

# OEG *Findings*

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## Development of Financial Institutions Assisted by IFC

IFC's experience with financial institutions in developing countries has provided important lessons on institution building. IFC's independent Operations Evaluation Group (OEG) reviewed the Corporation's experience with institutions that provide financing to private enterprises and analyzed the elements necessary for the development of successful institutions. Although there is no simple formula for success, OEG finds that viable institutions can be built only if the following components are sound:

- Ownership structure
- The board of directors
- Management
- Technical partners or advisors
- Staffing
- Training
- Policies and procedures
- Information systems and controls
- Strategic planning
- Institutional culture

The OEG study covered leasing companies and other spread-based institutions, venture capital companies (VCCs), and investment or merchant banks. It considered the performance of IFC's mature loans and equity investments in 35 development finance companies, 9 investment or merchant banks, 15 leasing companies, 8 VCCs, and 2 other institutions. It then examined more intensively the performance of a sample of 20 institutions in 14 countries in Africa, Asia, and Latin America. These institutions, which had total assets ranging from less than \$1 million to \$17 billion, were selected to reflect the range of IFC's investments and the range of outcomes. Although the sample was not necessarily representative, it provided a good basis for developing an understanding of what is necessary for the development of successful financial institutions.

### Ownership structure

In many of the institutions reviewed, shareholders provided overall guidance and capable board members, access to an experienced team of managers, assistance in attracting business, advice in assessing potential clients, support in establishing systems and procedures, access to resources, and-most important-leadership in dealing quickly and decisively with problems, including the need to change management. The willingness of shareholders to provide active guidance and support generally depended on their having a substantial stake. Based on the experience of the institutions reviewed, shareholders (other than IFC) with holdings of less than 25 percent seldom provided leadership or meaningful support, and even larger holdings were often necessary to ensure adequate continuing interest.

## Board of Directors

An effective board plays a useful role in questioning, guiding, and, when necessary, opposing, or even changing management. Having an effective board can be particularly important for a new financial institution owned by a number of partners, as in most of the cases reviewed. Some of the institutions did well despite having passive boards, but others owe their survival and success to assertive boards that took the initiative in addressing critical problems.

Generally, the most effective boards were small, with fewer than ten members. Their high caliber, experienced directors provided overall guidance and were independent enough to challenge their institution's chairman. The boards functioned best when given sufficient information for an overview of operations and problems, but not so much that they were inundated with details and minor issues. Continuity of membership and consistent attendance were also important.

A director who is a strong leader and who can act independently of management is needed to handle problems that threaten to overwhelm an institution. For example, when major portfolio problems began to appear after a leasing company's first few years, the non-executive chairman, calling for greater selectivity in credit decisions, increased emphasis on collections and, subsequently, replaced two of the three top executives. Similarly, when an investment bank floundered after having abandoned its initial business, IFC's board nominee called for a major financial restructuring to allow the institution to take advantage of an attractive market niche.

## Management

Without capable management, no institution can prosper. In the successful institutions, management maintained an appropriate balance between prudence and aggressiveness, giving priority to prudence in the early years. In these institutions, management was sensitive to emerging problems and opportunities and flexible in adapting to them.

As new institutions, often the first of their kind in the host country, many of the institutions reviewed had to choose between hiring a foreign chief executive with technical expertise but a lack of country knowledge or a local chief executive with an understanding of the environment and a knowledge of the local business community but a lack of specific technical experience. Most chose local chief executives. These institutions were in countries that could provide managers with enough related experience to undertake the management of a new type of institution. They all started out on a modest scale, and most of the successful ones built up their operations gradually, giving management time to learn. Several arranged for technical assistance or hired foreign staff. In the few cases where foreign chief executives were used at the outset, local board members or local members of the management team were expected to play an active role, and local executives replaced the expatriate chief executive within the first few years.

While delegation is important in large, mature institutions, smaller ones, especially in the early years, need a firm hand on the reins. The chief executives of the successful spread-based institutions all maintained tight control over credit decisions during the initial years. Centralized decision-making certainly involves some risks in a financial institution but, with a capable chief executive, can help greatly in establishing standards.

Management requirements differ among types of institutions. Spread-based institutions require managers who are prudent and relatively risk-averse while managers of VCCs, for example, require more enterprising, risk-oriented individuals with a knack for assessing entrepreneurs and future business prospects and adding value to fledgling companies. Remuneration packages must reflect those differences.

## Technical partners and advisers

IFC, when confronted with a lack of experience on the part of local sponsors, has usually sought assistance from foreign partners, managers, or advisers who could provide know-how about specific products or services, assistance in establishing appropriate systems and procedures, training, and general advice and guidance.

Where technical partners have been considered necessary, their effectiveness has usually depended heavily on their assigning their own staff to one or more managerial positions. Technical partners without a meaningful stake are unlikely to provide staff or proper supervision. Investment or merchant banks are particularly hesitant to commit staff to institutions in which they have only a small stake because of the earnings they can normally expect from the use of staff in their own operations. Technical assistance is most likely to be productive when the foreign executives or advisers are experienced managers in the type of business being promoted, and when they are sensitive to the local culture and capable of gaining the respect and understanding of local staff. Also, the local side must be open, willing to learn, and prepared to give its trust and respect to the foreign executives or advisers. When the leading personalities on the local side are more interested in increasing their own power than in benefiting from the presence of a foreign manager or adviser, the arrangements are unlikely to be successful.

## Staffing

An institution's ability to attract and retain enough capable staff members depends on the country's general level of education, the type of business, and the institution's own management. Institutions in countries with good educational systems generally had fewer staffing problems. Nevertheless, in two relatively well-endowed countries, a rapid increase in the number of financial institutions led to sharp competition for the number of qualified staff available.

The experience and skills needed to staff a VCC are rare in any country. Most of the VCCs reviewed found difficulty hiring capable staff even when other types of financial institutions experienced no problems.

Management played a crucial role in attracting and retaining an adequate number of capable staff members. Three factors were important:

- Several of the well-managed institutions exercised great care in screening new staff. For example, in one case, the expatriate managing director took nine months and had six persons interview the leading candidates before selecting a deputy.
- The well-managed institutions generally paid a premium to attract and retain good staff and to discourage corruption. Some had profit-sharing plans. In contrast, many of the institutions that suffered from staffing problems paid only the market rate and often fell behind the market.
- The better institutions were viewed as good employers because they offered, along with better salaries and bonuses, bright long-term career prospects with overseas training opportunities. Their managements were respected and considered free of corruption.

## Training

Training is vital to the development of a healthy institution, particularly when a new type of institution is introduced. The institutions most successful in attracting and retaining capable staff did a thorough job in training and devoted resources to it. IFC board nominees could encourage increased attention to training by calling for periodic reports on the training programs in place and their results.

## **Policies, procedures, and systems**

Financial institutions must establish clear and appropriate policies and procedures that lay down what the institution may or may not do and how things are to be done. Policies must cover general issues such as exposure limits, asset-liability management, capital adequacy, power to make commitments, and conflicts of interest. Procedures must cover more specific issues such as requiring audited financial statements from clients, security, collections, and regular visits to clients. Institutions, moreover, must periodically consider the need for revisions to reflect changes in their operations or the environment. The OEU report suggests that IFC encourage institutions to carry out systematic, periodic reviews of their policy statements to deal with changing conditions.

Preventing imprudent revisions, waivers, or circumvention of policy statements is at least as important as encouraging necessary changes. To this end, IFC has encouraged provisions subjecting policy statement amendments or waivers to a stricter test than a simple majority. Such provisions are not always effective. For example, in one unsuccessful VCC, directors with direct or indirect interests in a client company participated in board discussions and provided the votes to approve investments in this company going well beyond the policy statement limits. Despite the efforts of its board nominee, IFC was powerless to block these approvals, which resulted in the VCC's poor performance.

Obviously, for efficiency's sake, most institutions give responsibility for some or all investment or credit decisions to committees composed of board members, management, or both. But this delegation of authority calls for additional safeguards to ensure that policy guidelines are followed. The study suggested that such safeguards might include careful drafting of policy guidelines; ensuring that the committee authorized to approve commitments include at least one board member fully independent of management; and calling for unanimous approval of all commitments, or at least, commitments over a specified limit. The study recommended that IFC encourage institutions to recognize that, no matter how well-designed their policies, procedures, and systems may be, management and staff need time to learn to carry them out effectively. Consequently, well-run institutions should try to build up volume slowly, allowing time for staff to learn.

## **Information systems and controls**

Institutions must have adequate information systems so that the shareholders, board, and management can understand the institution's financial performance and condition. Deficient information systems and controls, and management that resists suggestions for improvements, are signs of impending trouble. To ensure that information is reliable and that policies and procedures are being followed, financial institutions should have a system of internal control, an external auditor (who not only comments on the institution's financial statements but also provides a comprehensive management letter each year), an internal audit unit (except for very small institutions), and a board audit committee to oversee the work of the external and internal auditors.

The most successful institutions recognized the importance of information and controls, established appropriate systems, carefully considered any criticisms by auditors (or others, such as IFC), and made improvements when necessary. In the unsuccessful institutions, management information systems, internal controls, internal audit arrangements, and even, in some cases, external auditors were inadequate. Management frequently resisted criticisms and suggestions. These shortfalls contributed significantly to the poor performance of some of these institutions. Inadequate information supplied to one institution's board led to a failure to recognize serious portfolio problems resulting from aggressive attempts to increase volume. Serious deficiencies in internal control caused another institution to take an excessive exposure in a client that subsequently went bankrupt. In another case, an investment bank went bankrupt because serious flaws in information systems and controls prevented the board from understanding the risks the institution was taking.

The OEU report recommends that IFC should insist that essential information systems and internal controls be put in place by the time operations begin;

- seek adequate information on, and pay particular attention to, mismatch risks, loss provisions, reschedulings, and non-accrual practices;
- ensure that every institution, with the possible exception of VCCs, establishes an internal audit unit that reports to the institution's chief executive or, preferably, its board;
- clearly spell out the issues to be covered in management letters, insist on compliance by the auditors, and follow up to ensure that management makes necessary improvements or provides satisfactory reasons why it should not do so;
- call for financial institutions to provide permanent instructions to their auditors to notify the shareholders in the event the auditors become aware of fraud or material breaches of legislative or administrative regulations;
- encourage the formation of audit committees made up of independent directors to oversee the work of the external auditors and the internal audit unit, to consider the adequacy of the loss provisions, and to ensure that management seriously considers any recommendations made.

### **Strategic planning**

Although one of the institutions reviewed used strategic planning with considerable success, few others did so. Some that tried met with only limited success because of unrealistic management proposals, difficulties in reaching a consensus among the shareholders, or failure of the board to ensure that changes were carried out. Other institutions were either too young to concentrate on anything other than initial institution-building efforts or else had not taken the initiative for a systematic review of potential problems or opportunities. Strategic planning may not be appropriate for all institutions but should be encouraged where appropriate.

### **Developing an institutional culture**

Developing an institutional culture is difficult and takes many years. One of the key difficulties for an institution that is engaged in a range of operations is to develop a culture appropriate to all of its operations. For example, several of the venture capital companies that sought to provide fee-based services suffered from the conflict of cultures inherent in these different businesses. Moreover, changing the culture of an existing institution is hard and requires special efforts. Despite having decided, ten years ago, to convert itself into a merchant bank, one finance house still retains its earlier culture as a spread-based institution. Certainly, some financial institutions are able to maintain cultures appropriate for a range of operations. But IFC should be aware of the potential problems and should recognize that a good deal of time and effort may be needed to deal with them.