The role of development finance corporations

Experience in India and Korea

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Development finance corporation is the World Bank's name for an institution more commonly known as a development bank. Originally designed to complement existing financial arrangements, these corporations have generally been established in developing countries where commercial banks are not able to provide either the longer-term financing needed for development projects or short-term loans to unproven entities that nevertheless have the potential to contribute to growth. Commercial banks in these countries traditionally finance inventories in urban trade and industry. Their loans are generally short term; the borrowers' inventories form collateral; and the recipients of the funds typically have an established financial record. Because these banks are usually risk averse, and do not have the capacity to evaluate longer-term or unusual projects submitted by unproven borrowers, commercial bankers neglect the investment opportunities that could be profitable beyond the short term. DFCs were conceived to meet several needs—to make the long-term loans or equity investment required by a nascent industrial sector; to strengthen national development strategies by investing in rural areas or by improving project appraisal methods; and, no less important, to mobilize long-term investment resources.

This article looks at the Bank's experience with two of its most successful DFC borrowers during the 1970s—the Korean Development Finance Corporation and the Industrial Credit and Investment Corporation, India—to illustrate how effectively such institutions could be adapted to different conditions in an economic environment not always conducive to long-term investment. The Bank has been lending to DFCs since the 1950s, when inadequate long-term credit was widely recognized as a primary constraint on the growth of the private industrial sector in the developing world. The investments suitable for promoting each individual project in the sector were relatively small—and therefore too expensive in terms of cost and staff time—for direct Bank loans. The Bank viewed DFCs as a way of financing a broader cross-section of enterprises than it would otherwise be able to reach. It also saw DFCs as potential catalysts for local development initiatives; through their work with raising resources and stimulating local entrepreneurs it was hoped that they would become a source of innovative solutions to local constraints.

The main contribution that KDFC and ICICI made during the 1970s to working out new solutions to investment problems was probably to instill the discipline of systematic project design and evaluation among their clients. KDFC also introduced novel features in its project design to advance broader development objectives: it attempted to diversify the domestic financial system by introducing instruments to promote resource mobilization, and it expanded its activities in the industrial sector. These activities were particularly appropriate in a country such as Korea, where the financial sector needed to become more flexible and sophisticated to sustain growth in its already very highly developed industrial sector. In India, however, a major constraint on growth in the 1970s was limited purchasing power in the rural areas, and ICICI, while remaining financially profitable, emphasized the promotion of productive industrial enterprise in backward areas. It developed a sophisticated approach toward the economic evaluation of these projects, which in general achieved high economic returns in difficult growth conditions.

Flexibility

It is difficult, of course, to draw general conclusions from the individual experiences reviewed in the illustrative boxes on these two corporations. Many external and often unique factors affected the perform-

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ance of these DFCs and could have been crucial in their success. KDFC, for instance, provided scarce foreign exchange to Korea's industrial sector at a time when this was growing at an average annual rate of 14 percent. In addition, both KDFC and ICICI were particularly well-managed and efficient compared with other DFCs, and were able to train and retain staff because there was a steady supply of skilled people within the country available to competing institutions. Few other developing countries are so fortunate. Both ICICI and KDFC, too, formed part of a relatively well-developed financial system, in which they were able to find a role for themselves; they did not encounter the operational problems of DFCs in countries with less mature financial sectors. However, a large part of their effectiveness must be attributed to their own efforts.

In particular, both have demonstrated a consistent ability to adapt to fit the investment needs of the time. Since the early 1980s, like all other financial institutions, DFCs have been affected by a deteriorating economic environment. Largely because of the increasing levels of financial distress experienced by the industrial corporate sector in many developing countries, there has been a marked deterioration in the quality of most DFCs' portfolios. KDFC—which became the Korea Long-term Credit Bank in 1980—and ICICI have faced the same problems, but their difficulties have not been so acute. During the latter part of the 1970s both corporations faced falling demand for foreign exchange and an increasing call for domestic currency loans,

The Industrial Credit and Investment Corporation of India

The Industrial Credit and Investment Corporation of India has had a relationship with the Bank for many years; the Bank was involved in its creation in 1955. The Bank's experience with it, as well as with KDFC, provides a practical example of how DFCs can function effectively in contrasting environments.

ICICI allocates resources to viable projects in the industrial sector. These may be privately owned or have joint government ownership. During the 1970s, the Bank granted loans to the Corporation to support its financing particularly of private productive enterprises in backward areas. This emphasis was echoed later in a shift in the government's priorities toward the development of small-scale, labor-intensive enterprises.

Between 1972 and 1978, industrial production in India was growing at about 5 percent a year, with a sharp increase in 1975–76, followed by a decline in 1977–78. Industrial investment remained fairly stable at 1973 levels, while private sector investment fell after 1975. However, ICICI was able to maintain a steady annual disbursement rate of 14 percent, in concordance with projections. In terms of its contribution to total investment in India, its disbursements fell as a share of investments made by all financial institutions—from a high of about 18 percent in fiscal year 1973 to about 11 percent in fiscal year 1977. But its lending is mainly directed to the industrial sector, and here its share more than doubled over the period—to reach over 10 percent in fiscal year 1977. This is primarily the result of the combination of its own high disbursement rates and sluggish national investment.

ICICI did not engage in activities in securities and capital markets in a major way, but it promoted new enterprises by underwriting or direct subscription—providing, on average, almost 13 percent of disbursements in these activities by all financial institutions during the 1970s.

Financially, the Corporation's performance was better than expected. Net profits as a percent of equity were, on average, 12 percent between 1971 and 1977, while they were projected to be about 10 percent. It increased its lending and dividend rates in line with its profits and was able to redeem some debts two years ahead of schedule in 1975. In general, its debt/equity ratio was kept within its contractual limits. However, total arrears increased almost threefold during these years, mainly because of some 35 problem companies—in the metals and electrical equipment sectors—which were badly affected by the oil crisis and the subsequent business recession in India. But these problems were manageable and did not have a serious impact on the Corporation's portfolio. Its profitability also testifies to its capacity for sound project evaluation. Consistent with its emphasis on development work, ICICI was the first DFC associated with the Bank to use systematically advanced economic evaluation methodology. It has a particularly good record in appraising large-scale complex projects.

It was also able to diversify its sources of foreign exchange somewhat, and was successful in raising domestic currency by obtaining a government guarantee on two 15-year bond issues. ICICI has always accounted for the bulk of foreign exchange disbursements made by India's financial institutions, but during the 1970s the share of its rupee disbursements rose from being about 28 percent of its total investments to represent almost 46 percent by fiscal year 1978. This increase was due mainly to the fact that more domestic goods were available to local enterprises, and also that they had alternative sources of foreign exchange.

The efforts made by ICICI to increase its promotion of projects, particularly in backward areas, led lending to these regions to increase by almost 30 percent of its total approvals between 1955–70 and 1974–76, some 6 percent of the total financing going to new entrepreneurs. Out of the 392 projects financed during the 1970s, 60 were new, and 63 were in backward areas. However, ICICI does not lend to small-scale enterprises; these are financed by institutions specifically catering to them.

Economic conditions in the 1970s in India were not particularly conducive to profitable long-term investments: growth in industrial production was sluggish; investment rates were low; and general conditions were not such as to promote enterprise. ICICI's problems with arrears, implementation delays, and cost overruns reflected those conditions. Furthermore, it was not easy for ICICI to diversify its sources of foreign funds. In spite of these disadvantages, ICICI's profitability was high, its investment levels well above average for similar national institutions, and its efforts to promote industrial enterprise in backward areas were sustained and sustainable.

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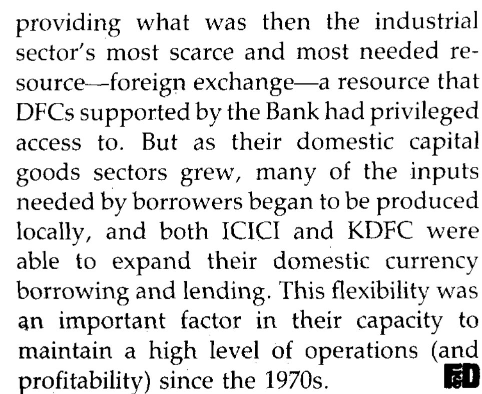
as more firms needed domestically produced equipment. ICICI was able to respond, and its domestic currency lending became an increasingly important part of its portfolio. KDFC was initially precluded by its charter from mobilizing domestic currency resources (except in the form of equity), but since its transformation into a long-term credit bank, it can issue long-term domestic currency debentures and accept domestic currency deposits from corporate borrowers. The share of domestic currency loans in its total loan portfolio has risen substantially. Both corporations have changed materially since 1980, as the need has grown to diversify their sources of funds and the scope of their operations.

In spite of their different functions, and the differing economic environments in which they were pursued, the two DFCs discussed demonstrate some important common features which have a bearing on how institutions such as these can continue to play a role in the development process. The Bank first supported DFCs as a way of reaching the small entrepreneur and



providing what was then the industrial sector's most scarce and most needed resource—foreign exchange—a resource that DFCs supported by the Bank had privileged access to. But as their domestic capital goods sectors grew, many of the inputs needed by borrowers began to be produced locally, and both ICICI and KDFC were able to expand their domestic currency borrowing and lending. This flexibility was an important factor in their capacity to maintain a high level of operations (and profitability) since the 1970s.

The Korean Development Finance Corporation

The Korean Development Finance Corporation was established in 1967 as a privately owned corporation to accelerate industrial growth by providing long-term finance to private manufacturing enterprises. Until 1980, when it became Korea's first long-term credit bank and was authorized to expand its domestic currency lending, KDFC dealt almost exclusively in foreign currency long-term loans, and investments. During the decade that followed its creation, the Korean economy was growing at about 10 percent a year, and the export-oriented manufacturing sector at 18 percent a year, supported by an annual gross capital investment of about 12 percent a year in real terms. Commercial banks were, and continue to be, the principal institutional source of funds to the private sector; KDFC was a major provider of long-term foreign exchange financing to medium- and large-scale private enterprise that did not receive government funds.

During the 1970s, the Bank made five loans to KDFC to meet the corporation's foreign currency requirements over the period. The Bank's experience with these loans provides a useful illustration of the ways in which KDFC was able to experiment with promoting manufacturing, albeit in a booming economic environment, and remain financially profitable. Each loan had a slightly different emphasis; the first ones aimed primarily to ensure efficient allocation of scarce foreign resources to private business and to strengthen the institutional side of KDFC, particularly its economic analysis. With institutional strengthening achieved, the next loans stressed the Corporation's development potential—to expand export-oriented enterprises, to deepen and strengthen the financial system, and to promote small entrepreneurs in the business of producing machinery and agro-industrial products in less developed areas.

Between 1971 and 1979, the corporation used its Bank funds to invest in 146 projects (108 of these investments were for the expansion and modernization of existing firms). Few had cost overruns, and most were completed on time. In their first year of operation, 42 had losses and 24 of these ran at a loss in their second year, but by 1979 most were financially sound and none were in arrears. These projects created a total of 12,950 jobs, and generated returns and exports well above estimates. The export-oriented textile industry received 20 percent of the loans made, and, in line with government priorities, machinery, deep sea fishing, and marine transport received significant shares.

The success of its lending to projects reflected the Corporation's sound appraisal and evaluation capacity. This is also evident in its ability to raise foreign resources; between 1969 and 1979 it mobilized $561 million, about 79 percent from official sources, although its reliance on these is rapidly decreasing. KDFC's net income rose by 25 percent annually between 1971 and 1979, and paid a return on equity of about 17 percent a year (although the effective rate is much lower given the 6.5 percent devaluation of the won against the dollar over the same period). It should also be noted that KDFC was able to increase its share capital through offerings in the market during this period. Perhaps the greatest achievement of the Corporation in terms of efficiency was to reduce its operational expenses from 2.4 percent of assets in 1971 to 0.9 percent in 1979.

Profitable operation is clearly a *sine qua non* for an enterprise's existence, but to perform its proper function, a development finance company has to play more than a financial role. After 1975, KDFC had a developmental strategy which it pursued in an innovative and highly successful way. To draw more enterprises into the financial net, KDFC helped to establish a leasing company to purchase foreign and domestic manufactured equipment and lease it to firms that could not otherwise afford it. The Corporation also cooperated with some of Korea's regional commercial banks to increase the funds—particularly in foreign currency—available to small enterprises in rural areas. To promote technology development, it helped to found a firm that assists ventures using technical patents and processes developed by another company supported by KDFC. To diversify the financial system, it helped to establish an institution to handle short-term credit transactions—an innovation that led to the establishment of 15 other short-term financing companies between 1973 and 1979. By the end of 1979, these companies had mobilized 765 billion won (about $1.6 billion) in discounted notes.

Although KDFC only accounted for 23 percent of total fixed investment in Korea's manufacturing sector between 1971–78, it created 44,600 new jobs out of a total of 1.7 million in that sector. Its ability to innovate in the financial sector, and its efficient operation clearly had a greater impact than the size of its investments would indicate.

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