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D01742

United Nations Industrial Development Organization

Distr.
GENERAL
ID/CONF.1/B.8
26 May 1967

ENGLISH ONLY

INTERNATIONAL SYMPOSIUM ON INDUSTRIAL DEVELOPMENT
Athens, 29 November-20 December 1967
Item 3 (d) of the provisional agenda

Background paper

THE ROLE OF NATIONAL DEVELOPMENT FINANCE COMPANIES IN INDUSTRIAL DEVELOPMENT

Document prepared for the Symposium

Presented by the World Bank Group (the International Bank for Reconstruction and Development, the International Finance Corporation and the International Development Association

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Introduction

1. The aim of this paper is to review the experience of the World Bank Group in helping the creation or expansion of development finance companies in the Group's member countries. It is important to appreciate, from the start, that most of the experience of the World Bank Group with development finance companies has been of fairly recent origin. The Bank and its affiliates, the International Finance Corporation (IFC) and the International Development Association (IDA) are associated with development finance companies in twenty-one countries. In two countries, Ethiopia and Turkey, the association goes back to 1950, but in fourteen of the twenty-one countries the association goes back no further than 1961. Given this qualifying factor and the additional factor of the diversity of the experience in different countries, it would be difficult at this point in time to attempt any definitive conclusions about the actual impact of such institutions upon the industrial development process. But the Bank Group's experience is worth consideration to the extent that it identifies some of the potential contributions and some of the problems of these institutions.

Development finance companies defined

2. A host of different types of institutions which share the common objective of providing medium-term and long-term funds for productive investments and, usually, also the technical advice needed to formulate and carry out such investments, are broadly identified as "development banks". One category of institution falling within this broad definition is the private development finance company. Institutions of this type are designed to provide medium-term and long-term loans and equity capital for industry and other private

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productive enterprises, to underwrite securities of such enterprises, to promote new enterprises and to assist entrepreneurs in preparing investment proposals. They also act as channels for foreign capital and technology, in particular by bringing together foreign and local investors in joint ventures. By becoming an important element in a country's capital market, they can help to mobilize domestic savings and, in combination with technical know-how, canalize them into productive activities.

3. To perform these functions, the development finance companies need three main tools. The first is a supply of long-term capital, which will be particularly useful if part is available in foreign exchange. The second is experienced management, possessing both a world-wide acquaintance with modern investment techniques and a knowledge of national conditions, and capable of appraising objectively investment opportunities, market possibilities and investment risks and of assisting clients to obtain technical and managerial aid. The third tool is contact with foreign business and investment institutions and international financial and technical assistance agencies, to help in recruiting outside capital and know-how.

World Bank Group assistance to development finance companies

4. This, in outline, is the nature and purpose of the private development finance companies whose establishment or expansion the World Bank Group has been encouraging. By the close of the fifties, the Bank was associated with six such companies, in Austria, Ethiopia, India, Iran, Pakistan and Turkey, and had made loans to them totaling $76.7 million. By the end of 1962, five more institutions in four countries, China, Colombia, Morocco and the Philippines, had joined the list, and the cumulative total of Bank and IFC financing of development finance companies had risen to $167.1 million. The

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escalation at the beginning of the sixties in the Bank Group's interest in this type of institution resulted in IFC being designated, in 1962, to act for the Group as a whole in this particular field.

5. There is an increasingly distinctive pattern to the World Bank Group's assistance to development finance companies. The pattern takes the form of an equity investment by IFC accompanied by loan funds from the World Bank. Two institutions, the China Development Corporation and the Industrial Development Bank of Turkey, have been relent at commercial rates the proceeds of IDA credits extended their respective governments for that purpose. By the end of March 1967, the Bank Group's direct financial assistance to development finance companies in the form of loans, equity investments and credits amounted to $570.6 million to 25 companies in 21 countries. Of this total, some $512 million represented World Bank loans, $40 million was in the form of IDA credits and the remaining sum in IFC investments and underwriting commitments.

6. This, however, is an incomplete statement of the role that the Bank Group has played in supporting these institutions, for IFC has in several instances helped to expand and reorganize existing companies and has lent assistance in establishing new concerns of this nature. It has helped to bring in private investors and has provided a wide range of technical assistance including help in drafting statutes, preparing policy statements, finding experienced management, training staff and developing proper procedures for project analysis. In some cases IFC has found it appropriate to cement its close working relationship with a company by acceptance of a seat on the company's board; at the moment it is represented on the boards of ten of them. Although IFC's investments range through several different categories of enterprise, the development

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finance company is, in fact, the only kind of enterprise in which IFC has accepted an offer of board representation.

Ownership

7. Before embarking on a more detailed discussion of the nature and role of development finance companies and the Bank Group's association with them, it is important to clarify the reason why, of the several categories of development finance institutions to which the name "development bank" is applicable, it is the privately controlled institutions that have attracted the support of the Bank Group. It is the experience of the World Bank and IFC that development finance companies are most likely to operate successfully if their ownership is predominantly private. This appears to be the best way of assuring continuity of sound investment policies and experienced management, so that operations will be conducted on sound business lines and with reference to economic rather than political criteria. Examples are numerous of publicly controlled development banks that have failed in their purpose because their investment decisions were dictated mainly by political considerations.

8. For this reason, the World Bank by choice limits its assistance to development banks to those that are in wholly or predominantly private hands. As far as IFC is concerned, there is no choice. By virtue of its Articles of Agreement, it may not invest in government-controlled enterprises. It does, of course, have the competence to associate with institutions in which the government is a minority shareholder, which is sometimes the case. In certain circumstances it might be impossible to establish a new development finance company as a genuinely national institution -- which it ought to be -- without the presence of the Government amongst the shareholders. In some countries the paucity of domestic investors, combined with the presence of investment

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opportunities which offer a larger and more immediate return than that which a development finance company can offer may make it impossible to marshall more than a token amount of private domestic capital for investment in the company's shares. In such circumstances it may be necessary for the Government, as an interim step, to subscribe to a substantial block of shares in order to achieve the requisite degree of domestic ownership. So long as the Government remains in a minority, and non-controlling, position, this is no bar to an IFC investment, but in cases where the Corporation has subscribed in such a situation, it has first satisfied itself that the company was effectively isolated from government control, and that the Government was prepared to sell its shares to domestic private investors as and when they could be interested. The Government and IFC, on several such occasions, have agreed to make such sales pari passu from their respective holdings.

9. Since IFC has been regarded as national, so that a combined IFC-domestic majority in the company conveys sufficiently the image of a national institution, the Corporation has a certain duty not to dispose of its shares to foreign investors in a measure that would destroy the company's national character. In recognition of this, IFC is willing in certain cases that its sales from its holdings of the company's shares be confined to sales to private domestic investors. For example, when the Liberian Bank for Industrial Development and Investment (LBIDI) was set up in 1965, IFC and the Liberian Government both subscribed to the initial share capital, and agreed to reserve their shares for sale to private Liberian investors as a means of encouraging wider local ownership of the institution. In addition to establishing and maintaining the national character of a development finance company, it is also advantageous that the ownership be broadly based. By avoiding control by a

single investing group, the company is in a better position to persuade the Government that it is in the public interest for the company to receive some special benefits.

Capital structure

10. Even with considerable government aid, it is unusual for a development finance company to be very profitable in its early years. While its initial stockholders have therefore to be motivated by something other than immediate financial gain, the organizers of the company, on their part, must plan the capital structure of the enterprise in such a way that investors will at least feel that their capital is safe from impairment and that in the not-too-distant future they will begin to receive at least a modest return on their investment. Sufficient net earnings will have to be generated to cover the cost of adequate management and staff, the building up of adequate reserves, the payment of taxes and, as soon as possible, payment of a moderate dividend to shareholders. To achieve such earnings, the company must plan on obtaining a substantial part of its resources from borrowed funds, which can be lent at a higher interest rate than the company has to pay, and thus provide "leverage" to enhance the return on equity. The problem, however, is that the "spread" between the interest rate which the company can charge its borrowers and the rate which it must pay to conventional sources of capital, domestic, foreign and international, is rarely sufficient for a new company to become soundly established.

Government assistance

11. Most of the development finance companies assisted by the World Bank and IFC have, with the help of their respective Governments, found a way round this problem. They have been able to obtain special government assistance, in the form of so-called "quasi-equity", that is to say a long-

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term loan -- usually about 30 years with 15 years' grace -- interest-free or with a very low rate of interest, which will be subordinated to or, at the most rank "pari passu" with the share capital in case the company has to be dissolved. The absence of interest gives the company a far better chance of reaching a profitable stage early in its life, while the subordination to equity provides a cushion to protect the shareholders in the years before adequate reserves have been established. For example, when the Industrial Credit and Investment Corporation of India, (ICICI) was established in 1954, the capital resources of the Corporation included a 30-year interest-free advance of 75 million rupees ($15.75 million) with a fifteen-year grace period. Similarly, when the Pakistan Industrial Credit and Investment Corporation (PICIC) was established, with Bank assistance, in 1957, the capital resources of the Corporation included a 30-year, interest-free loan of 30 million rupees ($6.1 million) from the Government of Pakistan. In both of these cases, the loans were subordinated to the share capital. But a government loan on similar terms extended to the Industrial and Mining Development Bank of Iran (IMDBI) ranks pari passu with the share capital.

12. Other forms of government support which are helpful to the finance companies (but do not eliminate the need for quasi-equity or its equivalent) are preferential income tax treatment and guarantees of foreign loans. In some countries, the Government has entrusted the finance company with the management of special public investment funds, for which a managing agency fee is paid. For example, the Government of Iran turned over to IMDBI for management existing loan portfolios totalling the equivalent of $18.7 million and also made available a "special equity fund" of the equivalent of $12 million with which IMDBI could take up equity participations in private enterprise.

13. Thus a Government may support a development finance company in a number of ways: by taking a minority participation in the share capital, by providing long-term "quasi-equity" loans, by turning over investment funds for management by the company in return for a fee, by giving preferential income tax treatment and by guaranteeing foreign loans. We must now identify the non-governmental sources of equity and loan capital.

Private domestic investors

14. On the domestic front there are two categories of private investors to whom a development finance company looks for participation: institutional and individual. Institutional investors are usually motivated by a mixture of public-spiritedness and an expectation of indirect benefits to their own businesses through a general strengthening of the economy. But sometimes inducements are necessary. For instance, commercial banks, industrial firms and trade associations took up the entire initial share capital of the IDB of Turkey, but first it was necessary for the Government to offer a guaranteed minimum dividend.

15. Individual investors are harder to attract. For one thing, they are inclined to be small in numbers in the developing countries anyway, and except where the known investment alternatives are considered less safe or attractive than investment in the finance company's shares, they tend to adopt a wait-and-see attitude. They may well come forward later. There were no individual subscribers to the initial share capital of IDB, but a capital issue four years later was over-subscribed and many of the subscribers were individuals.

16. As has been noted earlier, it is important that ownership of a development finance company be as broadly based as possible to avoid control

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by a single investing group and to demonstrate the nation-wide character of the institution. Some development finance companies reserve a percentage of the shares for individual investors as opposed to industrial groups and financial institutions. When ICICI was established, it reserved 30 per cent of the initial share capital for individual domestic investors. More than half the applications received were for fewer than 20 shares, the par value of the shares being 100 rupees (the equivalent of $US21 at that time).

Foreign Investors

17. Most development finance companies have substantial foreign shareholdings, and there are several advantages in such participation. For one thing, it may help to insulate management against local pressures to make or decline to make particular investments, thereby strengthening the company's independence. It may promote a flow of external capital to local industry and provide contacts with financial institutions in the capital-exporting countries. It may facilitate the importation of technical skills in industrial production and management. Finally, the evidence that overseas capital regards the company's shares as a fair risk may give confidence to potential domestic investors. Banks and insurance companies doing business in the country feature prominently amongst foreign investors, one reason being that they have the advantage of being able to pay for their shares in local currency, an advantage not enjoyed by non-resident investors who are, consequently, somewhat more difficult to enlist.

18. Foreign shareholders, largely United States, European and Japanese, have, according to preliminary figures for the close of 1966, provided $47.5 million of the $280 million total share capital of the 25 institutions in which the World Bank and IFC have an interest. Local investors provided $218.5 mil-

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lion and IFC $14 million. A breakdown of the ownership of PICIC, as a fairly representative example, shows the investors, as of 31 December 1966, to be 60 per cent local, 10.9 per cent United States, 10.8 per cent British, 7.3 per cent Japanese and 6 per cent German, with IFC holding the remaining 5 per cent of the shares.

Additional resources

19. This equity base, supplemented in many cases by quasi-equity, has made it possible for development finance companies to obtain substantial additional resources in the form of fixed interest loans. Loan funds have sometimes been provided by Governments at commercial interest rates (as distinct from the concessionary terms of quasi-equity loans), but more often such loans are likely to come from international organizations, such as the World Bank or the Inter-American Development Bank, or from foreign Governments as bilateral aid. Private foreign institutions have been a much less important source of loan capital.

20. If quasi-equity amounts to one and a half times the share capital (the usual proportion), then the "borrowing base" of a company with a share capital of $1 million is $2.5 million. Lenders like the World Bank (which has encouraged the adoption of this form of capital structure) feel that a finance company may in time borrow up to three, four, or even for some well established companies five times the amount of capital, free reserves and quasi-equity. The company with $1 million share capital may thus in due course be able to command total capital resources of $10 million or more.

21. The amount of leverage this has provided for the operations of the 25 development finance companies associated with the Bank Group can be illustrated fairly simply. As previously mentioned, the total share capital of

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these institutions on 31 December 1966 amounted to the equivalent of $280 million. Their total resources (equity, quasi-equity and loan funds) as of that date amounted to the equivalent of $1,048.7 million. In turn, these resources had made it possible for the development finance companies to enter into commitments in excess of an estimated $1,700 million, chiefly in such industries as textiles, food processing, chemicals, iron and steel, machinery and equipment and pulp and paper.

Management

22. A suitable capital structure is one indispensable ingredient. Good management is another. Since, in the less developed countries, there is generally a shortage of skilled people with managerial abilities and investment experience, the chief executive officer at least will often have to be recruited from abroad. Helping to find such a man is one technical assistance task that IFC has often undertaken. Putting an experienced manager in from the start is important not only in order to get operations off on the right footing, but also in order to begin the process of training nationals for senior positions from the earliest possible moment.

23. There must also be from the beginning of operations sufficient skilled staff to carry out engineering and financial appraisals, and to follow up projects assisted. In IFC's experience, it has proved a false economy for a development finance company to wait until its income is large enough to cover the cost of such a staff, since, in the absence of capacity to make adequate appraisals, the investment of the company's resources is almost certain to be slow, or poor investments may be made. The key to this problem lies in the capital structure which, as has already been pointed out, should be so organized as to produce an adequate level of earnings fairly soon.

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Investment policies

24. The indispensability of experienced and, above all, intelligent management arises from the fact that the formation and execution of proper investment policies is by no means an easy undertaking. A development finance company is at the same time both a development institution and a profit-making institution. Its investment decisions must principally take account of the economic and financial prospects of the enterprises being assisted but not ignore the credit and security factors.

25. For example, new enterprises often require substantial equity capital, and most development finance companies are willing to make equity investments (provided there are no managerial responsibilities to be assumed, except possibly in the initial promotional phase). But unless they operated in a reasonably well-developed capital market and with a fairly ready market for industrial securities (as in India), they would be imprudent to hold in their portfolios equities amounting to more than their paid-up capital and free reserves. One form of investment which may be especially well adapted to the needs of both the company and the client is the loan with equity features such as conversion rights or profit participation. Through this medium the development finance company should be able to secure a proper yield on its investment.

Equity investments

26. Equity investments have many advantages for a development finance company. It is true that at the outset of operations, a loan portfolio generating regular and immediate income can be invaluable for building up reserves, meeting administrative expenses, servicing borrowed capital and paying dividends on share capital. Turkey's IDB deliberately avoided equity investment in its early years, believing it too risky for a private finance

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company in the initial phase of operations. But once the finance company is a going concern, the attraction of equity investments becomes very real. They enable the finance company to share in the profitability of successful enterprises, thereby adding to the company's income, providing a cushion against possible losses on other investments and demonstrating the attractiveness of industrial financing. Furthermore, by selling equity out of its portfolio, the company can help to spread share ownership and develop a capital market.

27. Though an equity investment may very well suit the finance company, the company is still bound to take into consideration the attitude of the applicant toward outside participation. Businessmen are frequently reluctant to share their ownership since it usually means disclosing the details of their operations. Furthermore, they may be concerned about the direction in which the finance company may eventually dispose of its shares. PICIC, for instance, has found that some entrepreneurs would rather pay more to borrow funds elsewhere in these circumstances.

Loan financing

28. In loan financing, a balance between the interests of the lender and the borrower must be reflected in the terms. The duration of loans must be long enough not to place undue hardship on borrowing enterprises, which anyway would jeopardize repayment, and also must be related to the duration of the finance company's borrowings. The company's loans will generally include a substantial grace period to allow for construction and start-up of the project.

29. Interest rates charged by the finance company should bear a relation to the opportunity cost of capital. For Governments to impose a much lower rate -- as some have done -- tends to encourage uneconomic investment as well as diminishing the profitability of the finance company's operations. The

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level of lending rates cannot always be fixed by independent decision of the finance company. In some countries the Government sets the maximum rate. Whether or not Governments exercise control over or otherwise influence the lending rates, there is in any case an upper limit on rates determined by the rate at which capital is available from alternative sources. Reluctance to borrow from a development finance company may be due simply to the fact that commercial banks or insurance companies or equipment and materials suppliers may be able to lend at lower rates, even if at shorter term.

Size of investments

30. We come next to the question of the size of a finance company's individual investment. Here there are rather severe limitations. Small loans and participations are generally subject to such a high degree of risk and, compared to the eventual yield, are so costly in terms of staff time absorbed in appraisal, administration and follow-up that companies are obliged to set a lower limit to individual operations. This lower limit is set by most companies at somewhere between $20,000 and $50,000. This lower limit removes development finance companies almost completely from the field of aid to small enterprises, even though in many countries such aid appears to be of great social and economic importance, and in some countries may constitute the bulk of assistance needed in the private sector. In some countries, attempts are being made to devise ways of remedying this situation. For instance, in 1963, as a condition of a government loan, Malaysian Industrial Development Finance, Ltd. (MIDFL) agreed to make up to 20 per cent of its annual commitments in amounts equivalent to between $17,000 and $50,000. In fact the small loan program accounted for much less business than expected, with only 4 per cent, 5 per cent and 8 per cent of total

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commitments in the past three years being in amounts of less than the equivalent of $50,000. Many of these were hire-purchase and factory mortgage loans which have proved somewhat less profitable than ordinary long-term loans. On the other hand, orthodox small loans proved fairly remunerative, so that the small industry program in total has not been significantly less profitable to MIDFL than the rest of its business. In an effort to raise the return on small lending, the company has taken steps to simplify appraisal and follow-ups and to increase the interest rate on hire-purchase loans. It has also formed a new subsidiary specifically aimed at assisting small industry by providing standard factory units on industrial estates which are sold for cash or through factory mortgage loans. This approach, however, is not typical, and its success has yet to be ensured.

31. At the other end of the scale, an upper limit is set on the size of a finance company's investment in any single enterprise by dictates of prudence, which call for diversification of the company's portfolio. Thus, as a matter of policy, few finance companies will commit funds representing more than 15 per cent of their capital and reserves in a single project. More liberal than most in this respect is the National Investment Bank for Industrial Development S.A. (NIBID) of Greece. NIBID is prepared to commit an amount equivalent to 20 per cent of its share capital and surplus in an equity investment and up to 25 per cent in a total commitment. The five Colombian Financieras will not normally commit more than 15 per cent of net worth to any enterprise, and in no event would they exceed 25 per cent.

32. There is a limit to which institutions of this kind can offer direct financial assistance to large-scale projects. It is here that the finance company's international connections are especially valuable, enabling them

to secure participations from foreign or international financing institutions. The policy statements of most development finance companies stipulate that the company should not provide more than half the finance required for any given project. Often a company has been successful in recruiting foreign capital by taking the lead in the financing and allowing the example of its own commitment to draw in the foreign investors. A number of development finance companies have engaged in joint financing with another institution, where the terms and nature of the investments have often been identical. In a country with more than one development finance company it would clearly be logical for two or more of them to join in supporting large ventures, and indeed this has been the case in Colombia.

Joint financing with IFC

33. More and more frequently IFC has participated with development finance companies in the financing of larger projects, and, indeed, at the present time IFC does not normally invest directly in an enterprise located in a country where it has relations with a development finance company, except in co-operation with that company. In most cases the development finance company has turned to IFC because the project has been just too large for it to handle. Foreign exchange is usually the key factor, especially in the financing of large new enterprises such as a textile mill or steel plant, where there is a high foreign exchange component in the project cost.

34. As an example of IFC joining with a development finance company in a financing operation, one can cite the case of Industria Ganadera Colombiana (INDUGAN), a Colombian livestock company. INDUGAN was seeking finance which would enable it to increase greatly its production of beef cattle and to begin a meat marketing program. The company had been established in 1961 by a group of leading Colombian cattlemen together with local financial and industrial

investors including Corporacion Financiera Colombiana (CFC), a privately owned development finance company in which IFC is a shareholder. The total cost of INDUGAN's expansion program was estimated at the equivalent of $7.5 million. In June 1966, IFC agreed to an investment consisting of a nine-year loan of $1 million and the purchase at a cost of approximately $620,000 of one million new shares of the company, and CFC, together with the rest of the shareholders, joined in the financing by taking up an equal amount of new stock. Most of the remaining cost of the program was expected to be covered by cash generation from the company's operations.

Project selection

35. By and large, the development finance companies with which the World Bank Group is associated have built up well diversified portfolios through selection of a broad range of industries for assistance. India's ICICI, for instance, during the period 1955-1966 brought financing assistance to upwards of 20 different types of industry, while between 1963 and 1966 the Private Development Corporation of the Philippines, (PDCP) engaged in financial operations in upwards of 15 different industries. There cannot be any single criterion or rule in project selection by development finance companies. Objectives and policies vary from company to company and from time to time. But basic to all of them is the fact that unlike purely financial institutions for which earnings are the exclusive test of economic efficiency, finance companies cannot reduce all the ingredients of investment decisions to a single measurable standard, for, as development organizations they are also concerned with the total impact of a project on the community. This does not mean that finance companies must formally apply an economic priority test; they do not establish preferred categories of industries nor do they

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require as a condition of financing that, for example, in a country with surplus labor, the enterprise be employment-creating, or in a country with balance of payments difficulties, that it earn foreign exchange or replace imports. In effect, the ability of a finance company to set any pattern at all is only as great as the choice of viable projects presented to it will allow. Moreover, if the country has an effective development program, it is likely to be in only those areas designated as of relatively great economic urgency that businessmen and industrialists will be granted the official licenses and sanctions without which a project could not go forward. This is particularly true of medium and large-scale industrial enterprises in need of imported equipment and machinery. Thus, while development finance companies may not be bound by any set of rules regulating project selection, this selection tends to fall into a pattern set by the nature of a country's economy and the planned steps being taken to develop it. For example, given the importance of tourism to Morocco and Tunisia, it is not surprising that the development finance companies in these countries have been active in assisting hotel construction and transport facilities.

36. One special characteristic of the industrial lending patterns of development finance companies is the high proportion of resources devoted to new industries and to new enterprises. This is in part a reflection of the difficulties which a new venture has encountered in raising capital; as a general rule it is true that well-established industrial concerns are considered relatively creditworthy and therefore find it easier to attract investment. But often it is the result of deliberate policy on the part of the management in seeking to diversify the industrial base of the country. This has happened in India, for example, where the Industrial Credit and Investment Corporation

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of India (ICICI) has chosen to minimize its assistance to the country's traditional industries like jute and other textiles. Again, in Finland the Industrialization Fund of Finland has made a point of spreading its assistance among newer industries like metals, furniture manufacture and textiles in an effort to reduce the country's industrial dependence on timber and paper. Typically, NIBID, in Greece, has devoted approximately half its assistance to new enterprises.

Technical and managerial assistance

37. A most important function of a development finance company is the provision of technical and managerial advice and assistance to existing and new enterprises. The company's operational staff should be able to provide guidance to prospective clients in preparing their plans for establishing or expanding their businesses. When, as frequently occurs, a finance company is unable itself to provide technical assistance, it should be in a position to put its clients in touch with expert consultants, domestic or foreign, who can provide the needed help. In some cases it may even be necessary to help a client find suitable management, and in the case of enterprises promoted by the finance company itself, finding such management will be one of the crucial elements of success.

Promotional activities

38. Most development finance companies have at one time or another taken the initiative in promoting specific business projects. Systematic attempts by finance companies to interest private investors, both foreign and local, in particular investment opportunities can have important results in countries that lack an experienced entrepreneurial class or where the business community shows little entrepreneurial spirit. While the promotional function is, there-

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fore, an important one, there is a limit to the extent to which a development institution whose primary purpose is financing can engage in it. For one thing, promotion is likely to be expensive and unlikely to produce an immediate return. Furthermore, to promote a proposal of its own and to induce others to join in it, a development finance institution must be even more sure of the prospects of success than it need be when it is financing someone else's project. This implies a degree of investigative, analytical and organizational work for which a finance company is not necessarily well prepared. There is also an extra degree of continuing responsibility, very likely extending well into the start-up period of a new enterprise, and if the project runs into difficulties, the promoting group may have to become intimately involved in the management.

39. Effective promotion can thus call for an extraordinary measure of effort on the part of the finance company, and in order that the devotion of time, effort, finance and technical resources should not jeopardize the proper discharge of its regular financing functions, the company must be extremely selective in its choice of what is to be promoted, and insist on a careful and objective judgment of what is selected for promotion.

40. Basically there are three types of promotional activity in which a development finance company might engage. The first consists of examining a project proposal and modifying it so that it takes the most economic and most commercially profitable form. A second kind of promotion is much more general and consists of surveying a geographic region which may be economically backward or an economic sector, to see what kind of opportunities exist for industrial development that may be of interest to entrepreneurs and investors. A third, like the first, is quite specific and consists of

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promoting the establishment of a particular enterprise to fill an important and well defined gap in the country's economic structure.

41. The first kind of promotional activity is one to which development finance companies should be particularly suited. An appraisal by the finance company of the project's economic, technical, managerial and financial aspects may well reveal the need for substantial modifications in the project proposals. For example, in a complex industrial undertaking, the need may be revealed for a technical partner, from abroad if necessary, willing to provide share capital, and the finance company, with its wide foreign and domestic connections, should be prepared to give assistance in finding such a partner.

42. The second kind of promotional activity -- endeavoring to identify general areas of need in the economy -- is in theory an important exercise. But, in the World Bank Group's experience, the practical results of such studies have not been very encouraging. For example, IFC was approached in 1961 by the Plan Organization of Iran and the IMDBI to arrange a survey of the Iranian chemical industry. The completed survey indicated some promising areas for investment but failed to arouse the interest of any likely sponsors.

43. The third kind of promotional activity has an important advantage over the general survey approach inasmuch as this kind of promotion concerns a project designed to fill a well defined gap in the industrial structure to meet a clear-cut market need. A successful example of this type of operation was the expansion of the cement industry in Pakistan in 1961. The agreement reached in 1960 between India and Pakistan over the division of the Indus River waters resulted in the launching of a huge public works program which in turn created a considerable demand for cement. PICIC volunteered to be responsible for a general review of the industry and

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chose an American firm of consultants to undertake the survey. The survey report recommended the expansion of two of the four existing plants and the construction of three new plants and PICIC soon found two prominent industrialists willing to sponsor and invest in the cement companies. For one company, PICIC subsequently negotiated for financial assistance from the Kreditanstalt für Wiederaufbau of Germany and for the other it received assistance from IFC.

Assistance to development of capital markets

44. Reference has already been made to the development finance company's broad objective of helping to fill a gap in, and contributing to the growth of the national capital market. One possible means of achieving this is to induce domestic investors to buy shares in the finance company itself. Although some will do so -- and to them the company will have an obligation to conduct its operations as profitably and safely as possible -- if the company is frank with the public it will not, in its early years, promise a very attractive return. Wider ownership of the equity of a development institution represents a major step toward gaining public confidence in industrial investment, but this is not likely to be achieved until a reasonable record of earnings and dividends can be shown. As was mentioned earlier in this paper, few private Turkish investors were interested in the shares of IDB when it began operations; today, as a result of 17 years of productive operations and an active marketing effort by the company, there are almost 250 private shareholders and the company's stock is among the most actively traded on the Istanbul Stock Exchange. BANDESCO, the Spanish development finance company, has no quasi-equity but relies on the public sale of its bonds for the major part of its total resources.

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45. But these are the exceptions. Far more useful and important are the activities which the finance company can engage in to promote the ownership of industrial and other shares, and other securities. Foremost among the techniques employed by a finance company to achieve this is the sale from its own portfolio of the securities of enterprises that have passed initial hurdles and have become successful. This, of course, encourages the broader ownership of industrial shares and increases the supply of marketable securities. But it also replenishes the finance company's resources. The replenishment can sometimes be quite substantial. By the end of 1965, IDB had received the equivalent of well over $2 million from share sales to some 200 investors in Turkey, with private individual buyers accounting for over half the amount. In 1966 IDB sold over $3 million of shares. In some cases, development finance companies have been able to attract participations from private investors in particular commitments at the time these are made and on the same terms as the institution itself.

46. Another technique used increasingly by development finance companies is the underwriting of public issues of shares (and other securities) of enterprises that it promotes or assists. The appraisal of an enterprise conducted by the finance company, and its willingness to invest some of its own funds, should help to create in the investing public confidence that such an enterprise is sound. Although underwriting calls for special skills not always available to development finance companies, many of them have nevertheless achieved a position of some eminence in the field in their respective countries. For example ICICI has engaged in 120 underwriting operations since its inception and has accounted for 12 per cent of all the shares underwritten and issued to the public in India in recent years. Many of

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the shares ICICI has been called on to take up for its own account have shown appreciable capital gains for the company when later sold. And C.A. Venezolana de Desarrollo (CAVENDES), in Venezuela, has been instrumental in pioneering an underwriting activity in a country unfamiliar with the practice.

47. The management of development finance companies can in many other ways encourage and assist the flow of private savings into productive investment. The Turkish Bank, for instance, has sponsored, in cooperation with the Planning Bureau and the Union of Chambers of Commerce and Industry, a major study into the economic, legal and financial aspects of the capital market in Turkey as a result of which legislation has been set in motion to amend the country's commercial code and tax laws have been drafted. The Industrialization Fund of Finland (IFF) has been active in studying the Finnish capital market and making recommendations for its further development.

48. In Iran, IMDBI's reputation as an investment institution is so well established that its advice is sought not only by private entrepreneurs and established businessmen but also by the Government. Its leading role in efforts to establish a stock exchange testifies to its ability to hold a central position in the financial field and to have an important impact on the economy of the country. Assistance of this sort, the devising of new forms of securities, advice to governments on many matters affecting the attractiveness of investment in productive enterprises in the private sector, are a few of the possible methods open to development finance companies in their efforts to fill the gaps in their nations' capital markets.

Limitations on role of development finance companies

49. A review of the World Bank Group's experience with private development finance companies would be incomplete without briefly discussing whether

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this type of institution would be appropriate in any and all countries wishing to speed their industrialization. At least three conditions must exist if the institution is to perform a useful function and to grow. First the development of a strong private sector must be consistent with the nation's over-all aims. It would be pointless to establish such an institution in a country whose objective was to organize productive activity mainly on a socialized basis. Secondly, unless a country possesses already at least a nucleus of entrepreneurial and managerial talent, a reasonably broad market for the products of new enterprises, some natural resources and basic services (power, transport and water), a supply of trained or trainable labor, and a reasonably good investment climate, there would be little or no need for the type of financial assistance such an institution will provide. And unless it can look forward to a certain volume of business, a development finance company will not be viable.

50. Third, there must be a clearly defined gap in the capital market which this institution should be trying to fill. If other sources are willing and able to provide the same sort of financial assistance, no purpose is served by establishing such an institution. It so happens, however, that there are few suppliers of medium and long-term capital in the new nations. In many of them, those who have savings prefer to hold them abroad or to invest in the traditional, and sometimes more immediately lucrative, fields of real estate and commerce. Where credit can be obtained, it is usually on short-term or at very high rates of interest. New and unfamiliar industrial enterprises, from which returns are often slow and which offer a prospect of risk, are bound, in this sort of circumstance, to find it difficult to attract investment.

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51. Among the new nations, and particularly the smaller among them, meeting these conditions is exceptionally difficult. For them, alternative methods of financing the productive sectors have to be devised -- and discussion of that is outside the scope of this paper. In judging the performance of private development finance companies in those countries which have already crossed the threshold of development, it is fair to say that, in a number of respects at least, these institutions are furnishing the ingredients for industrial growth. To an extent determined principally by their own financial resources and the availability of viable projects, they are contributing to the growth of medium and larger scale enterprises as well as playing a promotional role in the establishment of new enterprises and new kinds of industry. Through sales of shares from portfolio and through underwriting arrangements, they are in a number of cases assisting the growth of local capital markets. These contributions can be expected to grow as the development finance companies themselves acquire more experience. It must, however, be recognized that there are many gaps and weaknesses in the capital markets of most developing countries, and no single institutuion can be expected to provide an answer to this situation. This factor needs to be taken into consideration in making any interim assessment of the performance of the development finance companies associated with the World Bank Group.

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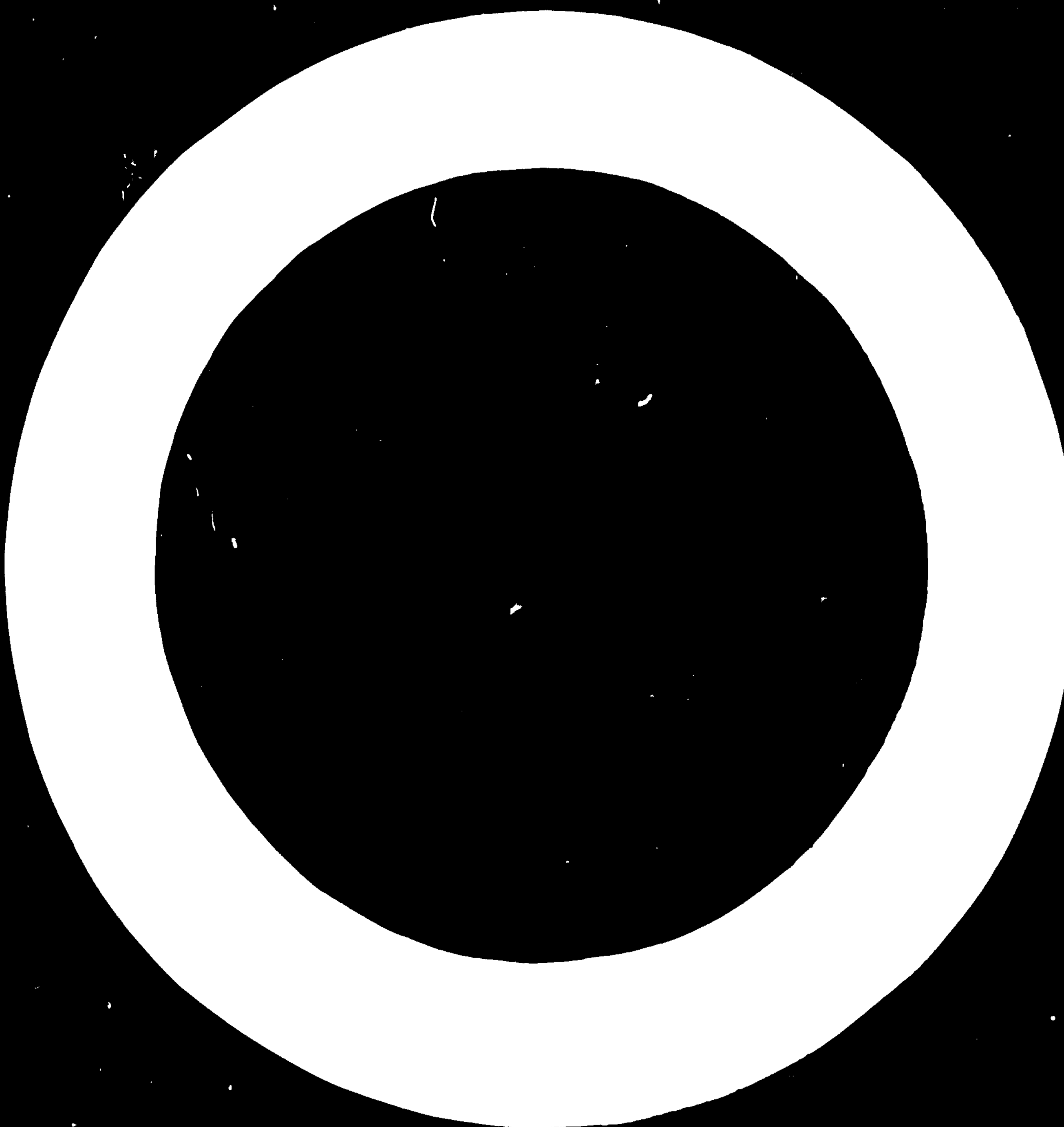

Annex I

Financing provided by the World Bank, IFC and IDA to development finance companies

(as of 31 December 1966)

Beneficiary		Amount (US$ Millions)
AUSTRIA		
Osterreichische Investitionskredit A.G. (IVK)	3 Bank loans	23.3
CHINA (TAIWAN)		
China Development Corporation (CDC)	1 IDA credit and 1 Bank loan	19.9
COLOMBIA		
a. Corporación Financiera Colombiana (CFC) b. Corporación Financiera Nacional (CFN) c. Corporación Financiera de Caldas d. Corporación Financiera del Valle e. Corporación Financiera del Norte	3 IFC investments and 1 Bank loan	29.8
ETHIOPIA		
Development Bank of Ethiopia (DBE)	2 Bank loans	4.0
FINLAND		
The Industrialization Fund of Finland (IFF)	2 Bank loans and 1 IFC investment	21.3 [a]/
GREECE		
National Investment Bank for Industrial Development, S.A. (NIBID)	1 IFC investment	0.7

Beneficiary		Amount (US$ Millions)
INDIA		
Industrial Credit and Investment Corporation of India, Ltd. (ICICI)	6 Bank loans	139.1
IRAN		
Industrial and Mining Development Bank of Iran (IMDBI)	3 Bank loans	40.1
ISRAEL		
Industrial Development Bank of Israel (IDBI)	1 Bank loan	20.1
IVORY COAST		
Banque Ivoirienne de Développement Industriel, S.A. (BIDI)	1 IFC investment	0.2
LIBERIA		
Liberian Bank for Industrial Development and Investment (LBIDI)	1 IFC investment	0.2
MALAYSIA		
Malaysian Industrial Development Finance Limited (MIDFL)	1 Bank loan and 1 IFC investment	9.3
MOROCCO		
Banque Nationale pour le Développement Economique (BNDE)	2 Bank loans and 1 IFC investment	34.0
NIGERIA		
Nigerian Industrial Development Bank (NIDB)	1 IFC investment	1.4
PAKISTAN		
Pakistan Industrial Credit and Investment Corporation Ltd. (PICIC)	6 Bank loans and 1 IFC investment	109.3

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Beneficiary		Amount (US$ Millions)
PHILIPPINES		
Private Development Corporation of the Philippines (PDCP)	2 Bank loans and 1 IFC investment	44.4 a/
SPAIN		
Banco del Desarrollo Económico Españ̃ol, S.A. (BANDESCO)	2 IFC investments	0.6
THAILAND		
Industrial Finance Corporation of Thailand (IFCT)	1 Bank loan and 1 IFC investment	2.7
TUNISIA		
Société Nationale d'Investissement (SNI)	1 Bank loan and 1 IFC investment	5.6
TURKEY		
Industrial Development Bank of Turkey (IDB)	3 Bank loans, 1 IFC investment and 4 IDA credits	63.5
VENEZUELA		
C.A. Venezolana de Desarrollo (CAVENDES)	1 IFC investment	1.3
		$570.6

a/ Includes underwriting commitments acquired by others.

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Annex II

Resources outstanding as of 31 December 1966 of development finance companies

(Preliminary Figures)

Institution	Amount[a/] (in US$ millions)
IVK (Austria)	57.8[b/]
CDC (China)	37.4
CF Caldas (Colombia)	11.5
CF Colombiana (Colombia)	35.8
CF Nacional (Colombia)	21.2
CF Norte (Colombia)	5.8
CF Valle (Colombia)	10.8
DBE (Ethiopia)	7.7
IFF (Finland)	24.2
NIBID (Greece)	15.6
ICICI (India)	132.3
IMDBI (Iran)	62.2[c/]
IDBI (Israel)	223.5[d/]
BIDI (Ivory Coast)	8.0[e/]
LBIDI (Liberia)	2.1
MIDFL (Malaysia)	25.9
BNDE (Morocco)	31.9
NIDB (Nigeria)	15.7

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a/ Consists of DFC's equity, i.e. paid in share capital, reserves and surplus, and outstanding short and long-term deposits and borrowing.

b/ As of 31 December 1965.

c/ As of 31 December 1966. Including public funds entrusted to IMDBI for management.

d/ Including managed loans on account of AID.

e/ As of 30 September 1966.

Institution	Amount f/ (in US$ millions)
PICIC (Pakistan)	118.8
PDCP (Philippines)	23.6
BANDESCO (Spain)	63.3
IFCT (Thailand)	6.4
SNI (Tunisia)	9.6
IDB (Turkey)	82.9 g/
CAVENDES (Venezuela)	14.7
Total	1,048.7

f/ Consists of DFC's equity, i.e. paid in share capital, reserves and surplus, and outstanding short and long-term deposits and borrowing.

g/ Including public funds entrusted to TSKB for management.

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Annex III

Foreign shareholdings in development finance companies

(Preliminary figures)

Institution		Amount paid-in (US$'000)
CDC (China)	as of 10/31/66	306.3
CF Caldas (Colombia)	12/31/66	1,188.8 a/
CF Colombiana (Colombia)	11/30/66	3,765.7 a/
CF Nacional (Colombia)	12/31/66	2,627.6 a/
CF Norte (Colombia)	12/31/66	362.9 a/
CF Valle (Colombia)	12/31/66	600.0 a/
IFF (Finland)	12/31/66	625.2
NIBID (Greece)	12/31/66	4,499.9
ICICI (India)	12/31/66	2,978.8
IMDBI (Iran)	3/9/66	1,280.0
IDBI (Israel)	11/30/66	1,158.2 b/
BIDI (Ivory Coast)	12/31/66	1,671.1
LBIDI (Liberia)	12/31/66	738.7
MIDFL (Malaysia)	5/23/66	4,021.2
BNDE (Morocco)	12/31/66	2,815.6
NIDB (Nigeria)	12/31/65	4,143.6
PICIC (Pakistan)	6/30/66	3,359.9
PDCP (Philippines)	12/31/65	2,128.6
BANDESCO (Spain)	12/31/66	3,499.8
IFCT (Thailand)	12/16/66	787.9
SNI (Tunisia)	12/31/66	798.0
IDB (Turkey)	3/4/67	925.3
CAVENDES (Venezuela)	12/31/66	3,233.7
	Aggregate total	47,516.3

a/ Exchange rate of Col. $13.50 to US$1 is used.
b/ Ordinary A shareholders only.

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