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The Promotional Role and Managerial Responsibilities of a Development Finance Company

E. T. Kuiper

[Development finance companies have in varying degrees taken on entrepreneurial functions in promoting new industrial enterprises, risking their capital and reputation in the process, and influencing the subsequent management of such enterprises. The degree of involvement with enterprises depends on the economic environment, which may or may not require such involvement, and on policy judgments. This essay is based on discussions at a conference of 18 chief executives of finance companies supported by the World Bank Group.]

The provision of capital is the hard core of the function of a development finance company. But, should it also help formulate, initiate and organize a proposal for industrial investment? Does it have such 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? And what should be its subsequent relationships with management of enterprises it has helped to create?

The promotion of new enterprises requires the following steps, regardless of who performs the particular functions. The promoter will first identify a project that appeals to him, perhaps the manufacture

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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 promoter will almost always have to seek expert assistance. If the venture passes this critical stage of formulation, the promoter 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. A development finance company may contribute to the success of a venture at any one of these stages of project development. There is a thin line between "financing only" and "promotion," for effective financial appraisal involves a careful scrutiny of each of the factors involved in promotion. The difference reflects mainly the development finance company's degree of initiative, and the margin of risk it is willing to assume.

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 prewar industrial history, but one that had greatly suffered from the War. This development finance company felt no need to engage in promotion; 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. The attitudes of the development finance companies associated with the World Bank Group toward promotional activities reflect the stage of economic development of their respective countries. The institutions most reluctant to engage in promotional activities are those in the more advanced of the underdeveloped countries with a large and active entrepreneurial class. Their preoccupation is with finding funds, stimulating the capital market, attracting foreign investment, and strengthening their staffs in order to deal more effectively with their many applications. In due course, as their capabilities and confidence grow, they may follow more enthusiastically the promotional example of the large, active and prosperous development finance companies 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. Promotional interest is also found at the opposite end of the scale: the development finance companies of countries with a shortage of entrepreneurs 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.

The Elements of Promotion

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. The real test of the development finance company's effectiveness as a promoter of ideas lies in its contacts with private entrepreneurs, foreign and domestic. A development finance company can help bring men who have new ideas or technical knowledge together with men who have capital. The function of negotiating such a marriage is particularly important in bringing foreign and domestic businessmen together. Close and continuing contact with the private business community is crucial. Through its day-to-day business contacts, a development finance company can bring its knowledge and experience to bear on the investment proposals of others; if it has good international connections, it will be in a position to bring the experience of other countries to bear upon the local situation. 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.

It should be noted 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. It would be naive to think that the catalytic function of a development finance company will go very far if the company is not prepared to back ideas with capital. The capital, however, need not be its own. 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.

Consultation and study. 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. 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 while executing the project. Such a prospect is more likely if the study or survey is narrowly focused. A general economic survey is the least likely to pay off; a study of a specific project is the most hopeful. 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. 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.

When to promote 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—without much financial risk. But where there is not a plentiful supply of entrepreneurs working to exploit investment opportunities and seeking capital to finance them, it must sooner or later wet its feet in the treacherous waters of company

promotion. The classical approach to starting new companies 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 may 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; the staff will learn its business by trial and error and through contacts with more experienced foreign companies.

It is a good rule for a development finance company that service to its clients should normally take precedence over its 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, there are business and political groups in every country that will resent any promotional activity by a development finance company because they suspect that funds and attention are being diverted from matters which interest them. It should be remembered that development finance companies differ in one vital respect from the private entrepreneur when promoting new enterprises for their own account. 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.

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. Thus, the development finance company becomes both a partner in the promotion and a co-sponsor of the project. In

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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 unable 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 development finance company may also prepare an overall 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.

Requisites for promoting new companies. The extent to which a development finance company may assume promotional functions 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 promoter 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.

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. 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 matter is that development finance

companies must try to combine profit-making with a developmental orientation. 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.

Even if the project promoted is successful, it is often difficult to recover these costs from the sponsors who carry out the venture. 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 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.

Many development finance companies receive substantial support for promotional expenses 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 major financial consequences of a promotion, whether favorable or unfavorable, derive not from the costs of 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." 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. 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.

The greatest non-financial risk of promotion is overinvolvement. "Pet projects" often go wrong. Overdevotion to promotions may result in underdevotion to clients. Both may result in loss of the respect and confidence of the business community—without which a development finance company cannot survive. 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.

Involvement in Enterprise Management

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 calls, in the first place, for the careful selection of investment proposals. No factor in selection is more important than a judgment regarding management, and a decision that management is satisfactory—technically, commercially, administratively, and in terms of honesty. But satisfaction with management before the investment is made is not enough. Management remains a matter of continuing concern thereafter, especially when the enterprise is a promotion of the finance company. But there are differences of opinion on how this responsibility of a development finance company can best be carried out.

Obtaining information. It is a common experience that management and staff devote much more time and effort to project preparation and loan negotiations than to keeping themselves well informed on the current 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 assessments of performance. 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, 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 for improvements. 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, and 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.

Usually, but not always, the client knows his own business best, although the development finance company may have a broader range of experience from which suggestions can be drawn to help a specific client. 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. He should always remember that the managers of these enterprises remain responsible for their operations.

Representation on boards of directors. When development finance companies underwrite or finance in one way or another a very substantial amount of the total cost of a venture, information gathering and inspections may not be considered sufficient. A seat on the board of directors may seem to be called for. 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 discussion in the board brings out facets of an operation that cannot be appreciated in any other way. 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. Such influence, however, implies a degree of involvement in the enterprise which many finance companies do not welcome. In some cases it could even give rise to a conflict of interest for the board member in question, e. g., on dividend policy.

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 seemed agreed that they should be represented on boards when they own an amount of stock large enough to justify such representation. But there was no consensus 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.

Direct participation in management? It is not surprising that, as a rule, development banks refuse to be directly involved in management. First, 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, a development finance company is set up to serve many clients in many fields of activity, and it should not identify itself with the interest of one particular enterprise in one particular field; by doing so it risks compromising its position vis-a-vis other firms 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, there are exceptional cases where such managerial responsibilities should be undertaken by finance company staff. Three instances may be cited. In some countries clients with constructive ideas and funds to back them are conspicuously absent; yet 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; and there is often no alternative to involvement in management if the promotion is to be successful. A second type of situation would be when 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 impossible to find qualified outside managers. Still another kind of case involves jeopardy. Where an investment

has gone sour, the taking over of management may offer the only alternative to outright loss. 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.

[Excerpted from Chapters 1 and 3 of Development Finance Companies: Aspects of Policy and Operation, William Diamond (ed.). Baltimore (Md.): The Johns Hopkins Press for The World Bank Group, 1968, pp. 5-23 and 49-58. Copyright © 1968 by The Johns Hopkins Press. Reprinted with Permission.]