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**DYNAMICS OF CHANGE AND EFFECTIVENESS
OF DEVELOPMENT BANKS:
A VIEW FROM THE DFL**

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THE DYNAMICS OF DEVELOPMENT BANKING IN A WORLD OF CHANGE - the recent experience of Development Finance Limited

This paper provides a perspective on change and effectiveness in development banking based on the experience of Development Finance Limited (DFL) from 1991. Drawing on this experience over the last five years the author provides a view as to why this type of institution should be considered a necessary part of the region's financial structure. The paper ends by outlining briefly some of the factors which will affect development banks in the region over the next five years.

PROFILE OF THE COMPANY

DFL is licensed to operate as a finance house and merchant bank under the Financial Institutions Act (FIA). The Company provides funding to private business enterprises mainly through long term debt instruments and various forms of equity and quasi-equity financing. The Company also provides short-term funds for financing trade and working capital needs.

Most of the firms served by DFL have total assets of US\$500,000 to US\$5 Million. However, some companies have assets of US\$20-30 Million and some smaller ones are between US\$150,000 to \$300,000 in size. Loans under US\$400,000 account for 48.5% of total loans of which 7.5% are loans under \$100,000. The remainder (51.5%) is made up of loans ranging from US\$400,000 to \$ 1,800,000².

¹ The author is the Managing Director of Development Finance Limited (DFL) in Port-of-Spain, Trinidad and Tobago. He worked previously as Corporate Planning Manager with the Neal & Massy Group and as a General Manager of one of its industrial subsidiaries. He is a graduate of the University of the West Indies (St. Augustine, 1970) and earned a diploma in development banking at American University (Washington DC, 1972). He is a member of the Board of Directors of the Trinidad and Tobago Chamber of Industry and Commerce and has served on the Boards of several firms since 1973.

² The maximum loan size to a single enterprise is restricted by Company policy to 15% of capital and reserves while the minimum loan size is currently US \$ 50,000.

DFL began operations in 1970 as a "DFC" and in 1988 was restructured because of severe portfolio losses which resulted in the loss of shareholders' capital and inability to fully meet debt obligations. Government's shareholding was restored to value by transferring to another company debt due from DFL. New capital was provided by the private sector and by international financial institutions resulting in a reduction of state ownership from 95% to 28%. There was also a radical change in the culture of the Company. The change in culture was influenced by many factors not the least of which was the positive attitudes of young professionals who adapted readily to increased responsibility and direct accountability. Market perceptions of the Company also changed and today DFL enjoys the confidence and respect of its clientele and the business community. DFL is profitable and has been paying dividends to its shareholders since 1990.

The recent history of the Company underscores the statement that change is the essence of development banking. While it is not the purpose of this paper to describe all the changes that have taken place, a brief listing of the more significant differences from 1986 and then from 1991 to 1995 should be sufficient to provide an insight as to how the world of DFL has changed.

What's different from ten years ago ?

- More informed analyses of projects and industrial sectors
- No loans or funds from the Government
- DFL raises funds on its own on the local capital market
- DFL regularly makes investments in equity and quasi-equity
- DFL conforms fully with the Financial Institutions Act (Trinidad & Tobago) and is regulated by the Central Bank
- Great deal of emphasis on internal controls, staff development and strategic planning
- Remuneration of staff is identified strongly with achievement of results and performance
- 50% of the graduate staff hold positions of direct, measurable responsibility
- Senior Managers, personally, are directly accountable for decision-making on loans
- An Audit Committee of the Board reviews risk and evaluates results

- Loans and other assets in foreign currency (close to 30% of total assets)
- Strong financial management function

What's different from five years ago ?

- Capability of providing strategic management advice
- DFL provides loans in foreign currency
- IFT's compete with DFL on projects over US \$ 5 million
- Internal Audit function established
- Engineers integrated fully into the lending functions
- Staffing stabilised at forty through attrition (from fifty-four in 1988)
- Productivity increased by 18.5% *per annum* since 1989
- (revenue per employee deflated by the Retail Price Index)

What's new in 1995 ?

- Assets and Liabilities Committee set up to manage increasing complexities of financial management
- New risk management function introduced at senior management level
- Scope of operations expanded to include virtually all business activities
- Scope of business extended to enterprises within the Caribbean region
- DFL no longer needs guarantees for its bond issues
- In-house capability in Information Technology
- Major investment in sophisticated loan accounting software
- Establishment of a networked Executive Information System
- DFL wins mandate to arrange financing for a US \$ 26 million hotel

- Intense need to accommodate more diversity and dialogue among staff
- The skill level of the “average” staff has risen significantly
- IFT’s make “development funds” available to all licensed financial institutions (not just to development banks)

FINANCIAL PERFORMANCE

The result of all these changes is a financially sound, innovative *financial intermediary* which is also involved in providing strategic management advice for developing new enterprises or restructuring existing ones.

DFL’s financial performance compares favourably with that of commercial banks and with merchant banks as illustrated by the financial performance ratios in Appendix 1. Other comparative data is also included in Appendix 1 based on data for 1994 published in 1995 by the Central Bank of Trinidad and Tobago. The year 1994 is reasonably typical for the purpose of presenting a profile of DFL.

Two characteristics need to be highlighted:

- DFL must be highly cost-efficient and growth-oriented to be viable because it does not have any subsidised or concessionary funding for its lending operations.
- To provide a reasonable return to shareholders and maintain a suitable capital adequacy ratio to allow risk-taking, DFL must be compensated adequately for risk.

RATIONALE FOR EXISTENCE

DFL's existence is justified, quite simply, because it is accepted by the market. Since the Company is not subsidised ³ and is in no way supported by public funds, its existence depends entirely on acceptance by its customers and by investors who provide funding by way of bond issues. Clearly the customers and the investors see a rationale for DFL's existence. However, we need to determine what makes the Company different and whether it is necessary to have institutions of this kind.

DFL is a "development bank" and defines this role in terms of:

- establishment and growth of business enterprises
- expansion of trade and investment
- encouragement of entrepreneurship
- development of capital markets
- private sector development in general
- innovation and flexibility

This role is much wider, and more important, than that envisaged for DFL twenty-five years ago but times have changed. In one way or another, most commercial banking institutions in the country place emphasis on these same objectives. These banks have evolved but so has the DFL which now has the competence and competitive strengths to be an effective financial intermediary. This comparison is important. The multilateral development finance institutions have a view that small development banks, even if they are financially sound, are likely to fail or become unnecessary because of inability to compete with commercial banks.

All local commercial banks are shareholders of DFL and as a group, own 10% of the Company and are represented on the Board. There is far more co-operation than competition though there are different interests especially with regard to security for loans. DFL does not set out to compete directly with commercial banks. There is no need to do so because:

- Commercial banks gain from non-loan business when firms expand
- DFL focuses on business opportunities which require DFL's specific skills or resources whether these are for large or small enterprises

³ The only concession from Government which the Company enjoys which is not available generally to all financial institutions is exemption from corporate taxation. This exemption is important because it allows the Company to pay acceptable levels of dividends to its shareholders while still subsidising some of its services to clients. Without this exemption, the Company would still be profitable but it would have to eliminate some of its services and structure its business differently to take advantage of several tax exempt activities available to financial institutions.

- Commercial banks do not have DFL's technical advisory capability or enterprise development skills
- Commercial banks have no experience with equity or quasi-equity investments
- While DFL's rates are competitive it does not compete on price
- In certain *industries*, there is risk which some banks may not be prepared to take but which DFL can manage well.

DFL is a specialist investment bank. It offers competitive financing packages mainly because of its ability to provide long maturities at market rates of interest and because of its ability to make equity and quasi-equity investments.

What is different about DFL (and similar institutions)

DFL provides financing to private firms and provides services which help to make such enterprises successful. Usually, such financing and such services are closely related and are provided as a package which is structured by a team of professionals to meet particular needs. This business can be called *corporate finance* and it includes providing equity and quasi-equity financing as well as arranging funding through capital market operations. This approach requires the Company to develop skills and financial resources suitable to the increasingly varied and complex needs of client enterprises. All of this makes the business of DFL different from that of commercial banks.

The reason for DFL's profitable existence in 1995 in a highly competitive environment is the same as that which provided the rationale for the Company's formation in the late sixties. There is need for a highly-skilled, soundly financed investment bank which specialises in businesses which are either new or growing rapidly or which have financing needs which require innovation and adaptation. Twenty-five years ago the view was that commercial banks ought to meet these needs but were unable or unwilling to do so. Then as now, commercial banking centered more on trade than industry and funded mainly short-term transactions. This business can be carried out with a low capital ratio (less than 10%) and with short-term deposits as the main source of funding. This business must avoid risk. It must limit exposure to short time frames and potential loss to minimal amounts. If this is not the case then a different type of bank is needed and this would be called an investment or merchant bank, finance house, development bank or universal bank. Whatever the description it would be different from a commercial bank even though it would serve similar markets and maybe even the same corporate customers.

In developed markets, such entities are involved mainly in capital markets and are of great importance to the financial system but this is not generally not the case in our local and regional markets. Our markets are dominated by commercial banks and most of our investment or merchant banks are departments of commercial banks which have become subsidiaries. A question arises as to how capital markets institutions will evolve. Will they be subsidiaries or associates of local commercial banks or of international banks or will they be independently owned and managed? The question becomes important when we consider competition with international banks (including international development finance institutions) and when we consider the prospects for mergers among local banks.

The feasibility of such mergers has been enhanced considerably by the availability and low cost of information technology. By international standards, the average return on assets earned by commercial banks in Trinidad & Tobago is high but operating expense ratios (overheads to assets or to income) are also high. If spreads, which are high, were to decline significantly, there would be a need to create economies of scale through mergers or more likely, by operating as branches of international banks as in the case of Citibank in Port-of-Spain.⁴

There is a development which is new to Port-of-Spain but not unknown in Jamaica. A few months after DFL was licensed as a financial institution a licence was granted to ANSA FLEMING a new merchant bank formed by the ANSA McAL group of companies. CLICO, which is well-known in the Caribbean as an insurance company and as a conglomerate, also owns an investment bank. Neither of these institutions is a subsidiary or associate of a commercial bank. This probably signals a new direction or a new era for banking in Port-of-Spain, that is, investment banks serving niche markets with specialised services and focusing on strategically important enterprises - which is exactly what DFL does. Both of these investment or merchant banks are considerably smaller than DFL⁵ in terms of assets and capital and neither has yet raised any significant capital on the local market

The need for corporate finance specialists and for intermediaries in capital markets make it necessary to have DFL and similar institutions in the region. Such institutions are required if only to ensure that adequate attention is given to small and medium-sized enterprises or to new, large projects involved in new technologies or in new markets.

⁴ It is interesting to note that if all locally owned commercial banks in Trinidad & Tobago were merged the new entity would only just barely be included in the list of the world's 1,000 largest commercial banks.

⁵ DFL ranked # 34 by total assets among private sector companies in Trinidad & Tobago as listed in a survey for 1995 by Coopers and Lybrand in Port-of-Spain.

A REGIONAL PERSPECTIVE

What does the regional private sector think? Development banks are considered important by the private sector. This importance is demonstrated by the level of private capital invested in three private development banks in the region. It is even more noteworthy that many eminent executives who are well-known throughout the region, find time to serve on the boards of private sector development banks. For example, Mr. Rafael Diaz, Chairman of Grace Kennedy, is Chairman of Trafalgar Development Bank (TDB) in Jamaica. Mr. John Stanley Goddard of Barbados chairs Caribbean Financial Services Corporation (CFSC) which also has as a director, Mr. Sydney Knox, Chairman of the Neal & Massy Group. The Chairmen of Republic Bank, WITCO and NEMWIL (which are all shareholders of DFL) each sit on DFL's Board⁶. What do they think ?

In June 1995, at a meeting of development banks in Jamaica, Mr. Diaz noted that *"despite the aggressive entry of insurance companies, merchant banks and new commercial banks into the market for investment capital for productive enterprises, DFL's will still have a critical role to play"* He attributed this role to the fact that investment finance is still being met predominantly from the retained earnings of businesses and also that:

"the slow development of entrepreneurial and managerial capabilities means that people are still not prepared to take all the risk involved in establishing their own business, especially small and medium enterprises."

This year, in the Sunday Guardian of September 24th congratulating DFL on its 25th anniversary, Mr. Thomas Gatcliffe, Chairman of Angostura and former Chairman of the Bank of Commerce and of DFL, had this to say:

"The Development Finance Limited occupies a special niche and has a special role to play and I believe that if we did not have such an organisation, we would probably want to create one".

The comment is particularly appropriate. The dynamics of development dictate that development banks be re-created from time to time. Change is the essence of development banking and the initiation and management of change is one of the skills that development bankers must learn to master. To illustrate the point I will refer to a comment made about the North American Development Bank (NADBank) being formed by the USA and Mexico to finance environmental projects in Mexico. The comment made by Raul Hinjosa, a professor of urban and regional planning at the University of California at Los Angeles, was as follows:

⁶ Mr. Frank Barsotti is Chairman of Republic Bank; Mr. Audley Walker is Chairman and CEO of WITCO; Mr. Alwin Poon Tip is Chairman of NEMWIL and Chairman of the Investment Committee of Guardian Life of the Caribbean Limited.

NADBank represents a new wave in development banking institutions to the extent that already, from the beginning, it is set up to do a wide variety of *investment banking* functions, from equity participation to credit enhancements to direct project loans to direct government sovereign debt.”⁷

Should we in the Caribbean take any cues from this new thinking? Should we re-position the CDB as an investment bank or re-focus the investment banks to finance environmental and infrastructure projects? Can small development banks in our small countries ever have sufficient resources to function effectively, to perform efficiently and to adapt to changing needs ? What are the changing needs that present a challenge for the future?

The list below identifies some of the external factors that will determine change over the next five years for institutions such as DFL. Appendix 2 provides an overview in the form of notes by a senior DFL executive⁸ on the internal dynamics of change as experienced by DFL. DFL’s experience over the last five years is not unique. There are other development banks, especially large ones such as Korean Long Term Bank, which have been even more successful and pioneering. What happens in the Caribbean region will depend on:

- a re-assessment by Governments and related authorities and the private sector as to the functions of these types of institutions
- the determination to change organisational structures to focus urgently on the single objective of developing private enterprise
- the support given to good leaders who can build professional management teams capable of creating independent, adaptive organisations

⁷ “Can NAFTA reinvent development banking? - Lucy Conger” pps 63-66 Institutional Investor - March 1994

⁸ Notes prepared by Ms A.N. Persad, Senior Corporate Manager, Portfolio and Operations.

WHAT WILL DETERMINE CHANGE OVER THE NEXT FIVE YEARS

The needs

- Urgent need to increase level of entrepreneurship
- Response to global competitiveness
- Restructuring of economies (Services ; Export Trade)
- Emphasis on Infrastructure and on the Environment
- Reduction of poverty

The threats

- Expansion of other financial institutions
- Foreign financial institutions more active in the region
- Inability to respond to needs

The opportunities

- Information technology
- Higher levels of staff capability especially at middle-management level
- Development of capital markets
- Co-operative and co-financing relationships with foreign institutions
- broadening of ownership to include employees and members of the public
- Co-financing with other regional financial institutions

New areas of emphasis

- International Trade Financing
- Commercial and Personal Services
- Regional operations
- Private sector Infrastructure financing
- Environmental projects

**G.M. Pemberton,
Port-of-Spain,
November 3, 1995**

APPENDIX 1

Profitability ratios based on assets

	DFL	Merchant Banks	Commercial Banks
Operating Income	10.6%	13.1%	10.9%
Interest Expenses	6.8%	8.1%	4.6%
Non-Interest expenses	2.1%	2.0%	4.8%
Profit before tax	2.0%	3.4%	1.0%

The data shows that DFL operates with the lowest net interest margin (spread) but produces a reasonable profit level because it is efficient in terms of non-interest expenses (i.e. overheads). The actual cost of DFL's funding is higher than that of commercial banks but the yield on assets (operating income) is about the same. While DFL 's performance compares reasonably, its operating income could be increased (either by earning fees or by uplifting lending rates) compared with other merchant banks. This is required because DFL has a higher capital to assets ratio than all other licensees and must earn a higher return on assets if it is to produce a reasonable return to shareholders. High capital adequacy provides financial soundness which allows risk taking but it requires a higher level of profitability.

Funding structure

The data below shows how the funding side of the balance sheet is structured in the respective financial institutions. DFL will change its funding structure significantly in November 1995 when bonds (capital market issues) will be funding 30% of assets and financing from IFT's would have been reduced to 45%.

	DFL	Merchant Banks	Commercial Banks
Deposits	0%	55%	78%
Long Term Debt (Foreign)	51%	0%	0%
Long Term Debt (Local)	19%	11%	5%
Other Liabilities	9%	24%	9%
Capital & Reserves	21%	11%	7%

Composition of loans

	DFL	Merchant Banks	Commercial Banks
Production/Services (Private)	100.0%	61.5%	36.4%
Real Estate Mortgages	0.0%	6.3%	15.0%
Personal/Consumer Loans	0.0%	30.2%	33.6%
Public Sector	0.0%	2.0%	15.0%

APPENDIX 2

INTERNAL DYNAMICS

What stimulates the organisation to identify and respond to change.

- board directive to re-orient the company's business focus
- learning, creative and entrepreneurial culture nurtured and encouraged by top management
- age differences among staff lead to fresh ideas balanced by judgment
- responsiveness to clients
- awareness of global trends in the industry and desire to keep pace
- culture of accountability for results
- desire to pioneer own brand of modern development bank driven by a desire for independence and success
- strong sense of responsibility among management for own destiny.

How is change originated and implemented.

- Proactive :
 - continuous scanning of external environment (discussions with clients and businessmen) to identify new ways of meeting business needs *e.g. financing trade by warehouse financing, bulk purchasing.*
 - identifying our competitive strengths and capitalising on these to differentiate our product *e.g. we do not sell money, we sell services backed by funding either through in-house specialist skills, or access to information or industry expertise.*
- Reactive:
 - because of the realisation that an existing process, policy or procedure is no longer effective
 - demand for product or service has dropped
 - re-organisation because of staff turnover
 - changes in the industry or market (*falling spreads because of intense competition can cause a shift/dependence towards more fee income from investments*).

• Methods of Implementation:

- ongoing strategic management
- “just do it” approach
- careful evaluation before implementing (new areas of business)
- get key persons to demonstrate new desired behaviours

How is effectiveness identified and measured.

Individual effectiveness

- By setting measurable targets, goals, budgets or objectives upfront and doing regular evaluations
- Results-based rather than effort expended
- Financial return to the organisation

Company effectiveness

- Image in the business community
- Respect from other financial institutions
- Caliber of company approaching us
- Efficiency of operations (response time to clients)

How do staff respond to change.

- differs according to age, mindset, confidence, sense of security
- generally positive if they understand the rationale
- most staff now want survival of successful business and understand the steps that must be taken to ensure this.