

## SRI LANKA

# DFCC BANK

## ONE AMONG THE SUCCESSFUL FEW

The DFCC, Sri Lanka's pioneer Development Finance Institution (DFI), completed 50 years of successful operations in 2006. Many similar institutions established in other parts of the world, most notably following World War II, have ceased to exist because they have become financially not viable. The DFCC is one among a small number of DFIs that not only has continued to remain viable, but also has been successful in transforming itself into a multi-product and robust financial institution in a changing international and local environment.

Why and how did the DFCC succeed when other similar institutions failed? What did it do that others did not, and what did it do differently? What was unique in its structure or governance framework that may have enabled it to withstand more effectively the varied political and other pressures it may have been subjected to as a development-oriented institution that worked closely with the government? This study attempts to answer those questions, with a view toward learning from this experience.

THE WORLD BANK

SRI LANKA - DFCC BANK: ONE AMONG THE SUCCESSFUL FEW



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South Asia Region  
The World Bank

# THE DFCC BANK

## One Among the Successful Few

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# Foreword by the World Bank

DFCC Bank was set up by an Act of Parliament in 1955 as a result of a recommendation of the first World Bank mission to Sri Lanka to set up a strong institution to support private sector access to medium and long term capital. At the time, the Sri Lanka financial sector was dominated by commercial banks that offered mainly short term loans, and there was a need for a development finance institution to help meet the medium and long term financing needs of the economy.

While today several institutions in the country provide medium and long term finance, DFCC Bank is credited with having pioneered the market. In 1957, it started with a small capital base of Rs. 8 million and a government loan of Rs. 16 million. It was mandated to exclusively support the private sector in industry, commerce and agriculture and eventually became a licensed specialized bank. Many of the country's leading industrialists of that time in the textile, apparel, tourism, hydro development and food and beverages acknowledge the support received from the DFCC Bank, especially during their infant stages.

From 1950s, the DFCC Bank traversed through socialist era of the 1960s and 1970s, and in mid 1970s had the monopoly of providing foreign exchange for import of capital goods of the private sector. However, with the introduction of liberalization policies in 1977, exchange controls were relaxed and in 1978 the wholly state-owned National Development Bank was set up with a larger equity base to focus mainly on development financing, including for SMEs. In addition, foreign banks were encouraged to open branches in the country. As a result of these and other developments, DFCC Bank was subject to strong competition. However, DFCC Bank adjusted to the changing political and economic environment successfully. The 1980s saw the DFCC Bank successfully adapting itself to face the new challenges and maximize its growth opportunities. It was a time of modernization, expansion and the acquisition of human and technological resources to fulfill its vision of becoming one of the major financial services conglomerates in the country.

In 2006, DFCC Bank marked its 50th Anniversary. In much of the world, the development finance institution (DFI) model has not often proven successful. In Sri Lanka, other state banks could not insulate themselves from the political pressures at different times of history. However, the DFCC Bank had been able to retain its autonomy. Therefore, with the completion of its first half century, the World Bank commissioned a study as to how the 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.

**Naoko Ishii**

World Bank Country Director

Sri Lanka

# Foreword by the DFCC Bank

DFCC Bank, a specialized bank under supervision of the Central Bank of Sri Lanka was established originally through an Act of Parliament in 1955 under the name of Development Finance Corporation of Ceylon with a mandate to provide long-term project finance to private sector initiatives. The Bank, which was the pioneering development finance institution in the country, has over the years played an innovative and catalytic role in the development of the private sector, a role not confined to the mere provision of long term loans but one encompassing capacity building, employment generation and business facilitation, which in turn has had a significant impact on society at large.

While DFCC Bank continues to be cognisant of and strongly committed to its primary role in development banking, it has also taken heed of the evolving financial landscape and the changing market environment. In response to development such as intense competition, eroding margins and diminishing product differentiation within the banking sector, we have had to redefine ourselves. Over the 50 years of our existence we have diversified our operations within the Bank to include finance leasing, and investment banking services. Through its associate and subsidiary companies the Bank has also ventured into commercial banking, stock broking, venture capital, unit trust management, consultancy services and industrial estate management. Thus, the Bank has evolved itself from the narrower confines of a DFI to become a multi-product bank. Today as a prominent banking group in Sri Lanka we have geared ourselves to be a significant player in the country's financial arena offering a wide range of financial services aligned with the country's development objectives and thereby realise our vision to be Sri Lanka's premier financial services group .

Today DFCC Bank celebrates its golden jubilee marking 50 years of development banking in Sri Lanka continuing to be the premier development bank in the country. In the next phase of its growth the proposed new initiatives that will be introduced by the bank will propel DFCC Bank into a next generation financial institution committed to being a dynamic resource centre for enterprise building in Sri Lanka.

I wish to thank the World Bank for commissioning this important study on DFCC Bank with a view to describing and assessing the key factors facilitating the relative success of the Bank as a DFI and more recently as a licensed specialised bank offering a wide range of fund and fee based services. We hope that the lessons of experience highlighted in the study will be of relevance to similar financial institutions that have to face up to many pressures and strive to succeed in a fast changing environment.

**Nihal Fonseka**

Chief Executive Officer

DFCC Bank

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# Acknowledgements

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# Acronyms and Abbreviations

ADB	Asian Development Bank
CEO	Chief Executive Officer
DFCC	Sri Lanka's Pioneer DFI
DFI	Development Finance Institution
ESD	Energy Services Delivery Project
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
ISGA	Interim Self Governing Authority
LSB	Licensed Specialized Bank
MIS	Management Information System
NDB	National Development Bank (of Sri Lanka)
PERC	Enterprise Reform Commission
REREDP	Renewable Energy for Rural Economic Development Project
SAP	Structural Adjustment Program
SME	Small and Medium Enterprise

## **Currency**

SL Rs. - Sri Lankan rupees

# Executive Summary

The DFCC, Sri Lanka's pioneer Development Finance Institution (DFI), completed 50 years of successful operations in 2006. Many similar institutions established in other parts of the world, most notably following World War II, have ceased to exist because they have become financially unviable. The DFCC is one among a small number of DFIs that not only has continued to remain viable, but also has been successful in transforming itself into a multi-product and robust financial institution.

Why and how did the DFCC succeed when other similar institutions failed? What did it do that others did not, and what did it do differently? What was unique in its structure or governance framework that may have enabled it to withstand more effectively the varied political and other pressures it may have been subjected to as a development-oriented institution that worked closely with the government? This study attempts to answer such and other similar questions, with a view toward learning lessons for the future.

The proposal to set up the DFCC was first mooted in Sri Lanka by the first World Bank mission, which visited the country in 1952. Having accepted the DFCC proposal, the government submitted a draft Act of Parliament to incorporate the institution for the approval of the World Bank. The latter had disagreed with the model proposed by the government and instead suggested the incorporation of a company under the Companies Ordinance. The unique structure that eventually took the form of the present-day DFCC was the compromise solution agreed on by the parties at negotiations that followed.

The DFCC became a legal persona via an Act of Parliament. The government had no direct shareholding in the institution; however, it provided a non-interest-bearing long-term loan twice to the institution equivalent of the initial paid-up capital. The Act provided for private sector shareholders with a board of directors elected by such shareholders. Although the government did not hold any share capital, it reserved for itself the right to nominate a director. The Act provided for two nonvoting ex officio directors, including the chief executive officer (CEO). All of the usual procedural practices characterizing a company, such as holding annual general meetings, passing special and general resolutions, and so on, were incorporated into the Act either directly or by reference to the companies ordinance.

Because the Act was a piece of legislation passed by parliament, it could be amended only by parliament. Thus, a unique situation emerged of an entity owned by private shareholders, whose shares could be transacted on the stock exchange, but whose objectives—or, for that matter, even simple provisions in its incorporating document—could not be changed by the owner shareholders.

The hybrid structure that resulted from the above provisions represented a desire, on the part of the government and the World Bank, to establish a public-private partnership that would extend the financial and other support for development activity undertaken by the private sector. The model recognized the pivotal role played by governments in most developing countries, particularly in the sphere of economic development. If the proposed institution was to play a critical role in the development process, it required the support and involvement of the government. Such support and involvement should not extend to operational decision making, however, because that held out the risk of bringing political bias as well as bureaucratic rigidity to operational decision making. Thus, many safeguards were built into the Act to ensure the operational independence of management. The presence of private sector shareholders ensured that the institution was operated on a

commercial basis. This meant that developmental projects, which would eventually receive the support of the institution, would not be purely charitable, welfare-oriented projects that did not answer the test of financial viability.

The DFCC commenced business in November 1955 with a paid-up capital of SL Rs 8 million. Business volumes in the early years were modest largely on account of the slow growth of the country's private sector that was constrained by socialist-inspired macroeconomic policies. Threats to market share from competition, the growth of the private sector following the introduction of pro-market macroeconomic policies, the installation of more dynamic leadership, the influence of foreign equity and technical partners, and so on infused more dynamism into the institution's operations in later years. Although consistently increasing lending volumes, during the past 50 years, DFCC has played a pioneering role in supporting new entrepreneurs, new investment ideas, and new sectors. It has expanded its product and service range to the extent that it can now provide a comprehensive package of financial products and services to its clientele. In doing so, it has contributed significantly to the widening as well as the deepening of the country's financial sector.

The DFCC has been one of the more profitable institutions quoted on the Colombo Stock Exchange. The share has been one of the most liquid stocks traded on the exchange. In terms of market capitalization, it has been consistently among the first five companies, and for a short period, it occupied the number one slot. The profitability of the organization and the attractiveness of the stock had enabled the DFCC to raise capital in times of need at a premium and to the extent required. By doing so, it has been able to support the large borrowings it secured for itself on concessionary terms for on-lending purposes. Its profitability has been healthy but not excessive. The return on equity and return on assets has been better than industry averages. The conservative dividend policy it has followed over the period under review has enabled the institution to build an equity base close to SL Rs 10 billion and more than six times the actual funds subscribed by shareholders.

Many lessons can be learned from the 50-year experience of the DFCC. Structuring institutions that are expected to deliver public goods poses many challenges. On the one hand, they require and deserve public or government support. By enjoying that support and by virtue of playing a public role, they tacitly obligate themselves to work within the macroeconomic framework of the government in power and, to that extent, function under the aegis of the government. Such an alliance with the government, however, should not lead to the politicization of the institution and the surrender of its operational independence. The challenge in structuring such institutions is to build in adequate checks and balances to safeguard its operational independence, while at the same time subjecting them to the developmental priorities of the government.

In many developing countries, the word "developmental" has come to mean welfare-oriented, subsidized, poverty-alleviating, and often unviable projects that cannot be funded by private capital. Developmental projects can be profitable and viable. In fact, they should be viable so that they may be sustainable. The unique structure of the DFCC as an institution brings together and harmoniously combines private ownership with public purpose. In doing so, it thereby imposes private sector norms and criteria in judging the success, or otherwise, of its operations regarding the delivery of public goods. The governance framework embodied in the DFCC Act is conceptually brilliant yet simple and practical.

The record of the DFCC demolishes the view that being developmental is incompatible with being profitable. Its 50 years' experience shows that the need to reward private capital can be satisfied, while at the same time employing such capital for financing developmental activity. The absence of

a single shareholder with a controlling interest and the efficacy of the checks and balances built into the incorporating statute to safeguard management independence have undoubtedly contributed significantly to the institution's success. The DFCC experience reaffirms that competition brings out the best in a person or an institution. Over the years, the institution has consciously transformed itself to meet the needs of an ever-changing environment. Several new financial products and services, including commercial banking, have been added to its product portfolio. From the country's point of view, however, its developmental role as defined in the original Act is still very much in demand and relevant. The challenge before it would be to retain that focus while continuing to build on its commercial success.



# Introduction

The DFCC, Sri Lanka's pioneer Development Finance Institution (DFI), completed 50 years of operations in 2006. The significant contribution it has made to the development of the economy of Sri Lanka has been well documented on several previous occasions, including when it celebrated its 25th and 40th anniversaries. Updating those documented accomplishments, perhaps for posterity, is not the primary purpose of this document. Such accomplishments are discussed in fair detail, however, in the third chapter of this report (but only incidentally). This information is included in the course of examining several fundamental issues that arise from the fact that DFCC is one of the few DFIs that has not only survived but also done well in commercial terms for itself and for its private sector shareholders, while fulfilling the broad developmental purposes for which the institution was formed.

The DFCC belongs to a category of institutions called DFIs, many of which were created following World War II for the principal purpose of rebuilding the war-devastated economies. These institutions were sponsored by governments or donors for the provision of term financing for developmental projects. In the words of Mr. William Diamond, the father of development banking, "by and large the principal activity of the appraisal of investment proposals and the monitoring of investments after they are made, became the core of the Development Bank's work".

Around 60 percent of DFIs around the world were owned by the governments of their respective countries. Another 25 percent were privately owned, while the balance (15 percent) has a mixed ownership. Irrespective of ownership, however, it is evident that all of the DFIs have received some form of assistance from their governments. The justification for such assistance came on the basis that DFIs filled a void created by a failure of the market and that they were an essential instrument in promoting and financing development. This led to the paradoxical situation that although many of them were privately owned and mandated to serve the private sector, they were viewed as quasi-government institutions and expected to behave in the public interest.

The negative effects of the close association with governments became pronounced in the case of many DFIs, especially those that were owned by governments. The continued dependence of these institutions on the government (1) for its resources for lending and (2) for subsidies to maintain profitability of operations and increase portfolio infection ratios that arose from behest lending not only created unhealthy market distortions but raised the question of the appropriateness of the DFI model in the context of a liberalized global financial market. A significant number of DFIs have failed to provide an acceptable return on the funds invested. The portfolio quality of some among them has deteriorated to such an extent that the viability of the institutions is threatened. There are others whose continued profitability depends on governmental subsidies of one kind or another.

Institutions function in an ever-changing dynamic macro environment. Globalization has increased the pace of such change. The success or, at a minimum, the very survival of any institution depends on its ability to adapt to such changes and to reinvent itself from time to time. Only a few DFIs have been able to do so, and the DFCC is among those that have done so successfully. The purpose of this study is to examine the incorporating statute, governance framework, policies and procedures, and checks and balances built into its corporate model. Identifying the factors that have contributed to its success is one of the many ways to celebrate the DFCC's 50th anniversary.

The results of this study are organized and presented in four chapters. The first chapter deals with

the birth of the institution, the rationale for its establishment, its legal form, and the debates that preceded the selection of that legal form. The chapter also discusses significant changes in the macro environment during the 50 years of its existence and the impact of those changes on the growth of the institution.

Chapter 2 deals with the governance framework and how the dynamics of the relationship among the principal stakeholders changed during this 50-year period. The interplay of pressures from the government and the private sector, the extent to which the institution catered to development priorities set by the government while also preserving its operational independence, the stresses to which the governing structures and their composition were subjected to at different times, and how they coped with such stresses are among the matters that are addressed in this chapter.

Chapter 3 focuses on an issue that comes up perennially in developing countries. That is, to what extent, if any, does the private ownership of an institution and the resulting pressures by such owners to earn a return on their investments stand in the way of the institution to perform a developmental role? In other words, are the words “profit” and “development” mutually exclusive? Has the DFCC played a developmental role and fulfilled its objectives despite its private ownership? Would it have performed its developmental function better if it were government owned?

Chapter 4 relates some unique features of the model, its functioning policies and procedures, the governance framework, the checks and balances inherent in its constitution, and its operational procedures and its demonstrated ability to change itself and adopt to new conditions as well as to withstand the many threats and obstacles it has faced during the past 50 years. Particular attention will be placed on lessons that can be drawn from the structuring of institutions that have some form of public accountability arising from their particular line of business, and on the connection these institutions have with the mainstream developmental process of the country, although owned by private individuals.

# Chapter 1

## Conception, Birth and Growth

The first World Bank mission in 1952 to the newly independent “Ceylon,” as it was then called, is credited with identifying and articulating the need for establishing a Ceylon Development Corporation. Its main purposes are as follows: (1) to provide the financing necessary to initiate new projects in industry, agriculture, or miscellaneous business; (2) to assist the progress of promising ventures already started by individual enterprise; and (3) to furnish or arrange for managerial and technical assistance to new ventures or to others in need of such assistance. The 12-member mission was led by Sir Sidney Cain, KCMG, who stated in the final report that the proposed institution would be “a pioneering agency, charged with giving the primary impulse to economic expansion in productive fields where private enterprise was lacking or laggard.”

The report identified certain features that it considered essential if the institution was to fulfill the objectives assigned to it. These objectives were (1) freedom of initiative, the ability to explore all avenues of economic development; (2) independent and secure finances, that is, adequate long-term funding and independence in their use; and (3) spirit of vigorous enterprise, that is, the vigor that any pioneering work requires.

To ensure that the aforementioned features were embodied in the structure of the new institution, the mission recommended the following:

- The corporation should be an autonomous body with an independent management, free from the inflexibility of government financial and civil service regulations, as well as from arbitrary interference with management.
- Its capital, amounting to a total of SL Rs 100 million, should be raised by the joint participation of the government, the Central Bank, the commercial banks, and possibly the investing public. No single participant should have a controlling interest. Further funds, if and when they become necessary, might be raised by the sale of bonds to the public or to overseas institutional lenders.
- Officers and staff of the corporation should be appointed and promoted solely on the basis of competence. This should be a permanent policy, which means that the administration should enjoy complete freedom to hire and fire without outside interference. Furthermore, to attract a capable staff, salaries should be adequate and work conditions should be superior.

The proposal to establish the Ceylon Development Corporation was one of three main recommendations made by the mission. The other two recommendations were proposals to establish an Economic Planning Secretariat and an Institute for Applied Research. The three institutions were to be complementary to each other in that the Economic Planning Secretariat was to assist the Economic Committee of the Cabinet in coordinating the development planning as a whole, supervising the necessary general surveys, and coordinating requests for external technical advice. The Ceylon Institute for Applied Research was to function as a competent organ of technical research and inquiry. The Ceylon Development Corporation, the executive financial arm, was to promote and carry out, in partnership with the private sector, specific projects of a commercial nature.

The report had repeatedly emphasized (1) the need for the proposed Ceylon Development



Corporation to be an autonomous institution, and (2) the importance of carefully selecting the staff for the new institution. The mission was clear regarding the nature of the institution, whose establishment it proposed. The Corporation was to be an institution sponsored, established, and supported by the state, for the purpose of performing a public or quasi-public function, and was to be professionally managed.

The need for an institution such as the DFCC arose from a perceived gap in the institutional infrastructure pertaining to the financing of industrial and investment projects. Defined carefully, this gap existed not only in the absence of institutional sources for long-term financing, but also in the absence of institutional assistance in the structuring of industrial projects, measured risk-taking, entrepreneurship development, and the identification and formulation of pioneering ventures. The DFCC was one of three institutions recommended by the World Bank mission to close that gap. The commercial banks operating in the country focused on providing the short-term working capital needs of production units. Their intervention in the term lending market was minimal, sporadic, and inconsistent.

The late Dr. J.B. Kelegama, an economist held in high esteem, contributed an article to *The Ceylon Economist* (vol. 3, no 1, September 1954) entitled “A Development Corporation for Ceylon,” and referred to the prevailing situation in the following manner:

Thus we have in Ceylon a situation where short term capital is available for economic development, but long term capital is in short supply. This is the well-known “Macmillan Gap” which assumes greater proportions in under developed economies as that of Ceylon. At the present stage of her economic development, it is mainly long term capital that is required by private enterprise in the country.

Dr. Kelegama also identified the other aspects of the perceived gap, referred to above, which the new institution was expected to fill:

The number of persons able to provide entrepreneurial judgment, managerial skill, and technical advice are quite limited in Ceylon. One advantage of the Development Corporation is that it offers the possibility of making available a pool of such resources for use in several fields. This is specially the contribution of the Development Corporation. The ability to conceive, plan and put into operation various investment projects is a much more limiting factor in the country than the amount of financial resources available. The decisive factor may well be the business leadership and stimulus provided. This places a special responsibility therefore on the Directors of the Development Corporation and its technical staff.

The needs or gaps identified by and articulated so well by Dr. Kelegama reemphasize the essential characteristics that the new organization should possess if it was to effectively close the gaps.

## **Negotiations with the World Bank**

The government accepted the recommendations of the World Bank mission and proceeded to take steps to establish the proposed institution. In line with the practice normally followed in setting up an entity sponsored by the state, it drafted an Act of Parliament for the incorporation of the proposed Development Corporation. Mr. William Tennekoon, former chairman of the DFCC, contributed a message to a commemorative publication marking the DFCC’s 25th Anniversary and explained how the draft bill finally saw the light of day:

Having been closely associated with the Corporation in the early years and for many years thereafter, initially with the negotiations for setting up the DFCC and subsequently as the government Director in the late fifties and early sixties, and, currently as Chairman of The Board of Directors (since August 1974), it would be appropriate to relate briefly the early history and later developments of the Corporation.

The World Bank mission that came to Sri Lanka in 1952 recommended, among other things, the setting up of a Development Corporation to finance the industrial development of Sri Lanka (then Ceylon). The government, on accepting this recommendation sent the late Mr. Raju Coomaraswamy, then Assistant Secretary of the Ministry of Finance, to Washington in 1955 to get the approval of the World Bank for the Draft Bill. I was able to assist Mr. Raju Coomaraswamy in the negotiations being at the time an alternate Executive Director of the World Bank.

The World Bank team consisting of two senior officials refused to negotiate on the basis of a draft bill but instead wanted the government to set up the Development Finance Corporation as a company and have it registered under the companies' ordinance.

We then met the President of the World Bank, Mr. Eugene Black to whom we propounded the reasons why it was more appropriate to set up the Corporation by an Act of Parliament in a developing country. Having listened to our arguments Mr. Black invited an outside expert, to examine the draft Bill. The expert, while agreeing to the principle of the Government setting up the DFCC under a special Act, suggested certain amendments to the draft Bill, which, when cabled to the government, were approved. The World Bank then agreed to assist the DFCC and give foreign exchange loans for its operations.

From the quote above it is apparent that the issue of the proposed institution's relationship with the government was the subject of debate right from the time of its birth, or more correctly, even before the birth of the institution. The arguments adduced by the two senior officials of the World Bank for establishing the institution under Companies Ordinance, and the counterarguments adduced by the delegates from Ceylon for incorporating the institution under an Act of Parliament, are now a matter for conjecture. The principal actors involved in that debate are not among the living, but not much imagination is required to list them, and they have been articulated eloquently time and again.

The case for establishing the institution under the Company's Ordinance was based on the need to distance the institution from possible political interference in the conduct of its day-to-day commercial operations. The institution was set up exclusively to serve the needs of the private sector and, as such, its establishment under the company's ordinance would have sent a strong signal as to where it truly belonged and how it should have functioned.

On the other hand, the case for incorporation under an Act of Parliament would undoubtedly have been based on the premise that, in a developing country, the government is in the forefront of the economic developmental process, with the private sector being weak and still in a nascent stage of development. Its incorporation via an Act of Parliament would have given it the status of being seen as an intrinsic part of the mainstream economic development process. This viewpoint is supported by Mr. Tennekoon's remarks, which explicitly state that the arguments adduced by them, in support of establishing the institution via an Act of Parliament, were based on the premise that such an option was the more appropriate one in a developing country.

## Unique Structure

Although the negotiations resulted in a decision to incorporate the institution via an Act of Parliament, some specific clauses introduced features typical of a company structure, which makes the DFCC a unique and a somewhat hybrid organization. Thus, for instance, section 11 of the Act requires the board to make regulations on matters that would normally be dealt with in the Articles of Association of a company formed under the Companies Ordinance. Section 12 makes the provisions of the Companies Ordinance applicable on matters not provided for in the Act or the Regulations, but dispenses with the requirement of registration under the Ordinance and removes the jurisdiction of the Registrar of Companies over the affairs of the institution.

The Regulations accordingly provide for the holding of an annual general meeting, submission of annual audited accounts to shareholders, the passing of shareholder resolutions, the election of directors by the shareholders, and so on. These provisions effectively, and in no unmistakable terms, introduce the principle of the DFCC's accountability of management to the board, as well as to shareholders, which is the hallmark of the governance framework in a company structure.

It is unlikely that the original draft bill prepared by the legal draftsman in Ceylon would have contained provisions that introduced company features into the working of a corporation that was to perform a quasi-public function. These provisions in all probability were introduced at negotiations with the World Bank, as a compromise to the latter's request to incorporate the institution itself under the Companies Ordinance. The significance of these provisions will be discussed further in chapter 2.

## The Act of Parliament

The draft legislation entitled "An Act to provide for the establishment of The Development Finance Corporation of Ceylon and for matters connected therewith" was presented to parliament on September 6, 1955, and subsequently passed into law.

The Act provided for a share capital of SL Rs 8 million divided into 80,000 ordinary shares of SL Rs 100 each. These shares were to be offered to the public for subscription at the discretion of the Corporation. Furthermore, the Corporation could not commence business until at least 60,000 shares had been fully subscribed and allotted. It took a while for this minimum subscription to materialize, probably because the share was seen as unattractive from a return point of view. The Central Bank used some gentle persuasion to prod the leading British and Indian banks and insurance companies to make an investment. The initial shareholders of the Bank were institutions such as the National Bank of India (5,000 shares), Indian Overseas Bank (1,000 shares), National Mutual Life Association of Australia (1,000 shares), the Hong Kong and Shanghai Banking Corporation (4,000 shares), Grindlays Bank (1,000 shares), Eastern Bank (2,000 shares), the Chartered Bank of India, Australia, and China (5,000 shares), The Mercantile Bank of India (3,000 shares), The Commonwealth Development Finance Company (3,250 shares), and the Bank of Ceylon (2,8000 shares). The only local Bank, the Bank of Ceylon, was persuaded to take up approximately 35 percent of the initial paid-up capital. In addition to the institutional shareholders, a few individuals purchased a few hundred shares.

## Capital Structure

The capital of DFCC at inception was SL Rs 8 million divided into 80,000 shares of SL Rs 100 each. In June 1993, the par value of the share was changed to SL Rs 10, thereby increasing the number of shares in issue. It is significant that the government did not subscribe to the share capital of the DFCC at inception or at any time thereafter.

The government, however, supported the new institution with an interest-free loan of SL Rs 16 million (twice the initial capital), which was repayable over a 30-year period, which included a 15-year grace period. The applicable terms clearly revealed that the loan was, in fact, quasi-equity and was structured to give the new institution the status of a private sector institution. The grace period of 15 years was later (1967) extended to 25 years.

Foreign loans obtained by the DFCC were to be guaranteed by the government, and the exchange risk on such loans was also to be borne by the government. Incidentally, the Cain mission of the World Bank did envisage a mixed (state and private sector) ownership for the new institution they proposed.

## The Board of Directors

Section 10 of the Act provided for a board of directors composed of a government-nominated director, two ex-officio directors, and a minimum of four (subject to a maximum of six) shareholder directors. The government director was to be nominated by the minister for finance, in consultation with the minister of industries, housing and social services, only so long as there were any outstanding loans made by the government to the Corporation. The two ex officio directors were the holder of the office of director of The Ceylon Institute of Scientific and Industrial Research (CISIR), and the general manager of the DFCC. The ex officio directors had no voting rights.

The initial shareholder directors were to be appointed by the minister of finance. One of them was to retire at the end of each financial year to be replaced by a director elected by the shareholders.

The chair was to be elected by the board of directors from among the shareholder directors. All directors had to hold 50 shares as qualification shares either in their name or in the name of a company partnership they represented. The first directors of the new institution were Mr. J. A. Martenze, Mr. E. R. G. Edward, Mr. C. Nadesan, Mr. H. Watson. Peiris, Mr. Richard Peiris, and Mr. N. E. Weerasooriya.

The first directors were all shareholder directors initially nominated by the minister of finance. Mr. D.W. Rajapathirana was the government-nominated director and Dr. Francis Godwin was the ex-officio director from the CISIR. Mr. W. T. Yoxall joined the board as the other ex officio director when he assumed office as the chief executive officer (CEO) of the DFCC in April 1956. Mr. Martenze, who was a lawyer by profession, an appointed member of parliament, and the deputy chairman of committees in Ceylon's first parliament, was elected the first chairman of DFCC.

The first board comprised professionals, industrialists, and outstanding personalities from the business community, setting a precedent that was to be followed throughout the years to come. The list of past directors of the DFCC represents myriad personalities who have held leadership positions in the fields of business, commerce, and finance during the past five decades in Sri Lanka. This was true of both the elected directors as well as the nominated directors. Why this was so, when many other financial institutions under the influence of the government in power had to accommodate people with known political leanings, is a matter that will be discussed in chapter 2.

## The Appointment of Auditors

The Act provided (section 16) that the accounts of the DFCC will be audited by two qualified auditors, annually appointed by the shareholders. This provision is significant, because it dispels any doubt as to the private sector status of the new institution. It is also in contrast to the parallel provisions in the statutes setting up the state banks for which the auditor of the books of accounts is the auditor general.

## Commercial Operations

The DFCC commenced commercial operations on November 9, 1955. The first facility was granted in June 1956. As an institution serving the industrial sector, the growth of its business and lending operations depended heavily on the growth of the economy in general and the industrial sector in particular. DFCC, by its incorporating statute, was mandated to exclusively serve the private sector. Thus, its fortunes and growth were directly linked to the growth of the private sector in the country. Looking back at the past 50 years, we can discern distinct periods during which the macropolicy framework favored the growth of the private sector in contrast to other periods during which the state sector was encouraged to play the lead role in the economy. It is not surprising to find a direct correlation between the periods of growth or dormancy of the DFCC and the changes in the macroeconomic climate.

### 1956–1965

The election held in 1956, the year after DFCC commenced commercial operations, saw the installation of a government enthusiastically supported by nationalistic forces that were awakened during the election campaign. The new government's economic policies were inspired by the Soviet model, characterized by central planning and the control of the commanding heights of the economy by the state sector. DFCC, which was established to exclusively support the private sector, found that it had lost its relevancy almost overnight. A policy regime of import-substituting industrialization, which was supported by licensing, high protective tariff levels, price controls, and import and exchange controls, followed. Many of the large import-substituting industries were state owned and therefore fell outside the defined target market of the DFCC. In an attempt to align itself with the prevailing policy regime, an amendment to the DFCC Act, defining a "private industrial or agricultural enterprise" as one in which the government holds not more than 20 percent of the capital, was passed in February 1958. However, the effect of the amendment on business volumes does not appear to have been significant. During the nine years leading up to 1965, the DFCC had assisted only 60 undertakings in an amount approximating SL Rs 38 million.

The deteriorating investment climate in the country and its effects on the flow of foreign direct investment (FDI) to the country was the subject of comment by the chairman in his annual report presented to the shareholders in 1965:

At the very beginning of your Corporation's existence in 1956, private foreign capital supported the economic development of this country by subscribing generously to your Corporation's shares. During the five to six years immediately succeeding, it continued to show its faith in the future of the country by participating in a number of projects, several of which have been essentially successful. During the last two to

three years however, mainly as a result of the steady deterioration that has been taking place in the investment climate in the country, there has been a noticeable reduction in the ventures in which foreign capital participation was a feature. It is my earnest hope that the government will adopt early measures to improve the investment climate and stimulate the flow of foreign capital into the country, specially, at the present time when the tempo of our industrial growth is seriously threatened by the acute shortage of foreign exchange.

In 1961, the Bank of Ceylon, which was the largest bank in the country by any measure, was nationalized. The Bank of Ceylon was the largest single shareholder of DFCC. With the change in its ownership, the government indirectly became the largest single shareholder of the DFCC. A few years later, the insurance industry was nationalized, resulting in the indirect holding of government increasing to approximately 45 percent. Nearly 61 percent of the profits earned by the institution during the first nine years of its operations were paid to the government by way of taxation. Dividends paid to shareholders approximated to 20 percent of the profits, while the balance was retained as reserves. The average annual return on the share capital invested by shareholders was less than 2 percent.

The decade following the establishment of the institution was not the best for the institution, nor was it the kind of period that the board and the management of the DFCC would have wished for this new institution.

## **1965–1970**

At the elections held in 1965 a government, more supportive of the private sector, was elected. The new government introduced policy reforms, with a view toward resuscitating the economy. A dual exchange rate was introduced and imports were liberalized. The dual exchange rate was designed to give a significant boost to nontraditional exports, while a general devaluation of the currency was simultaneously introduced to provide incentives for exports in general. Although supported by the international financial institutions, the enhanced resources made available were inadequate to sustain the liberalization attempt, compelling the government to resort to commercial borrowings. This, in turn, created serious balance-of-payment problems. The brief flirtation with liberalization policies ended with another change of government at the elections that followed in 1970.

Despite the unsuccessful attempt to liberalize the economy, the DFCC performed better during this period. A successful share issue concluded in 1966 and raised the paid-up share capital to SL Rs 8 million. The Bank of Ceylon divested a little more than 40 percent of its holding in the corporation in the following year. These developments resulted in the indirect shareholding of the government falling to 25 percent by the end of 1967.

Negotiations with the World Bank to obtain a loan in foreign currency for relending commenced in 1966. The facility was finally approved in 1968. The credit line enabled DFCC to provide much-needed foreign currency to industrialists for the importation of machinery and equipment. During this period, the government provided fiscal and other incentives to the tourism sector with a view toward promoting Sri Lanka as a tourist destination. The DFCC played a lead role by assisting and financially supporting local entrepreneurs who responded to the government's incentives by setting up star-class hotels on the island. As a result of the improved macroeconomic climate, and the positive response of the private sector, DFCC's portfolio recorded a healthy growth from SL Rs 38 million at the end of the financial year 1964/65 to SL Rs 58 million as of March 31, 1970.

## 1970–1977

The state sector-led, import-substituting industrial policies of the post-1956 period were given another lease on life during this period. Quite apart from policy considerations based on its political beliefs, the continuous fall in the terms of trade and a deteriorating current accounts deficit compelled the government to introduce more and more controls and restrictions. The plantations were nationalized and their management was vested in two large government-owned corporations. A Business Acquisition Act was introduced into the statute book which hampered private sector development. These and similar restrictive measures resulted in the creation of an inward-looking economy, with little scope for private enterprise.

During this period, the DFCC remained the only source of foreign exchange to industrialists who wished to import machinery and equipment or essential spares. Foreign currency lines of credit, obtained by the DFCC from multilateral agencies such as the World Bank for the purpose of relending, required a guarantee of the government. The DFCC Act authorized the government to provide such guarantees. As a quid pro quo for providing such guarantees, and considering the pivotal role played by the DFCC in the disbursement of these funds to the industry, the government, deemed it necessary to exercise some form of control on the affairs of the corporation. The presence of one government director on the board was considered insufficient from a control point of view. Accordingly, the DFCC Act was amended in 1972 to—

- Provide for the appointment of an additional director (named the Appointed Director) by the minister in charge of the subject of industries. This was in addition to the right already vested with the minister in charge of the subject of finance to nominate a director (named the Government Director). It must be noted that the nomination of the Appointed Director was not subjected to any limitation, similar to that applicable when nominating the Government Director, that is, that the power to appoint the government director could only be exercised so long as there were outstanding loans made by the government to the Corporation.
- Provide for the minister in charge of the subject of finance the power to, in consultation with the board of directors, from time to time, issue general directions in writing, to the board, on matters of policy, and the board of directors shall give effect to such directions.
- Render the election of a director from among the shareholder directors as the chairman of the board of directors, by the other directors, ineffective unless approved by the minister in charge of planning and economic affairs.

These amendments, reflected the political ideology and the economic development strategy of the government. They were not, however, in keeping with the independence, which the original promoters of the institution attached much importance to and strived hard to build into its structure and operational procedures. At this stage, many people may have wondered whether the interests of the institution would have been better served if it had been set up under the Companies Ordinance, as proposed by the World Bank officials during the initial negotiations.

It appears that the inclusion of the clause empowering the minister in charge of the subject of finance to issue directions to the board was inspired by a similar provision in the statutes incorporating the People's Bank and the Bank of Ceylon. Significant changes in the wording of the clause, however, points to a tough debate between the ministry and the board and management of the DFCC, which likely preceded the decision to include the clause in the amending legislation. The relevant clause, identical in both Acts (People's Bank Act no 29 of 1961 and the Bank of Ceylon Ordinance of 1938) reads as follows:

The Minister may from time to time give general or special directions in writing, to the Board of Directors as to the performance of the duties and the exercise of the powers of the Bank and it shall be the duty of the Board to comply with such directions (clause 33 of the Bank of Ceylon Ordinance and clause 42A of the People's Bank Act).

The following significant differences can be seen in the wording of the above clause when compared with the wording in the amending clause introduced into the DFCC Act:

- The amendment to the DFCC Act includes the words “in consultation with the Board of Directors,” that is, the minister can issue directions only in consultation with the board of directors of the DFCC. No such obligation is cast on the minister in the case of the Bank of Ceylon and the People's Bank.
- The directions could only be “General directions on matters of Policy” in the case of the DFCC, while the clause in respect of the two state banks included the power to issue special directions in addition to general. Such powers were not restricted to matters of policy but extended by implication to operational matters as well.

The above are significant differences that in all probability were introduced on representations made by the board of directors and the management of the Corporation. It is also of interest to note that the Act of Parliament, which incorporated the National Development Bank (NDB) of Sri Lanka seven years later as a state-owned Development Bank, included the identical clause found in the legislation relating to the two state banks. The distinguishing feature was the ownership of the three institutions (the People's Bank, the Bank of Ceylon, and the NDB) by the Government.

The operations of the DFCC, during this period, reflected the restrictive environment for private enterprise that prevailed in the country. In fact, the lending portfolio dipped from SL Rs 62.8 million as at the end of financial year 1970/71, to SL Rs 58.1 million at the end of financial year 1973/74. By the end of the financial year 1976/77, the outstanding portfolio stood at SL Rs 99.8 million, registering an average annual growth of less than 10 percent during the seven-year period.

## 1977–1994

The elections in 1977 brought about yet another change of the government in office. The government, which won a landslide victory at this election, introduced a sharp turnaround of the economic policies adopted by the previous regime. A trade-liberalizing package, which included the simultaneous removal of licensing and quotas, drastic reductions in tariffs, and the removal of nontariff barriers, was introduced. The two-tier foreign exchange rate system was replaced with a unified exchange rate linked to a basket of currencies in what was termed a managed float. Simultaneously, the rupee was sharply devalued.

Regarding industrial policy, an export-oriented industrialization regime replaced the import-substituting strategy. FDI was encouraged with tax holidays and other incentives, and a free trade zone was established within which normal exchange control laws did not apply. Private enterprise was actively promoted while existing state-owned enterprises were selectively privatized. Subsidies were pruned back while price controls were removed. Imports were liberalized and capital and intermediary goods were brought under a lower tariff band. Government expenditure on infrastructure development and housing was substantially increased and the implementation period of large infrastructure projects was contracted. Public capital expenditure, which averaged approximately 6.5 percent of the gross domestic product (GDP) in the 1970/77 period, increased to approximately 18.5 percent in 1980.



Following the opening up of the economy, GDP growth during the first five years (1978-83) averaged 6 percent. The growth in 1978, the first year after liberalization was 8.2 percent, almost three times that of the previous year. The unemployment rate had halved by 1983.

However, the rapid growth recorded during this period was the short-term effect of the unprecedented level of public expenditure incurred by the government. The massive investments in infrastructure projects, which had long gestation periods, resulted in double-digit inflation. Rising interest rates dampened private investment. In addition to the above, there was a sharp decline in the terms of trade. The cumulative decline during the period from 1978 to 1982 was 62.3 percent. With a view toward curbing strong inflationary tendencies, the Central Bank imposed a credit ceiling on all commercial banks in May 1981. In August of the same year, the bank rate was increased to 14 percent and the penalty rates were raised within a range of 21 to 35 percent. The balance of trade as well as the current account recorded increasing deficits. The external debt increased by almost 50 percent while the debt service coverage ratio rose to above 16 percent of GDP. In 1987, there was a visible slowdown in the economy with the growth rate falling to a low of 1.5 percent in 1987.

Despite the downturn in the economy, the ruling party retained power at the elections held in 1989. This was a period of great political turmoil. The election itself was held under tense conditions. Many attributed the victory of the ruling party, in large measure, to a commitment made during the campaign to introduce an extensive safety-net program, popularly referred to as the Janasaviya program. The new government commenced its term in office by introducing a Structural Adjustment Program (SAP), the highlight of which was an accelerated privatization program. Although the poverty alleviation program announced during the election campaign was watered down when implemented, it nevertheless resulted in budgetary transfers to households amounting to 23 percent of total revenue and 5 percent of GDP in the 1990–94 period. The conflict in the north and east had escalated during this period, necessitating heavy defense expenditure. Among the large number of privatizations effected during this period was the vesting of the management of the plantations owned by two large state corporations in 22 private sector companies.

The energetic and rigorous implementation of the SAP resulted in much improved economic conditions. This period, often referred to as the second wave of liberalization, was characterized by strong political leadership, although the governance record of the government during this period raised many questions. The average growth rate during the period from 1990 to 1993 rose to 5.5 percent. The debt-service ratio declined, while the country's net external assets doubled from an equivalent of three and a half months of imports during the 1983–89 period to six and a half months during the 1990–93 period. The unemployment rate also declined to 14 percent by the end of this period.

The post liberalization period from 1977 to 1994 can be broken down to three sub periods, which are as follows:

- The 1977–82 period immediately following the liberalization of the economy, during which most of the benefits arising from the liberalization exercise were enjoyed,
- The 1983–89 period when the economy slowed down, with inflation and unemployment rising once more. The benefits of higher capacity utilization experienced immediately following the opening up of the economy had worn off by this time. Despite these developments, growth continued to remain above 5 percent for the first three years of this sub period. But thereafter, it started to decline and ended in 1987 with the lowest growth rate for the entire post liberalization period (1977–94).

- The 1989–94 period, during which the economy registered a recovery. The privatization of a large number of state-owned enterprises including the plantations figured prominently during this period.

How did the DFCC fare during this period? It was no surprise that the DFCC welcomed the radical measures taken by the government to liberalize the economy. In a report to the shareholders at the 22nd Annual General Meeting held in August 1978, the chairman referred to the change of direction by the new government in the following manner: “The events of July 1977 laid the political groundwork and the Budget in November 1977 set out the outline of the new economic framework.”

As expected, there was a significant spurt in the lending operations of the DFCC immediately following the opening up of the economy. Facilities approved yearly, which were SL Rs 79.8 million in 1978 increased to SL Rs 253.8 million by 1982. The profit after tax of SL Rs 2.4 million in FY 1977/78 had increased to SL Rs 18.2 million in 1982. The loan portfolio, which stood at SL Rs 146.5 million at the end of FY 1977/78, increased to SL Rs 470.7 million by the end of FY 1981/82.

The paid-up share capital of DFCC was doubled to SL Rs 16 million by a successful public share issue in 1977. The share capital was further increased to SL Rs 24 million in 1979. A significant development, which took place simultaneously with the second share issue, was the admission of three reputed international financial institutions as shareholders of the DFCC. These shareholders included the International Finance Corporation, a subsidiary of the World Bank; the German Development Bank, KfW Bankengruppe; and the Dutch Development Bank, FMO. In fact, 60 percent of the second share issue was taken up by the FMO.

It is noted above that the seven-year period (1982–89) following the first subperiod (1977–81) saw a downturn in the economy. Gross approvals of facilities by the DFCC in 1982 (SL Rs 56.1 million) fell drastically when compared with that in the previous year (SL Rs 253.8 million). The profit after tax also dropped similarly from SL Rs 18.2 million in FY 1981/82 to SL Rs 15 million in FY 1982/83. Thus, in the first year of the downturn, we saw a corresponding dip in the business volumes conducted by the DFCC. That trend was reversed in the following years. This may have been largely due to the fact that growth continued to remain above 5 percent, despite other unhealthy trends in the economy such as inflation, deteriorating terms of trade, and so on. The dip in volumes in 1983 may have been more directly linked to the civil disturbances and the political uncertainties than to macroeconomic factors. The loan portfolio of the DFCC grew from SL Rs 569 million at the end of 1983 to SL Rs 1.8 billion at the end of 1988. The profit after tax grew almost fourfold during the same period.

The economy recovered somewhat during the period following, (1989–94) largely as a result of the reforms vigorously pursued and implemented during this period. The growth rate, which was only 2.3 percent in 1989, stepped up to 6.1 percent in the very next year and even touched 6.9 percent in the year 1993. The average for the period was approximately 5 percent. The approval of facilities by the DFCC increased significantly during this period. Total approvals, which stood at SL Rs 1.3 billion in 1989, increased to SL Rs 9.2 billion in 1994. The portfolio increased nearly 400 percent, while profit after tax increased from SL Rs 112 million in 1989 to SL Rs 691 million in 1994, an increase in excess of 500 percent.

An event of great significance not only to the DFCC but to the financial sector itself was the launch of the first unit trust in the country in December 1991. In fact, the period under review witnessed the launch of several new entities under the leadership of the DFCC, thus expanding its range of products and services. These entities included Lanka Ventures Ltd in February 1992; HDF Securities Ltd, a securities brokering firm in November 1992; and the Lanka Industrial Estates Ltd in the same

year. The DFCC recorded the highest profit after tax among all listed companies for the year ending March 1992. It also recorded the highest profits in terms of market capitalization among all quoted companies in August 1993.

## 1994–2000

The presidential election held in August 1994, following the assassination of President Premadasa in May 1993 and the interim presidency of President Wijetunga, witnessed yet another change of the ruling party. The presidential election was followed by a general election held in November 1994, when the party represented by the new president captured power in the legislative assembly as well. The successful election campaign was conducted on the slogan an “open economy with a human face,” heralding an era during which the two major political forces in the country for the first time committed themselves to an open economy. The “human face” part of the slogan was used to differentiate its open economy model from the model that prevailed earlier. It held out a pledge to distance itself from the governance record of the previous regime as well as a promise to cushion the effects of the open economy on the lower strata of society.

Some of the major decisions relating to the economy implemented during this period were the creation of the Public Enterprise Reform Commission (PERC), which undertook and accomplished the privatization of the telecommunications industry, and the introduction of the value added tax in place of the general sales tax.

On the political front, the new government, succeeded in bringing about a cessation of hostilities in the north and east, although it was short-lived. Hostilities resumed once again in April 1995. This period witnessed heightened hostilities, resulting in greater loss of life and property. The attacks on the Central Bank, Stock Exchange, Colombo and Port during this period caused much damage to the economy as well. The government responded by increasing the budgetary allocations for defense, which at this time accounted for 6 percent of the GDP.

The presidential election was held in December 1999, amidst these unsettled conditions, and the incumbent president won the election.

Despite the heavy expenditure on the military, economic growth averaged 5 percent during this period. Large budget deficits and heavy domestic and foreign borrowings, however, were sustained. A significant increase in the international price for oil in the year 2000 escalated the problems to crisis proportions. By this time, public debt as a percentage of GDP had reached 100 percent. The government was forced to seek a standby facility from the International Monetary Fund (IMF) to overcome the crisis.

Business volumes at the DFCC registered a healthy growth during the initial years of this period. Approvals, which stood at SL Rs 7.3 billion in FY 1995/96 rose to SL Rs 11.5 billion in FY 1998/99. The crisis situation in the macro economy that developed by the year 2000, however, had an impact on the operations of the DFCC as well. Thus, approvals in the year 2000 dropped to SL Rs 8.4 billion.

Another important development during this period was the amendments to the Banking Act in 1995 that, among other things, categorized the DFCC as a Licensed Specialized Bank (LSB) along with the NDB and the National Savings Bank. This resulted in the Development Finance Institutions (DFIs) falling under the regulatory umbrella of the Central Bank of Sri Lanka and the progressive introduction of the prudential requirements that previously were applicable only to the commercial banks. The restricted license only permitted the DFIs to accept deposits that were not payable on demand. DFIs

could not act as authorized agents for foreign exchange, which was ironic because the DFIs had greater access to long-term foreign currency loans provided by bilateral and multilateral institutions. Another by-product that had an impact on the DFIs was the introduction of the 90-day rule for classification of nonperforming loans, whereas the DFIs previously followed a 180-day rule in accordance with accounting standards. What prompted the policy makers to take this step at that stage is not known, because neither of the DFIs were taking significant public deposits at the time nor were they a part of the payment system. It is fair to say that this move on the part of the policy makers did impose a requirement on the DFIs to take fewer project risks when selecting projects for financing.

Although a free float of the rupee was announced by the government, many other administrative controls introduced simultaneously rendered the free float meaningless. These controls included the imposition of restrictive conditions via the banks on forward sales and purchases of currency by clients, settlement of export loans from export proceeds within 90 days, and pre-settlement of import loans. Thus, although the free float was enacted to adjust the exchange rate so that interest rate pressure would ease, that result did not materialize. The IMF package negotiated by the government at this stage brought some relief, but that relief turned out to be temporary. The pressure on interest rates and exchange rates continued. At the same time, a new constitution incorporating provisions that held out a greater degree of devolution to the periphery was introduced in Parliament.

## **2001–2005**

At the elections held in December 2001, the opposition party secured power. The new government set about the task of reviving the economy, which for the first time in the postwar period had recorded a negative growth rate in the year 2001. The government gave high priority to the task of negotiating a cease-fire with the Liberation Tigers of Tamil Eelam (LTTE). A formal agreement was signed in February 2002. The cease-fire gave much relief to the general public and a sense of optimism to businessmen. The peace dividend, which was expected as a consequence, did not materialize for the people in the south and less still for the people in the north. The new government recommenced the implementation of the SAP that had been virtually abandoned by the previous regime during its last few months in office. Accordingly, unpopular measures—such as the pruning of the fertilizer subsidy; more focused targeting of the Samurdhi benefits, resulting in a significant reduction of the number of beneficiaries; and the freezing of new recruitments to the public sector—were implemented by the new government.

The above-mentioned reform measures were implemented without much attention being paid to the impact of such measures on the most vulnerable members of society. With a quarter of the country's population below the poverty line, the numbers adversely affected were significant. The strict enforcement of fiscal discipline by the treasury left little room for populist measures that, at least temporarily, had softened the impact of the reforms. The ever-present threat to the continuity of the government, posed by a president representing an opposing political party, appears to have been seriously underestimated by the ruling party.

By April of 2003, the peace talks had broken down. Although the international community had pledged large amounts of funds in the form of aid for reconstruction and rehabilitation, such funds could not be used since consensus was not reached on the administrative mechanism. This was not viewed favorably by a large section of the population. Sensing a change in public sentiment, presidential powers were exercised to bring three ministries under the wings of the president, to dissolve Parliament in February 2004, and to decree the holding of a general election in April 2004.

The president's party won the election comfortably. The support extended by the left-wing Janatha Vimukti Party was a decisive factor in winning the elections. The JVP declined to accept ministerial portfolios in the cabinet, however, and distanced themselves from the policies of the government specifically on its approach to the national issue. The general election was followed by the presidential election held in November 2005. The candidate from the governing party won the election on a narrow margin.

As with previous elections, this most recent presidential election was also contested, among other reasons, on promises of increased subsidies and other benefits. The honoring of these promises has placed, at least partially, an enormous burden on the budget, resulting in ever-increasing budget deficits. In turn, inflation has reached double digits. Interest rates too have escalated significantly. In an attempt to release the pressure on interest rates, the rupee has been allowed to depreciate.

In 2006, fighting broke out once more in the north and the east but the government still maintains its commitment to a negotiated settlement. Large transfers to householders as a consequence of increased benefits under welfare schemes, mounting public spending, and the absorption by the government of the increases in the cost of providing utility services have all resulted in further increases in the budget deficit.

During this period, the volume of facilities approved by the DFCC increased consistently year by year. Although the macroeconomic climate has not been ideal from an investor's point of view, investors who own and operate projects in the country appear to be continuing with expansion, replacement, and modernization plans. The gross loan portfolio of the DFCC has almost doubled during this five-year period under review. Although there may be ups and downs in the security situation as well as in the overall investment climate, there is a level of confidence that the open economic policies are here to stay. The DFCC has also moved strongly into commercial banking by introducing additional services in its existing branches as well as by expanding its branch network.

The DFCC's primary focus is on the industrial sector. Industrial ventures—new and existing, small, medium, and large—are the recipients of the bulk of the DFCC's facilities. Thus, the volume of business contracted by it during any given period depends largely on the outlook, growth, and fortunes of the industrial sector during that period. The contribution made by the industrial sector to the country's GDP has increased from 5.2 percent in 1960 to 27 percent in 2005. In the period immediately following independence, Sri Lanka had adopted an industrialization strategy based on the promotion of import-substituting industries. In developing the economy during this period, the leadership role was played by the state sector. It was only in 1977 that a policy shift to an industrialization strategy based on export-oriented industries took place. Simultaneously, the private sector was conferred the lead role in achieving economic growth. These policy shifts flowed from a change of the party holding political power. Strong democratic traditions rooted in the cultural ethos of the country ensured that elections were held at regular intervals. Voter sentiment at these elections has alternated between the two major political parties—one left of center, and the other right of center. Since the mid-1990s, both major political groupings have pledged to work within the framework of an open economy, thus reducing the risk of radical swings in policy taking place. Such phrases as “with a human face” symbolize the continuing ideological debate about the role of the state sector in economic development, the ability or otherwise of the market economy to alleviate poverty in the short to medium term, the degree of protection that ought to be given to local industries, and so on.

The above analysis shows the correlation between the growth or decline of business in the DFCC and changes in the macro environment for business in general and industry in particular. Rather than

resigning to the ill effects of uncontrollable factors such as the macro environment, however, the DFCC has been able to take a critical and searching look at itself at periodic intervals. Three significant reviews completed with the assistance of reputed external consultants stand out for recognition. The first was a study commissioned in February 1985 with the help of consultants from the Private Development Corporation of the Philippines. The study was designed to focus on a few critical issues faced by the institution during this period, such as its dwindling market share, restrictions emanating from its incorporating statute, and so on. The study was to lead to the preparation of a corporate plan. Among the recommendations made were a proposal to amend the Act, a plan to broaden the product range by providing working capital loans for import and export finance, and diversification of the funding base.

The second such review occurred in 1987 with Morgan Grenfell as external consultants. The specific objectives of the study were to review the implementation of the corporate plan and to identify measures to implement the strategies agreed upon. Particular attention was given to the need to develop and retain staff, and to diversify funding sources while being competitive in pricing. The main recommendations included the diversification of income sources by engaging in fee-based merchant banking activities, development of unit trust instruments, assignment of responsibilities within the organization and clear definitions of accountability, and the development, retention, and motivation of staff.

In August 1998, PricewaterhouseCoopers of the United States was engaged as an external consultant to assist in developing appropriate corporate strategies based on an analysis of the internal and external environment, recommend internal restructuring, and map out a plan for effective implementation. The consultancy was prompted by several key issues faced by the organization at that time. These issues included the need to optimize benefits and synergies to be derived from its 28 percent ownership of the Commercial Bank of Ceylon, the leading privately owned commercial bank in the country, and the need to devise strategies to be active in the emerging private debt market, introduce mortgage financing, devise a proactive customer acquisition and retention plan, improve the management information system (MIS) within the organization, and align rewards more directly with performance. The principal recommendations included directing a greater focus on the middle market, arranging commercial bank facilities for DFCC clients, creating a corporate management layer with defined functions and responsibilities, establishing and executing an assets and liabilities committee, strengthening corporate governance, and clarifying the demarcation of the roles of the board, the CEO, the corporate management team, and the front-line managers.

The reviews done by reputed external consultants helped the DFCC in many ways. First, they provided expert advice on specific issues from mature markets, thereby helping the institution to adopt and introduce cutting-edge technology, innovative products, and higher service standards. They helped the institution to benchmark itself against international standards. Second, as independent external consultants, they provided an objective view on the issues. Third, and more important, their independent advice on organizational changes and on matters relating to personnel policies had greater acceptability by staff on the basis that external consultants were free from bias.

By the mid-1980s, the two DFIs in the country had become the principal sources of term financing in the country. They accounted for committing and disbursing approximately 90 percent of the credit lines made available by the multilateral lending organizations. The commercial banks always had access to funding from credit lines that exclusively targeted the small and midsize industrial sector. By the late-1980s, the commercial banks were also given access to funding from credit lines that targeted large-scale industrial projects. The two DFIs actively sought the participation of commercial banks in syndicate-type lending to larger projects principally to share risks and stay

within single-client exposure limits. In doing so, the DFIs shared their appraisals and expertise with the staff of the commercial banks, thereby encouraging them to participate more actively in term lending. Some of the commercial banks set up separate in-house project financing departments and made an effort to meet the not-so-large term financing needs of their existing clients. Nevertheless, the term lending business of commercial banks, as a percentage of their total lending, remains small.

## Chapter 2

# The Governance Framework

The degree to which the organizational structure and the operating procedures of any corporate entity conform to the Principles of Corporate Governance has increasingly become an important measure of good behavior as well as a criterion in evaluating a company. The principles of Corporate Governance have been greatly expanded and sharpened since they were first propounded by the Cadbury Committee (1978) in the United Kingdom. The Hampel Committee, appointed in 1983, consolidated the recommendations of the Cadbury Committee with those of several other committees that subsequently deliberated on the same subject. Regulatory bodies of many countries have since published the principles in the form of a code for voluntary or compulsory compliance by local companies, particularly by those whose shares are traded in the respective stock exchanges. High-profile corporate scandals have prompted regulators in some countries to move some of the more important provisions in their respective codes to the Statute Book, for example, the U.S. Sarbanes-Oxley Act.

### Importance of Governance

There are at least two schools of thought as to the reason behind attaching so much importance to the principles of corporate governance. One point of view is that compliance results in the improvement of the overall performance of the entity. In an article entitled “The State of Corporate Governance,” Ira Millstein] states,

I am always surprised when people debate the linkage between corporate governance and corporate performance - it seems so obvious. To me it is intuitively correct that to maximize the corporation's wealth producing capacity, we must ensure that the accountability mechanism provided in the legal structure of the governance system, works. After all, the certain knowledge of being subject to review, improves accountability and performance, at every level of an organization.

In contrast to the above view, the Conference Board Research Report, entitled “The Link between Corporate Governance and Performance,” which refers to 14 studies conducted on the link between corporate governance and performance, as well as a number of other surveys of the extensive literature on the topic, notes that “to some commentators the link between governance and performance was ‘intuitive’, and thus they, commendably decided to adopt a more balanced approach.” They concluded that “[t]he studies examined herein have achieved only scattered success in establishing a link between corporate governance and performance. Moreover, they have failed to hit a true bull's eye... In a word, measurement is difficult.” The report argued that the real benefit derived from the concept was its usefulness in the prevention of an abuse of power.

Anthony Williams, in his book entitled *Who will Guard the Guardians?* examines all of the above views and comes to the conclusion that—

In short, the central issue is whether accountability mechanisms are there mainly to improve the performance of the entity or to prevent abuse of power. I am convinced



that, even if it could be conclusively demonstrated that performance was improved by such mechanisms, the overriding reason for putting them in place is indeed to prevent abuse of power.

Did the design of the corporate structure or the operating procedures of the DFCC conform substantially with the principles of corporate governance? To what extent did the incorporation of those principles result in the better performance of the DFCC as a financial institution? To what extent did those provisions discourage, prevent, or reduce an abuse of power by those to whom such power was conferred? Before considering the above questions, it may be useful to clarify what exactly is meant by the concept of corporate governance and the manner in which its principles apply to the major stakeholders in a company.

## **Definition**

In its report, the Cadbury Committee defined corporate governance as “the system by which companies are directed and controlled.” Though accurate, the definition in the context of the increasingly complex world of business appears simplistic. The pith and substance of the concept of corporate governance is the striking of a healthy balance between power and accountability. The checks and balances that permeate the interrelationship among the principal stakeholders in a company, that is, the shareholders, the board of directors, and the management, constitutes the core of the concept of corporate governance. The shareholders elect the board of directors who become trustees acting on behalf of the shareholders. In the course of performing their fiduciary functions, the board appoints the management of the company headed by the CEO. The day-to-day operations of the company are carried out by the management. The dynamics of exercising the freedom to manage and take risks, while submitting oneself to the supervision and control of the board and the shareholders, is the crux of the corporate governance dilemma.

## **The Government: A Stakeholder**

In the case of DFIs, apart from the three major stakeholders mentioned above, there is yet another important and powerful stakeholder: that is, the government. Even in DFIs for which the government is not a shareholder, such as in the case of the DFCC, the government should be recognized as a stakeholder for several reasons. In almost all countries, the government has been the principal sponsor in setting up the DFI. In many countries, the government has been the sole owner or at least the single-largest shareholder of the DFI. Even in Sri Lanka, the second DFI set up in 1979 by the government was fully owned by the government and government-owned institutions. As noted in chapter 1, establishing the DFCC in Sri Lanka was proposed by the first World Bank mission to the country. The government not only accepted the recommendation, but having done so, proceeded to sponsor as well as set up the institution via an Act of Parliament.

As discussed in chapter 1, the government provided a loan of SL Rs 16 million at the time the DFCC was established. The initial loan was repayable over a period of 40 years inclusive of a grace period of 25 years. The Act also provided for the guarantee of the government to be extended to any borrowings made by the Corporation from the International Bank for Reconstruction and Development. Such loans were to be designated in foreign currency and the exchange risk was to be borne by the government (section 14).

These concessions were extended no doubt on the basis that the new institution was to play a major role in the development of the economy, more particularly the industrial sector, by the provision of long-term financing to eligible projects, in addition to providing technical and managerial advice to the borrowing entities. The government, via the Act, secured for itself the right to appoint a government director, to the board of the Corporation, in addition to another state sector official (the director of the Ceylon Institute of Scientific and Industrial Research) who also became a director by virtue of his office (section 10). Furthermore, the dividend payable by the institution in any given year was restricted to 12 percent of the share capital (section 13). The Corporation was required to submit a copy of the annual audited accounts to the minister of finance.

The above arrangements—including the significant assistance provided by the government to the new institution and, in turn, the opportunity conceded to government to influence and monitor the activities of the institution via the government director—bestowed on the government, in no uncertain terms, the status of a stakeholder of the institution. Although the government director was but 1 of a possible total of 10 directors, he or she could have wielded much more influence over the deliberations of the board of directors. In view of the above, the government was not only a stakeholder, but by its very nature, was perceived as an important stakeholder of the Corporation.

Having noted the essence of the concept of corporate governance, and having recognized that the government was a significant stakeholder of the DFCC from the start, we can return to the questions raised earlier, that is, did the corporate structure or the operational procedures of the DFCC conform substantially to the principles of corporate governance? To what extent did the incorporation of those principles result in the better performance of the DFCC as a financial institution? To what extent did those provisions, discourage, prevent, or reduce an abuse of power by those to whom such power was conferred?

## **Incorporation of Governance Principles**

A careful study of the incorporating statute, the unique structure of the organization it has given birth to, and its operating procedures makes it abundantly clear that much thought has gone into incorporating the principle of checks and balances in all of these aspects related to the DFCC. Some of the significant innovations are noted below.

In chapter 1, the debate that took place in Washington between the government delegation and World Bank officials on the draft statutory enactment for the establishment of the institution was discussed. The World Bank finally agreed to the government's wish that the organization be incorporated via an Act of Parliament, subject however to the inclusion of amendments proposed by the World Bank. Unfortunately, the nature and content of the specific amendments that were introduced at this stage cannot be determined. But some reasonable deductions can be made.

Section 7(2) of the Act requires the Corporation to offer its shares to the public for subscription. Furthermore, section 8 stipulates that the institution shall not transact any business until at least 75 percent of the authorized capital has been fully subscribed. Following the commencement of the Act, section 11 requires the board of directors to make regulations dealing with those matters not provided for by the Act, which in the case of a company formed under the Companies Ordinance would be dealt with in the Articles of Association. Subsection 11(4) confers the force of law on the regulations framed.

Section 12 of the Act brings into effect the provisions of the Companies Ordinance in regard to matters not provided for in the Act or the regulations. The regulations framed by the board of directors deal with all of the matters normally set out in the Articles of Association of a company, such as annual general meetings, declaration of dividends, adoption of accounts by the shareholders, meetings of directors, and so on. Incidentally, a clause in the statutes relating to the two State Banks expressly excludes the application of the provisions of the Companies Ordinance to those two institutions (sections 45 and 70 of the People's Bank and Bank of Ceylon Acts, respectively).

The above provisions in the incorporating statute strongly suggest a desire on the part of the framers of the DFCC law to structure the institution as a limited liability company (LLC), although it was incorporated by an Act of Parliament to facilitate its functioning. It is unlikely that the legal draftsman responsible for drafting legislation on behalf of the government would have included these provisions in the original draft, because the government's desire was to incorporate it as a statutory corporation. The dual character of the institution resulting from these provisions brings into force, in an ingenious manner, the governance principle of accountability to shareholders who are the real owners of the Corporation. To that extent, such accountability also counterbalances the implied accountability of the organization to government regarding its developmental objectives.

The DFCC is unique in respect to its dual character. It was sponsored and set up by the government but was never owned by it. A clear attempt has been made, perhaps largely under the influence of the World Bank, to structure it as a company and facilitate its functioning as a company. The two state-owned banks in Sri Lanka do not have similar provisions in their statutes. They are government-owned institutions with boards of directors appointed by the government. Such appointees have invariably been changed every time a new political party has come into power, although some effort has been made in the recent past to insulate management from political influence and to encourage professionalism.

## The Dilemma

The DFCC was established at a time when it was fashionable for governments to believe they were responsible for, and consequently ought to play a direct role in, economic development. The active role played by the government in setting up the DFCC, the generous assistance provided to the institution in its formative years, and the statutory provisions to ensure its continued involvement in and influence on the activities of the institution, have been largely influenced by this line of political thinking. Although the government's involvement and influence was inevitable or even desirable during this era, at the same time, there was a need to ensure and preserve the independence of management, particularly in the day-to-day decision-making function. Striking the proper balance between working in partnership with government in the pursuit of developmental goals and keeping a fair distance from government to preserve the independence of management undoubtedly would have been the foremost governance issue to those who conceptualized the model and to the framers of the incorporating statute. The statute is replete with provisions that are designed to address this dilemma. These provisions bear the unmistakable signs of a balancing act. Some of these provisions are as follows:

- Section 10 provides for a government director to be nominated by the minister. The relevant section begins with the words "So long as there is outstanding any loan made by the Government to the Corporation pursuant to the provisions of this Act...the Minister...shall be entitled to appoint one person as a Director." This appears to be the justification for acquiring the right in the absence of a shareholding by the government. In fact, the lending referred

to in the section was twice the authorized capital at inception. The terms attached to the loan, such as being free of interest, with a repayment period of 15 years after a grace period of 15 years (later the grace period was increased by another 10 years), changed the character of the loan to quasi-equity. This, together with other provisions such as the guaranteeing of loans to the corporation from foreign sources and the bearing of the exchange risk on foreign currency loans, placed the government in the category of a stakeholder of the corporation. By stating that the government director will have no special status, the section attempts to neutralize the perception of that director being considered the most powerful.

- Section 10(6) requires the board to elect one of the shareholder directors as the chair of the board. The majority of the directors on the board are those elected by the shareholders. The chair of the board of directors of the DFCC is elected by the board from among the shareholder directors. The original Act was amended later, by a left-of-center government, to stipulate that the person elected should receive the approval of the minister. The amendment was deleted by a later government. In contrast, in the case of the two state banks, the chairman is appointed by the minister.
- The significance attached to these board appointments was sharply driven home when a finance minister, , persuaded Parliament to amend the Act, making way for the appointment of two nominees of the government as directors. In addition, the chairman elected by the shareholders had to obtain the concurrence of the minister. It was argued in Parliament that the changes were necessary in light of the responsibilities borne by the government on behalf of the Corporation by guaranteeing loans obtained by the Corporation from foreign sources (Hansard of April 2, 1974). However, these same amendments were later removed by a legislature controlled by a right-of-center government.
- The amendments to the Act referred to above also included a new clause that gave the minister the power to issue directions to the institution that the institution was bound to follow. A similar provision is found in the statutes incorporating the People's Bank and the Bank of Ceylon. On closer examination of the relevant clauses, however, significant differences in the wording and consequently its effect can be identified. In the case of the two state banks, the relevant clause was included in the Acts at the time of incorporating the banks. This was also the case when the NDB was set up as a fully state-owned development bank some years later. The original Act of the DFCC did not include this clause, perhaps a further result of the initial negotiations that took place in Washington (see chapter 1).

The clause in the Acts relating to the two state banks enables the minister to give general and specific directions to the respective boards (section 33 of the Bank of Ceylon Ordinance, and Section 42(a) of the People's Bank Act). The identical clause appears in the NDB Act save for one change. In the case of the two state banks, the minister's directions have to be addressed to the board, whereas in the case of the NDB, they can be directed to the bank. Furthermore, the mandatory obligation to carry out the order is cast on the board in the case of the two state banks, whereas in the NDB Act, it is cast on the bank. Was this change introduced with a view toward extending the jurisdiction of the minister to include the CEO or management of the bank? That may have been the intention, because the minister's directions may be specific and not restricted to matters of policy. In fact, the section states that the subject matter of the directions ought to be "as to the performance of the duties and the exercise of the powers of the Bank." Although the powers, functions, and duties of the bank in accordance with section 9 of the NDB Act are to be exercised by the board, they

can be delegated to the CEO and other officers of the bank (section 13). Accordingly, it can be argued that the CEO and other officers of the bank would be within the ambit of the minister's authority to issue directions.

Thus, we see that significant changes in the wording were made to the standard clause when it was introduced as an amendment to the DFCC Act by the finance minister. First, the minister's powers can only be exercised after consulting with the board of directors. Second, the directions are restricted to "general directions on matters of policy." These are significant changes and would have come about only as a result of hard negotiations with the government, and by asserting the private sector status of the institution and the importance of maintaining the independence of management. These clauses were subsequently deleted..

- Another clause that is special to the DFCC Act is Section 9(4), which casts a duty on the board to "ensure that every application dealt with on behalf of the corporation is considered strictly on its financial and economic merits irrespective of all other considerations." Quite apart from the salutary effect of such a provision, it is likely that the right of a potential borrower, whose application for assistance has been rejected for extraneous reasons, to bring such an issue to justice has been greatly strengthened by this provision.
- The DFCC Act includes the provision found in the other three Acts relating to the appointment of a general manager who shall be the CEO of the Corporation. In the case of the Bank of Ceylon, however, the appointment of the general manager has to be made only with the prior approval of the minister.

Reflecting on the structure and the design of the Act as a whole, and the sections addressed above, it is abundantly clear that the framers of the statute attempted to balance the concerns and expectations of the two principal stakeholders, that is, the government and the private shareholders. Judging by what the institution has achieved in the past 50 years, they have no doubt succeeded in that attempt.

One may wonder what assurance the government had at inception, when it agreed to provide generous support to what was to be a privately owned institution (as opposed to the government-owned corporation they, in all likelihood, proposed earlier), that it would realize its developmental objectives via the new institution. On the other hand, what confidence would one expect a potential private shareholder to have (when subscribing to the share capital of this new entity) that the management of this entity would be able to conduct its operations independently, profitably, and without political interference? The institution, after all, was to engage itself in "developmental lending," a phrase that had definite political connotations and was merely a euphemism for noncommercial, soft loans that would eventually be written off.

The government would have drawn comfort from the fact that the objects to be pursued by the new institution were clearly defined in the incorporating statute and that the provisions of that statute could only be changed with the consent and perhaps the initiation of the government. The government also had the right to have its nominee on the board of the new entity and thus was able to influence the policies adopted and pursued by the institution.

From the point of view of private shareholders, it was perhaps their very concerns that resulted in the lukewarm response to the initial share issue. It is on record that the Central Bank had to use some gentle persuasion to induce even the potential institutional shareholders, such as the banks, to subscribe to the issue. Years later, however, when the institution had demonstrated its profitability,

and in particular the management had displayed its professionalism and independence, the share became one of the most sought-after shares among those quoted on the stock exchange.

## **The Role of Multilateral Institutions**

Apart from the above-mentioned statutory provisions, which sought to bring about the checks and balances among different stakeholders so central to the governance issue, other factors contributed significantly to maintaining a proper and healthy governance regime, particularly in the case of the DFCC. A good example is the discipline and professionalism that was nurtured as a consequence of the DFCC's relationship with the multilateral lenders, such as the World Bank and the Asian Development Bank (ADB). One of the objectives to be served by the DFCC was to obtain foreign currency resources for relending to industrialists in Sri Lanka. The state-controlled and highly regulated closed economic model that prevailed during the 1950s and 1960s resulted in severe foreign currency constraints being experienced by industrialists, in particular, and businesses, in general. During this period, the DFCC became the only source of foreign currency to industrialists. The DFCC sourced these funds from the World Bank and later from the ADB, too, in the form of long-term loans that were guaranteed by the government.

The relationship between the DFCC and the World Bank, documented in formal loan agreements signed between the parties, contained provisions that went beyond those normally applicable to a debtor-creditor relationship. This relationship was largely reflective of the institution-building role played by the World Bank when extending these credit lines as well as the long tenor applicable to these loans. These agreements accordingly contained conditions that went beyond the terms and conditions of the loan facility itself. Thus, for instance, there would normally be a requirement that the borrowing institution should prepare and submit for approval by the World Bank a policy statement that defined the institution's lending policies, exposure limits, operational procedures, staffing levels, training policy, and so on. Once approved, any future amendments to the policy statement can only be effected with the prior approval of the World Bank. Furthermore, because all loans were channeled via the government, there were agreements executed between the government and the World Bank that often placed conditions on the government itself. The violation of these loan conditions could have resulted in the suspension of the credit lines and so on, causing considerable adverse effects on the industrialists, the institution, and the country's economy.

The World Bank had the practice of preparing a completion report after a credit line was fully committed. This report evaluated, among other things, the level of achievement against the agreed-on objectives of the credit line. The follow-up was not confined to the performance of the borrowing institution, which in this instance was the DFCC, but extended to the performance of projects funded by the DFCC. The completion report also focused on the non lending policy-based objectives of the credit line. The economic benefits that may have accrued to the economy as a whole received special focus. These post commitment evaluations resulted in a deep sense of accountability, particularly because the approval of further credit lines would depend, to a large extent, on the results.

## **How Effective Are Checks and Balances?**

At this stage in the evaluation, there are two relevant questions? To what extent did these checks and balances built into the structure of the institution, via the statutory provisions referred to above,

and the procedural safeguards, serve the institution in performing better or in preventing an abuse of power? How effective were they in preserving the independence of management?

It is likely that during the 50 years under review, there would have been several instances in which conflicts related to the safeguarding of the independence of management by way of the board or the board by way of the government, for example, would have surfaced and been addressed. Any evidence of such conflicts surviving to the present day would only be anecdotal, however, because of the sensitive nature of such conflicts and the level of personalities involved. Suffice it to say that no such conflict has been of sufficient significance for it to leave an indelible mark on the operations, structure, or reputation of the institution. One instance of note occurred when immense pressure was brought to bear on a DFI to increase its exposure to a particular sector (in excess of the maximum limit desirable from a prudence point of view). This situation was successfully resisted by citing the sectoral exposure limit spelled out in unambiguous terms in the policy statement of that DFI.

This analysis clearly demonstrates that much thought has gone into the design and operational procedures of the DFCC, thus enshrining in them the essence of governance principles that have gained universal acceptance. It is incredible that both the design and procedural safeguards were conceptualized and formulated 50 years back when corporate governance, as a phrase, was not even whispered in business parlance.

## Chapter 3

# Development vs. Profitability

At one time or another, DFIs the world over—specifically the ones that are privately owned—have been accused of pursuing profit at the cost of sacrificing their developmental objectives. Among the critics are those that advocate that DFIs should make no profit. There are others who say that they should not make excessive or unconscionable profits. These critics, of course, do not offer a definition of “excessive” or “unconscionable.”

It is also not uncommon to find individuals who, and in some instances organizations that, hold and expound the view that the pursuit of profit by way of a return to shareholders and the pursuit of developmental goals cannot coexist. They submit that the two are mutually exclusive. They closely associate the “private sector” with “profit” and “government and the state sector” with “development.” At the extreme, “profit” conjures up, in some, notions and images of exploitation, making the rich, richer and so on, whereas the word “development” conjures up images and notions of “common man focused government sponsored projects.”

DFIs have been criticized for insisting that projects supported by them should demonstrate that they are capable of generating a reasonable return on the capital invested. The word reasonable in this context often means the cost of the capital invested. Return also should be commensurate with risk. As such, an integral component in the evaluation of a project is the assessment of the risk associated with the prospect of earning that return. The higher the risk, the higher should be the return to both debt and equity capital.

The concept of security or collateral is yet another area of conflict and misunderstanding. A development bank, it is argued, should not take security for its lending and should lend on the basis of the viability of the project. There are others who submit that a DFI should restrict its collateral to just the project assets. Yet others willingly provide collateral cover, but in the event of a default, resist any attempt on the part of the DFI to realize the value of such collateral. DFIs have been criticized by politicians and others for precipitating the closure of establishments when collateral is put up on the basis of a judgment made by the DFI regarding the nonviability of the project.

Although all of the above criticisms ought to be considered and examined, the fundamental question remains, that is, whether the DFCC has fulfilled its mandate to be a catalyst for development or sacrificed that objective, even partially, by being profitable at the same time? Could it have played a bigger or greater role in development if it did not aim to be a profitable institution? Did its private ownership retard its developmental effort or blunt its developmental focus?

## What Is Development?

Before attempting to consider the above issues, it may be useful to reach some understanding as to what development is. Is the setting up of an enterprise producing goods or services to satisfy a demand for such goods and services developmental in nature? Emphatically, “yes,” because such an activity creates employment, adds value within the economy, and contributes to economic growth. If one answers the said question in the affirmative, then any activity supporting that endeavor is also developmental. Does that endeavor cease to be developmental just because it happens to be



profitable? The answer is a resounding, “no.” On the contrary, no project can be developmental if it is not profitable, because such a project is not sustainable.

## How Much Profit?

As to the level of profit, in a market economy, profit is controlled by competition. If a competitive environment cannot be created for any reason, such as in the case of some large public utilities, a regulator may have some role to play in regulating prices, costs, and consequently profits. History has proven, over and over again, that there is no superhuman-being capable of controlling all prices for the benefit of the consumer. Price control only creates shortages and a thriving black market. As long as an enterprise does not make monopoly profits, and as long as there is a competitive environment with ease of exit and entry, the assistance extended by the DFCC for profitable projects would be undoubtedly developmental. In fact, it would have been self-destructive if it did not insist on the project assisted being profitable, because in such an event the recoverability of the funds lent would have been in jeopardy.

The concept of security is tied up with the assessment of risk in a project. If the project seeking assistance is strong in all development aspects—where the sponsor’s honesty, capability, and experience in the related field is undoubted; the market for the product is fully assured; the process for manufacture and the machinery to be used has been tried and tested; the margins are assured; the competency of management is not in doubt, and so on—then there is hardly a risk in supporting such a project. In reality, however, we do not find such projects. Projects, in real life, may be strong in one respect and weak in another. It may be difficult, even after much effort, to assess the market for the product, with any degree of certainty. As such, there is always some level of risk, in a project. The task, when appraising a project, is to strengthen the weak areas in the project to the extent possible, and thereafter, assess the residual risk in the project. If there was no residual risk, there may not be a need for additional collateral cover. The extent of security cover that is desired depends on the level of risk remaining.

A DFI cannot ignore risk and therefore ignore collateral cover, because it has to sustain itself. The non realization of security in a project that has failed will result in the DFI having to bear the loss. Having done so to remain viable, it then has to recover that loss from the rest of the clientele who operate successful projects. This would be patently unfair to the enterprises that operate profitably and to the sponsors of such projects, who are likely to have devoted much of their resources and all of their energies to achieve success. Such a policy would be tantamount to rewarding failure and punishing success.

Despite all the effort taken by entrepreneurs, and all of the care exercised at appraisal, there is bound to be a number of projects that will fail. Projects operate in a dynamic environment. A project that was viable at the appraisal stage may become unviable because of changes in the business environment. It is only the resourcefulness of the entrepreneur that can ensure sustainability under those circumstances. The maximum assistance must be provided to the sponsor to restructure such a project. Some projects, however, cannot be restructured. To prop up such projects, which have become unviable and cannot be restructured, would be counterproductive and cannot be sustained. Some who genuinely champion the cause of such projects do not realize the small percentage such projects account for in the total portfolio of a lending organization. These champions tend to ignore, or at the least acknowledge, the multitude of projects and entrepreneurs who succeed with the support of the DFI.

## DFCC Assistance

Over the 50 years of its existence, the DFCC has assisted nearly 50,000 projects. More than half that number has been new projects. The total facilities approved for enterprises exceed SL Rs 169 billion. Assuming that its share of funding to any single project accounted for 60 percent of the total funds invested in that project, the total capital formation via such projects exceeds SL Rs 281 billion. Expressed in current, terms using the GDP deflator, the figure approximates to SL Rs 545 billion. The annual report of the Central Bank in table 2 of the special statistical appendix provides the total investment made in the economy, each year, as a percentage of the GDP. To obtain a measure of the contribution made by the DFCC to the economy as a whole, the capital formation resulting from projects financed by the DFCC each year was expressed as a percentage of the total investments realized in the economy each year. When these percentages were averaged for the 50-year period, we arrive at a figure of 4.21 percent, which is a significant contribution by one institution. The average is depressed by the low percentages recorded in the early years. The average for the period from 1990 to 2005, for example, approximates to 7 percent, whereas in some recent years the average exceeds 9 percent. The direct employment created as a result of projects assisted by the DFCC is estimated to be in excess of 500,000.

Apart from the numbers assisted or the amounts lent, the DFCC has pioneered the opening up of new sectors for investment. A case in point was the hotel sector, which was promoted as an integral part of the tourism development effort of the government. DFCC actively assisted sponsors of hotel projects not only with the finance but also with technical inputs from a specialized unit established in house. Other such sectors as horticulture, mini-hydro, telecommunications, small and medium-scale industry, prawn culture, and so on were to follow. DFCC played a pioneering role in the promotion and establishment of all these sectors in partnership with government agencies and the organized private sector.

DFCC, functioned as the apex bank in the implementation of the Energy Services Delivery (ESD) Project under which long-term financing on market terms was provided for grid-connected mini-hydro projects, off-grid village hydropower schemes, and solar photovoltaic electrification. The ESD Project was launched in 1997 with the assistance of the World Bank and the Global Environment Facility. This credit program, administered by a special unit within the DFCC, achieved the highest ratings for all performance indicators, including outcome, sustainability, and institutional development impact. The follow-on Renewable Energy for Rural Economic Development (RERED) Project is also administered by the special unit at the DFCC. By December 2006, the two projects had financed a capacity addition of more than 90 MW to the grid, with more than 106,680 rural homes and micro enterprises obtaining off-grid electricity through community-based village hydro and solar power residential systems. As an innovator and pioneer in renewable energy development, the special unit at the DFCC is now regularly invited to share its experience with other countries throughout Asia and Africa.

In addition to debt capital, DFCC also provides equity capital primarily to start-up projects. On many occasions, DFCC's investment filled a gap in the initial equity structure of a company. Simultaneous to the equity investment, in selected instances, DFCC has nominated an officer of the institution to serve on the board of a start-up company. In addition to watching the interests of the corporation, the DFCC nominee director has contributed actively to the issues deliberated at meetings of the board. These equity investments were divested by the DFCC, mostly in consultation with the sponsors.

The DFCC contributed significantly in the development of the capital market and the financial

infrastructure of Sri Lanka. It pioneered the establishment of the first unit trust in the country. In doing so, it helped to establish the legal and regulatory framework necessary for unit trusts to operate. The efficient and successful manner in which it conducted its operations attracted international attention, and Asia Money, an internationally recognized and prestigious magazine, named it the best managed company in Sri Lanka. Its stellar performance and international stature enabled it to attract to the country foreign financial institutions of repute, such as Deutsche Morgan Grenfell, with whom it collaborated in advising the government and assisting it in the restructure of the telecommunication sector.

Judged by any standard or measure, all of the above-mentioned accomplishments are developmental in nature. It is also abundantly clear that DFCC has made a significant contribution to the development of the country's economy during the past 50 years. This contribution has not been something incidental to its lending operations, but rather the very focus of the many pioneering activities it has undertaken during this period. The fact that the institution was owned by shareholders in the private sector—who quite naturally expected, and did receive, a return for the funds invested by them—has not prevented the DFCC playing the developmental role it was expected to play.

Had DFCC not been owned by private shareholders and, consequently, had profitability not been a concern or corporate goal of management, another question raised is whether DFCC would or could have played a greater role in development. Posed in this manner, the answer can only be speculative. An answer is possible, however, if a different question is posed: Has the fact of being privately owned helped or hindered the institution to play its developmental role?

## **Objectives That Cannot Be Changed by Shareholders**

DFCC was privately owned, which imposed a moral obligation to be profitable and thus enable it to provide a return to its shareholders, but its lines of business were restricted to those specified in the objective clauses in the Act. The objectives of the corporation are clearly spelled out in section 4 of the Act.

The purposes of the Corporation shall be as follows:

- 1)
  - a) to assist in the establishment, expansion, and modernization of private industrial and agricultural and commercial enterprises in Ceylon, and
  - b) to encourage and promote the participation of private capital, both internal and External, in such enterprises.
- 2) Any industrial, agricultural or commercial enterprise in Ceylon in which the government holds not more than forty-nine percent of the capital shall, for the purposes of paragraph(a) of sub section(1), be deemed to be a private industrial, agricultural or commercial enterprise in Ceylon.

Accordingly, if being profitable is a corporate goal, such profitability can only be achieved by pursuing the objectives or purposes specified in the Act. Thus, for instance, the profit motive cannot lead to a situation in which the management undertakes, or is persuaded to undertake, some other activity that appears to be more profitable than the development role mandated in the Act. Even if the great majority of shareholders wants to maximize profit and wishes to amend the objects clause,

thus enabling the corporation to undertake some other profitable activity completely different from the developmental objectives set out in the Act, the shareholders have no power to do so, because the Act can only be amended by the legislature. This creates a unique situation in which the owners of the institution are not at liberty to change the purposes of the institution they own. These owners are (perhaps) presumed to have become shareholders with such knowledge. Whatever view one takes on the reasonability of this situation, the danger alluded to by critics that the institution can be pushed to vigorously pursue profits at the cost of its developmental goals appears to be unfounded.

## Record of Profit Earned

What is DFCC's track record on profits? Has it made excessive or unconscionable profits? In analyzing an entity's profitability it is not the absolute profits that matter. What matters is the ratio of that profit to the investment made. This should be obvious because the profitability of company A, which has made a profit of say SL Rs 2 million on an investment of SL Rs 100 million, will not be the same as in the case of company B, which has made the same profit with an investment of only SL Rs 20 million. The word investment in this connection can be taken to mean one of two things: (1) it can refer to the capital or the investment made by shareholders, and (2) it can refer to the total investment made in the venture, which is the share capital and the debt capital obtained to set up the project. Annex 1, table A-1, sets out DFCC's record on both measures during the past 50 years.

The results shown in table A-1 can be summarized as follows:

- A return below 10 percent for 22 years
- A return between 11 and 15 percent for 9 years
- A return between 16 and 20 percent for 5 years
- A return between 21 and 25 percent for 4 years
- A return above 26 percent for 7 years

The risk-free rate of return during this period has peaked at 21.04 percent. Accordingly, the returns noted above are reasonable. On top of the risk-free return, these returns include the specific risks inherent in the business of development banking in which the financing of start-ups constitute a significant proportion. Similarly, the return on assets exceeds 5 percent in only 4 of the 50 years under review. The higher and lower returns noted above correspond, respectively, to the specific periods addressed in chapter 1, during which time favorable and not-so-favorable business climates prevailed.

## Dividends Declared

Although it is quite apparent from the above analysis that the profits made by the Corporation have been modest by any standards, one could argue that the institution has declared high dividends, that is, 40 or 50 percent in several years. Those who make this comment ignore the fact that the rate of 40 or 50 percent is expressed as a percentage of the nominal value of the share of SL Rs 10. The share, however, is traded in the stock exchange at a much higher value. Presently, it is traded around SL Rs 200 per share. Accordingly, a shareholder may have bought the share at this price or at a similar cost. In the alternative, the shareholder could sell the stock at this same price, which is the current

market value of the share. If the dividend is expressed as a percentage of the market value of the share, referred to as the yield, the dividend has performed modestly.

For prudent reasons, most corporations do not distribute all of their profits as dividend. The percentage declared as a dividend, which is expressed as a percentage of the profit available for distribution, is referred to as the dividend payout ratio. In the case of the DFCC, the payout ratio has exceeded 50 percent in only 16 years of the 50-year period under review. In other words, more than 50 percent of the profits available for distribution to the shareholders as dividend have been ploughed back into the business during 34 of the 50 years under review. That is a conservative dividend policy. The profits not distributed as dividend accrue as reserves in the company to the credit of the shareholders and are referred to as equity in the company. As discussed later in this report (see “Competition always help), DFCC has raised money from the market on six separate occasions during its 50-year history, The amount raised, including the premia and the original share capital, totals SL Rs 1,456.6 million. The equity of DFCC as at December 31, 2006, was SL Rs 9,351 million. Thus, approximately 85 percent of the equity of DFCC has been accrued via profits.

The amount of equity in a company is a decisive factor when it comes to borrowing funds, because the amount one could borrow would normally be a multiple of the amount of equity in the business. Even for a development bank whose main business is lending, providers of loan funds will insist that its shareholders have contributed a minimum amount as equity. The equity of the DFCC stood at SL Rs 9,351 million as of December 31, 2006. This equity contributed by the shareholders has enabled the Corporation to borrow approximately SL Rs 38.7 billion as of the same date. This has enabled the DFCC to become a major source of term financing in Sri Lanka. In addition to the original capital, on six subsequent occasions, the shareholders have contributed to the capital of the corporation to enable it to expand its services to the clientele. The shareholders have benefited from four bonus issues during the 50-year period.

It may be argued that the government, too, if it was the owner, could and would have provided the money to the DFCC for relending purposes. That may well have been the case. However, the contributions made by the private sector have enabled the government to apply those funds elsewhere. These contributions, via the DFCC, have also mobilized private capital for development. As discussed elsewhere in this chapter, such funds have in turn led to capital formation in excess of SL Rs 281 billion.

There is, however, no doubt that the biggest contribution made by the presence of private shareholders in the DFCC is the corporate accountability that it encourages. The discipline of the market imposes an obligation on management and the board to conduct business in an efficient and ethical manner and maintain proper records, as well as earn a reasonable return on the funds invested. It is the duty of the board of directors elected by the shareholders, who are their trustees, to appoint competent management and to hold such management accountable for preparing plans to achieve the objectives of the entity and implementing such plans successfully. The whole of that relationship, with its built-in checks and balances, is referred to as corporate governance.

Can the government, as the single or major shareholder, play the same role of a private sector shareholder? Can it appoint a board that will perform the same trusteeship role, and appoint a competent management team that will prepare plans and implement them and hold itself accountable to the board? Yes, in theory, that is possible. But in reality, the political machinery in the country does not permit it.

Thus, for instance, the boards of the two state banks change each time the governing party changes. Because the chair is appointed by the minister of Finance, the incumbent in office is asked to resign

and another chair is appointed. Competency is not necessarily the single-most important criterion in effecting such appointments. Frequent changes of this nature have disastrous consequences on the efficient functioning of the institution. In contrast, no such change took place in the case of the DFCC, consequent to a change of government. The board is elected by the shareholders annually in an orderly manner. The members of the board elect the chair for a fixed term in office. Personnel who constitute senior management are not changed because the governing party has changed. Management is selected and rewarded on the basis of competence and performance.

This analysis makes it abundantly clear that the benefits the DFCC has gained as a consequence of being privately owned far outweigh any negatives. In fact, given the fate that has befallen other state-owned entities, it is quite likely that quite apart from providing benefits the achievement of its declared developmental goals, too, in a sustainable manner and without being a burden on government, may have suffered as a consequence.



## Chapter 4

# Lessons from 50 Years of Experience

What lessons can we learn from the 50 year experience of the DFCC: the experience of fulfilling its developmental objectives, while at the same time remaining a viable and profitable institution? How did the DFCC succeed when many other DFIs have failed? What did the DFCC do that sets it apart from other institutions? What did others do that DFCC studiously avoided? Did the unique structure of the DFCC help thwart attempts to abuse power by any of the stakeholders? In the paragraphs that follow, I attempt to answer these questions, with a view toward discerning any lessons that can be drawn from the DFCC experience.

### The Importance of the Governance Framework

The DFCC experience shows that a privately owned institution quoted on the stock exchange, for which profitability becomes an important measure of success, can play a significant developmental role in partnership with government, provided that an appropriate and effective governance framework is installed from the beginning. The governance framework within which the DFCC operated—by which we mean the organizational structures and the operational procedures, which superimposed a system of checks and balances over the exercise of power by the respective stakeholders, and the specific safeguards against a possible abuse of power by any one of them—was not only unique in many respects but also quite effective.

The governance framework was unique in many respects. The incorporation of the institution via an Act of Parliament, the generous assistance given by the government at inception, the recognition by the government of the important role the institution was expected to play in the mainstream of economic development, as evidenced by its continued presence on the board, the guaranteeing of foreign currency loans sourced from multilateral institutions, and the absorption of the foreign currency risk left little doubt in the minds of the public and those who dealt with the institution, including the financial community in general, that the new institution was a government-sponsored institution. As a partner in its development, much was expected of the government. This role of the government brought the DFCC into the mainstream of national development, at the same time bestowing much prestige to the organization. Conversely, the leverage that accrued to government as a consequence of these factors, which could have been used to serve political objectives, was judiciously counterbalanced by such measures as keeping the government out of the institution's ownership and the vesting of ownership in the private sector, which invoked the provisions of the companies ordinance, albeit in a residual role, and annual accountability to shareholders.

### The Role of the World Bank

The involvement of the World Bank from the conceptualization of the institution to its structuring, and later to its evolution as a long-term lender, not only helped create the public perception of a strong and independent organization, but also helped it assert its independence from the government. The conditions attached to the loans provided by the World Bank imposed a greater sense of financial discipline both on the DFCC and the government.



## Ownership Pattern

Among the specific recommendations made by the first World Bank mission to Sri Lanka regarding the desirable features that the proposed DFI (Ceylon Development Corporation, as they termed it) ought to possess, one stated that “no single participant (shareholder) should have a controlling interest.” In accordance with that recommendation, the shares of the DFCC have been widely held throughout the period under review, except during the early years when government-owned institutions held a significant percentage of the capital in issue (although short of a controlling interest). This feature no doubt has had a direct bearing on the independence of the directors who have served on the board of the institution.

As in the case of a commercial bank, the share capital collectively contributed by the shareholders constitutes only a small percentage of the total resources at the command of a DFI. The principle of not having any single shareholder, or group of shareholders who own a controlling interest in the share capital of a bank or a DFI, is therefore based on the desirability of employing such resources for the common good of the people rather than to serve the hidden agenda of any single shareholder. The recent prudential regulation imposed by the Central Bank limiting any single shareholding in a banking institution to 10 percent was established in recognition of this principle and is long overdue.

This principle has been observed by the DFCC throughout its 50-year history. This has no doubt enabled each director and the board, collectively, to act independently and solely in the interests of the institution. The election of the chairman by the directors should be determined based on the most deserving person being elected, rather than on any other consideration. The DFCC has established a reputation for professionalism and independence in its decision making. Such a reputation cannot be earned by a publicly owned organization that acts in accordance with an agenda set out by any single individual. DFCC’s past and future success is attributable, in significant measure, to its reputation and the continuation of its noteworthy practices.

## Operational Independence and Professionalism

As discussed in chapter 3, the private sector shareholders were locked into the developmental objectives of the institution, as specified in the Act. They could not amend or change the purposes and objectives of the Corporation. Changes could be implemented only by the legislature, which was controlled by the political party in power, that is, the government. They, of course, had the option of disposing their shares in the market and ceasing to be a shareholder.

There is no doubt that the professionalism, competence, and independence of management has contributed in no small measure to the success of the DFCC. We have noted that the board of directors is largely elected by the shareholders. Except for a short period during which two directors could be nominated by the government, the right of the government to nominate directors was restricted to one. The Act specifically provides that the rights and privileges enjoyed by the director nominated by the government, as well as the obligations to which he or she will be subjected to (other than with regard to tenure, remuneration, and the holding of qualification shares), will be the same as those applicable to any other director. The chair of the board is to be elected by the other members of the board. More important, he or she has to be a director elected by the shareholders. This clearly indicates the intention of the framers of the Act not to bring the board within the control of the government, but rather to vest it with the independence to function as a private sector board. This contrasts with the position in the state banks where the board as well as the chair is nominated by the minister.

The salutary effect of these provisions are evident by the replacement of the entirety of the boards of state banks, including the chairs, with every change of government and the adverse effects this has on the operations of such banks. In contrast, changes in board composition are unrelated to political changes in the case of the DFCC. The first board of the DFCC, apart from the ex officio directors and the government director, included four shareholder directors nominated by the minister. At the end of the subsequent financial years, these four directors were replaced by people who were directly elected by the shareholders.

The first board was largely nominated by the minister, and included professionals and business officials of repute with no visible political identity. The first chairman elected by that board was a lawyer who was also the head of a well-known law firm. Thereafter, 11 other chairmen have held office, including the present incumbent in office, all of which have been elected by the rest on the board. Six of these chairs have been leading businessmen during the relevant period, and the other five civil servants have held high positions in government or leading professional industries in their respective fields. Seven of the 11 chairmen who have held that office were members of the board before being elected as chair.

The above account does not suggest, however, that the government did not have any influence on who was elected as the chair by the rest of the board. In at least one instance, the government initiated and encouraged the swap of the two chairmen of the two Development Banks—the DFCC and the NDB of Sri Lanka. Considering the caliber of the individuals who constituted the rest of the board, it is almost certain that the board members acquiesced to the wishes of the government because the person chosen by the government more than satisfied other criteria they deemed important.

It is said that the most important decision a board makes is the selection of the CEO of the institution. The first CEO of the DFCC was a nominee of the World Bank. Mr. W.T. Yoxall was a professional banker who had served as the Far Eastern Manager of the Hong Kong and Shanghai Banking Corporation. Thereafter, seven other CEOs have served the institution, including the present incumbent. They have all been appointed by the board after due process. Five of them have held senior positions in the banking industry before joining the DFCC. The very presence of a professional and independent board that has the sole authority for appointing the CEO is tantamount to nine-tenths of the effort required to make the correct choice. The success of the DFCC is in large measure attributable to the high-caliber, competent leadership qualities and professionalism of the CEOs who have led the institution over the past 50 years.

One of the key lessons, reinforced yet again, from the DFCC experience is the tendency for competence, independence, and professionalism to cascade from top to bottom in any organization. Unfortunately, the same holds true with incompetence, mediocrity, intellectual dishonesty, and lack of professionalism. Structures, procedures and a culture that ensures the enthronement of the positive attributes, and that keeps negative attributes in check, are critical to the success of any organization. The role played by high-caliber individuals cannot be overemphasized.

## **Competition Always Helps**

As with any other organization, the 50-year journey of the DFCC had its trials and tribulations. It has had its share of ups and downs. In chapter 1, we noted that these ups and downs had a positive correlation to changes in the country's political and economic landscape. The growth of the institution slowed down during the period when the economy was inward looking. The promotion

of import-substituting industries, protected by high-tariff barriers and administrative controls characterized this period. Although the DFCC enjoyed monopoly status during this period, being the only source of foreign currency to industrialists, its lending volumes never reached the levels it achieved during periods when controls were removed and the economy opened. With the opening of the economy during the late 1970s, the DFCC not only lost its monopoly status but was also confronted with fierce competition from the commercial banking sector.

In 1979, yet another event caused ripples within the DFCC. This was the launch of the NDB of Sri Lanka, a government-owned development bank with an authorized capital of SL Rs 600 million, which was more than 25 times the paid-up capital of the DFCC at that point of time. The NDB became a direct competitor and engaged in the same lines of business undertaken by the DFCC. With its large capital base and the weight of government ownership behind it, the NDB was funded by the World Bank and was able to quickly carve out an apex role for itself in a financing scheme targeting the small and medium-scale sector. After its ownership was privatized, the NDB moved aggressively into the project-based term financing market, previously monopolized by the DFCC.

The official publication of the DFCC, “A Pioneer’s Journey,” published on its 40th anniversary, captures the impact of these events and its response in the following manner: “As it happened, the DFCC was indeed jolted out of its stupor and by the early eighties, was embarked on a path of promise.”

Pushed to the wall in some sense, the DFCC took up the challenge. Meeting this challenge meant bringing about change, and change requires good leadership. Fortunately for the DFCC, it found that leadership in Mr. Moksevi Prelis, who had been a director on the board of the corporation since 1977, representing the Bank of Ceylon, a major shareholder of the DFCC. Mr. Prelis, an engineer by profession had later chosen a career in banking by joining the senior management team of the Bank of Ceylon. In April 1981, while still in his mid-forties, he took over the reigns by becoming the seventh CEO of the DFCC, after resigning from the post of deputy general manager he held in the Bank of Ceylon. This was a bold move, because in making this appointment, the board broke with the tradition of appointing a retired banker as the CEO usually on short-term contracts.

In December of the following year, Mr. Baku Mahadeva, a respected senior civil servant was elected as the Corporation’s seventh chairman. This change of leadership at the management and the board levels was the harbinger to a new era in the history of the DFCC.

In “A Pioneer’s Journey,” Mr. Prelis recalls some of the initial measures taken “to put our own house in order.” The DFCC Act was amended (Act No. 42 of 1982) to, among other things, enlarge the institution’s scope and powers, increase the authorized capital, and limit the maximum term of a shareholder director to eight years. The amendment compelled the chairman and several other directors who were on the board for a long time to resign from office. The vacancies created were filled by individuals from the private sector who were, as described by Mr. Prelis, “more attuned to the emerging realities of development banking.” The amending Act increased the authorized capital, enabling the institution to increase its issued capital by a bonus share issue and a public share issue. The removal of the upper limit on the dividend payable by the DFCC, also enacted by the amending Act, no doubt helped in the mobilization of the additional capital. A change in the corporate culture, characterized by an increased market orientation, recruitment of better-qualified staff, greater efficiency in operations, and greater focus on the bottom line, was also pursued with vigor.

By the mid-1990s, the domestic commercial banks as well as some of the established foreign commercial banks moved into the business of project lending. The credit lines from multilateral institutions were made accessible, which resulted in the DFIs being subjected to further competition.

Commercial banks had the advantage of being able to provide the follow-on working capital and to take care of trade finance requirements. When Mr. Prelis retired, the changing environment prompted the board of the DFCC to again disregard tradition and select an experienced banker, Mr. Nihal Fonseka (also in his mid-forties), from a multinational bank as the CEO and charge him 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.

The advent of a competitor appears to be one of the more significant factors that catalyzed and prompted the visible change that occurred both within the organization and in its market position. Monopoly conditions apparently did not bring out the best in the DFCC, although unfavorable macro conditions also affected its lackluster performance during those years. The new leadership and the threat of competition, among other things, appear to have encouraged the institution to restructure itself, become more customer focused, and emerge as the leading institution it is today.

## Quality of Leadership

In chapter 1, the performance of the DFCC was examined in relation to the political and economic policies that prevailed during the respective periods. From an entirely different perspective and taking a bird's-eye view of the performance of the institution during the entire 50-year period, it is quite apparent that much of the institution's growth and expansion has taken place during the latter 25-year period of its existence. Annexes 2 and 3 illustrate the growth in approvals and the profits earned during the two 25-year periods. Two factors that may explain the different results achieved during these two periods have already been noted: (1) the open economic policies that were introduced and practiced during the latter period, and (2) the competitive market conditions that characterized this latter period. But do these two factors fully explain the difference in performance? Are there any other factors that may have influenced the different results?

In searching for factors or characteristics that distinguish the two periods from one another, one observes a clear difference in the profiles of the CEOs who led the institution during the first half of the 50-year period and those of the CEOs who held office during the second half. The CEOs during the first half were mostly retired bankers who were in their late fifties. Almost all of them had held the CEO position in the banks they worked for before joining the DFCC. In contrast, the two CEOs during the second half of the 50-year period were in their mid-forties when they joined the DFCC and were assuming the role of CEO for the first time in their respective careers. Although the CEOs during the first period had a wealth of experience in banking, their personal profiles, with the benefit of hindsight, appear to have made them more suited for a board position rather than for the post of CEO, especially in an organization that was experiencing the convulsions of change and the challenges that accompanied it. The personal profiles of the CEOs during the second half of the 50-year period appear to have been more suited and aligned to the leadership challenges that the individual who took up the post would have faced.

## Organizational Culture

The DFCC experience brings into focus the importance of creating the appropriate culture within an organization. Some of the important elements that contribute to the creation and sustenance of that culture are as follows: (1) an honest, independent, and professional leadership; (2) the enthronement of meritocracy; (3) the relentless pursuit of excellence; (4) willingness to accept

change and reinvent itself; (5) high standards of quality and customer service; and (6) a private sector-oriented employer-employee relationship characterized by merit-based remuneration and a guarantee of tenure in employment based on performance. At different critical stages in the history of the organization much emphasis has been placed on the above aspects.

The organization took pride in whatever it undertook. The interaction with international organizations (who were among its shareholders and business partners) when undertaking special assignments jointly, and in managing subsidiary and associate companies, exposed the organization to international standards and practices against which it benchmarked itself. It submitted itself to international scrutiny based on those standards and achieved recognition such as when it was named the best managed company in Sri Lanka by Asia Money. Even before a direct competitor appeared on the scene, the DFCC strived to be a significant player within the broad financial sector dominated by commercial banks. In doing so, it pioneered the introduction of new financial products such as unit trusts and thereby contributed to bridging the gaps that existed in the financial sector's regulatory and legal infrastructure.

Without a doubt, the organizational culture, which was consciously nurtured and came into prominence during the evolution of the organization, contributed to the success of the organization.

## **Development or Profit?**

Chapter 3 was devoted to a discussion of the issue of whether—and, if so, to what extent—a development bank should pursue profit in addition to its developmental objectives. The 50-year record of success of the DFCC clearly establishes the need for, and the benefits of, a DFI not only being profitable, but also avoiding monopoly status and being competitively profitable compared with other companies quoted on the stock exchange.

If a DFI was not profitable, it is highly unlikely that private capital would have found its way to such an entity. Because the objectives of a DFI are developmental, should the government have provided the required capital without seeking a return on the funds invested? Questions framed in this manner presuppose that a government has unlimited resources or that no cost is attached to the use of such resources. We are well aware that both presumptions are incorrect. Even if the government could provide such funds, and could do so free of cost, we are establishing an institution fully owned by the government and subject to all of the constraints that come with government ownership.

If private capital is to be mobilized, without relying on the government budget, then the institution's bottom line becomes relevant, because investors would look to a return on funds invested by them.

The DFCC, over the 50 years of its existence, has gone to its shareholders on six separate occasions to raise additional funds to boost its equity. On each of those occasions, shareholders have responded enthusiastically, with each issue being oversubscribed many times over. The shareholders responded positively because the institution was profitable and they could reasonably expect a decent return on the funds invested.

Approximately 50 percent of shareholder subscriptions, in the case of the DFCC, have come from foreign sources. Sri Lanka, with its comparatively low savings rate, has experienced a recurring problem in meeting its requirements of investment capital. In 1993, it was estimated that if the country was to double its per capita income by the year 2000, it had to achieve a growth rate of at least 9 percent per year, during the period from 1993–2000. The capital investment that should be made annually to achieve that growth rate should be at least 45 percent of GDP, given the prevailing

Incremental Capital Output Ratio (ICOR) of 5. If, however, the efficiency of capital can be improved, resulting in the ICOR decreasing to 4, then the level of investment required will be approximately 36 percent of GDP. Currently, the country's national savings rate is 17.2 percent, while its investment rate has been 26.5 percent of GDP. The gap between investments and savings need to be filled with foreign savings.

By mobilizing private capital, the DFCC has been able to leverage on such capital and mobilize an amount in excess of SL Rs 32 billion by way of long-term loans. These loans are made on concessionary terms to the country. Technically, these loans are provided to the government. However, the decision to grant the loans to the government is no doubt influenced by the fact that the proceeds are to be disbursed to the ultimate borrowers by a strong, reliable, and competent institution, which would have screened the recipients, appraised the viability of their investment proposals, and monitored the end use of the funds provided.

What possible harm or negative effect can the pursuit of a profit objective impose on the fulfillment of a DFI's developmental objectives? Is it the practice, or is it even possible, that a DFI will refuse to finance a project that is unlikely to contribute to the profits of the institution?

The decision to finance a project is made by a DFI based on the results of an appraisal of the investment proposal by its professional staff. The appraisal process, endemic to DFIs, is an examination of different aspects of the project, including the market for the product or service, the technical arrangements, the proposed management structure and arrangements, the total cost in setting up the project, the financing sources, and the forecast profitability. The objective of that process is a determination of the viability of the project, that is, the ability of the project to provide a return in excess of the cost of the capital invested in the project. There is also the need to evaluate and assess the risks associated with obtaining that return: the higher the perceived risk, the higher the expected return. In other words, there is a trade-off between risk and return.

Would the DFCC have rejected the funding of any project on the grounds that it did not contribute to the profitability of the DFCC? All development banks, at some point in their existence, are likely to decline the funding of a project. It is not possible, however, that such rejection is based on the project's inability to contribute to the DFI's profitability, because that is not a determining factor in a project's appraisal.

Clearly, the DFCC could not have played the role it did if the institution was not profitable. Investors have different options for investment in any market. As such, a DFI not only has to be profitable but also competitively profitable to raise funds in the stock market. The DFCC could have been set up with funding from the government budget. But then we would be looking at an institution quite different from the one we have, with little or no independence of management, a feature that the framers of the incorporating statute of the DFCC considered critical.

## **Government Support**

The importance of maintaining operational independence, and the risk of becoming a tool in the hands of the government for the fulfillment of sectarian political ends, has been stressed over and over again, particularly when analyzing the causes for failure of many development banks. This, however, does not mean that a DFI ought to avoid all contact with government and operate independent of government. The experience of the DFCC shows how a mutually beneficial relationship can be maintained, while preserving operational independence. Several facets of that relationship are worthy of mention.

Reference has been made to the important role played by the government in establishing the institution. The presence of a nominee director of the government on the board of the DFCC facilitated the consultative process between the government and the DFCC in determining industrial policy. The government sought and obtained the assistance of the DFCC in implementing several reform measures relating to ventures owned by the state. The valuation of the assets of the Ceylon Electricity Board, the conversion of a closed state venture into a modern industrial estate (as a joint venture between the state and the DFCC), and the formulation and implementation of a policy with regard to large-scale prawn farming without harming the environment are all examples of working together for mutual benefit.

Another important collaborative effort was the assistance package created for the hotel sector when it was badly affected by the country's civil disturbances. The industry, in hindsight, would have not survived if not for this generous assistance package worked out by the intervention of the chairman of the DFCC, who also happened to be the advisor to the ministry of finance at that time. Sacrifices were made by all parties and the compromise formula benefited the DFCC, too, since its exposure to the hotel sector at that time was significant. But more than any other consideration, the package was a lifeline to the hotel sector, which was on the verge of total collapse. In contrast, although the DFCC made a similar effort to revive the prawn aquaculture sector when it faced difficulties in the mid-1990s, such effort did not yield a positive result largely because of inaction on the part of several agencies involved with the sector.

The benefits that could accrue to all parties by maintaining a healthy relationship with the government, and the importance of maintaining the correct equilibrium in that relationship, is yet another lesson that can be drawn from the DFCC experience.

## **Diversification**

A further lesson to learn from the DFCC experience is the need to diversify the portfolio of products and services of a DFI. Many DFIs that have failed continued to offer the standard product of a DFI, such as term loans, to its clientele year after year. Although banking was traditionally compartmentalized into commercial banking, investment banking, development banking, and so on, when the financial sector opened in many countries, synergies were seen in combining these products and services under a single institution or group, thereby creating major powerhouses in the financial services industry.

The DFCC began its diversification efforts in 1984. Consequent to a review of its corporate strategies, with the help of external consultants, it introduced several new products to its product portfolio, such as leasing and working capital funding. Consultancy services, venture capital, and unit trusts (the latter introduced into the country for the first time) were some of the other products. In 2005, the DFCC took yet another major step by acquiring a small commercial bank and along with it a commercial banking license. This bank has now been rebranded under the aegis of the DFCC Group.

Universal banks are now widely accepted as a viable and desirable alternative to specialized single-product banks. Specialized long-term lending organizations, such as DFIs supported by funding via credit lines from multilateral lending organizations (often at rates subsidized by the respective governments), may have served a purpose at a particular stage of the economy's development. A model that had to focus only on the asset side of the balance sheet, while the liabilities side was taken care of by a fairy godmother, is not sustainable in the long term. Thus, DFIs reached the end of the road when multilateral institutions ceased to provide dedicated credit lines. A few DFIs

anticipated that change and met the challenge posed by that change. The DFCC was one among that few.

The diversification of the DFCC has not only made it a strong and robust institution, but also helped it increase its client base and profitability. Of all the products offered by the banking industry, project loans appear to be the most risky in that they usually carry long periods of repayment and are subject to all of the uncertainties that the project itself is subject to in a competitive market. These loans are usually secured by the assets of the project itself, the value of which falls drastically, if the project fails. Accordingly, it stands to reason and commercial sense that a DFI, which invariably takes a significant part of the initial project risk by extending term loans, should find a way to capture additional income from the same client via working capital loans, trade financing facilities, and so on.

## **The Future of Development Banking**

With the liberalization of the financial sector, many DFIs have not only diversified their project-related, long-term product range, but also have entered other segments of the financial services industry, such as commercial banking and insurance. One of the principal arguments adduced in support of this initiative was the need to sustain and improve the profitability of DFIs. In light of the policy decision taken by multilateral institutions and governments to disengage themselves from directed lending—and accordingly to discontinue the practice of providing cheap funds via credit lines to DFIs for onlending to investment projects—alternate sources of funding were also needed. A further inducement for DFIs to become self-reliant was provided by the removal of restrictive barriers thanks to the deregulation and liberalization that swept across almost all countries. Thus, universal banking was embraced by many DFIs.

We noted in the preceding chapters that the unique feature of the DFI model was its ability to serve two seemingly incompatible objectives: maintaining commercial viability and contributing significantly to the achievement of the long-term developmental objectives of the economy. The fact that the DFCC was privately owned, and thus dependant on the market for its capital requirements, imposed a discipline on management to be profitable. The latter requirement, in turn, compelled management to insulate itself from political interference and maintain operational independence.

Governments as well as multilateral lending institutions had provided significant assistance to these institutions. This assistance was given with the expectation that these institutions would develop the required expertise and play an active role in promoting entrepreneurship, assisting in the structuring of projects, providing long-term capital, and sharing project risks, thereby encouraging private capital to flow increasingly into productive enterprises. Many of these institutions were set up by Acts of Parliament, wherein the developmental objectives were clearly enshrined. Such objectives could not be changed even with the unanimous will of the owners (that is, the shareholders). The government invariably secured representation on the boards of these institutions so that it could monitor the performance of these institutions, particularly in fulfilling the developmental objectives.

In the process of carving out a niche for themselves within the new financial order, many of the changes that DFIs are experiencing are desirable and justifiable, but there are others that give rise to concern. The exiting of government from the ownership of DFIs is a step in the right direction. The ill effects of government ownership of financial institutions are too well known to need further elucidation. But in the case of some DFIs, the incorporating statute has been made inoperative and



the institution has been reincorporated under a Company Ordinance. This has resulted in the government having no legal authority or the opportunity to influence the future policy direction of the institution. The check and balance that was so unique to the DFI model and that, as a feature, contributed so much to the success of DFIs has been removed. Accordingly, if the lure of superior returns in the short term, or any other consideration, entices the DFI to move away from pursuing the developmental goals, for the achievement of which it was specifically set up with generous assistance by and support from the government, there is nothing that the government can do to change its course.

Has the level of entrepreneurship and the ability of investors to structure viable projects and resource allocation via the market reached a stage of development that would render the supporting role of a DFI redundant and superfluous in Sri Lanka? The investor community, the organized industrial and commercial sector, and the government do not think so. In fact, the government, responding to popular demand, has set up two new government-owned development banks. The establishment of these government-owned development banks, one focusing specifically on small and medium enterprises (SMEs), has been justified on the premise that the existing DFIs have either abandoned or given low priority to development banking. Establishing government-owned development banks is not the answer and is undoubtedly a mistake for which the public of this country will be compelled to pay dearly. It is no secret that more than 30 percent of the portfolio of one of the newly established government-owned development banks (that is, the SME bank) is already nonperforming. A further 30 percent is reported to be in the questionable category. No professional banker would be surprised at these poor results.

The two established DFIs in Sri Lanka appear to be taking different paths in transforming themselves into universal banks. The NDB has merged its development banking operations with its commercial banking operations. It appears to be focusing less on development banking. The DFCC, on the other hand, continues to retain a separate identity for its development banking activities. The Act of Parliament under which the DFCC was set up continues to be the document that defines its purposes and objectives. It may be too early to arrive at conclusions on the relative merits and demerits of the different paths taken by these two institutions. Even at this early stage, however, a warning light is visible. Just as government ownership and control, although invoked ostensibly to achieve developmental goals, will not deliver the desired developmental objectives, the elimination of any form of accountability in the pursuit of developmental goals and objectives, which are being left to the good sense of the management and a board of directors entirely representing private interests, similarly will not deliver the desired objectives.

Among the lessons that can be gleaned from the extremely successful operations of the DFCC, spanning these 50 years, the one relating to the unique structuring of the organization stands out for recognition. It is incredible that 50 years ago those who conceptualized the DFCC, and the framers of its incorporating statute who translated that concept into an institution, had the foresight and wisdom to recognize the potential benefits and the perils that competing interests of different stakeholders could bring into play in the years to come, and accordingly, could put together a structure and operational safeguards to ensure that the correct balance between such competing interests were maintained. It is incredible that even with the benefit of hindsight it is difficult to recommend any specific and significant improvement to the governance structure that is unique to this institution. Picking a line from a recent television commercial to mark the DFCC's 50th anniversary, it appears that the institution is poised for another 100 years of service to the business community and the country.

## Annex 1: DFCC Financial Record

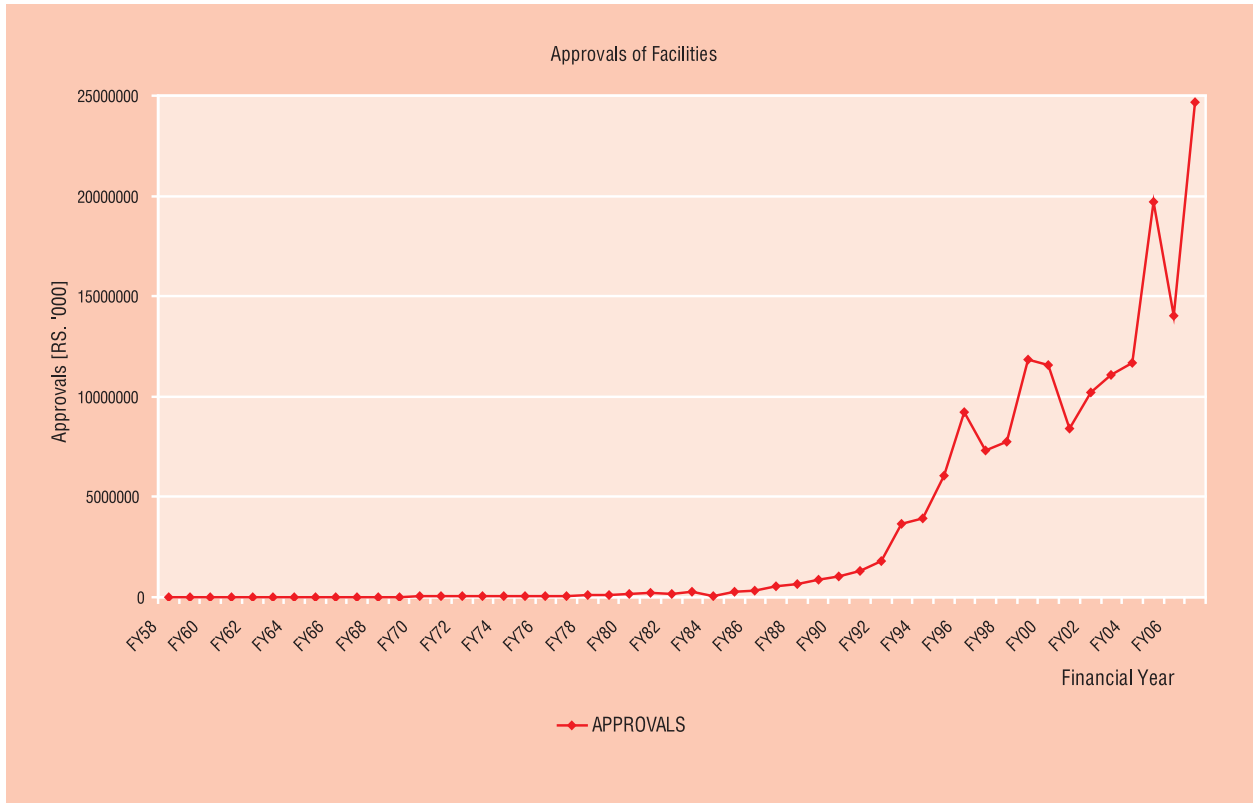
Table A-1: Return on Equity, Return on Assets and Dividend Payout

YEAR	ROE%	ROA%	DIV/PO%	YEAR	ROE%	ROA%	DIV/PO%
1956/57	0.00	0.00	0.00	1981/82	31.5	3.99	15.7
1957/58	0.60	0.19	0.00	1982/83	14.3	2.55	16.7
1958/59	2.60	0.81	0.00	1983/84	9.7	2.05	69.4
1959/60	3.30	1.04	0.00	1984/85	10.7	2.00	59.9
1960/61	3.20	1.00	89.0	1985/86	18.0	2.69	37.5
1961/62	3.90	1.23	96.5	1986/87	22.2	2.78	25.2
1962/63	3.80	1.21	95.9	1987/88	23.5	2.90	23.4
1963/64	6.40	1.99	70.2	1988/89	24.6	3.20	20.0
1964/65	5.00	1.54	87.4	1989/90	29.4	4.00	17.7
1965/66	6.60	2.01	90.3	1990/91	31.4	4.65	22.9
1966/67	9.30	2.92	71.3	1991/92	35.9	6.11	20.8
1967/68	8.10	2.55	79.7	1992/93	31.3	5.64	16.4
1968/69	8.60	2.42	72.4	1993/94	28.3	6.87	14.3
1969/70	7.50	1.57	72.6	1994/95	23.0	6.75	15.3
1970/71	8.00	1.31	62.1	1995/96	16.7	4.45	17.9
1971/72	7.40	1.14	63.1	1996/97	10.7	2.59	22.5
1972/73	6.80	1.08	72.3	1997/98	13.6	3.30	20.1
1973/74	6.60	1.10	62.2	1998/99	13.9	3.04	24.3
1974/75	8.80	1.44	46.7	1999/00	10.2	2.15	39.6
1975/76	7.40	1.13	46.0	2000/01	11.2	2.51	41.1
1976/77	11.8	1.59	33.5	2001/02	13.8	3.20	33.7
1977/78	15.1	2.10	30.8	2002/03	15.8	3.97	27.2
1978/79	16.7	2.26	27.3	2003/04	16.6	4.20	28.9
1979/80	18.5	2.42	24.1	2004/05	14.3	3.53	30.0
1980/81	27.9	3.70	18.2	2005/06	15.8	3.74	31.0

Source: DFCC

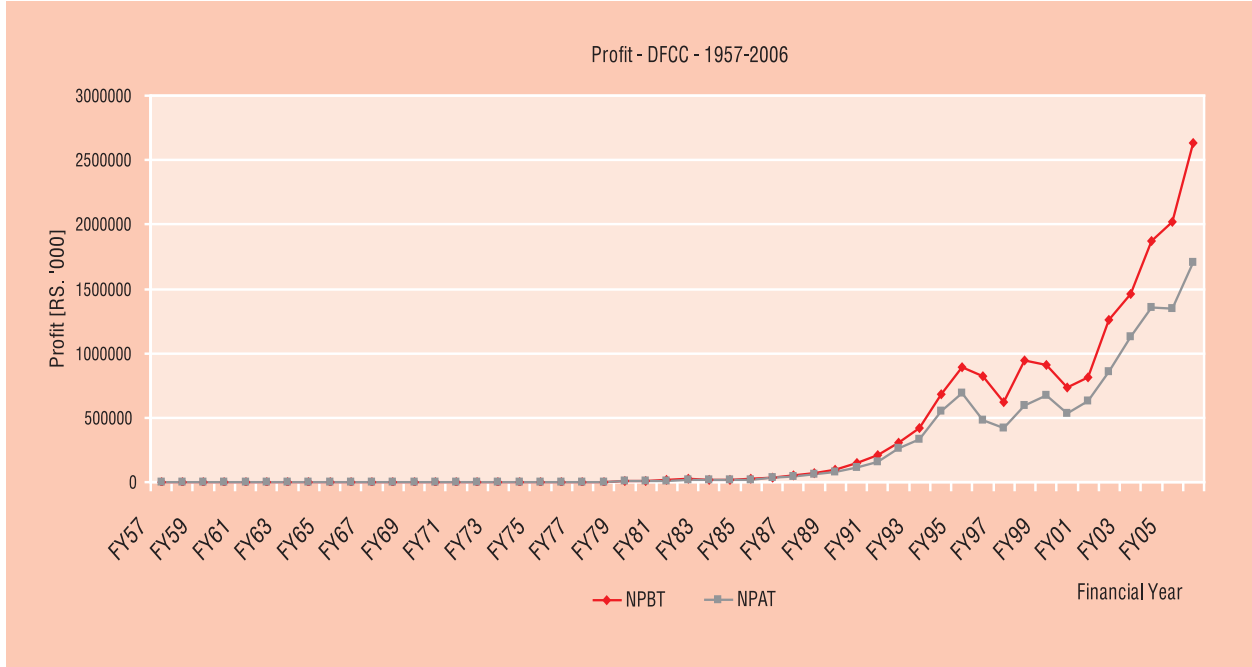
Note: Return on Equity = ROE; Return on Assets = ROA; Dividend Payout = DIV/PO

## Annex 2: Approvals of Facilities



Source: DFCC

## Annex 3: DFCC Profit, 1957–2006



Source: DFCC



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## Note on the Author

Mr. Ranjit Fernando is an Attorney-at-Law from the Ceylon Law College and has a LLB degree from the University Of Sri Lanka. He is also a Fellow of the Chartered Institute of Bankers, United Kingdom and a Fellow of the Chartered Institute of Management Accountants, UK. In addition, he is a member of the Bar Association and a Honorary Fellow of the Association of Business Executives in UK. Mr. Fernando is also a Companion of the Chartered Institute of Management in UK.

He has an illustrious career in banking starting at Peoples Bank in 1961. He has worked at the DFCC for 10 years and joined the National Development Bank in 1989 and was the CEO of the National Development Bank (NDB) from 1989-2001. His contribution to the development of the NDB as a DFI is well known in the country. This institution which started as a state owned organization finally was privatized and was strengthened during his tenure. He also served as the Secretary to the Ministry for Investment Promotion, Industrial Policy, and Constitutional Affairs during 2002-2004.

He has contributed immensely to the conceptualisation and implementation of financial sector reforms in Sri Lanka especially in the SME sector. Mr. Fernando has been an international consultant and advisor to the World Bank and the Asian Development Bank and is a member of the Board of Trustees in Women's World Banking, New York. He has worked in Maldives assisting the Government to set up the Housing Finance Development Corporation and also conducting training programs for the Ministry of Finance and Stock Exchange. Mr. Fernando was a member of the team of ADB consultants that helped the Government of Bhutan set up its Development Bank.

The author was the CEO of the National Development Bank of Sri Lanka, which was engaged in the same line of business as the DFCC Bank, and in direct competition with it. However, he states that he had no qualms about taking on the present assignment, since even while competing fiercely; he had great respect for the institution and its leadership. In addition, he fondly remembers learning his basics in development banking at this institution.



