

# **Commonwealth Development Corporation**

A report on the efficiency and costs of, and the service provided by, the Commonwealth Development Corporation



MONOPOLIES AND MERGERS COMMISSION

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A report on the efficiency and costs of, and the service provided by, the Commonwealth Development Corporation

**Presented to Parliament by the Secretary of State for  
Trade and Industry by Command of Her Majesty  
June 1992**

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<sup>1</sup>These members formed the group which was responsible for this report under the chairmanship of Mr P H Dean.

## **Note by the Department of Trade and Industry**

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests. The omission is indicated by a note in the text.

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# 1 Assessment

## The reference

1.1. On 13 November 1991 the Secretary of State for Trade and Industry referred to the MMC certain questions concerning the efficiency and costs of, and the service provided by, the Commonwealth Development Corporation (CDC). The full terms of reference are set out in Appendix 1.1.

1.2. In this chapter we discuss the main issues arising from our inquiry. A list of our recommendations appears at the end of the report in Chapter 10.

## Background

1.3. CDC is a public corporation whose members (ie CDC's Board) are appointed by the Secretary of State for Foreign and Commonwealth Affairs. CDC began life as the Colonial Development Corporation in 1948 with a duty to carry out projects 'for developing resources of colonial territories'. Its role was redefined in the 1960s, when further legislation extended its remit first to independent Commonwealth countries and subsequently to overseas countries generally. Its present statutory purpose is defined as being 'to assist overseas countries in the development of their economies'. It operates as of right in the remaining British dependent territories, while the Secretary of State directs in which independent countries, both within and outside the Commonwealth, CDC may operate. At present it is empowered to operate in 68 territories and developing countries and it has investments and commitments in 50 of these. Of these 50, 19 are in Africa, 12 in the Caribbean, 10 in Asia, 4 in Latin America, 4 in the Pacific and 1 (Gibraltar) in Europe. They range in size from India, with a population of over 800 million, to the Turks and Caicos Islands with just 7,000 people.

1.4. CDC's business consists primarily of investments, both loans and equity, in the establishment or expansion of productive enterprises in developing countries. Its portfolio currently comprises over 300 projects with a book value of £830 million (£1,037 million gross, less provisions of £207 million) at the end of 1991. A few of these are in wholly-owned subsidiary companies but the vast majority are joint ventures. It has a wide range of investment partners: private sector companies and public sector bodies in the host countries themselves; other development finance institutions (DFIs) such as the International Finance Corporation (IFC) (part of the World Bank Group), regional development banks and CDC's equivalents in other EC countries; and private sector companies from the developed world. CDC itself manages 35 projects-about 10 per cent of its total portfolio by number and rather more by value-usually where it holds a majority of the equity in the project company, and seconds individual managers to a number of other projects. It also provides consultancy and other ancillary services to some of the projects in which it has invested.

1.5. CDC has always been funded by loans from the British Government (the Government), most of them at concessionary rates in recognition of CDC's developmental role. Since the mid-1960s indeed CDC has been part of the Government's Aid Programme. At present all new loans, which are channelled via the Overseas Development Administration (ODA) as CDC's sponsoring department, carry an interest rate of 3.5 per cent and are for 25 years, repayable in equal annual instalments after a grace period of seven years. Because the rates charged on some of CDC's loans from the Government in the past were higher, the average interest rate which it pays on its outstanding loans is around 4 per cent. Although it has no equity capital as such, it has built up reserves over the years by earning surpluses on its operations so that reserves now represent 25 per cent of its capital employed, the remainder consisting of long-term Government loans.

1.6. CDC's investment portfolio, financed by its reserves and existing Government loans as described above, has reached a stage of maturity such that it now generates most of the cash flow required to finance new investments. Over the last three years new investments have averaged £152 million per annum, to which new Government loans, net of repayments of principal, have contributed an average of £46 million. CDC's self-generated funds principally comprise interest receipts on its loans to projects, dividends on equity holdings, fees, the proceeds of equity disposals, and the difference between repayments of loans from projects and CDC's repayments of its own borrowings from the Government. The last element arises because the overall length of CDC's loans to projects averages around 12 years, compared with the 25-year term of most of its borrowings. This difference in loan maturity produced 27 per cent and 39 per cent respectively of CDC's self-generated funds in 1990 and 1991.

## **Framework of accountability**

1.7. As noted above, CDC's fundamental purpose is to assist overseas countries in the development of their economies. While fulfilling this purpose it has a statutory duty to ensure that its income covers its expenses, taking one year with another.

1.8. These statutory provisions are amplified by a framework of policy supervision by the Government which comprises the following elements:

- five-yearly reviews carried out by CDC and the interested Government departments under ODA chairmanship (Quinquennial Reviews);
- CDC's annual Corporate Plan, looking five years ahead on a rolling basis;
- a twice-yearly submission by CDC, called a 'Planning Framework' submission, setting out its financial projections for broadly the same period as the Corporate Plan; and
- a requirement on CDC to seek political clearance through ODA for all individual investments over £2 million and also capital sanction for all investments over £5 million.

As noted in paragraph 1.3, the Government also approves the countries, other than dependent territories, in which CDC may operate.

1.9. Since 1987 CDC has been operating to the objectives agreed in the last Quinquennial Review, completed in March 1987. The review considered how CDC should strike the balance between its development and financial objectives and concluded that CDC's aim should be to achieve as much development benefit as practicable within the financial, commercial and political conditions in which it operates. In order to define CDC's development objectives more clearly, the review agreed on certain specific targets: that CDC should aim to make 60 per cent of its new

commitments in poorer countries (defined as having a gross national product (GNP) per head of less than US\$800 in 1983); 67 per cent in Commonwealth countries and Pakistan; and 40 per cent in renewable natural resources (RNR). It was also agreed, but without a quantified target being set, that CDC should seek to increase the proportion of its business in the private sector. CDC subsequently adopted a target that at least 60 per cent of new commitments should be in the private sector. The Quinquennial Review also recommended as an efficiency target that the ratio of CDC's operating costs to its total investments and commitments should not exceed the level achieved in 1985.

## **CDC's performance against its agreed objectives**

1.10. Since economic development can take many forms and has many aspects, it is not possible to measure CDC's performance against its overall development objective in a purely quantified way. It has comfortably achieved its targets for new commitments in poorer and Commonwealth countries, with averages of 70 per cent and 79 per cent respectively over the years 1989 to 1991. It has not achieved the target for commitments in RNR, the three-year average being 29 per cent. CDC told us that this was mainly because of low actual and expected commodity prices and a shortage of suitable land for large new agricultural projects. CDC has achieved its own target for commitments in the private sector, which have averaged 72 per cent of the total in the last three years.

1.11. As to financial results, CDC has earned surpluses after interest and tax ranging from £5 million in 1987 to £28 million in 1991. These results can be looked at in various ways. CDC's surpluses before interest and tax have represented a return on average capital employed-defined as CDC's outstanding borrowings plus reserves-ranging between 5 and 8 per cent. Interest cover-the ratio between CDC's surplus before interest and tax and its interest payments to the Government-has ranged from 1.3 to 2.6 times. CDC's provisions, which are an important factor in its financial results, have represented between 46 and 76 per cent of its surplus after interest and tax but before provisions. Capital gains on the disposal of equity investments were exceptionally high by historical standards in 1989 and 1991 and represented 46 per cent and 55 per cent respectively of the net surplus before tax. Thus while CDC has earned a surplus in each year, its margin for error has been quite low.

1.12. In the period 1987 to 1991 CDC's gross and net operating costs (ie before and after deducting fee income) have averaged 1.3 per cent and 0.7 per cent of investments and commitments compared with the targets of 1.2 per cent and 0.6 per cent taken from the actual levels in 1985.

## **Overall assessment**

1.13. Our assessment of CDC's performance has been coloured by its unique and in some respects ambiguous character. There is no comparable institution in the United Kingdom; and although there are DFIs elsewhere which have some of the same characteristics, there are also significant differences between them. CDC is distinctive in having a direct management capability, an extensive presence in developing countries via its network of 21 overseas offices, and a close involvement, frequently involving board membership, in many of the projects in which it invests. Its capital structure is also unusual in being wholly based on debt finance.

1.14. The apparent paradox of CDC is that its central objective is to maximise development, not profit, but it must operate in a commercial manner. In one sense there is no conflict in so far as economic development needs to be pursued through investments which are market-based and

commercially viable if it is to be sustainable. CDC invests in projects which it believes will be profitable, as well as satisfying developmental criteria. Its approach to this task is largely commercial, and its procedures and corporate style are in many respects akin to those of a private sector company in business to make profits. As noted above, it has over the years accumulated a significant surplus and has not incurred a deficit in any single year since the 1950s.

1.15. By virtue of its remit, however, CDC's operations are in countries where risks and uncertainties are generally greater than in the developed world and where investment capital is less easily obtainable. Not only do conditions often make it hard for projects to succeed in themselves, there is also frequently an element of 'country risk', eg that a shortage of foreign exchange will cause remittances to CDC, even from successful projects, to be blocked. Moreover, CDC has traditionally had a strong focus on RNR projects, which make up nearly half of its portfolio, and is therefore particularly vulnerable to the vagaries of commodity prices. CDC's targets for the proportion of commitments to be in poorer countries and in RNR show the high risks which it is expected to cope with. It is for these reasons that CDC's funding from the Government is on concessionary terms. Thus CDC is not simply a donor agency providing grants or highly concessionary loans, nor a profit-seeking financial intermediary, but occupies a position somewhere between the two. Notwithstanding its broadly commercial approach, CDC is a public sector body and faces various constraints which private sector companies do not.

1.16. Because of CDC's unusual characteristics, assessing the effectiveness of the organisation is not straightforward. It is not possible to construct a simple or quantifiable measure of CDC's overall contribution to economic development. At the same time, CDC does not set out to maximise profits and therefore cannot be judged solely by its profitability. Instead we have looked at a number of different indicators and tried to reach an overall judgment.

1.17. CDC is an investment institution and one important indicator is the rate of return achieved on its investment portfolio. CDC's statutory requirement to break even, considering that it receives funds on such highly concessionary terms, is not in itself demanding. CDC has recognised, in conjunction with ODA and the Treasury, that because the extent to which its borrowings are on favourable terms had increased since the break-even requirement was set, a more demanding target was necessary. It therefore now aims to achieve a three-year rolling average return on average capital employed of 6 per cent per annum. This is close to the actual return which CDC earned in the three years 1988 to 1990 and reflects CDC's view that this level of return is appropriate in giving a sufficient margin over the break-even requirement and generating a reasonable level of surpluses. Its actual return in 1991 on this basis was 7.9 per cent. The basis of calculation and the level of this target are to be considered in the forthcoming Quinquennial Review.

1.18. The interest rates which CDC charges on its loans to projects are on average below what even a first-class commercial borrower would pay in the United Kingdom. CDC said that its policy was to pass on part of the subsidy element in its own borrowings from the Government, but that the interest rates which it charged were not in practice very different from those charged by other DFIs who purported to lend at market rates. CDC also told us that if it found that it was exceeding its financial target, it would look for projects which offered high development value but also higher risks and lower financial returns.

1.19. It is clear that CDC feels constrained not to make surpluses which it considers the Government and Parliament would regard as excessive. In one sense CDC's financial performance is impressive in that it has consistently achieved the modest levels of surplus which it considers appropriate given its framework of accountability. In view of the difficult operating conditions it has to contend with in some countries, and bearing in mind the heavy losses which many commercial banks have incurred on their business in developing countries in recent years, this is

no negligible achievement. It owes much to the diversification of CDC's portfolio, both by country and sector, and to the basic soundness of its appraisal, monitoring and control procedures. But in real terms, CDC's returns have almost certainly been negative in the long run, though they may at present be positive given that inflation is currently at a low level by the standards of the last 20 years. CDC does not produce inflation-adjusted accounts, and because of the recent change to equity accounting comparisons are difficult to make between the years from 1989 onwards and earlier years, although CDC estimates that its reserves increased by 19 per cent in real terms between 1986 and 1991. In order to focus attention on the effects of inflation we have recommended that CDC should have a new target at least to maintain the real value of its accumulated reserves.

1.20. CDC's own financial results, however, give only a very indirect indication of the financial success of the projects in which it has invested and say even less about development benefits. Our assessment of these factors has been hampered by the fact that CDC does not calculate the actual rates of return achieved by most of its projects, by the relative lack and unrepresentativeness of its evaluation reports, and by the absence of reports on its development achievements. A substantial proportion of CDC's projects encounter financial difficulties of one sort or another. Around one-third of the total are in arrears on payments of loan interest or repayments of loan principal at any one time. Among CDC's equity investments more than half (85 out of 141) had current valuations below cost as at September 1991.

1.21. CDC analysed for us the situation, at the time of our inquiry, of the 251 projects which were in its portfolio at the end of 1987. Twenty-five had left the portfolio because they had paid off their loans or, in the case of equity investments, had been sold. Of the remaining 226, only five had failed altogether, five were in need of financial reconstruction or threatened with receivership or liquidation, ten were earning returns which were too low for the projects to be sustainable financially on current trends, 53 were generating cash but not yet servicing debt in full, and 35 were servicing debt in full but not yet making what CDC regarded as a full return to equity investors. Eighty projects to which CDC had made a loan only were servicing the debt in full, but CDC was unable to say whether they were generating a return for equity investors (indeed CDC said that many of these, notably publicly-owned utilities projects, would be financed by loan capital only). Twenty-eight projects were servicing debt and returning dividend flows satisfactory to CDC, while ten could not be classified. This analysis is incomplete but the broad picture is one of few outright failures, a relatively large number of projects failing to service their capital fully (whether loan or equity or both) and a relatively small proportion making fully satisfactory returns. On the other hand a substantial majority were at least servicing their loan capital. Equity investments overall earn a higher return than loans for CDC, but over 80 per cent of the net surplus of valuation over cost in CDC's balance sheet is contributed by four highly successful projects.<sup>1</sup>

1.22. In addition to examining information provided by CDC we have made comparisons with other DFIs on the basis of published financial results. Although these comparisons are subject to various qualifications, we are satisfied that they are broadly to the advantage of CDC. We have also visited nine of the overseas countries in which CDC is active-four in Africa, three in Asia, one in the Caribbean and one in Latin America-and received a wealth of evidence, oral and written, from people with whom CDC has regular dealings in those countries including government ministers and officials, project sponsors, co-financiers and British Government Posts. Apart from these visits, we have held several hearings with interested parties in the United Kingdom, and received an unusually large volume of letters from people writing to us in response

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<sup>1</sup> CDC announced the sale of its holding in one of these, Modern Terminals Ltd of Hong Kong, shortly before our report was due. CDC had made a loan to the company of £2 million in 1971, part of which was subsequently converted into equity, and has now sold its stake for £45 million.

to the advertisements which we placed at the outset of the inquiry. Details of the parties who gave evidence to us and of our visits are to be found in Appendices 1.2 and 1.3.

1.23. On the strength of the evidence available to us we are left in no doubt that CDC is generally held in high regard throughout the world in which it operates. Due allowance must be made for the fact that the very nature of CDC's operations is likely to make it popular in the countries where it invests. Many of the comments made to us, however, compared CDC favourably with other DFIs. Unsurprisingly, perhaps, CDC's name is far better known in many overseas countries than it is in the United Kingdom.

1.24. Besides examining CDC's outputs and collecting views from other parties we have devoted considerable attention to CDC's internal policies, systems and procedures. CDC is a project-based organisation. Its first concern, in deciding how to invest the funds available to it, is to satisfy itself as to the financial and developmental qualities of the projects which come before it. Having made its investment decision, CDC regards itself as a committed, long-term investor in its projects and frequently plays an active part in resolving difficulties that arise throughout a project's life. We found this approach to investment, and the organisation which CDC has established for putting it into effect, to be well suited to CDC's objectives. The part played by the overseas offices, both in generating new business and in looking after CDC's interests in its existing investments, is crucial to its success, even though the principal decisions are all taken at the London Office. The relationship between the overseas offices and London Office appeared to be working reasonably well. Although as noted above (paragraph 1.12) CDC has slightly exceeded its target cost ratios, we consider that costs are not excessive and are well controlled. Cash management is effective, and the staff are of high quality and well motivated.

1.25. Our conclusion is that, given the framework within which it operates, CDC is a competent organisation. Notwithstanding this overall judgment, we have found a number of areas where efficiency could be further improved. We summarise the main points in answering the reference questions later in this chapter. The one general comment we would make is that, while CDC rightly emphasises the importance of business judgment, its exercise of such judgment is sometimes insufficiently supported by quantified analysis, both in its decisions on investments and in monitoring and evaluation. CDC argued that it would be bureaucratic and costly to make greater use of analytical tools and to engage in further information gathering and evaluation, although it modified its position somewhat in the course of our inquiry. In our view the results of analytical techniques need not and should not be applied in a mechanical way, but we consider that CDC needs to use its business judgment—the importance of which we do not deny—in the context of a disciplined approach. We also believe CDC's efficiency and impact are constrained by various limitations and controls imposed on it by the Government, a matter to which we now turn.

## **Disadvantages of the policy framework**

1.26. In this section we comment on a number of ways in which the framework of Government policy and control presents disadvantages for CDC. Some of these matters can be addressed without major change but others require a more radical approach. All of them are probably best dealt with in the context of the forthcoming Quinquennial Review.

1.27. Our starting point is that CDC's strengths fit well with the trend of international thinking on development assistance. Current official policy in many developing countries places increasing emphasis on the private sector as the main engine of economic growth. Although CDC has investments in many public sector projects, it is particularly well equipped to invest in joint ventures with private sector partners from the host countries themselves. It brings managerial and

technical skills and a wealth of experience which can be invaluable in helping projects succeed, as well as indirectly in giving project sponsors greater credibility in looking for other sources of finance. As noted above, CDC has a target that at least 60 per cent of its new investments should be in private sector projects. Paradoxically for a public sector body, it is playing a part in helping governments to privatise state-owned industries by investing in new privately-owned structures-though it is debarred by statute from investing in projects which consist solely of the refinancing of existing assets-and has recently received approval from the Government to play an advisory role in assisting privatisation in Eastern Europe.

1.28. In these circumstances CDC's contribution to British aid policy is particularly important. We believe that CDC's activities are a highly effective form of aid despite the low financial returns referred to above. The relative degree of independence from Government which CDC has succeeded in maintaining has enabled it to adopt a commercial approach in many respects and to preserve a strong corporate spirit. But there are drawbacks in CDC's present financial framework.

1.29. First, CDC's lack of equity capital, other than the reserves which it has accumulated, gives the impression that it is only an extension of the Government. We believe it is right that CDC should have its own equity in the form of Public Dividend Capital (PDC). This would improve the structure of its balance sheet, which is highly geared by commercial standards at present, and would help to underline CDC's relative independence from the Government. PDC could be provided either as new money or by converting some or all of CDC's outstanding borrowings. Dividend policy, to be agreed between CDC and the Government, should reproduce the concessionary element of CDC's Aid Programme borrowings but could be reviewed in due course if, as we envisage, CDC were able to earn higher financial returns in future. Given the fundamental purpose of CDC and the risks entailed in investing in developing countries in general and poor countries in particular, we think it unlikely that CDC could operate effectively without some element of concessionary funding.

1.30. Secondly we have commented earlier on the ambiguous nature of CDC which can perhaps best be summed up by the term 'quasi-commercial' which is frequently applied to it. We consider that this ambiguity is itself undesirable since it blurs CDC's objectives and the measures for assessing its success. We suggest that consideration be given to dividing its activities into two parts, on the model of certain other DFIs: one which would be entirely commercial, directed at investments in the more prosperous developing countries, and the other aimed at the poorest countries and hence subject to different criteria.

1.31. Thirdly, if CDC is to make a full and efficient contribution to sustainable economic development in the new international environment, it should be free to expand its activities by financing more projects and investing at a greater rate. Under the current arrangements the amount of growth CDC should plan is a matter for Ministers to decide. ODA told us that in considering the allocation of funding to CDC, Ministers looked primarily to the level of investment which CDC would be able to finance. The implication of this approach is that an increase in the funds generated by CDC from its operations could lead, at least indirectly, to an offsetting reduction in new Government loans. This reduces the scope and incentive for CDC to expand its activities and, in particular, to achieve profitable equity realisations. We have suggested that the amount of CDC's new Government loans should be set, instead, as a given percentage of the Aid Programme.

1.32. A further constraint on CDC's growth is its inability to borrow from commercial sources. Part of the intention behind the CDC Act 1986 was that CDC should be able to borrow commercially through an overseas subsidiary, and hence outside the Public Sector Borrowing Requirement, but CDC has been prevented from doing so by a Treasury policy that public bodies will only be allowed to borrow commercially if they can do so at rates as fine as the Government itself. Not surprisingly CDC has been unable to satisfy this requirement. We see the logic of the Treasury's position but we believe that CDC could borrow funds on terms not substantially worse than those available to the Government and that the difference in cost is outweighed by the desirability of giving CDC more control over its business. Moreover if CDC were able to borrow in foreign currencies it would be in a better position to advance loans in the most suitable currency. A significant proportion of project sponsors would prefer to borrow in currencies other than sterling.

1.33. Fourthly, CDC is currently obliged to operate very much on a hand-to-mouth basis by the restrictions which the Government imposes on its liquidity. These restrictions distort CDC's behaviour in various ways and are inappropriate to a body which is expected to operate in a commercial manner. We have recommended that some of the existing constraints should be substantially eased.

1.34. Finally, we have considered whether it would be feasible and beneficial to reconstruct CDC wholly or partially in the private sector with a view to loosening further the constraints-particularly the constraint upon growth-while keeping intact the developmental purpose for which the Corporation exists. It has not been possible for us during the span of this inquiry to arrive at an answer to this question. We acknowledge the difficulty of achieving such a transformation in a way which properly safeguards the public and private interests involved and think it unlikely that a wholly private sector arrangement would be feasible. The potential advantages of introducing some private capital seem to us to be significant, however, and we hope that this question will be further pursued by CDC, ODA and the Treasury.

## **The reference questions**

1.35. We have been asked two general questions: whether CDC could improve its efficiency and thereby reduce its costs without affecting the level of assistance it provides to overseas countries, and whether the service it provides could be improved without an increase in costs. We have not identified specific areas where significant cost savings could be achieved, although we believe some of our recommendations concerning CDC's procedures will improve its efficiency. We do see scope for improvement in CDC's overall effectiveness as a result of our recommendations, listed in Chapter 10. Some of these recommendations would entail cost increases but these would be modest and, we believe, fully justified by the results.

1.36. Our responses to the particular questions posed in our terms of reference are set out in the following paragraphs (references are to the sub-paragraphs as set out in Appendix 1.1).

## ***The scope for improving financial and management systems***

1.37. CDC's systems are concerned with overall planning; the development and monitoring of the investment portfolio; the control of financial flows; and the evaluation of project results. The existing systems are appropriate to CDC's operational needs and have enabled it to stick reasonably closely to its plans both in terms of new commitments and financial results.

The main weakness lies in the area of evaluating and reporting on the development benefits of projects. CDC maintains that it generates the information it needs for operational purposes and that as a commercially-oriented body it cannot afford to devote substantial resources to special assessments of development benefits. Given the generally close correlation between financial and economic returns, the financial performance of the projects should, in CDC's eyes, be taken as the main indicator of developmental success.

1.38. There is some force in this argument, but the fact remains that CDC's fundamental purpose is to assist development and the best way of assessing the results is to carry out evaluations of a representative sample of projects. CDC's evaluation programme is of relatively recent origin and it has concentrated on looking at projects which have performed poorly in the belief that it could learn more lessons from those. CDC agreed with us, however, that it needed to increase the number of evaluations which it performs, or commissions from other bodies, and that the range of projects covered should be more representative of the portfolio.

1.39. At a more routine level, CDC should recalculate the forecast financial and economic returns of projects at the end of the disbursement phase in order to see how they compare with expectations at the time of appraisal. This will shed light on the question of appraisal optimism and yield lessons for future appraisals.

1.40. The monitoring of project financial indicators in CDC's London Office is currently done mainly by the Regional Investment Managers (RIMs), who each have responsibility for a number of geographical areas. We believe this task should be performed centrally by the Finance Department, which is not closely identified with the projects and can take a more detached view than the RIMs in deciding whether to initiate enquiries which might help to anticipate problems before matters become serious.

### ***Whether improvements would be achieved by changes in performance measures***

1.41. Any financial target which is set for the Corporation as a whole, in addition to the statutory duty to break even, must have regard to the fact that CDC's primary objective is developmental. We endorse CDC's present approach of setting a financial target, currently a three-year rolling average return on capital of 6 per cent, which is consistent with the development objective and reflects recent past experience (see paragraph 1.17). The method of calculation and the level of the target will need to be reviewed in the light of decisions on our other recommendations, particularly those concerning capital structure, sources of funds and lending rates. In view of the long-term nature of CDC's business, however, and the desirability of stability, the target once set should be fixed for five years.

1.42. We have also recommended that, in order to take some account of the effect of inflation, CDC should have a target of maintaining the real sterling value of its accumulated reserves (see paragraph 1.19).

1.43. As regards the targets stemming from the last Quinquennial Review (see paragraph 1.9), we consider it is quite appropriate that CDC's broad development remit should be given focus by targets for the proportion of new commitments to be in specified categories of countries. The target for the proportion of commitments to be in RNR projects is more problematical. As noted above (paragraph 1.10), for reasons largely outside its control CDC has not come close to achieving this target. We have considered whether, in the light of this experience, it might be inappropriate to specify such a target at all. Since CDC has particular experience and expertise in RNR, we have concluded that it makes sense to seek to capitalise on these strengths and that CDC

should continue to have a target of this kind. The level of the target will, however, need to be reset at a more realistic level in the Quinquennial Review.

1.44. CDC has an efficiency target, also agreed in the last Quinquennial Review, that its gross and net operating costs should be within certain percentages of the total value of its investments and commitments (see paragraph 1.12). We endorse this approach, which is frequently followed by financial institutions. Normally one would consider whether such targets should be progressively tightened to give a spur to efficiency. Our comparisons with other DFIs, however (see Appendix 4.2), suggest that CDC's costs are low by the standards of other bodies operating in this field. CDC will have to devote additional resources to the implementation of some of our recommendations and we consider that it will do very well to achieve the existing target (which it has not quite succeeded in doing since the target was set in 1987). The target will need to be adjusted to allow for the 1991 purchase by CDC of a long lease on its headquarters building, which has the effect of reducing operating costs.

1.45. CDC has a number of implied performance indicators for overseas offices arising from the corporate planning and budgetary process but there is scope for a more systematic and wide-ranging approach. We have recommended that CDC should identify current best practice and ensure that the next Unit Plans set explicit targets based on the chosen indicators.

### ***The scope for improving CDC's management structure and use of assets***

1.46. CDC's Board is unusual among public corporations in being wholly non-executive and in particular in not having the Chief Executive, to whom extensive powers are delegated, as a member. We recognise the value of the current arrangement whereby the Chief Executive is appointed by, and fully accountable to, the Board rather than to the Secretary of State who inevitably has a much less detailed insight into the work of CDC than the Board. Nevertheless, we consider it is in principle unsatisfactory that the Chief Executive, and indeed other senior executives, should not be on the Board and hence share directly in shouldering its statutory responsibilities. Our preferred solution is that the non-executive members, including the Chairman, should continue to be appointed by the Secretary of State but that they should then have the power to appoint a limited number of senior executives as members. We recognise that this would require legislation.

1.47. Board members other than the Chairman and Deputy Chairman are remunerated on the basis that they give one day a month to CDC business, but they appear to be spending significantly more time than that. Bearing in mind the diversity of CDC's work, and the fact that Board members travel from time to time to the countries in which CDC invests and fulfil a representational role, we consider that one day a month is inadequate for the purpose and that two days would be more appropriate.

1.48. CDC has a tradition of long-serving Chief Executives each of whom has put his stamp on the organisation: there have been only three since the Corporation was established in 1948. The present incumbent, Mr John Eccles, is a strong and skilful manager who has served CDC well over the last seven years. The post calls for an unusual blend of managerial, political and diplomatic skills. Mr Eccles is due to retire by May 1994. The Board has recognised the need to give careful attention during 1993 to finding a suitable successor. The senior management structure depends significantly on the particular qualities of the Chief Executive and should be reviewed when the new incumbent takes office.

1.49. The structure of London Office was changed from a geographical to a functional basis early in 1991. We believe that there is no reason in principle to prefer one basis to the other. It is too early to reach a final judgment on the success of the reorganisation but the present indications are encouraging. The role of the RIMs should be reviewed early in 1993 when the reorganisation will have been in force for two years.

1.50. We recommend two ways in which CDC could make greater use of the financial resources available to it. As noted above, there is at present a concessionary element in the terms of CDC's loans to projects. This approach sits uneasily with CDC's view that financial viability is essential for sustainable development. It also appears that CDC's loan terms are rather more favourable than those of equivalent DFIs which have a policy of lending at market rates. If CDC aimed to charge a broadly market rate for its loans, it would generate increased income which could in turn be ploughed back into new investments. Secondly, CDC should give increased attention to ways of realising its equity investments. Although it has made a few substantial sales since 1989 and is currently exploring a number of other possibilities, it should identify further opportunities for disposals in the 1992 planning round and annually thereafter.

1.51. We have reviewed the background to and reasons for CDC's purchase of the lease of its headquarters building and have no reason to question the justification for it.

### ***The scope for improving funding arrangements***

1.52. We have discussed above (paragraphs 1.29 to 1.34) the changes we think are desirable in the financial framework which the Government has laid down for CDC.

### ***The scope for improving CDC's portfolio management and criteria for new investment***

1.53. As already mentioned (paragraphs 1.16 and 1.20), there are difficulties in assessing CDC's outputs. While we recognise that in this field quantified indicators are not the complete answer and need to be used with care, we consider that in order to help assess achievements and to inform future investment decisions, CDC should aggregate and monitor development benefits using the economic rates of return of its projects, expected and actual, by country and sector, and should calculate and monitor financial returns for its portfolio in each country. The distribution of expected rates of return on projects mirrors CDC's investment policy. This distribution should therefore be reviewed annually by the Board of CDC as part of its overall appraisal of the performance of the Corporation. Furthermore, comparison of expected and realised rates of return is one valuable guide to the reliability of CDC's investment judgment.

1.54. The great majority of decisions to reject project applications are taken by overseas Representatives. CDC's Guidelines should lay down procedures and criteria for this process and Representatives' decisions should be reviewed periodically. We welcome CDC's recent decision to carry out a preliminary calculation of development benefits, at the stage when clearance in principle (CIP) is given (ie before full appraisal), where these are in doubt.

1.55. In principle CDC should approve projects only if they clear specified rate of return thresholds, any exceptions being clearly identified and justified. The thresholds should be determined separately for each country in which CDC invests and should approximate to the opportunity cost of capital there.

1.56. Many of CDC's projects raise social and environmental issues, and CDC frequently pays considerable attention to these. We recommend, however, that CDC should adopt a clear policy that it will not invest in projects if it cannot satisfy itself that the impact of the project on social and environmental factors will be acceptable. It should also establish procedures to check regularly that projects are being operated in accordance with the relevant guidelines dealing with these matters.

### ***The scope for improving CDC's management of projects***

1.57. There is an element of ambiguity in CDC's attitude to whether it should seek out new projects for it to manage directly. The Corporate Plan sets targets for it to do so but CDC also told us that it sought to manage only if no other party could be found to act as lead project sponsor.

1.58. At present CDC manages 35 projects. The return on these projects is above the average for the portfolio as a whole because they involve a higher proportion of equity finance, though this result depends heavily on a few very successful cases. CDC argues that, because of the technical and managerial skills it can bring to bear, Managed Projects can yield particularly valuable development benefits. This being so we find it a little surprising that CDC does not seek more unequivocally to build up this side of its activities. We have recommended that CDC's policy on this point should be defined more precisely in a formal statement.

### ***The scope for improving project appraisal systems***

1.59. In 1991 CDC produced formal appraisal reports for only a minority of the projects which it approved, although we found no cases where appraisal work had not been carried out. We recommend that CDC should produce a formal appraisal report for each proposed investment of £1 million or more.

1.60. With strictly defined exceptions, CDC should only approve projects where both a financial and an economic rate of return have been calculated. We have made recommendations for improvements in CDC's treatment of risk. CDC should make small investments, up to £750,000, primarily through intermediaries, but should give further consideration to devising a simpler procedure for the appraisal of those smaller projects where direct investment is justified.

1.61. Implementation of our recommendations on evaluation and on the monitoring of existing projects' rates of return will generate lessons for CDC's appraisal methods.

### ***The scope for improving the basis for setting accounting provisions***

1.62. The setting of accounting provisions to reflect reductions in the value of investments is a key element in the calculation of CDC's results. We have looked closely at CDC's approach to this and have questioned both the Board and the auditors on it. As a result we are satisfied that CDC's provisions are set in a prudent and objective way.

### ***The use made of private sector partners and the scope for contracting out project management***

1.63. CDC has considerably exceeded, in recent years, its target for the proportion of new investments to be with private sector partners. Since equity investments have been, on average, more profitable than loans, CDC has an incentive to invest in private sector ventures and we see no need to make recommendations in this area.

1.64. So far as project management is concerned, CDC is a minority partner in 90 per cent of the projects in which it invests and is not directly responsible for decisions on how capital investment should be managed. As to its own Managed Projects, CDC enters into these only where it believes its own management capability has a comparative advantage. Those directly Managed Projects have a good record and we would not advocate that CDC should give up this activity or weaken its control by contracting out project management on a greater scale than it does at present.

### ***The source of CDC's ideas for new projects and investments***

1.65. Proposals for CDC investment come from a wide variety of sources. Overseas they may come from private sector entrepreneurs, the management of state enterprises and indeed governments. Proposals are also submitted by British and European businessmen interested either in exporting capital plant or in seeking equity or loan finance in support of proposed investments. Other DFIs approach CDC to meet a shortfall in the financing plans of projects they are considering, or to obtain access to CDC expertise in certain sectors. Finally CDC itself develops ideas in areas where it has expertise, and these may lead to Managed Projects if another party willing to sponsor and manage them cannot be found.

1.66. CDC's general approach is to make known its investment facilities and criteria among the business communities and public sector bodies in the countries where it operates, and to encourage project sponsors to come forward with proposals. Its Representatives have targets for the levels of new business to be generated and we learnt on our overseas visits of the marketing efforts which they made with a view to achieving these targets. In most countries CDC receives far more proposals than it can proceed with. This is entirely appropriate, in that it enables CDC to choose projects which offer the greatest development benefits as well as being financially viable.

### **Priorities for action**

1.67. We attach priority to four areas:

- (a) CDC's lending terms;
- (b) the financial framework, embracing both the easing of constraints under the present framework and the possibility of moving to a different structure;
- (c) certain aspects of CDC's project appraisals and the criteria for approving projects; and
- (d) CDC's evaluation programme.

The relevant recommendations are shown in bold type in Chapter 10.

## **Conclusion**

1.68. We are required to say whether, in relation to any matter falling within our terms of reference, CDC is pursuing a course of conduct which operates against the public interest. We conclude that CDC is not doing so. CDC provides a particularly valuable form of assistance to the economies of developing countries. Notwithstanding our recommendations, we have been impressed by CDC's competence and by the dedication with which its staff work, often in difficult circumstances, towards the Corporation's objectives.