DailyMirror
Financial Times
28 March, 2008
http://www.dailymirror.lk/DM_BLOG/Sections/frmNewsDetailView.aspx?ARTID=10359

Sri Lanka DFCC Bank

Book Review

One Among the Successful Few, published by the Finance and Private Sector Development Unit, South Asia Region, The World Bank

Reviewed by SAMAN KELEGAMA

This publication was brought out to mark the 50th Anniversary of the Development Finance Corporation of Ceylon (DFCC) and is published by the World Bank. Naoko Ishii, the current World Bank Country Director in Sri Lanka, in her foreword to the publication states: "In much of the world, the development finance institution (DFI) model has not often proved successful….DFCC Bank evolved over the years to become one of the more successful banks in the country, and probably in the region, without losing its focus on development". Why and how did the DFCC succeed when other similar institutions around the world failed? What did it do which others did not ? What was unique in its governing framework to withstand the varied political pressures it may have been subjected to as a DFI that worked closely with the government ? These are some of the questions addressed in this publication.

It follows from Ishii's foreword that the World Bank considers DFCC as one of its success stories in the developing world that deserves wider publicity. For this purpose, the World Bank commissioned this study. Chapter 1 gives a broad overview of the conception, birth and growth of the bank. The governing framework is discussed in Chapter 2. Chapter 3 is on dilemmas of Development vs Profitability and Chapter 4 is on the key lessons from the 50 years experience of the bank. The Chapters are supported by some data in the Appendix. The publication builds on the 'Pioneers Journey' – the publication brought out by the DFCC to mark its 40th anniversary in 1997.

What is a successful DFI model ?

To begin with the fundamentals, the DFI model according to Ishii has not often proved successful. Why is this so ? Large scale long term oriented financing was not attractive to the private sector five decades ago, thus there existed a major market failure in provision of this type of financing and the government had to come in with financial resources fully or jointly with the private sector to rectify the failure. The correction of the market failure obviously led to some form of government ownership of the DFIs and they were expected to behave in the public interest. This led to an anomalous situation where DFIs had to serve the private sector and maintain profitability. This became a challenge to most DFIs and those that could not maintain an acceptable rate of return on the funds invested proved to be failures. According to the publication, the DFCC managed to maintain the delicate balance of public interest through development activities and profits through prudent lending and this was the key to its success.

Main argument

Among many factors highlighted in the publication, the unique governing framework that the DFCC enjoyed since its inception, the visionary leadership it had at its hour of need, and external presence in the Board via international funding clearly stand out as the key factors behind the success. All other contributory factors to the success are in one way or another related to these three factors.

First, the unique governing framework, although it was created by an Act of Parliament, had specific clauses which introduced features typical of a company structure and which made it somewhat a hybrid organization. The regulations provided for accountability of the management to the Board and to the shareholders -- holding of the annual general meeting, submission of annual audited accounts to the shareholders, the passing of shareholder resolutions, the election of directors by shareholders, and so on. Unlike the two state banks (Bank of Ceylon and People's Bank) where accounts are audited by the Auditor General, the DFCC accounts are audited by two qualified auditors annually appointed by the shareholders. And unlike in the two state banks, the Minister in charge of Finance can issue directives only " in consultation with the Board of Directors" and directives can be only "general directions on matters of policy" (p.15). This unique governing framework gave it a degree of autonomy and insulated it from certain political pressures.

Second, all financial institutions function in an ever-changing dynamic global and local environment. Their success and survival depends on their ability to adapt to such changes and reinvent themselves from time to time. DFCC was able to do so fearlessly, move from the narrower confines of a DFI to become a multi-product bank, due to the youthful and dynamic leadership it enjoyed especially after the early 1980s. The leadership mattered at crucial times and it was readily available at the correct time. A case in point is at the time of entry of the National Development Bank (NDB) to the market. Until the NDB arrived in 1979, the DFCC enjoyed monopoly power in development lending. But the lending volume of the DFCC did not increase significantly because the monopoly position was enjoyed during a closed economic regime when private sector activities were less. NDB came to the market with more than 25 times of the paid-up capital of the DFCC and was thus in a position to quickly carve up an apex role for itself. Pushed to the wall the DFCC had to meet the challenge. Here the leadership of Maxi Prelis (GM/CEO from 1981-1999) went a long way – the DFCC Act was amended (1982), inter alia, enlarging the institution's scope of powers, increasing the authorized capital, and enabling it to accept fixed deposits and engage in a full range of development banking activities. These measures enabled the DFCC to increase its issued capital by a bonus and public share issue. Team effort inspired by leadership also contributed to the success. The publication documents the noteworthy lending of the DFCC to the hotel sector, particularly after Black July 1983. This was risky business at that time when there was over exposure to the hotel sector but the management team took the risk which later paid dividends.

A change in corporate culture, characterized by increased market orientation, recruitment of better qualified staff, greater efficiency in operations, and greater focus on bottom line, was pursued with vigour. Discipline and professionalism was natured as a consequence of its relationship with multilateral lenders. In a Survey done by Asiamoney in 1995/96, DFCC was named the "best managed company of Sri Lanka".

By late 1990s, the government and multilateral institutions took the decision to disengage themselves from direct lending and discontinue the practice of providing cheap funds via credit lines to DFIs for on-lending for investment in projects. DFIs had to become self reliant – thus universal banking was embraced by many DFIs. During this time, DFCC saw a change of leadership and the new CEO was "charged… with the responsibility to upgrade the technology platform, improve risk management, diversify funding sources, and change the operational culture to a more proactive customer-centric one" (p. 43). Like Prelis, the new GM/CEO, Nihal Fonseka, meticulously performed this role and took DFCC to greater heights. In 2003, for instance, DFCC went into commercial banking with the establishment of the DFCC Vardhana Bank which formed a strong pillar on its diversification path.

Third, the external lever was an equally important component of the success, especially the role of the ADB and the World Bank. Their lines of credit had covenants which made bowing down to political pressure difficult. External shareholder presence, viz., IFC (International Finance Corporation), KfW (German Development Bank) and FMO (Dutch Development Bank) from the early years of the open economy also gave an autonomous identity. As the government was relying on some of these donors for project lending, it did not dare to unnecessarily antagonize them via interfering with the functioning of the DFCC.

Shortcomings

There are three minor shortcomings. The publication seems to over emphasise the unique structure bestowed by the Act of Parliament as the key factor to the success of the DFCC. While it was a necessary condition it was by no means sufficient and there are reasons to believe that all the abovementioned three factors played a significant role. In other words, the hybrid structure could be preserved and made functional by dynamic leadership and the structure could be best made use of by strong external stakeholders' presence.

The publication states: "the absence of a single shareholder with controlling interest and efficacy of checks and balances built into the incorporating statute to safeguard management independence have undoubtedly contributed significantly to its success" (p. 3). Till the late 1990s this was valid but no longer with the growth of powerful players in the share market. DFCC's hyper-success also made it a target and the Act does not have any safeguards to prevent an interested investor through related parties becoming a dominant shareholder. This has already happened and it is now up to the government nominee in the Board and the CEO to ensure that the DFCC does not deviate significantly from the original mandate. The publication avoids commentary on this crucial area which is of public interest. What needs emphasize here is that while the Act was used/amended by the leadership of the bank to keep the government at a distance, it was not used/amended to ensure that large corporate investors are kept away from taking over the bank.

A map with milestones of the DFCC's journey -- as presented in the last two Annual Reports of the DFCC -- in the Appendix would have facilitated the reader to keep track of the key events. A Table depicting the changing pattern of ownership over each decade, especially after 1977, would also have been useful. Some Boxes highlighting the international experience on DFIs – those that have ceased to exist either because they became financially unviable or ending their mission with the deepening of the financial market -- would have further enriched the narration of the Sri Lankan success story.

Future

Have the DFIs that were conceived during the post-World War II era of reconstruction and development outlived their usefulness? No, not in developing countries with shallow financial markets, but the sustainability of DFIs in the modern world requires repositioning to meet the wider financial requirements of their customers in a changing financial landscape. This is manifested in most DFIs embracing universal banking, but alternative routes may be considered. For instance, the DFCC and NDB have taken different paths in transforming themselves into universal banking. While the NDB has merged its development banking with commercial operations with more emphasis on the latter, the DFCC continues to maintain its separate identity for development banking activities while diversifying with new products. The NDB has exited from the Act of Parliament and is now governed by the Companies Act. The publication says that it is too early to judge which path is more sensible but laments over the changes that have taken place in the NDB and casts doubts whether such changes will make pure commercial interests drive the lending strategy thus undermining developmental lending. Does the government and the private sector in Sri Lanka think that DFIs are not relevant now ? Here again the answer in no, but as correctly pointed out in the publication the government getting fully involved in establishing DFIs like Lankaputra and SME Banks (now merged under the former) is not the answer because they are vulnerable to political directives and thus their long run sustainability is questionable (already running at a loss). The SME White Paper of 2002 which was produced by a team that included the current GM/CEO of the DFCC and which was chaired by the reviewer, never advocated an SME Bank very well knowing such pitfalls. But the political establishment thought otherwise when the DFCC experience clearly showed that DFIs work when the government is kept at a distance.

So what is the answer for growing development finance in Sri Lanka ? The DFCC, with its current footing in the economic system and other commercial banks which have a window for long term lending will have to come up with innovative and affordable finance packages for development lending. In this process, the DFCC cannot afford to stand on its laurels, for the competition is getting tougher by the day. The challenge is to retain its development financing while continuing to build on its commercial success. Under the new ownership control, only time will show whether the DFCC will live up to this challenge and remain the premier development bank in the country.

Despite minor shortcomings, this publication is very informative and can be recommended as a useful piece of work for bankers, those interested in the financial market, and above all economists and policy makers. It will be a useful addition to a library that collects economic literature.