



**The Trinidad & Tobago Development Finance Company:
Evolution and Role by Gerard Pemberton**

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THE TRINIDAD & TOBAGO DEVELOPMENT FINANCE COMPANY

EVOLUTION AND ROLE

This paper first traces the evolution of the Trinidad and Tobago Development Finance Company Ltd (TTDFC) since its inception in May 1970 and describes its role and performance as a development finance institution (DFI).

The paper then draws some lessons from the experiences during the years 1970 to 1986 and provides observations on the financing of DFI's, the management of operations and related matters.

The paper ends with a brief description of the Company's restructuring plan which was developed toward the end of 1987.

Unfortunately most of the TTDFC's records were destroyed by fire in 1982. As a result the commentary related to the early years of the Company relies mainly on the author's own experiences while employed with the Company from 1971 to 1980 and on project performance audit and project completion reports prepared by World Bank staff (IBRD) in 1977.

THE AUTHOR

The author holds a BSc degree in economics, majoring in management studies, from the University of the West Indies at St. Augustine and studied development banking in 1972 at the American University in Washington D.C. on a scholarship from the Inter-American Development Bank. He was first employed with General Motors Acceptance Corporation and then with the TTDFC as Manager of Management Services & Industrial Promotions leaving in 1980 to join a local conglomerate as Manager of Corporate Planning and subsequently becoming the General Manager of one of its subsidiaries. He was appointed Managing Director of the TTDFC in July 1987.

OBJECTIVES OF THE COMPANY

The broad objective of TTDFC is to promote economic development by assisting in the establishment and expansion of business enterprises in the private sector, principally by providing long-term financing in the form of loans and equity investments to industrial enterprises. Its Memorandum of Association also specifically includes the development of the capital market as one of its objectives.

Initially, during the sixties, the intention was to establish a privately-controlled industrial development bank. An equity participation by the International Finance Corporation (IFC) was expected to act as a powerful catalyst to mobilise domestic as well as foreign private resources.

The need for the institution was based on the absence of adequate facilities to accommodate the private sector's fixed asset financing requirements. In other words TTDFC was to be a provider of long-term finance to reduce dependency on the use of short term credits (bank overdrafts) especially since access to this source of funding was limited to enterprises which were already well-established. However a new financial institution in an un-developed financial system would naturally take some time to establish itself. More specifically as bank lending rates fluctuated with liquidity a long-term lender could face interest rate pressures if it had to lend at prevailing short-term market rates from borrowed funds. This raised the need for a high level of equity or quasi-equity funding and not surprisingly, given the social and political climate at the time, the TTDFC started up with the Government of Trinidad and Tobago (GOTT) owning 94% of the share capital with four commercial banks, three insurance companies and a few industrial enterprises owning the remainder.

The GOTT provided loans to TTDFC on a concessionary basis (low interest rate and extended repayment terms) and it was expected that the IBRD would eventually provide financial assistance to meet the foreign currency component of the cost of projects financed. In May 1972 the IBRD did in fact approve the first of two loans to TTDFC. This introduced the issue of foreign exchange risk which was borne fully by the GOTT.

From discussions with the commercial banks the IBRD's staff drew the conclusion that TTDFC would have sufficient medium and long-term business to become a viable institution since the commercial banks had indicated a desire to limit their long-term lending to their largest clients while leaving the medium-sized businesses to TTDFC.

EX-POST EVALUATION

An analysis of loans data over the period 1970 to 1976 showed that 59% of loan commitments were under TT\$ 500,000 accounting for 101 loans out of a total of 118. The remaining 17 loans accounted for 41% of total commitments.

Fifty (50) new enterprises accounted for 53% of total commitments and 114 firms (96 % of the total) accounting for 72% of total commitments had assets of less than TT\$ 2 million.

The manufacturing sector accounted for 71% of total commitments (85 loans) while ten (10) loans in the the tourism sector accounted for 10%.

By the end of 1976 the TTDFC had established itself as a long-term financier of fixed assets to new medium-sized enterprises, owned mainly by nationals, in the light manufacturing and in the tourism sectors. The IBRD staff reported that "there is today general agreement that TTDFC is playing a useful role within the economy, notably by filling a gap in the financing of the industrial sector and fostering its diversification from oil-related industries". The staff speculated that while commercial banks may have provided funding there would have been minimum risk-taking and the promotional function carried out by TTDFC would not have been fulfilled. This promotional function deserves some discussion. At the time TTDFC's loan supervision staff comprised mainly non-graduate staff with book-keeping backgrounds managed by a qualified accountant with little industrial management experience. There was no engineer on staff and there were no experienced business advisers. On the other hand however, TTDFC's appraisal process, in the view of the IBRD staff, had improved substantially since its inception though the number of experienced appraisal staff was only eight. An expatriate adviser had helped improve the quality of appraisals and the TTDFC had been able to "maintain and in some respects improve on the standards set by the adviser" after he left in 1975.

Nevertheless the IBRD staff quite correctly, as later events would show, was concerned with the under-capitalisation of client companies, incomplete technical information and weak marketing assumptions in some projects based on insufficient data.

THE PROMOTIONAL FUNCTION

TTDFC at that time had only limited capacity to provide managerial assistance to new and often in-experienced entrepreneurs yet it did manage to have a promotional function. The author's view on this paradox is that the appraisals which TTDFC staff were required to do encouraged, if not forced, entrepreneurs to think more comprehensively about their business ventures. The process also brought the young graduate staff closely in touch with the realities of the business world. Given that the commercial banks generally did not at the time require in-depth appraisals from their clients or staff, TTDFC's appraisal process was actually helpful to its clients notwithstanding their impatience with the requirements. This brought the staff closely in contact with the management of industrial operations and this involvement, spurred by the desire to expand TTDFC's operations, facilitated a project development function. This experience in turn gave rise to TTDFC's success in turning around problem cases especially since by 1976 40% of TTDFC's loan portfolio had principal in arrears in excess of three months. These developments prompted the IBRD staff in 1977 to conclude that "TTDFC is more promotional than most DFC's involved with the bank (IBRD)".

The IBRD's operational involvement in TTDFC ended in 1977 after the GOTT, at TTDFC's request, cancelled the remaining 50% of the second IBRD loan in 1976.

After six years of operations it was evident that TTDFC had not only filled a gap in the financial system but had also played a strong development role which was acknowledged by the IBRD staff and generally accepted in the country.

FINANCIAL PERFORMANCE

The Company managed to show a modest profit in every year between 1971 and 1976. This was due largely to the low cost of funds which was less than 3% of average total assets in each of those years resulting in a spread of 7% in 1971 which, with the introduction of borrowed funds, was reduced to 5.4% in 1976. The spread was adequate to cover general overhead costs which improved from 5.3% in 1971 to 2.6% in 1976.

Despite a 40% level of principal in arrears the level of write-offs was very low because of TTDFC's success in turning-around problem cases but moreso because of the unusually high increases in the values of property taken as security. In this regard, and in terms of its portfolio growth, much of TTDFC's success in the seventies may be attributed to the rapid growth in the economy caused by the oil boom which began in 1973.

It would have been logical to have expected that the oil boom would have made the TTDFC redundant. Clearly this was not the case. During the period of the oil boom between 1970 and 1983 the compounded rate of increase in the annual level of approvals was 37% (approximately 15% in real terms) demonstrating the high level of demand that was available for TTDFC to handle.

The Company's year-end portfolio level increased at the compounded rate of 40% per year from 1973 to 1983 while total assets of the local financial system as a whole increased at the compounded rate of 26% per year from 1973 to 1983.

PERFORMANCE OF THE PORTFOLIO

The high rates of growth in approvals from 1977 onward bore the seeds of eventual disaster, bringing back into focus the earlier concerns of the IBRD staff regarding the under-capitalisation of client firms, the weakness of assumptions based on insufficient market data and inadequate technical analyses.

Most of the core of the experienced professional staff had left the organisation in the early eighties. The staffing level however increased from 30 in 1980 to 66 by 1986 though very few, if any, of the new staff had any training or experience in lending or in industrial operations.

In 1984 and in 1985 the level of approvals continued to increase despite the onset of a recession which was evident from 1983. Predictably most of the small number of high value loans made during this period quickly turned out to be disasters.

When a detailed evaluation of the portfolio was made in 1987 by a newly-appointed Board of Directors and reviewed by a firm of accountants, it was discovered that 60% of the loans outstanding were not generating interest income and that 40% of the total portfolio was unlikely to be recovered. Most of these losses were in fact incurred as far back as 1980 but had not been recognised in the accounts. The losses included un-paid interest that had been taken into account in previous years but which was un-collectible.

It is obvious that almost all the failures, by definition, could be attributed to the failure of the management of the client companies. It was also obvious from the ex-post analyses and review of the loan files that the poor performance of the portfolio was due in most cases to the reasons cited previously.

There were other internal reasons which contributed to the failure.

Firstly the organisation had neglected to maintain and improve on the standards set in the seventies and given the relative inexperience of new staff and the lack of adequate training one can draw the conclusion that standards may have deteriorated. The new Board appointed in 1987 found it necessary to revise the Company's statement of policy and procedures which was originally drawn up prior to the Company's inception and which were virtually un-changed over seventeen years.

Secondly there was no evidence that the Company had a clear concept of portfolio management nor was there any conscious effort to examine the performance and the prospects for the various sub-sectors at the time loans were being considered. For example the Company did not consider the undue risk involved in financing urban hotels which relied on business "oil boom" visitors and which were not geared to tourism which is a less volatile market. All of these particular hotel projects resulted in heavy losses. By contrast, with the exception of one hotel acquired by the state, the tourism-oriented hotels in Tobago financed by TTDFC generally fared better and did not result in portfolio losses for the Company.

Thirdly the lack of effective loan supervision and proper technical appraisals was responsible for many additional loans being made to clients who had found themselves with un-finished projects which would later turn out to be non-viable or which never managed to start up operations successfully.

Fourthly the portfolio was affected by the recession which caused many firms in the construction and retailing sectors to fold up. TTDFC was affected by the decline in the construction sector though in fact many of the quarries it had financed during the construction boom had never been operational. TTDFC had quite correctly recognised the lack of quarrying expertise as a constraint but was never able to address the problem effectively.

The recession affected the private sector badly and commercial banks also suffered heavy portfolio losses particularly, in the distribution (retailing) sector which accounts for a significant percentage of commercial bank credit. Most of the loans made by the TTDFC after the start of the recession naturally were doomed to failure.

FOREIGN EXCHANGE RISK

From 1982 the TTDFC had been financed largely by the European Development Bank (EIB). These loans, denominated in European Currency Units (ECU), were disbursed in various currencies. TTDFC therefore faced the risk of losses arising from devaluation of the local currency as well as from cross-currency exchange fluctuations since its loans were to be repaid in \$US.

The depreciation of the United States dollar, a 50% local devaluation in December 1985 and a further devaluation of 18% in August 1988 led to significant exchange losses which were borne by the GOTT. However the GOTT indemnity extended only to principal and as a result loans from the EIB in 1982 and in 1984 at 5.05% and 7.4% respectively were effectively costing in excess of 9% and 13% by the end of 1988. Prior to the devaluations TTDFC had lent out these funds in local currency at fixed interest rates of between 11% and 12%.

TTDFC always believed that its interest rates had to be set with reference to the short-term lending rates of the commercial banks and could be fixed since its own borrowing rates were fixed. Accordingly there was no mechanism to compensate for interest rate risk (mainly arising from the foreign exchange risk) nor for the effect of inflation on its own overhead costs nor for increases in its average cost of funds arising from new borrowings. The Company's lending rate for long-term funds had always been set close to the average commercial bank prime rate. The commercial banks usually lent out funds at a margin above prime to most bank customers and were free to vary lending rates to existing customers. As interest rates rose, especially after 1983, the TTDFC was not only providing its clients with a subsidy but also with an encouragement to pay off the banks rather than the TTDFC.

LESSONS OF EXPERIENCE

What are the lessons to be learnt from these experiences ?

FINANCING

DFI's which operate in economies which lack adequate foreign currency reserves to finance the import of capital goods must borrow foreign currency and therefore must face the issue of foreign currency risk. There are sound reasons for passing on this risk to clients if the DFI is lending to projects which are efficient in economic terms relative to the external sector. However there is also a strong argument for an indemnity from the government which in effect is a subsidy. A workable solution may be a combination of both measures. Nevertheless it is crucial that DFI's be organised to raise adequate amounts of local currency funding either from government sources or from the market to meet the local cost component of projects. Sourcing from the local capital market would also help the

DFI to achieve one of its key objectives which is assisting in the development of a local capital market. However there are three conditions precedent to this development :

1. The role of the DFI must be perceived as important and the organisation must be judged to be operating effectively and efficiently ;
2. The DFI must operate as a financial institution and must be financially viable ;
3. Lenders must have confidence in the Board of Directors and the management.

Even when these conditions are present the market will judge the DFI to be a risk until and unless it has a record of sustained success. In practice therefore it is likely that loans made by DFI's on local markets would have to be guaranteed by international or regional agencies or governments. This however is preferable to direct government funding or direct foreign currency financing which would be used to finance the local component of project costs.

CAPITAL BASE

The entire capital and reserves of the TTDFC had been eroded by 1986. A DFI is in the business of long-term financing which itself presents a degree of risk, it is involved in a high proportion of new enterprises and if it is truly a DFI it is also involved in business activity that is relatively new to the economy. A DFI must have a strong capital base comprised of a high level of share capital and reserves and should restrict its borrowings to the traditional DFI guide-line of five times its capital base. ③

The need for a relatively high proportion of share capital to debt suggests that DFI's should be widely owned. While there are sound financial and other reasons for state involvement the experiences of DFI's around the world indicate that state participation should be limited rather than extensive. Moreover, an effective DFI needs to have constant interaction with the business and financial communities. It cannot do justice to its role without this interaction which itself encourages a high degree of discipline and commitment on the part of the DFI. Widespread ownership of a DFI and particularly ownership participation by other financial institutions may be regarded as not simply useful but absolutely necessary.

STAFF

② A DFI must provide non-financial services which other financial institutions are not required to provide and must have staff who are well-trained in project appraisal and loan supervision. Yet overheads should not exceed 3% of the gross portfolio value. Considerable attention must be paid to recruiting and retaining the best staff that can be found particularly at management level. Development banking in the industrial or large scale agricultural sectors is essentially investment banking with a high level of involvement in client operations and a deliberate orientation to new enterprises and activities in new sectors. In many respects development banking, faced with pressures from a particular economic, social and political environment, is more difficult to manage than other forms of banking. The choice of staff is more critical than in most other organisations.

LENDING POLICY

① A development bank, by virtue of its very purpose, must ensure that the projects it supports must be designed to make a positive net contribution to economic development and growth. However this contribution will not materialise if the projects are not also financially viable. TTDFC's financing made a definite contribution to job creation and to some extent, to the diversification of the economy. It also made a contribution to the development of entrepreneurship among nationals. However the impact of TTDFC's operations may not have been sustained since many of its client companies eventually went out of business. At the same time it must be noted that the assets of some of these companies were eventually sold off and put to productive use in one form or the other.

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Small business lending is also development banking. In view of its special importance and its particular objectives and characteristics it is felt generally that small business lending should be carried out by a development bank dedicated to this purpose.

INTEREST RATE POLICY

A DFI must set interest rates at competitive levels but must also establish an interest rate structure that covers its costs and allows a surplus, taking inflation into account. It should be particularly careful not to set its interest rates significantly below comparable market rates. Interest rates on fixed asset financing that are too low create a bias against labour intensive production when wage rates and un-employment are both high. DFI interest rates that are too low also provide encouragement to its borrowers to give preference to liquidating other debt at a higher cost instead of meeting its obligations to the DFI.

From a practical point of view a DFI which ends up with a large spread between its portfolio yield and its cost of funds will find that it has many important uses for a surplus if it is fortunate enough to be in that position. While the TTDFC's spread in 1976 was normal by local standards it was hardly enough to finance later costs and never significant enough to allow the Company to under-take new development initiatives nor to support its troubled clients with technical assistance.

MANAGEMENT OF OPERATIONS

A DFI must be a dynamic institution. Its job is never done and its role must evolve continually as the economy in which it operates changes in character and responds to changing conditions. A DFI must perceive the needs of its clients and the needs of development and must be prepared in advance to meet those needs. The management of operations must include strategic planning and regular review of economic conditions and developments in the financial system. Above all a DFI must be aware of the needs and problems of entrepreneurs and must be prepared to develop forms of assistance to meet genuine needs and to overcome obstacles if the DFI is to be an instrument of development and a successful financial institution. (4)

A DFI must have strong, broadly-based operational management who are committed to employing the "best practices" in accounting and finance and who are prepared to have a close involvement with the operations of their clients.

Finally the management of a DFI must discipline itself to be objective in its judgements and to be diligent in ensuring a good reputation as a financial institution.

EQUITY INVESTMENTS

Many of the companies financed by TTDFC were under-capitalised from the start and this deficiency worsened as start-up problems and operational difficulties surfaced. On the other hand share capital was difficult, if not impossible, to raise. This situation is typical in developing and under-developed countries. A DFI, which by definition, is a provider of long term funds must be involved in equity funding even though it must separate its loan operations from its equity participations from an operational view-point and must source its own funding for these two operations differently.

The emphasis on equity funding should not be totally altruistic. TTDFC's level of equity investments never exceeded 2% of its portfolio and more than 60% of its equity investments were entirely lost. Yet it did provide loan financing to several successful companies. Had equity investments been taken in some of these companies, if this was acceptable to the promoters, TTDFC may have been able to improve its overall yield and may have also benefitted from capital appreciation.

THE ROLE OF EXTERNAL LENDERS

External lenders are usually development banks which have accumulated considerable experience from observing practices in a large and varied number of institutions. For this and other reasons an external lender can be of great value to the board and management of a DFI if there is a good relationship between the two parties. External lenders are usually, and correctly so, not inclined to exercise considerable influence on the actual operations but do have a major role to play in the shaping of policy and moreso in the regular review of the organisation. The objectivity and expertise of an external lender, notwithstanding the danger of attempting to transplant models and concepts which may not be appropriate, will almost always be of great value to the management and staff.

TTDFC'S 1987 RESTRUCTURING PLAN

The restructuring plan was based on the fact that there was clearly a need for the organisation and more particularly, in view of the economic decline since 1982, the realisation that TTDFC would have a special role to play in the revitalisation of the private sector.

The restructuring plan, approved by the GOTT, was presented to the IFC and CDC (Commonwealth Development Corporation) in November 1987 and subsequently to the DEG (German bank for developing countries). The plan involved six main elements :

- * An increase in share capital to be subscribed by IFC, CDC, DEG and the local private sector and a consequent dilution of the GOTT's shareholding from 94% to 42% of the ordinary share capital ;
- * Major improvements to the Company's operating policies, systems and procedures, strengthening of the financial management function and the introduction of a strategic planning function ;
- * Changes in the organisational structure to reflect an emphasis on Project Development and Project Engineering and major improvements to the investment appraisal and loan supervision functions. ;
- * The expansion of the Company's activities and the introduction of new financial services including a new initiative in the area of equity investments through a newly-established Corporate Finance Division ;
- * Closer working relationships with other institutions in the financial system in particular with the commercial banks ;
- * Restructuring of GOTT loans to TTDFC and sourcing of new local and foreign funding which would be used to finance projects which will produce a positive net contribution to economic development and growth ;

CONCLUSION

The purpose of the paper was to trace the evolution of the TTDFC since its inception in 1970 and to describe its role and performance as a development finance institution.

Misconceptions among the staff, due to lack of experience and training in development banking, as to the role and functioning of a development bank, may have dulled what could otherwise have been a good performance. An overly enthusiastic, but perhaps understandable, effort to cater to socio-political, rather than to strictly economic and financial objectives, may also have contributed adversely.

The GOTT eventually suffered the loss of \$ 70 million of its loans to TTDFC and had to reschedule the remainder of its loans and capitalise un-paid interest after converting a further \$ 26 million into preference shares. However, TTDFC never failed to meet its external obligations from its own local resources.

Clearly the TTDFC did play an important developmental role through the years though, arguably, it could have been even more effective had it paid more attention to improving organisational efficiency and had it exercised a greater degree of care and due diligence in its loans management processes.

Nevertheless, as the current directors and management of the TTDFC acknowledge fully, the lessons of experience have provided a framework for a restructured TTDFC. These lessons echo the observation made by William Diamond on February 26th 1973 when speaking of development banks at a course in Bombay :

" The sound [development bank], that is, the one living up to its under-lying goals, both financial and economic, is a changing one, seeking continually to regenerate itself in the light of changing circumstances. It cannot do so if it relies on automatically and repetitiously satisfying yesterday's standards. Continuing rejuvenation requires that a development bank never end the process of reviewing its own work in the light both of its own experience and of society's changing needs; requires that its policies and procedures be changed accordingly ; requires that it maintain a mutually effective relationship with the individuals and institutions on whom its effectiveness depends ; requires that its staff and its training programs be oriented toward inculcating in everyone, staff and management alike, the concepts of institutional renewal and innovativeness."

G.M. PEMBERTON
Port-of-Spain
Trinidad & Tobago.

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