DEVELOPMENT FINANCE INSTITUTIONS:
A DISCUSSION OF DONOR EXPERIENCE

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FOREWORD

In 1982, the Development Assistance Committee of the Organization for Economic Cooperation and Development (DAC/OECD) established an Expert Group on Aid Evaluation to improve donor evaluation methods and practices; to strengthen donor coordination standardization, and joint efforts in evaluation; to promote and support the evaluation capabilities of developing countries; and to contribute to aid effectiveness by synthesizing from donor evaluation experiences operational lessons for improving project and program design and implementation.

With regard to the last objective, the DAC Expert Group on Aid Evaluation has in recent years produced various reviews of the effectiveness of donor approaches in the priority areas of health care, program sustainability, and technical cooperation, asking the fundamental question, What, in the conduct of development interventions, works, what does not work, and why? A.I.D.'s Center for Development Information and Evaluation (CDIE) has found such syntheses of mutual donor experiences to be valuable in providing a broader basis for assessing development intervention than that provided by a review of A.I.D. experience alone. Insights from such studies can contribute to improving the quality of development assistance and to promoting greater harmony among donor operations and practices.

Recently, CDIE staff prepared two reviews of donor experiences for the DAC meetings in February 1990: The Development Impacts of Program Food Aid: A Synthesis of Donor Findings and Current Trends and Strategies and Development Finance Institutions: A Discussion of Donor Experience. The reports are syntheses based on evaluations of program food aid and of development finance institutions carried out by donors, including A.I.D., and on assessments by other development professionals. Because the reports present a compendium of donor experiences in these areas and highlight common donor findings and lessons, they have relevance to a broad audience of program and project managers in both A.I.D. and the wider donor community.

To broaden the awareness of the development community on the valuable lessons learned from these reviews, CDIE is publishing the DAC papers under its Program Evaluation Discussion Paper series. CDIE wishes to express its sincere thanks to all members of the DAC who supplied evaluation reports for the reviews.

This paper examines key issues with respect to the decision of continued donor support for development finance institutions (DFIs) based on a review of donor experience to date. Donors

have supported DFIs in developing countries as intermediaries for providing credit to targeted beneficiary groups, such as small businesses. The issues raised in the paper include the effectiveness of DFIs as intermediaries for targeting credit to priority sectors, the long-term viability of DFIs in developing countries, and the contribution of DFIs to the development of financial markets. The paper aims to stimulate discussion on donor strategies for developing financial systems that are able to mobilize local resources and supply long-term credit to priority groups in developing countries.

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SUMMARY

Development finance institutions (DFIs) have for several decades been important intermediaries for donors aiming to channel financial resources to priority groups and to fill the long-term credit gap. The 1989 Development Assistance Committee (DAC) agenda report recommends continued support for these institutions, contending that DFIs are indispensable for reaching small- and medium-sized enterprises. This review of donor evaluation reports of DFI projects aims to stimulate needed discussion on key issues concerning continued donor support to DFIs. The paper focuses on three questions: (1) How effective have DFIs been as intermediaries for targeting credit to priority groups? (2) Are DFIs sustainable? and (3) Have DFIs contributed to the development of financial markets in developing countries?

Two different objectives leading to two different orientations have characterized donor support of DFIs during the 1970s and 1980s. Some donors looked to DFIs as instruments of financial market development, expecting DFIs to fill the long-term credit gap in the private sector, to mobilize domestic savings, and, ultimately, to be financially viable institutions. Other donors conceived of DFIs primarily as vehicles for targeting long-term credit to predominantly disadvantaged groups, intending loans to improve income distribution and increase production and employment. Thus, these institutions were expected to fulfill roles both as promoters of development objectives and as self-sustaining financial intermediaries. The findings from the review of the evaluation reports suggest that DFIs have had and may continue to have considerable difficulty achieving either of these objectives.

Recent evaluations and studies of DFI programs have found that in some developing countries, DFI programs have helped expand the supply of long- and short-term credit to the private sector, thus stimulating growth in that sector. However, donor evaluations have become increasingly pessimistic about the capacity of DFIs to reach target beneficiaries. The high collateral requirement for credit, significant transaction costs of loans, and subsidized interest rates charged to subborrowers have typically resulted in tremendous concentration of resources in a few large subborrowers located in particular areas. Furthermore, donors have often operated at cross purposes. They have supported a multiplicity of DFIs targeting a range of economic sectors, creating confusion and sometimes excess of funds. Adding to the complexity, donors have set different terms for their assistance. They established different interest rates and loan criteria for subborrowers in each of the DFIs assisted, often leading to further confusion among subborrowers, underutilization of donor loan funds, and instability of the lending institution.

In addition, recent research on the informal sector has pointed to this sector's continued lack of access to formal sources of credit, including loans from DFIs. In fact, donors are increasingly acknowledging the inability of DFIs to reach the informal sector and marginal farmers, and are instead giving priority to developing alternative programs for reaching these target beneficiaries.

Many donors have operated under the assumption that DFIs will become sustainable financial intermediaries; however, a review of a wide spectrum of donor evaluation reports reveals that poor financial performance is typical of most donor-supported DFIs. Many DFIs suffer from high levels of arrears on their loan portfolios, and some even have difficulty covering their operating expenses and are dependent on government and donor resources for their sustainability.

A serious constraint to achieving sustainability has been the inability of DFIs to mobilize domestic savings and to operate as full-fledged financial institutions. As a result, DFIs have not been able to diversify risk or compete effectively with commercial banks and other sources of long-term credit operating in developing countries. Furthermore, the cost associated with providing a wide range of services aimed at reaching development objectives has added to the financial burden of these institutions. This leads to the question, When does financial selfsufficiency become the overriding objective to the exclusion of development aims? Another major constraint to sustainability of DFIs is the limited management capacity of the institutions, which has hindered their ability to compete in the increasingly complex economic environment.

Finally, DFIs have not been able to contribute effectively to strengthening financial markets in developing countries. First, the assumption of donors that DFIs would have a virtual monopoly over long-term finance has proven false in face of increasing

competition from commercial banks, leasing companies, and other sources of long-term credit. Second, financial policy in many developing countries controls interest rates and credit allocations, limits short-term lending and commercial paper operations, restricts competition among financial intermediaries, and constrains financial diversification. Such policy measures have placed severe limits on the ability of DFIs to offer new financial services, raise substantial local resources, and help develop local capital markets. Given the increased competition, diversification of financial services is an important option for DFIs in many countries. However, with regard to developing financial markets, financial policy reform may be more critical than reliance on DFIs.

In summary several lessons emerged from the review of donor evaluation reports of DFI programs:

1. Donors have operated at cross purposes in supporting DFIs. The result has been confusion among subborrowers and inefficient use of loan funds. To increase the efficiency of existing and future sources of long-term credit, donors may need to adopt more coordinated responses to promoting DFIs.

2. DFIs have had limited success in reaching target beneficiaries. To expand supply of long-term credit to these beneficiaries, donors need to assist DFIs in lowering the administrative cost of the loans, encourage DFIs to charge real positive interest rates, rely more on established financial institutions with extensive branch networks, and direct DFIs toward credit and financial market development to ensure more efficient use of available credit.

3. Few DFIs have achieved sustainability. The most successful tend to be financial institutions capable of mobilizing domestic savings and offering a variety of services and a strong management capacity. Donors may need to reassess their goals for DFIs: Should DFIs be self-sustaining institutions to the exclusion of some of their development goals or should they pursue development objectives, even if this requires continuing subsidy to DFIs?

4. DFIs have not been particularly effective in contributing to financial market development; instead policy reform appears to be the critical factor in the development of such markets. In this context, increased competition among DFIs and diversification of financial services are important for promoting capital markets in developing countries.

GLOSSARY

ADEMI - Associacion Para el Desarrollo de Microempresas

A.I.D. - U.S. Agency for International Development

BKK - Badan Kredit Kecamatan

BMZ - German Federal Ministry for Economic Co-operation (Bundesministerium fur Wirschaftliche Zusammenarbeit)

CDIE - Center for Development Information and Evaluation, U.S. Agency for International Development

DAC - Development Assistance Committee

DANIDA - Danish International Development Agency

DFI - Development Finance Institution

NORAD - Royal Norwegian Ministry of Development Co-operation

1. INTRODUCTION

Development finance institutions (DFIs) have for several decades been key instruments of donors aiming to fill the long-term credit gap in developing countries and channel financial resources to priority groups. The Development Assistance Committee (DAC) agenda report Development Co-operation in the 1990s contends that DFIs continue to have an important role in developing countries:

> Financial intermediaries in developing countries, such as local industrial and agricultural credit institutions, are indispensable to reach -- with credit and advice -- the large number of small and medium sized enterprises. It is an important function of development cooperation to strengthen these institutions. The record of the past has been mixed. It is important to ensure that these institutions combine judiciously their development promotion function with financial prudence (DAC 1989a, 81).

However, this review of donor evaluation reports of DFI projects suggests that these intermediaries have had and may continue to have considerable difficulty achieving these ends. Not only have DFI-directed credit programs had serious problems reaching their target beneficiaries, but the poor financial performance of many DFIs has caused some donors to question whether these institutions can serve effectively as development-oriented financial intermediaries.

Moreover, donors have operated at cross purposes in assisting DFIs in developing countries. Developing country governments, supported by various donor assistance programs, have often created a multiplicity of DFIs and have promoted other forms of intervention in credit allocation, as well. The result has been a confusion of many different kinds of directed credit programs implemented by many different institutions. For example, the Kenyan Government has supported the creation of eight DFIs, targeted to a range of economic sectors from agriculture to housing, industry, and tourism. This complex situation has been further aggravated by donors setting different terms for their assistance and establishing different interest rates and loan criteria for subborrowers in each of the DFIs assisted. Not surprisingly, subborrowers are confused, donor loan funds are often underutilized, and the viability of the DFIs is undermined.

Another question raised by donor reports is whether DFIs contribute to or undermine the development of a stable financial system. Recently several donors, particularly the World Bank and the U.S. Agency for International Development (A.I.D.), have given greater attention to helping developing countries improve their economic policies in order to build strong financial systems, rather than to directing additional resources to DFIs. Other donors, such as the German Federal Ministry for Economic Co-operation (BMZ), are interested in expanding their support for financial market development (BMZ 1982, 10).

The DAC agenda for the 1990s stressed the importance of financial market development.

> Financial sector development and reform, which requires both an appropriate policy framework and appropriate institution-building efforts, must therefore be a fundamental priority in these developing countries where domestic resource mobilization is low or where allocation and use of financial resources is inefficient and financial institutions encumbered by low or non-performing assets. A well functioning financial sector is critical to the evolution of the private sector and critical to the promotion of equity (DAC 1989a, 128).

At the same time, donors are increasingly acknowledging the inability of DFIs to reach the informal sector and marginal farmers, and have given priority to developing alternative programs to reach these target beneficiaries. For example, the United Nations' International Fund for Agriculture and Development and other donors have supported the Grameen (Rural) Bank program for the informal sector in Bangladesh. This small private initiative reaches the rural poor with group-based lending schemes and has an excellent loan recovery record; this effort is in marked contrast to government-run development bank programs aimed at similar beneficiaries. In Indonesia, A.I.D. has supported the innovative Badan Kredit Kecamatan (BKK) Government credit program for very small firms, which reaches almost 30 percent of Central Java's villagers and has had a 14-percent return on its outstanding loan portfolio (Goldmark and Rosengard

1983, passim; World Bank 1989b, 120).

These trends suggest that donors are at a critical juncture in their support for development finance institutions. More discussion is needed on key issues to provide the basis for a coherent approach by donors to reaching priority groups with long-term credit.

2. PURPOSE AND APPROACH OF THE PAPER

This paper aims to stimulate and broaden donor discussions about future credit assistance to key target beneficiaries, such as small business, and the use of DFIs to support such efforts. The paper focuses on three questions central to donor support of DFIs:

- How effective have DFIs been as intermediaries for targeting credit to priority groups? The question is to what extent are DFIs actually benefiting their target population, and if not, why.

- Are DFIs sustainable? The question is whether DFIs are currently or potentially viable financial institutions in developing countries.

- Have DFIs contributed to the development of financial markets in developing countries? The question is whether DFI institution-building promotes or retards the development of effective financial systems.

Rather than summarizing evaluation findings from donor reports, the paper draws on selective findings to highlight issues requiring greater donor attention and coordination. Specifically, this paper draws on evaluation reports from nine donors: the Danish International Development Agency (DANIDA), the Swedish International Development Assistance Agency, the Royal Norwegian Development Assistance Agency (NORAD), A.I.D., the Canadian International Development Agency, BMZ, the World Bank, the Inter-American Development Bank, and the Asian Development Bank. (See bibliography for a full listing.) These documents include reports submitted by donors responding to a request from A.I.D.'s Center for Development Information and Evaluation and reports available through databases and the A.I.D. library.

This paper gives principal attention to donor evaluation reports covering projects executed from the mid-1970s through the late 1980s. This list is by no means exhaustive, nor does it constitute a randomly determined sample of donor projects. Rather, it draws on selected studies and donor evaluations of DFI projects, which were considered representative of donor views.

3. DONORS AND DEVELOPMENT FINANCE INSTITUTIONS: THE BACKGROUND

Not surprisingly, donors have different objectives in supporting development finance institution projects. On the one hand, some donors have conceived of DFIs principally as instruments of financial market development in developing countries. These non-bank intermediaries are intended to fill the long-term credit gap for priority groups, mobilize domestic savings, and, ultimately, be financially viable institutions. On the other hand, some donors have conceived of DFIs largely as vehicles to target credit to disadvantaged groups. These intermediaries are intended to channel long-term credit to particular beneficiaries to improve income distribution and increase production and employment. In some cases, donors have paid little attention to measures for loan recovery and to the financial viability of the institution.

The difference in orientation of donors is partly a reflection of the contradictory character of DFIs. These institutions were expected to fulfill roles both as promoters of development objectives and as self-sustaining financial intermediaries. These differing perspectives make comparisons of DFI project outcomes difficult.

Donors have also devoted considerably different levels of resources to support DFI projects in developing countries. The donors who have made the greatest commitment to DFI projects, in terms of the overall level of financial support, include the World Bank, the Inter-American Development Bank, the Asian Development Bank, and A.I.D. Other donors -- the Canadian International Development Agency, DANIDA, and BMZ -- have all devoted only modest amounts to support DFI projects.

Not surprisingly, donors devoting substantial resources to DFI projects have given more priority to evaluating and analyzing the outcome of this support than have donors with more modest commitments to DFI projects. Therefore, the views expressed in studies and evaluations by the major donors are more prominent in this paper.

In addition to issues raised by donor involvement, the academic literature on financial markets has challenged several basic assumptions of DFI projects in recent years. In their pathbreaking research on rural financial markets, Dale Adams, Douglas Graham, and J. D. Von Pischke, among others, criticized small farmer credit schemes for supply-led approaches to rural finance. They argued that focusing on supplying more and cheaper formal loans has tended to undermine the financial viability of credit intermediaries, discourage mobilization of deposits, and raise the costs of providing credit. In many cases, DFIs have been unable to cover their transaction costs, recover loans, and reach their target population (Adams, Graham, and Von Pischke, 1984 passim). This finding challenges the assumption of many DFI programs that supply-led subsidized credit programs are the most effective means of reaching small borrowers.

Similarly, research on the informal sector has documented this sector's lack of access to formal sources of credit, including loans from DFIs. Moreover, studies have found that entrepreneurs in small business and in the informal sector have not been deterred by the high interest rates charged by such informal sources of credit as rotating savings and credit associations, suppliers' credit, and moneylenders (Timberg and Aiyer 1980, 43-59). A number of microenterprise credit programs, such as Association Para el Desarrollo de Microempresas (ADEMI) in the Dominican Republic and BKK in Indonesia, have succeeded in reaching their target population. These programs undercut the rate charged in informal credit markets, but they are still able to charge high real interest rates (Biddle et al. 1989, 4-10; Poyo, Hoelscher, and Mahotra 1989, 11, 18). These findings challenge the assumption of many designers of DFI programs that informal credit markets are not fulfilling an important role in reaching target groups and that subborrowers are not willing to pay high real interest rates.

These factors -- the contradictory objectives of donors in supporting DFIs and research challenging basic assumptions about directed credit -- strengthen the argument that donors need to reflect on key issues concerning their support to DFIs.

4. DIRECTED CREDIT: ARE DFIs REACHING THE TARGET GROUPS?

During the 1970s and early 1980s, donors were enthusiastic about the potential for directed credit to be effectively channeled by DFIs to priority groups. A multiplicity of credit programs executed by DFIs were developed for medium- and small-scale firms, small farmers, and exporters among others. Recent evaluations and studies of such programs have found that in some developing countries these DFI programs have had a positive effect on credit availability and private sector growth. However, donor evaluations have become increasingly pessimistic about the capacity of DFIs to provide access to the target beneficiaries and to provide credit services at a reasonable cost.

Projects supporting development finance institutions have expanded the supply of long-term credit and stimulated private sector growth in a number of developing countries. The Korean Development Bank is an excellent example of how a DFI can stimulate a sharp rise in industry's share of credit; credit available nationwide in Korea between 1965 and 1986 increased from 44 percent to 69 percent. DFIs in Pakistan and Indonesia are cited by the World Bank as other examples of institutions able to successfully expand the supply of credit (World Bank 1989b, 57). In Ecuador, two DFIs assisted by the World Bank and A.I.D. contributed almost 30 percent of credit for industrial investment in 1979, and increased the share of credit to the private sector from 10.5 to 18.4 percent during the 1972-1983 period (Eckersley, Pinto, and Roark 1985, 11, 13; World Bank 1985, 5). In Costa Rica, A.I.D.'s support of privately held DFIs contributed to the expansion of long- and short-term credit available to the private

sector (Gonzalez Vega 1982, 26).

Moreover, DFIs have provided access to credit to some groups previously denied any support. For example, in Tanzania, a DANIDA-assisted DFI reaches "many people in rural areas and does give them access to inputs or equipment which can result in significant increases in food security and incomes. No other bank in Tanzania does this" (DANIDA 1987a, 5.10).

As noted above, DFIs have also contributed to the growth of the private sector in several developing countries. A review of ADB rural credit projects found that "evaluations confirm the positive impact of bank-funded credit projects on output" (Wihtol 1988, 146). DFIs assisted by A.I.D. have stimulated modest increases in exports, jobs, and start-ups in such countries as Ecuador, Barbados, Costa Rica, and Jamaica (Eckersley, Pinto, and Roark 1985, 43; ISTI 1987, 26; L. Berger International 1987b, 19, 26, 28; Quiros 1987, 2, Exhibit 3; Quiros and Quiros 1986, 16).

However, the contribution of directed credit to growth of output can only be really measured relative to the policy environment, specifically one that ensures that capital is put to its most productive use. Not surprisingly, several World Bank studies conclude that directed credit has tended to have a more positive impact on growth in economies with macroeconomic stability and minimal price distortions, such as in Korea, Pakistan, and Indonesia. Furthermore, the studies found that directed credit has had an adverse effect on the target beneficiaries in economies with highly protectionist trade regimes and macro-economic instability; the firms in these economies were usually unstable after adjustment (World Bank 1989b, 58). The tendency to fund inefficient industries in countries with protectionist policies is evident in the Dominican Republic, Ecuador, Costa Rica, and the Philippines. For example, in Costa Rica prior to a major structural adjustment program, import substituting firms benefiting from dollar loans were especially hard hit by the devaluation of the dollar in 1981 (Arthur D. Little, International 1982, 11, 22; Eckersley, Pinto, and Roark 1985, 17; Gonzalez Vega 1982, 6-7; Wihtol 1988, 151).

Despite these successes, donor evaluations and reviews have emphasized how few DFIs are able to efficiently and effectively reach particular target groups. A German review of DFI projects concluded, "the majority of the assessed programs of assistance by development banks appear rather unsuccessful....The beneficiaries of this assistance were not generally the intended target groups" (BMZ 1982, 5, translated by CDIE staff). The beneficiaries were larger enterprises, were concentrated in particular regions, and had greater access to foreign capital than had originally been anticipated. This tremendous concentration of resources in a few large subborrowers located in particular areas is a trend identified in many A.I.D., World Bank, Inter-American Development Bank, Asian Development Bank, DANIDA, and other evaluations (ADB 1985, 35; ADB 1986a, 9; DANIDA 1989, 4 Eckersley, Pinto, and Roark 1985, 44; IDB 1984a, 10; IDB 1984b; 2, World Bank 1985, 25; 8).

Several factors have contributed to the trend toward credit concentration, resulting in limited access and high costs. They include the following:

-- The eligibility requirements to obtain credit

-- The transaction costs of credit

-- The interest rate charged to subborrowers

First, the criteria for borrowing established by development banks have tended to deny access to the target population and to favor a select few. The high collateral requirements of many DFI programs have often skewed credit to larger, richer clients (BMZ 1982, 6; IDB 1984b, 28; World Bank 1989a, 5). Similarly, by granting multiple small loans to large borrowers, lenders have avoided or ignored quotas for targeting particular groups (IDB 1984b, 11; Meyer 1989, 10). In some cases, government control and ownership of the DFI determines what group of subprojects are funded. As a result, state enterprises and other special interest groups have benefited relatively more from DFI assistance than have other firms (ADB 1985, 35; World Bank 1989a, 55). A World Bank study also found that the high rate of default of agricultural credit banks could be attributed in part to inappropriate lending criteria (World Bank 1989a, 106).

Second, the administrative requirements of managing a directed credit program particularly targeted to the agricultural sector have burdened DFIs with significant costs. An Inter-American Development Bank review of agricultural credit programs found that the institutional costs of channeling the credit were high and were a reflection of the low efficiency of the institutions (IDB 1984a, 16). A review of agricultural credit programs in Asia also found that the "heavy reporting and documentation costs create high lender transaction costs" (Meyer 1989, 10). Similarly, a German Government review concluded that the stringent conditions contained in their loan-agreements are of dubious value and provide a negative incentive to intermediary institutions The review argues that the conditions of the loan agreements must be more flexible (BMZ 1982, 10-11).

An outcome of this additional cost burden has been to encourage DFIs to be more conservative lenders, despite the intentions of quotas and eligibility criteria to encourage more diversified and higher risk lending. A case study in Honduras of the transaction costs of extending credit found that the heavy administrative expenses associated with the loan-targeting criteria of the development bank contrasted with the low administrative costs of a commercial bank reaching similar clients. The development bank gave more priority to post-loan monitoring and supervision than did the commercial bank, which emphasized pre-loan evaluation and analysis, an approach more effective in lowering administrative costs and reducing arrears in the long term than post-loan recovery (Graham and Cuevas 1984, 110).

Third, subsidized interest rates on loans to subborrowers, characteristic of many DFI programs, have created excess demand for these cheap resources, effectively reinforcing the concentration of credit. Inter-American Development Bank evaluations of both industrial and agricultural DFI programs have found that DFIs have tended to extend credit at negative real interest rates (IDB 1984a, 21; IDB 1984b). The IDB review of agricultural credit programs found that 85 percent of the loan programs were lending to subborrowers at a negative real interest rate (IDB 1984a, 21). Artificially supported interest rates normally have a negative effect on the target group. For example, producers with the highest assets have been able to monopolize the bulk of the credit available in many DFIs. It is interesting to note that the IDB found that subborrowers were not deterred from taking out loans from those few DFIs charging positive real interest rates.

Another factor limiting the capacity of DFIs to effectively reach their target groups has been the multiplicity of directed credit programs executed by DFIs. This situation has caused confusion for beneficiaries and often an excess of funds. In a number of developing countries, including the Dominican Republic and Costa Rica, donor funds have been made available to DFIs in excess of real demand; as a result, there have been extended delays in the use of some donor funds since more credit is available than can be effectively absorbed. Moreover, donors provide funds for such programs on different terms to DFIs and set different interest rates for lending to subborrowers. Needless to say, this situation has contributed to low utilization of some donor loan funds, which offer terms less attractive to the intermediary or the subborrower than other loan funds equally available (ADB 1986a, 3; DANIDA 1989, 53; IDB 1984b, 12).

In brief, DFIs have had limited success in reaching target beneficiaries and resources have concentrated in a small number of larger subborrowers.

5. SUSTAINABILITY: ARE DFIs VIABLE FINANCIAL INSTITUTIONS?

Many donors have operated under the assumption that DFIs will become sustainable financial intermediaries. This mandate has been difficult for DFIs to fulfill. Evaluations by a wide spectrum of donors come to a remarkably similar conclusion: DFIs have not proven to be sustainable intermediaries. A recent World Bank study (1989a) concluded that

> it cannot be said that the institutions studied have achieved sustainability in a broad sense. Most have achieved the basic financial function of transferring investment resources to industrial borrowers at a profit, however small. However, given the high level of arrears which most of them have, their apparent financial profitability may be illusory (p. v).

A World Bank review (1989a, 6) of a sample of 18

industrial DFIs worldwide found that half of their total loan portfolio was in arrears (by value) and that accumulated arrears constituted 17 percent of their portfolio value. The loan default rate of subsidized agricultural credit programs was also high, averaging 30 to 95 percent (World Bank 1989a).

The poor financial performance of DFIs is typical of many donors. Many rural credit institutions assisted by the Asian Development Bank have not been financially viable due to high risk associated with such lending and low debt recovery (Wihtol 1988, 146). In Asia, development banks in the Philippines and Nepal have exhibited unsatisfactory financial performance (ADB 1986b, 3-4,7; ADB 1985, 35; Wihtol 1988, 149). Agricultural and industrial credit institutions assisted by the Inter-American Development Bank have had considerable difficulty managing high levels of arrears and refinanced debt (IDB 1984a, 6; IDB 1984b, 23). In some cases, default rates increased due to worsening economic conditions and to the aging of the debt (IDB 1984b, 23).

DFIs assisted by A.I.D. have also had problems achieving sustainability. Several DFIs tasked with multiple, ambitious objectives for reaching particular target groups have had significant difficulty covering their operating expenses. The costs associated with the provision of a wide range of services aimed at reaching development objectives have not strengthened the financial viability of A.I.D.-assisted DFIs. Instability in foreign exchange markets, particularly the effect of devaluation, has severely weakened the institutional viability of DFIs extending dollar financing. In many cases, the problem has been that producers for the domestic market have been unable to cover their dollar-based loans in periods of severe devaluation. Those DFIs not targeting export industries have had high levels of arrears (Arthur D. Little International 1982, 11, 22; Eckersley, Pinto, and Roark 1985, 17; McKean 1988, 6-7; Wihtol 1988, 151).

A serious constraint to achieving sustainability has been the inability of DFIs to mobilize domestic savings and to operate as full-fledged financial institutions. Many DFIs are non-bank institutions legally restricted from accepting deposits and offering a variety of financial services that could enable them to generate revenue in addition to their loan portfolio. Moreover, these intermediaries are often government creations and are heavily dependent on government and donor resources for their initial capitalization and sometimes even their operating expenses.

Restrictions, such as interest rate ceilings and legal or contractual prohibitions on deposit banking, leasing, warehousing, merchant banking, and other financial services, have limited the capacity of DFIs to improve profitability. This situation has become problematic, since DFIs face increasing competition from commercial banks, leasing companies, and other sources of long-term and equity finance in many countries. Unlike commercial banks extending working capital, DFIs operate at a disadvantage because they lack such day-to-day contact with short-term borrowers. The long-term effect of specialization has been to

limit the ability of the DFIs to diversify risk.

As a result, some donors have encouraged established DFIs to diversify their operations. An Asian Development Bank evaluation concluded that the National Development Bank of Sri Lanka "should widen its range of traditional operational activities, expand its merchant banking type of operations and suitably adapt its organizational structure" (ADB 1988, 11). In Tanzania, DANIDA has promoted the evolution of the Cooperative Rural Development Bank into a fully fledged commercial bank (DANIDA 1987a). A.I.D. promoted diversification of a Costa Rican DFI, COFISA, into a minifinancial conglomerate to strengthen its commercial base (Quiros and Quiros 1986, 13).

Other donors have concentrated resources on creating new financial intermediaries. For example, in Jamaica, several donors joined together to create the Agricultural Credit Bank, a limited liability company with sufficient legal capacity to undertake wholesale banking and to coordinate all lending to the agricultural sector (INMANEX, Inc. 1983, 16). A.I.D. supported the establishment of new DFIs in Jamaica, Barbados, Costa Rica, and Haiti, which have the legal mandate to provide a variety of financial services, including deposit mobilization.

However, several evaluations have commented that many of these DFIs seem to be more commercial than developmental in their orientation. These evaluations use the term "developmental" to refer to lending that is of higher risk than short-term working capital credit (e.g., long-term financing) and creates new jobs or supports start-ups or new ventures.

For example, in BANEX, an A.I.D.-assisted bank in Costa Rica, only 30 percent of its loans could be considered developmental. Several other commercially oriented DFIs have only modest development portfolios. The question for donors then becomes, When does financial self-sufficiency become the overriding objective to the exclusion of development aims (Arthur D. Little, International 1983, 4; Checchi and Company 1988, 3 DANIDA 1987, 1; ISTI 1987, 5-6, 30; Quiros 1987, 2)?

Donor evaluations have also concluded that the sustainability of DFIs is strongly linked to their management capacity, often including a strong, competent local intermediary institution (Management Systems International, N.d., 42; World Bank 1989a, vi, 44). One of the problems with the performance of DFIs has been their limited capacity to cope in an increasingly competitive and complex economic environment.

A World Bank report (1989a, viii) has criticized multilateral donors' long-standing emphasis on economic and financial rates of return as a basis for evaluating DFI performance. For example, it is not very useful to rely mechanistically on rate of return analysis for DFIs in highly protectionist policy environments that divert financial returns away from their most productive uses, since typically the financial rate of return will diverge from the economic rate of return in such environments. Donors

have paid insufficient attention to assessing the management capabilities of DFIs and their future prospects, which may be more critical to supporting DFIs' ability to cope in a volatile economic environment than producing contradictory data on rates of return.

In brief, few DFIs have been able to achieve sustainability The most sustainable tend to be full-fledged financial institutions capable of mobilizing domestic savings and offering a variety of financial services and a strong management capacity to cope with with a competitive economic environment.

6. FINANCIAL MARKET DEVELOPMENT: HAVE DFIs MADE A CONTRIBUTION?

One expectation of donors in supporting DFIs has been that these institutions would contribute to strengthening financial markets in developing countries. Regrettably, DFIs have done a poor job in contributing to financial market development. "Development finance institutions carry out programs that do not substantially change, enrich or strengthen the financial infrastructure of the country" (BMZ 1982, 7). This conclusion of a German Government review of DFI programs is typical of evaluations by the World Bank (1989a, 24), the Inter-American Development Bank (IDB 1989b, 84) and A.I.D. (Mckean 1988, 4-5). Other donors have been only marginally concerned with strengthening local financial markets.

Until recently, many donors entered into projects with DFIs expecting these intermediaries to have a virtual monopoly over long-term finance in developing countries. This assumption has proven false. Instead, DFIs in many countries face increasing competition from commercial banks, leasing companies, and other sources of long-term and equity finance. In some lesser developed countries, particularly in Africa, this situation is less common.

Financial policy measures have placed severe limits on the ability of DFIs to offer new financial services, raise substantial local resources, and help to develop local capital markets. These measures have ranged from limits on short-term lending and commercial paper operations, to controls on interest rates and on credit allocation, to restrictions on competition between financial intermediaries and on financial diversification.

DFIs reviewed for purposes of this study have financially been remarkably conservative and cautious. Many adopted a passive stance toward contributing to capital market development, partly because they have operated for many years virtually without competition. Government and donor provision of capital to DFIs at subsidized interest rates has been a significant deterrent. Few DFIs have offered bonds for secondary markets. Equity portfolios are typically very modest and those taking major equity positions in new firms are few (ISTI 1987, 28; World Bank

1989a, 24-26).

In view of increased competition from other financial intermediaries, diversification of financial services is an important option for DFIs in many countries. Some DFIs have diversified into commercial banking operations and export guarantee schemes, but efforts to develop merchant banking operations have had considerable difficulty getting underway. In the early 1980s, a series of projects developed by A.I.D. have supported the establishment of new DFIs able to offer diversified financial services, ranging from merchant banking operations to leasing and equity financing.

However, evaluations have found that these newly established DFIs have either had considerable difficulty in or have delayed providing these services. Problems emerged for several reasons. The DFIs were not sufficiently established financially to assume additional responsibilities. The transition to diversified financial conglomerates, with which they had no previous experience, would require considerable expense, risk, and time (L. Berger International 1987b, 20,34-35; Quiros 1987, passim; ISTI 1987, 28). Moreover, the design of several programs were complex and overambitious. Still, a few DFIs, which have operated as established DFIs for a number of years, have successfully incorporated leasing and import warehousing services.

This paper suggests that DFIs have not been particularly effective in contributing to financial market development. Rather, financial policy reform may be more critical to financial market development.

7. LESSONS LEARNED AND RECOMMENDATIONS FOR CONSIDERATION

This discussion of issues central to donors' experience with DFIs provides an opportunity to reflect on the DAC mandate to "ensure that these institutions [DFIs] combine judiciously their development promotion function with financial prudence" (1989a, 81). Several lessons have emerged that may provide a basis for further discussion among donors.

1. Donors have operated at cross purposes in support of DFIs. The result has been confusion among subborrowers and ineficient use of loan funds. In attempting to increase the efficiency of existing and future sources of long-term credit, donors may need to

-- Adopt more coordinated responses to promoting DFIs, as well as financial market reform.

2. DFIs have had limited success in reaching target beneficiaries, and resources have concentrated in a small number of large subborrowers. To expand the access of target beneficiaries to long-term credit, donors may need to

-- Develop approaches other than DFI lending to increase access to particularly hard-to-reach target groups, for example, the informal sector and landless farmers.

-- Assist DFIs in lowering the administrative cost of DFI lending, for example, simplifying loan procedures and regulations and reducing donor requirements for documentation and reporting.

-- Encourage DFIs to charge real positive interest rates to subborrowers.

-- Rely more heavily on established financial institutions with extensive branch networks.

-- Direct DFI efforts toward credit and financial market development to ensure more efficient loan utilization. Greater collaboration is needed on setting the terms for lending to DFIs, the rate of interest charged to subborowers, and the eligibility criteria for these programs.

3. Few DFIs have been able to achieve sustainability. The most sustainable tend to be full-fledged financial institutions capable of mobilizing domestic savings and offering a variety of financial services and a strong management capacity to cope with a competitive economic environment. In attempting to support the sustainability of DFIs, donors may need to

-- Reassess their goals for DFIs and decide whether DFIs should be self-sustaining institutions even if some of their development goals have to be foregone, or whether ensuring that clients become sustainable is their primary objective even if it requires continuing subsidy to DFIs.

-- Encourage established DFIs to charge positive interest rates to subborrowers.

-- Assist established DFIs in diversifying their operations, which would allow them to generate additional local revenue sources and be more competitive with other financial intermediaries.

-- Direct primary attention to improving the management capabilities and future prospects of DFIs.

-- Assist DFIs to cope with the foreign exchange risk associated with dollar borrowing and lending.

4. DFIs have not been particularly effective in contributing to strengthening financial markets in developing countries; rather, financial policy reform may be more critical to financial market development. In efforts to develop local sources of finance for investment, donors may need to

-- No longer use DFIs as a principal instrument to promote capital markets in developing countries.

-- Give adequate attention to the economic and financial framework in which these DFIs operate before extending assistance.

-- Give priority to policy reform in the financial sector to provide the appropriate environment for DFIs and financial market development.

-- Encourage competition among DFIs and similar financial intermediaries. For example, the World Bank has changed its lending approach to DFIs, making umbrella loans available to more than one DFI at a time, and including non-DFI intermediaries, such as private sector banks.

This paper has not attempted to reach closure on the complex issue of donor assistance to DFIs. Rather, the aim has been to stimulate needed discussion about donor strategies for developing financial systems that are able to mobilize local resources and supply long-term credit to priority groups in developing countries.

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