite the finance it has provided, the merit of being abstemious and in allowing the company to act on strictly economic and financial grounds, the result is an effective private financial institution which is both a responsive and a responsible partner in the government's developmental efforts.



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JOINT FINANCING OF SPECIFIC ENTERPRISES WITH  
THE WORLD BANK GROUP

[all in italics]

Note:

The World Bank Group is a promoter and financier of development finance companies. It is also prepared to collaborate with them in the financing of specific ventures. In the World Bank Group, it is the IFC which deals with private industrial enterprises, and it is therefore with the IFC that such collaboration occurs.

Joint financing of specific enterprises by IFC and the development finance companies associated with the World Bank Group has become increasingly frequent. The basic reason for this, on IFC's side, is that one of its principal objectives is to work with local investors and there is a natural affinity to institutions in which it is a shareholder and which the World Bank has financed. IFC's policy, if a proposal comes from a country in which an associated development company is located, is to

direct it to that company or to share the proposal with it. A local institution should know more about local conditions and be in a better position to keep an eye on the affairs of a local client, than IFC should. On the side of the finance company, there are many advantages to collaboration with IFC: technical, financial and psychological. The underlying pressure stems, however, from the fact that the size of their individual investment proposals is increasing to the point that sharing the investment and the risk is essential.

Although the advantages of joint financing are clear - virtually self-evident, this is by no means easily carried out. There are problems of coordination of effort, and of adjustment of the parties to each other's peculiar requirements.

Dr. Guillermo Herrera Carrizosa, President of the Corporacion Financiera Colombiana of Colombia, led a discussion of joint financing. For this discussion, IFC's two Directors of Investments, Mr. Neil Paterson and Mr. Laslaus von Hoffmann, joined the Conference. They drew the following general conclusions from their experience of specific cases.

Projects involved were generally large for the finance company in question. Often domestic as well as foreign skills were necessary and frequently production techniques new to the country were involved. Quite often the particular project required special financing techniques which were either untried or the financing involved was of such substantial size that it would be beyond the means of any one institution. Joint study of a project did not necessarily imply joint financing; in some instances IFC assisted a finance company to develop a project which the

latter proceeded to finance without participation by IFC. In other cases, consultation with the local development finance company helped IFC to devise a suitable course of action regarding a difficult project which did not require new financing. They noted that the first transaction with a development finance company was the most difficult and the slowest, for problems were encountered that were relatively new to IFC and the finance company. Second and third transactions moved more quickly and easily. The relationships with the borrower, which basically should be handled by the local finance company, sometimes became a problem of prestige. Also, joint financing operations required joint staff work which might become complicated due to language difficulties.

An Essay on Joint Financing, by David Grenier

Introduction

Capital market weaknesses constitute a major barrier to industrial growth in developing countries. The shortage of venture capital and deficiencies in financing techniques are among the factors that make it difficult to obtain effective financing for the larger, more ambitious projects which help to broaden the industrial base of an economy. Local technological resources and managerial and other skills are often inadequate to meet the needs of new enterprises and new types of industry, and in some countries even the entrepreneurial impulse may be deficient. For these and other reasons, it is both desirable and necessary to devise means for attracting external resources to supplement those available domestically.

One approach is a joint venture between a local entrepreneur and a foreign industrial partner, in which both can make distinctive and complementary contributions. A parallel, though less well established, approach is collaboration between local and external institutions in the joint financing of projects. This type of partnership offers a number of advantages. It may make it possible to initiate and finance projects beyond the scope of either institution acting on its own. It may also strengthen the confidence of other investors and, by attracting capital from a variety of sources, spread the risks involved.

As the term "joint financing" implies, the institutions involved must be prepared to work in close partnership. The need is not only for complementary skills but also for closely related objectives. In a joint-

financing operation, as in a joint venture, a key factor is the choice of a partner with compatible objectives. This compatibility is more likely to exist between development financing institutions than between other agencies.

There are a number of ways in which common objectives can contribute to the success of a financing operation. These include a readiness to undertake the financing of complex projects that are not "bankable" in ordinary terms, but which deserve consideration and support on the grounds of economic priority; agreement on the need to forego quick returns in favor of establishing an enterprise on a basis that will strengthen its long-term viability and profitability; and a more limited participation and involvement in a company's management than would appeal, for instance, to an industrial holding company. Moreover, in making a commitment, a development financing agency is likely to be more mindful of the need to revolve its funds and to increase the supply of securities available to local investors, thereby broadening the local capital market.

Joint-financing operations may offer measurable advantages when the institutions concerned have a similar philosophy and operate on broadly similar lines. These conditions are likely to be satisfied when such operations involve both a member of the World Bank Group and a development finance company associated with the Group. The arrangement is logical for a number of reasons. Close operational relationships exist within the family of institutions at the staff, management and, in some cases, board levels. In turn, these offer opportunities for establishing effective channels of communication and for developing common attitudes to the financing of projects.

### Forms of Cooperation

The activities of the institutions associated with the World Bank Group family are complementary in a real sense. The development finance companies tend to look to their outside connections for assistance when external resources are needed and the Bank Group, in turn, stands ready to assist and support the local institutions. Joint operations involving development finance companies and the Bank Group can take a number of forms. One possibility is collaboration on technical studies, such as feasibility or promotional studies involving entire industrial sectors. Another is assistance in appraising projects for which a development finance company proposes to use Bank Group funds. This kind of assistance can be particularly effective when an independent investment opinion is needed. For example, a project may originate with a local entrepreneur or a foreign equipment supplier who brings it to the attention of a development finance company, which, in turn, may find a second opinion useful as a counterbalance to the zeal of the promoters of the project and as a means of getting an impartial opinion on factors likely to bear on its success.

In practice, the most extensive form of cooperation has been joint financing by development finance companies in partnership with the International Finance Corporation (IFC). There are two major reasons for this. One is IFC's special position as a shareholder in seventeen of the twenty-five development finance companies associated with the Bank Group, as well as its responsibility for the appraisal of all development finance company projects brought to the Group for financing. The second reason is that it is one of IFC's principal objectives to work with local investors, and the development finance companies represent natural partners for the IFC in its own investment operations.

IFC's recognition of the potential advantages and effectiveness of joint-financing arrangements has been reflected in an increasing trend toward this type of operation. In the case of projects of a size larger than a development finance company can handle on its own, it is IFC's general policy to try to work out arrangements for joint financing. In some cases, projects suitable for joint financing have been brought to IFC's attention by a development finance company; in other cases, foreign investors sponsoring projects have approached IFC, which in turn has brought in a development finance company. For example, nearly all of IFC's recent transactions in India and Pakistan have directly involved the Industrial Credit and Investment Corporation of India (ICICI) and the Pakistan Industrial Credit and Investment Corporation (PICIC) respectively. There are cases, however, in which the promoters of a project approach IFC but do not wish to be involved with the development finance company associated with IFC; IFC will not necessarily refer such projects to the local institution.

An analysis of joint-financing operations involving IFC with development finance companies associated with the Bank Group reveals some interesting facts. There have been eighteen transactions of this kind in some ten countries, involving projects with a total capital cost of over \$160 million. IFC's total commitments in these transactions have accounted for approximately \$34 million of its cumulative commitments, to date, of approximately \$205 million. But these figures do not tell the whole story, since joint-financing arrangements of this kind have effectively been initiated only in the last five years.

A number of common features characterize these transactions. In nearly every case, they involve companies and projects that are substantial by



the standards of the country concerned. A large proportion involve new enterprises, often promoted by the development finance companies themselves. The types of industry represented have generally been either new to the country or have involved advanced technology and hence have presented unusual financing problems. They include alloy steels, steel forgings, textile machinery, ball bearings, pharmaceuticals and synthetic fibers. Over half the projects have involved joint ventures between local and foreign industrial partners. The arrangements for financing also have some common features. In most cases, both financing agencies have undertaken to provide a combination of equity and long-term loan financing. In some cases, partly because of the long-term objective of broadening local capital markets, more complex financing arrangements have been undertaken, in the form of joint underwritings or a combination of direct investment and underwriting.

#### Advantages of Joint Financing

From the point of view of a development finance company, perhaps the major reason for joint financing is that a particular transaction is too large for it to handle on its own. Most development finance companies have an effective ceiling on individual investments of 10-20 per cent of their net worth. When the needs of the enterprise seeking financing are larger than a development finance company can meet alone, the latter can use its connections with other financing institutions to find a partner or partners to share the risks. Even if the expected exposure of the development finance company is below the 10-20 per cent limit, the call on its resources may still be larger than would be prudent in view of the risks involved in a transaction. It may also wish to avoid being placed in a position where it is the largest single shareholder of an enterprise, since this in turn may lead to involvement in

managerial decisions, while the size of its interest may reduce the eventual marketability of its holding.

Since most development finance companies prefer to spread their funds over a larger number of projects and to diversify over a range of different industries, a development finance company may on occasion feel that a particular industry is already sufficiently represented in its portfolio. If it should be approached to finance other companies in the same industry, it may then find itself in the invidious position of having to turn down an otherwise eligible project in order to maintain a well balanced portfolio. Here, too, a joint-financing arrangement may provide the solution.

An example of this is the recent joint financing by IFC and the Malaysian Industrial Development Finance Limited (MIDFL) of a leading Malaysian cement producer, Tasek Cement Limited. The company brought its original plant into production in mid-1964, and soon decided that the market justified doubling the original plant capacity. During the course of 1965, the company developed a plan to finance the cost of the expansion, estimated at approximately 12.1 million Malaysian dollars (US\$3.95 million), and placed orders with equipment suppliers. At this stage, the company could count on suppliers' credits and cash generation from operations to cover part of the cost of the expansion, and it expected to obtain the remainder of the funds needed through its regular banking connections. When this could not be arranged, the company applied to MIDFL to cover the gap in financing; but, because it had already invested in another cement company, MIDFL felt that it could not undertake the entire commitment. In November 1965, MIDFL asked IFC to join in the financing. Early in December, an IFC mission undertook an appraisal of the Tasek expansion program and concluded that the company's technical, commercial and financial

performance justified an IFC investment.

Under the terms of the investment, which was approved by the IFC Board in February 1966, IFC undertook to make a seven-year loan of US\$1,275,000 and to subscribe to shares of the company in an amount equivalent to US\$284,000. MIDFL undertook to make an equity investment equivalent to US\$108,000, a loan in local currency of M\$500,000 and a loan in foreign currencies equivalent to US\$382,000 from funds provided by the World Bank. The IFC and MIDFL loans carried the same interest rate, with both loans secured by a first floating charge on the assets of the company. Because the project was relatively well-defined, the total elapsed time between the approach to IFC and the initial disbursement of IFC funds was only about four months.

In this case, the joint financing demonstrated the advantages of the technique in helping MIDFL fulfill its objective of diversifying its portfolio and making the most effective use of its limited resources. In turn, IFC benefited from MIDFL's knowledge of the local cement industry and its assessment of the sponsors. In most respects, however, the Tasek Cement financing was atypical. Much of the preliminary work in market research and in developing a financing plan had already been completed by the company when IFC was brought in by MIDFL. The terms of the financing were simplified by the fact that the company's assets were unencumbered. Finally, although the plant had been in operation only a short time, the management had already demonstrated its ability to operate without the assistance of an outside technical partner.

The joint-financing technique is most likely to afford advantages in new or large-scale industries or industries with complex technological

requirements. Often there may be an added risk factor in the introduction of a new product or a new manufacturing process. Such enterprises are apt to require a relatively long lead time, with the possibility of difficulties in production and marketing in the early years. As a consequence, the financing of such enterprises presents several problems. The foreign exchange requirements are likely to be substantial. The risks involved indicate the need for a strong equity base and a conservative debt-equity ratio. At the same time, the absence of prospects of earnings or dividends in the near term makes it difficult to raise venture capital from local sources. In such a situation, there is a clear advantage to a joint financing in which both IFC and the development finance company are associated as shareholders, strengthening the equity base, sharing the risks and helping to create confidence in local investors who might otherwise hold back. IFC's association with the project, in particular, may also serve to encourage the participation of foreign investors.

The joint-financing approach may in this way strengthen the arrangements for an actual joint venture. If a foreign technical sponsor is needed, IFC may be able to help the local sponsors find such a partner and provide an appraisal of the caliber of the foreign group. To ensure the prospects of the enterprise, an agreement linking both partners into the project through a meaningful investment in the share capital may be needed; if necessary, this may even be a pre-condition to IFC participation in the financing. Once a plant has been constructed and brought into operation, adequate arrangements will have to be made for the management of the company. In some industries, the equipment suppliers acting as industrial partners may have no direct experience of the manufacturing process and it may therefore be necessary to

bring in a partner who will not only participate in the equity but also provide management during the initial stages. In such circumstances, it may be useful to have IFC's assistance in working out the details of technical collaboration agreements or in assessing the reasonableness of management fees.

Special circumstances may make it difficult for a development finance company to handle a project on its own. If a company plans to produce a commodity that enters into world trade, any judgment about the economic viability of the project will require an appraisal of the world supply-demand situation and other relevant factors. A project may present special problems for a development finance company acting on its own, because of factors peculiar to an export-oriented enterprise which sells most or all of its output in world markets. Effective financing of the company's operations requires assessment of trends in the company's principal export markets, as well as an analysis of its quality control, marketing and sales arrangements and any other factors likely to affect its competitive position.

An enterprise of the latter type has been financed jointly by IFC and the Banque Nationale pour le Developpement Economique (BNDE) of Morocco. The company in question is a Moroccan exporter of food products, principally to the European and North American markets, which has gained substantial acceptance under highly competitive conditions. The project was first referred to IFC by the Spanish sponsors of the company in late 1963. Originally, it was conceived as part of a program to expand both agricultural and industrial operations of an integrated agribusiness venture, producing its own raw materials on its own land holdings and supplying these materials to its processing and canning facilities.

In line with its general policy of working wherever possible with an associated development finance company, IFC regarded BNDE's partnership in the financing as an essential condition to IFC investment in the project. At the same time, IFC recognized that the needs of the project were larger than BNDE could meet on its own, and consequently joint financing appeared the logical approach. A joint appraisal of the technical and commercial aspects of the project was undertaken by IFC and BNDE staff early in 1964. The availability of raw materials, the suitability of the plant and equipment the company proposed to buy, production costs, selling prices, markets and competition were analyzed.

On the basis of this study, the IFC and BNDE concluded that the expansion program was soundly conceived, that the prospects of profitability appeared reasonable and that the company had a capable and experienced management. The company, BNDE and IFC agreed upon a tentative financial plan. Meanwhile, however, it had become apparent that government land reform measures had created a risk that the company might lose control of the land it owned and hence of the purely agricultural side of its operation. It was therefore proposed that the existing enterprise be split into two companies, one for industrial operations and the other for agriculture, and that IFC and BNDE channel their financing into the industrial company.

By early 1965, it was clear that it was feasible to split the enterprise into two companies, although it was recognized that the economic viability of the industrial company would depend to a large extent on the ability of the agricultural company to supply raw materials of satisfactory quality at a reasonable price. BNDE helped in drawing up the contractual arrangements between the agricultural and industrial companies in order to assure an

adequate supply of raw materials; it was also instrumental in selecting a local firm to handle the various financial and administrative problems arising from the split. A new financial plan was prepared, amounting to the equivalent of \$3.6 million. IFC and BNDE agreed to invest on the same terms. Each subscribed to shares of the newly created industrial company, Compania Industrial del Lukus, S.A., in the amount of 2 million Dirhams (\$400,000) and each made a long-term loan equivalent to DH4.5 million (\$890,000), with part of the BNDE loan being provided out of World Bank funds.

The Del Lukus financing involved several unusual features. The corporate reorganization raised complex commercial, legal and financial problems. Because of the desirability of securing broader local ownership of the enterprise, both IFC and BNDE undertook to acquire a relatively substantial equity interest in the new company (each holds about 23 per cent of the share capital), leaving open the possibility that part or all of these shares will in due course be made available on the local market. This was of particular importance because of the close ownership of the company and the fact that individual Moroccan investors could not be found to take up shares of Del Lukus. Because of the size and complexity of the transaction, it could not have been handled or financed by BNDE alone. In turn, it was BNDE's participation that made it possible to introduce a Moroccan interest and thus to satisfy a condition of IFC financing. By joining forces, IFC and BNDE were able to complete the unavoidably protracted financing of a project that will generate substantial new foreign exchange earnings for the Moroccan economy and will also assist the economy of a lagging region in northern Morocco.

The purpose of a joint-financing arrangement should be to complement, rather than to substitute, resources and expertise. By working together, a

development finance company and IFC are able to have a more comprehensive base for appraising a project than either might have working alone. A development finance company can make a special contribution because it is much closer to local economic and business conditions than IFC would normally expect to be. It can assess the ability of the local sponsors to carry out a project, knows local business practices and is informed about local problems of production, distribution and sales. It can assess conditions in the local capital market. It can also act as a clearing house for contacts with the business community and with the government. For example, when a new industry is being established, one of the key factors to its success may be adequate tariff protection. This is one area where the local financial partner and the local sponsors can work together to get appropriate action at the right time. Otherwise importers may be able, during the period of plant construction, to stockpile the products that the new company plans to manufacture, thereby reducing or even eliminating the company's local market in its early years of operation.

The development finance company can also play an important role in arranging local currency financing and attracting local investors. It can also take part in promotional activities and represent local participation in a project, with the prospect that it will subsequently be able to dispose of its interest to local investors. This role may be particularly relevant when a foreign-owned enterprise is being opened to local participation at a time when the sponsors are unable to secure local interest, as in the case of the Del Lukus financing.



Underwriting Operations

Another potential area for joint operations is that of underwriting arrangements for public offerings of shares or other securities. Through such arrangements, it may be possible to achieve the common objectives of developing local capital markets and securing broader ownership of industrial equities. A joint underwriting transaction may take a number of forms. It may involve IFC and the development finance company as principals. Alternatively, the development finance company may act as principal underwriter, with IFC needed as a sub-underwriter because of the size of the issue and the desirability of strengthening the selling group, thereby reassuring local investors that any stock not subscribed by the public will end up in strong hands.

IFC can also assist in deciding what kind of securities would be appropriate and in pricing the issue. Through its connections with institutional investors in the developed countries, IFC can bring in foreign investors. On the other hand, the development finance company can provide specific knowledge of local capital market conditions and can help determine what the market will bear in terms of the size, shape and timing of an issue. As a result of its contacts with the local financial community and through its placing power, it can contribute to the success of an issue by bringing other local financial institutions into the selling group. Since IFC does not sell securities directly to the public, it may also be appropriate for the development finance company to act as broker for IFC during the selling period. The value of a joint underwriting approach will depend on circumstances, but it is most likely to be useful where little true underwriting activity has been attempted and where companies have had to rely on a "best efforts" arrangement. It is also likely to be advantageous if the development finance company is

still acquiring experience in the underwriting field, in which case the backing of IFC can increase the confidence of the investing public.

#### Coordination in Joint Financing

Given the apparent advantages of joint-financing techniques, what can be done to make operating procedures more effective and to prevent unnecessary duplication of effort? Although joint financing represents an attractively pragmatic approach to specific situations, this in itself should not detract attention from the practical problems of working out effective arrangements. One area in which procedures should probably be clarified at an early stage is the responsibility for the actual appraisal of a project, and whether or not there might be some advantage in a joint appraisal. If a development finance company is still in the process of building up its own appraisal staff, there may be a distinct advantage to a joint approach. If, however, a development finance company has an experienced and seasoned staff, it may prove feasible for IFC to draw its information basically from its partner's appraisal, modified, where necessary, in the light of IFC's own experience in similar projects in other countries and of IFC's peculiar needs.

Coordination of staff work can also include drawing up a suitable financial plan for a project. This may involve bringing together funds from a number of different sources, in order to ensure that the capital costs and working capital needs will be taken care of, that the foreign exchange and local currency requirements will be met and that the debt servicing cover is sufficient. Finally, it may sometimes be possible to simplify the security arrangements for an investment and to cover both IFC and the development finance company investments by a single legal agreement.

IFC may also benefit considerably from having a local partner who is in a position to carry out regular visits and hence to establish a closer relationship with the management of an enterprise than IFC itself could hope to achieve even with regular financial reporting and occasional staff follow-up missions. Here the development finance company can represent a common interest in requiring satisfactory reporting and independent auditing of the company's books. It can see to it that the auditor's reports are in satisfactory form; it can also explain the differences between accounting principles in a particular country and IFC's own requirements.

The local partner has other advantages in following the progress of a project. He is often in a better position to see problems developing and hence to take action before the problems get out of control. This is not to underestimate the difficulty of follow-up work, in the sense that it takes both experience and detachment to recognize and admit mistakes. The need for follow-up work is particularly obvious when problems arise: for example, because the sponsors have made basic changes in the scope of a project, with resulting higher costs. Here a development finance company can assist in arranging additional local currency financing and in getting prompt coordination between the various financing agencies in order to deal with the situation. Yet another area in which the development finance company can be of assistance is in reporting the effects of changes in the economic climate of a country. This might involve assessing the impact of devaluation on the costs of an uncompleted project or on a company's ability to meet its foreign exchange obligations.

Closer and earlier coordination of staff work may also help to reduce the relatively long lead-time required to complete joint-financing

operations. In many cases, delays may be unavoidable because the projects likely to qualify for joint financing are those that present special problems because of their size and complexity. It has also been argued, however, that IFC's own appraisal procedures tend to take longer and that it is therefore slower to act than a development finance company. This criticism is often valid, but it should be pointed out that an international agency has peculiar problems of presentation and is in some respects at a disadvantage to a local institution, particularly in appraising local factors. Moreover, very few projects ever reach IFC in a form where they are eligible for IFC financing. In most cases, further work is necessary to firm up the project and the financial plan, and this is bound to take time.

#### Limitations of Joint Financing

The technique of joint financing is clearly not without some limitations and disadvantages. Sometimes it is the economy of a country or local market conditions that are the inhibiting factors. For instance, there may be stringent government regulations affecting foreign investment. These requirements would apply to IFC though not to a local investor such as a development finance company and might lead to time-consuming delays and negate some of the advantages of a joint-financing operation. In some countries, it may also be difficult to negotiate investments that satisfy IFC's normal practice of providing part of the finance in the form of equity. For a start, entrepreneurs may be reluctant to part with equity, and even if they are prepared to sell an equity interest, tax and other factors may make a share investment unattractive. Factors such as these have been responsible for limiting the opportunities for IFC participation in joint financing in countries as different as Finland and Iran. In other cases, IFC's own policies may limit the

opportunities for joint financing. For example, IFC will not take the exchange risk involved in making local currency loans. This has meant that it has been unable to participate in underwritings of local currency debenture issues proposed to it by some development finance companies.

Some difficulties may spring from differences of judgment that are a result of different perspectives. IFC and the development finance company may propose to make their respective investments on different terms, and their appraisal needs may therefore differ. A lender's appraisal is likely to stress security rather than the risk-reward criterion applicable in an investor's appraisal. There may also be genuine differences of opinion on the actual risks of a project and hence different opinions about the appropriate terms for financing. IFC may attach greater importance to the strictly financial aspects of a project, in view of its need to devise investment terms that will attract participants. The development finance company, on the other hand, may attach greater weight in some cases to security, or in other cases to the developmental aspect and to the economic benefits of a project, while it may be less immediately concerned with the objective of revolving its own portfolio.

Although experience in joint-financing operations is still relatively new, it is likely that the first joint operation between IFC and a development finance company presents the most difficulties. The problems tend to diminish as the partners become acquainted with each other's operating methods and develop a common working language. Yet the basic difficulty is by no means simply one of better communication; what is also required is better coordination. In some cases, it may be possible to undertake a joint operation more

effectively if there is an agreed division of labor and responsibilities. With early coordination and a clear understanding of where the initiative lies in a joint-financing operation, many delays may be avoided. The balance of advantage would more clearly be seen to lie with joint financing in the case of larger and more complex projects, if there was stronger evidence that this type of approach makes possible speedier and more efficient processing of projects than either agency on its own could provide.

APPENDIX

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