

*Percy S. Mistry*

# Multilateral Development Banks

An Assessment of their  
Financial Structures, Policies and Practices

FONDAD  
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To

*Banoo & Pauline*

*(Without whom nothing would have been possible)*

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# Abbreviations

AfDB	African Development Bank
AfDF	African Development Fund (AfDB's soft-loan window)
AsDB	Asian Development Bank
AsDF	Asian Development Fund (AsDB's soft-loan window)
BP (or bp)	Basis Point
CCCC	Convertible Currency Callable Capital
CCTA	Cumulative Currency Translation Adjustment
CVBC	Committee for the Valuation of Bank Capital (in the IBRD)
DEM	Deutsche Mark
DFC	Development Finance Company
DFL	Dutch Guilder (or Florin)
EBRD	European Bank for Reconstruction and Development
ECO	Expanded Co-financing Operations Programme
ECU	European Currency Unit
EPP	Equal Payments of Principal
FFR	French Franc
FSO	Fund for Special Operations (IDB's soft-loan window)
FSU	Former Soviet Union
FY	Fiscal Year
GCI	General Capital Increase (of the MDBs)
GEF	Global Environment Facility
GIR	General Increase in Resources (which applies only to the IDB)
GCE	Guarantees and other Credit Enhancements (under IBRD's B-loans)
GBP	The British Pound Sterling (also UK£)
IBRD	International Bank for Reconstruction and Development
ICR	Interest Coverage Ratio
IDA	International Development Association (World Bank's soft-loan window)
IDB	Inter-American Development Bank
IFF	Intermediate Financing Facility (of the IDB)
IIC	Inter-American Investment Corporation (of the IDB)
IMF	International Monetary Fund
JPY	Japanese Yen (also ¥)
JSF	Japan Special Fund (in the AsDB)
LDR	Loan Disbursement Requirements
LIBOR	London Inter-Bank Offer Rate
MDBs	Multilateral Development Banks
MDFs	Multilateral Development Funds (soft-loan windows of MDBs)
MOV	Maintenance of Value
MVLR	Modified Variable Lending Rate
NCR	Net Cash Requirements
NGOs	Non-Governmental Organisations (also known as PVOs or private voluntary organisations; they are usually non-profit making)
NTF	Nigeria Trust Fund (in the AfDB)
OCR	Ordinary Capital Resources

OECD	Organisation for Economic Co-operation and Development (which comprises 23 developed country members as well as Mexico and Turkey)
PIBOR	Paris Inter-Bank Offer Rate
PVOs	See NGOs
RCL	Reserves-to-Loans (Outstanding) Ratio
SAL	Structural Adjustment Loan
SAP	Structural Adjustment Programme
SCI	Selective Capital Increase
SCVLR	Single Currency Variable Lending Rate
SDR	Special Drawing Right (in the IMF)
SECAL	Sector Adjustment Loan
SOV	Standard of Value
SPTF	Special Progress Trust Fund (in the IDB)
SFR	Swiss Franc
TA	Technical Assistance Account (in the AfDB)
TASF	Technical Assistance Special Fund (in the AsDB)
TCP	Targeted Currency Pool
UA	Unit of Account (in the AfDB; it is equal to one SDR)
US	United States (of America)
USD	United States Dollar (also US\$)
VLR	Variable Lending Rate
VTF	Venezuela Trust Fund (in the IDB)

# Glossary of Terms

- Allocation Criteria:** These determine the amount of MDF resources that a particular country should get in a given year or over an MDF replenishment cycle.
- Arbitrage:** To take advantage of differences in the price/cost of the same type of security or commodity or credit risk that may be reflected on different markets at the same time. As used in this book the term generally implies the inclination of MDBs to take advantage of their ability to borrow at very low costs and to re-invest those funds in money/capital markets at a higher yield while still maintaining an acceptable risk profile.
- Arrears:** Amounts due by way of interest and principal payments on MDB loans, which have not been paid by borrowers on time.
- Articles of Agreement:** These are the basic “constitutional charters” of the MDBs and MDFs. They specify their purposes, how they are to be financed and how they are to be managed.
- B-Loan:** A conjoined facility offered by the IBRD between 1983-88 in conjunction with a regular IBRD loan to facilitate co-financing by the private sector through direct funding or partial guarantees.
- Basis Point (bp):** One basis point is equal to one-hundredth of one per cent i.e. it is 0.01%. Thus 35 bp = 0.35%.
- Bilateral Assistance (or flows):** Aid flows or capital transfers from governments to governments, usually from OECD and Arab-OPEC to developing country governments but, increasingly also from richer developing country governments to poorer ones.
- Brady Bonds:** The syndicated loans of commercial banks to indebted developing countries which have been restructured as bonds. These bonds can be either ‘par bonds’ (which have the same face value as the original loan but a long maturity period and an interest rate which is below the market rate at the time of conversion) or ‘discount bonds’ (which have the face value discounted by between 25-40% but which carry shorter maturities and market rates of interest). Such loan-to-bond restructuring is usually achieved through overall debt reduction negotiations under the framework of the Brady Initiative of 1989 - named after the US Treasury Secretary Nicholas Brady - which aimed to achieve sufficiently large reductions in the debt overhangs of indebted countries to permit their economies to recover.

- Callable Capital:** The portion of the share capital of MDBs which is *not* paid in but is provided in the form of a guarantee to pay should the need for such a payment materialise. Callable capital is also sometimes referred to as “guarantee capital”.
- Cofinancing:** An operation which involves joint lending by an MDB and other financiers - official and/or private - for a project or programme.
- Conditionality:** A general term used to depict the conditions that MDBs or the IMF impose on borrowers as an essential part of their loan obligations. These conditions may concern changes borrowers must make in economic policies, sector policies, institutional changes, tariffs etc. which MDBs deem necessary for their loans to generate developmental returns.
- Credit Rating:** As used in this book, this term refers to the ratings given by the major international issuers of debt on capital markets. The highest rating is a ‘triple A’ (or AAA or Aaa) and the lowest is a ‘D’ rating which signifies that the issue is of speculative grade subject to a higher risk of capital loss.
- Currency Pooling:** A system whereby the MDBs place all the currencies they borrow into a single currency pool (or two separate pools, one for lending the other for investments) and average out the cost of the whole pool as a basis for pricing their loans. Thus though the composition of the pool changes with each new borrowing made or every old borrowing retired the cost of the pool changes relatively slowly and is much more robust and stable than the changes in the marginal cost of borrowing in any given currency or maturity.
- Derivatives or Derivative instruments:** This term usually refers to financial transactions which involve a ‘derived transaction’ around a core security. Such derived transactions may be in the form of *options* to buy or sell a particular security on or before a particular date at a particular price; *futures* which involve a commitment to buy or sell a particular commodity or security at some date in the future at a premium or discount to the current market price; *swaps*, which involve an agreement to exchange a stream of cash flows in one currency for a stream of cash flows in another currency at a pre-agreed exchange rate. Derivatives also include combinations of options and swaps (known as swaptions) for a particular transaction. For a detailed understanding of how derivatives work the reader is referred to specialised textbooks on these types of transactions.
- Eligibility Criteria:** Since MDF resources are scarce they are rationed out to the poorest countries with limited access to other types of resources. These countries must meet eligibility criteria usually based on their income levels and credit-worthiness.

**Expanded Cofinancing:** This programme was a successor to the IBRD's B-Loan programme which had "enhanced" features making such operations less restrictive and more flexible.

**Exchange Risk:** The risk that arises when an MDB borrows in one currency and lends in another or in a composite of currencies.

**Expropriation Risk:** The risk of being nationalised or taken over by the public sector.

**Emerging Markets:** Creditworthy developing countries with capital markets which are at a sufficiently advanced stage of development to attract significant inflows of foreign portfolio capital for investment in their secondary markets for equity and debt.

**Financial Instruments:** A range of equity or debt securities, bank deposits, promissory notes or derivatives (swaps, options, futures) which are tradable or non-tradable on established exchanges.

**Foreign Direct Investment:** Usually primary investment by a foreign party in a joint-venture in the receiving country. Direct investment is often accompanied by a transfer of technology, management know-how, and/or the transfer of brand rights.

**Foreign Portfolio Investments:** Usually these are investments in secondary markets for securities - either debt, equity or convertibles. These are usually investments in securities which are liquid, traded and priced regularly in stock exchanges. Portfolio investment can also be in bank deposits, in property and in derivatives.

**Gearing or Gearing Ratio:** This refers to the extent to which a financial institution can lend (or borrow) a multiple of its capital without incurring serious risks of illiquidity or insolvency given the particular characteristics of its operations and its portfolio. The 'gearing ratio' is the ratio of a financial institution's capital to its outstanding loans or its outstanding borrowings depending on the context in which the term is applied.

**General Capital Increase:** An increase in the capital of MDBs whose primary aim is to increase the resources and lending capacity of the institution with all shareholders subscribing to such an increase proportionately.

**Grant Element:** The computed concessional component of a financial transfer. Concessionality may be derived from either a below-market, interest rate or from extended maturities and grace periods which reduce the net discounted present value of the transfer.

**Guarantee Powers:** The ability of an MDB under its Articles of Association to guarantee the loan obligations of developing country borrowers to private or other lenders for a project or programme. Originally expected to be made much wider use of by MDBs, these guarantee powers have so

far been only partially exercised with MDBs preferring to resort to direct lending themselves.

**Hard Loan Window:** This term refers to the ‘bank’ part of an MDB from which it lends on market terms.

**Head Room:** The amount of further lending or borrowing capacity available to an MDB given the limitations of its existing capital base before a new infusion of capital has to be negotiated. Under their charters, all the MDBs are required to limit their outstanding loans and guarantees to the amount of their subscribed capital base (i.e. paid-in and callable). They may also be required under internally agreed rules to limit their borrowings. To satisfy creditors in international capital markets, MDB borrowings are usually limited only to that part of the available capital base which is subscribed by their fully creditworthy shareholders, i.e. those members whose securities in international capital markets have the highest credit ratings. When the total amount of outstanding loans and guarantees (or borrowings) approach the limits, the MDBs run out of headroom for expanding their operations further.

**Loan Approvals:** Loans approved by MDB Boards but not yet signed by borrowers.

**Loan Commitments:** Loans approved and actually signed up by borrowers.

**Loan Disbursements:** Amounts which are actually paid out to suppliers or borrowers on a loan account which has been committed and made effective.

**Loan Disbursement Requirements:** The estimate of the amount of cash needed to cover expected disbursements under committed and effective MDB loans over the next year or two.

**Loan Effectiveness:** The opening of a loan account after all the conditions which borrowers are required to fulfil - after loan signature but prior to being able to draw on loan funds -- have been fully met.

**Loan Loss Provisions:** Unlike reserves these provisions are financed from “above the line” and represent an operating charge against gross income. Loan loss provisions are made against either specific or general expectations of losses in loan portfolios.

**Maintenance of Value:** Based on the numeraire chosen to determine the standard of value (SOV) for a particular MDB’s share capital the value of the shareholdings of different members will change with time if they have contributed to their shares in their local currencies, depending on whether their currencies have appreciated or depreciated against the SOV. To maintain the same relative shareholdings, members whose currencies have appreciated against the SOV need to be refunded the differential. Those whose currencies have depreciated will need to make additional payments

to “maintain the value” of their shareholdings. Such payments are known as maintenance of value (MOV) obligations.

**Marketisation:** The process of converting a command economy into a market economy.

**Multilateral Assistance (or Flows):** Flows of concessional or non-concessional funds from multilateral agencies (MDBs and UN) to developing country governments.

**Negative Pledge Clause:** Under the Articles of the MDBs borrowing member countries are not required to pledge collateral for their loans from the MDBs. However, if as sovereign entities they pledge collateral to *other* lenders (which are invariably ranked as subordinate to the MDBs) then the Articles of the MDBs require those borrowers to provide equivalent or superior collateral for their loans from MDB creditors as well. This requirement is intended to ensure that the position of the MDB as *preferred* creditors (in terms of their capacity to recover on their loans) is never subordinated to that of other creditors in instances where the exposure of such creditors is secured by collateral. In recent times the negative pledge clause has inhibited the amount of external financing borrowing countries are able to raise from non-MDB sources. Consequently, the MDBs have been approached by some borrowers to waive the negative pledge clause which, in some selective instances, they have done.

**Net Cash Requirements:** The estimate of cash needed to cover loan disbursements, debt service on MDB borrowings and administrative expenses after taking into account cash inflows from loan repayments and other sources.

**Net Resource Flows:** These are the difference between disbursements and repayments of only *principal* amounts of loans or other financial transactions.

**Net Transfers:** These represent the difference between disbursements on the principal account and repayment of principal *and interest* (or dividends) on loan accounts and other financial transactions.

**Net Worth:** This is the sum of paid-in capital, reserves and represents the excess value of assets over liabilities.

**Non-Accrual Status:** This term usually refers to an outstanding MDB loan on which payments of interest and principal have been overdue by more than 180 days. At that point, the MDBs stop accruing the interest income due from those loans for their periodic financial reporting purposes. At this point such loans are classified as *non-performing assets* because they are no longer generating a stream of income whose collectibility can be relied on.

**Paid-In Capital:** The portion of the share capital of MDBs which is actually paid-in in cash form; a part of such cash is provided in convertible currency and a part in local currency. Some poor developing country members usually place restrictions on how the local currency component can be used.

**Prepayment Options:** When MDBs borrow they usually reserve the right to pre-pay (i.e. pay in full before maturity) the amounts borrowed if market conditions change sufficiently to justify that line of action. Such prepayments are usually funded by new borrowings at much lower cost.

**Pre-emptive Rights:** This refers to the right, which every shareholder has, to subscribe proportionately to *any* increase in the capital of an MDB in order to maintain its share or its ranking. These rights are usually an issue only in SCIs and have, with a few notable exceptions, invariably been waived by most members in these instances.

**Provisioning:** For loans on which payments are more than six months overdue, the non-accrual of income from those loans does not protect against the possible risk that the *principal* may not be repaid and that an MDB might therefore incur a possible loss. To prevent such losses from impairing the capital of MDBs, prudential provisions are made against the risk of losses on the outstanding loan portfolio. Earlier on, MDBs made provisions specifically against loans in non-accrual status and other loans owed by borrowers or borrowing countries in default. This practice did not take into account the probability that the loans of other borrowers might fall into non-accrual status as well. Accordingly, MDBs have recently switched from specific to general provisioning; i.e. setting aside from each year's income an amount of loan loss provisions sufficient to ensure that total accumulated provisions are large enough to cover any foreseeable risk of default across the entire outstanding loan portfolio.

**Put Option:** An option which involves the right to sell a security or loan to a counter party at an agreed price at some future date.

**Rating Agency:** The bonds issued by MDBs (and other types of public and private borrowers) on international capital markets are usually "rated" in terms of their credit quality (i.e. their inherent riskiness in terms of prospective capital loss to the investor) by specialised independent rating agencies. These include such institutions as Fitch, Moody's, Standard & Poors, etc. The rating agencies are extremely influential in determining the views of institutional and individual investors on the quality of particular debt securities which they are inclined to purchase. MDBs are particularly anxious to ensure that rating agencies continue to give their securities the highest possible quality rating i.e. AAA.

**Reflows:** These are the revolving funds of the MDFs. MDFs are funded by grant contributions from donor governments while they in turn lend these funds and expect to be repaid. When repaid the funds are available for new lending.

**Reserves:** Reserves are the amount of accumulated net income over the years which has not been distributed to shareholders and not used for other purposes. Effectively they represent a build-up of the 'cash' stake of shareholders in a corporate organisation. Reserves are built up to augment cash capital and to buffer a financial or other corporate institution against transient shocks (factors which may temporarily effect income or assets). In the MDBs reserves may be classified either as general or special.

**Sanctions:** In addition to non-accrual and provisioning MDBs invariably apply other punitive measures to borrowers in default. These include measures such as suspending disbursements, stopping the processing and consideration of new loans, etc. These measures are known as sanctions.

**Sectoral Adjustment Programme (or Loan):** Similar in concept to a structural adjustment programme but confined to a single sector in which policy, institutional and operational changes are sought.

**Selective Capital Increase:** This is an increase in MDB capital whose main purpose is to change the relative standing of certain shareholders in the institution with the increase in resources being only of tertiary importance.

**Soft Loan Window:** This term refers to the MDF or 'Soft loan' part of an MDB which on-lends concessional resources that have been donated to the MDFs by Donor Countries.

**Standard of Value:** This is the numeraire in which the share capital of various MDBs is to be valued.

**Structural Adjustment Programme (or Loan):** A structural adjustment programme (or loan to finance such a programme) is usually designed and financed by MDBs and/or the IMF with the aim of changing the structure and functioning of a country's economy. Usually a SAP/SAL involves changing a country's trade and exchange regime, its monetary and fiscal policies, withdrawal of the State from economic activity with more emphasis on private activity, market orientation, greater liberalisation and openness of the economy.

**Swaptions:** As the name implies this derivative contract involves a combination of an *option* and a *swap*. These derivative contracts involve an MDB granting options to counterparties in exchange for up-front payments under which those counterparties have the right to trigger an interest rate swap with the MDB at an agreed future date. They have been resorted to mainly by the AfDB.

**Transfer Risk:** The risk that even when borrowers repay in local currency the central bank will not have sufficient foreign exchange to transfer the borrowers' repayment to the creditor.

**Term Transformation Risk:** This refers to the risk involved in a financial institution borrowing funds from the market for a shorter average maturity than the average maturity of its outstanding loans. This may mean that the institution is undertaking a funding risk for a time period for which it is effectively uncovered.

**Usable Currency or Usable Capital:** Currency which is readily convertible in foreign exchange markets and can be used without restriction. The same meaning applies to usable capital which is that portion of paid-in capital provided in usable form as well as that portion of callable capital subscribed by countries with convertible currencies with no restrictions placed on use.

# Preface

In their work with the Multilateral Development Banks (MDBs), the Nordic countries have till now focused their attention mainly on development policy issues. In recent years, financial issues have become an increasingly important part of the policy agenda in these institutions. Furthermore, cases have arisen from time to time in the MDBs that require thorough understanding of MDB finances, and active shareholder engagement in such issues. The Nordic countries therefore felt the need to devote more attention to MDB financial matters, and to increase their understanding of such issues through a coherent and easily understandable presentation.

To meet this need, the Nordic countries asked the former Senior Financial Advisor to the World Bank, Percy Mistry, to develop a comprehensive presentation of financial issues in the MDBs, primarily to serve as a reference book and training material for use by officials in Nordic ministries responsible for dealing with the MDBs. The idea was to produce a broad overview describing the banks' role in the international development finance system, how they are financially structured and how they mobilise and manage their financial resources. As the process of preparing it evolved, it was clear that the book had become more than just a reference work for Nordic officials. In addition to serving its original purpose, we believe that the book now constitutes an independent and valuable contribution to the ongoing debate on the role and future of the MDBs. The author's wide personal experience and his clear, if sometimes controversial, views on the subject matter have rendered the book more interesting and thought-provoking than originally anticipated.

The author, Percy Mistry of Oxford International Associates, has a background which makes him well suited for undertaking the complex and specialised assignment of presenting these issues in a way that even non-economists and those who are not financial experts can understand. He has wide experience in the field of international finance, in general, and in development finance in particular, and he has the rare gift of being able to communicate his broad knowledge to others. His experience includes working in both the financial and operational complexes of the World Bank for several years. He has also been an Advisor to several governments in Africa, Asia and Europe on matters of debt and macroeconomic management, as well as a Consultant to a number of bilateral and multilateral organisations.

The opinions expressed in the book are those of its author. The four sponsoring Ministries of Foreign Affairs do not necessarily share all the views expressed in the book. Furthermore, the responsibility for possible errors and omissions remains with the author. However, the book constitutes in our opinion a valuable background for and contribution to the ongoing discussions on the role of these institutions as financiers of development in a changing world. The sponsoring Ministries have therefore found it desirable to share Mistry's work with a larger audience. In addition to being useful for government officials in shareholder governments, it is our hope that the book can be of use to researchers, to NGOs, to the world of international finance and to individuals with interest in the MDBs and development issues in general.

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# Author's Foreword

This book was the result of an idea expressed by Helge Semb and Henrik Harboe of the Norwegian Ministry of Foreign Affairs which, to our collective delight, was supported by the four Nordic governments i.e. of Denmark, Finland, Norway and Sweden. In focussing on their *financial* functions and the *financial* policies and strategies they have pursued to support their operational role as development agencies, it attempts to fill a void in the extensive public literature on multilateral development banks.

In its present form the book has been shaped and crafted with much help from Helge and Henrik, as well from Harriet Bengtsson of the Swedish Foreign Ministry, Jens Haarløv of the Danish Foreign Ministry, and Pertti Ikonen of the Finnish Foreign Ministry. In meetings to discuss its chapters in Oslo and Helsinki, it was my privilege and sheer good luck to have struck a rapport with all the members of this informal working group. They have, individually and collectively, contributed a great deal to improving this work.

The intent of this book is to explain in plain, comprehensible English, to as wide an audience as possible, the financial workings of the MDBs and to provoke further thinking on the part of policy-makers in the MDBs themselves and in shareholder governments. It is also meant to stimulate debate on the part of a much wider constituency which has become involved in the working of the MDBs in both borrowing and donor countries. The *cognoscenti* will find this book neither comprehensive nor deep. That is as it should be. This book was not intended for them. The non-financial audience, tempted to read it in an effort to understand how the MDBs fulfil their financial functions may, on the other hand, find it heavy going. That is inevitable. The balance between comprehensibility and complexity is difficult to achieve in dealing with this type of subject matter. Each reader will have to judge whether the right balance has been struck. In writing this book I have discovered that it is far easier to slide into the jargon which one has been used to in dealing with the financial affairs of MDBs, than it is to make complicated issues sufficiently simple to grasp. For the brave reader intending to plough through every chapter I can only extend the hope that I have managed to make dull topics as interesting as possible. For the reader short of time I would recommend scanning the first and last chapters to either dull or whet the appetite.

The MDBs should be vital institutions. They constitute an important part of the international financial system. No thoughtful observer can subscribe to

the view that they are superfluous. But even well-wishers of the MDBs can and should be concerned about their weaknesses. These are not merely optical illusions caused by misperceptions. There is much evidence to suggest that the MDBs are in danger of losing their way; despite their unquestionably good intentions. They have not adapted sufficiently rapidly to the needs of a changing environment. Their behaviour occasionally suggests more concern about protecting their own limited institutional interests than those of their shareholders, borrowers or the world at large. They have led the world to expect much of them and have assumed an aura of infallibility. Unfortunately they have often fallen short of the expectations they have created and proven all too fallible. The perception that MDBs have of themselves is now very different from that which the world has of them. But, in the final analysis, it matters not what the MDBs think of themselves. It matters much more that the world thinks they are useful and effective. For the world to do so, it has to be informed and cognisant. If this book makes even a small contribution to improving understanding on the part of a wide constituency of how the MDBs operate as financial institutions, the effort put into writing it will have been more than worthwhile.

Various internal documents have been cited in the case of all the MDBs. All of these are not public documents and several have limited circulation. The author expresses his deep gratitude to the managements of the MDBs for their willingness to have these documents studied and cited. However, in the case of the Asian Development Bank all the documents referred to are classified as confidential. It has therefore not been possible to identify them in detail.

It only remains to be said, somewhat obviously, that no book is a sole effort. This one owes much to the members of the working group mentioned above, to my publisher, Jan Joost Teunissen of Fondad, and to my Executive Assistant, Margaret Benson who helped enormously in producing this manuscript. More importantly, throughout its long and difficult birth, she exhibited the kind of patience, grace, humour, tact and tolerance which would put the average saint to shame.

*Percy S. Mistry*

# 1 The Role and Intermediation Functions of the MDBs

## *Introduction: The Role of MDBs in the International Financial System*

Multilateral development banks (MDBs), owned by the governments of the developed and developing worlds, are now an entrenched feature of the international financial system. They are the premier, specialised long-term lending intermediaries for developing countries at global and regional levels. Structurally they usually comprise a core bank or 'hard-window' with a number of affiliates attached (e.g. soft loan windows, private sector financing arms, and guarantee agencies). The key MDBs include:

- **The World Bank**, formally known as the International Bank for Reconstruction and Development (IBRD). As of August 1994, it had 178 member countries and operates world-wide.
- **The Inter-American Development Bank (IDB)** with 46 members operates in all Western Hemispheric countries south of the United States as well as in the islands of the West Atlantic Ocean and the Caribbean Sea.
- **The African Development Bank (AfDB)** with 76 members whose ambit is continental Africa as well as the islands of the Eastern Atlantic and Indian Oceans;
- **The Asian Development Bank (AsDB)** has 56 members, including three of the recently independent Asian republics of the former Soviet Union (FSU). It operates across continental Asia and islands in the Pacific Ocean and South China Sea; and
- **The European Bank for Reconstruction and Development (EBRD)** which operates in Eastern Europe and Central Asia (i.e. it serves the Asian republics of the former Soviet Union). It presently has 59 members; but with the kaleidoscopic changes still taking place in the political evolution of the FSU and the former Republic of Yugoslavia, this membership is subject to further change.

These five MDBs<sup>1</sup> are the subject of this book. Together they constitute the main *official* international channel through which capital resources (mainly in the form of loans) are intermediated between *developed*<sup>2</sup> and *developing* countries (often referred to as the South or the Third World) as well as the *economies in transition*.<sup>3</sup> With the exception of Yugoslavia and Romania, which had both borrowed heavily from the World Bank during the 1970s and early 1980s, economies in transition (mainly from the former East Bloc) have become significant recipients of MDB lending only in the 1990s.

All the MDBs (except the EBRD, which is the youngest and constitutionally the most different of the MDB family) have grown significantly in the size of their lending operations, staff and balance sheets since their inception. However, the role and importance of the MDBs as intermediators of global capital flows to the developing world, *relative* to other *private* sources and intermediaries, has fluctuated over time. In the 1950s and 1960s, with the World Bank setting the lead, they were the primary source of finance for **infrastructural** (mainly power, transport and water supply) and **industrial** investment in the developing world. Industrial investment was financed directly by the MDBs as well as indirectly, through domestic development finance institutions which they helped to establish.

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1 There are a host of other multilateral lending institutions which are prominent though much smaller. They include several international organizations such as the International Fund for Agricultural & Rural Development (IFAD); sub-regional institutions such as the Caribbean, Pacific, East African, West African, PTA and other similar development banks; and several Arab institutions such as the Islamic Development Bank (IsDB), the Arab Fund for Economic and Social Development (AFESD); the Arab-African Development Bank (BADEA); the OPEC Fund etc. While all of these institutions are, in their own context and milieu, significant, they are very diverse in their ownership, functions, orientation and political colouration. Also they are individually and collectively quite small. The five MDBs referred to above account for over 85% of all multilateral bank lending with the World Bank Group alone accounting for nearly 60%. For these reasons, these smaller institutions cannot be covered easily in a book of this nature and have accordingly been omitted.

2 Developed countries (often referred to as Part I countries in the lexicon of the World Bank) are mainly those which are members of the Organisation for Economic Co-operation and Development – the OECD – also referred to in colloquial terminology as the First World.

3 This phrase refers to the middle-income countries, mainly in Eastern Europe and the former Soviet Union which were formerly members of the Council for Mutual Economic Assistance (CMEA or Comecon) colloquially known as the East Bloc or, until 1989, the Second World. As an economic or geopolitical identity the Second World has of course disappeared. Parts of it aspire to be ranked as *developed* as soon as possible. Other parts will remain *developing* for some time to come. The term *economies in transition* excludes CMEA members such as Cuba, Mongolia and Vietnam which are developing countries. From the viewpoint of the MDBs the distinction between developing economies and those in transition is moot. For ease of reference throughout this handbook the term *developing countries* will be used to embrace borrowing countries of both the Second and Third Worlds. All these economies are, in a sense, *in transition* though not all confront the transition from command to market economies.

In the late 1960s and 1970s they branched out into financing **agriculture** and the **social sectors** (such as education, health, nutrition and population) embarking on visionary programmes of **poverty alleviation** through integrated **rural and urban development** projects and programmes. In the midst of the successive large oil price increases the 1970s, the MDBs focused some of their attention to increasing investments in hydrocarbon and other **energy** resources in the developing world. In the 1980s, when the debt crisis emerged, their emphasis shifted yet again from financing mainly projects in various economic sectors to financing an increasing proportion of fast-disbursing, balance-of-payments support under **structural and sectoral adjustment programmes** aimed at wide-ranging reform of economic policies and at improving the quality of economic management at sector and economy-wide levels. In the late 1980s and 1990s, the MDBs have been compelled by external pressures from developed country governments and NGOs into incorporating newer developmental priorities (e.g. environmental protection, gender sensitivity, good governance requirements etc.) in their project and programme lending operations.

Geographically, through the 1950s-80s, MDB financing has been concentrated largely in Asia, Latin America and Africa. In the 1990s the attention of the World Bank and the newly established EBRD has been captured by the economic crises in Eastern Europe caused by the collapse of command-economy regimes. With rapid geopolitical transformations occurring elsewhere in the aftermath of that collapse, other significant claimants for reconstruction and development assistance have also emerged. Global and regional MDBs will therefore need to focus henceforth on meeting the reconstruction and economic transformation financing needs not just of Eastern Europe, but also of several countries in the Middle East, Indo-China, West and Central Asia. After the South African elections of April 1994, the World Bank and the African Development Bank are now engaged in financing the rapid extension of basic development benefits to the hitherto deprived majority in South Africa. In confronting these challenges the MDBs will be faced with the relatively recent phenomenon of capital markets being more willing (and more able) than they have so far to share in taking the risks involved in financing developmental opportunities in these areas.

Thus from a period of relative stability between 1945-73 the MDBs have, between 1974-94, had to respond to different and shifting demands from their clientele caused by the *oil shocks* of the 1970s, the *debt shock* of the 1980s, and the *transition shock* of the 1990s, resulting in the emergence of a large number of new claimants for their products and services. Although these successive impulses have created new demands, the role of MDBs *vis-à-vis* private capital markets in meeting the external finance requirements of developing countries has fluctuated unpredictably between 1970-94. Since

1989, private sources of international capital have become increasingly familiar with financing all kinds of investment in *emerging markets*, including long-gestating infrastructural investment. Consequently, the *financial* role and importance of MDBs might be expected to diminish in *relative* if not in *absolute* terms, as private markets penetrate terrain which was formerly the exclusive preserve of MDBs such as infrastructure financing, and even the financing of education and health (e.g. through private hospitals and universities).

Present trends suggest that the role of MDBs in the next century may be focused progressively on: (a) the *poorest developing economies* (e.g. those in Africa and South Asia) which global capital markets are unprepared to finance until higher levels of economic, financial, institutional and social development have been achieved; (b) *investment in human capital* – which is now seen as the key constraint to rapid development – of the non-cash flow generating kind which capital markets do not finance (e.g. public primary and secondary education and rural health care); and (c) investments in the basic *institutional infrastructure* essential for market economies to function properly (e.g. in legal and judicial systems and institutions, enforcement of property rights, transparent accounting systems, essential business support systems and services, improved systems of public administration and of political governance etc.).

This recent focus apart, in their traditional areas of activity MDBs may need to consider a shift from financing governments and their agencies to financing investments undertaken directly by the private sector. This will become an important line of activity especially for catalysing investments involving the kind of risks and gestation periods which may require MDB participation to provide comfort to private market financiers.<sup>4</sup> Rapid movement in that direction is to be expected and is long overdue. As *private* international capital market conditions and propensities change so should the functions and resource transfers of *public* institutions which were designed initially to overcome the shortcomings of imperfect capital markets. This point requires some historical elaboration. Though they were principally *political* creations, whose emergence owed more to geopolitical exigencies rather than purely economic and financial considerations, the five major MDBs – global and regional – were established, ostensibly at least, to provide

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4 This may require amendment of the Articles of Agreement of some of these MDBs which, with the exception of the EBRD, generally require MDBs to lend directly only or mainly to governments or their instrumentalities. Lending to non-governmental entities is of course permitted by their Articles but only if accompanied by an explicit government guarantee. By contrast, the Articles of the International Finance Corporation (IFC) – the World Bank's private sector financing affiliate – prohibit it from requiring a government guarantee for its loans of equity investments.

developing countries with long-term capital for investment in development; capital of the kind that they would not otherwise have had access to. Until quite recently, capital markets in developed countries were mainly domestic and fragmented. Influenced by the memory of defaults on bonds by several Latin American countries in the 1890s and again in the 1930s, capital markets in the US and Europe were disinclined from the 1940s upto the 1980s to assume the risks involved in providing long-term capital for investment in developing countries<sup>5</sup>.

With the benefit of hindsight, it is now clear that these risks were heightened unnecessarily by the nationalistic, inward-looking economic policies which all too many developing countries chose to follow in the first flushes of independence when unshackled from their colonial heritage, most of which were based on market economy regimes. These nationalistic policies gave rise to the kind of expropriation risks, commercial risks and transfer risks which were much too high for capital markets to contemplate taking. Such reluctance made it difficult for developing nations – especially those just emerging from colonial rule – to obtain sufficient international capital i.e. foreign savings in the form of foreign exchange.

With the development theory of the day ruling that domestic savings and foreign exchange (the two gaps) were the key constraints to development,<sup>6</sup> MDBs seemed the most practical way of providing developing countries with access to foreign capital under conditions which were controlled and carefully monitored. The capital structure of MDBs – about which more will be said later – was designed specifically to use a relatively small amount of government provided *cash* (as paid-in equity in usable and non-usable currencies) accompanied by a much larger guarantee (or *callable* capital) to cover the perceived risk of lending to developing countries. Government-provided capital was the pivot on which a large amount of borrowings by MDBs (mainly in the form of bond issues) could take place in international capital

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5 To avoid any confusion this statement may cause it should be remembered that the orgy of private lending to developing countries in the 1970s was undertaken by global money centre banks. It was not coursed through capital markets. Capital markets only stepped into the breach after 1987-88 when these loans were eventually written down to discounted values and the residual values were credit-enhanced, securitised and traded.

6 Though it has evolved considerably since 1945, it should be recalled that early *development theory* rested heavily on the *two-gap* model; i.e. it was firmly believed that economic development in the Third World was hindered by two gaps (i) the gap in savings which the domestic economy, being underdeveloped, was incapable of generating a sufficiency of in the early phases of development; and (ii) foreign exchange, which was needed to import capital and intermediate goods in order for the developing economy to undertake incipient industrialisation by domestically producing consumer goods under protective regimes. Currencies were made inconvertible and capital controls were imposed to prevent capital outflows from capital-short countries.

markets. Such borrowings were then on-lent to developing countries as long-term loans.

After the creation of the World Bank in 1945,<sup>7</sup> only marginal refinements took place in the constitutional make-up of the three MDBs established between 1955-66 when the Inter-American, African and Asian banks were created (in that order). Since then, of course, the MDBs themselves and the global financial environment in which they operate have both evolved and changed quite dramatically. Not unexpectedly,<sup>8</sup> the environment has changed far more rapidly than the MDBs have adapted.

Partly for that reason there was considerable controversy surrounding the creation of the EBRD in the early 1990s. It was not obvious that another MDB was needed at this juncture to address the long-term financing and *marketisation* needs of the Eastern European and former Soviet economies in transition. It is now commonly acknowledged that the EBRD's establishment in the first flushes of euphoria over the fall of the Berlin Wall reflected perhaps the triumph of political over economic sense. A genuflection to the realities of a changed marketplace was essential nevertheless. Major alterations were made in the constitution and mandate of the EBRD vis-à-vis those of the other MDBs, signifying how much things have changed in the operating environment of the MDBs.

The limitations of private capital markets which existed when the MDBs were created and flourished are difficult to imagine or recall against the situation which exists today. Despite the debt debacle of the 1980s, or perhaps because of it, private capital markets are now much less imperfect than they used to be; also they are rapidly becoming globally seamless. Their ambit now embraces an increasing number of developing countries, euphemistically referred to in a new lexicon as *emerging markets*. They operate across a much wider and deeper spectrum of risk and reward with the pricing of such risk being more finely tuned and being made more manageable through an array of financial instruments which did not even exist prior to the mid-1980s. Today, private capital is willing to invest in the

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7 The World Bank and the International Monetary Fund were established as part of the architecture of a post-World War II global order under the Bretton Woods Agreement of 1945 which involved a regime of fixed exchange rates and open trading regimes accompanied by a massive effort at reconstructing the war-devastated economies of Europe and Japan under the Marshall and Dodge Plans.

8 Departure from channelling long-term resources flows to developing countries mainly through the MDBs in the 1970s, with petrodollar surpluses being recycled through the global banking system, led to the debt debacle of the 1980s. In the aftermath of that crisis, and due to the role played by the International Monetary Fund (IMF) and the MDBs in averting systemic default risk, private capital markets have, in the 1990s, replaced commercial banks in becoming the most prominent private providers of finance to emerging markets.

equity and debt structures of complex, long-gestating projects and to take risks which would have appeared unthinkable even a decade ago.

Of course, this turnaround cannot be attributed simply to evolutionary trends in capital markets themselves. It is as much the result of a profound change in global development thinking and development policy which has occurred and accelerated since mid-1985. That change has resulted in a progressive redressing of the imbalance that had arisen from excessive state intrusion into economic life. In too many developing countries (not to mention a number of developed ones as well) dirigiste states had succeeded in dominating development and capital investment while shrinking ever more narrowly the economic space in which the private sector and the market were permitted to function. After nearly five decades of experience with the underperformance of state-dominated, closed, inward-looking economies – with their high rates of protection, increasingly ineffective capital controls, inconvertible currencies and fiscal profligacy – the developing world has shifted decisively in favour of greater openness, liberalisation, market orientation and fiscal discipline.

Financial system liberalisation through the abandonment of interest and exchange controls and the adoption of convertible currency regimes, is resulting in an acceleration of the pace at which many developing economies are becoming integrated into the global market for money and capital thus concomitantly reducing their dependence on specialised financing mechanisms such as the MDBs. Many developing countries can now raise funds directly on international capital markets at lower cost and risk (i.e. exchange risk) than those they incur in borrowing from the MDBs. Nor do they need to incur the development conditionalities or the administrative burdens and costs of dealing with institutions whose bureaucratic ways of working impose onerous demands on their own governments.

As development agencies, MDBs have received the greatest exposure and visibility for their lending orientation and operations, for their technical assistance and advisory functions, and, more recently, in the era of policy reform and adjustment, for their delphic policy pronouncements and exacting conditionalities. Rightly or wrongly, since the 1980s, they have taken on the complexion of becoming instruments of economic and political governance over the developing world instead of being simply international financial intermediaries. Very little is known publicly about their *financial* policies and operations. Apart from some knowledgeable insiders, a few capital market specialists who sell and trade multilateral agency bonds, and even fewer rating agency analysts whose job it is to track these matters, very few members of MDB staff, or those of the governments that own these banks, really know about or attempt to influence MDB financial policies.

Until recently, these policies have been portrayed, especially by the

financial managements of MDBs themselves (often for self-serving reasons), as too complex and arcane for any but the initiated to comprehend and therefore dangerous to be made transparent or be opened to public scrutiny and exposure. Fortunately however, the degree of opacity that has enshrouded the financial operations of MDBs, coupled with rising concern about arrears in their portfolios, have led to calls for greater understanding, more public exposure (for accountability reasons) and transparency in the financial policies of the MDBs. Obviously, the MDBs cannot be evaluated only as *financial institutions* in the normal sense of the term because that is not what they were intended to be.<sup>9</sup> Their financial operations are undertaken to support their developmental role. For that reason, this book attempts to render understandable, in terms comprehensible to those who are not financial experts, the main financial policies and practices of the MDBs as well as the implications and consequences of those policies/practices.

### ***Resource Flow and Net Transfer Functions***

For a long time, MDBs were judged qualitatively by the nature and responsiveness of their operations and activities to the development priorities of the day. Despite a continual shifting of the goal posts, such judgements remain important in assessing MDBs as effective *agents of development*. But, as specialised intermediaries with a critical *financial intermediation function* to perform (which indeed is their *raison d'être*) MDBs also need to be assessed on their performance in affecting real resource flows and net monetary transfers between developed and developing countries. Such evaluations must be made on the entirely reasonable premise that for development to occur at an accelerated pace in the poorer countries of the world, capital needs to flow from richer to poorer countries and that the MDBs should be at the forefront in inducing such flows.

Over the last decade of debt crisis and adjustment MDBs, and particularly the World Bank Group, have adopted a much higher profile as agents of policy reform through their structural and sectoral adjustment lending operations (SALs and SECALs). Yet, at the same time, their resource flow functions have paradoxically not been performed with distinction. This has led, inevitably, to considerable defensiveness, accompanied by much dissembling and disingenuous reasoning, on the part of MDB managements about the validity of judgements being made about their performance on the basis of *resource flow* and *net transfer* criteria.

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<sup>9</sup> It should be emphasised that although the MDBs are major *financial institutions* in their own right, they are beyond the reach or influence of any national or global *financial regulatory authority*.

The resource flow functions of MDBs cannot be judged by the *annual lending volumes* that these institutions invariably highlight and draw attention to in their annual reports, publications and the large number of speeches that their senior managers make in public to applaud the achievements of their institutions. They can only be judged on the basis of the MDBs' annual *disbursement* performance relative to the amount of their annual principal and interest collections on their outstanding loan portfolios. The *net resource flow* is the difference between their annual disbursements of loans and their annual collections of principal. The *net transfer* they achieve is the difference between their annual disbursements of loans and their annual collections of total debt service; i.e. principal *and interest*. As the figures quoted below suggest, these net resource flows and net transfers are a fraction of the annual lending volumes which the MDBs loudly trumpet.

Developing countries obtain financial flows from a vast variety of sources<sup>10</sup> which include:

- *Bilateral Assistance*: mainly from OECD governments in the form of grants, as well as concessional and non-concessional loans. Formerly, the Arab-OPEC and CMEA countries (mainly the former Soviet Union) were a major source of bilateral assistance. Arab-OPEC surplus nations have reduced their assistance drastically in the wake of the oil price falls of the 1980s. Assistance from CMEA has ceased altogether as its members have become recipients rather than donors of such largesse. More recently an increasing amount of bilateral assistance has come from some large developing countries – Brazil, India and China – as well as the newly industrialised countries (NICs such as Korea and Taiwan) – to other developing countries in their regions or in Africa. While most bilateral flows from all these sources is classified as *development assistance*, the bulk of it is in reality aimed at achieving the particular political, military, or commercial objectives of the *source* country rather than the development priorities of the *recipient* country. This factor leads to a considerable amount of confusion and disillusionment when judgements are attempted on whether the development assistance provided is effective or not.

Between 1990-93, bilateral *grant* assistance has averaged about US\$30 billion annually while bilateral *loans* (net of repayments) classified as official development assistance (ODA) – i.e. with a grant element of at least 25% – have averaged about US\$12 billion annually. Since they

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<sup>10</sup> These are usually broken down into their respective components in the Annual Reports issued by the Chairman of the Development Assistance Committee (DAC) at the OECD and by the OECD's other Annual Report on Financing and External Debt of Developing Countries.

involve no interest or principal repayments the full amount of bilateral *grants* are a net transfer. After interest payments are taken into account, net transfers on bilateral *loans*, however, averaged US\$4 to 5 billion between 1990-93, i.e. about a third of the gross amounts committed.

- *Multilateral Assistance*: emanates from the five MDBs (both their hard and soft windows), their sub-regional and other cohorts, from the International Monetary Fund (IMF), and from a plethora of development agencies within the UN system (which provide resources only on a grant basis). Between 1990-93, the MDBs achieved an annual average net resource flow of around US\$15 billion annually but a net transfer of only US\$2 billion annually after interest payments were accounted for. These figures combine the resource flows and net transfers from both their hard and soft windows. The *hard* windows of the five MDBs achieved a net resource flow of only around US\$6 billion annually with a *negative* net transfer of around US\$4.5 billion annually. The UN system of development assistance has averaged resource flows and positive net transfers of around US\$4 billion annually in the early 1990s.
- *Private Financial Flows* of various types including grant flows from non-governmental organisations (NGOs – also known as private voluntary organisations – or PVOs); flows from commercial banks, as well as from capital markets (i.e. international bond markets and equity markets). Some bond market flows represent former commercial bank debt that has effectively become securitised and tradeable (e.g. the Brady Bonds of former severely indebted countries). Equity flows into developing countries can be in the form of both foreign *direct* investment as well as *portfolio* investment. Private flows which are repayable in some form or other may be either guaranteed by the government of the receiving country (or occasionally a third party like a bilateral or multilateral guarantee agency of one kind or another) or unguaranteed. Grant flows from NGOs/PVOs (partly supported by donor governments) have averaged around US\$5 billion annually in the early 1990s while flows from the various private commercial sources (banks, bond markets and equity markets) have recently mushroomed. Between 1990-93 private resource flows have increased from around US\$43 billion to around US\$113 billion. Flows from commercial banks have increase from a negative (-) US\$2.5 billion in 1990 to about +US\$20 billion in 1993. Net resource flows from *international bond and fixed income markets* have increased from just under US\$3 billion in 1990 to over US\$30 billion in 1993 with the amount of bonds and other fixed income instruments outstanding having risen from a stock of US\$5.6 billion in 1990 to a stock

of US\$42.6 billion in 1993. Net resource flows from *foreign direct investment* in developing countries rose from US\$26.3 billion in 1990 to US\$56.3 billion in 1993 while flows from *foreign portfolio investment* in emerging markets increased from just under US\$4 billion in 1990 to over US\$13 billion in 1993 with the outstanding stock of such investments exceeding US\$65 billion at the end of 1993.

The resource intermediation role of the MDBs can be judged relative to the role played by other sources of funds available to developing countries as well as by the standard of how well they accommodate the external financing needs of any particular country. For that reason judgements about resource flows and net transfers are best made in the context of an individual country rather than in the context of resource transfers to the developing world as a whole. Yet, although judgements about the global resource transfer performance of MDBs need to be carefully qualified, they are not by themselves invalid. Clearly, country-by-country data represent too detailed a level for this handbook to examine in any depth; the paragraphs that follow therefore focus on the more readily available global resource flow and net transfer figures from sources such as the World Bank, the IMF, and the OECD.

### *Net Resource Flows from MDBs*

Taking all the above sources of external finance for developing countries into account, the hard-windows (i.e. the core *banks* themselves) of the five MDBs accounted for about 2.5% of total *resource flows* to the developing world in the **1960s**<sup>11</sup> while their soft windows (i.e. the special funds financed directly by donors) accounted for a further 1.7%. Between **1970-74**, these shares remained at around 3% for the hard windows and increased to 2.6% for the soft windows. In the latter half of that decade (**1975-79**), the hard window share (annual average) increased to around 4.2% while the soft window share edged up to just under 3%. Commercial bank petro-dollar recycling to developing countries was burgeoning at the time. Banks, which provided less than 5% of total resource flows to developing countries in the 1960s, increased this share to 21% between 1970-74 and 24% between 1975-79.

In the **1980s**, during the debt crisis when commercial banks withdrew their lending at a rapid rate, the MDBs' share of resource flows to developing countries increased substantially. The hard-window share of total resource

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11 Source: "OECD: Twenty-Five Years of Development Cooperation. A Review", DAC Chairman's Report for 1985, OECD, Paris, 1986 (see Tables VI-2 and VI-3, pages 162 and 165).

flows increased to 6.6% between **1980-84** while the soft-window share increased to 3.3%. Between **1985-89** those shares rose even further to an annual average of over 8.5% for the hard windows and 5.4% for the soft windows. In the **1990s** (i.e.1990-93) that pattern has reversed dramatically with the hard-windows' share dropping sharply to 4.2% and the soft-window share stabilising at around 5%. Indeed the share of MDBs in total resource flows to developing countries has been dropping since 1987 when it was nearly 17% to an average level of 10-11% in the 1990s. Table 1 and Figure 1 below, depict these fluctuations.

**Table 1** **MDBs' Shares in Total Resource Flows to Developing Countries 1960-93**  
(billions of U.S. dollars)

Period/Year	Total Net Resource Flows	Net Resource Flows from MDBs					
		Hard	%	Soft	%	Total	%
1960-69*	24.2	0.6	2.5	0.4	1.7	1.0	4.2
1970-74*	30.7	0.9	2.9	0.8	2.6	1.7	5.5
1975-79*	77.8	3.3	4.2	2.3	3.0	5.6	7.2
1980-84*	111.2	7.3	6.6	3.7	3.3	11.0	9.9
1985	84.0	8.2	9.8	4.1	4.9	12.3	14.7
1986	82.0	9.5	11.6	4.7	5.7	15.2	17.3
1987	89.1	8.5	9.5	6.4	7.1	15.0	16.6
1988	102.3	6.1	6.1	5.0	5.0	11.1	11.1
1989	116.9	6.5	5.6	5.2	4.5	11.7	10.1
1990	127.3	8.5	6.8	6.3	4.9	14.8	11.7
1991	131.5	7.9	5.9	7.0	5.1	14.9	11.0
1992	156.6	4.9	3.1	7.3	4.7	12.2	7.8
1993(e)	176.7	9.8	5.4	8.5	5.0	18.3	10.4
(a)	176.7	3.1	1.8	6.6	3.4	9.7	5.2

\* Annual average for five- or ten-year periods.

(e) Latest available estimates of 1993 figures as provided in the World Debt Tables 1993-94 series.

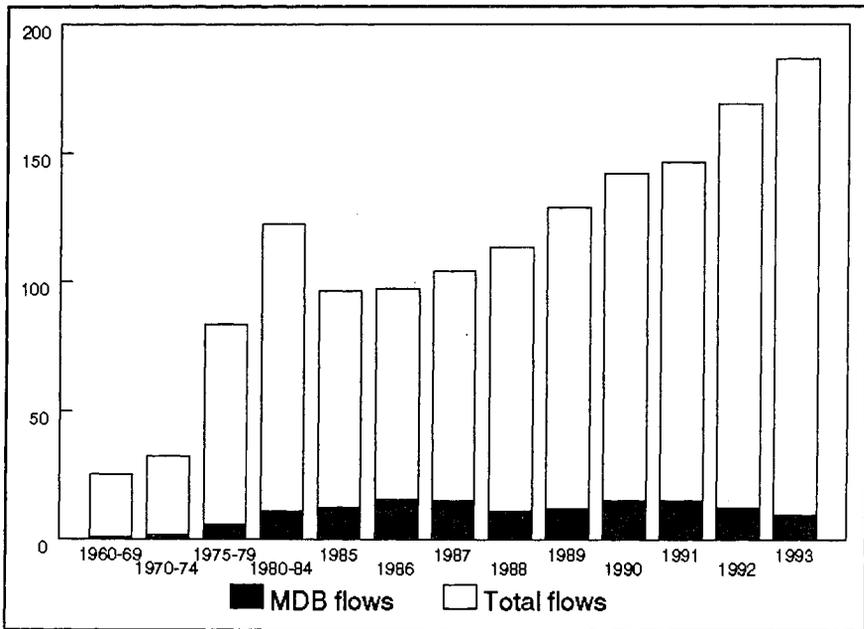
(a) Actuals from the Annual Reports of MDBs.

Sources: OECD, 'Annual Reports of the DAC Chairman' from 1985 through 1992. OECD, 'Annual Reports on Financing & External Debt of Developing Countries' from 1987 to 1992. World Bank, 'World Debt Tables' series 1988-89 through 1993-94.

Part of the reason for the dip in the share of total resource flows provided by MDBs to developing countries in the **1990s** has been the resurgence of flows from private capital markets. Total private resource flows to developing countries had fallen from a peak of nearly US\$75 billion in 1981 (when banks

were the main providers of funds) to a nadir of US\$26 billion in 1986. Recovering to an annual average level of US\$50 billion between 1987-91, they have since ballooned to exceed US\$102 billion in 1992 and an estimated US\$113 billion in 1993. This time private flows are being driven not by bank lending but by *portfolio and direct foreign investment* in developing country bonds and equities. In 1992 and 1993, private capital flows accounted for about 65% of total capital flows to developing countries, a much higher proportion than has so far been recorded by the OECD's DAC secretariat; even at the peak of commercial bank lending, the share of private flows did not exceed 55% of total flows to developing countries.

**Figure 1 MDB Share in Total Resource Flows to Developing Countries**  
(billions of U.S. dollars)



### *Net Transfers from MDBs*

As observed, resource flows from MDBs are a fraction of annual commitments. For example, against total MDB commitments of over US\$40 billion in 1993 (with US\$24 billion from the World Bank alone) resource transfers in 1993 were estimated at US\$18 billion. Net transfers from these

institutions are even lower. Indeed the IBRD (the largest of the MDBs) has consistently recorded *negative net transfers* (i.e. after taking interest payments into account, it has been extracting monetary resources from its borrowers rather than providing them) since 1987 with such negative transfers escalating from about -US\$1.5 billion in 1987 to over -US\$7.7 billion in FY93 and -US\$8.6 billion in FY94. Negative transfers are particularly large in the case of Latin America and East Asia; between FY90-94 the World Bank has extracted over US\$11 billion from Latin America and US\$2 billion from East Asia. The World Bank's soft-loan window IDA (i.e. the International Development Association) which provides funds on highly concessional terms has, however, recorded substantial positive net transfers which until 1990 enabled the World Bank as a group to show positive overall net transfers. However, between FY92-94 the negative transfers from IBRD were too large to be offset by IDA resulting in the group as a whole recording negative net transfers for those years. The negative net transfer from the World Bank Group in FY94 was -US\$3.9 billion.

Between 1987-91, the rest of the multilateral hard-loan windows (primarily the three regional MDBs for Africa, Asia and Latin America) managed to maintain positive net transfers to their borrowers (averaging US\$1 billion annually). But these were not sufficient to offset negative transfers from the IBRD, resulting in the multilateral hard-loan windows as a whole achieving a *negative* net transfer (averaging -US\$2.3 billion annually). Overall net transfers from their soft windows (including IDA) over the same period averaged US\$5 billion annually resulting in total combined net transfers (from the hard and soft windows) averaging a positive but desultory US\$2.7 billion in that 5-year period. In 1992 and 1993, however, dragged down by the very large negative net transfers on the IBRD's accounts, the MDB system as a whole (including their soft-windows) recorded a negative net transfer of -US\$0.4 billion in 1992 and -US\$2.3 billion in 1993 despite the fact that the other MDBs (and IDA) recorded positive net transfers of nearly US\$7.3 billion in 1992 and US\$6.3 billion in 1993 respectively. For 1993 the World Bank had projected an overall positive net transfer from all MDBs of US\$4.2 billion but its record of such projections which has been hopelessly over-optimistic upto now, was again proven wrong by an estimation error of over US\$6.4 billion in the wrong direction (see Table 2).<sup>12</sup>

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12 For example, in the previous WDT 1992-93 series, the World Bank projected an overall positive net transfer from MDBs of about US\$4.6 billion for 1992. The actual outcome was a *negative* transfer of -US\$0.85 billion with the Bank's estimate being out by nearly US\$5.5 billion on the optimistic side. The World Bank's Annual Report for 1994 suggests, in contrast to its WDT for 1993-94, that negative net transfers from the IBRD might actually increase rather than decrease over the foreseeable future.

**Table 2 Net Transfers from MDBs to Developing Countries 1970-93**  
(billions of U.S. dollars)

Year	Total Net Transfers	MDB Net Transfers	Hard-Window Net Transfers	o/w IBRD Net Transfer	Soft-Window Net Transfer	o/w IDA Net Transfer
1970-74*	n.a.	1.00	n.a.	0.32	n.a.	0.46
1975-79*	n.a.	4.06	n.a.	1.12	n.a.	1.12
1980-84*	n.a.	7.52	n.a.	2.56	n.a.	2.04
1985	n.a.	6.77	3.28	1.74	n.a.	2.57
1986	-5.10	6.05	2.19	0.41	3.86	2.81
1987	-2.90	3.86	-0.89	-1.48	4.75	3.49
1988	-5.40	1.56	-3.05	-4.08	4.61	3.37
1989	2.30	2.41	-2.18	-3.49	4.59	3.11
1990	25.50	4.03	-1.45	-2.07	5.48	3.83
1991	44.50	1.87	-3.77	-5.45	5.64	3.95
1992	79.60	-0.43	-6.74	-7.73	6.31	4.43
1993(e)	91.60	4.20	n.a.	n.a.	n.a.	n.a.
(a)	n.a.	-2.28	-8.24	-8.55	5.96	4.69

\* Annual average for five-year period.

(e) Estimated by the World Bank in World Debt Tables 1993-94.

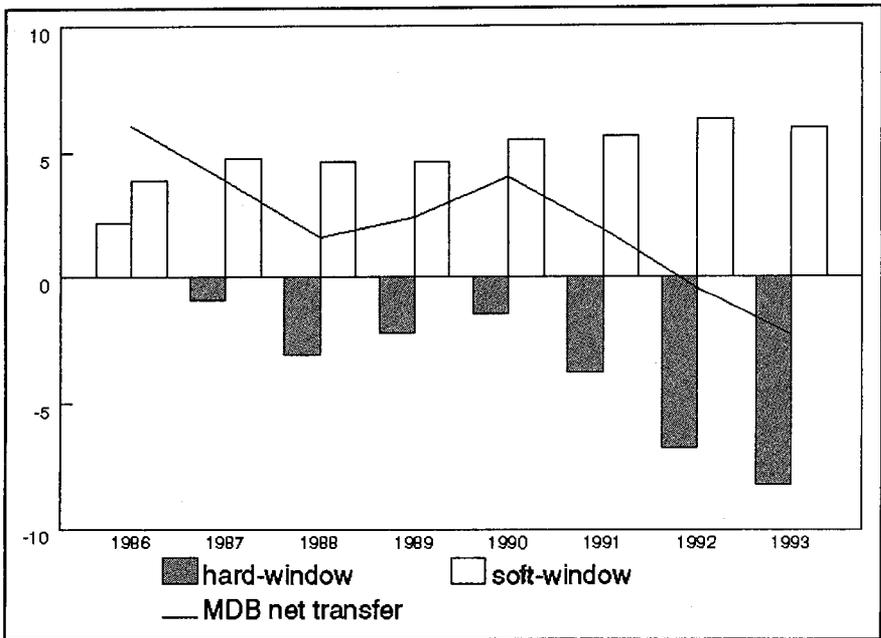
(a) Actuals from the Annual Reports of MDBs.

Sources: OECD, 'Annual Reports of the DAC Chairman on Development Cooperation' 1985 through 1992. World Bank, 'World Debt Tables' series 1988-89 through 1993-94, 'Annual Reports' 1985-94.

When it comes to effecting net transfers of financial resources, the unfortunate reality is that once hard-loan portfolios reach a size where annual principal and interest repayments to MDBs by their developing country borrowers become structurally very large, the hard-windows of MDBs become inefficient and inflexible devices as financial intermediaries. Interest payments by developing countries to MDBs (on both hard and soft window accounts) have increased from \$0.3 billion in 1970 and \$2.7 billion in 1980 to an average of nearly US\$13 billion between 1990-93. That annual level will increase to US\$16 billion between 1994-97 and, on present trajectories of lending, to US\$20 billion towards the end of this century. Annual principal repayments to MDBs reached US\$17 billion in 1993 and will escalate to over US\$25 billion by the end of the century.

To maintain zero net transfers therefore, the MDBs as a system will need to increase gross disbursements from US\$28 billion in 1992 to over US\$45 billion by the end of the century. If they focus on slow-disbursing project lending (which experience suggests remains their real forte) this would require them to commit between US\$100-120 billion by the year 1999. By comparison with these requirements of increasing gross disbursements by US\$17 billion between 1994-99 (or by approximately US\$3 billion each year), the MDBs as a whole increased gross disbursements by only US\$3.5

**Figure 2 Net Transfers from MDBs to Developing Countries**  
(billions of U.S. dollars)



billion between 1987-92. If that track record is not improved substantially, the MDBs are likely to become less and less significant as resource transfer agents to the developing world. Since, in the final analysis, it is the financial dimension that governs relationships between MDBs and their borrowing countries, the influence of MDBs as a whole – even as agents of development and purveyors of policy prescriptions – is bound to diminish except in those countries which are dependent on borrowing from MDB soft-windows.

A final point on the subject of MDB net transfers. To avoid making themselves look bad, MDBs now portray their net transfers by combining the figures from both their hard and soft loan windows or try to avoid mentioning them altogether. This is misleading for two reasons. First, the annual commitments and gross disbursement levels from the soft-windows result in much larger net transfers than from the hard-windows. The reason is plain. Interest payments on soft loans are very low and annual principal repayments on these facilities are much smaller as they are spread out over

longer maturity and grace periods. Second, these two windows are invariably orientated towards different groups of borrowers. Except in the case of the African Development Bank<sup>13</sup> the hard-windows of MDBs are orientated principally towards middle-income, creditworthy countries (mainly in Latin America and East Asia) while the soft-windows lend mainly to the poorer countries of Africa and South Asia. Today, the principal blend countries (i.e. those which receive funds from both hard and soft loan windows of the MDBs) are the large poor countries like China, India, Indonesia, Nigeria, Pakistan and Egypt. Hence, when the MDBs show combined net transfer figures for their hard and soft windows they obscure the degree to which their core hard-windows are failing in their resource transfer functions (especially to middle-income countries) thus deliberately obfuscating reality.

### *The Hard And Soft Loan Windows of MDBs*

Frequent references have been made earlier to the *hard* and *soft* loan windows of the MDBs. The **hard loan window** comprises the core 'development bank' in each institution. It has a capital structure in two parts: *cash* capital and *callable* capital. MDB capital is subscribed and paid-in by *all* member governments in negotiated proportions. The basis for determining these proportions (over which much negotiation takes place each time there is an increase in capital) varies in the case of each multilateral bank; it is notably different in the case of the World Bank and the regional development banks. Against their capital base the *banks* borrow resources on world capital markets through public bond issues, private placements and syndicated loans, or, occasionally, facilities made available for lending by a single member country (e.g. Japan and Saudi Arabia) which has generated sudden large current account surpluses. These borrowings, which are raised on market terms, far exceed the amount of *cash* capital contributed to the MDBs and constitute the bulk of the resources they intermediate.

For that reason the *bank* part of the MDBs has to lend on market-related *hard terms* (hence the term *hard-window*); i.e. its interest charges must cover its own *borrowing cost* plus a *spread* or interest margin to cover its internal administrative and operating costs. MDB loans must also have maturities (and grace periods) which match roughly the maturities of the MDB's own pooled long-term borrowings. Such matching of maturities is necessary to avoid the prospect of the MDBs taking an excessive *term transformation risk*; i.e. the risk of borrowing funds for shorter periods than it lends them thus exposing itself

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13 The AfDB has been lending too large a proportion of its hard loans to patently uncreditworthy poor countries in Africa when these countries, given their over-indebtedness, should be receiving only concessional soft funds.

to the possibility that, if capital market conditions change adversely, it may need to pay a much higher price to cover its funding requirements for loans it has committed to disburse over a long time frame. The term transformation risk is of course lessened to the extent that MDBs can lend to their borrowers at variable rates of interest which can be adjusted in tune with periodic changes in their own borrowing costs.

Since the Articles of Agreement of the MDBs do not permit them to take any *exchange risks*, these are also passed on to the borrower, adding a further element of cost and risk to the facilities that MDBs provide. Such risks arise when an MDB borrows in one currency and lends in another. In the case of most MDBs the practice that has developed over time is to borrow in a mix of currencies and to on-lend these currencies through a currency pool in which all borrowers share more or less the same risks.

The hard windows of MDBs are constrained in the amount of loans they can make only to the extent that their outstanding borrowings have reached nearly the same level as that of their existing capital resources (cash and callable). Their Articles of Agreement usually limit their outstanding borrowings to their capital in a 1:1 ratio. In practice MDBs never actually reach this limit because MDB managements alert their member governments to the need for a capital increase a considerable amount of time before the 1:1 limit risks being approached.

In contrast to the hard windows whose financial structure (with the exception of the callable capital feature) approximates that of any commercial long-term lending institution, the **soft loan windows** of the MDBs – i.e. their special multilateral development funds (MDFs) or associations – are legally set up and funded entirely differently, except in the case of the IDB where the Fund for Special Operations (FSO) is an integral part of the institutional structure. They are not banking entities with a limited capital structure on which borrowing leverage can be exercised as such. They are structured instead as separate funds in the case of the regional banks or as an association, in the case of IDA. Even borrowing member governments make insignificant, nominal contributions to these funds/associations to establish their membership and eligibility for borrowing and voting on their various functions and operations. The financial architecture of the MDFs is based on the concept of multilateral clubs of donors who collaborate in providing permanent grant resources to these respective funds. The resources thus provided are on-lent to borrowers on highly concessional terms. There is no interest cost as such levied on these facilities but a small service charge (usually between 0.5% to 1%) is applied to outstanding balances to cover administrative costs.

MDF resources are made available to borrowers for 35-50 year maturity periods with around 10 years grace. Such terms usually have a *grant element* of

between 75-85% which is regarded as extremely concessional or *soft* (hence the term *soft-window*) compared to the alternative cost of market borrowings; assuming that access to financial markets was possible in the first place. Because these funds are financed by budgetary contributions from donor country governments, and because they cannot be leveraged with market borrowings (i.e. the amounts lent out to recipients are limited to the resources provided by donor governments), they are tightly constrained and carefully rationed out among eligible recipient countries. The funds are set up to be revolving in nature. Upto now they have been replenished regularly on a three or four year replenishment cycle depending on the MDF concerned. Table 3 shows the present level of capital and concessional resources available to the five MDBs.

**Table 3 Hard and Soft Loan Windows of the MDBs**  
(billions of U.S. dollars)

	World Bank	AfDB	AsDB	IDB	EBRD
<b>Hard Window</b>	IBRD	AfDB	AsDB	IDB	EBRD
<i>Established</i>	1945	1964	1966	1959	1991
Capital -93/94 (Paid-In Capital)	170.00 (10.67)	22.25 (2.56)	23.08 (2.78)	54.20 (3.17)	11.03 (3.31)
Retained Earnings	14.47	0.57	4.94	4.76	0.005
Paid-In/Subscribed(%)	6.3%	11.5%	12.1%	5.9%	30.0%
Loans Outstanding	109.29	8.31	13.71	22.18	0.40
Loan Provisions	3.32	0.21	0.01	0.71	0.05
Total Reserves	14.47	0.57	4.35	4.75	0.01
<b>Soft Window</b>	IDA	AfDF	AsDF	FSO	None
<i>Established</i>	1960	1972	1974	1960	-
Resources -93/94	100.01	10.60	17.63	8.65	-
Disbursed Credits	62.81	4.96	9.38	5.93	-
Undisbursed Credits	25.07	4.33	6.00	1.98	-

*Note:* Figures for the World Bank relate to June 30, 1994; Figures for the other MDBs relate to December 31, 1993.

*Sources:* MDB Annual Reports for 1993. IBRD Annual Report for 1994.

## 2 The Capital Structure of the MDBs

### *Conceptual Architecture of the Equity Base*

The conceptual architecture common to the equity (i.e. ownership) capital construction of all the MDBs was established with the formation of the IBRD – i.e. the core of the World Bank. From the outset the IBRD was designed to be an institution which would be owned, and whose capital would be provided, by governments and not by private sources. Also, in the aftermath of the Second World War, it was designed to incorporate as much inclusiveness in its ownership as possible. In the event, that did not happen until 1990 when, after the collapse of the Berlin Wall, the countries of the former East Bloc joined or rejoined the institution. Its initial authorised capitalisation of US\$10 billion (of which US\$9.1 billion was subscribed) consisted of: (a) 20% *paid-in capital* and (b) 80% in the form of *callable* or *guarantee* capital. Of the one-fifth paid-in capital component, 2% was to be provided in convertible form, i.e. in gold or US dollars, and 18% was to be paid in the domestic currencies of member countries. The Bank's Articles of Agreements required it to limit its outstanding loans to the total amount of its subscribed capital (i.e. both paid-in and callable) i.e. a 1:1 loans to capital ratio.<sup>1</sup>

This capital structure was designed with several objectives in mind:

- Every member country – no matter how poor – should be able to participate in providing its share of equity capital without having to bear an unaffordable fiscal burden, by providing only a minuscule fraction (2% originally) of its capital payment in *usable* form;
- Countries which were temporarily poor and experiencing balance-of-payments difficulties were permitted under this arrangement to contribute the larger part of their paid-in capital (the 18% domestic currency portion) in a way which would gradually become usable later. This was the

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<sup>1</sup> Thus, compared to most market-based financial institutions whose loan assets often exceed their stockholders' equity by a considerable multiple (averaging between 10-15 times) the Bank might be deemed to be very conservatively geared in terms of its total capital base. But the more comparable capital base would of course be the usable and available (i.e. paid-in and convertible) cash capital provided by those shareholders regarded as creditworthy in international capital markets.

case with most European countries and Japan immediately after the Second World War whose currencies only became fully convertible after the 1960s. The domestic currency capital contributions of a large number of *developing* country members with inconvertible currencies are now usable although often on a restricted basis under certain specified conditions (e.g. such as use for certain types of local expenditures in that country). In some cases these inconvertible currencies are now even lent out by the IBRD and other MDBs as occurs with Indian rupees provided they are used for procurement from India. When currencies on loan are not fully convertible, and therefore not openly available on foreign exchanges, borrowers and MDBs have to make special arrangements to ensure the availability of these currencies for repayment.

- A high level of *cash* gearing was induced by emphasising the mobilisation of loanable capital from private market sources. Such market-capital would of course be underpinned by the collective guarantees of the world's governments. Framing the capital structure in this manner, the architects of the IBRD envisaged that the Bank would make extensive use of the guarantee powers which were highlighted in its Articles.<sup>2</sup> Persuaded that it should not become a purely government funded agency vulnerable to the political willingness and ability of its member states to finance its operations, the original architects of the Bank designed its capital structure to encourage it to mobilise resources from international capital markets for financing its lending operations rather than relying on the use of its government-provided capital to finance lending.

It took some time for the World Bank to get off the ground and for capital markets to accept without qualms the underlying risk on the securities it issued. By the time the next MDB was established in 1959 (i.e. the IDB), however, this capital structure had proven its durability and was replicated for every MDB that has been set up since. All the multilateral development banks therefore have their financial edifices constructed on a figment of confidence, originally incorporated in the financial architecture of their progenitor. MDB balance sheets – i.e. the size of their asset and liability structures – have since been highly geared by permitting them to borrow and lend substantial

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<sup>2</sup> As events transpired of course the World Bank did not even begin to use its guarantee powers in any serious fashion until the late 1980s. Even now it uses them very sparingly while the other MDBs have not yet begun to use their guarantee powers at all. In September 1994, the President of the Bank issued an instruction to all staff requiring that henceforth guarantees were to become a mainstream instrument, alongside loans, in the Bank's regular operations.

amounts against a relatively small amount of *paid-in* (cash) capital. This point is explored in greater detail later in this chapter.

### *Callable Capital*

The figment of confidence underlying the capital structure of the MDBs is embedded in the notion of *callable capital*. This feature assures the creditors of these institutions that each dollar lent is fully backed by a dollar of shareholders' equity, given the 1:1 limitation on the loan assets to capital ratio. Allowing for the cash equity and *reserves*<sup>3</sup> components of MDB liabilities, that assurance enables the borrowings undertaken by the MDBs to be fully covered by total net worth. However, only a small fraction of the *equity dollar* in MDBs is paid up-front in cash. The bulk is subscribed in the form of a guarantee provided by shareholder governments which could be *called* in the event that repayments from MDB borrowers' and available liquidity are insufficient to cover the MDB's own obligations to its creditors.

MDB managements and their shareholders (particularly those OECD countries whose budgets are likely to bear the brunt of the burden of any calls) have laboured over the years to ensure the application of high standards of financial soundness and performance on the part of these institutions. This emphasis has been placed so as to maximise MDB reliance on *internally generated* capital resources (i.e. retained earnings and reserves) and to minimise, to a level of insignificance, any risk that callable capital might actually be required to be paid-in.

Until the mid-1980s, confidence in the financial strength and backing of the MDBs was rarely, if ever, questioned in global capital markets. But, since the debt crisis which engulfed a large number of developing countries in the 1980s, their financial standing and performance has come under increasing scrutiny in financial markets. Yet, despite a discernible deterioration in the intrinsic quality of their portfolios during the 1980s, all the MDBs have managed to maintain the highest ratings for their debt issues in international capital markets, enabling them to continue borrowing at extremely fine spreads. Indeed MDBs are now borrowing at even finer spreads over prime government issues in major world markets than they were before. Their credit ratings thus appear to rely less on the financial performance and

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3 These reserves, relative to the paid-in cash capital, are now quite sizeable in the case of all the MDBs except the AfDB and EBRD. These reserves are essentially a paid-in capital substitute. They belong to the share-holders as retained earnings which have not been distributed as dividends. The only difference is that they do not have attached to them a callable capital guarantee as paid-in capital does.

standing of the MDBs themselves<sup>4</sup> and much more on the *callable capital* guarantee.

It has always been recognised (albeit quietly) within the MDBs, and in the markets that provide them with funds, that the *quality* of the capital provided by all member governments in the form of domestic currency payments and in callable form was not uniform or equal. But this realisation was more specifically explicated in the 1980s when markets noted bluntly that the callable capital obligations of many of the MDBs' poorer member countries could not be counted upon to support the full safety of MDB borrowings. They signalled clearly that the callable capital of a severely-indebted, low-income country (SILIC) – whose currency was not readily convertible, subject to high devaluation and exchange risk, and whose international reserves were supported mainly by aid flows – could not be given the same weight as the callable capital of an OECD country or of a newly industrialised country.

### *Usable Capital*

Hence the notion of *usable capital* – which markets had always been conscious of but, until the 1980s, not too concerned about – was refined through the 1980s as the more relevant dimension against which comfortable levels of borrowing and lending ought to be gauged. In other words, it was regarded as imprudent by markets (in terms of heightening the risk of calls on guarantee capital being made) for MDB managements and shareholders to extend MDB balance sheets to the limits of 100% of *subscribed* capital as their Articles clearly permit. Prudence dictated instead that MDB borrowing and lending should be more appropriately gauged against limits of *readily usable capital*; with capital increases being negotiated and concluded before borrowings or outstanding loans approached the limits of usable capital. Obviously, considerable differences of opinion exist as to what proportion of callable capital is *readily usable*. Financial analysts and rating agencies vary widely in the definitions of usable capital which they employ. Most judgements are arbitrarily based on including in usable capital only that portion which is provided by the following shareholders: (a) countries which are members of the OECD or which enjoy the higher investment grade ratings on their own debt instruments in international capital markets; (b) some Arab members of OPEC which have enjoyed large, sustainable current

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4 In terms of strict financial analysis it would be difficult to make the case that their relative strength and standing had not deteriorated since the 1970s with the MDBs now being affected by protracted arrears and non-payment risks of a sort that simply had not occurred or even been contemplated until 1984.

account surpluses and have accumulated large holdings of international reserves relative to their import needs; and (c) some newly industrialised developing countries (NICs) which generate large current account surpluses, have large reserves and can easily access international capital markets for funds on a voluntary basis (e.g. Hong Kong, Korea, Singapore and Taiwan).

From time to time, with the legislatures of certain countries being unwilling to appropriate funds for MDB hard and soft loan windows (even after they have been authorised), questions have been raised about whether the callable guarantee provided by certain OECD countries should be counted in *usable capital*. With the complex, unwieldy parliamentary procedures which some of these countries have, it is conceivable that they might find it difficult to meet calls quickly in the event of an unforeseen financial calamity befalling the MDBs. These worries range from the intellectually interesting to the extremely unlikely. But they do emphasise the need to codify clear rules and criteria, in the case of each MDB, to define unambiguously the make-up of its *usable capital* and to reach a consensus among all parties – i.e. the MDBs themselves, analysts in financial markets and the rating agencies – as to exactly what components of capital are to be regarded as usable.

### ***General and Selective Capital Increases***

The capital base of the MDB hard-windows has, since their inception, been increased several times (except of course in the case of the EBRD which is a relatively new Bank) through both *general* and *selective* (or special) capital increases. For example, in the IBRD, the authorised capital has been increased more than 18 times over the last fifty years through a number of formally negotiated capital increases. The purpose of a *general capital increase* (GCI) is to increase the share capital of the Bank concerned when it approaches the limits of its present capital base in expanding its lending capacity further. Under a GCI such an increase in capital is spread proportionately among existing shareholders on a *pari passu* basis i.e. relative to their extant weight in share ownership. However, almost every GCI negotiation has witnessed some marginal shifts in the relative shareholdings of member countries to reflect changes in their relative economic weight.

*Selective capital increases* (SCIs) on the other hand are not intended primarily to provide additional capital for an MDB. Instead, they are aimed principally at adjusting the relative weight and voting power of one or a few members in the shareholding structure of a particular MDB. SCIs are propelled largely by political impulses and are usually instigated at the urging of the larger more important shareholders of MDBs to reflect voting right

adjustments among themselves.<sup>5</sup> The considerations surrounding an SCI to accommodate a changed position for a major shareholder usually induce other smaller shareholders to also argue for periodic relative changes in their positions vis-à-vis their cohorts. Most SCIs attempt to correct the inevitable anomalies in their shareholdings as well, though not always successfully. The politics underlying an SCI are usually more difficult for MDB managements to handle than the imperatives of a GCI which benefit the standing of the institution more than the standing of particular shareholders within that MDB.

The main developments by way of GCIs and SCIs which have occurred in each of the MDBs since their inception are summarised briefly below.

### *The World Bank*

The World Bank (IBRD) has had six GCIs and several SCIs which have increased its authorised share capital from US\$10 billion in 1947 to US\$184 billion now. Subscribed capital has increased from an original amount of US\$9.1 billion to US\$170 billion at the end of FY94. The first GCI in 1959 more than doubled the original size of the IBRD's capital from US\$10 billion to US\$21 billion. The paid-in portion of the capital contributions was reduced from 20% to 10%, with the same proportions (1:9) being maintained for the convertible (i.e. payable in gold or US dollars) and domestic currency<sup>6</sup> payments. Thereafter there were three small GCIs between 1963-70 which increased capital by a further US\$6 billion, mainly to accommodate the entry of new members. The fifth GCI in 1979 increased the Bank's authorised capital base from US\$27 billion to nearly US\$72 billion while reducing the paid-in portion further to 7.5% and retaining the 1:9 ratio for convertible and domestic currency payments. The IBRD had a large intervening SCI in 1984 of about US\$8.5 billion aimed largely at improving the position of Japan from being the Bank's fifth largest shareholder to becoming its second largest

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5 In the IBRD, *selective capital increases* can be triggered by (i) changes in relative IMF quotas among members; (ii) the entry of a new member country into the shareholding of the institution; or (iii) the particular circumstances of an IDA replenishment when the willingness of a major country to contribute substantially more concessional resources is made conditional upon an increase in its shareholding in the affiliated MDB. In the regional banks, SCIs are negotiated on much the same types of principles and grounds although often in different ways, given the differences in political modalities and relationships among countries in different regional institutions. What is a particularly sensitive issue in the regional banks is the shareholding of non-regional members.

6 For historical reasons dating back to the origins of the IBRD when the domestic currency portion of paid-in capital amounted to 18%, this element of capital has always been referred to as the *18% capital*.

with a corresponding decline in the share of the UK which dropped from second position to a joint fourth position with France. This was followed by two smaller SCIs in 1987 and 1988 and by a sixth GCI in 1988 which increased IBRD's authorised capital from around US\$88 billion to its present level of US\$184 billion. In that GCI the paid-in portion of capital was reduced to only 3%; again with the 1:9 ratio of convertible to local currency payment remaining intact. The most recent review of the capital adequacy of the IBRD did not signal any immediate need for another capital increase unless: (a) the Bank's sustainable lending level<sup>7</sup> of US\$21 billion annually was exceeded through the mid-1990s, and (b) other issues relating mainly to movements in exchange rates and the standard-of-value for the Bank's capital remained unresolved. The first eventuality seems unlikely to materialise if the sharp drop which occurred in the IBRD's lending in FY94 is repeated in FY95 and beyond.

Whereas the basis for successive GCIs in the World Bank has been fairly clear and largely unarguable – at least to those who favour a continuing expansion of its lending operations – the rationales for its SCIs have been more contentious. This is understandable because SCIs disturb the equilibrium of previously (and delicately) negotiated balances between the conflicting interests of different shareholders in what are rigidly constrained environments. As such, they raise difficult issues for the many in order to accommodate a few. Despite the pain and effort involved, SCIs are agreed to partly because of genuflection to notions of *fairness* but much more because of *realpolitik*. In the absence of such agreement the World Bank would probably have been deprived of as much funding for IDA from offended *nouveau riche* members (as it actually has obtained by increasing their shareholding in the IBRD, where votes really count).

As a general rule, the allocation of IBRD shares among its now 178 members is based on the principle that their relative shareholdings in the IBRD should, by-and-large, reflect their relative positions in the world economy. The catch, of course, is that no completely objective and unarguable set of criteria or of economic measurements have yet been devised which can translate a *theoretical* concept of relative standing in the world

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7 This contrived, notional concept of the **sustainable level of lending** is roughly defined as the maximum amount of annual lending (in commitments) that the Bank can reasonably sustain indefinitely in nominal dollar terms under a certain set of assumptions (about exchange rates, repayments, etc.) without running the risk that disbursed and outstanding loans might exceed the amount of the Bank's total subscribed capital and retained earnings (or ordinary reserves). The SLL concept was devised in 1976, at the time of a selective capital increase, in order to accommodate a policy aimed at planning annual levels of future IBRD lending which would not require disruptive adjustments to be made in the event that further capital increases could not be agreed.

economy in concrete, mathematical terms that everyone can readily accept. In its *practical* application this principle has therefore been translated to imply that members' shareholding in the IBRD should be *parallel* to their relative quotas in the IMF. The other justification for the *principle of parallelism* with quotas in the IMF is that countries cannot become members of the World Bank unless they are already members of the Fund. IMF quotas are calculated on the basis of a number of mathematical formulae which, though flawed and imperfect, attempt to reflect in some consensual manner the overall weight of a particular country in the world economy. Consequently members who get special (selective) increases in their IMF quotas should also receive similar special increases in their allocations of IBRD shares. Yet, relative shareholdings in the IBRD do not reflect strict parallelism with relative IMF quotas for a number of reasons:

- Some countries (India, for example) have followed a policy of always exercising their *pre-emptive rights*<sup>8</sup> (enshrined in the Bank's Articles of Agreement) in previous increases of IBRD capital even though such rights negate the intent of an SCI.
- Some members have not taken up all the shares allocated to them.
- The issuance of an equal number (250) of membership shares to all members in the 1979 GCI has affected relative shareholdings. These shares were issued to protect the voting power of the smaller shareholders and to avoid too precipitate a decline in the collective voting power of developing countries relative to that of the developed countries.
- In 1987 and 1988 there were two SCIs for the developed (i.e. Part I) and developing (Part II) countries respectively which deviated from the principle of parallelism by taking into account, for example, relative contributions by Part I members to IDA replenishments.

Despite attempts by ad hoc committees of the IBRD's Executive Directors to establish a clear set of common criteria for the allocation of shares in the IBRD, no such criteria have as yet been established and no consensus has been reached on deriving or applying them. In the regional banks, similar complications and contentions apply in determining the share allocations of

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<sup>8</sup> Under the Articles of Agreement of the IBRD, whenever the capital of the Bank is increased, for whatever reason, all members have the right to obtain sufficient shares to maintain their relative position should they so wish.

individual members. In these cases, the basis for allocation is more the weight of member countries in the *regional* rather than the global economy. Further complications arise when the relative weights and share allocations of the *non-regional* members have to be negotiated. One way of cooling down the desire of certain members to insist on SCIs for reasons of political prestige rather than economic justification would be to require them to provide 100% of their specially allocated share subscriptions in fully paid-in and convertible form. That measure would certainly benefit the MDBs more than present SCIs actually do. This measure could not, of course, be applied in cases where a change in relative standing was clearly justified on economic grounds (e.g. if a major change in relative IMF quotas had occurred) or in the case of admitting new members. The same measure might be contemplated for application to all members who insisted on exercising their pre-emptive rights.

### *The African Development Bank*

The authorised capital of the African Development Bank (AfDB) on its formation in 1965 was US\$250 million of which US\$218 million was subscribed by 1968. Of the amount initially subscribed, 50% was supposed to have been paid-in. In the event, only about 25% was actually paid-in by the regional members presaging the problem of chronic arrears in capital subscriptions which has since characterised the AfDB.<sup>9</sup> The Bank has since had four GCIs and eight special increases which have resulted in increasing its authorised capital to US\$22.25 billion at the end of 1993. The most significant of these increases were: (a) GCI-3 (comprising the combined capital increases of 1979 and 1981) which saw the admission of non-regional members into the shareholding of the AfDB, along with a substantial increase in the Bank's capital base to over US\$5 billion; and (b) GCI-4 in 1987 which increased the AfDB's capital to more than four times that amount. With GCI-3 the principle was adopted that regional members (i.e. those physically located in the continent of Africa) would at all times have among them no less than two-thirds of the subscribed capital stock of the Bank.

As noted above, prior to GCI-4 in 1987, the *paid-in* portion of AfDB's subscribed capital was 25% with the remaining 75% being callable. Under GCI-4 the paid-in proportion was reduced sharply to 6.25%. It was expected that when the shares allocated under the three previous GCIs and GCI-4 had

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<sup>9</sup> See Culpeper, R., "The Regional Development Banks: Exploiting their Specificity", p. 227; Volume II of "Bretton Woods: Looking to the Future", A Report of the Bretton Woods Commission, Washington DC, July 1994.

been fully subscribed to by all members, the average paid-in proportion of all outstanding shares would amount to 12.5%. Prior to GCI-3 all payments for paid-in capital were required to be made in freely convertible currencies.

To accommodate the difficulties most of them faced in providing their paid-in portions in convertible currencies under GCI-3 *regional* members were given two options. They could pay in five equal annual instalments of which: (a) at least 50% was payable in convertible currencies and 50% in domestic currency; or (b) at least 20% was payable in convertible currencies and the remaining 80% was payable in non-negotiable, non-interest bearing serial notes. These notes were payable only in convertible currencies and encashable in ten equal instalments with the first instalment being encashed on the fifth anniversary of the date of subscription and the remaining instalments being encashed annually thereafter. *Non-regional* members were required to provide paid-in capital only in convertible currencies.

Under GCI-4, these options for the paid-in portion of subscribed capital were changed again. *Regional* members could provide their 6.25% of paid-in capital in two parts: (a) 50% of the amount due was payable in five equal annual cash instalments in freely convertible currencies with the first instalment being made on the date of subscription and the remaining four instalments annually thereafter; and (b) 50% was to be paid with the deposit of five non-negotiable, non-interest bearing, serial notes of equal value denominated in AfDB Units of Account (1 UA = 1 SDR) and encashable between years 6-10 from the date of subscription, in convertible currency amounts equivalent to the UA value. *Non-regional* members were required to make their payments in five equal cash instalments in their national currencies, if those currencies were freely convertible. If they were not then non-regional members were required to deposit notes denominated in convertible currencies and payable on demand. Failure to subscribe to shares allocated to members under GCI-4 within four years of allocation would result in members forfeiting their allocations and the released stock becoming available for other members to take up, providing the 2:1 ratio of subscribed capital between regional and non-regional members was not violated.

The failure of some regional members to subscribe to the shares allocated to them under all preceding capital increases by 1992, resulted in the desired level of callable capital being marginally below the intended level of 87.5% when all the shares allocated had been fully subscribed. Also the Bank was left with unclaimed stock from various prior GCI's which had the same share value (UA10,000) but with different paid-in requirements and terms, resulting in pre-GCI-4 stock becoming unmarketable. Accordingly, in May 1992 measures were taken to restructure the Bank's capital stock so as to achieve the intended average 1:7 paid-in to callable capital ratio. These measures entailed: (i) the general application of the AfDB's share transfer

rules to shares issued under all previous capital increases; (ii) cancellation of forfeited and unsubscribed shares along with (iii) their immediate reissuance as a single block of available shares with the same terms and conditions of subscription with a ratio of 7:1 for callable to paid-up shares; and (iv) requiring the statutory 2:1 ratio for non-regional to regional shareholdings to be maintained.

As of March 1994, over 93,000 allocated shares (or about 6.1% of total allocated shares) remained unsubscribed. GCI-4 was intended to support AfDB lending operations between 1987-91. In the event, the rapidly deteriorating creditworthiness of most African borrowers resulted in that capital increase being stretched out to meet AfDB's capital needs for another five years. With annual lending now approaching its sustainable limit under the present capital base, and with the prospective entry of South Africa in its membership, the management has initiated discussions on proposals for a further increase in capital (GCI-5) to the Board of Governors at the AfDB's Annual Meeting in May 1995. If the presently unsubscribed shares were to be fully taken up by the members to whom they have been allotted, a further US\$1.3 billion in subscribed capital and (US\$163 million in paid-in capital) would be made available to the AfDB thus reducing the urgency of negotiating the next GCI.

### *The Asian Development Bank*

In May 1994, the Asian Development Bank (AsDB) announced a fourth GCI which would raise its authorised capital base (for its Ordinary Capital Resources) to around US\$48 billion and provide sufficient capital for that institution to expand lending into the next century. The paid-in portion of only 2% (with 98% callable) for GCI-4 is the lowest negotiated for any GCI in any MDB so far. It continues the trend of lowering the paid-in portion that was set in train by the IBRD in 1959. In all of the AsDB's capital increases, the 40:60 ratio (equivalent to the World Bank's 10:90 ratio) for convertible to domestic currency payment of the paid-in portion of capital has remained unchanged.

The AsDB was originally capitalised at US\$1 billion at its formation in 1966 with the capital base being increased through four subsequent GCIs (in 1971, 1976, 1983 and 1994) and a few smaller special increases (in 1983, 1985, 1987 and 1988) to an authorised level of almost US\$48 billion at the end of 1994. At inception its usable capital resources amounted to US\$700 million. The paid-in proportion which was 50% of total capital at the time of the AsDB's formation has been progressively reduced in successive GCIs to a level of 5% for GCI-3 and of 2% for GCI-4. The most recent *special* capital increase (1988) was agreed to enable Japan, Sweden and the USA to increase

their relative shares. Part of GCI-4 (50,000 shares) has been earmarked to accommodate the entry of three Asian republics of the former Soviet Union into the AsDB's membership.

The AsDB is bound by a statutory regional (including Japan) shareholding requirement of 60%; this shareholding amounted to 63% of the total shares subscribed at the end of 1993. The AsDB has employed variations of the same stretched-out note deposit and encashment formulae for meeting the paid-in portions of members' subscriptions as in the IBRD and AfDB. This device made it easier for members facing budgetary pressures to commit themselves to taking up their subscriptions in full while paying for these subscriptions in instalments.

### *The Inter-American Development Bank*

Starting with an initial capital base of US\$1 billion in its Ordinary Capital Resources (OCR) of which US\$850 million was subscribed (with 50% of that amount paid-in) when it was established in 1959, the Inter-American Development Bank (IDB) has since had eight General Increases in Resources (GIRs).<sup>10</sup> As a result, IDB's authorised OCR capital base has increased to its present level of over US\$101 billion with subscriptions amounting to US\$54.2 billion at the end of 1993. The largest increments to IDB's capital base have occurred since 1978 when GIRs 5 to 8 have added a total of US\$90 billion to the capital stock. Thus, over 90% of the IDB's existing capital base of the IDB has been contributed in the last 15 years and 66% in the last four years alone with GIRs 7 and 8 in 1990 and 1994 together adding a total capital increment of US\$66.5 billion.

The paid-in component of capital has fallen progressively from 20% in the original capital base to 7.5% under GIR-5, 4.5% under GIR-6 and 2.5% under GIRs 7 and 8. The proportion of paid-in capital provided by the *borrowing members* (except Venezuela) in convertible form has varied with each GIR. Upto GIR-5, the ratio of paid-in capital provided by the regional borrowing members in convertible form vs domestic currencies was 1:1 (i.e. 50% in gold or US dollars and 50% in domestic currency of the member) except in the case of Canada which paid its subscription entirely in Canadian dollars. In GIR-5, this ratio was changed to 2:1 for the borrowing members

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10 These have combined simultaneous increases in its OCR – including inter-regional capital – and FSO resources. An Intermediate Financing Facility (IFF) was established under GIR-6 in 1983. It was replenished under GIRs-7 and 8 which came into effect in 1990 and 1994. The capital base of the IDB was earlier divided into two parts, regular OCR and inter-regional capital. The distinctions and make-up of these two components are rooted in history and need not be delved into here. They are explained in some detail in Annex D of the Proposal for GIR-6 dated February 1983 (Document AB-910). In GIRs-7 and 8 these distinctions became moot.

with the USA, Canada and Venezuela providing all their paid-in capital in convertible form (US dollars). In GIRs 6 to 8, *all members* were effectively required to provide paid-in capital entirely in convertible form although in GIRs 7 and 8 that requirement was expressed in somewhat convoluted fashion.<sup>11</sup> The requirement that the full amount of paid-in capital from all members be paid in convertible form goes further than in any of the other MDBs. It should be seen as a useful precedent which other MDBs might emulate especially as the amount of paid-in capital with each successive GCI or GIR diminishes to virtually insignificant levels. As in the other MDBs, note deposits and stretched-out payment and encashment schedules for capital subscriptions are also resorted to in the IDB in order to ease the budgetary burdens on members. Shareholders have the option of depositing non-interest bearing notes which are encashable over a period of years with some back-loading under GIR-7 but not under GIR-8.<sup>12</sup>

The IDB's Articles specify clear boundaries on inter-regional as well as non-regional participation in its shareholding and capital structure. Until 1994 when GIR-8 was agreed, no capital subscription could become effective, and any rights to such subscription had to be waived, if it had the effect of reducing the voting power of: (i) the regional developing country members below 53.5%; (ii) the USA below 34.5%; and (iv) Canada below 4%. This left only 8% of voting power (and as a rough proxy, for shareholding) for *non-regional* members, primarily from Europe, Japan and the rest of Asia. Though the IDB's General Rules provided for voluntary waiver of these three distinct rights by those members which had them, in practice such waivers have not been applied. Indeed, to the contrary, in order to accommodate the perennial legislative difficulties that the US has had (and will continue to have) in meeting its obligations to the MDBs on schedule, the IDB has had to postpone the due dates for accepting all four instalments of members' subscriptions to the OCR capital under GIR-7, and to regulate the acceptance of other members' subscriptions in order to avoid breaching these voting power limits.<sup>13</sup> It will probably have to do the same under GIR-8. At

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11 The actual wording in the Proposals for GIRs 7 and 8 being: "For the paid-in capital, payments shall be in the currency of the member, in such a manner as to assure that the currency is freely convertible for the purposes of the Bank's operations or with the agreement of the member to convert on behalf of the Bank its currency into those of other members for the same purpose".

12 With respect to paid-in capital subscriptions the encashment of notes under GIR-7 was scheduled so as to complete encashment of about 41% in the first three years with the balance of 59% being encashed in the following three. Under GIR-8 the arrangement was for both paid-in and callable capital to be provided in six equal annual instalments between 1994-1999.

13 See, for example, the Memorandum to the Board on the Seventh General Increase in the Resources of the Bank: Fourth Instalment of the Increase in OCR and FSO, Document FN-436-10 of the IDB dated January 24, 1994.

the end of GIR-7 the relative shareholdings of the developing members were 53.8%, that of the US and Canada, 34.69% and 4.38% respectively and that of the non-regional group, 7.14%. In GIR-8 a major change in this pattern of shareholding was agreed. The shareholding of the *non-regional* group was increased from 7.1% to nearly 16% with corresponding reductions in the shareholdings of developing members from nearly 54% to 50%, the US from 34.67% to 30%, and Canada from 4.38% to 4%.

### *The European Bank for Reconstruction & Development*

The European Bank for Reconstruction and Development (EBRD) was established in record time in mid-1990 and began operations in 1991. Its initial capital base was ECU10 billion (over US\$11.5 billion) with a paid-in capital requirement of 30% (ECU3 billion or US\$3.4 billion) making it the most budgetarily expensive of the MDBs for member governments to have financed in recent times. By comparison, the paid-in capital requirements for the last GCI's of all the other MDBs together amounted to only US\$3.7 billion. The paid-in capital of EBRD is to be contributed in five equal annual instalments with 50% being paid in either ECU,<sup>14</sup> USD or JPY, and the remainder in promissory notes encashable on demand (in theory) but on a three year fixed encashment cycle (in practice) with the final encashment due in 1997. Such notes are to be non-interest bearing and non-negotiable and denominated in the same three convertible currencies. Even callable capital, in the (unlikely) event of a call being made, needs to be provided in any of these three currencies. Hence there is no provision for inconvertible domestic currency contributions being made by any member to either the paid-in or callable capital of the Bank. The adequacy of the EBRD's capital stock is to be reviewed by its Board of Governors at intervals of no more than five years.

The Articles of Agreement of the EBRD require the European Union (EU) and the European Investment Bank (EIB) together to always have the majority of issued and subscribed capital stock. In the initial capital structure, the 12 individual members of the EU (which then included a divided Germany) had subscribed to 45% of the issued shares. The EU as an entity in its own right and the EIB subscribed to 3% each, thus exceeding the majority

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14 Payment in ECU -- which is not an issued currency as such but a composite European Currency Unit of Account representing the weighted value of the currencies of member countries of the EU which, until September 1992 were all included within its Exchange Rate Mechanism (ERM) -- requires to be discharged by payment in any convertible currency equivalent to the value of the relevant obligation denominated in ECU on the date of payment or encashment. Subscriptions to initial capital which are made in USD or JPY are settled at fixed exchange rates defined in Article 6.3 of the Articles of Agreement for this purpose at: 1 ECU=US\$1.16701; and JPY169.95.

condition (Article 5.4) with a combined total of 51%. European countries, which were not in the EU when the EBRD's capital structure was agreed, but some of which may shortly become members of the EU, subscribed a further 11.37% of the capital while the *borrowing* countries of Eastern Europe and the republics of the former Soviet Union (FSU) together subscribed 13.45%. Out of the remainder, 24.17% was subscribed by non-regional countries, with the USA and Japan having a 10% and 8.52% share respectively. With the possible accession of Austria, Finland, Norway and Sweden to the membership of the EU, the combined EU plus EIB share could rise to 58.08% with a corresponding fall in the non-EU European share to 4.31%.

Following the reunification of Germany, the 15,500 shares originally allocated for East Germany were added to the unallocated shares available to new members for subscription. Of these, 1000 shares were allocated to Albania at the end of 1991 and 1,000 shares each were allocated to Estonia, Latvia and Lithuania in 1992. At the end of 1993, therefore, 11,625 shares of the EBRD remained unallocated. The shares originally allocated to the FSU were reapportioned among the separate republics in 1992 with Russia retaining two-thirds of the original allocation and ending up with a 4% share in the EBRD. In early 1993, an initial 100 shares each from the block of 12,800 shares formerly allocated to Yugoslavia in the EBRD were reallocated initially to Slovenia, Croatia and Macedonia. This pragmatic step facilitated their early membership without holding that process hostage to arriving at a final determination of what proportion of the total Yugoslavian shareholding these republics should be allocated. The remaining 12,500 shares have been set aside for accommodating the entry of other republics from the former Yugoslavian federation. When all these republics have become members, the original Yugoslavian shareholding will be more appropriately distributed among them. The shares originally allocated to Czechoslovakia were divided between the Czech and Slovak Republics in early 1993. With the process of political reorganisation in Eastern Europe and the FSU not yet having been completed, further changes in the membership of the EBRD can be anticipated before its relative shareholding structure stabilises.

Like the other MDBs, the EBRD's Articles require it to limit loans, equity investments, and guarantees to the amount of its *subscribed capital* and reserves. A second limitation (which does not apply in the other MDBs) is that the EBRD's outstanding *equity investments* may not exceed its *paid-in capital* and reserves. Finally, the EBRD is required by its Charter to limit its lending to the state sector of its borrowing members to 40% of its committed loans, guarantees and equity investments. This limitation applies both to its overall lending as well as to its lending in individual countries. This is in contrast to the other MDBs whose Articles require them to lend mainly to

borrowing governments directly, or to their instrumentalities or other bodies with the guarantee of the government concerned. The shift in emphasis from the public to the private sector reflects the new development thinking, which is reinforced by unprecedentedly large private capital flows through securities markets and the progressive withdrawal of the state from the ownership and operation of productive enterprises and utilities. In such an atmosphere, all the MDBs are now focusing on finding ways of orienting their operations more towards supporting the private sector directly and indirectly through lending, investments and guarantees. Thus there is a clear trend being established in the movement of the entire MDB system toward the EBRD type of structure.

### *General Issues raised by the Capital Structure of the MDBs*

The capital structures of individual MDBs and their substantial expansion especially in the last two decades, raise several issues, of which three are worth exploring further. These concern: (a) the consequences of diminishing proportions of paid-in capital in successive GCIs; (b) the valuation of MDB share capital and (c) the need to maintain the value of such capital in terms of an acceptable *numeraire*.

#### *Diminution of Paid-In Capital*

As is evident from the foregoing paragraphs, apart from the case of the EBRD, the proportion of paid-in capital which member governments are willing to provide to MDBs under successive GCIs has been diminishing relentlessly. This is particularly true of developed country governments whose capital contributions remain critical in supporting or limiting the amount of borrowing and lending any MDB can undertake. This situation is, of course, changing. Several developing countries are becoming economically stronger by the day, especially in East Asia and Latin America. These countries are achieving both acceptable levels of creditworthiness and of currency convertibility to join their OECD counterparts in providing credible support for MDB capital or indeed, as Mexico has just done, joining the OECD themselves. In other words, the amount of *usable capital* in the total capital base of the MDBs will, with the temporary exception of the AfDB, gradually and inevitably increase. Yet, paid-in capital will remain difficult to come by.

The reasons for continually diminishing proportions of paid-in capital are not hard to find. *First*, most OECD governments are now hard-pressed to compress their burgeoning fiscal deficits even under benign economic conditions. It is therefore becoming increasingly difficult for them to agree to

maintaining former proportions of paid-in capital in the GCIs of MDBs.<sup>15</sup> *Second*, the size of recent GCIs has become much bigger than was contemplated when these MDBs were first established. Capital increases are now between 15-40 times larger than the original capital of the MDBs when they were set up. Each succeeding capital increase is almost double the size of the previous one. Keeping to the same proportions of paid-in capital would therefore require very substantial cash contributions to these institutions. In the current political and economic climate prevailing throughout the OECD world, such contributions would impose burdens which were (except in a few small countries) politically unacceptable, if not legislatively impassable. *Third*, the strong financial performance of the MDBs (except for the AfDB and, for the time being, the EBRD) has resulted in a steady accretion of retained earnings and reserves on their balance sheets. With the MDBs not paying out any dividends to their shareholders, these retained earnings/reserves are, in effect, coming to be seen by the members as almost perfect substitutes for paid-in capital. *Fourth*, smaller paid-in capital contributions reduce the budgetary and foreign exchange burdens on the *poorer* members in subscribing to their shares, especially when only a part of them have to be paid in convertible form.

Taking into account all of these reasons, and extrapolating from them the obvious trends, it is entirely possible to envisage future GCIs, especially for the World Bank, AsDB and IDB, which involve no paid-in capital at all. Indeed this was more than a theoretical consideration when the last GCIs for all of these institutions were negotiated. In all three cases, it was broadly acknowledged that there was no real *financial* need for members to provide paid-in capital. MDB managements and shareholders were convinced however that a token fraction of paid-in capital was necessary to indicate to international capital markets that member governments did indeed support these institutions and were not taking a soft option. Whether that conviction was contrived or genuine cannot be proven, unless it is tested in the marketplace.

Obviously, reducing the paid-in capital proportion in GCIs or providing

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15 Employing this line of reasoning, which has become time-honoured in its use, the very high paid-in proportion for the share capital of EBRD, and the stunning speed with which that institution was established, came as a surprise (if not as a rude shock) to those who had been labouring on negotiating hard-window GCIs, soft-window replenishments in the other MDBs, and replenishments of various UN development funds, with decreasing success in getting OECD governments to loosen their purse-strings. Clearly the political will for establishing the EBRD -- especially in Western Europe -- was far greater than the political will required to support the expansion of the other MDBs. That contrast is especially vivid when one considers that, had OECD countries decided to finance the same amount of lending through the World Bank's last GCI to support the former East Bloc, rather than to create a new institution, they could have done so for only 10% of the cash contribution they had to make to set up the EBRD.

no paid-in capital at all has its downsides. There are three main disadvantages. *First*, the absence of *usable cash* equity leaves MDBs virtually no room for reducing the interest charges they levy on their lending. With no additional free equity, all intermediated resources have to clear at above the market rate. This may require the MDBs to enlarge their spreads as they will have a significantly reduced proportion of *own funds* with which to leaven or lessen their spreads. *Second*, it cannot be assumed that all retained earnings can or should be used as a paid-in capital substitute for relending purposes. Because of a growing problem of arrears the operating environment of MDBs has become more difficult, involving greater risk of deferred repayments or default (as the AfDB case shows dramatically) which now has to be explicitly provided for. Hence prudential loan-loss provisions need to be allowed for in the reserves that MDBs accumulate.

*Third*, with further constraints on paid-in capital MDB managements may be pushed into *overcharging* their creditworthy borrowers to generate net income surpluses and accumulate sufficient reserves. Three undesirable effects might result. Such a loan pricing policy would probably drive the more creditworthy borrowers away from the MDBs, even more rapidly than is the case at present, to borrowing directly from capital markets. In turn, that would affect adversely the quality of MDBs portfolios by concentrating them in the less creditworthy countries. Moreover, such an attempt would be almost tantamount to shifting the burden of financing the *paid-in capital substitute* from the developed countries to borrowing member countries. The asymmetry would lie in borrowing members effectively financing through MDB net profits the build-up of a paid-in capital equivalent (i.e. reserves) but with no advantages accruing to them in terms of their shareholdings or voting rights in these institutions. And finally, the absence of paid-in capital would constrain the ability of the MDBs to self-finance their soft-loan windows as the World Bank had been doing previously in the case of IDA.

#### *Automatic Attachment of Callable Capital to Retained Earnings*

Against these obvious disadvantages to reducing further the proportion of paid-in capital in future GCIs, there is one possibility which might represent a reasonable compromise and which might be considered in modifying the financial architecture of the MDBs to address future needs. That prospect concerns the *automatic* attachment of a callable capital component to the retained earnings of MDBs. Such a measure would do away with the long, protracted, increasingly difficult and contentious negotiations (at a very high cost) every five years or so on the GCIs for individual MDBs. With the replenishment negotiations of their soft-loan windows as well, these negotiations are beginning to impose heavier burdens and costs on the

overstretched administrations of all member countries. An automatic increase in callable capital, which expands total capital each year by an agreed multiple of retained earnings accumulated in that year, might also have the salutary effect of imposing discipline on MDB *borrowers* as well as MDB *managements*. The borrowers would see more clearly the costs to the institution concerned of their poor repayment performance. The managements on the other hand might become more responsive to the concerns of their shareholders about budgetary profligacy and about reducing their institutionally embedded tolerance for excessively high levels of administrative cost.

Seen from the viewpoint of shareholders, and especially the larger, more powerful shareholders, the major *disadvantage* of *automatically* increasing the capital base of MDBs would be the perceived diminution of political power and control over these institutions. The absence of periodic GCIs requiring parliamentary ratification, would lessen the ability of legislatures to influence periodically MDB policy and direction. Legislators might object to such a device on the grounds that in removing MDBs from parliamentary scrutiny it would place too much power in the hands of Treasury or Foreign Ministry bureaucrats who represented the interests of these countries on MDB Boards. There are clearly other, and certainly better, ways than the painful and costly process of negotiating and ratifying GCIs to ensure on-going rather than sporadic parliamentary interest and influence over the MDBs. But established habits and procedures die hard. Therefore, such a proposal – if it were ever to be considered – would raise profound objections. Nonetheless, as what is seen to be politically impossible today often becomes received wisdom tomorrow, this suggestion needs to be preserved and considered until the time is ripe for its adoption and implementation. Indeed, it is the logical consequence of a trend which can only culminate in a regime of zero paid-in capital for the GCIs of MDBs in the not too distant future. Of course, this argument only holds to the extent that one sees the need to expand the lending or guaranteeing capacity of the MDBs indefinitely for the foreseeable future. If, however, one sees the value and size of the MDBs as having reached their peak, then the rationale for the above proposal is weakened considerably.

### *Valuing MDB Share Capital*

The standard-of-value (SOV) is a central feature in the Articles of all the MDBs. Essentially, it is the unit which determines both the price of the MDBs' shares and the mutual rights and obligations of the MDB to, and among, its members with respect to their relative shareholdings. Except for the EBRD, which has valued its share capital in ECUs, all the other MDBs have been grappling for several years with the issue of how their capital is to be valued. Yet it remains unresolved. The issue arises with the other MDBs

because their Articles all established their capital stock and expressed the par value of their shares in terms of US dollars of the weight and fineness (of gold) in effect on a date close to that on which the Articles of the MDB concerned were agreed. As a result, the value of the shares of the IBRD is expressed in “US dollars of the weight and fineness in effect on July 1, 1944” or, in vernacular terms, the 1944 *gold dollar*. Similarly, the par value of the IDB’s shares is expressed in 1959 gold dollars, that of the AfDB in a Unit of Account equivalent to 1964 gold dollars and that of the AsDB in 1966 gold dollars.

With the breakdown of the Bretton Woods Agreement in the 1970s, the simultaneous repeal of US legislation which established the value of the US dollar in terms of an amount of gold, and the Second Amendment of the Articles of the IMF on April 1, 1978, the gold dollar standard of value effectively disappeared. There was no longer any basis for translating 1944, 1959 or any other gold dollar into *current* US dollars. In the aftermath of the Second Amendment of the IMF’s Articles, the opinion of the General Counsel of the IBRD was that the Executive Directors of the MDBs could take either the *current* SDR or the 1974 SDR (at a fixed value of US\$1.20635) as the SOV for maintenance-of-value provisions. In the AsDB, the legal opinion was less ambiguous in seeing the *current* SDR (i.e. whatever its value might be in any other currency) as the proper SOV successor to the 1966 gold dollar.

In all the MDBs, all members except the US supported adoption of the *current* SDR as the new SOV. But, in none of the MDBs has it been possible upto now to reach unanimity on this issue. A final decision in favour of the SDR as the successor SOV to the gold dollar thus remains elusive. As a result, in all the MDBs the SOV for their share capital has been defined on a conditional basis for the sake of expediency. The choice of any single currency (e.g. the US dollar) as the SOV for all the MDBs was dismissed because: (i) there was no way of valuing any single currency against a neutral SOV applicable equally to all other currencies; (ii) it would result in an unequal application of maintenance-of-value (MOV) obligations among all members with the member whose currency was chosen being exempt from such obligations; and (iii) it would result in higher MDB vulnerability to excessive and sudden exchange rate fluctuations across currency than if a currency composite (such as the SDR) was accepted as the SOV.

To fill the vacuum, the Executive Boards of the MDBs have adopted different approaches to dealing with the practicalities of an undefined situation. The AfDB’s Board of Executive Directors decided in May 1978 that, effective 31 December 1977, one AfDB Unit of Account (UA) would be

redefined as being equivalent in value to one SDR.<sup>16</sup> However, ratification of this decision by the membership of the Bank (i.e. its Board of Governors) which is essential for its becoming effective, has not yet occurred. For the same reasons which apply to all the MDBs (except the EBRD), such ratification has been indefinitely deferred. Pending ratification, however, the AfDB has continued, for its financial purposes and statements, to define the UA as equal to one SDR. Similarly, the AsDB also temporarily values its capital stock for the purposes of its financial statements in terms of the *current* SDR<sup>17</sup> with the caveat in its financial reports that the Bank “could decide to fix the value of each share at \$12,063.50 based on the 31 March 1978 par value of the US dollar in terms of gold” (i.e. at the value of the 1974 SDR).

The Executive Boards of the IBRD (in October 1986) and the IDB took the other decision: i.e. to value share capital at the 1974 SDR with the US dollar equivalent being translated at the *fixed* rate of 1 SDR=US\$1.20635; i.e. at US\$120,635 per IBRD share and US\$12,063.50 per IDB share respectively.<sup>18</sup> These decisions were taken subject to eventual adjustment of values when the SOV issue was finally settled.<sup>19</sup> Effectively, this means that the IBRD and IDB have agreed to fix *for now* the value of their shares in terms of *US dollars* while the AfDB and AsDB have done so in terms of *SDRs*. The IBRD’s Executive Board agreed to review this decision every three years.<sup>20</sup> These interim arrangements, of course, do not provide a definitive basis for determining members’ obligations with respect to *callable* capital. This too has been indefinitely deferred, but with no practical consequence

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16 The value of the SDR which varies from day to day is computed daily by the IMF in the equivalent of US dollars and (using prevailing cross exchange rates) for all other convertible currencies. For its accounting purposes the AfDB uses for each quarter the SDR rate quoted by the IMF on the last day of the preceding quarter.

17 For their financial statements for the year ending 31 December 1993 therefore, both the AfDB and the AsDB valued their capital in US dollar terms at the equivalent of 1 SDR=US\$1.37356 i.e. at US\$13,735.60 per share. The effective value of each of their shares remains at 10,000 SDRs and is translated into US dollars in interpreting their financial statements at the prevailing SDR to US dollar exchange rate.

18 Each share of the IBRD is valued at 100,000 1974 SDRs, those of the IDB are valued at 10,000 1974 SDRs; those of the AsDB are valued at 10,000 SDR and those of the AfDB are valued at 10,000 UA (equivalent to 10,000 *current* SDRs).

19 The IBRD Board suspended periodic maintenance-of-value settlements between April 1978 and October 1986 when it adopted the 1974 SDR temporarily as the SOV (until consensus could be reached on using the *current* SDR as the SOV).

20 Such a review was undertaken in 1989. See IBRD Board Document No R89-180, dated August 31, 1989 entitled “Report of the Ad Hoc Committee on the Valuation of Bank Capital (CVBC) to the Executive Directors”, for an excellent and lucid exposition of this complex subject. That Report provides an appreciation of the several options that were considered and why they were rejected. Again that Report stressed the preference of all members except the USA for choosing the current SDR as the successor to the 1944 gold dollar as the SOV for the IBRD’s shares.

because of the extremely unlikely eventuality that a call might actually materialise in the interim.

Though dealt with in these two pragmatic but quite different ways for accounting purposes, the SOV issue remains open in all the MDBs except the EBRD. It is likely to be settled finally in all the MDBs simultaneously when it is resolved in any one. Why has the SOV not been resolved for all this time, despite the interminable meetings and technical discussions among the staffs and Boards of the MDBs? Basically it is because the US, which is the largest single shareholder in the IBRD and IDB, and the second largest shareholder in the AsDB, is not yet *politically* able to accept a resolution which puts it on a par with other countries in the MDBs.<sup>21</sup> In other words, the US finds it difficult to accept having open-ended obligations to maintain the value of its share capital in the MDBs, should the value of its currency decline *permanently* relative to that of other countries and therefore to the SDR.<sup>22</sup> In accepting the terms of the original Articles of Agreement all the other countries explicitly undertook to maintain the value of their shareholdings in terms of the respective gold dollars which were accepted originally as defining the values of MDB shares. Shifting to the *current* SDR as the new standard-of-value therefore poses no insuperable political or technical problems for them in the same way that it does for the US. In the case of the EBRD, where the ECU is the SOV, the MOV issue has been finessed by Article 6.3 which enables all payment obligations of members for subscriptions to the initial capital stock to be *fully settled* (with no further MOV obligations) in ECU, USD or JPY on the basis of the average ECU exchange rate of the USD or JPY between 30 September 1989 to 31 March 1990 (i.e. at rates of 1 ECU=USD1.16701 or JPY169.95).

### *Implications of Not Resolving the SOV Issue*

There are three main implications of leaving the SOV question unresolved. *First*, an ambiguous position on the SOV is unfair to those countries (like Germany and Japan) whose currencies have appreciated structurally over the long-run against the intended SOV versus countries like the US, the UK and most developing countries (other than some NICs) whose currencies have

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21 In a response to the CVBC (see the footnote immediately above) the US authorities stated that: "The United States has consistently opposed a change in the IBRD's standard-of-value, because it has been the judgement of all US Administrations since the mid-1970s that the open-ended dollar commitment inherent in SDR denomination would be impossible to obtain from the US Congress".

22 It should be noted here that the US did make maintenance-of-value payments to the IBRD in 1972 and 1973 when the US dollar was devalued twice against gold to maintain the value of its capital in terms of the 1944 gold dollar par value.

depreciated structurally in the long-run. While the issue remains unresolved, the countries with appreciating currencies have, in effect, paid more for their shares in the MDBs than those whose currencies have depreciated. Put another way, in the absence of compensating repayments to countries whose currencies have appreciated even against the intended SOV (the gold dollar), they should have a larger vote in the MDBs than that to which their proportionate shareholding entitles them. *Second*, till the standard-of-value issue is resolved definitively, the capital of the MDBs (and therefore the structure of their balance sheets) remains vulnerable to exchange rate fluctuations. In particular, any major appreciation of the SDR vis-à-vis the US dollar would affect the *lending* headroom which the IBRD and IDB might have because of the effective resultant shrinkage of their capital base. In the extreme case, a sudden sharp fall in the value of the US dollar might precipitate the need for a premature GCI or, alternatively, require the lending operations of these two MDB hard-windows to be curtailed drastically and disruptively. Given the time it takes to gear up for and negotiate a GCI, the latter alternative would inevitably be taken to the detriment of these institutions and their borrowing members. The opposite would be the case in the AfDB and AsDB where any such appreciation would (possibly perversely depending on the circumstances) create more lending headroom.

*Third*, it is odd that within the same multilateral system different MDBs should be valuing their shares differently when the original basis for valuation was the same. For instance, at the end of 1993, the AfDB and AsDB were valuing their shares at the equivalent of US\$13,735.60 while the IDB and IBRD were valuing their shares at US\$12,063.5 and US\$120,635 respectively. *Fourth*, vulnerability to exchange rate fluctuations on the value of capital because of the expedient choice of a temporary SOV also leaves MDBs exposed to risk on inadvertently and suddenly breaching their *borrowing* limits. If the outstanding borrowings of MDBs have a different currency composition to their capital, and exchange rate movements affect the value of outstanding borrowings in the opposite direction to the way in which they affect the value of the capital base, then the MDB could be exposed to a technical default on its undertakings for bond issues.<sup>23</sup> This eventuality is not merely a hypothetical one.

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23 This issue is well explained in some analytical depth in a confidential document of The Asian Development Bank on "Valuation of the Bank's Capital and Maintenance of Value". To illustrate: if a particular MDB's capital is effectively valued in USD, while the bulk of its borrowings are in DEM and JPY, then a sudden depreciation of the dollar against the DEM and JPY would result in shrinking the effective value of the capital base while expanding the effective value of its borrowings. Since borrowings are usually limited to usable (callable and paid-in) capital rather than to total capital, the threat and impact of sudden turbulence in foreign exchange markets of the sort which has occasionally occurred could result in some MDBs breaching borrowing limits without any purposive action on their part.

## *Resolving the SOV Issue*

For these and other reasons, it is essential that the SOV issue is resolved in favour of adopting the *current* SDR as the successor SOV to the gold dollar in all the MDBs other than the EBRD. The issues surrounding that action have been considered time and again in every one of the MDBs affected. The inability of the US to agree with other members on resolving the SOV issue remains a serious stumbling block. It is unclear as to whether the passage of time alone will lead to a situation in which the US' reluctance to address the issue will gradually be eroded or overcome. In the meantime, the IBRD and IDB are exposed to greater exchange rate risk and to the threat of inadvertently breaching lending or borrowing limits than the AfDB and AsDB. A more appropriate solution would be for all the MDBs to adopt a consistent policy with respect to the *interim* SOV. That policy should adopt an interim SOV which all member countries except the US favour; i.e. the *current* SDR.

## *Maintenance-of-Value Obligation (MOV)*

Logically connected to the concept of a SOV for the share capital of an MDB is the need for members to maintain the value of their payments for MDB shares in terms of the chosen SOV. The Articles of Agreement of each of the MDBs (except, as noted earlier, the EBRD) require periodic payments to be made either from a member to the MDB, or *vice-versa*, an amount of that member's currency sufficient to maintain the value of its paid-in capital subscription against the applicable SOV. The MOV provisions apply to both the *convertible* and *domestic currency* portions of the paid-in amount. These MOV provisions in the Articles were inserted in order to protect the value of the MDBs' capital over time from the deprecations of currency devaluations.

While the status of the SOV remained unresolved, even on an interim basis, the MOV provisions were effectively suspended. They were revived when interim decisions were taken by the Executive Boards of these institutions on the use of a temporary SOV, pending final resolution of the issue. In theory the concept of MOV is understandable and generally unarguable. The operating rules and procedures required to translate that theory into practice have proven to be quite another matter; they have posed some difficult technical issues and choices for the MDBs, especially in determining the amounts and the appropriate periodicity of MOV settlements.

These difficulties have arisen for a variety of reasons and complications. The issues concerning the *amount* of MOV obligations which need to be transacted between MDBs and their members concern: (i) calculating and

making MOV payments under floating exchange rate regimes being procedurally quite different and administratively more onerous than in the case of the previous fixed exchange regime; (ii) difficulties over interpreting what level of change in the value of currencies for the purposes of the MOV Articles can be construed as “significant” in a floating exchange regime and therefore how frequently MOV payments need to be made and adjusted; (iii) determination of the amount of MOV obligations being influenced by interpretations what amount of currency being held by any MDB is actually subject to MOV;<sup>24</sup> this amount differs in the case of different MDBs; (iv) the amount of currency holdings which are unprotected by MOV and therefore subject to exchange risk; these amounts are larger for the IBRD, AfDB and AsDB than they are for the IDB; (v) issues of “equity of treatment” across members in the application of MOV provisions, such as the fairness of holding one member liable for MOV on those of its currency holdings which have been contributed by another member to meet the latter’s payment obligations, or requiring members to take on MOV obligations on that portion of its currencies which are held by an MDB through the accrual of its cumulative retained earnings (on which MDBs earn a market return); (vi) domestic budgetary procedures in member countries which complicate settlement of MOV obligations; (vii) the desire of members, especially developing country borrowing members to absolve themselves of further MOV obligations by making payments for their capital subscriptions in another (developed) member’s (convertible) currency; and (viii) the large MOV obligations that might arise if eventual resolution of the SOV issue was in a direction different to the interim SOV presently being used by the MDB.

Issues concerning the *timing* of MOV settlements include: (i) balancing the

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24 In the IBRD the convertible portion of paid-in capital is payable only in gold or in US dollars with the latter being treated as equivalent to gold for the purpose of payments for capital subscriptions. Therefore the MOV provisions in the IBRD’s Articles apply only to the domestic currency portion (i.e. the 18% currency). This is not the case in the AsDB and IDB where MOV obligations apply to both the convertible and domestic currency portions. Moreover there are differences between the AsDB and IDB as to what extent of a particular member’s currency holdings are subject to MOV. In the IDB, MOV provisions apply *without any limitation* to all holdings of a member’s currency other than those amounts in that currency which are obtained from borrowings. In the AsDB, MOV obligations apply to all holdings of a member’s currency irrespective of source (excluding those from borrowings) but such obligations are *limited* only to an amount equivalent to the value of the paid-in portion of that member’s capital subscription. In the AfDB, payments for capital subscriptions under original capital and GCIs 1 and 2 had limited MOV obligations. Under GCI-3 these payments were fixed in their national currencies with no MOV obligations attached. Under GCI-4 payments by members in USD were fixed at 1 UA=US\$1.20365. As a result of these variable practices and very loose MOV requirements, the losses or gains which arise when converting currencies received for capital subscriptions into UA are debited or credited to a Cumulative Exchange Adjustment Account on Capital Subscriptions and are carried forward through the AfDB’s income statement.

interests of the MDB vs that of its members;<sup>25</sup> (ii) establishing the size of variation in currency values which triggers an MOV settlement – the IBRD, IDB and AsDB use a 5% exchange rate variation rule to trigger settlement of MOV obligations while the AfDB simply courses all changes through its Exchange Adjustment Account; (iii) the burden put on members to settle large MOV obligations in any given settlement period – usually the MDBs provide for settlement in affordable instalments which are negotiated between the member and the MDB; (iv) the burden put on MDBs in managing their currency pools; (v) loosening of restrictions on the use by MDBs (either for lending or for administrative expenses) of their domestic (the inconvertible) currencies imposed by developing country members; (vi) clearing of MOV obligations in arrears before a member could exercise an option which would remove future MOV obligations;<sup>26</sup> and (vii) conflict between members' budgetary cycles and fiscal year ends and the fiscal year ends of MDBs when MOV settlements need to be made.

In concluding this chapter on the capital structure of the MDBs and the issues which it raises, the key features of the present situation are summarised in Table 4.

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25 The issue arises in recognising that, under a floating exchange regime, with large currency movements occurring within short periods of time, deferral of MOV settlements adversely affects the financial position of the MDB, while frequent settlement demands impose high burdens on the overstretched administrative capacity of members.

26 This issue arises in the case of the IBRD which in 1990 offered members an option of substituting a special US dollar note deposit in lieu of its 18% currency contribution. If members exercised that option then they would have no further MOV obligations on their 18% currency contribution.

**Table 4 Characteristics of MDBs' Capital Structures 1993/94**  
(billions of U.S. dollars)

	IBRD	IDB	AsDB	AfDB	EBRD
Authorised Capital	184.05	100.99	48.00	22.25	11.16
Subscribed Capital	170.00	54.20	23.08	20.97	11.02
Callable Capital	159.34	51.03	20.29	18.41	7.72
Paid-In Capital	10.67	3.17	2.78	2.57	3.31
Ret. Earnings/Reserves	<u>14.47</u>	<u>4.76</u>	<u>4.91</u>	<u>0.93</u>	<u>0.00</u>
PI+RE	24.14	7.93	7.69	3.50	3.31
Paid-In/Subscribed	6.28%	5.85%	12.04%	12.25%	30.00%
PI+RE/Subscribed	14.79%	14.63%	33.31%	16.69%	30.00%
No. of GCIs	6	8*	4*	4	0
Last GCI In	1988	1994	1994	1987	1991
Paid-In % for last GCI	3.0%	2.5%	2.0%	6.25%	30.0%
Interim SOV	1974 SDR	1974 SDR	Current SDR	Current SDR	ECU
Net MOV Deferrals	0.88	0.04	0.29	0.36	(0.01)

\* GCI-4 for the AsDB was agreed in March 1994 increasing its authorised capital to US\$48 billion with 2% paid-in. GIR-8 for the IDB was agreed in July 1994 increasing authorised capital to US\$101.5 billion with 2.5% paid in.

*Note:* IBRD's fiscal year (FY) ends on June 30; for the other MDBs it ends on December 31.

*Sources:* Annual Reports of the regional MDBs for FY 1993 and the IBRD for FY 1994 (ending 30.06.94).

# 3 Resource Mobilisation: Policies on Borrowings and Guarantees

## *Introduction*

The previous chapter dealt with issues concerning the capitalisation of the MDBs, noting that the basic architecture was designed to induce them to mobilise resources for development mainly from international capital markets through: (a) *borrowing* directly on their own account for relending to their developing members; and (b) *guaranteeing* the repayment of funds that the market was prepared to provide directly to borrowing members. As this chapter will show, MDB resource mobilisation efforts until the early 1990s were focussed almost exclusively on *direct* intermediation through borrowings. Their *indirect* intermediation capacity, i.e. through exercising their guarantee powers, have barely been resorted to. This issue will be revisited toward the end of this chapter.

Any impartial retrospective assessment of whether the objective of *direct* resource mobilisation from capital markets (through borrowings) was met by the MDBs must conclude that it was. In that sense the design of the capital structures of MDBs has stood the test of time very well. All the MDBs are now established borrowers in all the world's open or quasi-open capital markets, most of which they tap regularly. The debt instruments they issue (mainly long-term bonds) are well-regarded and carry the highest available credit ratings i.e. triple A (AAA or Aaa).<sup>1</sup> Whether, as events have unfolded, their powerful resource mobilisation abilities are matched by their present resource allocation capacities is a more troubling issue. On this question, judgement must, unfortunately, be more qualified and reserved. The growing asymmetry between the strength of MDBs' resource mobilisation capacity and the apparent diminution of their ability to deploy such resources well (as the IBRD's lending and financial performance in FY94 suggests) has become a matter of serious global public concern. This concern apart, Chapter 1 also suggests that, despite their relatively unconstrained capacity to mobilise resources from international capital markets, the MDBs as a whole, and the

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1 For one particular MDB -- the African Development Bank -- however, the continued application of such ratings poses disconcerting questions about: (a) the validity and value of these ratings; and (b) the kind of signals they send to the management and Board of an institution whose lending environment is much more difficult than that of other MDBs, and whose financial performance is therefore discernibly below that of its peers.

World Bank in particular, are falling short in fulfilling their critical resource intermediation and net transfer functions especially since 1989.

A much greater quantum and proportion of resources are now flowing directly from established international capital markets to a large number of *emerging markets*. This is happening without the benefit of either direct or indirect MDB intermediation. Some uncomfortable questions therefore arise about whether the future resource mobilisation capacity of the MDBs will (or should) remain as strong, in relative and absolute terms, as it has been in the past. Up to now, however, the unquestionable success that MDBs have enjoyed in mobilising loanable resources from capital markets is due in large measure to the astute manner in which, with the help of their investment bankers and external financial advisors, they have formulated, developed and executed their borrowing policies and programmes. That achievement has been a tribute to both: (a) the quality of their financial management which, by and large, appears to have been superior to the quality of their operational management; and (b) the oversight exercised by their Boards over their financial operations. It is to these issues that the attention of this chapter now turns.

### ***MDB Borrowings and Borrowing Policies***

Apart from the national governments of the G-7 countries themselves, MDBs are among the largest issuers of long-term debt instruments in international capital markets. In those markets they constitute a special category of issuers i.e the *supranationals*. As Table 5 below shows, in 1993 the five MDBs together borrowed US\$21 billion from capital markets and repaid US\$16 billion, resulting in *net* borrowings of US\$5 billion.<sup>2</sup> On their outstanding borrowings of US\$144 billion, MDBs paid US\$12 billion in interest payments and other charges. The two-way flow of financial transactions between MDBs and international capital markets thus amounted to US\$49 billion in 1993. The amount of their outstanding debt, however, was significantly lower than the amount of their subscribed capital base. This is true even if only that portion of capital subscribed by non-borrowing OECD member countries with convertible currencies is taken as the relevant denominator. The only binding limit that appears to be mildly troublesome arises in the case of the AfDB whose amount of senior debt outstanding is running out of further borrowing headroom; a point which is further explored later in this chapter.

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2 In FY94 the IBRD's level of gross borrowing dropped sharply from nearly US\$12.7 billion (in FY93) to US\$8.4 billion; including in that figure the reduction of its outstanding short-term debt by US\$0.5 billion. With total debt retirement of US\$9.6 billion that resulted in a net outflow of cash to capital markets of US\$1.2 billion; the same level of net outflow as in FY93.

**Table 5 MDB Borrowings - 1993**  
(billions of U.S. dollars)

	IBRD	IDB	AsDB	AfDB	EBRD
Outst. Borrowings	96.26	23.42	12.22	8.18	3.62
o/w Short-term	(3.78)	-	-	-	-
Gross Borrowings	12.68	3.94	1.72	0.87	1.52
Borrowings Retired	<u>12.28</u>	<u>2.40</u>	<u>0.95</u>	<u>0.20</u>	<u>0.05</u>
Net LT Borrowings	0.40	1.54	0.77	0.67	1.47
Net ST Borrowings	<u>-1.60</u>	-	-	-	-
Total Net Borrowing	-1.20	1.54	0.77	0.67	1.47
Borrowing Costs	6.95	3.17	0.83	0.55	0.18

Sources: MDB Annual Reports for 1993. FY93 for the IBRD ends on June 30; for the other MDBs on December 31.

### *Programming MDB Borrowings*

The level of borrowing undertaken by any MDB at a given time is closely linked to its liquidity policy, its *net* disbursement trends and the amount of its own debt service in forthcoming months. These factors are the three main determinants of how much any MDB needs to borrow to remain comfortably liquid.<sup>3</sup> When market conditions are particularly propitious for locking in long-term, low-cost borrowings, MDBs may, in the interests of their own borrowers, occasionally *overborrow* in anticipation of future needs. Since all the MDBs earn positive spreads on their liquidity holdings (i.e. their *investments*) such *over*-borrowing can be quite profitable, carrying no real additional cost or risk for the MDB, because it can immediately pass on to their borrowers: (a) all the *exchange risks*<sup>4</sup> on the currency composition of their borrowings; and (b) the *full cost* of their borrowings, with a spread.

The ability of MDBs to pass on these costs entirely, and the absence of any effective competition for these institutions in providing these types of funds

3 When any issuer of debt assumes a significant presence in any market a certain level of liquidity to generate confidence in that financial institution's capacity to deal with exigencies becomes an imperative in its own right.

4 MDBs avoid exchange risks on their borrowings by making loans under currency pool arrangements comprising the currencies they borrow and by holding liquidity in borrowed currencies until funds are disbursed. Borrowers are required to repay in the currencies that are disbursed to them over which they, of course, till very recently have had no choice. The AsDB, IBRD and EBRD now offer borrowers a choice of single-currency loans.

may, in the past, have obscured many borrowing misjudgements on the part of MDB treasury managements and absolved them from accountability for either the currency composition, or the timing, of their borrowings. Such misjudgements have rarely been identified or assessed independently<sup>5</sup> in the same way that the lending decisions and judgements of MDBs have been scrutinised; even though such misjudgements might have required borrowing developing countries to pay a higher than necessary cost for their loans and thus done more economic damage than some MDB lending decisions. In confronting such a charge, the general underlying counterargument which MDB Treasurers have used is that any occasional misjudgements are usually made up for by other good judgements and that, in the final analysis, for most borrowers, “it all comes out in the wash”. In any event, through techniques such as: refinancings, prepayments and debt repurchases when market conditions improve (which results in refunding former high-cost issues with lower cost new issues) the MDBs can recover to some degree the excess costs incurred from too much premature high-cost borrowing when it was not strictly necessary. With financial markets now being prepared to finance many developing countries directly, without any MDB intermediation, the relatively high cost and risk associated with borrowing from MDBs is becoming increasingly transparent. Though rarely acknowledged openly by MDB managements as such, it is also worrisome. It is resulting in a clear preference on the part of the more creditworthy developing country borrowers to borrow directly from markets instead of the MDBs.<sup>6</sup> This prospect has become evident in the sharp fall in developing country borrowings from the IBRD in FY94 when the volume of loan approvals dropped by over 16% from nearly US\$17 billion in FY93 to US\$14.2 billion.

The ability to pass on to borrowers the full cost associated with their borrowing decisions, of course, inevitably leads MDB Treasurers to persuade

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5 An examination of the reports on their borrowings which Treasurers usually provide to MDB Boards or put in MDB Annual Reports are, without exception, so glowing and self-laudatory of borrowing achievements – in each and every case – that readers can only conclude, and borrowing countries can only be grateful, that the Treasuries of all the MDBs are blessed with the gift of complete foresight and infallibility.

6 In this connection the argument is often made that countries which have direct access to market resources should always avail of them and thus graduate themselves from MDB lending. In theory that argument makes sense. In practice, as the debt crisis of the 1980s dramatically demonstrated, it may not. Markets, like MDBs, are fallible. In many *emerging market* cases, knowledgeable observers would agree that the optimal combination for external funding should include a reasonable proportion of MDB funding, especially for financing in areas where the technical expertise and advice that MDBs bring along with their financial facilities can be of additional value. Unfortunately the overall cost – both financial and administrative – of dealing with the MDBs has now become sufficiently high for many creditworthy developing countries to eschew borrowing from them when, in the absence of this additional premium, it would make considerable sense to do so.

their Boards that they should be permitted to borrow (and hold liquid investments) substantially in excess of purely *operational* funding needs; i.e. for meeting (in *net* terms) their loan disbursements, their debt service obligations and their administrative expenses. In other words there is an inevitable bias within MDB treasuries towards *overstating* genuine liquidity needs in formulating their borrowing and liquidity policies. MDB Executive Boards, in turn, are becoming inured to such pressures. Aware of the importance of MDB liquid investments as profit centres they have tried to strike a balance between: (a) permitting MDBs to hold sufficient liquidity to ensure reasonable net income performance; and (b) averting the build-up of excessive liquidity levels. MDB Boards have been legitimately concerned that permitting excess borrowings and liquid holdings might run the risk of MDBs coming to be seen more as money-market intermediaries, more interested in using their cost-free public capital and retained earnings for highly profitable short-term financial trading operations, rather than fulfilling their roles as long-term development lending institutions which hold liquidity for prudential purposes.

The tension between these two objectives: i.e. maintaining credible levels of institutional profitability while fulfilling their developmental roles, usually leads to MDB Boards requiring their Treasurers to execute tightly framed annual borrowing programmes which are closely monitored and controlled on a fiscal year basis. When too rigidly applied, however, such controls often run counter to optimal decision-making in the face of continually changing market conditions. Sometimes very large and sudden changes occur in financial markets, usually because of perceived or real G-7 policy failure. The infelicitious timing of such changes does not respect any artificial definition of a particular MDB's fiscal year end. For that reason, borrowing programmes which allow for a measure of flexibility in permitting opportunistic borrowing transactions, and ironing out increments or decrements between fiscal years, usually tend to be more successful in the long run than those which do not.

### *Borrowing Policies*

Though different MDBs may articulate their borrowing policies in different ways these are, in essence, driven by the same considerations for all MDBs and have the same three basic objectives: (i) ensuring the availability, *without interruption*, of funds for development lending purposes; (ii) minimising borrowing costs, both for the MDB and (ostensibly) its borrowers; and (iii) assuring the predictability of such costs, or, in other words, controlling their volatility – in terms of both the frequency and the magnitude of changes in them. The overall approach to MDB borrowing

policy has perhaps best been articulated (albeit somewhat inelegantly) by the World Bank in its 1994 Annual Report:

“The objectives of the IBRD’s borrowing and liability management strategy are to ensure the long-term availability of funds to the IBRD for lending and liquidity and to minimise the cost of funds for the IBRD and its borrowers. The IBRD seeks to ensure the availability of funds by developing borrowing capacity in markets in advance of need and by diversifying its borrowings by currency, country, source and maturity to provide maximum flexibility in funding. It also seeks to strengthen the continuing appeal of its securities by offering features that are tailored to satisfy investors’ asset preferences and by positioning its securities advantageously in each capital market (for example, from a regulatory-tax and investment-classification perspective). Another objective of the IBRD is to diversify the markets for its securities by offering them to private and governmental buyers in as many markets as offer terms acceptable to the IBRD.

Within the framework of the currency composition of borrowings required by cash and currency-management policy, the IBRD seeks to minimise the cost of borrowed funds through, among other things, the use of currency swaps to obtain cost savings compared with the cost of direct borrowings in target currencies; structured financings converted to conventional liabilities using over-the-counter financial derivatives; the use of short-term and variable rate instruments; and prepayment, market repurchases, and refinancing of higher-cost borrowings where significant savings can be realised.”

An additional insight into other nuances of borrowing strategy was provided by the World Bank in its review of its FY84-88 borrowing operations when it declared:

“In arriving at a currency composition and selecting markets and instruments in which to carry out the (borrowing) program, in addition to considerations of cost, the Bank seeks to maintain its premier credit status in each of the major markets, enhance long-term relationships with its investors and lenders, and position itself to expand its borrowings through particular markets and instruments when required.”

Every MDB would subscribe to those statements as defining reasonably its own borrowing policy; although no other MDB is as experienced or as proficient at borrowing as the IBRD. This is mainly because no other MDB has borrowing needs which are as large or diverse. Also, other MDBs do not yet resort to the full range of borrowing options in as many currencies, instruments and markets, or in devising quite as many innovative cost-saving options that the IBRD does. Usually the pattern has been for the IBRD to break new ground in its borrowing strategy which the other MDBs then explore. The MDBs also employ in some form or another, a borrowing limit which tends to be lower than their lending limit. Whereas under their respective charters lending is limited to the value of subscribed capital, in most MDBs borrowings are limited (either implicitly or explicitly) to the

amount of subscribed capital provided by their creditworthy, non-borrowing members (i.e. usable paid-in and callable capital). The differences (mainly in nuance and arising out of the size of the MDBs borrowing needs) between MDBs in their borrowing policies and limits are discussed below.

### *The World Bank*

Though it has no publicly articulated borrowing limit other than the obvious limit of its subscribed capital and reserves, the IBRD *in practice* confines the outstanding level of its borrowings to within the limits of subscribed capital provided by its Part-I (non-borrowing, developed) member countries. For example, as of June 30, 1994, the IBRD's outstanding level of borrowings was US\$98.9 billion against subscribed capital of US\$170 billion, of which nearly two-thirds was provided by Part-I member countries. Taking exchange rate fluctuations which influence the value of borrowings into account, the IBRD's outstanding borrowings grew by under US\$9 billion between FY90-94 and are expected to increase by less than US\$1 billion between FY95-97. Annual *long-term* borrowings over the last five years have fluctuated between US\$9-13 billion but are expected to be in the US\$9-11 billion range between FY95-97.

In FY94, the IBRD borrowed US\$8.9 billion equivalent through 29 long-term borrowings in 12 currencies in three major domestic markets and in three distinct non-domestic segments of the global market. Of these three issues in two currencies (DEM and SFR) for over US\$420 million equivalent were designed for central banks and government agency investors. The currency and interest rate swaps undertaken during the year were aimed at converting all borrowings (except for those undertaken to fund single currency loans) into equivalent fixed-rate liabilities in four of the IBRD's *core* currencies i.e. USD, JPY, DEM and SFR. Taking retirement of its own debt into account, net IBRD borrowings have been very low; in FYs 93 and 94 they were negative although that reality was obscured by the exchange rate effect. Net borrowings are expected to be either negative or marginally positive between FY95-97, suggesting that the IBRD may now have reached a steady state in terms of its financial flows. This also suggests that the IBRD does not expect to be performing any significant net transfer function through the 1990s.

Unlike the other MDBs, the IBRD has, since 1983 undertaken a programme of borrowing *short-term* instruments primarily in USD through its Discount Note program, its Central Bank Facility and its Continuously Offered Payment rights in SFR.<sup>7</sup> The short-term (ST) borrowing pro-

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7 The COPS programme was suspended in FY93 because of market conditions and has not been reactivated in FY94.

gramme was introduced both for better asset-liability management and cost-reduction reasons. The IBRD usually maintains about a fifth of its assets in ST liquid holdings which allows scope for a small amount of short-term borrowings at considerably lower cost than for long-term funds (except during odd moments in time when the yield-curve might be temporarily inverted). The IBRD is primarily a long-term lender, and must therefore fund its requirements on that basis. But, for prudential reasons, the Bank's management and Board felt it would be appropriate (given the size and regularity of its borrowing needs) for the Bank to establish a presence in the ST market. The main reason for doing so was to position the Bank to make greater use of such markets if, temporarily, conditions in bond markets became so volatile (as they did in 1980-82 and again between 1992-94) as to require greater resort to ST markets on an interim basis to lower overall funding costs. The level of ST borrowings authorised by the Bank's Board at present is US\$6.5 billion equivalent with the level of outstanding ST borrowings varying between US\$3.3 to 5.7 billion between FY90-94 and is expected to remain within the US\$3-4 billion range over the next three years.

As far as its traditional long-term borrowing in bond markets is concerned, the IBRD is a market leading innovator in its willingness to: (a) tailor-design its debt instruments to suit the changing needs of particular types of investors (central banks, and other institutional and individual investors, both public and private) around the world; and (b) diversify aggressively and pro-actively, the currencies, range of maturities, instruments and financial markets in which it borrows. This approach has enabled the IBRD to respond flexibly to shifting opportunities in different capital markets caused by changing patterns of nominal interest rates, inflation, savings availability and current account surpluses/deficits in these markets. The IBRD has also endeavoured to improve the attractiveness, liquidity and tradeability of its own issues, by seeking ways of reducing the costs to institutional investors of trading in them.

The flexibility and range which such an approach to frequent global borrowing permits has enabled the IBRD to be less susceptible than it might otherwise be to the inappropriate exertion of influence by one or two of its major shareholders who have attempted to misuse the leverage of *access to their markets* as a weapon to bend the IBRD to their will.<sup>8</sup> The Article which

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8 Such attempts are rarely publicised because they are so politically charged and sensitive. They have occurred in the 1970s and 1980s when two large shareholders (the US and Japan) used the issue of access to their markets as a political weapon. Under its Articles of Agreement, the IBRD may only borrow with the approval of the member in whose markets funds are borrowed, the member in whose currency the borrowing is denominated, and only if such member agrees that the proceeds of such borrowings may be exchanged for the currency →

requires IBRD (and other MDBs including the EBRD) to obtain the permission of members in whose markets or currencies it might borrow, or whose currencies it might exchange from the proceeds of borrowing, serves no useful purpose any longer. For that reason its inclusion in the EBRD's charter appeared to be particularly redundant. Short of amending the Articles of Agreement to delete it altogether, member countries which do not borrow from MDBs should reach agreement among themselves that they will no longer regard this particular Article as being in force. This would avoid any future prospect of MDBs being improperly restrained (i.e. politically influenced) from borrowing in the markets or the (reserve) currencies of the three largest shareholders who may, in temporarily denying access to their markets or currencies, have motives in mind which have little to do with the factors which this Article was originally meant to accommodate.

*Use of Derivatives:* To minimise its cost of funds, the IBRD was the first among the MDBs to resort to the use of short-term funding, variable-rate long-term borrowing, and, more importantly, the extensive use of derivatives i.e. currency and interest rate swaps<sup>9</sup> to allow for currency diversification, to permit flexibility in switching from fixed to variable interest rates, and for changing the cost basis of IBRD borrowings. Currency swaps enable the IBRD to acquire access to preferred currencies at rates below the rate at which the IBRD could effectively borrow that currency. They also permit the IBRD to separate its decision on which currency it wants to borrow, from the decision on which market it wants to borrow in, at any given time. There is no Board-imposed limit on the amount of currency swaps the IBRD can undertake. The annual volume of such operations, however, has ranged between US\$3 to 3.5 billion equivalent. Interest-rate swaps are used by the IBRD mostly to convert fixed-rate funds into floating rate funds (or vice-versa). Used in conjunction with currency swaps they provide greater flexibility for altering both the currency and interest rate composition of the IBRD's borrowings and, more slowly of course, of its lending currency pool. To minimise costs, the IBRD has also resorted to exercising its *pre-payment*

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of another member without restriction. This Article was perhaps relevant in another time and age when the Bretton Woods Agreement was in force, when domestic markets were more sharply segmented, when global markets did not exist and when, in a balance-of-payments crisis, a member could legitimately request the IBRD to restrain itself from borrowing in that member's market or currency to avoid exacerbating a difficult situation. In present conditions where financial markets have become globalised and virtually seamless, and where the reasons for inserting the Article are no longer valid, its continuing presence is now clearly anachronistic.

<sup>9</sup> The IBRD in fact initiated the very first long-term currency operation in 1982 when it swapped the proceeds of its own Swiss Franc borrowings with the proceeds of IBM's borrowings in US dollars. It is now regarded as one of the market leaders in swap transactions.

options more regularly (especially when such prepayments do not adversely affect the IBRD's standing in financial markets) and, since 1992, to refinancing its previously higher-cost borrowings through *debt-repurchase* programmes (presently limited to the IBRD's USD debt issues) when the efficiency gains of such transactions in terms of overall cost reduction are significant, and when market conditions permit such operations to be undertaken without influencing market sentiment adversely about IBRD's other outstanding issues.

Controlling the extent to which the *volatility* of its own borrowing costs are reflected in loan charges to its borrowers is an objective which the IBRD attempts to achieve by: (i) limiting its outstanding *short-term* borrowings to no more than 10% of its total outstanding borrowings; (ii) limiting combined *short-term and variable rate* borrowings to 15% of total borrowings; (iii) targeting the proportionate currency composition in its currency pool within limits which reduce the volatility of the effective cost of IBRD loans in US dollar terms; and (iv) gradually excluding from the *loan* currency pool those borrowings which are used primarily to fund *liquidity*. The IBRD's after-swap borrowings are presently aimed at achieving a currency composition in its loan currency pool which is divided into equal thirds of: US dollars; the DM group of currencies (which include the DM, the Swiss Franc and Dutch guilder); and Japanese Yen, at exchange rates of USD1.00 : JPY125 : DEM2.00.

### *The African Development Bank*

Unlike other MDBs, the AfDB has complicated matters somewhat by issuing two different types of debt instruments: (i) *senior debt* and (ii) *subordinated debt*. All debt of the AfDB is regarded as senior unless by its terms it has been expressly subordinated in terms of precedence of payment to other debt issued by the AfDB. Both classes of debt rank *pari passu*; i.e. holders of both types of debt receive their principal and interest payments on schedule without any preference being accorded, except in the event of a call by the AfDB on its callable capital. In the event of such a call, holders of subordinated debt would be repaid *after* holders of senior debt. As a matter of Board policy (not a charter limitation) the AfDB's senior debt, together with any outstanding guarantees is limited to 80% of the callable capital of *non-borrowing members*. Subordinated debt, when added to senior debt and guarantees outstanding is limited in total to 80% of the callable capital of *all members*. This division has been made in the belief that, with the nature of its membership and the perceived quality of its capital base, dividing its debt into these two different categories would give it greater funding flexibility. The underlying reason for this approach to funding is that, of all the MDBs, the

AfDB has the lowest proportion of subscribed capital that markets might consider *usable* or credible because it has constitutionally limited the share of non-regional members in its capital base to one-third.<sup>10</sup> That results in the AfDB being particularly constrained in its borrowings because the capital provided by its OECD members collectively accounts for a much lower proportion of its share capital than is the case in any other MDB.

The AfDB's borrowing policy and strategy has six objectives which broadly mirror those mentioned earlier for the IBRD.<sup>11</sup> These are to: (i) minimise costs; (ii) lengthen the average maturity of its outstanding debt to correspond more closely to the average maturity of its loan assets; (iii) improve the liquidity and secondary market trading of AfDB debt instruments; (iv) improve the image of the AfDB as a multilateral borrower and to bring it on a par with the other MDBs; (v) in doing so, reduce the borrowing costs of the AfDB – especially for its senior debt – to the same levels as the other MDBs; and (vi) consolidate the acceptability of its subordinated debt instruments in various markets and eventually reducing the cost of its subordinated debt relative to its senior debt. As *working principles*, the AfDB has adopted two other guidelines: (a) the amount of total debt outstanding at any given time would not exceed the level which would permit the AfDB to retain the highest ratings from the rating agencies; and (b) the ratio of senior to subordinated debt would be maintained at around 60:40. A key part of its borrowing strategy is to have its subordinated debt become more acceptable to investors so as to improve further the rating of subordinated debt and thus, as noted above, to further reduce the cost spread between its senior and subordinated issues.

The AfDB's *senior* debt now enjoys the same 'AAA' rating as the debt of other MDBs. Yet its borrowing costs for senior debt, on average, are still

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10 In a confidential report on the AfDB (see Mistry, P.S. "A Report on the Financial Condition of the African Development Bank", Swedish Ministry for Foreign Affairs, Stockholm, May 1993) it was estimated that the *usable capital* to support market borrowings of the AfDB amounted to only 45% of its total capital base, compared with 72% for the IBRD, 91% for the IDB and 95% for the AsDB. The concept of *usable capital* employed by the author in making these comparative calculations was more generous, less restrictive and more inclusive for the AfDB than the concept traditionally employed by the rating agencies. For the AfDB, **Standard & Poor's** defines usable capital as being the amount of paid-in capital available in convertible currencies + reserves + the callable capital subscribed by members which are rated AAA borrowers themselves. Under that definition the callable capital subscribed by many OECD member countries would not qualify. **Fitch** uses the concept of *strong* callable capital as that provided by the OECD member countries and defines *usable* capital as: convertible paid-in capital + reserves + strong capital + 60% of other non-regional callable capital + 25% of regional callable capital. **Moody's** defines AfDB's *usable* capital as convertible paid-in capital + total reserves + the callable capital of members rated Aaa/Aa.

11 See Jerlström B., "Banking on Africa: An Evaluation of the African Development Bank"; Swedish Ministry for Foreign Affairs, Stockholm, 1990.

marginally higher than those for the IBRD<sup>12</sup> and also for the other regional banks. Its subordinated debt is rated one notch lower at 'AA' with borrowing costs on subordinated debt being about 10-40 basis points (1 bp = 0.01%) higher than for senior debt.<sup>13</sup> The AfDB's concern about the standing of its debt instruments in global capital markets, relative to those of the other MDBs, is reflected in continual allusions to particular AfDB borrowings being awarded "deal of the month", or "borrowing agency of the year" by some financial journal or other. Part of its anxiety about its standing in global bond markets is embedded in the AfDB's chequered history of borrowings about which it is refreshingly candid in its June 1993 Review of Financial Policies where it observes:

"In the early years of its operations and prior to admitting the non-regional member countries, the Bank relied heavily on short to medium term loans, usually with floating rates, to finance its lending commitments. ...There was also limited flexibility in terms of the selection of its preferred currencies and the timing of borrowings contracted, mainly because, at the time, the Bank had limited fund-raising access in most of the major capital markets. The terms and conditions under which most borrowings were completed were not optimally suited to, nor consistent with, the profile of the Bank's loans to borrowing member countries."

As of December 31, 1993, the AfDB's outstanding borrowings amounted to about US\$8.2 billion, comprising senior debt of about US\$4.8 billion and subordinated debt of US\$3.4 billion (a 58:42 ratio). Total (senior and subordinated) debt amounted to about 44.4% of total callable capital while senior debt amounted to 66.9% of non-borrowing members' callable capital. In 1993, the AfDB undertook only three borrowing operations in two bond markets (Euro and Samurai) and two currencies (USD and JPY) for a total of US\$870 million while it retired debt of US\$200 million resulting in net new

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12 Though such comparisons need to be made with great caution and qualification, the all-in (after swap) borrowing cost for US dollars for the IBRD in 1993 in a range of maturities between 5-30 years but averaging 13 years was 6.44%. In the same year, the AfDB raised long-term (30-year) US dollars at an average all-in cost of about 7.61%. Issue-for-issue, however, the AfDB floated a 30-year US dollar bond (senior) with a coupon of 7.375% (all-in cost of 7.55%) in 1993. In the same year, the IBRD floated a global US dollar bond issue (also 30 years) at a coupon of 7.625% and an all-in cost of 7.66%. However, bond market conditions varied greatly during 1993. Arguably, had the AfDB and the IBRD come out with exactly the same issue on the same day the cost to the AfDB might have been between 35-75 bp higher depending on market sentiment and the tightness of bond market conditions. With only 3-4 borrowings per year, however, the AfDB has considerably greater flexibility over timing than the IBRD.

13 In its June 1993 "Review of Financial Policies" the AfDB observed that the extra cost of its subordinated issues over its senior issues was 35 bp in the Japanese market in 1991 and that this excess had been reduced to 25 and 10 bp respectively in 1992 and 1993. However, in the US dollar market the AfDB had to pay a cost of 36 bp for its subordinated issue over its senior issue for 30-year dollars.

borrowings of US\$670 million. The AfDB's total outstanding debt is now about US\$3.2 billion higher than at the end of 1990 suggesting a rate of growth considerably faster than for any other MDB except EBRD. This increase was slightly lower than growth in disbursed and outstanding loan assets (which increased by US\$3.6 billion) with the difference being funded by a drawdown of liquidity. Borrowings for 1994 were programmed at US\$850 million to cover debt retirement requirements of US\$380 million and a net increase in debt of US\$470 million.

The borrowing policies which the AfDB has put in place since 1982, when non-regional countries entered into its membership, have gone a long way toward bridging the wide asset-liability imbalances which arose in previous years, owing to haphazard, *ad hoc* borrowing driven less by logic and more by opportunity. By and large, the AfDB has met the objectives it set for itself and has now become a credible supranational on international capital markets. Borrowing costs have been reduced and are in line with (though still marginally higher than) those of the other MDBs. The AfDB no longer needs to be as sensitive about its credit standing in capital markets as it still appears to be, given its much improved liability management capabilities. Its senior debt issues have achieved the same rating as those of other MDBs. The average maturity of outstanding debt has been stretched out from 6.51 years at the end of 1983 to 12.6 years at the end of 1993, nearly approximating the average life of its outstanding loan assets (13 years). But its rapidly deteriorating portfolio, which has impaired its financial performance and standing, is raising new and different concerns about its continuing creditworthiness.

The AfDB acknowledges that its two-tier debt issuance policy is now running into some awkward stumbling blocks. Given the undisbursed loan commitments which it has on its books (US\$5.9 billion at the end of 1993), and which it therefore must contractually meet, the present trajectory of its senior debt borrowings suggests that it will reach or breach the 80% ceiling of total non-borrowing members' callable capital by 1996 at the latest if the 60:40 proportions of senior to subordinated debt are maintained. The headroom for further increases in outstanding senior debt is now only about US\$940 million. There remains much more headroom on the total debt ceiling and for subordinated borrowings; by 1996 these will only have reached about 53% of total callable capital of all members. If GCI-5 is not in place by then and if all GCIs upto GCI-4 have not been fully subscribed to by all members by the end of 1995, the AfDB will not be able to borrow any senior debt from 1996 onwards until its capital base is increased. There is little chance GCI-5 will be negotiated and subscribed by 1996. There is also some doubt about available capital under previous GCIs being fully subscribed by end-1995, given that about 93,000 shares with a value of US\$1.3 billion remained unsubscribed in mid-1994.

Beyond 1994, the AfDB's Board will need to consider whether the 60:40 ratio for senior to subordinated debt should be changed and whether such a change would be acceptable to rating agencies and capital markets. As things stand, under present capital constraints, the 60:40 ratio and the 80% of total debt to total callable capital limit are incompatible. The amount of total debt that AfDB can assume under the 80% limit is presently about US\$10.25 billion which will rise to US\$11.35 billion if available capital is fully subscribed. But, the amount of total debt that can be contracted if the 60:40 ratio remains binding is US\$9.55 billion. Alternatively, if total debt is taken to its existing ceiling (US\$10.25 billion) under the 80% limit, the 60:40 ratio will need to be changed to 54:46 or even further to 50:50 if it is taken to its potential ceiling (US\$11.3 billion). A change in the senior-to-subordinated debt ratio will require the AfDB to explain to market operators and rating agencies why it is altering a key undertaking which has governed its borrowings since 1983.<sup>14</sup>

Like other MDBs the AfDB has resorted to extensive use of derivatives (swaps, options and swaptions) to lower its borrowing costs, to lock-in lower interest rates in the face of the probability of rising rates, and to improve the quality of its asset-liability management. It is also resorting to debt refinancing programmes which involve replacing older high-cost debt with newer, low-cost borrowings. While adhering to the principle of diversifying its borrowing markets and currencies, the AfDB's opportunities for doing so are more limited than those of the IBRD with only 3-4 borrowings per year for amounts which are less than 10% of the IBRD's annual borrowing requirements. Disconcertingly, however, in its attempt to concentrate borrowings in the lowest coupon currencies and so keep its nominal interest rate low, the AfDB is currently heavily overweighted in the amount of JPY it has in its total borrowings (44%). With the Yen having appreciated more than any other major currency in the last 2-3 years, a large exchange risk has been passed on to AfDB borrowers which has far exceeded any savings in nominal interest costs; it has also exposed AfDB to a significant liability management risk. Overconcentration in any currency which is likely to appreciate, makes the debt portfolio less manageable against the limits which govern its growth; i.e. outstanding debt can grow and bump against limits *without any new borrowing* if the debt portfolio is in currencies whose value appreciates significantly against the value of AfDB's capital. It would, therefore, be wise for AfDB to adopt the same approach as the IBRD to currency management, i.e. aiming at a loan currency pool evenly divided

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14 This issue is fully analysed and discussed in the AfDB's June 1993 "Review of Financial Policies" although some of the recommendations made by management in the context of that analysis need to be more carefully considered before being accepted.

between USD, DEM group currencies, and JPY, with future borrowings being tailored to achieve that objective.

### *The Asian Development Bank*

In stark contrast to the AfDB, the AsDB's approach to borrowing in its early formative years was characterised by considerable conservatism. Although somewhat restrictive, this approach did much to build up the reputation of the AsDB in international capital markets and now permits it to borrow at virtually the same (and occasionally finer) costs as the IBRD. The AsDB has also been fortunate in being located at the heart of an extraordinarily good neighbourhood. Its borrowing members, with few exceptions, have shown remarkable economic and social performance over the last few decades. With one exception (the Philippines), they were unaffected by the effects of the debt crisis of the 1980s resulting in the AfDB escaping the traumas associated with protracted arrears leading to loans in non-accrual status and provisioning. The AsDB also has the unusual advantage of being located in the world's major capital surplus region with several *regional* capital markets having developed rapidly to assume global stature. In these markets the AsDB is developing a profile as a preferred *regional* supranational borrower over other MDBs which enhances both its access to funds and enables it to borrow at the finest costs.

Until 1983, the AsDB had a self-imposed policy constraint of confining its outstanding borrowings (and guarantees) to the amount of convertible currency callable capital (CCCC) stock i.e. the callable capital subscribed by members whose currencies were convertible. In practice, it went even further in limiting its outstanding borrowings to 75% of CCCC to allow for a safety margin for contingencies concerning delays in payment and subscriptions of CCCC. Upto 1981, the AsDB (much to its later inconvenience) actually inserted a covenant in its borrowing agreements that outstanding borrowings would not exceed CCCC and specified in those agreements a list of countries whose currencies were convertible at the time; a list which has expanded significantly since. After 1981, to give itself more flexibility, the AsDB dropped this covenant from its borrowing agreements. Since 1983, the AsDB has moved progressively away from the borrowing limitation based on CCCC. In 1993, it dropped such a limitation as a matter of policy. Like the World Bank it is legally bound only by the 1:1 loans to capital gearing ratio using the entire subscribed capital base as its denominator for this purpose. In practice, however, it still manages its borrowing programmes with CCCC limitations in mind although, with the increasing convertibility of Asian currencies, the CCCC itself is no longer the constraint it used to be. At the end of 1993, (and at the end of a GCI-cycle when limits are likely to prove

most difficult and binding) the AsDB's outstanding borrowings amounted to US\$12.2 billion or only about 52.8% of its total subscribed capital and only 65.6% of CCCC – these ratios indicate that the AsDB's borrowing profile still remains very conservative.

The AsDB's borrowing policies are similar in virtually all respects to those of the IBRD and are therefore influenced by the same considerations. Its particular priorities, as expressed in its 1993 Annual Report, are to: (i) maintain a borrowing presence in all markets where it has borrowed in recent years; (ii) tap new markets especially where by so doing the AsDB can foster the development of capital markets in the Asia/Pacific region; (iii) produce low-cost funds; (iv) emphasise borrowings with longer maturities; and (v) increase the size of its bond issues to enhance secondary market liquidity of AfDB bonds and to narrow the funding spreads of future borrowings. In 1993, the Bank formulated a borrowing programme of US\$2.9 billion. But, because of lower than programmed lending, prepayments by Malaysia, and a consequent increase in AsDB's liquidity, *actual* borrowings were reduced sharply to only US\$1.72 billion in a year when interest rates probably hit the lowest point they are likely to at for some time.

This large adjustment in the borrowing programme, especially when the opportunity for consolidating low-cost borrowings was never better, suggests that borrowing strategy is perhaps being driven more rigidly by AsDB's liquidity policy than it should be and almost certainly more so than in other MDBs. Greater flexibility in executing borrowing programmes may well be needed, even at the risk of temporarily breaching liquidity ratios in years when borrowing opportunities are particularly propitious. This is especially true for an institution that needs to maintain a significant borrowing presence in all the key global capital markets as well as those in its own region. Between 1994-98, it appears that the AsDB will be borrowing about US\$2-3 billion annually, through 10-15 borrowings in major and regional markets.

Like all other MDBs, the AsDB has been using derivative instruments (primarily currency and interest rate swaps) to lower its borrowing costs and to manage its liability exposure actively. It has also resorted to refinancing operations and to prepayments to restructure the cost base of its debt portfolio while attempting to stretch its average maturity as far as it can, keeping in mind the cost-maturity trade-off in doing so.

### *The Inter-American Development Bank*

The IDB's borrowing strategy and policy has evolved in stages over time, reflecting a conservatism based on self-imposed (though originally market-induced) borrowing limits which have changed with circumstances. From a fairly restrictive early regime, the IDB's borrowing limits and general

borrowing policies have evolved, as in the case of the AsDB, to come more closely in line with those of the IBRD. Unfortunately, the attempts of its management to convince its Board to undertake short-term borrowings in a fashion similar to the World Bank do not as yet appear to have been successful. That difference apart, the objectives and priorities which shape IBRD's borrowing policies and programmes are, unsurprisingly, similar to those of other MDBs.

Between 1962-74, the IDB committed itself to restricting borrowings to only the USA's *callable capital* – when that country was the only non-borrowing member of the Bank. This restriction was enshrined in the form of a specific covenant in all the IDB's borrowing agreements upto 1974. In 1975 the IDB stopped inserting this covenant in its agreements with creditors. Instead, it adopted a borrowing policy which limited borrowings and outstanding guarantees to 80% of the *total callable capital stock* of the Bank, i.e. a limitation similar to the AfDB. In 1984, this policy was changed again to limiting outstanding borrowings to the callable capital subscriptions of the *non-borrowing members* of the Bank; i.e. the US, Canada and non-regional members. At the same time, the IDB adopted the *net debt concept* which enabled it to include its Special Reserve in the *capital base denominator* used to calculate the borrowing limit or, looked at alternatively, to deduct the amount of the Special Reserve from the total amount of outstanding borrowings in the *numerator* when computing the borrowing limit.<sup>15</sup> This definition of the borrowing limit, of course, effectively confines the IDB's lending limit to below the amount specified by its charter.

Employing the same notions to drive its borrowing policies as other MDBs, the IDB's present strategic borrowing priorities are to:

“...achieve the lowest cost financing possible while securing strong, long-term market support for its issues. ...(and maintain) a regular presence in its core currency markets and broadening the market for its securities by diversifying its other borrowings in terms of currency, maturity, and target investor base.” (from the IDB's 1993 Annual Report)

It places particular emphasis on cost-minimisation and diversification of

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15 The justification for this approach lies in the fact that, in a worst case analysis of a 100% default on all outstanding loans, the Bank's holdings of liquid investments could be liquidated and the proceeds applied first to reduce the amount of the Bank's outstanding debt. The residual “net debt” could then be redeemed through calls on callable capital. However, in 1984 (in the throes of the debt crisis) the rating agencies were reluctant to accept this net debt concept while maintaining the IDB's AAA rating. In 1990 the rating agencies appeared more willing to accept the net debt concept given changed portfolio quality circumstances and the much higher holdings of IDB liquidity as long as usable callable capital and liquid holdings were sufficient to extinguish all debts.

markets. The aim of such diversification is to have a presence in, and access to, all major sources of funding in order to maintain maximum funding flexibility and respond swiftly to changes in financial market conditions. Like the other MDBs, the IDB also has the explicit objective of funding its loan assets with least-cost liabilities which, on average, have a similar maturity structure.

At the end of 1993, the IDB's outstanding borrowings amounted to US\$23.4 billion or about 43% of its total subscribed capital base and to 93.6% of the capital subscribed by the US, Canada and the non-regional members. Excluding the IDB's liquid holdings from the borrowings outstanding reduces these ratios to 28.8% and 62.5% respectively. This level of borrowings was about US\$6.2 billion (or 35%) higher than in 1990 with the increase in borrowings funding a commensurate increase in loan assets while allowing for a small increment in liquidity holdings over that period. In 1993, the IDB borrowed US\$3.94 billion in seven currencies through 18 operations in the Eurobond markets as well as in the domestic US, German, Japanese and Swiss markets. In the same year it retired about US\$2.4 billion resulting in net borrowings of US\$1.54 billion. Like other MDBs, the IDB resorted to currency swaps to lower costs and to achieve its preferred currency mix while borrowing in other currencies. It also resorted to prepayments and refinancing of former high-cost issues with lower cost funding at longer maturities. For the foreseeable future, the IDB is likely to borrow around US\$4 billion annually through about 15-20 operations with annual debt retirement averaging about US\$2.7 billion.

### *The European Bank for Reconstruction & Development*

As the newest of the regional MDBs the EBRD does not have much of a track record to assess although it has the advantage of learning from the borrowing experience of the other MDBs and selecting the most efficacious, proven approaches and options in formulating its own borrowing policies, strategies and programmes. The Articles of Agreement establishing the EBRD give no express indication of any borrowing limit relative to the capital base or any part of the capital base. Nor is any limit prescribed as a matter of working policy in the EBRD's Memorandum on Financial Policies of June 1993. As in the case of the IBRD and AsDB, the only *indirect* limitation which applies is that of the overall 1:1 gearing ratio (Article 12.1) which limits the EBRD's outstanding loans and guarantees to the amount of its subscribed capital at any given time. Clearly its outstanding borrowings would be lower than that limit.

As of the end of 1993, the EBRD had a paid-in capital base of US\$3.4 billion shown on its balance sheet. But in usable cash terms only about US\$2

billion equivalent had actually been available as of 31 December 1993<sup>16</sup> when outstanding borrowings totalled US\$3.5 billion of which US\$2.43 billion was in long-term borrowings. These equity and debt resources, together, had been used to fund outstanding loans of US\$400 million, equity investments of US\$215 million and *liquid investments* of US\$4.52 billion and *other assets* which accounted for the balance of US\$365 million. Unlike any of its predecessors the EBRD appears to have geared up its borrowings much earlier and to a much larger extent than its lending and investment operations are likely to warrant for some time. This has apparently been done quite deliberately, in order to generate profits and reserves from financial arbitrage in its early years. Even so, its very high level of administrative expenses (US\$153 million in 1993 and US\$105 million in 1992) resulted in net income being a desultory US\$4.5 million in 1993 while, in 1992, EBRD suffered a loss of US\$7 million. This occurred despite net interest income on financial securities and net profit from financial operations exceeding US\$106 million compared to gross income from lending and equity investment operations in its borrowing countries being a mere US\$17 million in 1993 and less than US\$2 million in 1992.

In its Memorandum on Financial Policies, the EBRD highlights two key objectives in its borrowing policy: (i) providing funds for lending and liquidity; and (ii) ensuring maximum cost effectiveness for the EBRD and its business partners. Another objective is to assure the availability of funds by developing borrowing capacity and establishing market access *prior to actual funding needs*. EBRD's borrowing policies underline the objectives of *maturity matching* (of assets and liabilities) and of *diversification* to achieve maximum flexibility by ensuring access to a broad range of currencies, markets and maturities through public bond issues and private placements in major capital markets. To achieve *cost-effectiveness*, the EBRD uses: (a) established underwriters and syndicates for its public and private issues; (b) borrowing instruments and techniques to match investor preferences; and (c) currency and interest rate swaps from vehicle currencies into preferred target currencies and rate bases. Like the IBRD, it also resorts to short-term and variable rate borrowings.

As in the other MDBs, the EBRD has specific guidelines for limiting its overall exposure in all the derivative instruments it uses for its borrowings, investments and for overall asset-liability management; with the use of swaps being an integral part of borrowing strategy. Such guidelines are to: (i) limit the eligibility of swap counterparties to those with the highest credit quality

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16 Subscriptions to paid-in capital were to be made in five equal instalments between 1991-95. Each instalment can be paid 50% in cash and 50% in promissory notes. EBRD had not yet received all the paid-in capital shown on its 1993 balance sheet in usable cash form.

rating; and (ii) limit credit exposure through three actions i.e. an explicit policy, require swap exposure to be marked-to-market, and limit maximum exposure to any single swap counterparty to a fraction of the total credit exposure limit.

The Bank's borrowing programme for 1993 indicated a requirement of US\$560 million to finance the next two years of the EBRD's lending operations and maintain a *prudent* level of liquidity. Its borrowing strategy was aimed at: (a) developing access to and establishing a regular EBRD presence in, well-established, high-volume, liquid bond markets such as the ECU market, so as to ensure reliability of future funding; and (b) focusing on selective instruments that enabled EBRD to achieve a sub-LIBOR funding cost, through the use of swaps. Its objective is to exploit rate differentials between Euro and domestic markets in a variety of European currencies, deploying swaps to convert such opportunistic borrowings into fixed-rate, target currencies. Its borrowing priorities are to: (i) develop demand for its paper from institutional investors in Europe, the US and Japan; and (ii) establish a AAA credit rating to put itself on a par with the other major MDBs.

Against the intended programme, the EBRD actually borrowed US\$930 million in 1993, through nine transactions in six different currencies with an average maturity of 8.5 years (for the long-term borrowings) at an average cost of Libor minus 41 bp. Allowing for debt retirement, the proposed borrowing programme for 1994 is a further US\$560 million which will result in net borrowings of US\$335 million. Given its projected disbursement requirements for committed loans, the EBRD seems to be indulging in a flurry of premature overborrowing for reasons which appear to have little to do with its operations as a development financing institution. In doing so, it runs the risk of being seen more as an aggressive *financial arbitrageur* than as a solid, long-term lender.

### ***Issues Raised by MDB Borrowing Policies and Strategies***

*Sophistication and Complexity:* Many of the issues raised by MDB resource mobilisation policies in general, or by the policies of certain MDBs in particular, have already been covered in the previous paragraphs. Clearly borrowing programmes and strategies have become increasingly sophisticated and complex in response to the increasing sophistication of financial markets themselves. The degree of complexity, however, is beginning to convey the disconcerting impression of being artificial and contrived rather than essential. It often appears as if borrowings are being driven more by the professional aspirations and ambitions of MDB financial officers, and the fee-generating imperatives of their investment banking advisors, than by the real

needs of the MDBs' borrowing clientele. All the MDBs now appear to operate on the belief that, having spent money on large advisory fees, on building up sophisticated financial expertise and on even more sophisticated technology, they have a vested interest in "churning" their financial operations (to justify their existence) on the ostensible grounds of cost-efficiency and maximising market access as objectives in their own right.

*The Possibility of Churning:* Are all of the sophisticated financial operations MDBs undertake really necessary? Are they cost-effective relative to the alternatives available? These questions are difficult, if not impossible, to answer even for financial experts. To do so, careful scrutiny is required of the way in which each of these financial operations is triggered and managed. What is clear is that the senior managements (and certainly most Board members) of MDBs are not sufficiently well equipped to make reasoned judgements when their financial managers present their case. Such justifications are usually based on sophisticated mathematical analysis which requires knowledge of a high order and specialised nature to comprehend. Not wishing to appear uninformed or lacking in knowledge, Executive Directors and senior MDB managers generally go along with approving complex financial operations when they have no way of evaluating whether these transactions make sense or what the risks involved are.

There is certainly a case to be investigated and answered as to whether MDBs undertook too many high-cost borrowings at the wrong times. In retrospect it is clear that many such borrowings could (and perhaps should) have been deferred because MDB liquidity was more than adequate. Many of these borrowings were later unwound through prepayments, refinancings and debt repurchases when market conditions were more propitious. These reversed transactions suggest that unnecessary borrowings in the first place followed by transactions which unwound them later, may have amounted to a form of *churning* and covering-up for previous misjudgements. Though that suspicion may be valid it remains difficult to judge whether each of these transactions could, in fact, have been justified in its own right.

*Independent Monitoring of MDB Borrowing Operations:* The major MDB shareholders, when instigated by their domestic political lobbies (such as, for example, their environmental lobby or their gender lobby) usually become overenthusiastically exercised about the possible misjudgements that MDBs have made in their *lending* operations and decisions; e.g. in financing dams or in financing unsuccessful adjustment. Shareholders have insisted on setting up elaborate and expensive, if not particularly effective or useful, Operations Evaluation departments in the MDBs to monitor and evaluate these operations/decisions regularly. They have even occasionally insisted on

augmenting such on-going internal evaluations with periodic “quasi-external” probes of effectiveness (e.g. the Wapenhans Report in the World Bank, the Qureshi Report for the IDB and the Knox Report for the AfDB). Yet the same shareholders appear quite sanguine about assuming that the quality of *financial management* in MDBs is so intrinsically sound as to be beyond the need for similar monitoring or examination. That sanguinity may perhaps be in need of more careful reconsideration.

*Borrowing Market Diversification:* In formulating their borrowing strategies and undertaking their borrowing programmes, all the MDBs seem intent on diversifying their *source* markets as much as possible. This is true even when it is not entirely clear whether diversification for its own sake is necessarily the correct pursuit; especially for the MDBs with smaller and less regular funding needs. Clearly, the AsDB’s sensitivity to developing exposure in *regional* markets, thus contributing to the development of these markets, is one positive dimension of its borrowing strategy which other regional MDBs should explore more thoroughly and possibly emulate, (although the AfDB may need to defer that approach for some time yet).

*Currency of Borrowing:* Similarly, in considering the before-and-after swap composition of the currency mix being borrowed, questions arise about the long-established emphasis that MDBs have placed on maximising borrowings of low nominal cost currencies. They have justified doing so on the grounds that such borrowings keep their borrowing costs, and therefore their nominal loan charges low. Has this been the correct approach? It is entirely possible that emphasis on such borrowing, especially in JPY, may have increased exchange risks and costs for MDB borrowers far beyond a tolerable level. Such exchange-rate related costs/risks may have been far greater than the small increase in nominal lending rates that might have occurred with a more balanced pool of currencies involving an inherently more stable exchange risk profile. After decades of justifying the former policy, the IBRD has shifted its stance on currency management quite radically. The AsDB has followed suit. The AfDB and its borrowers, who can afford to bear such costs the least, remain too heavily exposed to JPY. Clearly, MDBs need to gravitate towards a more consistent policy involving a balanced evaluation of what is most in the long-run interests of their borrowers and not what is most expedient to do in order to minimise, only ostensibly, a *visible* cost while obscuring the possibly higher *invisible* costs of their borrowing and currency management practices.

*Maturity Matching:* That most MDBs attempt to match the average maturity and durations of their *long-term* assets and liabilities is sensible and

laudable. All the MDBs have taken advantage of the highly propitious borrowing environment that has persisted between 1991-93 to stretch their maturities outwards. But, except for the IBRD and EBRD, the other MDBs do not yet match the maturities of their *short-term* assets and liabilities. Given the increasing level of liquidity holdings which all the MDBs appear to want to justify, there is a strong case for their managements and Boards to examine more carefully the advantages and disadvantages of permitting limited programmes of short-term borrowings to establish their institutions in all maturity segments of global financial markets. The experience of the IBRD and EBRD suggests that access to short-term markets, wisely and judiciously used, can be of significant benefit. It can lower overall borrowing costs and provide another line of defense to avoid *forced* borrowing in long-term markets when these markets are, for whatever reason, undergoing temporary bouts of turbulence (a phenomenon which is becoming more, not less, frequent). Access to short-term borrowings would enable all MDBs to ride out these periods with equanimity without necessarily having to run down their levels of liquidity below prudent limits.

*Timing of Borrowings:* Though MDBs usually justify high levels of liquidity to cope with disruptions in access to markets or to avoid *forced* untimely borrowings, their Treasurers often seem to proceed indiscriminately with agreed annual borrowing programmes when market conditions might suggest doing otherwise. Paradoxically, such an impulsion often argues against the reasons which they themselves cite for justifying the levels of liquidity they want to hold. The paradox is not all that difficult to explain. Once MDB Treasurers become accustomed to holding a certain level of liquidity, and to making an attractive level of profit out of those holdings, they are reluctant to diminish those levels of liquid holdings for whatever reason. Since they can pass on the full cost and the full exchange risk of their borrowing decisions, onto their own borrowers there is little incentive for them to hold back on borrowing even under unfavourable market conditions especially if that required running down liquidity. Doing so would only reduce the investment returns they might have committed themselves to generating on their liquid portfolios in the annual budget exercise or, depending on their private agenda, to exceeding their own targets.

This line of argument may appear to be suggesting even more hands-on Board involvement in, and more rigid control of, MDB borrowing programmes. In fact, it points to the opposite conclusion. Executive Boards should scrutinize and *evaluate* MDB borrowing programmes with even more care than they do now. But they should signal flexibility rather than rigidity in approach requiring a MDB's borrowing strategy to be geared to the long-run interests of their borrowers and not those of their treasuries. Levels of

borrowings and liquidity should be managed within broader, more flexible bands to permit greater expansion or contraction of annual borrowing programmes than is the case now. Such flexibility should be exercised on the basis of market conditions. But it should not run the risk of damaging the reputation of MDBs in financial markets by belatedly pulling out from issues which are almost fully cooked or, on the other hand, running undue risks in letting liquidity fall below prudential levels.

*Member's Permission to Borrow in their Markets and Currencies:* This issue has been discussed earlier in the section on the World Bank. It only needs to be reiterated that the Article requiring MDBs to seek the permission of their members to borrow in those members' currencies or markets, or to exchange those members' currencies into other currencies was designed at a time and for a purpose which no longer exists. That Article is now anachronistic and provides some members (especially those which issue the three major reserve currencies) with the power to misuse the authority it gives them. It should, in the interests of fairness and MDBs' financial soundness, be abandoned, repealed or declared invalid for application in some way which does not involve amending the Articles of Agreement of the various MDBs.

*Capital Market Concerns in Providing Resources to MDBs:* MDBs have established the highest quality of ratings for their debt issues on capital markets. The borrowing and debt service track record that these supranationals have now established over several decades is an unassailable one. Global capital markets therefore have no reluctance and suffer no inability in funding the resource requirements of the MDBs at current or even higher levels. However, the MDBs (in particular the World Bank and the AfDB but also the nascent EBRD) have been in the glare of continuous adverse publicity in the world press for some time. Such publicity condemns their lending, the failure of their policy advice, and/or their apparent lack of concern for controlling their edifice complexes and budgetary indiscretions on a daily and relentless basis.

The drip effect of such negative exposure may, at some stage, result in an erosion of the unqualified and unreserved support the MDBs have enjoyed on world capital markets so far. The problem is not one of ineffective public relations, as many MDB managers appear to believe, but of substance. It is difficult for even the most ardent supporters of these institutions to argue against the proposition that they appear to have lost their way. Formerly seen as virtually infallible these institutions are now perceived to be correct only occasionally – and then too by accident rather than design! At the same time capital markets have developed a powerful array of funding capabilities to finance directly an increasing number of emerging markets without MDB

intermediation. They often see such intermediation, even when it is well intended, as obstructive rather than helpful.

Except for the IDB which appears to have been revitalised under its current President, the other older MDBs convey the impression of going through a mid-life crisis. The EBRD of course has barely started life. In its case the question of whether it should have been created at all is now moot, although the fit of political euphoria in which it was born is now being seen as an expensive aberration. Such portents are clearly not propitious for the future. It is difficult to see capital markets sustaining the support for MDBs that they have provided in the past, even if governments do, unless MDBs can: (a) unshackle themselves from the multiplicity of conflicting and entangled objectives which they have attempted to convince their shareholders they can meet; (b) concentrate on a few clear priorities; (c) achieve them with a sense of mission and purpose; and (d) restore an image of being lean and effective rather than bloated and bureaucratically paralytic.

*The Role of Rating Agencies:* The key international rating agencies which continually analyse the credit quality of debt paper issued by governments, their agencies, supranationals and corporates, have played a significant role in the success enjoyed by MDBs in borrowing on international capital markets. The role of the rating agencies dates back to the inception of the IBRD and its first attempt at floating a bond issue in the US market – the only significant capital market in the world at the time. As the first authoritative published history of the World Bank<sup>17</sup> noted:

“The IBRD has enjoyed the favour of the rating services from its first issues and its position has steadily improved. The 1947 issues were rated AA by Fitch Investors and A by Standard and Poor’s. Moody’s, the bellweather of the group, had never before rated a financial institution, but in 1950 it made an exception for the IBRD, and the Bank’s third issue enjoyed an A rating from Moody’s, an A1 rating from S&P, and an AA rating from Fitch. Moody’s rating was soon improved to AA, but it took the Bank nearly ten more years to acquire AAA status. Since the mid-1950s Bank securities have been given a triple A rating by all three services.”

After those early days, all the MDBs have aspired to achieve and maintain the highest (triple A) ratings from the major rating agencies in international bond markets. The evolution of the IDB’s borrowing policy alludes frequently to the role that rating agencies played in determining its borrowing limits in order to protect the quality of its rating and the constraints it faced in negotiating changes to these limits in a gradual manner

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<sup>17</sup> Mason, E. & Asher, R., “The World Bank since Bretton Woods”, The Brookings Institution, Washington DC, 1973, pp. 132.

acceptable to the rating agencies.<sup>18</sup> Similar intent about maintaining their AAA ratings are regularly expressed by the AsDB and the AfDB. Although the AsDB has not experienced any problems with the rating agencies, the troubled borrowing history of the AfDB until 1982 resulted in its earlier debt issues not being rated at all. In 1983, with the entry of non-regional members into the shareholding and the adoption of more carefully thought-out borrowing policies, its *senior* debt was rated AAA by Moody's and Fitch and AA by S&P. It was not until 1987 that ratings were assigned to the *subordinated* debt of the AfDB with Moody's, Fitch and Euroratings assigning AA+ ratings, and S&P an AA- rating, to such debt.

With the onset of the debt crisis in 1982 and the emergence of unprecedentedly difficult circumstances arising for the portfolios of the IBRD and IDB, all the rating agencies insisted on even more intensive reviews of the strength of MDB portfolio quality, callable capital, and of the political support of their OECD members. The result of these reviews was that the triple A rating of these two agencies, which may have been under some threat during the worst years of the debt crisis, was maintained but kept under close watch throughout the 1980s. In that decade, the treasuries of these two MDBs were more preoccupied with the importance of regular rating agency reviews than had previously been the case when the AAA rating had come to be taken virtually for granted. During this period the AsDB, relatively unaffected by the debt crisis, was equally unaffected by the same concerns on the part of the rating agencies. As for the AfDB, its lending to patently uncreditworthy countries had not yet begun to escalate to the levels which it did between 1989-92 after GCI-4 was approved and ratified.

The gradual passage of the debt crisis in Latin America and in other middle-income countries between 1989-94 has eased somewhat the concern of rating agencies about the quality of the portfolios of the IBRD and IDB. But the AfDB now faces unusually difficult circumstances with: the continuing deterioration of its loan portfolio, the persistence of the debt crisis in Africa with too large a hard-window MDB debt exposure, and the intense shareholder scrutiny that it has come under as arrears have increased. In April 1992, Moody's and S&P left their ratings unchanged, but Fitch placed the subordinated debt rating of the AfDB on 'FitchAlert' because of what that rating agency saw as the AfDB's:

"...declining credit trend, continued growth in subordinated debt in the face of stagnant callable capital, greater risks to loan quality, and negotiations among bank members over the operational program for 1992-96. A related factor was the need to re-examine the support for the Bank in the post-Cold War era." (Fitch Special Report on the AfDB, September 21, 1992)

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18 See the IDB's Memorandum to the Board of Executive Directors on "A Review of Financial Policies", dated 7 September 1990, (Document No GP-117). pp 48-51.

However, the AA+ rating for subordinated debt was reinstated after six months following strong representations from the AfDB which resulted in the invention by Fitch of a *new stress test* for the AfDB's loan portfolio. Whether this premature vote of confidence in the quality of AfDB's debt paper was justified raises some fundamental questions about: (a) the quality of the judgements being made by the rating agencies; (b) their validity and value for investors and for the rated institutions themselves; (c) the kind of signals they send to the management of these institutions; and (d) the implied consequences of the wrong signals being sent to markets when no significant distinctions are drawn by credit ratings highlighting the clear and large qualitative differences which exist between the AfDB's deteriorating financial condition between 1991-93 versus the continued strong financial performance of the other MDBs over that period.

A recent evaluation of the financial condition of the AfDB<sup>19</sup> expressed concerns which have since been echoed widely throughout the international financial and development communities. That evaluation observed that the cold facts and deteriorating trends in AfDB's key financial indicators probably would have justified a proactive decision by the rating agencies to downgrade AfDB's debt in 1992. Such a step would have made the AfDB's management more cognizant of the severity of the financial crisis that AfDB faced and still faces. It would have impelled AfDB's management and its regional members to: (a) be less sanguine about market and rating agency perceptions of the AfDB's strength; and (b) move more swiftly than they actually did in making essential changes to certain financial policies in order to safeguard the strength of that institution, rather than delaying such measures until sustained pressure was exerted by non-regional shareholders with the threat of withholding funding for AfDF-7.

The absence of any such prophylactic action, however, seems to underline the reality that the rating agencies do not actually base their rating of the MDBs on the spuriously sophisticated and often confusing, if not almost irrelevant, financial ratio analysis they purport to impress their readership with. Instead, they now appear to be basing their judgements solely on the strength of *usable callable capital* and the extent to which this guarantee on the part of mainly the OECD governments ensures the safety of a MDBs' outstanding debt. Excessively heavy reliance on that one factor alone poses serious dangers in terms of the signals that such ratings send to the financial and top managers of these institutions. It places unnecessarily onerous burdens on the OECD shareholders of these institutions to enforce sound

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19 Mistry, P.S. *op cit.*

financial management by holding out the threat of exercising the ultimate sanction: i.e. withholding further capital or MDF support. Given the political complexities involved with OECD shareholders getting regional MDB managements to respond to their concerns, these shareholders ought not to be backed into the job that rating agencies and markets should be doing; especially when deterioration in the quality of an MDB's financial position clearly warrants markets rather than shareholders to signal that something is wrong and needs to be corrected.

### *The Use of MDB Guarantee Powers*

The Articles of all the MDBs were framed with the clear idea in mind that these institutions would use extensively their powers to *guarantee* loans and investments made by private lenders to borrowing member countries. After all, the delegates at the Bretton Woods conference had conceived of the IBRD largely as a confidence-building institution created to bridge an interim period of unspecified duration until private investors, mainly in the US, resumed the practice of buying the securities of foreign governments or of making private loans to these governments.<sup>20</sup> Such investors had become wary of foreign lending after the disastrous experiences of the 1920s and 1930s and the recurrence of a second world war. The primary purpose of the IBRD guarantee was therefore to bolster the confidence of private lenders in lending directly to borrowers as a prelude to bringing borrowers gradually into the market.

#### *Use of Guarantees by the IBRD*

In reality, however, for nearly forty years the IBRD did not guarantee either a foreign loan of a private investor to a developing country nor did it even consider guaranteeing the public offering of a member government. The same reticence was exhibited by the AfDB, AsDB and IDB. The initial reason given by the IBRD for avoiding the use of guarantee powers was that it still had to test the willingness of the market to buy its own securities and establish the quality of its own credit before it attempted to use its guarantee. But this reason became moot after the very successful sale in 1947 of US\$250 million in IBRD bonds in the US market. The reasons that the MDBs' powers of guarantee were never exercised lay in the following considerations:

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20 See Mason, E. and Asher, R. *op cit.*

- The use of the MDB guarantee added no value to the international flow of financial resources because the guarantee competed directly with the MDBs' own borrowing capacity in being a direct substitute for borrowings under the capital limit set.
- The cost to most borrowers would have been higher if the MDBs had provided guarantees for private credit than if the MDBs borrowed and lent directly. The guarantee cost would have been an add-on and the legal issues involved between the borrower, primary lender and guarantor were complicated and involved further costs.
- Even if the MDB guarantee had carried a uniform cost for all members, the overall cost of funds with a guarantee would have been different for different members based on how private investors perceived their individual credit quality. That would have made matters politically difficult since the MDBs chose to operate from the outset as multilateral credit co-operatives which spread their costs among all members equally.

### *The Guarantee Experience of the World Bank*

There were, however, in the case of the IBRD some interesting early operations involving participations and portfolio sales (with a guarantee) which amounted to quasi-guarantee operations. They were precursors – albeit with a long interregnum – to its present (post 1988) cofinancing, guarantee and credit enhancement operations. When the IBRD made its first loan for US\$16 million to Belgium in 1949, it arranged for the full amount to be taken up through participations by private investment institutions. At the end of the day, the Bank did not provide any money of its own in this loan; it effectively guaranteed the credit of Belgium. After that, the Bank continued to sell parts of its loan portfolio to private investors with its guarantee to them that payments would be met. That practice dwindled in the 1950s as the IBRD became more interested in selling its own bonds to the public and did not want to confuse the market with different kinds of guarantees on different debt obligations. The IBRD guarantee on portfolio sales never needed to be exercised and was not offered after 1955. However, loan portfolio sales without the IBRD guarantee continued throughout the 1950s and 1960s. They reached a high point in 1960-61 and declined thereafter, virtually ceasing between 1974-82 only to be revived again in 1983.

The reasons for the decline and cessation of loan-sales operations between 1966-82 included the following: (i) world interest rates began to rise and fluctuate much more rapidly during this period making loan sales less profitable or unfeasible without taking a face-value loss on principal; (ii) the

imposition of the US interest equalisation tax required the IBRD to act in a manner that did not contravene its purpose; (iii) an increasing amount of IBRD loans were being made to *developing* economies during this period which were not as attractive to private participants while loans to *reconstructing* economies had virtually ceased; and (iv) the attitude of IBRD's management to loans sales changed dramatically with succeeding Presidents not sharing the same enthusiasm as Eugene Black (until the arrival of A.W. Clausen in 1981) for keeping the overall size of the IBRD's balance sheet modest by selling loans as quickly as possible thus keeping the burden of outstanding loans low and avoiding unnecessary demands on governments for further capital increases to support expanded lending.

As it ended the practice of offering a guarantee on loan sales, the IBRD devised a *joint financing* approach, also called *cofinancing*, as a means to involve private investors in lending directly to its borrowers. The first such operation was a US\$50 million loan to Belgium in 1954 in which private lenders took up US\$30 million through bonds. The IBRD funded the tail-end of the package with repayment on the 15-year IBRD loan of US\$20 million not commencing until the bonds sold to private participants had been redeemed. This operation established a precedent for the IBRD and market lenders working together to share in credit risk on terms acceptable to the market. The presence of the IBRD and its effective subordination to private participants certified both the credit of the borrowers and the soundness of the project to which the funds were being applied. The IBRD did 15 similar operations until 1960 with total jointly financed loans amounting to US\$562 million and private participations providing about 55% of this amount. Most of these loans, however, went to *reconstructing* economies (in continental Europe and Japan) rather than to *developing* economies.

It was not till 1983, however, that interest was revived in the IBRD in cofinancing and guarantees as ways of enhancing the credit of borrowers to support either private bank lending to a particular developing country or to support a borrowing in the international capital market. Through a ripple effect, this interest has also been ignited in the AsDB and EBRD, but *not* yet in the AfDB and IDB. The IBRD signed its first commercial bank guarantee in 1983 under its programme of B-loan cofinancing, which was followed in 1989 by a programme of *expanded co-financing operations* (ECO) and guarantees.

The B-loan co-financing programme was undertaken between 1983-88. It involved three distinct categories of *special* IBRD involvement undertaken in connection with its regular (i.e. A-loan) lending: (i) direct funding by IBRD of later maturities upto 25% of the principal amount of a syndicated

commercial bank loan; (ii) IBRD guarantees of later maturities for the same proportionate maximum amount calculated on a present value basis; and (iii) IBRD financing of the residual principal repayment obligation on a variable-rate commercial loan in which the borrower would pay only a fixed amount of total debt service in each period. A total of 24 B-loan transactions were completed with US\$385 million in direct participations; US\$934 million in partial guarantees; and \$3.3 million in contingent obligations. Under B-loan guarantees, the fees charged were aimed at recovering from the commercial creditors involved, a fair proportion of the incremental value of debt-service payments resulting from the IBRD guarantee.

In July 1989 its Executive Board extended use of the IBRD's guarantee powers considerably under the ECO programme through which the IBRD could guarantee virtually any aspect or part of a commercial bank arranged loan transaction or public bond issue to give private lenders the risk profile they were willing to assume. It could also provide contingent obligations and limited recourse support for private participation in project finance e.g. bonds for project financing with *put options* or partial backing for underwriting facilities to support public note-issuance by developing country borrowers. In covering the credit risk on underlying repayment obligations of borrowers to private parties, in any transaction structured under ECO, the IBRD could guarantee any of the following: the entire amount of principal repayment obligations, or only the later maturity principal obligations; or a part of total debt service – i.e. both principal *and interest* payment obligations.

Under the initial ECO programme the following general guidelines were applied: (i) IBRD involvement in a specific transaction had to meet the test of *last resort* financing i.e. the IBRD should not be involved if other options were available; (ii) as with the B-loan programme, IBRD *guarantees and other credit enhancements* (GCEs) under ECO needed to be associated with regular IBRD direct lending; (iii) GCEs for commercial bank loans could not involve (on a present value basis) greater country exposure for IBRD than that assumed by the commercial or other lenders in an ECO transaction; therefore, such transactions had a ceiling of 50% for the IBRD's share of guarantees on the commercial bank loan; (iv) GCEs were to be limited so that the credit standing of the bonds or other tradeable securities issued under a particular ECO transaction were sufficiently differentiated from the AAA rated credit standing of the IBRD's own traded securities; (v) countries which had restructured their commercial bank debt within the preceding five years were generally ineligible for ECO financing although exceptions could be made if justified; and (vi) the fees charged for GCEs under ECO had to recover returns from the Bank's additional credit exposure equivalent to those it

would have earned from direct loans. For the purposes of calculating statutory lending limits, GCEs were computed at 100% of the face value of payments guaranteed, *from the date on which such a guarantee became callable*;<sup>21</sup> but for the purposes of *headroom* calculations and country exposure limits, guarantees were counted at their full face value. In computing borrowing and liquidity requirements a 50% guarantee call rate was assumed.

The pilot ECO programme was approved within an envelope of US\$2 billion. It was reviewed in late 1990 and again in mid-1992. The first review was clearly premature. Only two ECO operations had been done and a third was in the pipeline.<sup>22</sup> It concluded that the guidelines should be left unchanged and another review conducted within 18 months. The 1992 review included only one other ECO transaction – i.e. Pakistan – and concluded that the guidelines established were perhaps too restrictive, recommending the following changes:(i) the country eligibility guideline should be interpreted more flexibly to permit the inclusion of countries which had restructured their commercial debt within the five-year limit but had nevertheless re-established an encouraging degree of market acceptance for their tradeable debt issues (e.g. Mexico, and Chile); (ii) the requirement that ECO transactions must always be associated with direct IBRD lending needed to be relaxed or removed especially in the case of ECO transactions which were aimed at supporting “capital market access” operations in which the private sector in the borrowing country was involved; (iii) the 50% ceiling on the IDRD guarantee of a commercial bank loan to the *public sector* in a particular transaction needed to be retained *but* with the IBRD being permitted to cover 100% of the *sovereign* credit risk in cases where both public and private sectors were involved in financing large infrastructure projects in which the private and sovereign components of risk could be properly differentiated.

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21 In effect, for the purposes of calculating loans and guarantees outstanding against the statutory lending limit, the IBRD guarantees replace direct loans in a manner equal to the present value of guaranteed payments discounted from the date at which they first become callable.

22 The first ECO operation was in India for guaranteeing the principal of a US\$100 million bond offering by the Housing Development Finance Company (HDFC) in conjunction with a US\$250 million IBRD loan to that institution. The second ECO was in Hungary for guaranteeing a US\$200 million bond offering by the State Development Institute (SDI). The third (pipeline) operation was in Pakistan for the Hub River Power Complex where the IBRD will provide a 100% principal guarantee on senior loans of US\$240 million extended by a commercial bank syndicate to a private company in the event of debt service default due to the failure of the Pakistani Government to fulfil its obligations under its Implementation Agreement with the project management and operating company – i.e. the Hub Power Company. The ECO will also mobilise a co-guarantee of US\$120 million from the Japan EXIM Bank to cover a separate tranche of senior commercial bank loans to the Project.

Given experience upto 1994 with ECO it appears as if re-opened resort to GCEs by the IBRD may have been a better idea in *theory* than has proven to be the case in *practice*. ECO appears to have much more limited applicability than was earlier anticipated. In part, that may have been due to the large number of restrictions placed on where and how ECO operations could be undertaken and the internal wrangles between the IBRD, MIGA and IFC on what the proper role of IBRD involvement in a particular operation should be. The concordat between these institutions was that the IBRD should structure ECO operations only in instances where MIGA and IFC could not by themselves address the particular risk coverage needs of the borrower fully. A second problem was that the IBRD's bureaucratic ways and its long drawn out internal analysis and approval procedures for handling these operations were simply not suited to accomplishing the underlying objectives of ECO financing. They point to a larger concern about whether, given its established operating style, the IBRD would ever be able to operate sensibly with the private sector, in either developed or developing countries, in the absence of a fundamental change in its inflexible staff attitudes, its reluctance to adopt more constructive approaches and being more open to external influences, and its government-influenced Board culture. Third, the established management bureaucracy in the IBRD still favours traditional direct lending operations, with the regional country departments unwilling to encourage out-of-the-ordinary transactions which they cannot exercise full control over, or take the full credit for, or through which they cannot exercise sufficient direct policy or project leverage over the borrower. Fourth, there appears to be a residual subterranean concern (mostly on the part of some members of the Executive Board) that the ECO programme, instead of enhancing a gradual increase in market access on the part of developing countries, may actually inhibit it or, alternatively, may create an overweening dependency on IBRD guarantees to assure their sustainable future access to international capital markets. Board reticence to consider approving operations unless it can be clearly demonstrated that this will not be the case (which it never can since counterfactuals are always impossible to prove) may have acted as yet a further impediment to ECO from taking off.

These problems notwithstanding, an instruction was issued to IBRD staff in September 1994<sup>23</sup> requiring them to make guarantees a mainstream instrument in World Bank operations in order to meet the needs of a changing operational environment. The IBRD guarantee is now to be used in a variety of ways to support private sector projects and to complement the

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23 IBRD Memorandum from the President to All Staff on "Mainstreaming of Guarantees in Bank Operations", dated 19 September, 1994.

efforts of IFC and MIGA. The new features of the Bank's revised guarantee programme are designed to give comfort to private investors regarding broader sector policy risks (e.g. on tariffs) associated with regulatory or government performance while leaving the private investor to shoulder fully the commercial risks involved. In countries where such risks are perceived to inhibit the proclivity of the private sector to invest, the IBRD believes that its guarantee support could augment IFC's and MIGA's efforts without necessarily duplicating them. Under the President's instruction, the World Bank's regional country departments are now required to assess systematically the potential use of guarantees in developing their country assistance strategies. To assure a common approach and to reduce internecine conflict within the different parts of the World Bank Group, a high-level review committee has been established on which the IBRD, IFC and MIGA are all represented to guide the initial series of new-style guarantee operations. Whether this third attempt at increasing the use of IBRD guarantee powers is any more successful than the first two remains to be seen. On the basis of past experience there remains considerable ground for scepticism. If it does succeed there is little doubt that such a programme will rapidly be emulated in the other MDBs although, as is noted below, the EBRD is already far ahead of the IBRD in this respect.

The total face value amount of guarantees which the IBRD has provided since 1983 and which remains subject to call at some future date amounted to US\$1.18 billion on 30, June 1994. Of this amount only US\$173 million was actually subject to call. These amounts were not reported in the Bank's financial statements but were identified in the Notes to those statements. Between 1989-94, the IBRD has also participated in *guaranteeing* timely interest repayments by borrowers undertaking commercial *debt and debt-service reduction* (DDSR) under the Brady Initiative. The IBRD has (upto mid-1993) supported DDSR operations for Argentina, Mexico, Costa Rica, the Philippines, Venezuela, and Uruguay. Under such operations, the total amount of outstanding guarantees on timely interest repayments which were subject to call, has declined from US\$13.5 million in mid-1990 to US\$4 million in mid-1994.

### *Experience with Guarantees in the Other MDBs*

As briefly alluded to earlier, only the AsDB and EBRD have followed suit in opening their guarantee windows for borrowers to use, although on a highly selective and limited basis. The IDB and AfDB have not yet contemplated doing so. In its 1993 Annual Report, the **AsDB** noted that the outstanding guarantees which it had extended for the benefit of its members upto 31 December 1993 amounted to US\$132.3 million. None of this

amount was subject to call as of that date. The AsDB valued these guarantees at *zero* since it did not expect them to be called. There was no further elaboration in the Annual Report as to the nature of these guarantee operations or the guidelines governing their execution. In the 1992 Annual Report however, the AsDB referred to arranging, through the Complementary Financing Scheme (CFS) and guarantee facilities, the second and third commercial cofinancings for two projects in China. It was not clear what fees the AsDB derived in extending these guarantees and the basis on which they were charged. Nor were its approach to, or policies on, guarantees made transparent in its various financial policy reviews.

In its Memorandum on Financial Policies of 23 June 1993, the **EBRD** specifically mentions the use of guarantees as one way of meeting the needs of its public and private borrowers. Its policies permit such guarantees to be tailored to requirements ranging from *all-risk financial guarantees* to *partial risk-specific contingent guarantees* for debt instruments (loans, bonds or commercial paper) issued by its borrowers in their domestic, or in international, capital markets. In all cases, however, the EBRD's policies require its maximum exposure to be known and measurable at all times. Such guarantee exposure on the part of the EBRD is processed, appraised and supervised in the same manner as direct loans and investments and will be subject to the same limits and requirements. The fees which the EBRD charges for its guarantees depend on the specific coverage and risk involved in providing any particular guarantee. As do other MDBs, the EBRD faces the same processing and supervision costs with extending guarantees as with extending loans. For *headroom* calculation purposes (i.e. against statutory lending limits) guarantees are treated as if they were *on the balance sheet* and therefore entirely equivalent to loans. As with the IBRD, guarantees are counted in full as of the date when they become callable for the purpose of calculating the gearing ratio.

For all these reasons, EBRD's policy is to price guarantee fees on a basis equivalent to the returns it would derive from comparable loans involving equivalent risk. In addition to the guarantee fee therefore, the EBRD's policy (unlike the IBRD) is to charge a front-end fee, as well as a commitment fee on the amount of the guarantee which is not yet subject to call, if that is deemed by the management to be appropriate. The EBRD has already been making extensive use of its guarantee powers in a manner which exhibits much greater flexibility, imagination and innovativeness of approach than in the other MDBs; perhaps demonstrating what is possible in a nascent institution whose internal culture is not yet quite as rigid or ossified as that of its more established peers. For example, in a complex financing plan for the M1-M15 motorway in Hungary, the EBRD has provided guarantees both for

a *local currency* private placement as well as a partial guarantee for a *local currency* public debt issue.<sup>24</sup>

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24 Unfortunately no full list is readily available which outlines the type and nature of the guarantees EBRD has extended to date. Nor does the 1993 Annual Report outline with any specificity the EBRD's annual or cumulative guarantee operations in either its Operations section or in its Financial Statements and the Notes which accompany them. It is difficult therefore to discern transparently what guarantee risk the EBRD is exposed to; what proportion of its guarantees were actually callable as of 31 December 1993 or what fees it derived from its guarantee operations. This lacunae suggests that shareholder governments have much to gain from insisting on much clearer disclosure and standardisation of the Annual Financial Reports of the MDBs at least in certain aspects.

## 4 Resource Mobilisation: Soft-Loan Windows

### *Emergence of the Multilateral Development Funds*

This chapter focuses on the addition of soft-loan windows to the MDBs enabling them to finance a wider range of countries and activities than they would otherwise have been able to. It does so in a selective fashion focusing on those aspects of the multilateral development funds (MDFs) which affect and influence the overall resource mobilisation activities of the MDBs. It also raises some cross-cutting issues which affect both the hard-loan and soft-loan windows in each MDB. What this chapter does not do is attempt to provide a comprehensive analysis of every aspect of soft-window operations and administration; for this the reader would need to refer to other sources. Also, specific financial policies relating to soft-window resources, e.g. levels of liquidity, administrative cost-sharing, net income allocation are alluded in the relevant chapters that follow.

As the previous chapter demonstrated, the MDBs which were set up between 1945 and 1966 quickly established their credit ratings on international capital markets. They became adept at mobilising the resources they needed from the market on the strength of their capital bases and their gearing ratios. When these limitations threatened to become binding they were made more elastic. For example, the IBRD's capital was doubled in 1959 to enable continued expansion of its lending when it became evident that its capital base was the only binding constraint on its ability to raise resources on the market. The rapid recovery of the *reconstructed* economies of continental Europe and Japan through the 1950s, resulted in these economies ceasing to borrow from the IBRD although countries like Finland, Greece, Portugal, Singapore and Spain continued to require IBRD support into the early 1970s. With the task of post-war reconstruction having been largely accomplished, it became increasingly apparent that future MDB lending would be focused primarily, if not entirely, on *developing* countries.

Apart from countries in Latin America and those which emerged from division of the Indian sub-continent in 1947, most developing countries achieved independence only during the 1950s and 1960s. Providing international capital for financing *broad-based development* in such countries was a major new undertaking for the international community in the post-1945 order. Previously they had been colonies whose rate of development was determined (or restrained) by colonial governments and private metropolitan

investors, rather than by any organised effort on the part of the international community. The only external financing these countries had any experience with was primarily for private *enclave* investments in plantations, mining, shipping and railroads. With perhaps the exception of India, no significant investments had been made by colonial governments or by the private sector (either domestic or metropolitan) for broad-based (i.e. non-extractive) infrastructural development or for essential investments in human capital (e.g. in health, education and social security). A small amount of (mainly domestic) private investment had gone into limited import-substitution manufacturing.

Early assessments of the development financing needs of newly independent states made it clear that if their development was to be accelerated, large-scale investment in physical and institutional infrastructure would be necessary. Such investment would need to be coupled with improvement in domestic resource mobilisation capacity i.e. mainly through investment in development finance institutions which aimed at overcoming some of the imperfections of as yet unformed local financial and capital markets. Development investment in *infrastructure* also needed to be accompanied by unprecedented, internationally supported investment in the *agricultural* and *rural* sectors of these economies which accounted for the bulk of their economic output and employment. If development was to be people-oriented, and the aim was to alleviate mass poverty then, in addition to investment focused on large projects involving machinery, bricks-and-mortar, equally large investments would need to be made in developing institutional capacity and human capital in all these individual emerging nations simultaneously. Such investments, in their volume and diversity, involved mobilising funds for aggregate global development investment on a scale which had not hitherto been contemplated.<sup>1</sup> The borrowing experience of India and

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1 It is important to recollect one other powerful political reality. The realisation of what needed to be done for financing *development* occurred in the context of the Truman Doctrine shaped by the Cold War. In that war, influencing the political complexion and orientation of newly emergent countries (through whatever means, however unscrupulous) became a paramount objective in its own right for each of the two superpowers whose own development was based on violently opposed, antithetical ideologies. The partial alignment of the former colonial powers with one of these superpowers did not help matters. It triggered almost a reflex reaction on the part of untested, inexperienced governments in emerging economies. Anxious to establish their popularity and longevity in as yet nascent democracies, these indigenous governments pursued voter-friendly, populist and nationalistic policies which were as different as possible from those which former colonial governments had pursued. In such circumstances, influenced by unrealistically high domestic expectations, unproductive superpower competition exerted through the aid mechanism, and by radical academics in developed economies anxious to test new economic theories on blank canvases, it is not difficult to understand in retrospect why governments in the developing world decided to opt for statist, interventionist approaches. In doing so they followed currently fashionable economic thinking, which had become biased against markets and private capital since 1945, and their own political instincts believing that →

Pakistan and some Latin American countries through the 1950s and early 1960s also indicated that borrowing on market terms for these purposes would only result in their piling up more debt than they could possibly cope with and would call into question their creditworthiness for further borrowing from the IBRD.<sup>2</sup>

In such a climate it became clear, that market-based resources alone were not going to be either appropriate or sufficient for the newly independent and emerging developing countries that the MDBs would henceforth be focusing their lending attention upon. Gestation periods of development investments were too long, and the immediate *indirect* foreign exchange earnings generated too uncertain, for them to be financed on terms that the market could provide, even with the intermediation of MDBs supported by developed country capital. Hence, longer-term resources, with longer grace periods at below-market costs came to be envisioned as an essential *accoutrement* in the array of facilities that the international community needed to dispense. It did not require a great leap of logic on their part to conclude that such funds could only be provided by developed country governments in addition to MDB share capital.

Developing countries favoured coursing such funds through the UN in which they felt they had more influence and say. Developed countries were strongly opposed to that notion believing it would result in a loss of control, ineffective use and the possible waste of public resources for which they were directly accountable. They did not see the UN as having been created to perform the function of financial intermediation to promote development. If donor governments were to control the disposition of these funds, then the best way was to course them through MDBs over which they had greater control. They had a choice of providing such resources on soft-loan terms to the MDBs which would then intermediate them in the same way that they intermediated market funds. Alternatively, such funds could be provided to the MDBs *on grant terms* with the MDBs relending those funds as low-cost,

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dirigiste policies would result in more rapid and more equitable development through a fairer redistribution of private income and wealth. Needless to say, the fact that an interventionist approach would also give governments, politicians and their advisors much more power at national and international levels could not have been lost on those in the drivers' seats. It must also be recalled that between 1945-75 heavy doses of government intervention in various types of economies (including most OECD countries as well as those of the former East Bloc) actually worked, and worked quite well, with the foundations being laid for social accomplishments (universal education and health-care) and social security safety-nets which are now blithely taken for granted. It was only in the 1980s and 1990s that the negative features of excessive intervention, the social disincentives of the welfare state, and the fiscal unsustainability of presently structured societies have emerged as key issues triggering fundamental reversals in political and economic thinking.

2 See Mason, E. and Asher, R., "The World Bank since Bretton Woods", The Brookings Institution, Washington DC, 1973, pp. 38-394.

long-term credits to ultimate borrowers on a revolving basis. Wisely and generously, the donor countries opted for the latter approach. This chain of events established the context for setting up the International Development Association (IDA) as an affiliate of the World Bank although the developing countries had argued strongly for a Special UN Fund for Economic Development (SUNFED) to be established instead. In the event and with the benefit of hindsight, the MDB route proved to be the wiser and the more effective, if only in relative than in absolute terms.

### *The International Development Association (IDA)*

IDA was established in 1960. To informed observers<sup>3</sup> its emergence confirmed:

“the ability of bureaucracies to remain afloat, to unfurl fresh sail, and to benefit from prevailing winds ... IDA had to be invented to keep the World Bank preeminent, or at least eminent, in the growing complex of multilateral agencies attempting to facilitate international development.”

In substance, IDA is, of course, an elaborate fiction. It is not as its separate identity implies a different international institution but merely a fund administered by the World Bank. Its creation was a major step in the evolution of the World Bank itself, marking the beginning of the transformation of that institution from something resembling a *bank* into a *development agency*. Upon its establishment IDA had an authorised capital of US\$1 billion to be (paid-in and) used over five years; it came into being when fifteen governments agreed to subscribe a total of under US\$690 million. Unlike the IBRD, which could meet its resource requirements through bond-issues on capital markets, IDA's resources were limited to governmental budgetary contributions. Therefore they had to be rationed from the outset bringing into focus the need for both *eligibility* and *allocation* criteria to be applied in the rationing process. These are dealt with more thoroughly later in the chapter.

It was decided by the World Bank management and Executive Board, again from the outset, that the softness of IDA's terms should not influence the type of project that it would finance. Such terms would enable the Bank to finance countries it otherwise would not be able to lend to; but it would finance projects which met the same rigorous tests of financial and economic viability as those that might be financed by the IBRD. IDA's exceedingly soft terms were often combined with standard IBRD loans to provide a *blend*

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3 Mason, E. & Asher, R., op cit., pp. 380.

which could be varied with a considerable amount of flexibility to suit the circumstances of the country being financed. With each successive replenishment of IDA, however, donors have increasingly asserted their priorities for both the way in which IDA resources are allocated across countries as well as the broad purposes to which they are applied.

IDA's initial credits were provided at no interest cost for a term of 50 years with a 10 year grace period, although a small annual service charge of 0.75% was applied to amount disbursed and outstanding. The grant element of this type of credit (at a discount rate of 10%) was over 86%. In 1982, IDA's income levels fell below those required to cover its own administrative costs; it was decided at the time that a commitment fee of 0.5% should be applied to undisbursed balances but that such a charge should be reviewed if IDA's income position improved sufficiently to so warrant. As a result of the commitment charge, and with an increasing pool of liquidity being managed on IDA's own account (both to cover increasing levels of disbursement and to generate investment income), increasing net income surpluses were generated for IDA between FY83-88. With a much healthier net income position, IDA charges were reviewed in FY88 when it was decided that the commitment fee should be made variable within a 0% to 0.5% band and its level should be reviewed each year. This fee was reduced to zero in FY89 and has been maintained at that level upto FY94. During the negotiations for IDA-8, it was agreed that the terms of IDA credits should be changed to 40 years with the same 10 year grace period for *IDA-only* countries and 35 years with a 10 year grace period for *blend* countries while applying the same service charges. This adjustment reduced the grant element of an IDA credit to 77% with the 0.5% commitment fee and to 79% without it.

IDA's resources have been replenished on ten separate occasions at three-yearly intervals with the first replenishment (IDA-1) of US\$750 million being agreed in 1963 and the tenth (IDA-10) being agreed in 1993 for an amount of SDR 13 billion (or US\$16 billion equivalent). The total cumulative amount of resources which have been made available to IDA for commitment purposes between 1960 and June 30, 1994 amounted to over US\$89 billion and nearly US\$100 billion if the remainder of IDA-10 pledges which have yet to be converted into contributions (US\$11 billion) are taken into account. Of the US\$89 billion in *committable* resources, about US\$81 billion had been contributed by IDA members and nearly US\$4.2 billion by the IBRD (through annual transfers of a portion of its net income). The remainder (US\$4.8 billion) was accounted for by a positive exchange rate translation adjustment reflecting the increased USD value of contributions made by members in their own currencies.

The initial capitalisation of IDA in 1960 required contributions from all member countries, both Part I and Part II. Donors were required to make

100% of their contributions in convertible currencies (or gold) while recipients were required to make 10% of their subscriptions in convertible currencies and the remaining 90% in their own currencies whose use could be restricted and would depend on their approval. In the first replenishment which was agreed in 1963 (with the first instalment not being due until late 1965), it was suggested that Part II countries make no contributions. This proposal was rejected by the US as being politically unsaleable. It was not until IDA-3 that the principle of Part II countries not making contributions to IDA, except in nominal amounts to maintain their voting rights under a complex arrangement, was accepted.<sup>4</sup>

Upto mid-1993, the donor countries had provided nearly eleven times as much money (by way of politically difficult budgetary provisions) to IDA as they had to the paid-in capital of the IBRD with far less leverage being exerted from IDA contributions. However, the funds provided by donors and the IBRD to IDA before 1980 are now beginning to revolve in increasing amounts. About SDR 2.5 billion (or 16%) of total commitment authority (of SDR 15.5 billion) under IDA-10 is being funded by IDA *reflows*. As time progresses, the proportion of commitment authority funded by reflows relative to new contributions might well increase quite rapidly from the present level of 16% to around 50% or more by the time of IDA-15 (i.e. by the year 2010) especially as commitment authority needs before then will be relieved by the graduation of some major recipients (e.g. China, India and

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4 At the time of its inception IDA's initial capital structure carried voting rights with each member being given 500 membership votes plus one vote for every US\$5,000 of subscription. Contributions under IDAs 1 and 2 did not carry voting rights. Because the proportions contributed by different donors were different to the pattern of their initial subscriptions, the relative voting power in IDA of nearly all Part I countries got out of kilter with their cumulative contributions. In IDA-3, this situation was corrected by having donor resources separated into two parts: *subscriptions* carrying voting rights and *contributions* without voting rights. For IDA-3 the *subscription* portion (and the votes it carries) for each Part I member was calculated so that the total proportion of its votes, excluding the 500 membership votes, to the total of all Part I votes would equal: its proportionate share of total resources contributed under the 1960 subscription, contributions to IDAs 1 and 2, supplementary contributions, and contributions under IDA-3. To maintain the relative voting power of Part II versus Part I in IDA, recipient members were required to also make subscriptions to maintain their voting positions but such subscriptions could be made entirely in local currencies. From IDA-4 onwards the same formula has been used to maintain relative voting power with some major relative voting adjustments within the Part I grouping; e.g. with a large increase in the voting rights of Japan, Saudi Arabia and Italy. Also many Part II members have now become donors and have not yet been reclassified as Part I countries. This factor, along with the rapidly improved economic position of many Part II countries relative to many Part I members is resulting in the Part I and Part II classification in the World Bank becoming increasingly obsolete for practical purposes. That division may now even be counterproductive in discouraging many former Part II members from contributing as much to IDA and to IBRD capital as they otherwise might if their relative standing in the institution were to be significantly improved.

Pakistan) from IDA. This has already happened in the case of the Fund for Special Operations (FSO) in the IDB.

The foregoing paragraphs suggest that the World Bank's efforts to mobilise public resources through IDA have succeeded well beyond what might reasonably have been anticipated. However, such resource mobilisation has, expectedly, resulted in virtually no leverage being exerted in the same way that contributions to IBRD capital have; i.e. by making possible a much larger volume of market borrowings on the strength of the contingent guarantee of callable capital. The only multiplier effect is through reflows. Yet, IDA resources have permitted the World Bank to do far more in terms of the *net transfer function* than it would have been able to had its resources been confined to market borrowings alone. Indeed, IDA has made it possible for the World Bank to remain a *world* bank rather than being reduced to being largely a Latin America and Asia bank. To paraphrase a memorable advertisement, IDA resources have permitted the World Bank to "reach parts that its other resources simply could not reach".

In theory and principle, raising IDA resources should be a simple affair; in practice it is anything but. It usually involves convening a series of periodic meetings of senior officials (known quaintly as the *IDA Deputies*) from donor government aid ministries or treasuries to pledge new resources to the next replenishment based on some increment or occasionally, unfortunately, a *decrement* to that country's IDA's contribution in the previous replenishment. These meetings need considerable preparation both on the part of the World Bank and of donor governments. They incur a level of visible and invisible expenditure which is becoming increasingly difficult to justify. Combined with similar meetings for replenishment of other MDFs and GCIs for MDBs, they require a relentless cycle of 4-5 meetings a year in various parts of the world, imposing heavy burdens on the administrative capacities of donors which are invariably concentrated in a few officials being responsible for oversight of multilateral organisations. Whether this arrangement results in an effective system of governance over MDFs is open to argument.

IDA funding also raises a host of other issues some of which overlap with matters concerning the IBRD. The main issues which have arisen include: (i) disruptions caused by particular donors, in either replenishing IDA resources or in meeting their committed obligations, which have had adverse effects on levels of annual commitment authority – e.g. as happened with the US in IDA-2 and IDA-6; (ii) differing rates of drawdown from donors when their specific budgetary problems have made it difficult for them to meet drawdown schedules on a strictly pro-rata basis with other donors; (iii) the need for IDA liquidity and its impact on the rate of drawdown and on the need for investment income; (iv) the level of service charges and commitment charges required to ensure that IDA covers its operating costs; (v) cost-sharing arrange-

ments between IDA and IBRD; (vi) the net income surpluses that need to be generated by IDA; (vii) the use of IDA reflows for new commitments versus other purposes; (viii) the size of contribution by the IBRD to IDA from its annual net income; and (ix) the increasingly influential role that IDA Deputies have begun to play in determining overall World Bank lending priorities and policies in the course of replenishment negotiations thus detracting from the role and powers of the Executive Board. It would be impossible to do full justice to an exploration of all these issues in the context of a book on the financial policies of the MDBs. Some issues are mainly of a financial nature and are taken up further in this and other chapters. Others are not. They involve political and operational considerations which are beyond the scope of this book; they have been discussed at length in other volumes and writings.

IDA has its equivalents in all the regional MDBs except (as yet) the EBRD. Its regional counterparts are discussed briefly below. They share many of the same features and characteristics as IDA, and raise many of the same issues although there are some important differences as the following sections will reveal. In addition to IDA, the World Bank manages a plethora of special grant programmes, trust funds, and concessional facilities (including for example the GEF) which are too numerous to list individually. In FY94, there were about 1,800 active trust fund projects under management with total disbursements from these various disparate funds amounting to over US\$660 million; *Bank-executed* programmes accounted for about one-third of that amount.

### *The African Development Fund (AfDF)*

The AfDF was set up in 1972 with contributions from non-regional donors who were, interestingly enough, not yet involved in the membership of the core AfDB. Hence, unlike IDA, AfDF's membership was quite different to the original core membership of the AfDB. It remained so until 1982 when non-regional countries were finally invited to become members of the core institution. The initial capital contribution to AfDF was about US\$240 million of which US\$4.6 million was contributed by the AfDB itself with the remainder being contributed entirely by 26 non-regional donors. This initial contribution was supplemented by a further US\$58 million from 12 of the same donors and the AfDB resulting in a total capital base of nearly US\$300 million prior to the first replenishment. AfDF has since been replenished six times. Negotiations for AfDF-7 are just about to be concluded. The cumulative resources raised by AfDF upto the end of 1993 amounted to UA/SDR 7.74 billion (US\$10.6 billion) of which UA/SDR 6.6 billion (US\$9.1 billion) had been made available for commitment. The AfDB's share of this cumulative total is UA/SDR 111.74 million or roughly 1.4%

(compared to IBRD's contribution of nearly 4.2% to IDA's total resources).

The first three replenishments of AfDF which took place between 1975-81 resulted in total contributions of UA/SDR 1.9 billion. The next three replenishments between 1984-90 saw a three-fold increase in that amount with aggregate contributions under AfDFs 4-6 totalling UA/SDR 5.6 billion. In AfDF-7, management had first aimed at raising UA/SDR 4 billion. It later moderated that target to UA/SDR 3.5 billion. But AfDF-7 is likely to be concluded at a level of UA/SDR 2.8 billion; with a decline in real terms over the resources provided under AfDF-6 (UA/SDR 2.2 billion). This outcome is distressing as AfDF-7 resources will be grossly inadequate in terms of AfDF's needs and the additional burden of providing some debt relief (similar to IDA's Fifth Dimension) for refinancing extant AfDB amortizations with AfDF funds. Of the original 27 donors which contributed to AfDF, four dropped out under AfDF-6. These included the AfDB itself (because its net income position had become too fragile to sustain further transfers to AfDF), Argentina, the United Arab Emirates and Yugoslavia.

Even with the substantial increases in resources provided by donors to the AfDF since 1984, its role as a concessional multilateral financier for Africa remains peripheral to that of IDA. For example, in FY94, IDA's total commitments to sub-Saharan Africa amounted to US\$2.7 billion through 57 credits to 27 African countries. This was three times higher than the US\$894 million committed by the AfDF in 1993 through 41 credits (and 62 grants for technical assistance) to 25 countries. In terms of disbursements, whereas IDA disbursed nearly US\$2.3 billion to sub-Saharan countries, the AfDF disbursed just over US\$700 million to all of continental Africa. Perhaps no occurrence demonstrates the inter-linkage between donor contributions to IDA and AfDF as the current round of negotiations for AfDF-7. It has become painfully apparent that donor generosity with IDA-10 may perhaps have been overdone, at a time when budgetary pressures did not seem as acute, at the probable cost of underfunding AfDF-7 when severe budgetary pressures in donor countries (especially in the European ones) are making themselves felt with particular force.

Like IDA credits which are provided on nearly uniform terms, the terms of AfDF loans vary only slightly. AfDF loans are generally extended for terms of 50 years, with a 10-year grace period and back-loaded amortizations. AfDF loans are amortised at an annual rate of 1% between years 11-20 and at 3% thereafter for 40 year loans, and 2.25% per annum for 50 year loans. These loans carry a service charge of 0.75% per annum on amounts disbursed and outstanding with no commitment charges being applied. Lines of credit from AfDF to national development banks of recipient members, however, have a maturity of 20 years and a grace period of 5 years but carry the same service charge.

Five per cent of the resources available under AfDFs 3 and 4, and ten per cent of those available under AfDFs 5 and 6, have been allocated to a Technical Assistance (TA) Account. Resources for TA from AfDFs 3-4 have been provided to recipients as 50 year loans with 10 years grace and no service charge applied, while those from AfDF 5-6 have been provided as outright grants.<sup>5</sup>

The AfDB also has a small accompanying concessional Fund – the *Nigeria Trust Fund* (NTF) – which was set up in 1976 with an initial capital base of Naira 50 million, paid in two equal instalments made in fully convertible currencies. In dollar terms these two instalments together totalled US\$79.5 million. The NTF was replenished once in 1981 with a further Naira 50 million payable in three instalments which, by the time they had been fully paid in 1985 amounted to an equivalent of US\$70.2 million. Through prudent investment and accumulated net income surpluses of over UA156 million (after a negative currency translation adjustment of nearly UA79 million), the level of overall resources of the NTF amounted to almost UA300 million at the end of 1993. Loans from the NTF are denominated and repayable in UA; they are made from the interest earnings on the capital corpus of the NTF. They have a maturity of 25 years with 5 years grace on principal repayments with an interest rate of 4% on disbursed and outstanding balances and a 0.75% commitment fee on undisbursed amounts. The AfDB also administers three other small, special purpose Trust Funds; their combined resources amounted to UA18.04 million at the end of 1993.

The processes behind AfDF's resource mobilisation, operations and administration raise issues which are identical to those which arise in the case of IDA. In addition to these issues, perhaps the greater preoccupation on the part of AfDF *State Participants* (i.e. the equivalent of *IDA Deputies*) during AfDF-7 negotiations have focused as much on issues concerning AfDB, as on those concerning AfDF. They included: (i) management of the AfDB and its apparent unpredictability and instability during 1994; (ii) the deteriorating portfolio of AfDB and AfDF resulting in shortfalls of income as a result of non-accruals accompanied by unprecedentedly large provisions against possible loan losses which are affecting the net income positions of both these institutions; (iii) the inadequacy of financial policies and controls; (iv) inappropriate cost-sharing of administrative expenses between AfDF and AfDB; (v) the lack of control over administrative expenses incurred by senior

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5 When the AfDF grants loans for the preparation of pre-investment studies which determine that the project is unviable then the grace period is extended to 45 years with repayment of the TA loan being required between years 46-50. The same is true for TA loans granted to strengthen regional cooperation arrangements or regional institutions and such TA is not specifically aimed at projects or programmes.

management and the Executive Board; (vi) country eligibility, country performance and resource allocation criteria; (vii) the need for an internal debt relief mechanism; (viii) support for micro-enterprises in Africa; and (ix) sectoral and other operational priorities in the use of AfDF funds. As in the case of IDA above, some of these issues will resonate again in later chapters while others, which are of a political and operational nature will not be dealt with in this book.

### *The Asian Development Fund (AsDF)*

AsDF was established in 1974 with an initial (AsDF-1) capitalisation of US\$525 million. Since then AsDF's resources have been replenished five times with the last replenishment (AsDF-6) being agreed at a level US\$4.2 billion in late 1991. Unlike the regular triennial IDA replenishments, the intervals between AsDF replenishments have varied between one year between AsDFs 1 and 2, to almost six years between AsDFs 5 and 6. This has occurred largely because of: (a) variations in the anticipated growth of AsDF's annual commitment levels; and (b) favourable exchange rate movements which have stretched AsDF's commitment authority unexpectedly. The cumulative resources raised by AsDF upto the end of 1993 amounted to over US\$14.5 billion in *negotiated* terms. With Japan being by far the largest contributor to the AsDF (accounting for over 51% of cumulative contributions at the end of 1993) the sustained appreciation of the JPY against other currencies has resulted in the USD value of these resources having increased by about US\$1 billion. Of the cumulative amount negotiated by way of donor pledges, a total of US\$14.4 billion equivalent has already been contributed by donors.<sup>6</sup> In addition, the AsDF had accumulated a surplus of nearly US\$809 million by the end of 1993.

AsDF resources were contributed by only 13 countries in its initial capitalisation. Five of these countries provided contributions which were *tied* to expenditures on procurement from them. When AsDF-6 was agreed, the number of contributors had increased to 21 with some former borrowing members of the AsDB having become donors to AsDF (Korea, Nauru and Taiwan).<sup>7</sup> The three developed regional members (Australia, Japan and New Zealand) contributed 44.5% of total AsDF-6 resources. The largest single recipient of IDA – India – is excluded from access to AsDF as is China. Although AsDF resources have been disbursed to 25 countries throughout the Asian region, the South Pacific sub-region contains ten AsDF recipient

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6 The US dollar value of these contributions was actually US\$15.1 billion at the end of 1993.

7 Indonesia was a contributor to AsDF-V.

countries. Six recipients – Bangladesh, Indonesia, Nepal, Pakistan, the Philippines and Sri Lanka – accounted for 87% of the cumulative AsDF resources disbursed and outstanding upto end-1993.

The resources made available to the *African* Fund (AfDF), compare unfavourably with those available to IDA thus preventing the AfDF from playing as prominent a role as IDA in its own region. AfDF is clearly unable to do as much for Africa as IDA is. By contrast, the *Asian* Fund's (AsDF's) resources appear on the surface to be *less* constrained than IDA's. Part of the reason for this impression, of course, lies in the absence of access to AsDF resources for China and India. The internal rationing process thus permits AsDF to lend to certain blend countries which IDA no longer lends to on eligibility grounds (e.g. Indonesia, the Philippines and Papua New Guinea). Nevertheless IDA's operations in Asia are still larger than those of AsDF, although AsDF lending to countries other than India and China is as significant as, or even larger than, IDA lending to these countries. For example, in 1993, total IDA lending to Asia amounted to US\$3.44 billion equivalent. However, excluding its lending to India and China, (of US\$2.55 billion), IDA's lending to the rest of Asia amounted to US\$890 million compared to the AsDF's US\$1.3 billion giving AfDF a much more prominent profile among its poorer Asian clientele (other than China and India) vis-à-vis IDA than the AfDF could possibly hope to have in Africa. In FY94, IDA's lending to Asian countries other than India and China, increased to US\$1.54 billion, but most of this amount went to Vietnam, Bangladesh and Pakistan with very little by way of allocations to the smaller Asian countries. Providing sufficient commitment authority is available to AsDF, it is likely that AsDF will again in 1994 play as prominent a role in the smaller, poorer countries of Asia as IDA.

Although Asia is generally regarded as the most rapidly developing region in the Third World, the need for AsDF resources, somewhat paradoxically, is likely to rise in the intermediate term. The reason is that several very poor Asian countries, to which the AsDF has not been able to lend over the past five years, have, since the demise of the Cold War, become prospectively active borrowers again. These include the three countries in Indo-China (Cambodia, Laos and Vietnam); Myanmar which is gradually coming out of isolation; Afghanistan whose internal conflicts appear to be subsiding; and three of the newly independent Asian republics of the former Soviet Union – Kazakhstan, Kyrgyzstan and Uzbekistan – which were admitted to the membership of the AsDB in 1993 and whose concessional resource needs for development are likely to be significant. Thus eight more recipients are likely to press their claims on the AsDF for scarce resources which need to be mobilised at a time when the propensity and ability of traditional donors to provide such resources is apparently declining.

AsDF-6 was intended to finance concessional resource commitments for the four-year period 1992-95. Negotiations for AsDF-7 will begin around the end of 1994 or in early 1995.<sup>8</sup> However, the US has been more than usually dilatory in making its *pro-rata* contributions to AsDF-6<sup>9</sup> resulting in the possibility of other donors also slowing down the rate at which their contributed resources can be used by AsDF. With the changes in commitment authority caused by exchange rate movements and by policies affecting its cumulative lending limitation and its *headroom*, the AsDF's commitment authority at the end of 1993 was only US\$720 million compared to the US\$1.15 billion that it should have been if all donor contributions had been released on time.

The concerns expressed by donor representatives during negotiations for AsDF-6 were generally similar to those discussed under IDA-10 and AfDF-6 negotiations although in the case of the AfDF many donor concerns were more institution-specific. AsDF donors emphasised the following priorities for lending operations: direct poverty reduction projects and programmes; the promotion of growth-oriented policies; environmental protection; a concern for the role of women in development; and population control through effective, incentive based approaches. Other issues raised by the donors during negotiations concerned: the AsDB's operational policies; strategic planning; criteria for allocating AsDF resources; project quality; private sector promotion; and the Bank's organisation and staffing.

AsDF lending terms were reviewed when IDA terms were changed in 1987. As a result of that review, the terms for *AsDF only* countries remained unchanged while maturities for blend countries were reduced from 40 to 35 years.<sup>10</sup> In addition to AsDF, the AsDB administers two other concessional funds: (i) the Technical Assistance Special Fund (TASF); and (ii) the Japan Special Fund (JSF). TASF was established in 1967 to provide technical

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8 The AsDB concluded negotiations for GCI-4 in mid-1994. Gearing up for AsDF-7 immediately thereafter will strain donors.

9 The US should have made a qualified contribution of its first tranche (US\$170 million) under AsDF-6 before end-1992. It could not do so because Congress had not passed the necessary legislation. As a result the contribution of 2nd tranches by other donors was delayed. The US eventually made a partial 1st tranche contribution (US\$75 million) at the end of 1993 when most other donors had already made their 2nd, and some their 3rd, tranche contributions. Under the *pro-rata* rules which apply to all soft-window resources, this meant that other donors could require the AsDB not to use the full amount of their 2nd and 3rd tranches but use only that proportion (44%) which was equal to the proportion of the first tranche which the US had released.

10 Standard AsDF loans carry an annual service charge of 1%, have a maturity of 40 years with a grace period of 10 years and have back-loaded repayments (2% from years 11-20 and 4% from years 21-40). AsDF maturities for *blend* countries were reduced to 35 years in 1987 with the same service charge and grace period, and with back-loading being moderated to repayments of 2.5% for years 11-20 and 5% for years 21-35.

assistance on a grant basis to the AsDB's borrowing members.<sup>11</sup> It is funded by: direct voluntary contributions by members; allocations from ordinary capital resources; earmarked allocations from AsDF replenishments; income from investments and other sources. At the end of 1993, a total of US\$427.5 million had been provided to TASF (including an allocation of US\$140 million under AsDF-6) of which a cumulative US\$295 million had been utilised.

JSF was established in 1988 when Japan agreed to fund the JSF under AsDB's administration with the specific purpose of "helping developing member economies to restructure their economies and broaden the scope of opportunities for new investments, thereby assisting the recycling of funds to these economies". JSF resources are primarily for technical assistance grants although they can also be used for equity investments. The cumulative amount committed by Japan (through both regular and supplemental contributions)<sup>12</sup> between 1988-93 amounted to ¥43.36 billion (or about US\$376.7 million). Of this amount, about US\$110 million had been utilised by the end of 1993, mainly for technical assistance (US\$108.4 million) and for one equity investment in India.

### *The IDB's Fund for Special Operations (FSO)*

Established in 1960, the FSO had mobilised cumulative resources of about US\$10.2 billion by the middle of 1994 when GIR-8 was concluded. This amount comprises US\$9.65 billion in quota contributions from all members, its accumulated general reserve (US\$534.5 million), and technical cooperation contributions (US\$14.65 million). Among the MDB soft windows, FSO is unique in that it was created as a built-in feature in the constitution of the IDB. Therefore it does not have a separate charter (Articles of Agreement) nor is its juridical personality distinct from the IDB. FSO has been replenished eight times since 1960, with a special replenishment in 1976 designed to accommodate the entry of non-regional countries into the IDB's membership. Unlike the other MDBs, and because it is an integral part of the IDB, the resources of FSO have been replenished in the same unified negotiations and at the same time as the ordinary capital resources of the IDB have been increased (i.e. as an integral part of the

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11 When technical assistance funded by TASF leads to an AsDB loan, the amount of the grant exceeding US\$250,000 is refinanced under the loan thus resulting in some refunding of TASF.

12 Supplemental contributions to JSF amount to ¥5.36 billion (US\$48 million) and are to be used for the following purposes: symposia and training activities; gender issue related activities; environment related activities; and specific programmes aimed at promoting the private sector.

GIRs).<sup>13</sup> As with the AsDB this has resulted in a somewhat irregular replenishments occurring at intervals ranging from 2 years between GIRs 1 and 2, to 7 years between GIRs 6 and 7.

The amount of FSO contributions peaked with GIR-5 in 1980 when the FSO received contributions of US\$1.76 billion.<sup>14</sup> They fell sharply thereafter to US\$705 million in GIR-6 and to an abysmally low US\$200 million in GIR-7 before rising again to US\$1 billion in GIR-8. The experience of FSO may be a precursor for all the MDB soft-loan windows. Donor contributions are likely to fall sharply once the corpus of these revolving funds is perceived by donors to have reached a self-sustaining critical mass with reflows becoming the main support for future annual commitment levels to meet aggregate recipient needs under each of the MDFs. It is a matter of debate as to whether the level of funding for all MDFs might not already have peaked (in real terms) with the IDA-10 replenishment and whether the only real issue now concerns the gradient of the downward slope for future MDF replenishments. However, it would be unfortunate if these other soft-loan windows witnessed as precipitate a decline in their future replenishment levels as did the FSO upto GIR-7 before its fortunes were reversed. Obviously, if Cuba becomes a member of the IDB in the foreseeable future, and if Haiti's travails are overcome sufficiently for development investment to resume, donors may have to review the adequacy of even their recently increased support for FSO.

Unlike IDA, AfDF and AsDF which tend to employ standard terms for their loans and credits with slight modifications to reduce concessionality for blend countries, the FSO makes its loans on more widely variable terms. Depending on the development status of the recipient country and the nature of the project being financed, FSO's loans carry interest rates of between 1-4%, with an additional commitment charge of 0.5% on undisbursed balances, maturities of between 25-40 years and grace periods varying between 4-10 years. For the less developed of IDB's borrowing members the interest charge levied is 1% for the first 10 years and 2% for the remainder of the maturity period. The IDB also applies a one-time service fee of 1% of the FSO (or OCR) loan amount for inspection and supervision. Contrary to the view espoused by the managements of the other MDBs that, permitting wide

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13 See Culpeper, R., "The Regional Development Banks: Exploiting their Specificity" in the Volume containing the Staff Report and Background Papers prepared for the Bretton Woods Commission, Washington DC, July 1994.

14 The three regular (and one special) replenishments of FSO between 1967-1980 (i.e. GIRs 3-4) varied between US\$1.2 to 1.76 billion and averaged around US\$1.52 billion. The original capital and the first four replenishments of FSO resources required donors to meet MoV obligations whilst the last three did not have any MoV requirements.

variability in terms of IBRD/AsDB loans and IDA/AsDF credits would lead to intractable problems for managements and staff in convincing borrowing members of the fairness and impartiality of their judgements, the IDB apparently has had no significant problems in this connection. Also, whereas the other MDBs choose not to differentiate the terms of their lending by the type of project being financed, the IDB does.

Given the sharp reductions in donor contributions to FSO under GIRs 6-7, *FSO reflows* now constitute the main resource for supporting continued annual commitment levels. Reflows first emerged as an internal source of funds for supporting annual FSO lending levels under GIR-4 in 1975. From less than US\$40 million annually then, reflows now average between US\$300-400 million annually and support between 65-75% of FSO's annual lending. The relative importance of reflows is even greater given that they are net of the one-time inclusion of principal repayments projected to become available in the four-year period immediately following the end of the GIR-7 programme period.<sup>15</sup> The substantial dependence of the FSO on reflows to finance new commitments to this extent of course increases its vulnerability to disruptions caused by any delays in the receipt of repayments of FSO loans due. Were such reflows to be seriously affected by prolonged interruptions in repayment the cash-flow consequences would pose serious difficulties for FSO in meeting its contractual obligations for future disbursements against loans already committed.

The FSO has another burden to bear which the soft-loan windows of the other MDBs do not have. Since 1983, when the IDB's Intermediate Financing Facility (IFF)<sup>16</sup> was created, it has depended heavily on transfers of FSO net income for funding the interest subsidy element of the IFF. Total FSO commitments to IFF amounted to nearly US\$700 million at the end of 1993 of which US\$216 million has already been transferred. A further US\$484 million has to be transferred out of future FSO net income requiring transfers of US\$15.5 million annually between 1994-96, US\$23.5 million annually between 1997-2001, and US\$30 million thereafter upto 2010. These amounts are, of course, subject to adjustment depending on the status of FSO's net income.

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15 IDB Board Document No FN-461 dated 30 August 1991 on "Review of the Financial Status of the FSO and proposed modifications in FSO encashment procedures" (paras 2.10-2.12).

16 The IFF was created by the IDB Board of Governors to subsidise the interest cost of the IDB's OCR loans to certain eligible borrowing members. IFF also receives transfers from OCR net income (US\$35 million from 1991 net income) and can receive contributions from member countries. At the end of 1993, the total assets of the IFF amounted to US\$326.5 million kept almost entirely in the form of liquid investments in bank deposits and treasury instruments of various developed country member governments.

Under GIRs 7 and 8, the priorities emphasised by donors were more or less similar to those negotiated in the MDF replenishments and GCIs of other MDBs which were taking place at the same time. Operationally these placed emphasis on: the IDB's more prominent role in policy-based lending for both structural and sectoral adjustment; an emphasis on lower-income countries as beneficiaries; environmental concerns; the role of women-in development; support for micro entrepreneurs; allocation criteria; and technical assistance programme priorities.

As with the other regional banks, the IDB now manages a plethora of smaller trust funds, in addition to the FSO and IFF which are aimed mainly at financing small loans, as well as technical assistance and cooperation activities. The three largest of these are the Social Progress Trust Fund (SPTF), the Venezuela Trust Fund (VTF) and the Japan Special Fund (JSF). Smaller funds administered by the IDB include various bilaterally supported funds, the European Union Fund, and a plurilateral Technical Cooperation Trust Funds Program to which ten non-regional members and the EU have contributed a total of US\$20 million. SPTF was set up by the US in 1961 with an initial contribution of US\$525 million, of which about US\$184 million had been returned to the US by the end of 1993. VTF was set up in 1975 with total contributions of over US\$400 million by Venezuela; its resources were augmented by nearly US\$600 million in accumulated earnings on resources provided and invested. Of these amounts which have been on-lent and repaid by IDB's borrowers, over US\$727 million has been repaid to the Venezuelan Investment Fund. JSF comprised two contributions by Japan totalling ¥16.5 billion (US\$150 million) to finance non-reimbursable technical assistance for project preparation, small projects, emergency assistance and analysis of environmental problems.

### ***Special Funds administered by the EBRD***

The EBRD does not have any soft-loan window similar to those of the other MDBs, although its Articles provide for the creation of *Special Funds* (Article 19) which have to be distinguished and managed distinctly from its ordinary capital resources. At present it is thought unlikely that its donor shareholders would be willing to consider setting up a similar window in the EBRD to disburse large volumes of concessional resources to the EBRD's borrowing members. What is more likely is that the EBRD will be urged to set up a number of small special purpose funds which are highly focused and targeted at achieving specific objectives rather than being broadly aimed at enabling it to lend to the poorer countries among its clientele. At the end of 1993, EBRD was administering four small Special Funds: (i) the Baltic Investment Special Fund (ISF); (ii) the Baltic Technical Assistance Special

Fund (TASF); (iii) the Russia Small Business Investment Special Fund (SBISF) and (iv) the Russia Small Business Technical Cooperation Special Fund (SBTCSF).

The two **Baltic Funds** were set up in 1992 with contributions from the five Nordic countries (Denmark, Finland, Iceland, Norway and Sweden) totalling ECU 60 million for the ISF and ECU 5 million for the TASF. These two funds are open-ended. With targeted equity investments and technical assistance, they are aimed at facilitating the emergence of market economies through the development of *private* small and medium-scale enterprises in Estonia, Latvia and Lithuania. At the end of 1993, the EBRD had made share investments totalling ECU 1.5 million from the ISF and had disbursed ECU 2.64 million from the TASF.

The two **Russia** funds – SBISF and SBTCSF – were set up by the EBRD itself under Article 18 of its Basic Agreement in late 1993 and have yet to be fully funded. As of the end of 1993, the SBISF had attracted resources of only ECU1.48 million from Germany, Italy and Japan with no operations having yet been undertaken. The associated SBTCSF was set up in tandem at the same time and had attracted resources of just under ECU1 million (again from the same three donor countries) with no disbursements having been made by the end of 1993.

At the urging of the G-7 countries, the EBRD also set up the **Nuclear Safety Account (NSA)** in March 1993 aimed at enabling countries in Eastern Europe and FSU to improve safety in their nuclear power plants. The NSA had received pledges of ECU 104 million from thirteen countries at the end of 1993 but none had actually made their contributions available by then.

### ***Common Issues Raised by MDB Soft Loan Windows***

As noted in the paragraph relating to IDA, the MDF replenishments raise a host of common issues, some of which are explored briefly below.

#### ***Burden-Sharing***

All soft window replenishments are funded by donors on the notional principle of *fair burden-sharing*. Most donors usually aim to maintain their shares in previous replenishments while allowing for minor adjustments in succeeding replenishments to accommodate both the entry of new donors and changes in the *relative* economic circumstances of all donors. Of course what is seen to be a *fair share* of any donor in any MDF replenishment is a matter less of objective analysis (although donors invariably ask for such analysis based on various economic indicators to be carried out for each replenishment exercise) than of political bargaining among donors. Such

bargaining usually occurs within parameters which are bounded by considerations concerning their relative shareholding and voting power in the MDB whose soft-window replenishment is being negotiated. Requests by any donor for a downward adjustment of its share are usually resisted by other donors since that would mean their having to pay a larger share. Nevertheless, significant adjustments in the share of major donors have taken place over time. For example, the US' share in IDA has fallen from 42% in IDA's original capitalisation to just under 21% in IDA-10 while Japan's share has increased from 4% to 19%. Similarly the share of the UK in IDA has fallen from 17% to around 6% over the same period while Germany's share increased from 7% to 13% before falling back to 11%. During the 1970s Saudi Arabia, Kuwait and the United Arab Emirates countries took up fairly large shares of IDA-5 and IDA-6 but their shares have declined dramatically since then. These adjustments, which are also reflected in the replenishment of other soft-windows, have broadly reflected relative changes in the GNP shares and the external accounts of these donors in the world (or regional) economy.

The burden-sharing issue has bedevilled soft-window replenishment negotiations on many occasions. Some replenishments (e.g. IDA-7) have been negotiated at levels substantially below what might have been possible had the donor community as a whole been willing to accept reductions in the share of some donors, most especially the US and the UK. The changed nature of the aid constituency in the US since the Vietnam War, its protracted legislative processes for authorisation and appropriation of contributions to MDBs, and the disinclination of successive US Administrations to expend scarce domestic political capital on the MDBs, which do not win them any domestic votes, has resulted in the US having major problems with contributing an appropriate share to MDB soft-windows and paying-in its contributions on time (see below). In the context of strict burden-sharing rules being applied that feature has become a fundamental structural weakness in the processes of soft-window funding.

It must be acknowledged however that, on occasion, some large European donors have somewhat ingenuously used this characteristic to use the US as an excuse for reducing their own overall budgetary contributions (though not necessarily their shares) to MDB soft-windows while letting the US absorb the opprobrium for failed (i.e. smaller-than-would-have-been-possible) MDF replenishments. On other occasions, other smaller donors (e.g. the Nordic countries) and Japan have done the opposite. They have made *special contributions* over and above their proper shares based on burden-sharing to utilise fully their budgetary appropriations for multilateral aid. Such contributions have been made separately from their regular contributions in order to avoid locking themselves in for a higher share in the next replenishment. In the case

of IDA-7, for example, the US was unwilling to contribute an amount which, under normal burden-sharing, would have permitted an adequate replenishment. Consequently, other donors set up a large Special Fund (in which Nordic participation and inspiration was particularly strong) to accompany IDA-7. On the other hand, the US has been unwilling to reduce its share in the AsDB; the limitations on its contributions to AsDF therefore constitute a binding constraint on the size of AsDF replenishments.

The way in which the burden-sharing rules have been applied, and the absence of linkage between MDF contributions (which are far more expensive from a budgetary viewpoint than contributions to MDB capital) and *effective* voting power in the MDBs themselves has made it unattractive for some new donors (e.g. Singapore, Taiwan) to contribute as much to MDF replenishments as they could certainly afford while inducing other developing country donors to make token contributions (e.g. Brazil, Colombia, Korea, Mexico, and the former Yugoslavia in IDA; Indonesia, Korea and Nauru in the AsDF; Argentina, Brazil, China, India, Korea, and Yugoslavia in the AfDF).

The principle of burden-sharing has ostensibly provided a disciplined framework of rules within which MDF replenishments are negotiated. But there is a case for believing that some (large European) donors may have been too rigid in attempting to apply that framework – to the possible detriment of MDF replenishments and more so to their recipients. Their actions have been guided by the belief that without such discipline the US would have done even less than it has been inclined to. The US clearly has a particular problem in engendering broad-based political and popular support for multilateral commitments for development financing and now even for its own bilateral aid commitments. European donors, Japan and other donors have not yet had quite the same domestic political problems in funding development assistance. But, with growing (although somewhat ill-judged and unfair) perceptions of the failure of aid<sup>17</sup> these political problems now seem to be growing in other countries as well. On the other hand the US takes on a larger share of the financial burden than other donors in *global systems maintenance*; it spends commensurately more than other countries on global security, its market for goods has generally been much more open to imports from developing countries than those of Europe and Japan; and its labour market has been more open to unskilled immigration (legal and illegal) from developing countries in general but Latin American and Caribbean

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17 Public perceptions of aid failure have strengthened with the apparent failure of (and NGO opposition to) structural adjustment programmes in Africa and the more general and increasingly effective opposition of some special-interest lobbies (especially the environmental lobby) to multilateral institutions in general and the World Bank in particular.

countries in particular.<sup>18</sup> Last, but not least, it cannot be forgotten that the present multilateral edifice for development cooperation is based on the global vision, far-sightedness, generosity and financial support of the US in earlier halcyon days when those attributes were in abundance in a United States that was a much more confident and dominant leader of the global community than it is now. If cumulative contributions are measured in *real* rather than nominal dollars then the past contributions of the US (and by the same token those of the UK) have to be given somewhat greater weight in the reckoning of cumulative burden-sharing upto now than they actually have been.

For all these reasons, while the burden-sharing framework must continue to be applied in negotiating MDF replenishments, it must be applied with sufficient imagination, flexibility and accommodation to acknowledge circumstantial realities without damaging the size of replenishments. Most donors would argue that such flexibility is already present; but that would be a difficult argument to sustain in convincing those intimately involved with replenishment negotiation exercises. In particular, what seems clear is that the way in which the established donor community applies burden-sharing concepts, and de-links soft-window contributions from effective voting power in the core MDBs, provides no particular incentive for new donors like Singapore and Taiwan to emerge and play a prominent role in financing concessional development assistance although they could well afford to.

### *Pro Rata Note Deposits and Drawdowns*

Connected to the burden-sharing principle is the issue of *pro-rata note deposits* and *drawdowns* of donor contributions. The business of MDB managements negotiating instalment payments and drawdowns with donors has now become quite complex; replete with technicalities whose intricacy of detail is mind-bending although not of immediate concern here. In essence the idea behind the issue is quite simple. Whereas soft-window replenishments are negotiated every three years or so (the intervals have been different and variable for different MDB funds) the *commitments* made annually against donor pledges over the replenishment period are actually *disbursed* over a period of 10-12 years. MDB managements cannot prudently make commitments against negotiated pledges until they know that donors have legally obligated themselves (i.e. they have obtained all the due parliamentary and administrative approvals which their internal governmental processes require) to make their pledged funds available in cash to the MDB soft-

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<sup>18</sup> This thought is not an original one. The author owes it to Professor John Lewis of Princeton University.

window. Such legal obligations are expressed and conveyed in the form of *instruments* (effectively promissory notes) which convey a binding and irrevocable commitment on the part of the donor to pay to the MDB soft-window all or part of its pledged contribution. Since approval has to go through the normal annual budgetary process in each donor country, most donors prefer their contributions to be divided into three or four annual *instalments or tranches* of notes which are then deposited with the MDBs concerned. It is important to appreciate that these instalments are not made in the form of *cash* but in the form of *notes* which can be drawn down upon over a much longer period of time as funds are required to meet disbursement and liquidity requirements.

This process is conditioned by *pro rata* rules which require the MDBs to ask donors for deposits of instruments on a basis which reflect the proportionate shares of donors in the replenishment. In other words, donors have the right to reduce the size of their note deposits or to restrict the amount of their deposits which Management can use for the purposes of commitment authority, to the same level as any other donor which has so far released less than its proper share. This right usually results in a 'lowest common denominator' approach to the management of soft-window commitment authority. It has been sought by other donors in response to the continual lateness of the US in making its deposits of instruments available to MDBs and often depositing notes for less than the agreed instalment amount.<sup>19</sup> This happens now almost a matter of course for each instalment of each MDF replenishment with the US Congress failing to appropriate the amount requested by the Administration to honour its multilateral commitments. Given the separation of powers between the *legislative* and the *executive* branches of government in the US, the Congress often employs such tactics

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19 To explain the situation it is perhaps best to quote paragraph 65 of the draft Report and Resolution on IDA-10 (Board Document No IDA/R92-168) dated December 23, 1992. That paragraph conveys a sense of the problem that applies to all the MDBs as far as the US is concerned: "Donor contributions to soft-window replenishments are usually made in three or four equal tranches to support annual commitment authority. The practice of the US is to deposit a Qualified Instrument of Commitment to IDA with its payments being subject to annual legislative approvals. In view of the uncertainties attached to the US legislative schedule and the possibility of delays in receiving the US commitment, pro-rata release arrangements have been incorporated into the replenishment agreements since IDA 5. Under these provisions, other donors may exercise the right to reduce IDA's ability to commit against the second and third tranches of their authorised subscriptions and contributions on a pro-rata basis proportionate to any US shortfall." The same rights for other donors exist in the case of the other MDB soft-window replenishments as well (e.g. AsDB). Other donors are usually informed when there are delays or shortfalls in US tranches and are given thirty days after notification within which they can choose to adhere to their pro rata rights. If they do not respond within those 30 days their rights are assumed to have been waived. In the case of IDA most donors have waived these rights in order to avoid disrupting IDA's commitment authority.

in order to send a signal to the Administration about priorities or concerns which are often totally unrelated to the issue at hand. The susceptibility of Congress to powerful lobbying by single-issue interests often results in appropriation delays and cut-backs as do Congressional concerns on unrelated budgetary issues and priorities which are advanced by a peculiar process of bargaining between Congress and the Administration. What actually results is a disruption of MDB soft-window operations and considerable irritation throughout the donor community which believes it is bearing a larger than necessary share of the burden up-front, leading to other large donors insisting on having the right (even if they do not use it) to gear down their own deposit levels to proportionately the same levels as those of the US.

More often than not other donors choose to forego exercising their pro rata rights in order to avoid exacerbating disruptions in commitment authority caused by the US' delays. Some donors even offer to advance their own note deposits and sometimes (for budgetary reasons) permit earlier than necessary encashment of those deposits without insisting on pro rata rules. The US' larger cohorts in G-7 however have sometimes been less obliging, choosing to send a message to the US by leveraging down the release of their own contributions in the hope that the resulting disruption to the MDB soft-loan window will compel the US to accelerate the release of its deposits on the basis negotiated. In practice this almost never results, largely because the US Congress is relatively impervious to the views of other donors.

As with the burden sharing principles on which they are based, the pro-rata rules applied under all replenishments are generally sound in theory and intent. They work less effectively in practice. Instead of bringing about the necessary changes in behaviour on the part of a recalcitrant or a disabled donor what the application of such rules usually results in is damage to the MDB soft-window and to its recipients. That point has rarely been accepted by some donors more rigidly inclined in their thinking who believe that any dilution of such rules or laxity in their application would be unfair and who are disinclined to see the damage done to the institution and its recipients as a relevant issue.

The pro rata rules for note deposits and note encashment procedures, while fair in concept, are unwieldy and expensive to apply in practice. They do not achieve the intended result of fairness in encouraging sound behaviour on the part of donors. To the extent they are applied they only achieve a lowest common denominator type of balance in donor contributions which, by definition, damages the interests of recipients. It would be far better for donors to agree to simpler, if somewhat more arbitrary, formulae which would make their contributions more predictable in terms of their own budgetary procedures and make the flow of funds easier for MDB managements to handle. Such rules could be as simple as requiring all donors

to make three or four equal instalments of their replenishment contributions through the usual note deposits and to have each note encashed in equal or pre-tailored instalments (which can be front-loaded, back-loaded or bell-shaped) over a period of 6-8 years so that actual cash contributions were made over a period of 8-10 years.<sup>20</sup> MDFs could then manage the expansion or contraction of liquidity that might result from differences between profiles of pre-determined note encashment and actual disbursement (which they now do anyway).

### *Soft-Window Service Charges, Liquidity and Income Management*

The service charges which the MDFs levy are intended mainly to cover their costs in administering their concessional funds rather than to generate high levels of income. Depending on the concessional window concerned, these charges may include any combination of: a front-end processing fee; an annual service charge on disbursed and outstanding balances; a low or intermediate interest rate charge; and an annual commitment fee on undisbursed balances. Whereas the other MDFs provide their concessional resources on virtually similar terms, the FSO levies variable charges and terms over a much wider range depending on the country and project being financed. At different times for different funds, the income derived from charges applied has proven insufficient to cover costs<sup>21</sup> and income levels have had to be augmented through a change in either the levels of charges or the introduction of new charges. When income has been restored to adequate levels, these charges have been reviewed and reversed. In the FSO, where interest rates are also levied, the income generated is now becoming an important source of funding for future commitment authority.

### *MDF Liquidity*

Related to the issue of cost recovery, is the associated issue of maintaining sufficient *liquidity* in the accounts of soft-windows in order to: (i) meet

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20 In the case of IDA the subscription and contribution payment arrangements provide donors with considerable flexibility in phasing the payment of their contributions. Once made, contributions are drawn down in equal proportions (in terms of their unit of denomination) over an 8 year period. IDA's management consults with donors that experience unforeseen difficulties with meeting the encashment schedule and works out flexible arrangements which accommodate donor constraints as long as all encashments are fully made within a maximum of ten years.

21 In the case of AfDF and FSO too large a proportion of total MDB costs are being covered by the soft-window thus making the hard window appear to be artificially more profitable than it actually is and overloading the resources of the soft-window to finance administrative costs at the expense of depleting future commitment authority.

expanding disbursement requirements, especially when fast disbursing loans suddenly assume a higher profile in the operational mix of MDF loans as they have done since the mid-1980s in all the MDFs; (ii) generate investment income to supplement income earned through charges and thus reduce the overall cost burden on recipients; and (iii) in exceptional circumstances, to provide a cushion for protecting commitment authority from suffering an excessively sharp fall. In the past, donors took the view that, since concessional windows could meet disbursement requirements on call by encashing notes whenever needed, there was no case for maintaining more than nominal liquid balances in the accounts of the soft windows. Donors were reluctant to make cash payments (which inflated their own domestic borrowing requirements) to MDFs until absolutely necessary and preferred to internalise the returns on liquidity rather than pass them on to the soft-loan windows. Since the late 1980s donors have taken a more relaxed view on the subject (at least with IDA and AsDB though not yet with AfDF) and have been willing to prefund encashment in advance of disbursement needs to permit a greater amount of liquidity to be held by the soft-windows themselves and to permit earnings generated by such liquidity to be used to keep service charges in check or to fund additional commitment authority. The liquidity maintained by IDA at the end of FY94 amounted to nearly US\$3.1 billion (against disbursement requirements of about US\$5.5 billion) while at the end of 1993 AsDF liquidity was about US\$725 million, that of FSO was about US\$2 billion and that of the AfDF was US\$400 million. In the past, liquidity levels amounting to nearly 60% of annual disbursements were regarded as excessively high with MDF liquidity actually averaging about 25% of annual disbursements upto the mid-1980s.

#### *Administrative Cost-Sharing between MDB Hard and Soft Windows*

As the MDFs are operated as separate funds rather than as separate institutions (e.g. like IFC) the issue arises of apportioning administrative costs for the MDB as a whole, between its hard and soft-windows, and of course across other special funds which it might be administering. In the case of IDA and the AsDB the apportionment is done on a basis which appears to bear some justifiable relationship to the relative portfolio sizes and the other identifiable costs of their hard and soft windows. In the case of the AfDF and IDB the basis of cost-sharing is more difficult to comprehend. Neither institution applies a cost accounting system of the same sophistication as the IBRD and AsDB although by best practice norms even the systems of the latter two MDBs are inadequate. The basis for apportionment in the AfDF and IDB is therefore more arbitrary and *political* with an unfairly high burden of cost being borne by the MDF with the MDB proper consequently

appearing to be more profitable than it actually is.<sup>22</sup> Also, the overloading of costs onto the soft window results in depleting donor provided cost-free funds and depriving potential recipients of scarce concessional resources. In both the IDB and AfDB the basis for cost apportionment was reviewed in 1994 and a new formula is to be adopted in future years to reflect a more appropriate division of administrative expenses.

### *Concessional Resource Eligibility & Allocation*

Among the more difficult issues which arise during soft-window replenishment negotiations are those that concern the criteria applied to: (a) determine the *eligibility* of recipient countries for access to concessional multilateral funds; and (b) determine the actual annual and cumulative *allocation* of concessional resources across eligible recipients under any given soft-window replenishment. Since concessional multilateral resources are, by their very nature, scarce they need to be rationed out in some way which is seen to be fair and acceptable by those which are excluded from access. Another aspect of the same issue concerns the determination of those countries which are ineligible, on creditworthiness grounds, from access to hard window resources and can borrow only from soft windows (e.g. the *IDA-only* countries or their equivalents in the regional banks). These criteria, which have undergone continuous evolution in response to the shortage of concessional resources, also seem to differ across the MDBs at any given point in time with inconsistencies emerging in the treatment of the same country by two different MDBs.

### *Eligibility Criteria Applied by MDBs*

Under IDA-10 the criterion for eligibility of recipient countries was left unchanged at a World Bank calculated GNP per capita cut-off of US\$765 per annum or less in 1991 dollars.<sup>23</sup> However, exceptions can be made for access to IDA by: (a) small island economies with a higher per capita income; and (b) for temporary assistance to adjusting countries which have per capita incomes above this cut-off limit but which are not eligible for IBRD lending on creditworthiness grounds. In reality, about 80% of IDA's resources go to countries with GNP/capita of under US\$400; recipients whose national per capita incomes are higher are the exceptions. Consideration of whether the

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22 See Mistry, P. S., "A Report on the Financial Condition of the African Development Bank", published by the Swedish Ministry for Foreign Affairs, Stockholm, May 1993, p. 12.

23 In 1993 dollars the theoretical ceiling IDA eligibility was calculated at \$1,345 GNP/capita but with the effective operational cut-off being \$835 or the equivalent of \$765 in 1991 dollars.

cut-off limit should be lowered to reflect this reality led to the conclusion that the exceptions were important enough not to be excluded altogether and therefore the limit remains unchanged for now. Several of the poorest low-income borrowing countries in Africa, some in Asia and one or two in Latin America and the Caribbean are classified by the World Bank as *IDA-only* countries signifying that they are too poor, too debt-distressed and too uncreditworthy to be eligible for any IBRD financing without incurring the risk of running into difficulties in servicing their hard-window debt. Several others are classified as *blend* countries making them eligible to borrow from both windows but with their access to IDA resources constrained by allocation rules and their access to IBRD being constrained by creditworthiness considerations.<sup>24</sup> These countries generally have GNP/capita levels of between US\$290-1,345 in 1993 dollars. Finally, there is the *IBRD only* category of countries whose income levels, creditworthiness, and stage of development preclude them from having access to scarce IDA funds; generally these countries have 1993 per capita income levels of over US\$1,345. The *IBRD only* countries are classified into four distinct groups which enjoy different maturities and grace periods on their IBRD loans. The four groups are differentiated by their GNP/capita levels in 1993 dollars. Countries with per capita incomes of: (i) less than US\$1,345 are eligible for 20 year maturities; (ii) between US\$1,346 to 2,785 are eligible for maturities of 17 years; (iii) above US\$2,786 are only eligible for maturities of 15 years; while (iv) countries with GNP per capita above US\$4,865 become candidates for graduation from IBRD lending.

The *African Development Fund (AfDF)* has in the past attempted to be more inclusive in applying AfDF resources even to member countries with relatively high per capita incomes. Every single AfDB borrowing country has received AfDF loans and all of them still have outstanding AfDF obligations to repay. However, after AfDF-5 the application of eligibility criteria has become tougher although such criteria are not as rigidly based on income cut-off limits as under IDA. The AfDB categorises its borrowers into three groups: (i) *Category A*: comprising members with a 1990 per capita GNP of US\$540 or below; (ii) *Category B*: which includes members whose GNP/capita is between US\$541-1,050; and (iii) *Category C*: which includes members with per capita incomes above US\$1,050. This categorisation notwithstanding, AfDB has proposed that under AfDF-7, all members

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24 Under IDA-10, the proportion of replenishment resources that could be allocated to blend countries was limited to 30-35% of the total amount of commitment authority available during the IDA-10 period. Within this overall limitation there are caps on the amount of IDA funds available to China (10-12%) and India (15-17%).

eligible for assistance under the Special Programme of Assistance for Africa (SPA) are automatically classified in Category A regardless of their income level.<sup>25</sup> It has also been proposed that the effective income cut-off limit under AfDF-7 should remain the same as for AfDF-6, at US\$1,050 although countries with a higher income level should still be eligible for reimbursable technical assistance loans (with a grant element of 50%) financed under AfDF-7. The bulk of AfDF-7 funds (90%) are however expected to be committed to countries with GNP/capita of US\$540 or below.

Overall access to AfDF resources is governed by country creditworthiness and level of income. Category A countries with low creditworthiness can borrow only from the AfDF while those which are not debt-distressed and have some residual creditworthiness can borrow from both the AfDF and AfDB as blend countries. Category C countries can borrow only from the AfDB, except for technical assistance as noted. Category B countries are generally blend countries. Until recently, however, the AfDB was disbursing significant amounts of hard-window resources to Category A countries (like Zambia) which had been declared by the World Bank to be patently uncreditworthy and therefore ineligible for IBRD lending. This led to the anomaly of certain countries effectively being given debt relief for their IBRD debt service through IDA when they were servicing their debt to the AfDB and actually increasing their obligations to that institution. This resulted in the AfDB being a *free-rider* on the back of the World Bank's efforts at providing partial debt relief. Hopefully that anomaly will be rectified when negotiations for AfDF-7 conclude with greater consistency between the three borrowing categories identified by both the World Bank and the AfDF.

The effective eligibility criteria for access to *Asian Development Fund* (AsDF) resources are less clearly defined. Like AfDB, the AsDB also classifies its borrowers into three groups but unlike the World Bank and AfDB these do not fall neatly into precisely delineated income categories. For example in AsDB's classification of its borrowers: (i) *Group A* generally includes members with 1990 per capita GNPs of US\$610 or below (including China and India, its second and third largest borrowers as well as Bangladesh and Pakistan); but this group also includes eight Pacific Island countries whose GNP/capita is much higher; (ii) *Group B* comprises Indonesia (the AsDB's largest borrower) which had a 1990 GNP/capita of US\$550 and three other countries, Papua New Guinea, the Philippines and Thailand, with per capita GNPs of US\$760-1,420; and (iii) *Group C* which comprises all other

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25 This is justified on the grounds that "most of them are debt-distressed and are undertaking internationally monitored adjustment programmes" not the kind of logic which supports a disciplined approach to scarce resource rationing on a needs-based analysis but one which attempts to open as many loopholes as possible to keep AfDF as inclusive as possible. This proposal of management has not been accepted by the AfDB Deputies.

borrowers, whose GNP/capita was above US\$1,770. All these income levels pertain to 1990 and are measurable in 1990 dollars (the 1993 per capita income levels of Groups B and C were considerably higher). Eligibility for AsDF resources is confined primarily to Group A countries *excluding India and China* and, to a lesser extent, to the three Group B countries *excluding Thailand*. These criteria have their roots in history and in the intra-AsDB politics that have developed between donors and the two populous Asian giants. Therefore they do not reconcile with IDA's eligibility criteria. Thus China and India are IDA recipients but are ineligible for AsDF, while other Asian countries which are now almost ineligible for IDA (Indonesia and the Philippines) remain eligible for AsDF.

In Latin America and the Caribbean, eligibility for FSO resources is confined under GIRs 7 and 8 to the low-income, lesser-developed economies of Central & South America, and the islands of the Eastern Caribbean. The FSO-funded interest subsidy for the IFF is applied to some of the lower-middle-income island economies of the Western Caribbean and of Central America. Like the AsDB (but unlike IDA), the IDB does not use clear income cut-off levels to determine eligibility for FSO. It divides its borrowers into *four* groups not by income level but by the relative sizes of these economies and their importance in the region. Accordingly, the IDB's borrowers are classified as: (i) *Group A* which comprises Argentina, Brazil, Mexico and Venezuela, all economies whose GNP per capita in 1993 was in the range between US\$2,840-3,750; (ii) *Group B* which includes the three second-tier Latin American economies i.e. Chile, Colombia and Peru with 1993 GNP/capita varying between US\$1,490-3,070; (iii) *Group C*, which comprises a more diverse range of eight smaller middle-income economies in Central America and the Caribbean and includes Uruguay whose per capita GNP varies enormously between US\$1,390 (for Jamaica) to US\$11,500 (for the Bahamas) but with most countries in the group clustering around the US\$2,000-3,500 GNP/capita range; and (iv) *Group D* which comprises the ten low-income countries of the region (excluding Cuba which is not yet an IDB member) with 1993 per capita incomes below US\$1,200. Eligibility for FSO lending is confined to Group D, while the IFF with its interest subsidy is extended to countries in Groups C and D whose per capita incomes (as published in the IDB's 1993 Annual Report) were below US\$1,600.<sup>26</sup>

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26 There are significant disparities in the US dollar per capita income figures used by the different MDBs for the same countries in the same year, compounding the problem of significant inconsistencies in the eligibility of countries for concessional assistance across different MDFs. For example, under GIR-8 the applicable per capita income figure for Argentina as published in the 1993 IDB Annual Report is US\$4,532 while the World Bank Atlas has published a figure of US\$7,290 – hardly a minor difference! It would be more appropriate for all MDBs to use a single data series for this all important indicator.

### *Inconsistencies in Eligibility for MDF Resources*

As can be seen from the foregoing paragraphs, there are no clear and consistent guiding principles governing the eligibility of countries for multilateral concessional resources across the multilateral system as a whole even though the funds are provided largely in the same way, by more or less the same group of key donor countries. Nor do MDBs classify their borrowers in the same way; nor indeed do they even measure their per capita incomes in the same way. Obviously some flexibility must be allowed to accommodate the different characteristics of the borrowing universe in the different MDBs, and especially in the regional banks. The question is whether the flexibility presently being exercised results in excessive anomalies and incongruities which the donor community – which after all is largely the same for all the MDBs although the proportionate roles and shares of different donors in each might differ – would find it difficult to justify with any economic logic. The least ambiguous eligibility criteria are applied by IDA. The least clear criteria are applied by the *regional* MDFs which operate more or less as a distinct group and (perhaps rightly) attempt to take the peculiarities of their regions into account in determining eligibility. Yet these differences result in inconsistent treatment of specific countries in terms of access to concessional resources with no monitoring being done at the systemic level to determine the fairness of overall concessional flows from the MDBs as a whole. The problem is compounded by inconsistencies within the donor community in the determination of allocations of resources by different donors to different MDFs.

That per capita incomes cannot be the sole determinant of eligibility has been conceded even by IDA which allows for exceptions in the case of island and adjusting economies. Moreover, the GNP/capita indicator used by the World Bank is different from those used by other MDBs even though all of these indicators are based on averaging out official exchange rates over a three-year period. These indicators are subject to large methodological errors and to major year-to-year fluctuations because of their vulnerability to exchange rate distortions. For example, India's per capita income was calculated by the IBRD to be US\$330 in 1991, US\$310 in 1992 and US\$290 in 1993 although, over that period, the IBRD estimated that real per capita income had grown in India by about 3%! At the same time China's per capita income was calculated at US\$370 in 1991, US\$480 in 1992 and US\$490 in 1993 when the IBRD calculated a real increase in China's per capita income of around 10% in 1992 and 12% in 1993. In comparative terms, whereas in 1991 the per capita income gap between India and China was only US\$40, it had widened to US\$200 by 1993 – which is plainly absurd and obviously

misrepresents what has been happening in these two economies over the last two years.

Given the anomalies that arise in the use of highly contentious GNP/Capita indicators, it would clearly be more attractive and more appropriate for all MDBs to use the *Purchasing Power Parity (PPP)* based GNP/capita figures which are now published annually in the UNDP Human Development Report as a better basis for determining eligibility. But even these figures, though they are more stable, are still subject to methodological errors although it is open to question whether the size of these errors are of the same magnitude as the present GNP/capita figures calculated by the World Bank. Over time, movement towards using PPP figures has much to recommend it on a conceptual basis if not yet on a practical basis. The MDBs should invest resources jointly in developing, along with UNDP and the IMF, a more acceptable common methodology for deriving PPP figures for classification and differentiation purposes.

### *Reconsidering the Eligibility Question*

Eligibility for concessional resources is constrained because of their scarcity. A uni-product approach of the type followed by all MDFs other than FSO exacerbates the scarcity factor of these resources. The question therefore arises as to whether multilateral concessional resources should be provided on more *variable terms* in a fashion similar to the FSO. If that practice were adopted more widely the eligibility strait-jacket could be loosened considerably. Clearly the World Bank attempts to cater to intermediate terms through the IBRD/IDA *blend*; but the blend is becoming an increasingly blunt device which is not amenable to fine-tuning or to a quick adaptive response to changed circumstances. In any case, the blend in the MDFs is now being determined more by political negotiation than by economic logic. Moreover, there is a case for the *type of project* being financed also to influence the type of resource (and its terms) which an MDB might choose to provide rather than having it be determined exclusively by country income circumstances. For all these reasons it is clear that a fresh approach is needed in rethinking the issue of eligibility.

Another important new factor (i.e. post IDA-10) to consider post-1991 is that the larger MDF-eligible *blend* countries such as China, India, Indonesia, Pakistan, the Philippines and some others, are now able to access *private* external flows of both debt and equity on an unprecedented scale. By pursuing more appropriate policies and reforming faster they can expand access to such resources considerably. Contrary to the concerns of donors and recipients, not all such inflows are inherently *hot* i.e. easily reversible, although they can be if international capital markets lose faith in the

countries and governments they are investing in. Even portfolio equity flows and non-resident bank deposits can be stable and growing as long as global capital markets are satisfied that the policies being pursued are sustainable and growth-oriented and that they do not risk sudden large changes in external accounts or are subject to unacceptably large devaluation risks. Other poor countries (especially in Africa) which are now almost exclusively dependent on concessional resources simply do not have such access. The large IDA-eligible countries (and some of the smaller ones in Africa) also spend an inordinately large proportion of their public resources on military expenditures. At a time when concessional resource scarcity is growing due to budget pressures in donor countries it is appropriate to reconsider the eligibility of these large regional powers for concessional multilateral resources when the provision of such resources indirectly, because of resource fungibility, supports their ability to expend their own resources in non-productive ways. Moreover, new claimants are emerging for concessional resources whose incremental demands are unlikely to be matched by expansion of supply.

Taking into account all these changing contextual factors in a post-Cold War world, with private external flows dominating official flows in meeting the external resource requirements of developing countries, it is reasonable to suggest that the issue of eligibility for concessional multilateral resources should be reopened and thoroughly reconsidered in the context of IDA-11 and all succeeding soft-window replenishments. The aim of such an exhaustive review should be to make concessional multilateral resources both; (a) *more variable* e.g. with interest rates of 1-4%, maturities of 25-40 years, grace periods of 8-12 years and variable backloading of annual amortisation amounts; and (b) *more accessible* especially to the neediest countries for a wider variety of social investment oriented projects. The FSO provides an interesting model, in terms of the way in which it has evolved both operationally and financially, for the other MDBs and their donors to examine more carefully before considering similar evolutionary changes in their own soft-window facilities.

#### *Allocation of Soft-Window Resources*

If *eligibility* criteria are more judgmental, less transparent and less rigid (in terms of the applicability of income cut-offs) than they are often portrayed to be, then the *allocation* criteria, and the way in which they are applied within and across the different MDFs, for annual and cumulative MDF allocations to particular countries are even more so. MDB managements of course strive to make their decision-making on concessional resource allocations *appear* to be as impartial, objective, formula-based, and transparent as possible, with the

appropriate genuflections to whatever developmental priorities or fashions happen to be in vogue with donors at the time. The reality, however, is that allocations among the major concessional resource recipients (or groups of recipients) are often determined in broad terms by the senior managements of MDBs and the representatives of major donor countries exercising their judgements at the start of any replenishment cycle. These broad allocations are reviewed annually (more on a pro forma than a substantive basis) in the context of each MDB's budget and operational programme review cycle. Given the long gestating cycle of project preparation in the MDBs, and the relative predictability of projects at different stages of processing in the pipeline, the annual reviews do not, however, result in major changes to soft-window allocations except when a major event occurs e.g. in a country's politics or government or policy or major donor preference. For example, until IDA-6 in 1981, it had become almost axiomatic that India would absorb 40% of IDA's total resources and that the other countries of South Asia would absorb a further 20-25%, leaving between 35-40% for Africa and the other regions of the world. The entry of the Reagan Administration in 1981 resulted in a politically driven shift which reduced India's share to below 20%, China's share to around 12%, Africa's share to at least 50% with the remainder being absorbed by other eligible countries. Similar considerations have applied in the other MDBs as well though, in retrospect, none were quite as sharp, public or dramatic.

In addition, the *performance* of recipient countries *as perceived by MDB managements* has a lot to do with soft-window allocations. During and after the 1980s, that has mainly meant performance in terms of recipient willingness to implement MDB promoted economic policy reforms at both macro-economic and sector-specific levels. Since 1990, donor countries have emphasised more or less the same allocation criteria in all the MDF replenishments. Broadly, these include: (i) willingness to engage in *policy dialogue* and performance on policy reform, economic adjustment and growth; (ii) emphasis on *poverty reduction* in the recipient's own development priorities; (iii) recipient sensitivity to *environmental sustainability*, the linkage between environmental sustainability and poverty reduction in development plans and the undertaking of environmental impact assessments for development projects; (iv) responsiveness to *gender* issues (i.e. women-in-development priorities); (v) *good governance* issues (i.e. sound economic management in terms of administrative capabilities, the accountability of politicians, civil servants and public agencies, transparency, rule of law, emphasis on participative consultation with NGOs and groups affected by projects); (vi) emphasis on investments in *human resource development*; and (vii) emphasis on *institutional development* especially of those institutions which support the proper, competitive functioning of market economies and of

open transparent democracies. In the AfDF and FSO, donors also emphasised *support for micro-enterprises* and for *regional integration initiatives* in determining AfDF allocations. In the FSO, donors further supported an expansion of *sector lending* as a priority in resource allocation. In AsDF, donors placed particular emphasis on *population control* and on *promoting the private sector*, two priorities which are likely to resonate in the next round of all MDF replenishments.

In virtually all the recent MDF replenishments, donors placed a cap of 25-30% of the resources provided, being used for adjustment lending with the remaining 70-75% being applied to project financing. Donors are also more concerned about MDBs undertaking regular portfolio quality reviews, better appraisal quality improved monitoring and supervision, better donor co-ordination, among the MDBs themselves, between MDBs and bilaterals, and between MDBs and NGOs, applying the lessons learnt from ex-post evaluations in their country assistance strategies.

### *Concessional Resource Reflows*

The MDFs are all funded by *grant* resources from donors and by net income transfers from their affiliated MDBs which are permanently endowed. All the MDFs on-lend these resources in the form of long-term repayable credits, except for that small portion (5-10% of the total) which can be disbursed as technical assistance grants in the regional MDFs. The *revolving* nature of these funds was thus always an in-built feature of the MDFs. Donors fully intended that, at some future point in time, the corpus of their cumulative contributions would become sufficiently large, and the demands made on it would become sufficiently small for neutral equilibrium to be reached. At that point no further budgetary contributions from donors would be needed to sustain the *annual commitment authority* of the MDFs. Instead, the annual commitment authority would be fully funded by *reflows* from previous credits and, to a lesser extent, by the income earned on MDF liquidity. That state is closest to occurring in FSO although reflows now feature prominently in supporting IDA's annual commitment authority as well. They are not yet prominent in either AsDF or AfDF although they are likely to become so within a decade.<sup>27</sup>

The degree to which reflows sustain annual commitment authority should, in theory, be seen as a sign of development progress as uncreditworthy

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<sup>27</sup> This assertion is made on the assumption that these reflows will in fact occur; an assumption which seems reasonably safe to make except perhaps in the case of the AfDF which presently confronts an acute problem of protracted arrears and non-payment by too many of its members.

countries develop and graduate into becoming creditworthy ones. At the present time, however, it is really more an indication of donor fatigue and resistance to expanding aid allocations to MDFs from their overstressed budgets. Reflows are now sustaining an increasing proportion of commitment authority not because development is succeeding in any spectacular fashion (although in East Asia and perhaps now in Latin America, where few concessional resources are deployed, it undoubtedly is) but because *donors* are choosing to find more justifications for rationing and restricting the flow of concessional resources. Sadly, it is equally true that *recipient* countries are giving donors more than sufficient cause for adopting this posture by wasting scarce resources to an intolerable degree. They do so *deliberately* – as in the case of supporting egregiously high levels of military expenditure, armed conflict and civil wars, public graft and corruption, and the pursuit of patently detrimental economic and social policies – or *inadvertently*, as an unfortunate consequence of being underdeveloped; i.e. not having enough capacity to manage and use scarce resources as well as they should.

In the FSO reflows now constitute the principal source of funds for continued lending. They amounted to about US\$400 million annually compared to a 1993 FSO lending level of US\$423 million and total donor contributions for FSO in GIR-7 of US\$200 million although that amount was quintupled in GIR-8. In addition FSO also generates investment income from its very large pool of liquidity which goes towards financing the interest subsidy account of the IFF. By contrast, reflows are supporting a smaller but growing amount of IDA's commitment authority. The total commitment authority increment from reflows between 1994-96 will be about SDR2.5 billion (or US\$3.4 billion) thus financing about 16% of total commitment authority under IDA-10. In the AfDF annual reflows amount to less than UA/SDR 20 million and have not yet been taken into account in augmenting additional commitment authority. In the AsDF reflows are now about US\$100 million annually. Although they have not been taken into account for augmenting commitment authority, the future stream of reflows may well be factored into increasing AsDF's commitment authority in the next replenishment.

In addition to reflows, the *investment income* being generated by MDF liquidity is also reaching significant proportions. In FY94, IDA generated US\$168 million (US\$373 million in FY93) from its pool of investments. By comparison, in 1993 the FSO generated about US\$58.5 million, the AsDF earned US\$52.3 million and the AfDF earned US\$39 million. While forming a part of the overall income stream of these MDFs, these large and growing amounts earned from investments have been earmarked for specific purposes which include: financing increases in commitment authority; funding interest subsidy funds; or funding technical assistance facilities. Clearly further build-

up of liquidity would generate further income but such a liquidity build-up has obvious costs to donors and recipients. Where MDFs are still being funded largely by donor contributions (not the case in FSO) liquidity requires donors to contribute more cash earlier than is absolutely necessary. At the same time an MDF's store of liquidity also implies that it is withholding resources that could be expended more quickly on disbursements. Thus, in looking to MDFs to generate income from liquidity a reasonable view has to be taken, given the particular circumstances of the MDF in question, on where the overall balance of interest lies.

### *The Role of Replenishment Negotiators (the MDF Deputies)*

A final issue which might be touched upon concerns the role that representatives of donor governments involved in negotiating MDF replenishments (referred to here for convenience as *MDF Deputies* by borrowing terminology from IDA) play in influencing the operational and financial policies not just of the soft-window that they are focused on funding at that particular time but of the entire MDB. This is not a financial issue *per se* but it is a sufficiently important one to be raised here nevertheless. The point has often been made, especially by MDB Executive Directors from developing countries which are usually not represented in MDF Deputies meetings, that a group of donor government officials who only represent a part of the ownership of any MDB, and who have no constitutional standing or formally legitimate role in the governance of the MDBs, have now usurped the roles of both the Board of Governors (as a whole) and the Board of Executive Directors (as a whole). That concern is valid. There can be little doubt in the mind of anyone involved in a MDF replenishment negotiation of the powerful role played by the Deputies in decisively influencing the direction and content of MDB operational, financial, and even internal administrative policies. They do so by conditioning their support and the periodic contributions of their governments on being satisfied that their own *donor conditionalities and priorities* – often subtly and sometimes not so subtly expressed during replenishment negotiations – as to what the MDBs (and not just the MDFs) will do, how they will do it and how they are to be run, will be met by MDB managements.

In playing this role MDF Deputies exert far more influence over MDB policies and far more power over MDB management behaviour than do their Boards of Executive Directors. The development priorities that have crept in recently on issues such as environmental sustainability, good governance and gender sensitivity have really been pushed through less by Executive Boards than by the MDF Deputies. Deputies have also been forceful in supporting the efforts of some MDB Executive Directors in curbing the egregious

budget excesses of MDB managements and the compensation/benefit levels of MDB staff. Recently, in AfDF-7 negotiations the Deputies intervened to shore up the rapidly eroding financial foundations of the AfDB by insisting that emergency remedial action be taken before the AfDF-7 replenishment was negotiated. In that instance the AfDF Deputies performed a signal service to the institution and its members in the face of clear defalcation on the part of the AfDB's Executive Board; particularly those members representing regional interests. Thus there is no question that MDF Deputies can be a force for the good of the MDBs just as there are times when MDF Deputies can do much to incapacitate and diminish the standing of the MDBs and MDFs. The role of the two Reagan Administrations in the US between 1981-88 was particularly noteworthy in that respect when they succeeded in nearly destroying IDA.

But, the real issue is not whether MDF Deputies exert their power and influence in the interests of the good or the bad. The real issue is whether they – as an extra-constitutional body with no standing or authority granted to them under the charters of these institutions, who are ostensibly gathering together periodically to fund a particular MDF replenishment – should legitimately exert that sort of power at all. Their role in that capacity certainly does much to diminish the standing and credibility of the Executive Boards of the MDBs especially vis-à-vis the MDB's senior management and staff. That reality is incontrovertible. The influence of the MDF Deputies also effectively disenfranchises the developing country members of MDBs from representing their own interests properly and fairly. In theory the question of whether MDF Deputies should be permitted to intervene in such a forceful manner is easy to answer from a strict constructionist viewpoint. Obviously they should not play such a role because there is no provision in the MDB or MDF Articles which permits them to. MDB managements would be quite within their constitutional rights to ignore them should they, somewhat quixotically, choose to do.

In practical terms, however, that theoretical answer is of little value. A tradition has now been established of increasing MDF Deputy intervention in virtually all aspects of MDB (not just MDF) functioning over the last three decades. That entrenched encroachment on Executive Board rights will be nearly impossible to roll back. The Deputies forum provides the major (donor) shareholder governments with almost the perfect forum for collectively deciding on their interests and having them felt without the clutter and inconvenience of putting up with arguments, no matter how legitimate, of the developing country members whom they see as supplicants if not mendicants. The Deputies also provide a more effective layer of intervention between the Executive Board (which does have a tendency to be subject to regulatory capture) and the Governing Boards (of Ministers) who

simply cannot pay any serious attention to MDBs' institutional or policy issues on any focused basis.

In effect the MDF Deputies intervene so extensively and so forcefully because the Executive Boards of the MDBs in some cases are seen by donor governments as ineffectual and, perhaps occasionally, even inappropriate instruments of MDB governance where key issues are concerned. The issue therefore remains a conundrum wrapped in a dilemma. Unless there is some movement, however, towards examining the role of the MDF Deputies carefully and worrying about the impact it is having on already demoralised and incapacitated Executive Boards, the process of day-to-day institutional governance by shareholders of the MDBs may actually be weakened and not strengthened.

Moreover there is the moral dilemma of donor shareholders of MDBs deliberately choosing to act in a manner which effectively disenfranchises recipient shareholders from having their proper say, as they are entitled to, in the running of the MDBs. Yet the way in which recipient shareholders occasionally conduct themselves, as for example, in the AfDB, often provides just cause for donor intervention in the interests of safeguarding the MDB's integrity. The whole issue therefore needs to be addressed as a matter of urgency with a view to either rolling back the pervasive influence that the Deputies now exert over the affairs of the MDBs or, alternatively, having their role constitutionally legitimised. The present situation of MDF Deputies exerting an authority which they do not, and should not, have is the worst of all possible worlds simply because it is a manifestation of an internationally discarded credo; i.e. that, when it comes down to the nitty gritty, "might is always right".

# 5 Financial Resource Management Policies

## *Introduction*

Turning from the somewhat brief but necessary digression on the MDFs in the last chapter back to the financial policies of the core MDBs (i.e. the *banks*) themselves, this chapter focuses on the liquidity and investment, currency management, lending rate, net income management and reserves policies of the MDBs. These five sets of policies together comprise the heart of financial resource management by the MDBs; i.e. they are what makes MDBs function as banking intermediaries. That function is often obscured by the inevitable public focus on the *lending operations* of these institutions; operations which often suggest that the MDBs are not really banks at all but instead large and somewhat inefficient consulting, economic advisory or development research institutions.

The financial operations of the MDBs essentially comprise two core treasury (or front office) functions and four supporting administrative (or back-office) functions. The core *treasury* operations of the MDBs involve: (i) borrowings in capital markets (see chapter 3); and (ii) investment of liquid resources to generate investment income. The supporting *administrative* functions are the controllership and budget management functions which involve: (i) internal accounting; (ii) disbursements management and control; (iii) administrative budget formulation and (iv) internal expenditure control. A special issue also arises in the MDBs of *currency management* which overlaps the front and back-office operations in the financial complexes of MDBs. It arises because MDBs borrow in a number of different currencies from a wide range of international sources. They do not necessarily lend to their borrowers all the currencies they borrow from capital markets thus resulting in different currency compositions of their lending and investment currency pools. At the same time, MDBs are required by their charters not to assume any exchange risks in their financial operations. They must therefore pass on this risk in its entirety to their borrowers. Further issues arise in the determination of policies governing their lending rates because MDBs borrow from capital markets on a widely varying set of terms and lend to their borrowers on more or less uniform sets of terms, undertaking a term transformation risk at the same time.

All of these financial policies interact and are fine-tuned to achieve the goal of generating a reasonable level of *net income* which, ideally, should rise

gradually with the expansion of the portfolios and assets of the MDBs. That pattern of income growth enables markets to bolster their confidence in the financial strength of these institutions and permits unconstrained market access for borrowing at the finest possible rates. The bulk of MDB net income is allocated under agreed policies largely to the reserves and retained earnings accounts of the MDBs with small amounts being earmarked to support various other special developmental activities including contributions to their MDFs.

### ***The Liquidity and Investment Policies of the MDBs***

#### *Why is Liquidity Necessary?*

There are two reasons why MDBs and MDFs need to maintain a certain amount of liquid funds on hand. *First*, unlike commercial banks or securities markets which usually provide their borrowers or equity issuers with the cash they need in a single transaction (or at most in two or three pre-arranged tranches), MDBs usually lend for projects and programmes which take a number of years to implement. While these projects are being constructed or programmes are being implemented, the MDBs play an active role in monitoring and supervising these projects. Funds are released only when the equipment needed has actually been shipped by suppliers or is being installed, when civil works have reached various certifiable stages of completion, or when certain performance conditions and commitments have been met. Thus the MDBs disburse against their loans on a continuous basis over periods of time that may vary from 1-10 years. With that *modus operandi* it is self-evident that the MDBs need to keep a sufficient amount of liquid funds<sup>1</sup> on hand to meet disbursement requirements for the projects and programmes they have financed. The timing of such disbursements cannot be easily predicted in

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1 Liquid funds or “liquidity” in the MDBs is generally defined as the amount of cash or other financial resources available on short notice or call for meeting contractual loan disbursements, debt service obligations, administrative expenditures or other cash outflows. Liquid assets which, of necessity, can only include freely convertible currencies, usually comprise the following: cash held in the MDB treasury or in banks; investments in marketable securities of an acceptable grade; certificates of deposits and time deposits in global banks; and instantly tradeable money or capital market instruments of acceptable quality. Notes due from members for capital contributions are not classified as liquid assets because they are neither tradeable nor readily redeemable except on a fixed encashment schedule. Cash and assets in *non-convertible* currencies are excluded from liquid assets because their use is usually confined to cover cash needs only in the countries which issue those currencies. Investments for Special Reserves in the regional banks are also excluded because they are of a longer-term nature and are meant for meeting MDB liabilities on borrowings in the event of a default and not for covering regular cash needs.

advance for individual projects although forecasts of aggregate disbursement patterns for the loan portfolio as a whole can be made over a reasonable period of time with a fair degree of accuracy.

*Secondly*, MDBs cannot always time their borrowings to suit themselves. They must borrow opportunistically to take advantage of the best market conditions in different markets and currencies over any given borrowing period. A time lag therefore inevitably results between the inflow of funds from borrowings and the outflow of funds for disbursements, for the timely repayment of previous borrowings, and for other expenditures. From time to time, market conditions may change sufficiently for MDBs to prepay previous expensive borrowings and replace them with lower-cost funds. For all of those key reasons, a liquidity cushion becomes a *sine qua non* for effective financial resource management.

### *How Much Liquidity?*

The key question therefore is not whether the MDBs need to keep liquid funds on hand but *how much liquidity do the MDBs really need to keep at any given point in time?*<sup>2</sup> This question assumes particular relevance with the profound changes that have occurred in deregulated, liberalised global financial markets after 1981. Since then, new instruments have emerged rapidly to facilitate treasury management. The investment of liquid investments has now become an important profit centre in its own right in all the MDBs. Managing liquid funds is by far the most profitable and probably the single most effective activity that MDBs presently undertake. *Arbitraging* between the extremely fine rates at which they can borrow, with their established standing in capital markets and their callable capital backing, and the slightly higher rates at which they can place funds for short periods of time with banks and in traded treasury instruments, the MDBs earn sizeable profits without incurring any significant credit risk. Their investment income is now a very significant proportion of their total earnings. It enables them to: keep their lending spreads under control, alleviate pressures on them to control administrative costs as tightly as they should, and generate funds for a range of purposes without having to rely on donor support. Thus investment

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2 In the early days of their operations the MDBs used to fully fund all their outstanding commitments. This practice became untenable as the level of commitments grew and a pattern began to be established in determining the time lag between commitments and cash requirements as well as the cash needs for debt retirement. Certainly in the AfDB the practice of full funding continued upto 1982 and in the IDB till the mid-1970s. The EBRD, the newest of the MDBs presently has more liquidity than it needs to fully fund its presently outstanding commitments although that situation will quickly change as its portfolio grows.

income has become a useful safety-valve for releasing internal financial pressures that might otherwise have built up in the MDBs.

MDB managements, and particularly their treasurers, have therefore developed a clear vested interest in retaining and strengthening their roles as *financial arbitrageurs*. They use every conceivable reason to convince their Boards to keep liquidity levels as high as possible. They devise policies to justify maintaining much higher levels of liquidity than is strictly necessary, in present day financial markets, to support lending operations and to cover other cash flow requirements. Some Executive Directors (especially those from developing countries) have some sympathy for enabling MDBs to maximise their income from *other* sources in order to keep their lending rates as low as possible. On the other hand, other Executive Directors (especially from developed countries) also see the dangers of it becoming too obvious that MDBs make more *net* income from their liquid investments than from their lending operations which, after all, are their *raison d'être*. Under present circumstances it is highly likely that, if MDBs accounted for their costs properly, they would find that they either just broke even or actually lost money on their mainstream business of lending to developing countries.

A legitimate concern arises because the MDBs generate income from managing investments and trading securities on the basis of an *unfair advantage* vis-à-vis the private sector. After all, MDBs have an unusually robust, *publicly funded*, and cost-free capital base. If financial arbitrage by the MDBs were perceived to be overdone in any politically sensitive quarter, it could lead to embarrassment in international markets were private arbitrageurs to raise serious objections to large-scale MDB involvement in this business. As it happens, upto now private operators see it as being to their advantage for MDBs to maintain high levels of liquidity. Such policies increase their gross borrowing requirements. Therefore they also increase the fees made by investment banking advisors to the MDBs and by market-makers for their securities. Interestingly, and somewhat disingenuously of course, while the policy statements of all the MDBs on their liquidity policies provide elaborate justification and reasoning for holding high levels of liquidity, none actually alludes to what has become the main reason for doing so: i.e. generating high levels of investment income. Perhaps the AsDB comes closest to the heart of the matter when, in a confidential document, it acknowledges that the major source of the Bank's future net income will continue to be generated from income from the investment of its equity (paid-in capital and reserves), not from its loan charges. The Bank's equity is mainly held in liquid form. Net income in future will therefore depend very significantly on how future interest rate movements affect the AsDB's investment income.

It is certain that, were there to be real, rather than falsely imputed, costs to

holding liquidity,<sup>3</sup> MDB treasurers would be using their same well-honed skills of persuasion to convince their Boards that they should be holding *as little* liquidity as possible; certainly at levels substantially lower than those they presently strive to justify on other grounds.

With those concerns expressed up front, it is necessary to return to the question of what the liquidity policies of the different MDBs are and on what intellectual basis they rest. The basic justification for having liquidity has been provided in simple language above. In the virtually incomprehensible jargon that is now so characteristic of the MDBs (perhaps because jargon has become a substitute for clear thinking), the least inelegant justification for MDBs holding liquidity is provided by the World Bank:

“Liquidity plays a key role in managing and controlling funding risk. There are two fundamental aspects of funding risk: (i) the risk of not having sufficient funds to cover net cash flow obligations resulting from an excess of debt retirement over loan repayments; and (ii) the risk of not having sufficient funds to cover the Bank’s contractual obligations determined by undisbursed loan commitments. The level of liquidity should be an outcome of borrowing decisions based on prudent management of these risks. The liquidity policy should also provide flexibility to smooth undesirable variations in annual borrowings and to adjust borrowing to take advantage of market opportunities.

The primary objective of holding liquidity is to provide protection against voluntary or involuntary interruptions in cash flow, especially against possible borrowing shortfalls. There are five principal components of the Bank’s cash flow: on the *sources* side (i) cash from operations; (ii) repayment of loans; (iii) new borrowings; and on the *applications* side, (iv) disbursements; and (v) debt retirement. Borrowings are the single largest component of cash flow and differ from other large components in that they are not contractual. Disbursements, debt retirement, and loan repayments are contractual, and to the extent the Bank chooses not to fund all of its contractual obligations at the time they are made, there is a funding gap (i.e. the difference between committed cash outflows and contractually committed inflows). The concept of “net cash requirements” which underlies the (World Bank’s) current liquidity policy takes into account the net contractual obligations by year, but also the other elements of cash inflow and outflow such as cash from operations (net income) and additions to usable capital, and projected cash outflow from future contractual commitments.”

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3 On the questionable assumption that liquidity is funded entirely out of borrowings, thus ignoring the cost-free element of the capital base, the IDB asserts that there were only three years during 1975-89 when the Bank, on a combined basis, did not incur a cost in carrying currencies borrowed in liquidity. This analysis, presented in the IDB’s 1990 Review of Financial Policies, raises several technical issues which can be seriously argued with and proven to be a somewhat biased representation in order to make a misleading point. The reality, as the AsDB acknowledges, is that with a proper cost-accounting approach the net income derived on liquidity really accounts for the largest part of the net income of every MDB with lending operations (and the activities ostensibly undertaken to support them) either breaking even or actually incurring a net loss.

In addition to this reasoning, the financial managers of the AfDB, AsDB, IDB and EBRD cite the *protection of their positions in periods of financial stress and maintaining of market confidence*<sup>4</sup> as two additional reasons as to why they should hold the levels of liquidity that they recommend to their Boards. The main reason for this is the perception of MDB treasurers that, although the risk of MDBs having their access to market borrowings seriously interrupted is remote, it nevertheless exists and may even be marginally influenced by market concerns about MDB creditworthiness arising from the prevailing level of arrears on their loan portfolios.<sup>5</sup> Though the MDBs are still seen as premier credits by institutional investors, market operators and rating agencies, their treasurers believe that these groups have become more sensitive to the quality of MDB loan assets given the number of countries which are in *protracted arrears*, or whose loans are in *non-accrual status*. Under these conditions, larger than necessary holdings of liquidity are seen as being useful in strengthening the confidence of investors and in allowing MDBs to

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4 Though the views of the market are invariably used as a reason by MDB treasurers to justify whatever level of liquidity they wish to convince their Boards is essential, the fact is that no investor group or rating agency has ever hinted at what particular value or range of liquidity is acceptable to them for a given MDB. This lack of a specific view on the part of "the market" suggests that market perceptions about the adequacy of any one MDB's liquidity levels are based more on notions of *relative* levels of liquidity in comparison to other MDBs and similar supranational borrowers, and on overall notions of the MDB's financial soundness, rather than on any particular conviction that some absolute level is the correct one. Indeed that the market accepts so many different ways of determining liquidity suggests that the market view is no real guide to how much liquidity an MDB actually needs; except that the market is usually inclined towards accepting the status quo. The danger, of course, is that liquidity levels can simply be ratcheted upwards by one MDB acting as the market leader and other MDBs trying to catch up so that the market does not view them badly in a relative context through invidious comparisons.

5 At present arrears affect only the IBRD and the AfDB with the IDB no longer having this problem, the AsDB never having had it, and the EBRD being too new to have it. In reality, although this rationalisation may seem credible, the actual reaction of markets to rising levels of arrears has, surprisingly, been opposite to what might be expected. In fact spreads (over equivalent treasury instruments in the market) at which MDBs can borrow have actually come down quite dramatically even as IBRD and AfDB arrears have risen. Moreover, the market's (and rating agencies') somewhat obtuse reaction at not downgrading the rating of the AfDB's securities, when its financial performance and position relative to the other MDBs is so obviously inferior, is even more surprising. What these occurrences make clear is that markets regard usable callable capital, and the commitment of the major donor shareholders to support any particular MDB, as far more important than their actual financial condition, their arrears or their financial performance. In that context a recent paper by Eugene Rotberg, the World Bank's former Treasurer for 19 years (and from the viewpoint of financial market operators arguably the best Treasurer that any MDB has had or is likely to have) is instructive. See Rotberg, E. "The Financial Operations of the World Bank" in Volume II (pp. 185-214) of "Bretton Woods: Looking to the Future" Commission Report, Staff Review & Background Papers, published by the Bretton Woods Commission, Washington DC, July 1994.

buy time by abstaining temporarily from market-borrowings while clarifying the extent of any loan servicing problems that might arise. These priorities are underlined by all the regional banks. For example, the EBRD in its liquidity policy statement suggests:

“The purpose of holding liquidity is twofold. First, adequate liquidity provides assurance to members, bondholders, creditors and rating agencies that the Bank will be able to meet financial obligations such as punctual debt service, disbursements on loans and equity investments, calls on guarantees or unforeseen expenses regardless of circumstances and that callable capital will not be activated. ... Second, liquidity helps smooth the Bank’s borrowing patterns and retain flexibility in the execution of its annual borrowing programmes. For example prudent liquidity levels would enable the Bank to postpone borrowings when market conditions are unfavourable, without impairing its ability to meet all its financial obligations. Conversely, the Bank can use a flexible liquidity ceiling to take advantage of favourable borrowing environments.”

Different in one important respect to the other MDBs (although that difference may soon narrow given the emerging priorities of donor governments to tilt more development assistance directly towards the private sector), the EBRD also observes in framing its liquidity policy that:

“A major consideration is that the larger part of the Bank’s investments in borrowing countries will be to the competitive enterprise sector without government guarantees. These assets may be perceived as inherently risky, especially if a major crisis, such as a severe economic downturn, were to impair their performance. In such a case, prudent liquidity levels would allow the Bank to continue to service its debt for a sufficient period of time, while regaining its financial strength or, as the case may be, seeking additional member capital. Eligible securities and instruments for the liquid asset portfolio will therefore be subject to strict credit quality and marketability tests.”

Finally, the EBRD (the newest of the MDBs) goes one step further than its cohorts in suggesting that:

“A prudent liquidity policy should also ensure that liquidity balances are sufficient at all times to cover fully the amounts of committed and undisbursed loans, also referred to as a matched funding policy”, which is defined as “broadly matching the amount, currency, rate bases and maturities of loans with those of borrowings or other funding, on an aggregate or individual basis, at the time that the currency denomination of a loan and its interest rate are determined. This policy ... is designed to protect the Bank’s loan income by minimising currency and interest rate risk and is implemented through borrowings and unallocated net cash resources.”

Although the liquidity requirements of all the MDBs are predicated on much the same concerns, and their operations justify the same approach to liquidity management, the MDBs in fact use two quite distinct approaches to

determine their liquidity levels. The IBRD and EBRD<sup>6</sup> base their liquidity requirements on the concept of estimated *net cash requirements (NCR) over the next three-year period*. The three other regional banks (AfDB, AsDB and IDB) prefer to use the concept of estimated *future loan disbursement requirements (LDR) for the following year (or two)* in determining their liquidity. As the African, Asian and Inter-American regional banks would concede, the NCR concept makes the most sense, from an intellectual and practical viewpoint. The reasoning behind their continued adherence to the LDR concept is therefore interesting, if odd. The AsDB and IDB actually state in their more recent policies that they now attempt to combine the two concepts which, on the face of it, is even stranger and bears some examination.

Both the **IBRD** and **EBRD** use a ratio of **45% of their NCR over the next three years**<sup>7</sup> to determine their liquidity requirements although that ratio is used as a guide rather than a target ceiling. In practice the World Bank manages its liquidity within a 45-50% of the 3-year NCR range. Liquid holdings above the 45% ratio are reviewed by their Boards and the excess is regarded in both MDBs as “discretionary liquidity” justified on the grounds that it may be necessary to:

“... maintain a smooth progression in the growth of annual levels of borrowing, take advantage of exceptional opportunities to borrow which may occur from time to time and to provide for sufficient funding of covering disbursements on committed assets while protecting the Bank’s income on these committed assets.”

Also, it is not always easy to forecast accurately the level of disbursements on loans over the next three years; forecasting errors may require some temporary flexibility in lifting the ceiling rather than applying the liquidity ratio as a tight strait-jacket. In 1993 the EBRD’s liquidity actually amounted to 85% of NCR for the next three years with liquidity (of ECU4.05 billion) being significantly above the Bank’s contracted aggregate commitments (ECU2.27 billion). This absurdly high level of liquidity, far in excess of any reasonable needs, was lamely explained by the EBRD as being necessary to ensure that the Bank had sufficient resources to meet its disbursement obligations and had enough flexibility in making its funding decisions. In reality the explanation was that the Bank was committing resources at a far slower pace than had earlier been anticipated when the encashment schedule

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6 Since most of the Treasury staff of the EBRD were once at the IBRD the coincidence of policy between these two institutions should be no surprise.

7 Prior to 1987 this ratio was 40% in the World Bank. The EBRD had not been conceived then.

on shareholder capital was agreed. To the embarrassment of its shareholders, the Bank used the excess income from its unexpectedly high level of liquidity to cover unjustifiable expenditures on itself: marbled buildings, gastronomically refined dining rooms and staff perquisites. Fortunately, these excesses have been sharply curbed by the new President of the EBRD, who has ushered in an era of austerity and simpler living!

In contrast to the IBRD and EBRD, the **African Bank (AfDB)** presently has a policy of maintaining liquidity at a level of **1.5 times the LDR for the following year**. This represents a reduction from its former policy (between 1982-93) of maintaining liquidity at *twice* the following year's estimated LDR. A related policy objective – which does not appear to be conceptually sound – is to contain its liquidity to within the level of its *net equity resource base* supposedly to “avoid the costs and risks of carrying a high level of liquidity derived from *borrowed funds*” whilst at the same time retaining the flexibility to take advantage of unusually favourable borrowing conditions in financial markets. The restriction of keeping liquidity within the equity resource base is an artificial one since the level of equity resources has, at most, a tenuous and indirect connection with either LDR or NCR. That restriction almost suggests that liquidity should essentially be a representation, in cash form, of the equity base. If that concept has to have any meaning, it would require the “net equity base” to include only *paid-in capital in convertible and usable form* plus accumulated (convertible currency) reserves. But, even then, that would only be an artificial restraint to rein in management from resorting to unusually high levels of liquidity in order to generate investment income (the AfDB is the only MDB which actually concedes that imperative explicitly in its policy statement)<sup>8</sup> rather than to guide a defensible liquidity policy.

The AfDB's June 1993 *Review of Financial Policies* indicated however, that the current liquidity policy was unsatisfactory because it limited the Bank's capacity to absorb, through its liquidity, the impact of adverse lending or borrowing circumstances. The review concluded that the future liquidity policy of the AfDB should be defined more explicitly in terms of *effective cash flow requirements* (i.e. switching from the LDR to the NCR conceptual basis for formulating liquidity levels) with the objectives of: (i) enabling the Bank to meet its contractual loan disbursement commitments readily; (ii) assuring market participants that the Bank's own debt service capacity remained strong under adverse market and economic conditions; and (iii) hedging against the risk of temporarily being unable to access capital markets.

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8 See AfDB Board Document No ADB/BD/WP/92/117 - ADB/BD/WP/92/132, “Review of the Bank's Liquidity Policy” dated 9 November 1992, para 4.2.

The **Asian Bank's (AsDB)** liquidity policy at the present time is based indirectly on the LDR concept. But, instead of relying on estimates of future disbursements which are prone to error, it adopts a prudential balance sheet based ratio as a determinant. Its *minimum liquidity target* is set at **40% of its (previous) year-end undisbursed balance** of committed loans including those which are effective and not yet effective (because conditions precedent to effectiveness have not yet been met). This passive approach, which appears to avoid making any estimates or judgements about future NCR, does not establish any direct link between liquidity and the future cash flow risks it is meant to cover. In justifying its policy posture, the AsDB argues that the NCR approach is aimed at determining more the Bank's *borrowing* requirements, with *liquidity* needs under that approach being effectively related to judgements about the possible severity and duration of a possible crisis in market access for borrowings. Liquidity needs under this approach also require judgements to be made about the critical minimum level of liquidity below which any further reduction might itself impair investor confidence in the Bank's securities in addition to those risks which caused liquidity to shrink in the first place.

Thus the AsDB (somewhat lamely) asserts that the NCR approach tends to confuse uncertainties which might affect the Bank's ability to borrow from uncertainties which might affect the Bank's cash inflows. In reality the NCR approach does not confuse these two uncertainties but instead makes it incumbent on management to think through, simulate and evaluate, on a regular and thorough basis, all the possible risks/uncertainties that might affect each component of its *inward* and *outward* cash flows and to make reasoned judgements (for which ratios are supposed to be a guide and not a substitute) about how much liquidity is necessary to protect against these risks. In taking the posture that it has so far, the AsDB's management appears inclined implicitly to avoid the difficulties, effort and inconvenience of thorough analysis as a basis for making reasoned judgements, preferring instead, rule-based and ratio-driven heuristics to make decisions on auto-pilot. However, it is clear that the AsDB is in the midst of a shift from the passive, ratio-driven approach based indirectly on LDR to a more active NCR based approach to liquidity management. In its most recent review of liquidity policy the AsDB concedes that, while the cash flow (i.e. NCR) approach is *conceptually the best approach* to determine liquidity requirements, the present approach, which uses the year-end undisbursed balance of loans, is more practical *because it avoids the difficulties associated with forecasting the Bank's future NCR*. The AsDB Board has suggested to use *both* approaches to determine its liquidity needs until the Bank has gained more experience in the application of the cash flow approach.

Until 1971, the IDB followed a *full-coverage* liquidity policy as a prudential measure to avoid the prospect of having to lend funds at fixed rates lower than the cost of subsequent borrowings made to cover disbursement requirements. With the rapid build-up in liquidity which occurred as the Bank's operations grew, this policy was reviewed in 1971 as a result of which the IDB adopted a policy of maintaining liquidity at a level which either covered 50% of undisbursed loan amounts committed at a given point in time or amounted to estimated loan disbursements for the next two years, which was higher. In that sense the IDB's liquidity policy was partially similar to that of the AsDB in being based partly on an overall balance sheet ratio relating liquidity to undisbursed loan balances and partly on covering forward loan disbursements. Both indicators, of course, are based on the LDR approach but they ignore essential components of NCR other than gross disbursements. The policy adopted in 1971 and maintained till 1991 protected the IDB against two major risks which were not actually anticipated when the policy came into being: (i) poor profitability on *inter-regional capital* (established when non-regional members joined the IDB in 1976) which was not merged with its ordinary capital until 1987; and (ii) erosion of the IDB's statutory borrowing capacity which occurred between 1985-89 when the dollar depreciated sharply and until GIR-7 was negotiated.

In 1991, the IDB changed its liquidity formula, establishing a **ceiling for liquidity equal to the sum of 50% of undisbursed amounts from effective loans, plus 33% of NCR for the next 2 years** thus combining the LDR and NCR approaches. In 1993, the IDB retained this formula and the ceiling established but decided to reduce the target for liquidity to 80% of the amount suggested by the above formula but allowing for a margin of flexibility of  $\pm 10\%$  to permit the IDB to respond opportunistically to borrowing conditions in capital markets. The 1991 changes were made in response to two other risks which had emerged in 1987 and which were being perceived by management as being the more relevant to protect against: (i) deterioration in IDB's protracted arrears and non-accruals situation which might compel the IDB to enter the market with a poorly received bond issue thus resulting in a down-grading of its credit rating; and (ii) volatile or constrained capital markets which, if entered involuntarily, could increase its borrowing costs.

In making these changes the IDB's management opted for combining the LDR and NCR approaches to liquidity management on the grounds that the LDR component would provide *stability* in an environment of rapid lending growth while the NCR component would be more *responsive* to sudden changes in the Bank's contractually determined cash flows caused, for example, by sudden and large exchange rate fluctuations. This hybrid approach, of course, is based less on sound intellectual reasoning and more on

the belief in gradualism for the sake of gradualism, i.e. movement toward unfamiliar territory for psychological reasons, coupled with the belief that pragmatism needs to be justified on intellectually unsound foundations. Combining the LDR and NCR approaches effectively means a partial form of double-counting since a proper calculation of NCR over any future period would naturally incorporate the contractual LDR element over that same period. Thus separating out these elements and accommodating them individually in a two-element formula is an elaborate approach to self-delusion since the same result can be achieved by a unified NCR approach without risking any volatility. Unfortunately, unlike the AsDB the IDB has not yet brought itself to concede that the NCR is indeed the best conceptual (and even practical) approach to liquidity management instead complacently congratulating itself on the wisdom of the current policy and choosing to retain it rather than transiting to a fully NCR based approach.<sup>9</sup>

### *Revisiting Liquidity Requirements*

The foregoing review of policy suggests that the issue of how much liquidity an MDB should carry is largely a matter of judgement despite the apparent sophistication of analysis which underpins the different policies for liquidity management that the various MDBs choose to pursue. These exercises are sometimes little more than disingenuous attempts to “dazzle with numbers”. Given the fact that they operate in largely the same way, and need liquidity for essentially the same purposes, it is astonishing that the MDBs take such different approaches to justifying how much liquidity they need. If the essence of keeping liquidity is to protect against various risks which might interrupt cash flows (and especially *inward* cash flows) then conceptually the soundest approach to formulating liquidity policy is on the basis of NCR over some future period; mainly because LDR deals with only one dimension of *outward* cash flows to which the MDBs are contractually committed. Indeed, in the mature MDBs, the debt service on their own

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<sup>9</sup> In arguing its case, the IDB asserts that while a liquidity policy based on NCR has advantages over a purely LDR (or balance-sheet) based approach, in that it takes into account all the contractual cash flows, it still claims that such an approach would not be appropriate for the IDB. This is because it believes that an NCR approach lends itself to a situation in which an MDB finds itself in a position of smooth progression and growth in its operations (like the IBRD) rather than one which has a history of turbulence (like the IDB) in the funding of its capital increases and the growth of its operations. This argument though elaborately made and quantitatively substantiated at great length in the IDB’s “Review of Financial Policies” (Board Document No. GP-117 dated 7 September 1990) remains intellectually weak if not invalid although a detailed exposition of why that is so would perhaps be too involved and technical for a publication of this nature.

borrowings from capital markets is now becoming as important a form of contractual outward cash flows as disbursements. There is a strong case to be made therefore for all the MDBs to move towards a more consistent basis, based on NCR, for formulating their liquidity policies and managing their liquidity.

Given the manner in which global financial markets now operate, it is virtually inconceivable that any MDB would have its access (for borrowings) interrupted to all international and domestic capital markets in the OECD world simultaneously. For that eventuality to materialise it would take a cataclysm which disrupted entirely the world's financial system. Indeed such systemic ructions and near-meltdowns almost occurred in bond and currency markets in mid-1982, late-1985, October 1987 and September 1992, while bond markets were seriously disrupted again in June 1994. In all these cases the global bond market stabilised fairly quickly. Throughout all these episodes, market access for MDBs was never interrupted; to the contrary, access for MDBs actually became easier and increased, even for the AfDB. It is still possible that major shareholder governments, for political rather than economic or financial reasons, may choose to exert their rights to prevent MDBs from borrowing in their markets or their currencies, thus abusing the Article in MDB charters which gives them those rights. That has happened before and could happen again, although the likelihood of such occurrences in the three major reserve currency markets has diminished, again mainly because of fundamental differences in the way financial markets have operated since 1981. Obviously, as indicated earlier, it would be best if donor shareholders waived those rights altogether because, in current conditions, they are largely unnecessary.

Hence, continually expressed fears by MDBs about interruption of access to markets, of the kind which occasionally occurred before, appear now to be distinctly overplayed. Collective policy failures on the part of G-7 governments, however, may well occur which could disrupt bond and currency markets for short periods of time during which MDBs may choose not to borrow. But again, it is almost inconceivable that MDBs like the World Bank, the AsDB and IDB would (or indeed could) stay out of the market for too long a period, even under unpropitious conditions. As regular issuers who need continuous access to capital markets to fund their growing disbursements and to keep re-funding their own debt they need to issue their securities almost continually under good market conditions or bad. The AfDB and EBRD could stay out of the market for much longer periods as neither their capital-raising needs, nor their debt service and debt-turnover needs, are as yet as high as for the other three MDBs.

With that being the case, it is clear that the current levels of liquidity which MDBs are carrying are significantly higher than they need to be if the

only purpose of carrying liquidity were to cover various cash-flow risks and uncertainties. The MDBs could operate quite comfortably with a level of liquidity which was equivalent to around 30-35% of NCR for the next three years or 100% of NCR for the next 12-month period (on a rolling monthly basis). It would be nearly impossible for MDB financial officers to argue the case that such a reduced level of liquidity would be insufficient to cover potential cash-flow risks. Such a reduction would, however, almost certainly have the effect of lowering current levels of investment income by around 30-35%. That, in turn, would mean an inevitable increase in the loan charges of all the MDBs to maintain current levels of net income in order to retain market confidence and keep building up reserves at an adequate pace. The only alternative to an increase in loan charges would be for MDBs to cut dramatically their administrative costs (by an amount equivalent to the decline in investment income) so as to achieve intermediation efficiency levels comparable to those of the private sector. That option, however, though necessary for MDBs to exercise in any case, has proven almost impossible for MDBs (which have in some senses become the most protected and least accountable of public bureaucracies) to implement.

The present loan charge levels of MDBs are already high in comparison to the costs of borrowing directly from the market, especially for the more creditworthy developing countries given the added implicit cost to borrowers of carrying a significant exchange risk on MDB loans. A further increase in loan charges would make the MDBs sufficiently uncompetitive in their loan pricing to risk a sharp decline in their lending and even further marginalisation of their role as transferors of real resources from developed to developing countries. Hence the real, and perhaps even defensible, reason for MDBs maintaining a much higher level of liquidity than is necessary for risk coverage purposes is to generate sufficient investment income in order to: cross-subsidise MDB lending operations; avoid sharp (albeit essential) cutbacks in administrative costs; and maintain or increase current levels of net income.<sup>10</sup> Given that the *income imperative* drives the need to keep liquidity levels as high as they are, it would be wiser for MDB managements and their Executive Boards, since they are not entirely unaware of the situation, to be more transparent and forthright in justifying their liquidity policies on the basis of both: (i) their need to maintain income levels; and (ii) cover cash-flow risks. Instead, they continue to put the burden of the argument entirely on

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10 In the case of the AfDB, which faces a difficult portfolio performance problem, present levels of net income need to be substantially increased by taking all possible measures available i.e. (i) increasing investment income by permitting a higher than necessary level of liquidity (ii) cutting down administrative expenses; (iii) increasing loan charges marginally; and (iv) undertaking more effective collection and recovery actions in order to reduce the level of non-accruals and loan provisions which directly affect net income adversely.

the second of these reasons, thus stretching the credibility of the argument (as well as their own) beyond breaking point.

Their present approach only fosters the notion that MDB managements now have a general predisposition to being opaque and disingenuous. That is unnecessary when they can just as easily be transparent and straightforward and still attract support for the positions they wish to convince their shareholders to take. The issue, of course, in admitting openly that higher than necessary liquidity levels are maintained principally in order to generate income is that MDBs are likely to become more subject to close scrutiny on their risk exposure especially in derivatives markets, and on their relative prowess in managing their liquidity, with shareholders becoming more concerned about their returns on investments. That is likely to put more pressure on MDB treasurers than they would ideally like and expose them to far greater accountability and transparency than they might be comfortable with. It would also require MDBs to put in place much more sophisticated systems of cost accounting to indicate exactly what the *net profit* on their investment operations is, by apportioning more clearly the borrowing and administrative costs associated with the investment management activity, relative to their net profit from lending and lending support operations.

#### *Current Liquidity Levels of the MDBs*

The current liquidity levels of the MDBs and the income derived from them (as well as their significance in relative terms) are depicted in Table 6. As can be seen from that table, the ratios for EBRD reflect a start-up situation and are entirely out of line with the rest (except in the comparison on returns on liquidity) of the MDBs. They only suggest that shareholders have released too much money too soon to an institution which will take some time to gear up to meeting its lending and investment objectives. Until then the EBRD will be principally a financial arbitrageur, earning income sufficient to cover the high up-front expenses it must incur to develop its lending and equity investment operations. Even so, the question that shareholders need to ask themselves is whether the provision of too much money too soon to the institution might actually have encouraged it to indulge in some of the excesses in which it did before shareholders collectively acted to rein it in.

#### *Allowable Investments & Investment Authority*

In managing MDB liquidity, apart from the major issue of how much liquidity should MDBs keep, there arises the question of what kind of investments and instruments should MDBs be permitted to invest their liquid

**Table 6 Features and Characteristics of MDBs' Liquidity 1993/94**  
(billions of U.S. dollars)

	IBRD*	IDB	AsDB	AfDB	EBRD
<b>Liquid Assets</b>					
Cash in Banks	0.22	0.26	0.17	0.33	n.a.
Time Deposits etc.	11.62	n.a.	1.20	0.68	0.53
Tradable Instruments	9.70	7.54	4.44	1.48	3.99
Accrued Interest on Inv.	0.11	0.07	0.06	0.02	n.a.
<b>Total Liquidity</b>	<b>21.65**</b>	<b>7.87</b>	<b>5.87</b>	<b>2.51</b>	<b>4.52</b>
Total Assets	142.18	32.27	25.11	11.94	7.85
Liquidity/Assets	15.2%	24.4%	23.4%	21.0%	57.6%
Undisbursed Loans	43.66	14.97	8.96	5.91	2.53
Liquidity/Undisb Loans	49.6%	52.6%	65.5%	42.5%	178.7%
Investment Income	0.79	0.48	0.41	0.20	0.28
Income from Operations	7.81	1.86	1.09	0.60	0.04
Total Income	8.60	2.33	1.51	0.80	0.39
Net Income	1.05	0.40	0.57	0.11	0.0045***
Inv Income/Tot Income	9.2%	20.6%	27.2%	25.0%	71.8%
Inv Income/Net Income	75%	121%	72%	178%	6200%
Inv Income/Liquidity	3.65%	6.10%	6.98%	7.84%	6.19%

\* IBRD FY ends June 30; other MDBs December 31.

\*\* The figures for the IBRD are not strictly comparable to those of the other MDBs. They reflect investment incomes over different time periods when global interest rates were quite different. IBRD's investment income performance in FY94 was much worse than in FY93 when it earned over US\$1.36 billion on a liquidity portfolio of US\$18.8 billion yielding an average return of 7.24%. In FY94 the IBRD incurred significant losses on its portfolio with the reversals in interest income which occurred during the first half of 1994. Uncharacteristically, and in contrast to its usually astute financial management, the IBRD's Treasury did not anticipate those reversals. The management of IBRD's Treasury operations deteriorated discernibly in FY94. Any continuation of that trend would be disconcerting for shareholders and bondholders.

\*\*\* The EBRD's net income in 1993 was US\$4.5 million.

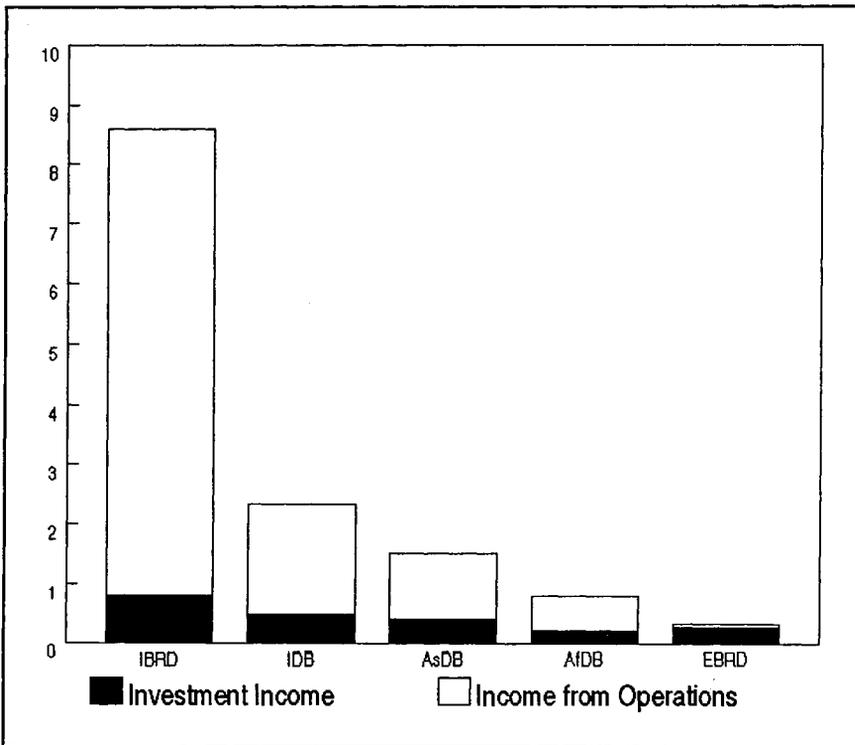
Sources: Annual Reports of the regional MDBs for 1993 and 1994 for the IBRD.

funds in, bearing in mind that such investments must be as close to risk-free as possible (from the viewpoint of credit quality to minimise the prospect of capital loss), whilst still permitting MDBs to earn a positive return. All the MDBs have explicit policies on this issue and all such policies are fairly similar. Of course, MDB investment authority has evolved over time in response to changes in financial markets, the emergence of new instruments,

and the characteristics which MDB liquidity must have. By and large the range of instruments in which MDBs can invest has expanded to permit greater diversification and improved risk management. That change has been accompanied by a commensurate change in the roles of Executive Boards which have moved from directly approving of specific investments (in terms of instruments and issuers) to providing MDB managements with greater flexibility to make specific investment decisions while still establishing clear guidelines on the types of instruments, eligible issuers, counterparties and the minimum credit standards which are permissible, and within which MDB treasurers are required to operate.

In earlier days, MDB investment authority was based on a degree of conservatism which today might be considered extreme. Detailed operating

**Figure 3 Breakdown of MDB Total Income**  
(billions of U.S. dollars)



instructions were provided to MDB Treasurers by their Executive Boards (with relatively little discretion permitted to MDB financial managers) on the instruments, volumes, maturities and proportions of liquid portfolios which could be invested in different types of instruments. The Boards retained the right to approve specific transactions and individual issuers in whose securities the MDBs could invest. With the changes that occurred in financial markets in 1981 and thereafter, such a *modus operandi* quickly became unworkable. Consequently, the approach to providing investment authority to MDB treasurers changed. Investment procedures were streamlined and MDB managements were permitted to operate flexibly in real time while Boards still maintained the right to determine investment policy and investment authority guidelines. A clearer dividing line was drawn between investment policy (the prerogative of the Board) and investment management and execution (the prerogative of MDB treasuries and their staff). At present, the investment authorities granted by MDB Boards set exposure limits on: (i) portfolio *durations*<sup>11</sup> and the maximum maturity allowable for certain types of transactions; (ii) the minimum permissible credit ratings of issuers of securities in which MDBs are allowed to invest; (iii) the types of issuers whose

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11 The most commonly used measure of the interest rate risk inherent in any debt security has traditionally been the term to maturity. This is because the impact of interest rate movements on the yield of a given security affects its price and the price impact of any interest rate change increases with the maturity of the security; securities with longer dated maturities are thus subject to much greater interest rate risk. While the maturity or average life of a security is a simple and easily understood measure it does not measure interest risk adequately. Its major weakness is that it gives unduly high weight to the final payment on the security and insufficient weight to the intervening payments. A second weakness is that differences in the maturity of securities do not appropriately reflect their vulnerability to price volatility in any simple or obvious relationship. A 30-year bond is not 15 times more volatile than a 2-year note but only about 6 times as volatile. Also the average maturity as an indicator of risk severely understates the price risks of zero-coupon instruments. A more appropriate measure of risk or price volatility of a debt instrument, is one which reflects a clear relationship between the percentage change in its price relative to a given change in yields. Such a measure usually does so by measuring the present value equivalents of the future stream of all payments which any security generates. This measure, known as the *duration* of the security, is one which implies for example that a 5-year security with a duration of 4.00 will see a 4% movement in price for a 1% variation in the yield to maturity. The duration of a security is less than the term to maturity except in the case of zero-coupon bonds when the duration is the same as the maturity. There is usually little difference between duration and maturity for short-term securities. There is considerable difference between the two for long-dated maturities. Also the duration of lower coupon bonds is higher than the duration of higher coupon bonds. The concept of *portfolio duration* is now widely used as a measure of market risk management instead of relying on maturity limits to define the mix of various assets in a portfolio. Since duration is a measure of portfolio risk which is based on the total cash flow deriving from a portfolio or an instrument (including cash flow from both principal and interest) it can be used to measure the effects of derivatives (futures, options) on portfolio risk.

securities are eligible; and (iv) the extent of risk that can be taken in specific markets, and for specific types of credits.

Generally speaking, the investment rules permitted by MDB Boards authorise liquid investments in: (i) obligations issued or guaranteed by governments with no credit rating requirement if such obligations are denominated in that government's domestic currency; (ii) obligations issued or guaranteed by governments with a minimum credit rating requirement of AA or equivalent in international markets if such obligations are denominated in currency other than the issuing government's own currency; (iii) securities issued by other multilateral or supranational organisations or governments agencies, which do not carry a guarantee of their governments, provided they are rated AAA; (iv) sales of US federal funds or their equivalents in Germany and Japan, (v) purchase/sale of deposits, bankers' acceptances and other obligations issued or guaranteed by banks and other financial institutions, provided that the debt of such institutions is rated at least single-A for maturities of less than 90 days and at least AA for instruments with maturities of more than 90 days; (vi) traded derivatives (futures, options, swaps, swaptions in interest rates and currencies); (vii) securities lending, borrowing and repurchase transactions (i.e. repos); and (viii) specific currency exchange agreements or covered forward transactions with a maximum maturity of one year.

MDB's are also permitted to incur short-term bank borrowings (overdrafts) for cash management purposes for upto 30 days and to undertake offset borrowings to reverse investments made with commercial banks or other pre-approved financial intermediaries. The average duration of MDB portfolios is not permitted to exceed 48 months in all the MDBs. All the MDBs have exposure limits for investments in any single security; for example, the AfDB (the MDB with the lowest absolute amount of liquidity) has a limit of US\$200 million for investment in any single security denominated in US dollars and US\$100 million in any other convertible currency. There are also limits on the proportion of any single issue that a given MDB can purchase for its own investment purposes as well as limits on the proportion of the total amount of liquidity that can be invested in any single type of security or in the paper of a particular category of issuer (e.g. supnationals, or government agencies which have issued unguaranteed paper). In short, the general approach to liquidity management in the MDBs is conservative and safe. The only risk lies in ensuring that the controls over liquidity management *practices*, to keep them in line with *policies*, are sufficiently tight and subject to frequent monitoring in real time.

Liquidity management also involves a number of other sub-policies and practices concerning the actual management of the investment portfolio and how the performance of the in-house investment department is rated and

evaluated against outside performers and against benchmark portfolios. A large part of the discussion and analysis of liquidity management issues presented by the MDBs in various Board papers is technically complex and arcane as is reflected in the detailed reviews of major financial policies which have been undertaken by the IDB in 1990, and the AsDB and AfDB in 1993. The most thorough analysis of the technical and conceptual issues is usually contained in the papers prepared by the World Bank which often reflect state-of-the-art thinking on portfolio management in particular and financial resource management in general.

### *Currency Management Policies of the MDBs*

Of the many MDB financial policy issues that emerge from time to time, among the simplest to deal with in broad conceptual terms, but the most technically difficult to construct and explain in practical terms are the issues concerning *currency pooling* and *currency management* by the MDBs. Simply put the problem arises because the MDBs, by their Articles, are required not to assume any exchange risk on their financial activities which they have interpreted to mean passing it on to their borrowers. As seen earlier, MDBs are capitalised in a variety of convertible and non-convertible currencies. They have to borrow from various capital markets in a different variety of currencies. Moreover, they prefer to use only certain currencies from their borrowing and capital pools for investment purposes, depending on which markets they can derive the highest risk-free arbitrage margins in, depending on prevailing interest rates in different currency markets, and future expectations about their relative movement across these markets.

Upto now, MDBs have seen themselves effectively as global or regional credit co-operatives, rather than as banks, which can discriminate among their borrowers in pricing their loans or offering a wide variety of *loan products* i.e. different types of loans for different purposes, in different currencies with varying costs and terms. Instead, on the grounds of *equity* and *uniformity* across their borrowers, all the MDBs (except EBRD) have chosen to lend in a way which distributes all the exchange and interest risks inherent in their borrowing and investment operations to all their borrowers equitably by designing loans with almost uniform characteristics. Through the 1980s, MDBs (especially the IBRD) were somewhat unfair to their borrowers by keeping currencies which then had high nominal costs (i.e. USD and GBP) in their *investment* pool and putting the low-nominal cost currencies (such as the DEM, JPY, DFL and SFR), with the highest attached exchange risks, in the *loan* pool while charging borrowers a spread on the average cost of all the currencies borrowed instead of a spread over the much lower nominal cost of only those currencies in the loan pool. Thus borrowers paid both a higher

cost and took a higher exchange risk than was necessary or fair with the IBRD benefiting from the difference.

Since 1989, these sharp practices have been moderated somewhat with fairer systems of currency pooling and management. At the same time, given the policy twist which occurred in Germany following reunification, the traditional relative cost structure of the world's major currencies was partially inverted. The DEM and its affiliated currencies (such as the DFL and SWF) atypically became high nominal cost currencies in the early 1990s while the USD and GBP became low cost currencies along with the JPY. It would be simplest, of course, if MDBs borrowed only in US dollars or some other currency or composite (ECU or SDR), if their investment pools were in exactly the same currency and if they were capitalised in that currency. But, things are not quite that simple. As seen in Chapter 2, there is as yet no consensus even on the standard of value in which capital contributions to MDBs are denominated or indeed on how to maintain the value of these capital contributions. The EBRD has finessed that issue in part by denominating its capital and its loans in ECU; but even the EBRD still borrows in currencies other than the ECU composite and its liquidity is certainly not managed in ECU.

The *currency pooling system* was adopted by the IBRD in 1980 and IDB in 1982 and a variant of it, i.e. the *exchange rate pooling system* (ERPS), was adopted by the AsDB in 1986 and the AfDB in 1989.<sup>12</sup> Both systems attempt to distribute the interest cost and exchange risk equally among all loans in the system by assigning each loan the same currency composition as the composition of the MDB's entire loan portfolio. Each loan made therefore has the same currency composition as any other, regardless of the individual currencies being disbursed or recalled on that particular loan. That sounds simple enough. The practical complexity arises because disbursements and repayments, which result in funds flowing in and out of the currency pool continuously, obviously alter the composition of the currency pool *with each transaction*. Therefore, at the end of each business day in the IBRD, and

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<sup>12</sup> Before 1980, although each MDB followed a different practice, each MDB loan to a borrower had a different currency composition based on the MDB's borrowings immediately prior to the loan being made. For example, the AsDB's loans were composed of 50% US dollars and 50% any other convertible currencies. The currencies disbursed against a loan, or recalled when the loan was being amortised, or when interest was being paid at any time, were 1/2 determined by the MDB's own needs (e.g. for debt retirement). Although some leavening and smoothing of the currency composition occurred for large borrowers who borrowed frequently over a long period of time, smaller and infrequent MDB borrowers were left with concentrated currency risks different from those of other borrowers. Moreover, the large movements that occurred in exchange alignments, misalignments and realignments between 1974-80 resulted in large variations in the obligations of borrowers to the MDBs, calling for an improved system for spreading and equalising risks, and resulting in the *currency pooling* approach.

fortnightly in the other MDBs, the composition of each MDB's currency pool (and by implication of each disbursed and outstanding loan) has to be recalculated. The outstanding balance of each loan is then translated into USD equivalent, taking into account fluctuations in the USD value of the loan as a result of daily exchange rate movements between the USD and the currencies in the pool.<sup>13</sup> Consequently, all loans funded out of the currency pool share equally with the cumulative exchange risk associated with the currency composition of the pool. In other words, the currency pool does not eliminate exchange risk for the borrowers; it only spreads the risk out equally among all borrowers and all loans.

The problem with the currency pooling system, however, was that it was managed (initially) in a way which was not transparent. It passed on to borrowers more costs than should reasonably have been passed on to them because of the different compositions of the *loan currency pool* and the *liquidity currency pool*. Borrowers could not predict the composition of currencies included in the pool, nor could they cope with the daily variations in the pool's composition. Consequently they could not even hedge the currency risk on their MDB loans (even partially) through the use of hedging instruments available in foreign exchange markets since they had no idea what their currency risk exposure was and it changed every day. The currency pool, instead of comprising a *balanced* set of the world's major currencies, became skewed towards low-nominal-cost currencies with a high associated exchange risk, thus introducing an added element of volatility in the effective cost of MDB loans when measured in USD equivalent terms.

In 1989, the IBRD began to target the composition of its currency pool under a modified *targeted currency pooling (TCP)* system with an equal division of at least 90% of the pool between USD, DEM group currencies, and JPY. The exchange rates used to determine these three equal shares between the major currency groups were 1 USD : 125 JPY : 2 DEM. Clearly if the new equilibrium between exchange rates established in 1994 persists for any length of time these exchange rates may need to be realigned to 1 USD : 100 JPY : 1.50 DEM. The TCP approach has: (i) enabled the volatility of currency risk and effective cost of MDB loans to be reduced; and (ii) permitted borrowers to predict their currency exposure risk on MDB loans in a better fashion and to hedge against those risks depending on the view they take on future currency movements.

The IDB also moved towards a TCP in 1990 followed by the AfDB in 1991. Following an intensive review in 1992, the AsDB chose to maintain its

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13 At any given time therefore, the repayment obligation for any MDB loan is thus represented by the original USD value when the loan was fully disbursed plus the pro-rata share of that particular loan in any exchange difference in the USD equivalent value of the currency pool.

ERPS approach offering borrowers a choice instead, of loans (at fixed or variable rate) either in USD or in a basket of currencies under an ERPS which would include only the DEM group and JPY.<sup>14</sup> In February 1993, the IBRD followed by introducing the option of offering its non-sovereign borrowers (i.e. agencies and DFIs) single currency loans in any of the five currencies that constitute the SDR, i.e. USD, JPY, DEM, GBP or FFR, with loan pricing linked to the 180-day LIBOR (or for the FFR, PIBOR )rate in that currency. This option was introduced on a pilot programme basis and limited to a total of US\$3 billion in commitments and subject to review in early 1995.<sup>15</sup> Neither the AfDB nor IDB have yet moved towards offering single currency loans although the IDB hinted at this possibility in its 1990 review of major financial policies and suggested the establishment of a separate USD lending window.

The EBRD has decided from the outset to offer its borrowers either fixed rate or variable rate loans in a wide choice of currencies (limited mainly to USD, JPY, ECU or any other convertible currency in which funding is available to the EBRD) or loans in any basket of currencies of the borrowers choice which is not standardised through a TCP.<sup>16</sup> The EBRD has also experimented with a borrowing and lending operation in the currency of its borrowing members which could be a precursor to a whole new approach in MDB borrowing and lending in the future.<sup>17</sup> In that sense the EBRD has chosen (perhaps wisely) to break new ground for the MDBs in acting more like any other commercial or merchant bank in offering loan products which are *demand-driven* – i.e. by the particular needs of the borrower and the project – rather than *supply-driven* by the strictures of a MDB concerned about homogenising its loan products (largely to simplify life for itself rather than for its borrowers), pooling all risks and spreading them equitably across

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14 Between July 1992-93, the AsDB disbursed additional USD into the loan currency pool (ERPS) for allocation to its earlier fixed-rate loans so as to improve the transparency of the applicable lending rate. Once the share of USD in the ERPS reached about 30% the AsDB removed all fixed-rate loans from the ERPS allowing the currency obligations under fixed-rate loans to be fixed thus reducing the size of ERPS from US\$11.2 bn to US\$ 7.6 bn. The AsDB is also working on providing VLR loan borrowers with a one-year advance estimate of their debt service requirements to provide a better basis for them to hedge their risks.

15 For a detailed (and excellently argued) exposition of the reasoning behind this proposal see IBRD Board Document No. R93-5 “A Proposal to Introduce Single Currency Loans” dated January 15, 1993. By the end of FY94, a total of over US\$1.7 billion in single currency loans had been approved, involving nine loans to nine countries. All these loans were in USD.

16 See EBRD Board Document No. BDS91-5 on “Financial Policies” dated 23 June 1993. Also see Board Document No. BDS91-50 on “Portfolio Risk Management and Lending Policies” dated 10 December 1993.

17 See EBRD Board Documents Nos BDS92-92 on “Borrowing and Lending in the Currencies of the Countries of Operations” dated 8 September, 1992 and BDS93-57 on “Local Currency Borrowing and Lending” dated 18 May 1993.

all borrowers. As the focus of development financing, including that from the MDBs, moves increasingly towards the private sector, the trend is already being established for other, more traditional MDBs which have become too set in their comfortable ways, to emulate the innovativeness and dynamism of the newest entrant into the MDB community.

### *From the Past to the Future*

As the foregoing paragraphs suggest, the established MDBs have chosen to respect the Article which prohibits them from taking exchange risks in ways which have evolved and become increasingly sophisticated and borrower-friendly over time. MDBs have moved from passing on currency risk on a loan-by-loan basis, to a currency pooling system, to a TCP system, to opening the door to making single-currency loans in the major convertible currencies. Evolution has been in the right direction. MDBs have moved away from making life as easy and as profitable as possible for themselves (while making it as difficult as possible for their borrowers), to gradually acknowledging and accommodating the legitimate concerns and interests of their borrowers. The process of evolution has also been heavily influenced by external factors; i.e. major changes in technology and in financial markets and instruments. It is difficult to conceive how currency pooling and TCP systems could have been devised and run without the power of quasi-super computers. It is equally difficult to envisage how MDBs could manage risk with increasing diversity of their loan portfolio without new instruments in financial markets.

As far as the future is concerned, the following factors are noteworthy. *First*, notwithstanding reservations about whether its existence is justified, an innovative and imaginative new MDB (the EBRD) has entered the scene and may already be setting a new pace and new direction for the future. *Second*, a wide range of private financial intermediaries are now becoming major participants in commercially oriented development financing. *Third*, a new ethos is emerging in development financing in the 1990s and beyond, with more focus on shifting the locus of attention away from financing governments and their instrumentalities to financing private enterprise. The more established MDBs are therefore entering difficult and unfamiliar territory. They face a future in which they will inevitably have to cope much greater complexity and risk in portfolio and balance-sheet management. They will need to move away from providing more-or-less homogeneous loan products to catering for a much more heterogeneous range of loan, quasi-equity, and guarantee products, some with built-in derivatives to cap or contain risk, and with switching features, in different currencies, with different prices and terms, which are tailored to meet the needs of specific

borrowers for specific projects. The established MDBs will not do so without resistance, largely because their present management and staff are neither qualified nor competent to handle such heterogeneity, nor are they as client-oriented as they need to be. But adapt they will have to, if they wish to remain relevant participants in the arena of development financing. These pressures to transform (or using their own terminology, to adjust structurally to a more competitive environment) will place a weak MDB such as the AfDB, at an even greater disadvantage than it is now to keep up with the other MDBs as they evolve and change.

### *The Particular Problem of the AfDB with Currency Risk*

Unlike the other MDBs which have assiduously avoided taking any currency risk on their lending from the outset, the balance-sheet of the AfDB suffers from a sizeable currency mismatch reflected in its Cumulative Currency Translation Adjustment (CCTA).<sup>18</sup> At the end of 1993 the CCTA amounted to over US\$374 million in potential exchange losses (or about 23% of the AfDB's total reserves). This mismatch arose because, in contravention of its Articles of Agreement, the AfDB *disbursed* against committed loans in a range of currencies which it held but *recorded* the repayment obligations of borrowers in the Bank's Units of Account (UA), or effectively in SDRs rather than in the currencies which it actually disbursed. The currency amounts billed for repayment were determined at UA/SDR exchange rates prevailing on the date of *repayment* rather than on the date of *disbursement*. This meant that when loans were fully repaid on the basis of billings, the total amounts collected in various currencies differed from the amounts actually disbursed in those currencies and, indirectly, from the amounts of those currencies which the AfDB had to repay to its own creditors. The AfDB thus assumed currency risks on its loans which were prohibited by its Charter. It was not until 1990 that the AfDB discontinued billing in UA and started billing, and collecting from, borrowers the exact amount of the currencies that had actually been disbursed on loans.

Unfortunately a cumulative mismatch remains on all loans made and disbursed between 1965-89. That mismatch has been exacerbated by the practice of: (i) accepting loan repayments in only the USD and FFR and converting them into the currencies disbursed; (ii) converting currencies

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18 See (1) AfDB Board Document No (ADB/BD/WP/91/46) on "Proposal to Correct the Currency Mismatch in the Bank's Balance Sheet" dated 24 April 1991 and (2) Board Document No. (ADB/BD/WP/91/68) on "Experiences of the Bank Group with the Currency Billing and Prospects for Implementation of an Exchange Risk Pooling System" dated 29 April 1991.

obtained from borrowings to meet the Bank's debt service obligations in other currencies – e.g. in 1979 the Bank borrowed DEM and exchanged them for USD to meet its debt service on previous USD borrowings, in 1984 it converted the proceeds from a JPY borrowing to retire USD debt, and in 1986 it borrowed and converted USD to repay a bond issue in Austrian schillings; and (iii) requesting currencies (mainly USD) for the payment of management fees by the AfDF and the NTF which are not the same as the currencies it expends for administration.

In 1991, the AfDB Board took steps to arrest and reverse the situation by correcting the causes of the mismatch as a first step and by authorising the management to engage in: (i) structured borrowing operations designed to reduce the CCTA; and (ii) a limited programme of currency balancing (selling currencies in which the AfDB was long and buying those in which it was short on its balance sheet) to minimise the mismatch on the AfDB's financial assets/liabilities. These actions were aimed at eliminating the CCTA gradually over a period of time subject to the availability of liquidity and minimising losses on the foreign exchange transactions involved in the currency buy/sell transactions by undertaking such transactions when market conditions were propitious.<sup>19</sup>

### *Policies on Lending Rates, Terms and other Loan Charges*

All MDBs charge an *interest rate* on the loan balances and outstanding. In addition some MDBs also charge *commitment fees* on undisbursed loan balances and *front-end service fees* although the levels of these differ. From being institutions which made only *fixed-rate* loans since their inception, the MDBs shifted to *variable-rate* lending in 1982 when financial market conditions became such that the funding risks for loans, whose interest rates were fixed in advance but disbursed over 1-10 years, became unacceptably high. Between 1982-84 (the period of the US Federal Reserve-induced worldwide monetary squeeze) it became almost impossible for MDBs to borrow long-term money at fixed rates themselves in international capital markets except at astronomic costs. These circumstances reversed after 1986-87 when long-term fixed rate borrowings at attractive costs were again possible for the MDBs to avail of.

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19 If the spot rates in foreign exchange markets for the currencies to bought or sold differ significantly from the rates used to value the AfDB's balance sheet, then the buy/sell transactions could lead to exchange gains or losses. Thus, in actually executing these transactions the AfDB would need to wait for market conditions in which spot rates were such as to avoid losses from arising on such transactions, unless the management's view was that equilibrium rates had changed structurally and that the desired market conditions might not arise in the foreseeable future.

The switch to variable-rate lending was an extraordinarily difficult and painful one for MDB managements to convince their Executive Boards to make; especially as many of the problems associated with the debt crisis (which was raging at the time) were associated with the variability of interest rates charged by commercial banks on their earlier loans to developing country borrowers. In retrospect it is difficult, for those who were not involved directly in the process of persuasion, to understand what all the fuss was about. Since 1986, with their own access to fixed-rate borrowings restored with changing financial market conditions, some MDBs have re-offered the option of fixed rate loans to their borrowers. As the paragraphs above have indicated, MDBs are likely in the future to offer a wider range of loan products which are priced quite differently resulting in significant changes in their current lending rate policies.

### *MDB Interest Charges*

As might be expected the interest charges levied by the different MDBs on their loans vary, with the World Bank being the leader both in terms of price setting and in determining the evolution of MDB lending rate policies in general. In the **World Bank (IBRD)** there are, at present, three types of *interest rate* regimes which apply to the IBRD loans presently outstanding. Loans signed before 1982 which are still being amortised, have *fixed* interest rates<sup>20</sup> which were determined at the time the loans was contracted. These rates will remain fixed till maturity. Loans signed by borrowers between 1982-89 were made at *variable* lending rates (VLR) with the pool of lending funds being structured in a manner which was far more stable and variability was much lower than with the single-currency floating rates available in global currency markets. These rates were recalculated every six months. As discussed earlier, however, although the interest rate variability was surprisingly low, the exchange rate volatility inherent in such a lending pool of different currencies was quite high. Consequently, in 1989 a *modified variable* lending rate (MVLRL) was formulated and became standard for all loans signed after May 18, 1989. Borrowers with loans signed before that date

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20 The IBRD's fixed interest rate was determined annually at the beginning of each fiscal year on the basis of a spread of 50 bp added to the weighted *actual* average cost of borrowings undertaken in the immediately previous semester and the estimated average cost of borrowings to be undertaken over the following semester. Reviews were undertaken every quarter and, if necessary, the fixed rate was changed more frequently if that was deemed to be necessary. The rate was fixed at the time of loan commitment and not, like the IDB, at the time of disbursement.

were given the option of converting to the modified rate.<sup>21</sup> The MVLR is also recalculated every semester and the borrowers informed of the new rate that is in effect.

At present the IBRD calculates both the VLR and MVLR and informs borrowers since some borrowers have opted not to convert their pre-1989 loans to the MVLR basis. In the first half of calendar 1993 the VLR was 7.43% and the MVLR was 7.40%. In the second semester these rates changed to 7.27% and 7.20% respectively; in the first half of 1994, the MVLR was 7.10%. The VLR/MVLR system has proved to be exceptionally stable and robust with the variation of IBRD's loan interest rates being contained within a 450 bp range over a 12-year period i.e. between 11.43% to 7.10% between 1982-94. Under the VLR system the IBRD's lending rates have declined almost continually from the level of 11.43% which was set for the first semester when the VLR was introduced, reaching their lowest point so far in 1994. With reversals in the decline of global interest rates since the first quarter of 1994, it is likely that the VLR/MVLR rates will begin to rise again in the second half of 1994 and beyond. On its new programmes of *single currency loans* (mentioned earlier) the IBRD charges a SC-VLR which is reset every January 15 and July 15. The SC-VLR comprises: (i) the *6 month LIBOR rate* for the currency concerned plus (ii) a *cost margin* which amounts to the IBRD's weighted semestral average funding costs for such loans relative to the 6-month LIBOR for the currency, averaged across the five currencies; (iii) plus the usual 50 bp *spread*. The SC-VLR rates applicable in the second semester of 1994 were 3.66% for USD, 2.41% for JPY, 5.91% for DEM, 6.28% for FFR and 5.27% for GBP.

In calculating its VLR/MVLR, the IBRD adds a spread of 50 bp over the weighted average cost of borrowings in the VLR/MVLR pools to cover its

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21 The 1982 variable lending rate (VLR) was computed on the basis of a 50 bp spread over the weighted average cost of *all* outstanding borrowings undertaken by the IBRD since July 1, 1982. The 1989 modification – the modified variable lending rate (MVLR) – attempted to eliminate two problems with the original VLR. One was the fact that outstanding borrowings funded not just the loan currency pool but the liquidity currency pool as well. Since the characteristics of these two pools were quite different, under the VLR borrowers were paying a cost for currencies which they were not receiving and were exposed to a higher exchange risk than they would have if the loan currency pool had the same currency composition as that of all of IBRD's outstanding borrowings. Second, interest-risk management was made unnecessarily complicated under the VLR system. IBRD typically borrowed long-term and (whenever it could at the right cost) fixed rate funds to support its long-term lending. But its liquidity, which is funded from such borrowings, is managed with a short average duration (4 years). To minimise interest rate mismatch and risk, liquidity needed to be funded (at least in part) by short-term or variable rate funds as well. The 1989-MVLR took into account this problem by separating out the loan currency and funds pool and the investment currency and funds pool and pricing loans based on spread over the weighted average cost of funds that were allocated to the lending pool and not the average cost of all borrowings.

own overhead and administrative costs. To encourage borrowers to make their debt service payments on time, the IBRD introduced a policy of interest spread waivers in July 1991. Borrowers making their payments on time (i.e. within 30 days of the payment being due) were eligible to a waiver of 25 bp on the interest spread charged in FY93. The size of the waiver was increased to 35 bp for FY94 but reduced again to 25 bp for FY95 as a result of IBRD's substantially reduced net income in FY94. Borrowers who do not make timely payments are ineligible for the waiver and depending on how late they are subject to the application of progressive sanctions and penalties (discussed in Chapter 6).

In the **African Bank (AfDB)** a pool-based VLR system also applies. It was introduced in 1990, eight years after it was adopted in the IBRD, prior to which interest rates on AfDB loans were fixed. The VLR is calculated on more-or-less the same basis as in the IBRD with a 50 bp spread applied to the weighted average cost of funds in the loan currency-pool. However, given the large weight of fixed rate loans in its portfolio along the high level of non-performing loans the 50 bp spread is inadequate for AfDB to meet its minimum net income requirements or its targets for adequate *interest coverage* and *reserves-to-loans* ratios. In its June 1993 review of financial policies, the AfDB's management recommended to the Board that a new policy be adopted from 1994 onwards of applying a *variable spread* above the Bank's average cost of borrowings which would be reset each year. The size of the spread would be determined by the AfDB's needs to meet that year's net income targets and to reach minimum interest coverage and reserves to loan ratios of 1.25 and 15% respectively. If this policy is agreed (it was being strongly resisted by the AfDB's regional members before the 1994 Annual Meetings) the spread for 1994 is expected to be increased from 50 bp to 75 bp. The VLR would continue to be calculated and reset on a semestral basis. The AfDB's VLR for the first half of 1993 was 8.05% dropping to 8.02% for the second half and again to 7.62% for the first half of 1994. In view of the AfDB's fragile net income position, these reductions (and especially the last) border on the incomprehensible, except perhaps for the possibility that the AfDB wished to remain competitive with the IBRD in its loan pricing regardless of the cost to its profitability or balance-sheet strength.

The **Asian Bank (AsDB)** shifted from a fixed-rate to a VLR system in 1986 after nearly three years of careful consideration. Fixed rate loans prior to 1986 still account for a significant (but diminishing) part of its outstanding loan portfolio. The AsDB *spread* component of the VLR is only 40 bp (the lowest of all the MDBs) and the basis on which the weighted average cost of its borrowings in the loan currency pool is calculated is similar to that in the other MDBs. The AsDB's VLR system has proved even more robust and stable than the IBRD's with interest rate variations being between a high of

7.65% when the system was initiated in 1986 to a low of 6.33% in early 1990; the VLR has fluctuated since then rising to 6.61% in mid-1991 and declining again to 6.34% in mid-1993. As noted earlier, since July 1992, the AsDB has offered its borrowers a choice of either mixed-currency VLR loans or straight US dollar loans also at variable rates. The VLR on the US dollar loans is based on the average cost of USD borrowings undertaken to fund the USD pool with a 40 bp spread applied. The VLR on the USD loans has varied between 6.63-6.64% between 1992-93.

Like the AfDB, the **Inter-American Bank (IDB)** shifted from a fixed-rate (fixed at disbursement rather than at commitment) lending rate to a VLR approach much later than it should have, consequently suffering a bumpier trajectory (and much higher levels of funding risk) in the generation of net income during the 1980s than it otherwise might have. Consequently, fixed rate loans continue to constitute the bulk of its outstanding loan portfolio generating income which is not interest rate sensitive. It adopted the VLR in early 1990 with the rate being determined as in all other cases with a spread over the weighted average cost of borrowings. In the IDB's case the *spread* has, in the past, been larger than for the other MDBs, (it was 100 bp in 1990), but is now more in line with the other MDBs at 58 bp. Interestingly, IDB's spread comprises a *fixed component* of 50 bp to cover the Bank's overhead and administrative costs at headquarters plus a *discretionary component* (presently 8 bp but it has been as high as 50 bp) which can be adjusted in line with achieving required net income levels. To safeguard its net income, the IDB has been pursuing an income-bolstering approach to its lending charges of the kind that the AfDB's management should follow and for much the same reasons. Indeed the IDB's experience through the 1980s has considerable direct relevance for the AfDB from which the latter could learn a lot were the regional members of its Board so inclined. The IDB's VLR is calculated and set semestrally as in the other MDBs. New borrowings are separated (and distinctly costed) into two pools: (i) to fund the pre-1990 fixed-rate loans; and (ii) to fund the post-1990 VLR loans. The lending rate for new disbursements of the fixed (at disbursement) rate loans was 6.96% in the first half of 1993 diminishing to 6.50% in the second half. The VLR was 7.53% in the first half of 1993 and 7.26% in the second half.

Given its quite different operational orientation and flavour, the **European Bank's (EBRD)** lending rate policies and charges are less uni-product oriented and much more variable than those of the other MDBs. Also, the EBRD depends to a much higher extent than the other MDBs, on returns from equity investments, guarantees and lending to the private sector than from sovereign risk lending alone. Thus it does not have any single currency-pool system or bench-mark lending rate similar or equivalent to the semestrally announced VLRs of the other MDBs. In some senses, the EBRD

(as prognosticated earlier) may be the precursor of the type of institution which the other MDBs may (painfully) have to evolve towards becoming in the coming decades. The EBRD's policies stipulate that its loan pricing must be determined according to risk, cost of administration, and contributing to its net income requirements, *with due regard to market terms offered by other lenders for similar loans*. To that end it is prepared to make single currency or multi-currency loans at fixed or floating rates in any currency that is available to it. EBRD usually operates on the basis of structured financing for each operation rather than in funding its operations from a general pool of mixed resources which all of its borrowers share the cost risk and currency risk in equally.

In that aspect, the EBRD operates in a fundamentally different fashion to the other MDBs – less as a mutual credit co-operative and more as a commercially oriented merchant bank. Its modus operandi certainly involve more administrative complexity for itself even though its practice is far more responsive in being custom-tailored to meet the particular needs of its clients. For sovereign loans the EBRD's margin or *spread* over cost of borrowed funds is a uniform 100 bp. In 1993, the EBRD's overall (after swap) cost of all outstanding borrowings was LIBOR *minus* 38 bp across a mix of currencies; in ECU equivalent terms the effective cost amounted to about 6.39%.<sup>22</sup> For loans to private and non-sovereign borrowers, the margin over the EBRD's cost of funds is variable. In the absence of a sovereign guarantee it is meant to reflect both the country-risk as well as the specific project-risk, the latter being decided on a case-by-case basis. The EBRD also levies other charges associated with its loans and investments which include: front-end fees, commitment, pre-payment and conversion fees. These fees fluctuate within a range and vary on a case-by-case basis. The rationale for them is to provide for partial recovery of the EBRD's overheads and contribute the building up of its reserves.

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22 The EBRD's superbly presented (and obviously expensive) Annual Reports are masterpieces of lack of transparency where the objective seems to be to conceal, confuse and self-congratulate as much as possible rather than to inform, clarify, simplify and enlighten. It would be more helpful if the EBRD's Annual Report tried to be consistent, if only for some comparability purposes, with those of the other MDBs. For example, it was only possible to determine the effective cost of EBRD's borrowings in percentage terms by deriving a crude figure from the income statement and balance sheet, estimating the level of outstanding borrowings during 1993 by using a simple average of the outstanding borrowing levels for the 1992 and 1993 year-ends. The way in which the EBRD's financial statements are presented make them difficult to analyse and translate without considerable effort on the part of the analyst; although it must be said that the information provided on the EBRD's exposure in derivatives is useful and different. Shareholders need to exercise some influence over EBRD management to make their Annual Reports more easily readable, informative and comparable to those of the other MDBs.

### *Commitment Fees*

The **IBRD** specifies a *standard annual commitment fee* of 75 bp on the *undisbursed* balances of contracted loans to be charged 60 days after loan signature and annually thereafter. The rationale for such a fee is that since assurance of future funding involves a cost to the IBRD, borrowers should pay towards covering that cost. A review of loan charges in 1988 concluded that a 75 bp fee was perhaps high for a VLR loan; as a *flat* fee it obviously increased the overall cost of a slow-disbursing (project) loan much more than a fast-disbursing (policy) loan. Since the loan income and profitability of the Bank was still subject to market risk and portfolio risk (i.e. the risk of non-accruing loans and loans for which provisions might need to be made out of income) the IBRD's management and Board decided that the 75 bp commitment fee should *not* be eliminated from the Bank's array of loan charges. Instead the IBRD now reviews its net income prospects annually; if the outlook is good, it waives some part of the commitment fee for the following fiscal year. These waivers lapse at the end of each fiscal year and are either renewed or the amount of the commitment fee to be waived is changed by the Executive Board on the basis of management's recommendations. In FY90, the IBRD waived two-thirds of the contractual commitment fee, charging only 25 bp; the commitment fee waiver for 50 bp was still in effect in FY94.

The **AfDB's** commitment charge remains at 100 bp with some pressure from borrowers to reduce it but resistance from non-regional shareholders to countenance any reduction in view of the AfDB's precarious financial circumstances. The **AsDB** charges a commitment fee of 75 bp as does the **IDB** (although the IDB's commitment charge was as high as 1.25% for loans approved upto the end of 1988). These fees are paid semi-annually on undisbursed balances although accrual of the commitment charges begins 60 days after loan signature. In the **EBRD**, commitment fees are variable, and payable on the committed but undrawn part of a facility and are chargeable from the date of signing. Commitment fees of bank credit lines start to accrue on each tranche as it become active and not the whole facility.

### *Front-end and other Special Fees*

In 1982 the **IBRD's** net income based on the prevailing structure of loan charges, threatened to fall below acceptable levels, in a global monetary environment characterised by extreme financial turbulence. Such a fall might have had severe adverse consequences for the Bank's standing in capital markets. Consequently, a *front-end fee* of 150 bp was levied on loans at the time of their becoming effective. Borrowers were given the option of capital-

ising the front-end fee thus allowing this additional cost burden to be spread of the life of the loan. In 1985, with the net income position of the Bank much improved, the front-end fee was discontinued. It has not been applied since. The AfDB used to have a Statutory Commission of 100 bp charged as a front-end fee to fund the Special Reserve of the Bank as required by its Articles. That charge was discontinued at the end of 1988. The AfDB has not levied any front-end fees since then, although in June 1994, management proposed to the Board that a front-end fee should be introduced to rectify current and projected shortfalls in minimum desirable levels of net income, although management conceded that even a 2% front-end fee would not be adequate to cover that shortfall fully. The AsDB has not levied any front-end fees and has no plans to do so.

The IDB levies a front-end fee of 100 bp of the approved amount of each loan for inspection and supervision. The cost burden on borrowers is moderated by the fee being charged in equal quarterly instalments over the originally contracted maturity of the loan. This fee is justified on the grounds that the IDB's extensive network of field offices needs to have its costs covered separately (unlike the other MDBs, the IDB has a field office in every borrowing member country). That fee has been subject to considerable controversy and some pressure for its removal; but as of the end of 1993 it remained in force. The EBRD has a policy of levying front-end commissions (these are variable depending what is being financed in which borrowing country) payable at the time of signing of the loan or facility extended but no later than the first disbursement. Front-end fees to the EBRD are payable in a single up-front lump sum; refunds are not offered to borrowers who do not avail of the full extent of a facility which has been approved. Unlike the other MDBs, the EBRD also has a policy of charging a back-end or *wind-up fee* in the event of a pre-payment or cancellation of its fixed-rate loan products. In addition, for both VLR and FLR loans the EBRD charges an administrative fee. It may also charge a *conversion fee* if a borrower chooses to switch the interest rate basis of the facility contracted from VLR to FLR or vice-versa. Such a fee may be charged either at the time of conversion or, in some cases, it is capitalised (i.e. added to the principal outstanding).

### *Loan Repayment Terms*

The maturities and grace periods for the loans of the more established MDBs vary within narrow bands but those of the EBRD vary quite widely. At present a three-tier structure applies to repayment terms of IBRD loans varying by the income level of its borrowers as shown in the table below. This was not always so. Until 1976, the IBRD's loan repayments were required to be made on an annuity basis with *level* debt service payments. In 1976 the

repayment terms were hardened to meet concerns about the level of lending that could be sustained without an increase in the Bank's capital. Consequently, the basis of repayment was shifted from an annuity method of level debt service payments (implying a gradually rising proportion of *principal amortisation* payments) to a method of *equal principal payments* (EPP) which involved a front-loading of amortisation payments and debt service payments (i.e. including interest payments) which were not level (as with an annuity) but diminishing (i.e. as the interest burden fell over time with increasing amounts of principal being paid). Also, prior to 1976, the IBRD differentiated its repayment terms by the nature of the project being financed and its profile of financial returns. After 1976, it differentiated repayments by the income level of the country being financed and not the project (see Table 7).

**Table 7 Loan Repayment Terms of the IBRD (as in 1993)**

	Grace	Maturity	Basis of Amortisation
<b>Low-Income*</b> (less than \$1,345 GNP/capita)	5 years	20 years	Annuity**
<b>Low Middle-Income*</b> (\$1,346 to \$2,785 GNP/pc) or	4 years 5 years	17 years 17 years	Annuity EPP
<b>Upper Middle-Income*</b> (above \$2,786 GNP/pc) or	3 years 5 years	15 years 15 years	Annuity EPP

\* The GNP/capita amounts which determine these three categories of borrowers change each year. The figures shown relate to 1993.

\*\* Annuity does not actually imply a fixed semestral debt service payment with the VLR. Such payments for VLR loans vary with exchange rates and with movements in the VLR or MVL. However, a crude degree of fixity of the semestral debt service payment is nevertheless attempted with the portion of the interest diminishing over time and the portion of principal repayment rising over time to result in as close a degree of 'equalness' in debt service payments as is possible allowing for VLR and exchange rate fluctuations which have occurred during the semester.

The repayment terms of AfDB loans vary from 12 to 20 years with grace periods varying from 2 to 8 years. Loans of the AsDB have repayment terms of between 10 to 30 years with grace periods varying between 2 and 8 years, while those of the IDB vary from 15-25 years with grace periods of 4 to 8 years. In these three MDBs the basis for determining the maturity and grace periods depends partly on the income level of the country and partly on the cash-flow profile generated by the project being financed. Decision-making on the repayment terms of particular loans is more discretionary and not quite as well-defined or as rigid as in the case of the IBRD matrix shown above. In the regional banks, as in the World Bank, higher-income countries tend to be

granted loans at the lower-end of the grace-maturity ranges while lower-income borrowers get loans at the upper end although these patterns are influenced by the type of project being financed. The EBRD's loans have repayment terms which vary from 3-20 years for state-sector loans and between 1-10 years for loans to private enterprises. The EBRD's view on grace periods is more commercial than is that of the other MDBs. EBRD believes that principal repayments should commence as soon as the projects financed begin to generate positive cash flow. For private enterprises with existing operations the EBRD's grace period can be as little as 3 months from the start of loan disbursements. For new projects without cash flow from other sources the maximum grace period allowable is 3 years. Principal repayments are to be made on an EPP basis at semi-annual or quarterly intervals depending on when interest payments have to be made and on what basis. VLR loans are usually serviced quarterly while FLR loans are serviced semi-annually.

### *Net Income Management Policies*

None of the MDBs are *profit maximisers* in the sense that classical economic theory posits. Therefore they do not need to generate high and growing levels of net income simply in order to support dividend payouts and appreciating market values of their shares as large commercial banks and other similar enterprises need to. But the MDBs are all major financial institutions which borrow significant amounts quite regularly on the world's capital markets; indeed, to a much larger extent than normal commercial institutions. Their financial performance (i.e. profitability and key performance indicators) must therefore be acceptable to markets even if their basic objective is not to maximise returns for their shareholders in the purely financial sense but to promote development through financial intermediation in a cost-conscious, cost-effective manner. Markets do not necessarily demand any particular percentage increase in MDB profits year after year. Nor do they wish to see declines in net income, or in the build-up of reserves which are anything but transient and certainly not structural. What is acceptable performance to financial markets is of course partly a matter of judgement. It is also a matter of what the market has become used to in terms of historical performance, and what it sees in terms of comparative performance across similar types of institutions (i.e. other MDBs and supranationals).

### *The Importance of Key Ratios*

What is indisputable, from an empirical rather than a theoretical viewpoint, is that financial markets prefer to see smooth growth in MDB

profitability and in free reserves (which are a substitute for usable paid-in capital) which are commensurate with growth in their outstanding loans. What the market also prefers is that key ratios like the *interest coverage ratio (ICR)* and *reserves-to-loans ratio (RLR)* are maintained at acceptable levels or improve over time throughout. Reserves in particular are important because they provide the MDBs with the capacity to absorb an increasing level of risk without the core corpus of MDB share capital being impaired. Most importantly markets wish to see MDB financial positions and performance which are sufficiently strong so as to raise not the slightest doubt in capital markets that there could ever be any prospect of a hiccup or interruption in debt service by MDBs on their own obligations to bondholders in global capital markets.

Apart from satisfying *markets* (important though that clearly is), a smooth progression of growth in the *net* income of the MDBs – after taking into account the need for *gross* income to accommodate more recent problems such as non-accruing loans and the need for specific loan loss provisions – is desirable even from the viewpoint of MDB *shareholders* and *borrowers*. For the donor shareholders, growth in free reserves, commensurate with growth in the size of MDBs' portfolios, eases the pressure on them to provide additions to paid-in capital from budgetary resources to finance the expansion of MDB lending programmes. It bolsters the security of their capital investment by strengthening the bulwarks against any risk of *callable capital* actually being called. From the borrowers' viewpoint, the perspective is more complicated and less clear-cut. To the extent that growth in net income is not financed by marked improvements in the profitability of income from liquid investments, then growth in net income and reserves has to be financed largely by the loan and other service charges they have to pay. Hence growth in MDB net income and reserves involves an immediate cost to them. But, such a cost may be worth paying, if it strengthens the MDB sufficiently to: (i) reduce borrowing costs; (ii) expand lending without being artificially constrained by the willingness of donor shareholders to negotiate GCIs; (iii) accommodate marginal changes in portfolio quality without disruptive consequences; and (iv) finance special activities which are of high developmental priority (such as contributions to the associated MDFs) and which are important to borrowers.

For all of these reasons, all the MDBs employ some form of net income targeting each year, although some do it better than others. In doing so they keep in mind that their net income remains vulnerable to a number of risks including: (i) *interest rate risk* on their loan and liquidity portfolios which cannot be fully covered by the VLR system or by their short-term hedges to maintain portfolio values; (ii) *commercial credit risk* on their liquidity portfolios, especially of sudden deterioration in the credit ratings of banks in which they keep cash or deposit accounts and in that of their swap counter-

parties or the writers of their options; (iii) *exchange rate risk* due to translations gains or losses on capital subscriptions and mismatches between currencies in their loan portfolios and reserves; (iv) *portfolio risk* caused by the emergence of unexpected arrears which require cessation of income accrual as well as an increase in loan loss provisions.

To cope with these risks, MDBs attempt to retain some flexibility in their loan and service charge structures which enable charges to be geared up or down in response to exigencies which affect net income, without the need for laborious and acrimonious argument between MDB managements and Executive Boards. In targeting their annual net income levels the MDBs pay particular attention to the two ratios indicated above i.e. the RLR and the ICR. They also focus on the need to fund other desirable activities through special allocations of net income such as, for example, IBRD funding of IDA through annual allocations of a percentage of its net income, AsDB funding of technical assistance in the same manner, funding of debt-relief facilities or activities such as the Consultative Group on International Agricultural Research (CGIAR). A comparison of MDB net income performance in meeting the two core income management ratios and meeting other allocation needs is provided in the paragraphs below.

#### *Meeting the Reserves to Loan Ratio (RLR) Test*

The key measurement of the adequacy of MDB net income is its contribution to *reserves* relative to the portfolio as reflected in the RLR.<sup>23</sup> In the **IBRD** the RLR declined from 23.4% in 1965 to an unacceptably low 8.5% in 1985. Sensing that a further decline would arouse a negative reaction in financial markets and the rating agencies – especially at a time when unprecedented questions were arising about the quality of its portfolio given its exposure in the heavily indebted countries – an explicit target zone of 8-10% for the RLR was established. That requirement was stepped up to maintaining RLR within a narrow range of 10-11% between FY91-93 and further to a range of 13-14% in FY94-95. In 1989, a policy decision was taken to ensure that currencies in the Bank's reserves were completely aligned (within a risk range of no more than 20 bp) with those in its loan portfolio thereby eliminating the prospect of exchange rate volatility adversely affecting the RLR thus removing an earlier mismatch problem which had complicated reserves management and engendered volatility in the RLR

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23 The RLR is defined as the ratio of: General Reserves plus Special Reserves divided by the sum of callable guarantees plus disbursed and outstanding loans net of Loan Loss Provisions. It reflects the ability of an MDB to withstand the most serious of shocks to its income without the risk of impairing its capital base in any material way.

caused only by exchange rate changes. In FY94 the IBRD's accumulated reserves stood at nearly US\$14.5 billion against a loan portfolio net of loan loss provisions of US\$106 billion with the RLR at 13.8%.

The net income and reserves position of the AfDB is far less comfortable with a serious problem arising in 1992-93 when net income fell to an unacceptably low level of US\$98.4 million and reserves were grossly inadequate relative to AfDB's deteriorating portfolio quality. Part of the problem was that the AfDB, unlike the other MDBs, did not explicitly adopt the prophylactic discipline of net income targeting and management nor did it take steps to ensure that the ratios it had targeted (the ICR and RLR) could be met. Consequently the 1993 Review of the AfDB's Financial Policies concluded that the Bank needed to adopt a policy of targeting its net income based on a multi-year analysis under which specific reserve accumulation targets, reflecting the financial and portfolio risks faced by the institution are complied with. The main failure of the AfDB has been the inability of the Bank's management and Board to come to grips with its rising arrears, non-accruals and escalating loan-loss provisions. It has now become imperative to arrest and reverse the decline in AfDB's net income mainly by taking actions to: (i) increase almost all of its loan and service charges and reimposing front-end fees; (ii) improve recoveries, collections and arrest further portfolio deterioration; and (iii) curb its administrative expenses sharply. If these actions are not taken the AfDB faces the real prospect of losing its high-quality credit rating, seeing an increase in its borrowing costs and, at worst, risking the prospect of a call on callable capital. If that were to happen, the AfDB would risk endangering the entire MDB system by calling into question the very basis of confidence in the preferred creditor relationship between MDBs and their borrowers, and between MDBs and their donor shareholders, on which the system has been built.

As the AfDB's management itself acknowledges,<sup>24</sup> the present situation:

“... is a threat to the stability of the MDB system. Because the system relies on certain fundamental assumptions – the concepts of preferred creditor status and of unqualified, irreversible shareholder support to mention but a few – and there has been a tradition of stable growth in reserves, the result of perceived weakness at one MDB could well be a re-examination by many shareholders, bondholders and other concerned parties of the beliefs and expectations that have governed the financing of MDBs for almost 50 years. ... A comparison of the AfDB's performance with that of other MDBs, if such a comparison was unfavourable, could result in widespread dissatisfaction among the Bank's current and potential bond investors. The damage to the Bank's financing ability that would result ...

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24 See AfDB Board Document No (ADB/BD/WP/94/63) on “Net Income Management” dated 17 June 1994., para 2.1, pg 2 and para 2.8, pg 5.

with the deterioration in the Bank's financial condition could potentially be very significant, with a magnitude and duration that are difficult to predict. It is therefore important that the Bank take timely action to arrest the deterioration in financial ratios, focusing on the factors that are the closest to being within its control."

At the end of 1993, the AfDB's total reserves (net of the CCTA) amounted to US\$941 million against an outstanding loan portfolio (net of loan loss provisions) of US\$8.31 billion. Against the AfDB's *target RLR of 15%*,<sup>25</sup> its actual RLR has therefore declined relentlessly each year from more than 15% in 1989 to 11.32% in 1993. Over this 5-year period non-accruals and provisions have multiplied dramatically. The AfDB's own projections suggest that, on the present trajectory of net income, without action being taken on the three fronts mentioned above, there is likely to be an aggregate shortfall of US\$470.5 million in net income between 1994-97 for the 15% RLR target to be met. The aggregate shortfall would be well over US\$1 billion if the target RLR were at the AsDB/IDB level of 25% instead.

In contrast, the picture at the **AsDB** is exactly the opposite to that of the AfDB with an overly prudent and cautious approach to the RLR being adopted from the outset. For a long time the AsDB has been adamant about maintaining the RLR in a range of 20-25%; a posture which was justified on the grounds of a much higher level of portfolio concentration risk than was present in the case of the IBRD.<sup>26</sup> Nevertheless after two reviews of policy in 1987 and 1993, the Asian Bank decided to retain a minimum RLR of 25% which, after any amount of reasonable financial analysis, might still be regarded as excessively prudent; especially in the light of the experience of

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25 For a regional bank, given its much higher degree of portfolio concentration, the target RLR of 15% is too low. The AsDB and IDB have target RLRs of 25% in each case. The AfDB has about the same level of portfolio concentration, but a much higher non-performing portfolio, than the AsDB or IDB. By the standards of these two regional banks, the AfDB should actually have an RLR target of 30-35% unless a convincing case can be made that the 25% RLR target in the other two regional MDBs is excessively prudent. Alternatively, if the RLR target of 15% is at all right for the AfDB then the target for the AsDB and IDB should, to maintain parity of treatment, be around 8-10% instead of 25%.

26 In the 1987 Review of AsDB's Financial Policies management confirmed its intention to build-up reserves to the share of the total loan portfolio which was represented by the total outstanding loans accounted for by its single largest borrower (Indonesia), which at that time was estimated to be 20-25%. The 1993 review conceded that this approach may have been somewhat over-cautious because the probability of a large borrower defaulting in a manner that would call for the immediate and total write-off of all its loans appeared to be extremely small and remote. Consequently the basis for reserves determination was changed to accommodate the more probable scenario of some vulnerable borrowers going into protracted arrears resulting in non-accruals and provisions. It was assumed more reasonable to adopt a policy which required making loan loss provisions of upto 40-50% of possible non-accruing loans and 10-15% of performing loans on the extremely conservative assumption that non-accruing loans might amount to 30-40% of its total portfolio.

Asian borrowers in handling their debt-servicing difficulties. During the 1980s, when the debt crisis was at its peak, Asian borrowers avoided any possibility of defaulting, even temporarily, on their payment obligations to preferred creditors, leave alone entering into protracted arrears or requiring non-accruals of income or provisions to be made.

Through the 1980s, when the IBRD and IDB were affected by disconcerting increases in their non-performing portfolios (although small relative to their total portfolios), and the early 1990s when the AfDB's vulnerability to defaulting borrowers has become all too clear, the AsDB has remained unaffected throughout. In 1993, the AsDB's total reserves (including 1993 net income appropriated to reserves after other allocations had been made) amounted to US\$4.93 billion against a loan portfolio (after provisions) of US\$13.7 billion resulting in an RLR of 36%, well above the minimum stipulated RLR of 25%, thus giving the AsDB an enormous amount of financial flexibility. Unlike the IBRD, the AsDB has not yet removed the currency mismatch between its reserves and its loan portfolio. This feature requires an extra RLR cushion to accommodate some inherent instability. The AsDB estimates that the margin for this purpose need not be above 2%, which still leaves it with a current RLR which provides ample room for manoeuvre.

Like the AsDB, the IDB has also adopted a target RLR of 25% as being an appropriate level in view of its portfolio concentration and the need to maintain market confidence. In 1993 its total reserves were US\$4.76 billion against a loan portfolio (after provisions) of US\$21.47 billion resulting in an RLR of 22.2% about 3% below its target but within an acceptable range. The net income and reserves position of the IDB was a matter of much greater concern in the mid-1980s when its portfolio was seriously affected. The portfolio position of the IDB has improved considerably since 1989 with the economic circumstances of major borrowers such as Argentina, Mexico and Chile having changed dramatically for the better. But, its two other large borrowers – Brazil and Venezuela – still provide cause for concern. Nonetheless the IDB's reserves are generally adequate and comfortable, similar to those of the IBRD and squarely in the middle of the polar extremes defined by the RLRs of the AfDB and AsDB respectively.

Finally, the EBRD's reserves in 1993 amounted to US\$19.2 million against an outstanding loan/investment portfolio (after provisions) of US\$564 million resulting in RLR of about 3.4% of the total portfolio – a grossly inadequate proportion by any standard and, in a relative sense, even worse than the AfDB. The inadequacy of EBRD's reserves results from the inadequacy of net income in the start-up phase of the institution. It is compensated for by the over-adequacy of *liquidity*, which is 8 times larger than the outstanding loans/investment portfolio, and of paid-in shareholder

capital, which is nearly 6 times larger. These peculiar proportions of liquidity and paid-in capital, relative to the outstanding portfolio, reflect the reality of an institution which has yet to reach maturity and about which the usual ratio-based judgements are therefore likely to be misleading. Nevertheless, the present level of its reserves does leave the EBRD vulnerable to the possibility of impairing its shareholders' capital with even a relatively minor early default in its overall portfolio (net of provisions) or a significant loss from its investments in equity holdings in those countries of operations which have not been specifically provided for. These were 11 times reserves at the end of 1993. Given the concentration of EBRD's portfolio in very nascent private sectors which have not established a track record, and in which the proper functioning of market economies has yet to be achieved, its vulnerability to portfolio shocks does provide cause for concern. The EBRD's overall target for total reserves and retained earnings, together with special provisions for losses on loans and equity investments has been set initially at 10% of outstanding loans and 25% of equity investments. While the reserves level for the equity portfolio seems uncontroversial, the RLR target for the loan portfolio is considerably below that of its cohorts; and, given the particularities of the EBRD's operating environment, perhaps distinctly imprudent.

#### *Meeting the Interest Coverage Ratio (ICR) Test*

The second major test of the adequacy of an MDB's underlying income generating capacity which capital markets look to is the ICR. It reflects, in particular, the capacity of an MDB to continue generating income and maintain an adequate level of reserves under unexpectedly adverse conditions; e.g. when a substantial proportion of the loan portfolio is affected by non-accrual. The ICR measures the excess by which net income covers the level of the MDB's own annual interest expense and associated financial charges on its borrowings.<sup>27</sup> A sudden drop in an MDB's ICR could indicate to markets an erosion of its capacity to service its own debt. The IBRD, IDB and AsDB use fairly sophisticated simulation models to project and examine their income statements and balance sheets under various *stress tests* to determine the adequacy of net income under a variety of possible (plausible) adverse risk scenarios. When such analyses indicate that future income generating capacity may be inadequate, these MDBs take early action to consider increasing their charges in an acceptable manner and raising their RLR targets: i.e. by reducing their share of borrowed funds, raising the RLR target

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27 The ICR for an MDB is defined by the formula:

$$\frac{(\text{Net Income} + \text{Interest Expenses} + \text{Financial Charges})}{(\text{Interest Expenses} + \text{Financial Charges})}$$

leads to increasing the MDB's income generating capacity. The AfDB and EBRD need to adopt similar models and create similar financial statement projection and simulation capacity.

In the **IBRD**, the ICR has been regarded as being satisfactory at the upper end of the range of 1.10 to 1.20. In FY93, the IBRD's ICR was actually about 1.16 and has ranged between 1.16 to 1.19 between FY90-94 thus satisfying internal requirements. The IBRD does not explicitly target the ICR in the same way that it does the RLR, although the ICR is closely monitored (the difference between targeting and monitoring in this instance being largely a semantic one). The **AfDB** has an explicit ICR *floor* target of 1.25. Between 1989-93 its ICR has fallen precipitately from a level of 1.66 in 1989 to 1.19 in 1993, i.e. below the targeted floor. The AfDB's minimum ICR target will not be met between 1994-97. If nothing changes, the ICR is projected to drop further to a disconcerting 1.07 by 1997, unless net income is raised substantially or, alternatively, borrowings are sharply curtailed temporarily until the institution's financial strength is restored. Since the latter option is unlikely to be feasible, the AfDB needs to take urgent action to prevent further deterioration in its net income generating capacity.

Like the AfDB, the AsDB and IDB also have ICR floor targets of 1.25. The **AsDB** is comfortably above that floor level (with an ICR of 1.73 in 1992 and 1.66 in 1993) and its projected income under *base-case* conditions suggest that the ICR will not fall below 1.50 till 1998 and even under a *worst-case* scenario will only fall below 1.50 in 1997. In 1993 the **IDB** had an ICR of 1.24 and its 1990 financial projections indicated that its ICR between 1994-2000 would range between 1.22 and 1.29 well within an acceptable range of income generation. In the case of the **EBRD**, its main objective upon inception has been to achieve a positive level of net income, which it managed to do in 1993 after two years of start-up losses. Hence an ICR based comparison at the present time would be invidious (as a matter of record the ICR in 1993 was 1.02). As its present policy statement observes, the Bank's net income objective will eventually enable it to determine the necessary margins and fees on its lending and its targeted returns from equity investments; but this stage will only be reached when the Bank has built up a substantial base of assets and establishes a basis for making projections based on operating experience.

### *MDB Policies for the Allocation of Net Income*

In addition to policies and practices which attempt to assure the adequacy of net income, MDBs also have policies for the allocation of their net income especially in those years when such income exceeds amounts expected or budgeted. Usually this happens when: (i) interest or exchange rates

movements in financial markets work in favour of increasing an MDB's returns from loans or from liquidity – usually by reducing that year's borrowing costs below expectations or increasing investment income above expectations; (ii) debt-service on loans previously in non-accrual or for which provisions have been made is unexpectedly resumed; and/or (iii) budgeted administrative and other expenses are below expectations (which happens all too rarely). Under such circumstances, the excess income, is allocated for special purposes after the basic purposes of adding sufficiently to reserves and making prudent provisions have been fully satisfied.

In 1990 the **IBRD** developed a *medium term policy framework*<sup>28</sup> for the allocation of net income to replace the previous practice of *ad hoc* annual discussions influenced more by exigencies and historically entrenched applications than by a prudent evaluation of present and future needs. In theory and concept, its basis applies equally to all the MDBs and not just the IBRD. While giving first priority to the continued accretion of reserves at an acceptable rate, that framework outlines three broad uses for surplus net income: (i) reducing the burden of loan charges on borrowers; (ii) strengthening the Bank's financial position; and (iii) promoting development through special transfers outside of the Bank. The case for reducing loan charges is obvious since the Bank, as a credit co-operative must strive to minimise its charges in a manner which is compatible with ensuring access to markets for borrowings at the lowest possible cost. The argument for the two other uses of income rests on the notion that the Bank's income is earned in large part from the *cost-free* usable capital, and the privileged access to their capital markets, which (mainly the developed country) shareholder members provide. These members neither request nor receive *dividends* on their capital. But, that does not mean that they, at the same time, relinquish the right to determine how income is to be used. Exercising such a right need not imply that, by so doing, the developed shareholders are automatically imposing an unfair burden on the borrowing countries. This will be true as long as foregoing possible reductions in loan charges that borrowers pay does not result in: (i) providing a *soft option* for the developed shareholders to reduce or cease future contributions for supporting Bank operations; or (ii) financing large transfers for special purposes, e.g. IBRD income transfers to IDA, at the expense of borrowing members in order to cover shortfalls in the contributions to IDA, or for other priority purposes, that donor shareholders should properly be making.

Both these lines of argument have some merit in them. The right approach to resolving the issue therefore is not to determine which argument

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28 See IBRD Board Document No. R90-193 on "Medium-Term Outlook and Policy on Annual Allocation of Net Income" dated September 21, 1990.

overwhelms the other but to strike a sensitive and sensible balance between the two. After due consideration, the IBRD has decided on the following order of priorities in the allocation of net income: (i) strengthening reserves to the fullest extent necessary; (ii) reducing loan charges, providing that such reductions maintain an adequate *positive spread* in the Bank's VLR over the cost of borrowing; and (iii) allocating income through transfers for special purposes. Thus, after the target RLR of 13-14% requirement is satisfied, any remaining IBRD net income is applied first to prefund waivers of loan interest charges upto 25 bp for the following fiscal year. Such waivers are provided only to borrowers which have serviced all their loans within 30 days of due dates during the previous six months. In view of much larger than expected net income in FY93, the size of the waiver was expanded to 35 bp for FY94 but has been reduced again to 25 bp for FY95. If additional income still remains after this application, it is transferred to a *surplus* account<sup>29</sup> in the Bank's reserves (retained earnings) or put to other uses (e.g. transfers to IDA, CGIAR, the Special Technical Assistance Fund for Russia etc.) which are: consistent with the Bank's Articles of Agreement, and agreed to by the Executive Board subject to approval by the Board of Governors. In FY93 the IBRD's net income of US\$1,130 million was allocated as follows: (i) a transfer of US\$675 million was made to the General Reserve; (ii) US\$215 million was allocated to prefund the waiver of 25 bp in interest charges for eligible borrowers and the 50 bp waiver of commitment fee for FY94; (iii) US\$100 million went to fund the Debt Reduction Facility for IDA-only debt distressed countries; and (iv) US\$140 million was transferred to IDA to provide additional commitment authority. Net income for FY94 of US\$1,051 had not yet been allocated as of this writing.

Prior to 1992, the AfDB, while having no clear policy on the allocation of its net income, was in the habit of funding a number of research institutions and programmes that were in line with its objectives, policies and priorities. In 1991, for example, the AfDB allocated US\$2.75 million for these purposes and set-aside a further US\$0.4 million for requests not received as yet. It also allocated a further US\$3.2 million to a Special Relief Fund. These relatively small allocations were perhaps justifiable at a time when the AfDB felt they were affordable although hindsight (which is always 20-20) suggests that, after 1988, the AfDB's only allocation priority should have been to build-up reserves to the exclusion of everything else. The present problem of not being able to generate sufficient net income to meet even the minimum

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29 The surplus consists of earnings from prior fiscal years which are retained by the IBRD until a decision is made on their disposition or the conditions of transfer for special uses have been met. The General Reserve simply consists of all accumulated earnings from previous years which are retained to support the MDB's ongoing business.

targets for the RLR and ICR precludes any serious discussion about allocating surplus net income for the foreseeable future. At present, the Bank's most pressing priority is to shore up its inadequate reserves to levels which are more capable of absorbing potential shocks to the balance sheet which the non-performing part of the portfolio may transmit. Hence current policy debate in the AfDB is, quite properly, focused on how to generate sufficient net income rather than on allocating income which is grossly insufficient.

The **AsDB**, despite demonstrating an income generation capacity which has enabled its floor targets for the ICR and RLR to be exceeded by an impressive margin, has no specific policy for the allocation or distribution of its net income. In 1992 it allocated US\$50 million of its net income (9% of the total) to the TASF and in 1993 increased that allocation to US\$60 million (10.5% of the total). The remainder of its net income has invariably been appropriated to its ordinary reserves. AsDB's total reserves now exceed its paid-in capital by a margin much larger than that for any other MDB (its total reserves, inclusive of 1993 income, amount to 1.81 times paid-in capital with the same ratio for the IBRD being 1.33, for the IDB, 1.50 and, for the AfDB, a meagre 0.48).

The **IDB** like the AsDB has no particular set of policies to guide allocations of surplus net income. With the exception of 1991 when income was considerably beyond expectations (largely because the payment of overdue obligations by two countries accounted for 26% of net income), annual net income is allocated between the Special Reserve and the General Reserve. The income attributable to special commissions (1% on all loans) on OCR loans is required by the Bank's statutes to be allocated to the Special Reserve established for the sole purpose of meeting obligations created by its own borrowings or by guaranteeing loans. The excess income in 1991 of US\$50 million, left over after ensuring that the ICR and RLR targets were met and the Special Reserve funded, was allocated in the following way: (i) US\$35 million to the lending resources of the IFF for use by five Group D countries facing severe economic difficulties; and (ii) US\$15 million to the independent account of the FSO to finance non-reimbursable technical co-operation grants.

The **EBRD** still has to build up its net income to acceptable levels relative to its portfolio; the issue of special allocations from net income will not, therefore arise for some time to come.

### ***Policies on Reserves and Provisions***

The RLR targets discussed earlier in the context of net income management, determine the quantum of reserves that MDB's keep under

various different accounts. As all the MDBs explicitly acknowledge, the first claim on their net income should be to maintain adequate reserves. The main purpose of reserves is to provide a cushion against adverse events which endanger the financial foundations of the MDBs. The principal risk that they face is the risk of default (or of protracted arrears during which there is a sustained loss of income) by a small number of borrowers whose loans account for a sizeable share of the total portfolio. The portfolio concentration risk is, of course, larger in the regional banks than in the World Bank, justifying to an extent their perception of the need for larger reserves in proportion to their portfolios. Moreover, financial markets and rating agencies place considerable emphasis on the total reserves adequacy of MDBs as perhaps the most important indicator of their financial strength and, therefore, as a key determinant of the fineness of the costs at which they can borrow. Markets and rating agencies are concerned about the ability of MDBs to withstand unexpected and large financial shocks and still service their debts without impairing their paid-in capital or, even worse, incurring the risk of a call on callable capital – an event which, it is widely agreed, would be seen as perhaps spelling the end of market confidence in the edifice of MDB financing that has been created and accepted over the last half century.

When a quantified reserves target (RLR) was first discussed in the IBRD in the mid-1970s, the target was related to a notion of potential risk based on the share of the total portfolio accounted for by the largest borrower. The response was to have a level of reserves sufficient to permit a complete write-off of loans to the single largest borrower or to two or more of the second-tier (next largest) borrowers. The Special Reserve (see below) was included in this calculation as a part of total reserves, but no specific allowance was made for loan loss provisions, since none existed at the time. Although a hypothetical sense of the need for having adequate reserves grew stronger through the 1970s, the spectre of an actual loan loss materialising in any MDB did not arise until the debt crisis of the 1980s, when the unprecedented occurred and some borrowers did go into protracted arrears on their debt-service obligations to the MDBs. The earlier, somewhat simplistic, approach to reserves accretion had two defects.

*First*, the transition from hypothesis to reality made it clear that prospect of either the *largest* borrower, or two or three of the other sizeable borrowers, defaulting suddenly in a manner which required immediate and total write-off of their outstanding loans to an MDB was extremely improbable. The much more likely prospect was that of a number of borrowers (large or small) going into protracted arrears and giving the MDB concerned, and the international financial community, a considerable amount of time to correct the situation, clear arrears and revert to normalcy. Thus it became clearer

with the benefit of actual experience and hindsight with temporary borrower defaults, that the real risk was not the risk of a complete write-off but the risk of a substantial “income loss” (because of both non-accrual and the need to provide against losses from current income) for a long period of time. Hence, the notion of a two-step defence mechanism to guard first against income loss and eventually, if all else failed, against portfolio (capital) loss emerged more clearly. *Second*, the simple approach of the 1970s made no allowance for the differential credit risk involved in assessing the likelihood of *individual* borrowers encountering debt-service difficulties and thus evaluating in advance the overall portfolio risk which an MDB might face at any point in time. These two flaws in early thinking about the need for provisions were corrected during the 1980s, first in the IBRD, then in the IDB, later in the AsDB and eventually (but even now not yet fully) in the AfDB. Since then a much more intelligent approach has been developed for the level of reserves needed. All the MDBs now have more sophisticated systems for evaluating individual country exposure risk, default risk and, as a result, for assessing more comprehensively their overall future portfolio risk.

The MDBs generally have three types of reserves, all funded either as charges against gross income (*above the line*) or allocations from net income (*below the line*) which can all be used as a buffer against the impairment of their capital resulting from either loan losses or from any other financial shock (e.g. losses on the liquidity portfolio because of mismanagement, imprudent exposure to derivatives, failure of counterparties or fraud). Assuming that loan losses are what trigger the process of liquidating these different reserves, the order in which they can be depleted is that: (i) Loan Loss Provisions are charged first, followed by a drawdown of (ii) the Special Reserve, and finally (iii) the Ordinary or General Reserve, which is effectively a paid-in capital substitute but without the callable capital component attached.<sup>30</sup> It is only after all three reserves have been fully drawn down that paid-in capital begins to be impaired in the event that the MDB’s outstanding obligations to its creditors exceed the combined amounts of all these reserves. Callable capital is called only after the full exhaustion of paid-in capital. Whether or not MDBs create loan loss reserves, and irrespective of the

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30 As the AsDB notes in one of its Reviews of Financial Policies: In the event of loan write-offs the accounting principles and practices currently in force require that such losses be charged first to the accumulated loan loss provisions. Because allocations to such provisions and to the Special Reserve are both charges against income, the MDBs could also charge loan losses directly to the Special Reserve. Given the explicit purposes of the latter under MDB Charters, however, loan losses can only be charged to the Special Reserve to the extent that the assets liquidated from that reserve are used to meet obligations arising from the MDBs’ borrowings or guarantees. Loan losses in excess of the combined amounts of loan loss provisions and the Special Reserve would have to be charged against income in the period in which the losses occur. Should →

accounting conventions which determine the order in which different types of reserves are to be drawn down, in the final analysis it is the total amount of all three reserves which protect the MDB's capital from being impaired. All three reserves thus serve essentially the same purpose (except in the case where a financial shock was felt not because of loan default but for another reason) of insulating MDB capital from the immediate shock of any financial disturbance.

### *Loan-Loss Provisions*

These provisions are funded annually by charges against gross income from loans determined on the basis of estimates about the probable amount of future losses. The cumulative amount of such annual provisions are known as loan loss reserves. The basis for making these provisions in each of the MDBs is more fully dealt with in the next chapter. Loan loss provisions can be of two types: *specific* or *general*. Specific provisions are those which are determined on the basis of the probability that specific loans to a country which have been in non-accrual status for a period of time, may not be collected and therefore need to be provided for against the risk of capital loss. General provisions are established on the basis of the overall probability that some as yet unidentifiable part of the loan portfolio may not be collected. The **IBRD** has been making such provisions since 1984 and the total loan loss reserve at the end of FY94 amounted to US\$3.32 billion or about 3% of its outstanding loan portfolio. The **AfDB** had an accumulated loan loss reserve of US\$208 million (1.2% of the portfolio) at the end of 1993 while the **IDB's** loan loss reserves at the end of the same year were US\$712 million (3.2% of the portfolio). The **AsDB** has not made any provisions to date for

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losses be so large as to wipe out the net income as well, the amount of the residual loss carried over would then be charged to the Ordinary or General Reserve, after that to paid-in capital and, after the exhaustion of both of these, covering the loss carry-over would finally require a call on callable capital. It is important to underline, that protection against potential MDB capital impairment, as a result of loan losses, is unaffected whether the MDB makes loan loss provisions or simply continues to allocate its net income to the Ordinary/General Reserve. Loan loss provisions are annual reductions from gross income, which reduce the amount of net income available (as do non-accruals because the income which is supposed to be derived from these loans is simply not recognised or accrued) for allocation to the General/Ordinary Reserve. Shareholders' capital is not affected by loan losses unless such losses are of a size which breach the four separate lines of defence represented by provisions, Special Reserve, the current year's net income and the General Reserve. Absent allocations of net income for any other purpose, the sum of these would remain the same whether or not the MDB made any loan loss provisions in any accounting period. Making provisions, however, enables an MDB to institute the discipline of periodic charges against its income in a manner that permits the problem to be dealt with in an orderly manner. By doing so future net income is therefore insulated to a degree from the disruption that large loan losses, which were not provided for, might cause.

losses against its sovereign loans but it has made specific and general provisions of US\$13.24 million for losses against its loans to the private sector (or 4.2% of its private sector loan portfolio) and of US\$9.12 million for possible losses on equity investments (8% of its total equity investment portfolio) under its private sector operations. These amounts are still insignificant (0.16%) relative to the AsDB's total loan and investment portfolio. The **EBRD's** provisions for losses against its loan and equity investment portfolio (of which a far larger share is in the private sector than in the case of the other MDBs) was US\$49.1 million at the end of 1993 representing about 8% of the combined loan and investment portfolio. The provisions for its *loan* portfolio amounted to 5.6% of the total loan portfolio while provisions against its *equity* investments represented 12.5% of the total equity portfolio.

### *Special Reserves*

All the MDBs have Special Reserves as a statutory feature. These are embedded in their Articles and are required to be funded by special loan commissions or guarantee fees and held in the form of readily available liquid assets. Such assets are set aside to be used as a first line of defence against the impairment of paid-in capital, or to forestall a call on callable capital, and can only be used for the purposes of meeting MDB liabilities on their borrowings or guarantees in the event of default on loans made, participated in, or guaranteed by the MDB. They were intended as a bulwark against the risk of capital impairment in the early stages of an MDB's life; most of the MDBs' Articles required these Special Reserves to be funded through a 1% front-end charge for at least the first five years of operation, after which the front-end fee could be reduced or eliminated at the discretion of the Executive Board. In the **IBRD**, the allocation of commissions to the Special Reserve was discontinued by the Executive Board in 1964. No further additions to the Special Reserve have been made since. This was because the continued need for a Special Reserve, with General Reserves increasing rapidly, became redundant. The IBRD's Special Reserve amounted to a mere US\$293 million at the end of FY94, less than 2.1% of its total reserves.

The *regional* banks, however, continue to fund and build up their Special Reserves which feature as a larger part of their total reserves than in the case of the IBRD. The **AsDB** discontinued funding the Special Reserve with loan commissions in 1985 but still funds it with the guarantee fees it collects. These are now very small amounts; e.g. in 1993 the allocation from income to Special Reserve was a mere US\$326,000. At the end of 1993 its Special Reserve amounted to US\$177 million or 3.65% of total reserves. The **AfDB** stopped charging its special front-end commission and funding the Special Reserve in 1989. At the end of 1993, its Special Reserve amounted to US\$259

million or 27% of total reserves. In view of its precarious income position it urgently needs to reinstitute the practice of replenishing its Special Reserve even though there is no particular need to distinguish between whether the additional fees charged go into the Special or Ordinary Reserve. It may simply prove to be easier to reactivate the Special Reserve on constitutional grounds. The **IDB** still funds its Special Reserve with a 1% commission charged on all loans approved. Its Special Reserve stood at US\$1.61 billion at the end of 1993 or about 34% of its total reserves. The **EBRD** is also funding its Special Reserve with all of its front-end fees, and other fees (excluding commitment fees) associated with loans, guarantees and underwritings. It will continue to do so till its Executive Board determines that a sufficient amount has been built up in the Special Reserve, which at the end of 1993 stood at US\$4.5 million or 40% of its total reserves. Although the proportion of total reserves accounted for by the Special Reserve in the African, Inter-American and European banks is high, the distinction between the Special and General Reserve is becoming moot even in these banks; for all practical purposes, it is perhaps time to abandon the distinction between the Special and General Reserves, regardless of the Articles and despite the differences in the way each is financed.

#### *Ordinary or General Reserves*

At the end of 1993 (FY94 for the IBRD), the Ordinary/General Reserves of the MDBs were as follows: the IBRD: US\$14.18 billion; the AfDB: US\$682 million; the AsDB: US\$4.69 billion; the IDB: US\$3.15 billion and the EBRD: US\$6.62 million.<sup>31</sup> While loan *provisions* are funded by deductions from gross income above the line, and Special Reserves are funded by specifically designated fees and commissions above the line, Ordinary or General Reserves are funded entirely from allocations of net income below the line. They simply represent an accumulation of the net earnings of the MDBs which have not been allocated to other purposes but have been retained internally to support the growth of the MDB's operations by augmenting the equity base of the MDBs. In essence they have proved to be the most effective means of MDBs' accumulating convertible, usable paid-in capital. They belong, in effect, to all the shareholders in proportion to their shareholdings as undistributed dividends, which would be distributed in the event of the MDBs being wound up after their creditors had been fully satisfied. The Articles of the MDBs, while requiring priority to be given to building up reserves through the allocation of net earnings, do not specify any uses of these Reserves nor do they impose any restrictions on their use.

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For footnote 31, see next page.

These explanations conclude our discussion of the set of financial policies which govern the processes of overall financial resource management in the MDBs, excluding policies governing administrative expenses which is the subject of the penultimate chapter. The next chapter turns to a more detailed treatment of the policies of MDBs on non-accrual and provisioning against their non-performing portfolios, issues which this chapter has introduced and opened up.

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31 Except in the case of the AfDB and EBRD the reserves position of the MDBs is robust. In the IBRD, AsDB and IDB reserves are now sufficiently large to permit their balance sheets to withstand any realistically conceivable shocks. In the IBRD, reserves and provisions now amount to more than US\$17.5 billion. Recently, in the context of an ongoing debate on reducing the multilateral debt of low-income, debt-distressed countries it has been suggested (not least by this author) that the IBRD's reserves and provisions are now sufficiently large to absorb a write-down of the debt owed to the IBRD (not including IDA) by a small number of eligible low-income debt-distressed countries (e.g. those like Uganda, Tanzania and Zambia) without any serious market repercussions providing the market had been carefully prepared to accept the wisdom of such a measure. The IBRD has riposted with the argument that any such measure would be fatal for its market standing and that of the other MDBs. Whether this response suggests that the IBRD is more concerned about the precedent setting effect of such a measure (which is an argument which has been proven to be over-wrought and false many times over throughout the debt crisis) or whether it is simply implacably opposed to any reduction of its reserves and provisions for any reason whatsoever, is not clear. But even the IBRD's response suggests that reserves and provisions are now sufficiently large for such a measure to be contemplated without any damage of consequence to IBRD's balance sheet. If IBRD's argument is to be taken at face-value, the question then arises as to whether the MDBs can have it both ways? Can they argue in favour of building up reserves and making adequate provisions to accommodate a deteriorating portfolio and then refuse to even consider doing anything with the financial strength they have built for this precise contingency when a need clearly arises which justifies its use?

## 6 Policies for Portfolio Quality and Management

### *Introduction: Why Country Exposure Risk matters*

The last chapter dealt with the building up of provisions and reserves to ensure the financial viability and sustainability of the MDBs. In this chapter the related issue of *loan* (not project)<sup>1</sup> portfolio management and quality control is taken up in greater depth. Managing portfolio quality and arrears was a relatively undeveloped area of financial policy in the MDBs for the first forty years of the IBRD's existence and the first 20-25 years of the AfDB, AsDB and IDB. It emerged as a key policy concern when the debt crisis engulfed a large number of countries in the 1980s in Latin America, the Caribbean, the Philippines in Asia, several countries in North Africa and the Middle East and nearly all the low-and lower-middle income countries of sub-Saharan Africa. The debt crisis continues to persist in the 1990s. But it no longer affects as severely the Latin American and other middle-income debtors whose creditors were principally private commercial banks. Instead it is now concentrated mainly in: the low-income sub-Saharan African countries; the lower middle-income countries of the Caribbean (e.g. Jamaica); several countries in Eastern Europe (e.g. the former Yugoslav republics); and, in particular, Russia. The main creditors in these instances are mainly OECD and Arab-OPEC governments, the IMF and the MDBs (including some of the smaller sub-regional and Arab funded MDBs) themselves rather than commercial banks.<sup>2</sup>

There are some other countries, not generally viewed as debt-distressed, which are large debtors to the MDBs and have recently flirted with economic

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1 Project portfolio management refers more to the regular Operations Evaluation exercises that MDBs now undertake as a matter of routine and to the periodic overall reviews of the project portfolios of the various MDBs such as those recently undertaken by Wapenhans for the World Bank, Qureshi for the IDB and Knox for the AfDB. Such exercises are aimed at improving the quality of MDB operations rather than the quality of their financial assets as such although the two are inextricably linked.

2 For recent discussions about the continuing debt crisis, see for example, (1) Mistry, P.S., "Multilateral Debt: An Emerging Crisis?", FONDAD, The Hague, Netherlands, 1993; (2) Report of the Non-Aligned Movement Ad Hoc Advisory Group of Experts on Debt, "The Continuing Debt Crisis of the Developing Countries", South Centre, Geneva, 1994; (3) The World Bank, "Reducing the Debt Burden of Poor Countries: A Framework for Action", World Bank, Washington DC, 1994.

crises of varying severity. Their debt situation is either troubling or on the borderline of being debt-distressed. These include MDB borrowers such as, for example, India, Indonesia, Pakistan and Turkey. What differentiates them from the incontrovertibly debt-distressed countries is that their recovery and growth prospects, are promising. The debt service ratios of these countries, once troubling, have been brought under control and are becoming increasingly manageable with time. If, however, their current trajectories of reform and economic resurgence are, for any reason (political turmoil or inability to sustain the tempo of reform), interrupted for any length of time, it is conceivable that the quality of MDB portfolios, which is presently unaffected by these countries, could again come under considerable strain. For that reason, the *ex-ante* control of portfolio risk through country risk exposure management, and the *ex-post* management of protracted arrears through sanctions, non-accrual and provisioning policies, remains a challenge for MDB financial managements. Portfolio quality control also constitutes the main area in which MDB financial and operational policies overlap; requiring the greatest amount of interaction and cooperation between the financial and operational staff in an MDB.

A difficult set of questions arises in reviewing the conduct of the MDBs (and especially the IBRD and AfDB) with respect to the quality of their loan portfolios. Does the automatic availability of borrowing government guarantees for every MDB loan, coupled with their status as preferred creditors, make MDBs less diligent about quality and risk in making these loans than they otherwise might be? Are the MDBs putting themselves in a conflict-of-interest situation with respect to portfolio quality when they get involved in every aspect of a project or programme from its conception and design to its pre-appraisal, appraisal and supervision? Can they be sufficiently objective in appraising a project or programme which they have designed themselves? When they are so deeply involved in designing the investment or the adjustment programmes which their loans finance, how much of the risk should the MDBs themselves bear for the failure of their projects or programmes to work or to deliver the anticipated economic and financial benefits? Have the MDBs compounded the debt service problems of their borrowers by their own lending actions and thus contributing to worsening the quality of their own loan portfolios? All these are valid questions. But they are difficult to answer unequivocally. They raise fundamental issues which need to be explored more thoroughly than most MDB managements would like them to be. Upto now, MDBs have invariably sought the protection of their preferred creditor status in requiring their loans to be repaid regardless of the conditions in which they were made and ignoring the role that they themselves might have played in contributing to the impairment of a particular borrower's debt servicing capacity. This issue is

brought up as a preface to this chapter in order to raise consciousness and provoke a change in the kind of thinking that is done by MDB managements and staff.

### *Country and Portfolio Risk Exposure Management*

All the MDBs now have systems for assessing, on a rigorous annual basis, the risk of protracted arrears and non-payment on debt owed to them (individually and collectively) by their borrowers. These systems vary in their degree of sophistication. The AfDB was the last to introduce such a system in 1993 while the AsDB and IDB have moved toward adopting systems involving the same rigour as that of the IBRD; if not being quite as elaborate or expensive. Following a careful review of their circumstances, borrowers are now classified in MDB portfolios into different risk categories on the basis of their: GNP income levels; economic structures, characteristics and performance; debt profiles (i.e. term structure, creditor composition, vulnerability to unforeseeable shocks); and actual debt service performance. These country-by-country risk assessments<sup>3</sup> are aggregated into an overall assessment of portfolio risk<sup>4</sup> each year through the application of intuitive or explicit scoring techniques which are refined continually with experience. Such portfolio assessments combine the judgement of the MDB's operational staff dealing with each country as well as financial staff experienced in assessing portfolio risk.

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3 Broadly defined **country risk** represents the probability that an MDB will suffer a loan loss in a country due to events which are both within the control of the government as well as those over which it may have limited or no influence. Country risk is affected by a number of internal and external economic, political and natural factors which interact to determine a sovereign government's willingness and/or its ability to service an MDB's debt through the provision of sufficient funds *in convertible currencies* to meet its debt service obligations to that MDB.

4 The overall **portfolio risk** is represented in the IBRD, for example, by a portfolio score ranging on a scale from 0-100 where zero represents no risk and 100 represents the risk of the entire portfolio being in default. In a 1993 review the IBRD rated its overall portfolio at a score of 61 which was regarded as uncomfortably high. By comparison the portfolio score was only 37 in 1980, 53 in 1985 and 59 in 1990. The outlook for any MDB's portfolio essentially depends on four interrelated factors: (i) the overall *strength of the world economy* and especially of growth and market demand in the OECD countries; (ii) the *political environment and policy stance of borrowing countries* individually and collectively; (iii) portfolio risk caused by the *MDBs' own lending and disbursement plans* – for example, in a large negative net transfer situation, MDBs can exacerbate the risk on their own portfolios whilst, at the same time, continued lending to high-risk countries for portfolio reasons may mitigate short-term repayment risk but exacerbate that risk in the medium and long-term; and (iv) *portfolio concentration*; i.e. the fewer the number of borrowers which account for the bulk of any MDB's portfolio, or the lower the credit quality of those borrowers, then the higher is the vulnerability of that MDB to portfolio default risk.

Individual country risk assessments are reviewed at two or three levels of management (divisional, departmental and vice-presidential) in the operations complexes of the MDBs. They are aggregated (jointly by working groups comprising operational and financial staff) into an overall portfolio review which is considered by high-level management committees in the financial and operating complexes of each MDB and finally at the apex; i.e. by the managing committee in the IBRD or its equivalent in each MDB. Given their nature and sensitivity, as well as the political difficulties and controversies that MDB managements' judgements on any particular country's credit risk profile invariably cause, such reviews are kept confidential by MDB managements and not publicly shared. The Executive Boards of the MDBs are of course informed of overall portfolio risk assessments, as well as individual country assessments for those borrowers which are in protracted arrears and therefore in non-accrual and/or provisioning status.

### *Country Exposure Limits in the IBRD*

All the MDBs have formal or informal country exposure limits of one sort or another. The **IBRD**, which has the most globally diversified, and therefore the least concentrated portfolio of all the MDBs, also has the most sophisticated country exposure risk management system. It emphasises the importance of detailed analysis and applies three main guidelines to limit its exposure risk. These are meant to guide judgement rather than to substitute for it. *First*, the IBRD has a single country exposure limit of 10% of disbursed and outstanding loans not being accounted for by more than any one borrower and applies an informal accompanying guideline that its *ten* largest borrowers should not generally account for more than 60% of its portfolio. At the end of FY94, however, its largest borrower (Mexico) accounted for 11.9% of the disbursed and outstanding portfolio while its ten largest borrowers accounted for just over 62% of the portfolio. The *second* guideline stipulates that the IBRD share of any country's public and publicly guaranteed *debt service* should not exceed 20% with the share of all *preferred creditors* together not exceeding 35%. The *third* guideline requires the debt service ratio for the World Bank's debt to be confined to 4% of total exports (goods, services and remittances) for high risk countries, 5% for moderate risk countries or up to 6% for low risk countries.

These guidelines are applied with flexibility and discretion on the part of IBRD's management rather than serving as rigid cut-offs which are mechanically applied. Taken together they serve as useful quantitative indicators of the extent of the IBRD's exposure in individual countries. Until country risk actually materialises, the numerical probability which expresses the likelihood of its occurring is more a matter of finely tuned judgement than of formula-

driven quantitative methodology. The country risk which exists in any particular case, indicated in composite form by these different quantitative signals, actually depends on overall borrower creditworthiness, the claims of other creditors and especially other *preferred* creditors, the government's performance record in improving domestic resource mobilisation and rapidly adjusting to external shocks and, finally (perhaps even most importantly) the overall quality and effectiveness of its relationship with the IBRD. Given this reality, a great deal of supplementary qualitative analysis is undertaken to make a judgement as to whether, in the event of indicators signalling trouble ahead, the IBRD needs to adjust its assistance strategy to a particular country sufficiently early to stop a problem from becoming a crisis. In practice, the IBRD's exposure guidelines are used to identify cases where close monitoring of country creditworthiness is indicated. The IBRD's exposure increases are then calibrated carefully to avoid increasing exposure too rapidly in difficult situations while ensuring, at the same time, that resources are not withheld too hastily so as to precipitate, rather than avert, a debt-service problem.

### *Country Exposure Limits in the AfDB*

In 1993, responding to the concerns of non-regional shareholders about deteriorating portfolio quality, the AfDB's management suggested to its Board the adoption of formal country exposure guidelines requiring that: (i) the amount outstanding on loans to any single borrower should not exceed its ordinary reserves – translated into a proportion of its outstanding loan portfolio, that restriction meant that, at the end of 1993, no single borrower should have a portfolio share larger than 10.5%; (ii) the annual debt service obligations to AfDB should not exceed 4% of a country's total debt service; (iii) the AfDB's outstanding loans to any borrower should not exceed 40% of its total debt stock; and (iv) the AfDB's share of debt service to preferred creditors should not exceed 25%. At the end of 1993, outstanding loans to three borrowers (Morocco, Nigeria and Tunisia) accounted for 14.7%, 11.8% and 12% of the total AfDB loan portfolio respectively. In 1993 the share of AfDB debt service in total debt service exceeded the 4% criterion in the case of 36 countries. The AfDB's share of total debt stock did not exceed 40% in the case of any borrower. As a share of debt service to preferred creditors, the AfDB's share exceeded 25% in 24 small countries.

Hence most of AfDB's exposure guidelines, if adopted immediately by the Board, would be honoured more in the breach than in the keeping. Therefore, at present they are statements of *intent* rather than of applicable *policy*. The *share of portfolio* criterion, as expressed in the AfDB's guidelines, may not be an appropriate rule to apply. It may even be unmanageable in that neither commitments, nor contractually obligated disbursements, can be

controlled in a manner which reflects AfDB's ability to generate adequate reserves. Therefore a criterion which limits the largest borrower to 10% or even 15% of its total portfolio (regardless of the level of *reserves*, which would be built up through a reserves-to-loans ratio anyway) might be a more easily applicable guideline. Moreover, given its much smaller eligible borrowing universe for hard-window resources, the AfDB's portfolio will, necessarily, be more concentrated than the IBRD's; therefore it needs to use a criterion which reflects that reality. In using the *share of preferred debt service* criterion, a share of 25% or even 30% would be justifiable as it is conceivable that in the smaller African countries the AfDB's exposure may need to be larger than that of the IBRD. It already is, in unjustifiable cases (such as Zambia). The *share of total debt service* criterion needs to be in balance with the *preferred creditor share of debt service* criterion. But, in the case of African debtors, whose debt servicing patterns are not usual or typical in comparison with those of most MDB borrowers, considerable caution has to be applied in interpreting this criterion.<sup>5</sup> Finally the *share of debt stock* criterion might appear to be a useful guideline, but it is not from an operational viewpoint. For such a guideline to have any meaning, the creditor composition of a country's debt stock, its term structure and concessionality, and the contractual debt servicing obligations it imposes, need to be taken into account. Because the need for useful exposure monitoring guidelines, which are realistic and applicable, is greater for the AfDB than for any other MDB, its proposed guidelines need to be reconsidered and redesigned.

In September 1992 the AfDB issued a policy paper on Country Exposure<sup>6</sup> and in April 1993 issued Terms of Reference for its internal Exposure Monitoring Committee.<sup>7</sup> These documents acknowledge the need for careful and continuous portfolio monitoring through quarterly reviews. Quite appropriately, and in keeping with portfolio review practices at the IBRD and IDB which reflect the sensitivity of the judgements involved, the AfDB

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5 It should be interpreted on the basis of *contractually obligated* (i.e. *scheduled*) and not actual, debt service in any given year. Most African low-income debtors today are servicing only preferred creditor debt. In doing so, they are giving seniority to servicing AfDB debt rather than the debt of other preferred creditors such as the IMF, IBRD and other multilaterals (EDF, EIB and the Arab multilaterals). For example, Sudan is servicing AfDB debt but not that of the IBRD or IMF. The same is true for a number of African countries. Thus the proportion of total debt service which is absorbed by the AfDB seems inordinately high on an actual basis when it would be much lower if these borrowers were meeting all their scheduled, contractual debt service obligations.

6 AfDB Board Memorandum on "Country Exposure Policy" dated 14 September 1992 (No. ADB/BD/WP/92/95).

7 AfDB Board Information Note on Terms of Reference to Exposure Monitoring Committee dated 8 April 1993 (No. ADF/BD/IF/93/32).

emphasises strongly the internal ownership of the exposure review process. But, a close scrutiny of the documentation (especially the September 1992 paper) suggests areas in which concern might legitimately be expressed by shareholders about how rigorous the exercise might be. While making a powerful case for ongoing exposure review and recognising the concentration of the AfDB's portfolio in severely-indebted, low-income countries (in most instances *IDA-only* countries), the stated policy contains several loopholes which do not appear justifiable on substantive grounds. In outlining exposure control policy the paper at the same time makes a case for deviating from strict standards in the name of *flexibility* when the AfDB's current financial situation demands the opposite approach. For example:

Para 5.2 "However, since the AfDB is a regional bank it also needs more flexibility in the application of exposure guidelines. The AfDB services a smaller number of borrowers than the World Bank, and the resources and absorptive capacity of its borrowing members are concentrated in a smaller number of countries, *so exposure guidelines should be tailored to meet a specific regional need.*"

Para 5.3 "Management therefore proposes to introduce more rigorous supervision of the Bank's funds. It will not however put an automatic mechanism into place *which prohibits the flexibility needed to take into account the variety of economies found among regional members.*"

Para 5.4 "Management wants not only to flag countries which may present exposure concerns to the Bank, but to *develop an active policy which will help augment the member countries' absorptive capacity and their growth rates.*" (italics by the author)

These loopholes – which imply that AfDB's management should retain the right to avoid doing what a rigorous approach to portfolio risk management might necessitate – may only serve to vitiate whatever benefits a country exposure policy and a review process might have. Under the financial situation which is presently evolving in the AfDB, the arguments actually favour permitting *less* flexibility and discretion on the part of management. The AfDB's highly politicised regional representation on its Board tends to take advantage of management discretion through special pleading which a politically-sensitive management finds extremely difficult to ignore. That practice explains, in part, the predicament in which the AfDB finds itself. For that reason alone, it is essential to introduce greater automaticity in requiring the AfDB to reduce country exposure levels rapidly, especially in patently uncreditworthy countries, unless there are sound reasons for doing otherwise. For the same reason there might also be grounds for having a small sub-committee of the Board (comprising mainly its non-regional members), or even the Audit Committee, participate in the portfolio review exercise, without usurping the prerogatives of the Bank's management, to ensure a

needed degree of transparency in the application of an overdue and critically important country exposure policy.

*Country Exposure Limits in the AsDB and the IDB*

Both the **IDB** and **AsDB** have country risk assessment systems with provision for annual reviews. But, in view of the limited number of regional borrowers that avail of their OCR facilities (much more limited in the AsDB than in the IDB) their approach to having firm guidelines and enforcing exposure limits was, until very recently, a deliberately flexible and cautious one perhaps best expressed by the AsDB in asserting that, while it is important to avoid making an unduly large share of the total loans to any one borrower, and to ensure that the general portfolio mix is carefully determined, care needs to be exercised in considering the establishment of any fixed limit or ceiling for lending to any one country. That view, expressed in March 1993, changed suddenly. In June 1993, the AsDB opted for a country risk exposure management approach similar to the IBRD's, adopting the latter institution's guidelines for an interim period while leaving open the possibility of modifying these after sufficient experience had been gained. The IDB's country exposure practices have not yet followed the guideline-based practices of the AsDB or IBRD although plans to do so are quite advanced.<sup>8</sup> In the IDB, country exposure is, of course, implicitly and automatically limited by the detailed fashion in which lending plans for its four different categories of borrowers are laid out when shareholders are approached for periodic GIRs, coupled with annual and end-of-period reporting on how those plans are being (or have been) executed.

At the end of 1993, about 36.3% of the **AsDB's** portfolio of OCR loans was concentrated in Indonesia, with a further 41% in three other countries (India, Pakistan and the Philippines). Two countries (China and Thailand) accounted for a further 13.4%. Just six borrowers thus accounted for nearly 91% of AsDB's total OCR portfolio. This is the highest level of portfolio concentration in any MDB except the nascent EBRD. Were significant economic or political disturbances to occur in any of its four largest borrowers – none of which are immune to such risks – the AsDB could be exposed to a degree of risk much higher than any of its cohorts. Upto now, (and throughout the debt crisis) the debt-service record of its major

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<sup>8</sup> It was reported that IDB was working on formulating a formal guidelines based country risk exposure monitoring system and was to present a paper to its Board before the end of 1993. That deadline has passed without any public knowledge that such a system has in fact been put in place.

borrowers has, however, been exemplary by any standards; even during periods when they have been severely traumatised by internal economic and political crises (the most recent case being India in 1991). If that record can be maintained in the future, then the AsDB's concentration risk, although very high, may not be much of an issue. What this degree of concentration does suggest though is that it may not be appropriate for the AsDB, even during the trial period of running-in its new country exposure risk management system, to adopt, without modification, the *single-country share of portfolio* guideline used by the World Bank. The other IBRD risk exposure guidelines of course are unobjectionable and relatively easy to adhere to.

The portfolio of the **IDB** was somewhat less concentrated at the end of 1993 with the largest OCR borrower (Brazil) accounting for 16.2% of the total portfolio and five other borrowers (Argentina, Chile, Colombia, Mexico and Venezuela) accounting for a further 51% with the risk being more evenly spread among these six borrowers than in AsDB. Unlike the AsDB, the IDB did have a number of troubling years with protracted arrears since, at one time or another, all of its six largest borrowers, and a number of smaller ones (accounting for almost the rest of the portfolio) were severely affected by the debt crisis. However that crisis has now passed though it has left a salutary legacy of prudence in anticipating problems and building up provisions and reserves.

### *Country Exposure Limits in the EBRD*

Given the limited number of sovereign borrowers that it deals with, the **EBRD's** start-up approach to country risk exposure focuses on the extent to which: (i) these individual borrowing countries have the capacity to service external debt obligations in general and EBRD debt in particular; and (ii) the EBRD's status as a preferred creditor, relative to other preferred creditors, is honoured.<sup>9</sup> As in the other MDBs, country risk is determined by using both quantitative measures and qualitative judgements. Quantitative measures include an evaluation of the usual macroeconomic indicators (i.e. debt stock, debt service, export earnings and growth, GNP growth, inflation performance, reserves and current and capital account balances). In addition the EBRD bases its country risk judgements on credit ratings provided by the

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<sup>9</sup> Unlike the other MDBs it should be recalled (as mentioned in Chapter 2) that the EBRD is explicitly required under its Charter to limit its exposure to the "state sector" (i.e. to sovereign governments or their entities) to 40% of its total committed loans, guarantees and equity investments and to direct at least 60% (preferably more) of its operations to the private sector in a direct effort at supporting the emergence and development of market economies in its eligible borrowing countries.

Institute for International Finance (IIF) and the commercial rating agencies, as well as on its own internal judgements about a country's ability and performance in: moving towards a market economy; economic diversification; internal economic and political stability; and the management of budgetary deficits. Quantitative and qualitative indicators are combined in determining the EBRD's rating of country credit risk.

EBRD uses two specific exposure guidelines: (i) annual debt service to *preferred creditors* – which in the EBRD's definition also includes debt service on bonds issued in debt stock and debt service reduction exchanges and short-term trade related credit – should not exceed 20% of a borrowing country's total export earnings; and (ii) annual debt service to EBRD should not account for more than 5% of total export earnings. If these two guidelines are breached, an intensive credit review is required before a lending operation is approved. As in the other MDBs, the EBRD's country lending limits reflect its concerns about risk diversification and are not used as a lending allocation or rationing device.

Individual country risk assessments are integrated into an annual loan portfolio review which is presented to the Board. Statutorily, the maximum amount of *committed* loans, guarantees and equity investments made to/in both state and private enterprises in any single country cannot exceed 90% of the EBRD's paid-in capital.<sup>10</sup> The limit for each country is related inversely to the assessed risk; as risk is perceived to decrease, the allowable exposure is permitted to rise to the present maximum exposure limit of ECU 2.7 billion (or US\$3 billion). The absolute size of the country plays a role in determining the exposure limit as does the size related to risk. The EBRD will not permit total exposure to approach the allowable limit in either high-risk large countries, or low-risk small countries. Given the incipient stage of growth in EBRD's lending operations, the individual country limits are not expected to be reached for several years and country exposure management will be refined annually as more experience is gained.

At the end of 1993, two countries (Hungary and Russia) accounted for 50.6% of the EBRD's disbursed and outstanding portfolio while three of its next largest borrowers (the Czech Republic, Poland and Romania) accounted for a further 39%. These patterns indicate a reasonably high level of start-up concentration risk although the amounts involved do not yet pose a market

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10 At least 60% of EBRD's aggregate OCR loans, guarantees and equity investments outstanding at the end of each fiscal year between FY92 to FY94 are to be in: Albania, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and the constituent republics of the former Yugoslavia.

risk of any significance since the total loan and investment portfolio amounts to a fraction of its paid-in capital at the present time.

### *Private Sector Exposure Risk Management*

Three of the MDBs (i.e. the AfDB, AsDB and EBRD), finance *private sector operations* directly through their own hard-windows rather than through separate affiliated corporations. The IBRD, finances the private sector through IFC, and the IDB does so through IIC. In the former case, risk assessments of loans to *private* borrowers must also be made by the three MDBs for portfolio risk management purposes. Lending to and investing in private borrowers involves different risks from sovereign risk, insofar as these loans/investments are not guaranteed by a sovereign. Direct lending to *private* borrowers exposes MDBs to standard commercial risks which sovereign lending does not, especially when sovereign borrowers are also shareholders in the MDBs. Loans and equity investments in *private* enterprises also expose MDBs to the risk of outright loss, whereas with *sovereign* borrowers, the risk – except *in extremis* – is more that of incurring protracted arrears and their consequences than of outright capital loss.

Moreover, in dealing with private borrowers, MDBs might be compelled to engage in normal *debt* rescheduling, refinancing and restructuring arrangements alongside other creditors which, if indulged in on a large scale, could endanger an MDB's own credit rating on international capital markets and increase its cost of borrowing and/or constrain its market access. Three issues therefore arise in ensuring that the impact of private sector lending/investment on adding to an MDB's portfolio risk is contained: (i) the size and nature of its private sector operations; (ii) the loan restructuring and rescheduling practices to be employed for such operations and (iii) the separate provisions set-aside for such operations to ensure that losses on *private* lending do not contaminate the MDBs' *sovereign* portfolio.

Direct lending to, and investment operations in, the private sector by the **AfDB** are minuscule in relation to its total operations. This is a relatively new activity for the AfDB, launched in 1991 with an allocation of UA150 million for private sector projects through a separate private sector development unit (PSDU). By the end of 1993, the AfDB's cumulative lending to the private sector amounted to UA39.5 million (US\$54.3 million) for 14 operations out of total cumulative lending of UA13.26 billion (US\$18.2 billion). Private sector lending operations thus accounted for less than 0.3% of total operations, although they accounted for 2.2% of annual operations in 1993. In addition to its strategic equity investments in a few plurilateral African institutions and in national and sub-regional development banks, the AfDB has made three equity investments in private companies of just over UA1.5

million (US\$2.1 million).<sup>11</sup> But it is planning a rapid expansion of its private sector operations in the coming years.<sup>12</sup>

The AfDB has given much thought in the last year to revising and strengthening its approach to controlling its burgeoning arrears. But its focus of attention has been on controlling arrears on sovereign, rather than private, loans/investments. Its policies on exposure in private sector loans and investments, and on arrears on loans to private borrowers, or on losses on equity investments in private companies have the same foundations as in the AsDB and EBRD (see below). AfDB's private sector loans are secured by collateral; ostensibly at least it undertakes intensive supervision and monitoring of the private sector projects it finances. Private sector loans which are more than 90 days overdue are classified as non-performing with non-accrual and provisioning being triggered at that point. The AfDB's policies require it to establish specific reserves for potential losses on its private sector loans and investments. Its policies also permit it to participate in various types of debt relief and rescheduling measures for private sector loans operations provided that doing so enhances the prospects of recovery and provided that such arrangements involve fair burden-sharing by all creditors and shareholders.

In its 1993 Accounts, the *carrying values* and *estimated fair values* of all disbursed and outstanding *loans* to the private sector (of UA5.53 million or US\$7.6 million) were identical, suggesting that their repayment record till then did not require any provisions for possible losses to be made. But, in the same year the AfDB adopted a policy of reviewing periodically its portfolio of all its *equity investments* (including both strategic investments and those made by PSDU) and creating specific provisions for those in which management expected there to be a significant and lasting decline in value. Accordingly, in its accounts for 1993 the AfDB made a provision of UA2.44 million (US\$3.35

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11 This amount excludes the equity participation by AfDB in major public, or quasi-public institutions such as the core capital of the AfDF, and in the common equity of the Africa Reinsurance Company (Africa-Re), the SIFIDA Investment Company, Shelter-Afrique, Meridien BIAO S.A., African Export-Import Bank, as well as several public national and sub-regional development banks in Africa, such as the East and West African development banks and the PTA Trade & Development Bank. Of these, the investments in SIFIDA and Meridien could be considered purely private investments although they are different (and more strategic) in character to the smaller investments in local private companies which AfDB is undertaking as part and parcel of its regular business operations through the PSDU. In total, the AfDB's strategic equity participations in these larger institutions amounted to UA138.3 million (US\$190 million) at the end of 1993 of which UA111.74 million (US\$153.5 million) was accounted for by the AfDF with the remaining UA26.6 million (US\$36.5 million) invested in the other pan-African institutions which AfDB has helped to establish.

12 See for example, President's Memorandum to the Board on "Mid-Term Report of the AfDB's Private Sector Operations" (Document No. ADB/BD/WP/93/131) dated 9 December 1993.

million) for possible losses on its equity investments. This amount represented about 9.2% of all its outstanding equity investments other than its investment in the core capital of the AfDF. No information was readily available on the procedures and policies which the AfDB applies to arrive at such provisions relative to its total equity portfolio.

In the **AsDB**, private sector operations (which actually began in 1983 with the establishment of a special equity investment facility) are also seen as a separate activity from mainline sovereign lending business. The amounts allocated for private sector lending and investment over an operational programme period are considered and pre-decided by the Executive Board. In 1990, the Board agreed to set the limit for such operations at a total of US\$1 billion before it became necessary to review the matter again. By March 31, 1994 cumulative lending and investment by the AsDB directly to the private sector totalled US\$947 million in about 100 separate operations.<sup>13</sup> It expects to commit a further US\$1 billion in private sector loans and investments between 1994-96. In 1993, AsDB's private sector operations accounted for under 6.6% of total lending operations and represented about 2.3% of the disbursed and outstanding portfolio. Apart from its policy of limiting its overall private sector exposure to a prudent level, the AsDB employs different credit policies for its private sector lending and investment operations to assure strong asset quality. Unlike its sovereign loans, the AsDB's loans to the private sector are fully secured by collateral. Private borrowers are required under loan and investment covenants to maintain satisfactory financial ratios, ensuring financial soundness and ability to meet debt service obligations, which are closely monitored on a regular basis to enable early detection of potential problems. Even so, the AsDB acknowledges that by their very nature, such operations involve a higher degree of risk in incurring potential losses and delays in recovering loans. Therefore, unlike the firm position it (and every other MDB) has taken on **not** rescheduling, refinancing or restructuring *sovereign* debt, the AsDB like the AfDB does engage in such rescheduling, under strict guidelines,<sup>14</sup> for loans and investments in its private sector portfolio.

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13 As the AsDB observes in a confidential document, there is a limit to the amount of resources that can be allocated for private sector financing beyond which it would have to: (i) change its financial policies and practices in a fundamental manner and (ii) be provided with additional paid-in usable capital by shareholders to support expansion of such operations. Equity investments in private companies are funded entirely from equity capital while private sector loans are funded by both borrowings and equity. AsDB's charter sets a limit on its equity investments to 10% of the unimpaired paid-in capital plus ordinary reserves.

14 Rescheduling is only one of several options which the AfDB, AsDB and EBRD keep open in dealing with problems in their private sector portfolio. Such an arrangement is undertaken only when these MDBs have determined conclusively that: (i) it would improve the prospects of such loans being serviced and eventually recovered; (ii) rescheduling is not being undertaken →

Unlike the AfDB and AsDB, lending to the private sector is a mainline activity of the EBRD which is required under its charter to provide (i.e. lend/invest) at least 60% of its total resources to the private sector. In the EBRD, the private enterprise portfolio is limited by a series of prudential exposure limiting guidelines which are to become effective from January 1995 onwards. These include: (i) a *sectoral or industry exposure limit* of 20% of the outstanding portfolio; (ii) a *single obligor*<sup>15</sup> limit of 5% of EBRD's paid-in capital (effectively ECU 150 million or US\$167 million) which applies to both private enterprises or state-owned enterprises whose obligations to the EBRD are not guaranteed by a member government; (iii) committed *equity investments in a single obligor* limited to a maximum of 3% of EBRD's paid-in capital (ECU 90 million or US\$100 million at present); (iv) the *five largest* private or non-sovereign risk commitments are limited to a maximum of 50% of the portfolio; and (v) normal EBRD financing for any *single project* is limited to 35% of the long-term capital needs of any obligor.

Like the other MDBs, the EBRD has a general policy of not rescheduling, refinancing or restructuring its loans to *sovereign* borrowers or state enterprises in order to preserve its privileges as a preferred creditor. But, like the AfDB and AsDB, the EBRD's policies permit it to engage in such practices where its lending to the private sector is concerned. And it employs much the same rationale and safeguards in doing so. Its policy posture is to undertake loan rescheduling where such a course of action provides the best means of protecting its own interests. The determination of the circumstances in which such a course of action is deemed correct is left to the discretion of management subject to the application of the following general principles: (i) whenever possible, an EBRD rescheduling is made conditional on other investors and creditors sharing equitably the burden of the problems faced by the borrower through further injection of equity, debt or both; (ii) the rescheduling, along with actions taken by other parties involved, must

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simply to avoid default; (iii) other courses of action, including liquidation, have been carefully considered and found to be less desirable or appropriate than rescheduling; (iv) the arrangement is properly coordinated with other creditors and shareholders to ensure consistency of treatment and the workability of the approach being taken; and (v) interest and restructuring charges can be applied on an appropriate basis, depending on the circumstances, to the rescheduled component. Authority is delegated by the Executive Board to the MDB managements to approve changes in loan repayment dates (in situations that do not involve basic or material changes in the scope of the project financed or in implementation arrangements) without prior approval by the Board providing the latter is kept informed of such actions through quarterly progress reports.

15 A single obligor is defined by EBRD as: (i) a single borrower, or (ii) a group of borrowers which are either majority-owned or effectively controlled by a single entity. For example, the total committed loans, investments and guarantees to two or more companies which are owned to the extent of "50% + one share" owned by the same parent company or the same shareholder cannot together exceed the limit applicable to a single obligor.

enable the borrower to achieve viability and service future financial obligations out of regular cash flow; (iii) all reschedulings which postpone repayments beyond time limits originally authorised by the Board must again be approved by it; (iv) rescheduling actions must be determined on a case-by-case basis to suit the particular needs of a specific borrower; (v) reschedulings are only undertaken after all the other options (including liquidation) have been thoroughly evaluated and determined to be less desirable; and, finally, (vi) rescheduling is not undertaken merely to avert an imminent default.

At the end of 1993, the EBRD had committed a cumulative ECU1.6 billion (US\$1.79 billion) to the private sector of which it had disbursed just over ECU0.49 billion (US\$0.55 billion). The private enterprise sector thus accounted for 89% of EBRD's disbursed and outstanding loans/investments. Against this portfolio, the cumulative *general* provisions set aside for possible losses amounted to ECU11.1 million for loans and ECU10.6 million for equity investments at the end of 1993. In addition, *specific* provisions of ECU12.5 million were made for three projects.

To avoid the risk that problems with their private sector portfolios might contaminate their sovereign loan portfolios, it would appear wiser for the AfDB and AsDB to consider financing their private sector operations through a separate corporate entity with limited liability and a different *modus operandi* with different policies, rules and regulations applying to its management and staff. The EBRD has, of course, been constitutionally structured to be a hybrid whereas the other MDBs have not. For that reason it may be more appropriate for the AfDB and AsDB to follow the route taken by the IBRD and IDB in establishing the IFC and IIC respectively. The AsDB has already participated in the establishment of the Asian Finance and Investment Corporation (AFIC) to which all of its private sector operations could easily be shifted. The AfDB may need to either participate in, or establish its own, African Finance Corporation. In the absence of such an approach, there is a real danger that any significant losses on the institution's private sector portfolio could impair the market image and operations of the MDB as a whole. This risk is perhaps particularly high in the case of the AfDB. Clearly in creating distinct corporate vehicles for this purpose, the two MDBs concerned should avoid duplicating unnecessary administrative functions, infrastructure and costs to the extent feasible. The suggestion to take a separate corporate route in handling private sector operations is made not because uniformity of approach across all the MDBs on all matters is *per se* good or essential. It is not. Instead the proposal is intended to safeguard the prudential interests of these institutions and to permit more flexibility to be applied in the way these operations are handled, and the way in which remedial measures can be applied when portfolio problems occur.

## *Policies for Arrears, Non-Accruals and Loan Loss Provisioning*

Despite their best efforts at trying to anticipate potential debt servicing problems through their country and private sector risk exposure management practices, different MDBs have, since the mid-1980s, experienced *arrears* on the servicing of debt owed to them by their sovereign and non-sovereign borrowers. These arrears have been of varying severity at different times and have been incurred by different sovereign and private borrowers. The experience of the MDBs in coping with such arrears and their consequences is only about a decade old. During that time, the policies and approaches of the MDBs in dealing with the problem of arrears, and in applying a series of *carrot-and-stick* measures to induce borrowers to reduce arrears and resume debt service on the basis of contractually agreed schedules, have been developed and refined continuously. Between 1984-92, the different MDBs evolved internal approaches which varied significantly. The AsDB and AfDB, for different reasons, adopted approaches which were quite distinct and more lenient than those of the IBRD and IDB. That may have been because, at the time, neither of them faced the same portfolio problems with the same degree of urgency as their two cohorts. Since 1993, however, there has been a trend towards all the MDBs adopting convergent policies and approaches with the IBRD setting the pace. A brief comparative analysis of these policies for the IBRD, AsDB, AfDB, and IDB is provided in summary form in Annex 2.1.

*The Problem of Arrears:* All the financial managements of MDBs (usually their Controller's Departments) monitor debt service payments on a continuous basis. A borrower is in arrears with an MDB when, in accordance with the applicable loan contract, it has not made payment to the MDB by the close of business on the day when interest and principal repayments are due. As arrears age, MDBs employ measures of progressively increasing severity in order to exert pressure on borrowers to meet their contractual obligations. In formulating these measures, it is of course important for MDBs to take into account the nature and causes of the arrears problem and to work with the borrower in encouraging the latter to make best efforts to clear arrears. In the interests of fairness the measures applied by MDBs need to take into account the size of the arrears, whether they have been caused by technical or procedural difficulties in procuring certain currencies for repayment, and whether the borrower has made acceptable payment arrangements which have not been properly implemented or effectuated. In looking at the policies which the MDBs have devised for coping with arrears it is therefore useful to consider them on the basis of their different durations. For operational purposes (i.e. from the viewpoint of triggering various sanctions and/or loss of various benefits enjoyed by borrowers not in arrears), these are

classified by the **IBRD** into four different categories: (i) arrears of less than 30 days duration; (ii) arrears between 30-60 days; (iii) arrears between 60-180 days; and, finally (iv) arrears of over 180 days. These same categories are now applicable in the case of other MDBs as well.

Arrears of less than 30 days are generally due to transaction-related complexities and difficulties, most of which are often quickly resolved. Arrears of 30-60 days duration provide more cause for concern and trigger the loss of interest spread waiver benefits (only in the IBRD), some sanctions, as well as more intensive efforts on the part of management to ensure timely repayments. Most countries whose arrears fall into this duration category are usually highly-indebted, confront serious debt servicing difficulties, are low on their reserves and are generally short of foreign exchange. After 60 days, the MDBs suspend disbursements on their other committed loans to the same sovereign borrower while simultaneously intensifying their efforts to prevent borrowers from having their arrears slip beyond 180 days.<sup>16</sup> When payments are overdue for more than 180 days they are referred to as *protracted arrears*; at that point, they trigger both *non-accrual* of income and require *specific provisions* to be made for possible losses on the loan. A borrower being placed in non-accrual status by any MDB reflects an unusual degree of financial distress. It may also indicate an unwillingness or inability on the part of the borrower to take immediately the kinds of measures necessary for restoring economic viability which are deemed adequate by the international financial community to justify the provision of extraordinary external financial support. Experience suggests that after some time most borrowers in non-accrual status do attempt to work out their problems with the MDBs through a series of special measures and approaches aimed at reviving flows of external finance and the restoration of normal debt-servicing relations.

*Non-Accrual Status:* In keeping with internationally accepted accounting standards, all the MDBs record their *income* from loans on the basis of accrual rather than actual cash receipts in convertible currencies. The same principles

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16 The volume of arrears in the two categories of 30-60 days and 60-180 days fluctuates considerably from month-to-month and is usually influenced by overdues of a few large borrowers. Combined arrears in these two categories have been growing rapidly for the IBRD and AfDB since the mid-1980s. They also grew for the IDB between 1984-1990 but have diminished significantly since. In the case of the IBRD *the arrears float* – i.e. the average arrears outstanding between 30-180 days grew from US\$32 million in 1985 to a high of US\$233 million in 1989 and have fluctuated since; they came down from an average of around US\$190 million in 1990 and 1991 to a low of about US\$55 million in 1992 but climbed again to US\$70 million in 1993. In the AfDB, this float has kept growing from about US\$44.7 million in 1988 to US\$263.3 million in February 1994.

require, however, that when any doubt arises about the collectibility of such income, it should no longer be recognised. When a borrower is placed in non-accrual status by any MDB, it means that in the judgement of the MDB's management, the debt service difficulties being faced by the borrower in question are sufficiently serious for the MDB to cease accruing income from that loan on its books. Until early 1993, only the IBRD, EBRD and IDB placed *sovereign* borrowers<sup>17</sup> in non-accrual status when payments were overdue by more than 180 days while the AfDB and AsDB did not do so until payments were more than one year overdue. In late 1993 and early 1994, however, the AsDB and AfDB also shortened their overdue periods for placing sovereign borrowers in non-accrual status to six months. None of the MDBs charge any penalty interest on overdue interest payments.

*Loan Loss Provisions:* Again, internationally accepted accounting principles require that, in the event of a reasonably quantifiable diminution in the value of a receivable (i.e. a loan), a provision equal to the judged diminution in value should be created. Financial institutions such as the MDBs therefore establish loan loss provisions when any loss of *principal* is expected to occur either from outright default, or from the borrower being a prolonged period in non-accrual. The purpose of the provision is to reflect a possible loss in the financial statements of the MDB immediately upon its being recognised. Loan-loss provisions are annual non-cash charges made against income after non-accrual. Cumulative provisions are shown on the balance sheets of MDBs until an actual loss materialises, at which time the amount lost is charged to (i.e. debited from) the accumulated provisions. However, in charging such a loss on its accounts, an MDB does not necessarily forego the legal right to recover the amounts it has charged off. Should it succeed in recovering its losses, such recoveries must then be credited to accumulated provisions. If actual loan losses exceed the total amount of cumulative provisions the excess of the loss must then be charged against the current year's income. Should expected losses not materialise, and instead should the debt-service record and performance of borrowers formerly in arrears improve, then the provisions made by an MDB may need to be reversed and

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17 For its private and non-sovereign borrowers the EBRD places loans in non-accrual status when payments are overdue by more than 60 days; a period which is shorter than that used by most commercial banks. It is not clear whether the AfDB and AsDB intend to follow the EBRD in pursuing different policies for their non-sovereign private borrowers as well. Prudence would dictate that they should although a 60-day period before triggering non-accrual seems very short. In keeping with standard commercial practice a 90-day period would be more appropriate for all MDBs to employ. The AsDB presently places private sector loans in non-accrual status when they are 6 months overdue and provides for them at the same time. For its sovereign borrowers its policy is not to provide until loans have been in non-accrual status for six months.

reduced with the amount of the reversal being added back to the current year's income as extraordinary income.

There are two approaches which financial institutions use in making loan loss provisions. One is the *specific provisions* approach which requires provisions to be made for loans to specific borrowers who are in arrears. The other is the *general provisions* approach under which provisions are made on the basis of an evaluation of the recovery risk on the entire loan portfolio. In those instances where a loan portfolio consists of a large number of homogeneous loans (e.g. auto loans, small business loans, or home mortgages), qualitative judgements about the adequacy of provisions can be augmented by actuarial analysis of the past record of arrears and defaults. In the case of the MDBs, however, the number of borrowers are limited to about 100 in the case of the IBRD and fewer than 40 in the case of the regional banks. Moreover, the history of arrears in the MDBs is limited and concentrated. These characteristics do not lend themselves to an actuarial risk approach for determining general provisions against the whole portfolio.

All the MDBs started out with specific provisioning. The IBRD and IDB shifted in 1991 to a policy of combining aspects of specific and general provisioning with the AfDB following in 1993. The EBRD started at the outset with both specific and general provisioning while the AsDB retains a policy of only specific provisioning. Specific provisions are clearly more defensible than general provisions. But they suffer from the weakness that they deal with problems in retrospect and not those which might arise in the future. Specific provisions deal with risks which *have already materialised* and do not provide any protection against hidden risks which *might* materialise but have not yet done so. For that reason, specific provisioning exposes MDBs to the risk of volatility in net income levels depending on whether a major borrower goes into or comes out of non-accrual status.

In the case of the MDBs (other than the AsDB) provisions are therefore arrived at judgmentally through a process which combines the following steps: (i) estimating provisions for loans already in non-accrual status; (ii) assessing the probability of loans which are in arrears, but not yet six months overdue, going into non-accrual; and (iii) evaluating the probability that a portion of the loans not yet in arrears may also go into non-accrual with particular attention being paid to those borrowers which are in the riskiest credit categories. These judgements are combined to determine an overall level of provisions on an annual basis which are then accumulated over time. Loan loss provisions are triggered simultaneously with non-accrual in the IBRD, EBRD and AfDB. At the IDB such provisions are made at the beginning of the next month after loans have been placed in non-accrual status. At the AsDB no specific policy on loan loss provisions has been developed yet and present practices suggest a case-by-case approach.

## *Sanctions on Borrowers in Arrears*

In the difficult interregnum between a country going into arrears and going into non-accrual status, different MDBs apply, as aforementioned, a number of incentives and disincentives to induce borrowers to avoid arrears if possible, or alternatively to mitigate their impact. These sanctions differ across the MDBs depending on their particular policies and whether or not they provide certain incentives (e.g. the IBRD's interest spread waivers) to borrowers that make timely payments. By and large sanctions include measures such as:

- *Loss of Eligibility for Interest Spread Waivers:* As indicated earlier, the IBRD has a system of providing interest spread waivers (presently 25 bp) to borrowers that make timely debt-service payments. On accounts in arrears, the *borrower* ceases being eligible for interest waivers after 30 days of the account being in arrears while the *guarantor* (if different from the borrower) loses eligibility after 45 days. No other MDB has, as yet, adopted the same practice although IBRD's experience suggests that this incentive for making timely payments is a powerful one and should be more widely applied across the MDB community.
- *Dissemination of Borrowers Identity:* After 30 days in arrears, all MDBs inform their Executive Boards, through regular reports on overdue debt service payments, of the identity of borrowers in temporary default. Such reports are made: (i) semi-monthly in IBRD; (ii) monthly in the AfDB and AfDB; and (iii) weekly in the IDB. Borrowers in non-accrual status are identified in the notes to the financial statements in the published Annual Reports of the respective MDBs.
- *Board Presentation and Loan Signature Suspension:* In the IBRD and AfDB, *borrowers* in arrears for more than 30 days are prohibited from signing any new loan or guarantee agreements. *Guarantors* of loans in arrears are prohibited from signing loan or guarantee agreements 15 days after the above sanction has been applied to the borrower (i.e. after 45 days of the account being in arrears). In the IDB such suspension occurs immediately upon a borrower/guarantor going into arrears on any of its disbursed loans while in the EBRD it occurs after 60 days.
- *Suspension of Disbursements:* Disbursements are suspended on loans in arrears and when payments are overdue by: (i) over 60 days in the IBRD; (ii) 60 days in the AfDB; (iii) 30 days in the IDB; (iv) 30 days on private loans and 60 days on sovereign loans in the EBRD; and (v) after a review

by the Executive Board, 60 days in the AsDB. In the IDB disbursements on *all loans* to the same borrower (and not just on the loan in arrears) are suspended after 120 days. In the other MDBs, disbursements on all loans to the same borrower are suspended at the same time as disbursements on the loan in default.

- *New Loan Processing*: The processing of new loans ceases to *borrowers* as soon as: they enter into arrears at the IDB; are in arrears for more than 90 days at the AfDB; while the processing and granting of new loans to *guarantors* of loans in arrears for more than 90 days is suspended 15 days after the above sanction has been applied to the borrower in the AfDB. In the IBRD and EBRD loan processing is continued except in the case of countries in non-accrual (and sometimes even in those countries when a work-out appears feasible) although loans are not presented to the Board or signed until all arrears have been cleared.
- *Cross-Effective Sanctions*: Sanctions and suspensions are made “cross-effective” across the different entities within an MDB group after different trigger points. In the IBRD, sanctions clauses are now triggered automatically and immediately for IDA credits, but not for IFC and MIGA operations. The AsDB has no specific policy on the cross-effectiveness of sanctions. In the AfDB, cross-effectiveness used to be staggered but sanctions have recently become effective immediately for the AfDF and the NTF. In the IDB, sanctions become immediately cross-effective for FSO and IFF funding but not for IIC.
- *Notification to Co-financiers and Suppliers*: All MDB loan co-financiers as well as all suppliers of goods and services under MDB loans are informed by the MDBs of disbursement suspension when it occurs.

These sanctions and other measures employed to manage arrears, including billing practices and other supportive measures are described in comparative fashion in Annex 2.1.

# 7 Budget Management and Administrative Cost control

## *Introduction: Why is it Necessary to focus on MDB Budgets?*

This penultimate chapter attempts to bring into focus the *budget management and administrative cost control* practices and procedures of the MDBs which have come under scrutiny in recent years. Strictly speaking budget management and cost control are not matters of financial policy in MDBs. Nevertheless, most MDBs entrust the programming and budgeting function as well as the cost control and monitoring function to their financial organisations and managers. The policies which govern MDB budgets fall into a range of different categories including: administrative, human resource management, information technology, operational, research, information dissemination, and financial; not all of which can be adequately dealt with in a book of this nature. The financial policies which might affect MDB budgets have already been discussed at some length in the previous six chapters. MDB budgets are, however, most profoundly influenced by policies on staffing and recruitment, use of consultants, compensation, travel and communications, research and non-operational programme priorities, and other similar matters which do not fall within the general purview of financial policies. They are therefore more appropriately the subject of detailed consideration elsewhere.<sup>1</sup>

Obviously, *all* policies which affect MDB budgets have a profound influence on determining their overall cost structure and, therefore, on their overall financial situation and their net incomes. Consequently, they also have a bearing on the capacity of the MDBs to: (a) make provisions and generate adequate *reserves* commensurate with the growth rate of their loan portfolios; and (b) deploy their residual net incomes for other developmental purposes. Moreover, there has been a strongly growing impression among OECD shareholders, borrowers, the private sector, non-governmental organisations, and the public at large, that MDBs – along with UN agencies – have become opaque and unaccountable in their annual expenditures.<sup>2</sup> They are not, for

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1 But there can be little question that they should be subject to effective external scrutiny outside of the confines of their managements and Executive Boards. The evidence seems to suggest that, on the issue of cost control, Executive Directors in the MDBs may be in a conflict-of-interest situation and are perhaps susceptible to regulatory capture; i.e. serving the interests of those whom they are supposed to regulate rather than those whom they are supposed to serve.

2 To enhance transparency, the MDBs could make a good start by emulating the World Bank but going much further than it by including a detailed section on budgets and—

instance, subject to the intensive public and parliamentary scrutiny that government departments and public enterprises are usually subjected to in most democratically run nation states. Nor are they subject to the competitive pressures of the marketplace and the discipline that is ostensibly supposed to be exercised in most commercial, profit-making corporations. Therefore, with their sources of income being assured by their privileged position as preferred creditors, and with the adoption of financial policies which are designed to pass on virtually all the costs and risks of what they do to their borrowers or shareholders, without any obligations to pay out dividends or to increase the value of their shares, there are no compelling *natural incentives* for them to control their costs.

Media exposure now focuses almost daily worldwide public attention on the seemingly excessive expenditures which MDBs make on: their new office buildings, staff, travel and communications costs, as well as on various other perks and privileges which their staff enjoy such as tax-free salaries, home-leave benefits, educational allowances, and generous pension plans which are funded in considerable part by the MDBs. These expenditures frequently pale in comparison with the egregious excesses of top managers in private industrial and financial corporations in the developed and developing worlds. But they are quite generous in comparison with most, if not all, OECD governments. Such public attention and unfavourable comparisons (invariably and inevitably seen as invidious by the MDBs themselves) have become particularly troubling and sensitive at a time when the MDBs have come under criticism for poor performance or even failure on many fronts. They were much less of an issue when the primacy and role of MDBs was not subjected to such intense scrutiny and when there was little public doubt about the focus or effectiveness of their activities. Part of the concern about MDB budgets and expenditures is unquestionably linked to changing perceptions (in the wrong direction) about the usefulness and efficiency of these institutions both as financial intermediaries and as development institutions and about the overall quality of their managements. But a portion of concern is also linked to the more general loss of faith in governments and governmental institutions as solutions to national or global problems.

Many NGOs of various hues have now mounted highly effective public campaigns pointing to the failure of MDBs on several fronts e.g. the environmental damage their infrastructural investment projects are alleged to have

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administrative expenditures in their published Annual Reports with tables, ratios and explanations to facilitate understanding of how MDBs justify their administrative expenditures. At present the World Bank has the most detailed section on this issue in its Annual Report although even it obscures more than it reveals. The other MDBs provide very little information. Much of this information should be required by shareholders to be published in standard table form which would facilitate cross-MDB comparisons.

done in the developing world. Such publicity raises questions as to whether these institutions are too removed from reality by the internally comfortable environments they create. The apparent inability of MDBs as *public institutions* to control their costs, and their inclination towards compensating their staff too well, is perceived as reflecting blatant dual standards at a time when the same institutions publicly proclaim their concerns about poverty alleviation in the developing world. The same is the case when MDBs which have proven themselves incapable of *internal* structural adjustment of a fairly simple nature, regularly suggest dramatic public expenditure cuts and civil service reductions to a large number of their borrowing countries under structural adjustment programmes. That image is exacerbated when the same institutions, which are trusted by the international community for supervising and monitoring the manner in which billions of dollars are spent annually on projects all over the developing world, are seemingly incapable of constructing or furnishing even their headquarters buildings within relatively untaxing time and cost constraints. Even so, these complaints are often trivial and exaggerated if not irrelevant in judging the overall efficiency of the MDBs and the *value-for-money* that they represent relative to many other forms of public expenditure. But the germs of truth they contain do disproportionate damage by bringing into question the basic competence of these institutions in managing their own affairs, and thus diminish their credibility which should be vital to the functioning of the world financial system. They constitute a serious failure of MDB management which cannot go unremarked.

Most disconcertingly, questions are now being raised as to whether large annual budgetary expenditures on MDBs as financial intermediaries can possibly be justified when they have entered an era of extracting resources (via large negative net transfers) from developing countries through their intermediation functions. As noted earlier, negative net transfers are not, *per se*, an indication of performance failure on the part of MDBs. Often, negative net transfers are perfectly justified when MDB borrowers have developed sufficiently either to avail directly of market borrowings on favourable terms or have even become net exporters of capital. Either or both of these conditions were met when European countries which had completed reconstruction experienced negative net transfers vis-à-vis the World Bank in the 1960s or when countries such as Japan, Finland, Spain and New Zealand financed negative net transfers in the 1970s and 1980s, i.e. when they too had reached a sufficiently advanced stage of economic development.

At the present time, however, large negative net transfers (taking into account wide regional differences) between the MDBs<sup>3</sup> and developing

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For footnote 3, see next page.

countries do not generally reflect those conditions. The circumstances of most MDB borrowers today certainly do not suggest that their development has reached the point where large, extractive resource transfers can be justified. Instead, these negative net transfers signal the dangers of MDB portfolios which have matured before their time. As a result the amount of new lending necessary just to keep pace with the debt service being collected is taxing the capacity of both the MDBs and borrowers to keep in a neutral resource transfer position (*the treadmill effect*). It also suggests that a large amount of MDB lending – and particularly fast-disbursing adjustment lending – has not as been efficacious as anticipated in generating the developmental returns necessary within the expected time frame. That has resulted in an overhang of unproductive MDB debt which a large number of developing countries owe and which they are straining themselves to service.<sup>4</sup> Finally, large negative net transfers between the MDBs and their borrowers are occurring at the same time as positive net transfers between developing countries and global capital markets. That *may* indicate that private capital markets are becoming more efficient than the MDBs in performing *resource transfer* functions, and possibly even some *developmental* functions (such as domestic capital market development and infrastructure financing), thus raising serious questions about the continuing *raison d'être* for the MDBs, and especially for their hard windows.

Many of the criticisms of the laxity of sufficient cost control by MDBs are driven by motives other than the desire to see genuine improvements in the efficiency of their functioning. Many are ill-informed and unjustified. But, unfortunately, far too many of the criticisms which have been levelled (and many that should be but, as yet, have not) are legitimate and need to be dealt with more satisfactorily than the MDBs have so far done. Their usual responses to criticism about their lack of sufficient cost-consciousness are to: attempt ineffectual though unceasing annual reorganisations; co-opt their critics in somewhat subtle ways; attempt deliberate obfuscation and cover-up of serious budgetary lapses; and complicate their already overcomplicated budget preparation and control processes even more. By and large all the MDBs have sophisticated budget preparation guidelines and devote a considerable amount of staff time (perhaps even too much) to budget control. However, the way in which they go about preparing their budgets and controlling their expenditures is in some instances (e.g. in the case of the

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3 As noted in Chapter 1 the problem of large negative net transfers affects mainly the World Bank which dominates the MDB system. It does not as yet affect the more established regional banks, although it could do so before too long, and will not affect the EBRD for some time to come while its portfolio matures.

4 For a fuller discussion of this issue, see Mistry, P.S., “Multilateral Debt: An Emerging Crisis?”, FONDAD, The Hague, 1994.

World Bank) so elaborate that the budget process itself may have now become a major source of unnecessary expenditure and inefficiency.

The problem of excessive expenditure, however, lies less with the budget and monitoring *process* (except perhaps in the case of the AfDB and until last year the EBRD) than with the nature of core policies which drive MDB budgets and with the plethora of functions which shareholders demand MDBs should carry out without due concern for the cost implications of such *mission overload*. MDBs have generally been reluctant to reconsider their staff compensation levels as well as their benefit and travel policies except under extreme shareholder pressure. Nor have they been particularly mindful of: making essential staff reductions, redeploying staff more effectively and relying more on local staff with substantive decentralisation of their organisations and operations. In dealing with their budgets MDB managements appeared, until very recently, to have imbibed implicitly the disturbing ethos that the preferred creditor status of their institutions vis-à-vis borrowers must automatically be accompanied by the same privileged and preferred treatment of their individual staff vis-à-vis the rest of the world. Consequently, despite the incessant reviews commissioned internally by MDB managements and Executive Boards aimed at reducing costs, improving efficiency, and reducing throughput time (between identification of a project and approval of a loan) these objectives have rarely been met. Some of these reviews have achieved the opposite of what was intended. MDBs therefore remain stubbornly resistant to budget control.

### ***Comparative Analysis of MDB Administrative Expenditures***

The annual administrative expenditures of the various MDBs are portrayed in Table 8. The comparisons made and the ratios provided in that table need to be interpreted with particular discretion and care although the table does highlight some points which are worthy of careful scrutiny. To develop more appropriate benchmarks of relative cost and efficiency across the different MDBs, their budgets need to be broken down and re-synthesised in different ways to arrive at more pointed and valid conclusions about relative efficiency in undertaking specific activities and operations rather than rely on aggregates which cover a multitude of sins. Nonetheless, even the crude ratios provided on the basis of budgetary aggregates available from their published Annual Reports underline some important points which MDB shareholders rarely look at in a comparative framework; nor do they analyse their implications with sufficient care. A detailed comparative analysis of MDB budgets and administrative expenses at relevant levels of disaggregation and detail is clearly outside the terms of reference of this book. Administrative budget breakdowns are needed in fine detail of the sort that

MDBs are reluctant to release publicly. Nevertheless such detailed comparisons need to be made to evaluate the relative and absolute efficiency with which MDBs deploy budgeted funds. Such analysis should be undertaken by qualified independent assessors (not subject to regulatory capture) on a regular basis to enable more effective shareholder control over the spending habits of these institutions.<sup>5</sup>

**Table 8 Administrative Expenditures of the MDBs (1993/94)**  
(millions of U.S.dollars, unless indicated differently)

<b>Total Institution</b>	<b>IBRD</b>	<b>AfDB</b>	<b>AsDB</b>	<b>IDB</b>	<b>EBRD</b>
Total Admin Exp.	1,388.4*	134.2	151.8	271.2	153.2
o/w Staff Costs	851.8	93.6	106.3	197.9	77.9
Consultants	133.7	n.a.	6.4	n.a.	n.a.
Travel	129.8	n.a.	9.4	33.6**	34.4***
Other/O'head	297.9	40.6	29.7	39.7	40.9
No. of Staff	(6,338)	(1,224)	(1,898)	(1,818)	(795)
Admin Cost/Staff (\$)	219,060	109,641	79,979	149,175	192,704
Staff Costs/Staff ,,	134,396	76,471	56,006	108,856	97,987
Other Costs/Staff ,,	84,001	33,170	23,973	40,319	94,717

<b>Hard Window</b>	<b>IBRD</b>	<b>AfDB</b>	<b>AsDB</b>	<b>IDB</b>	<b>EBRD</b>
Total Admin Exp.	731.0	54.5	88.9	178.6	153.2
No. of Operations	(124)	(28)	(38)	(69)	(91)****
Dollars Lent (\$Bn)	14.2	1.6	4.0	5.5	2.5
Dollars Disb ( ,, )	10.4	1.4	2.0	3.3	0.5
Cost per \$ Lent	5.1¢	3.4¢	2.2¢	3.2¢	6.1¢
Cost per \$ Disb	7.0¢	3.8¢	4.4¢	5.4¢	30.6¢
Cost per Op (\$Mn)	5.90	1.95	2.34	2.59	1.68

5 Some MDB managers argue, however, that since these are independent profit-making organisations their budgets do not need to be controlled or monitored in the same way as those of government departments or parastatals. There is some merit in that argument although the ability of MDBs to generate profits depends on the provision of free funds by member governments and on the willingness of borrowers to pay whatever charges MDBs levy. For those reasons, it is essential that MDBs are seen to be controlling their costs and their expenditures on themselves as tightly as possible. They are public institutions with public responsibilities and obligations which should be subject to the same rules of transparency as other public organisations especially when they create the strong impression that they are not effective controllers of their own costs.

Table 8 (continued)

Soft Window	IDA	AfDF	AsDF	FSO
Total Admin Exp.	545.0	76.8	74.7	93.2
No. of Operations	(104)	(41)	(40)	(23)
Dollars Lent (\$Bn)	8.3	0.8	1.3	0.5
Dollars Disb ( , , )	9.9	0.7	0.9	0.4
Cost per \$ Lent	6.9¢	9.6¢	5.2¢	18.6¢
Cost per \$ Disb	9.4¢	11.0¢	7.3¢	23.3¢
Cost per Op (\$Mn)	5.24	1.87	1.68	4.05

\* Totals may not add up to those for the main hard and soft windows because administrative expenses cover items other than those allocated to these two windows; e.g. support for private sector arms and guarantee agencies, special funds and trust funds. These costs are recovered to a degree but show up as totals in the MDBs annual budgets.

\*\* This item includes travel plus consultants.

\*\*\* This item includes travel and other direct operating costs.

\*\*\*\* This figure includes equity investments and is not directly comparable to the operations numbers for the other MDBs.

Note: The World Bank's FY ends on June 30, 1993.

Sources: MDB Annual Reports for 1993.

### Issues raised by MDB Expenditures

Table 8 raises some interesting points. *First*, the five MDBs taken together cost nearly US\$2.1 billion to run in 1993/94 (compared with substantially less than US\$1 billion in 1983) with the World Bank alone accounting for over 66% of that amount.<sup>6</sup> *Second*, the new EBRD already costs more to run than the older and more established AsDB even though it has only 40% of the number of staff and its present operational level is far lower. *Third*, average staff costs per staff member employed are much higher in the Washington and London based institutions than in the Abidjan and Manila based institutions. This is explained largely by the much lower cost of support and para-professional staff,<sup>7</sup> along with a much higher proportion of support and

6 The World Bank accounts for only 52% of the total staff resources within the MDB system although it does account for nearly 60% of the system's total lending but then it also accounts for the MDB system's overall negative net transfer position vis-à-vis developing country borrowers.

7 There is a much higher ratio of support staff to professional staff in the AfDB and AsDB reflecting the employment characteristics of their locales than in the other three MDBs. The overall compensation and benefit levels of professional staff in the MDBs is roughly similar,→

para-professional staff in the total staff mix, in the two developing country locations as well as their significantly lower level of overheads. *Fourth*, the overall overheads of the IBRD are much higher than those of the other banks other than the EBRD (but that is for an entirely different reason related to the way in which the costs of acquiring the lease on its building were charged in the 1993 budget). *Fifth*, staff costs (including those for long-term consultants) and benefits absorb around 70% of the total administrative expenditures of the established MDBs. *Sixth*, institutional overheads account for between 15-20% with other directly related operating costs (e.g. travel and communications) accounting for the remaining 10-15%.<sup>8</sup> What the Table makes clear is that there is little scope for achieving significant reductions in the operating cost structure of MDBs unless fundamentally different approaches to the use of human resources are considered. That point will be returned to shortly.

*The World Bank's Overheads:* The main reason for its much higher overheads is that the World Bank has a much more wide ranging *non-operational* programme of activities than the other MDBs. This includes its extensive research work and publications on development issues, its data and information services on matters such as debt statistics, development indicators, social indicators, population projections and its world development reports as well as its public education programmes. The Bank has also assumed the burden of (or improperly taken over, depending on one's perspectives) much of the technical assistance work that was once undertaken by agencies in the UN system. Such technical assistance programmes gravitated to the World Bank and other MDBs mainly because of the unwillingness of the larger donor countries to continue funding such programmes through UN agencies in the face of effective default by the UN system in managing these programmes.<sup>9</sup> It is, of course, accepted as axiomatic by the World Bank's management, staff and shareholders that all the elements of its expanding non-operational programmes are critical or

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with EBRD staff commanding a 10% premium over their IBRD counterparts while the IBRD staff are 10-15% better off than the staff of the regional banks who are compensated at about the same levels although their standards of living may differ based on their locations.

<sup>8</sup> The newly established EBRD is an exception to which these roughly similar ratios for the other MDBs do not yet apply. Staff costs in the EBRD account for about 51% of total expenditures while overheads account for an uncharacteristically high 27% largely due to the financing of start-up costs. When the EBRD settles down to a steady-state its ratios should approximate those of the other MDBs.

<sup>9</sup> For a deeper discussion of this issue see Mistry, P.S. and Thyne P., "Options for Funding the UN System and the Development Banks" and the four other studies contained in "The United Nations: Issues and Options", The Nordic UN Project, Stockholm, 1991.

essential. But is that so? To answer this important question it is clear that a major independent external review needs to be undertaken to examine whether all of the World Bank's diverse and numerous non-operational activities are indeed essential. In many instances it would appear that such programmes are being funded because of the vested interests of managers and staff employed in these areas, and the demands of one or two shareholders, rather than because of legitimate broadly-based demands across the borrower or OECD shareholder communities for such output. Budgeting systems which add incrementally to previous year programmes, in order to keep up with inflation and real increases in resources where these can be justified, are not particularly useful in controlling MDB costs; *zero-based budgeting* would perhaps be more appropriate in reconsidering entire categories of expenditure which the MDBs presently take for granted.

Focusing momentarily on just one important example, a large part of the World Bank's very extensive and growing *research and publication programme* appears to be undertaken more for gratifying the academic pretensions of its large number of intellectually inclined (but perhaps operationally not very useful) professional staff rather than to support the genuine developmental needs and priorities of its borrowers. Moreover, given the World Bank's cost structure and staff compensation policies such research, undertaken in-house and properly costed, is probably several times more expensive than research that is undertaken for the World Bank by the global academic and consulting communities. It is no secret that the all-inclusive cost of maintaining a research assistant at the World Bank is about the same as the all-inclusive cost of a professor at one of the better British universities and several such professors at well-known universities in developing countries. The World Bank's research – especially for example, its recent attempts at *proving* that structural adjustment is working in Africa – is also widely perceived (although sometimes unfairly) within the academic community as being biased, depending on the ideology or operational priorities which the Bank or its major shareholders happen to be purveying at that particular time.

Development economics researchers around the world depend heavily on the Bank's research output. Publicly they are quite complimentary about its obvious commitment to research in the development sphere. Privately, however, they are in agreement that much of the Bank's research is not always of particularly high quality. It is, as already observed, often intellectually inclined in support of the Bank's operational priorities, and is sometimes even misleading in an effort to justify the Bank's operational positions which have later been proven wrong, often because of independent research work done externally. A case in point concerned work done on the social dimensions of adjustment which the World Bank was forced to place attention on by the findings of external researchers and pressures applied by

donors and the UN system. At the same time, external researchers cannot replicate much of the Bank's research work to confirm or refute its findings because of the latter's access to privileged information and its possession of perhaps the most comprehensive data banks (longitudinal, macro-economic, sectoral and cross-sectional) on all aspects of development that exist in the world today. Perhaps much greater efficiencies and quality improvements in the World Bank's research and publications programme could be achieved by *privatising* most of the analytical work being undertaken, for example by sub-contracting more extensively to established research institutions around the world.<sup>10</sup>

Similarly the Bank could spin-off and privatise many of its information dissemination functions and provide these services (e.g. access to debt statistics and other statistical data bases) on a commercial or quasi-commercial basis through independent private organisations with established reputations. Cost-wise, it may be far more appropriate for the Bank to permit legitimate access to its impressive data bases to independent researchers than attempt to do analytical research work itself, especially in view of the suspicions it has aroused about its intellectual honesty, independence, *bona fides* and motives in undertaking development research.

Other examples abound to justify serious questioning of the need for all the MDBs (and even the IMF) undertaking similar non-operational activities. Many of the non-operational activities (especially of the Washington-based institutions) could be rationalised and done jointly rather than singly in order to achieve significant budgetary savings within the multilateral system. The same thought could be extended to the UN agencies as well.<sup>11</sup> This

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10 At the moment the allocation of its external research contracts suggests that the Bank appears to favour sub-contracting research mainly to universities in OECD countries rather than to those in developing countries; even when excellent development economics research capacity exists in the latter. To an extent, given the relative distribution of research capabilities around the world, that bias may well be justified if not inevitable. But there are also some disconcerting suggestions and actions which indicate that the Bank's bias towards developed country research institutions may be being reinforced by: (i) the regular movement of research staff between the Bank and a limited number of developed country universities; (ii) a greater proclivity on the part of the Bank's preferred developed country researchers to see issues from the Bank's point of view; and (iii) conscious or inadvertent efforts at constituency-building in the academic and research communities of major shareholder countries in order to exert the appropriate influence when legislation supportive of the Bank comes up for consideration or to ensure that the Bank gets a better press than it presently seems to in most developed countries.

11 A plethora of publications from different parts of the MDB community on the same issues often reflects less a healthy competition of different ideas and more of a herd mentality reminiscent of the kind of research which is done by financial houses which have a securities selling bias. Moreover, different publications from different MDBs on the same subjects (for example on debt or structural adjustment) often serve to confound and confuse rather than →

important issue needs to be explored thoroughly in a manner which cannot be attempted in this book (which must confine itself to using illustrative examples) in order to provoke more systematic, in-depth thinking about these issues by the MDB shareholding community. Clearly, the World Bank is not the only MDB whose non-operational programmes should be reviewed, although its relative high overhead cost ratios and the fact that it alone accounts for two-thirds of the total annual administrative costs of the MDB system suggest that the greatest scope for sensible pruning lies there.

From a *strategic* viewpoint – given that MDBs seem to find it difficult to adapt responsively to a rapidly changing operating environment because of their own internal labour market rigidities – achieving significant cost-reductions and efficiencies in MDB budgets and in the way that MDBs presently operate, requires attention on issues that are not really concerned with the administrative processes and protocols governing budget formulation and implementation. Tightening up the nuts and bolts of *budgeting systems* in the MDBs, which is what their managements usually resort to in the face of criticism of their free-spending habits, usually yield marginal and insignificant results at best. For example, despite unrelenting pressure from all external sources to control its budget and annual tinkering with its budgeting systems and procedures, the World Bank's annual operating budget in nominal (current) dollars has increased from US\$406 million in FY81 to nearly US\$1.4 billion in FY94 with the total budget proposal for FY95 (which started on June 1, 1994) being US\$1,420 million! The compound annual rate of growth in *nominal* dollars over the FY81-94 period was nearly 10% (when the average applicable annual inflation rate was 4%) whereas staff grew annually at a rate of 1.5%, the overall volume of lending (for both IBRD and IDA) grew at a rate of just over 4%, the number of operations remained level at between 220-254 per year while net transfers from the World Bank Group as a whole declined dramatically from positive to negative levels.

In nominal dollars the *total administrative cost per operation* (averaging both IBRD and IDA operations) in the World Bank has increased from US\$1.57 million in FY81 to an estimated US\$6.2 million in FY94 or a compound annual growth rate of 23%. In FY81, the IBRD's net profit exceeded total World Bank administrative expenses by a factor of 1.54. In FY94, the IBRD's

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elucidate and illuminate by using different data which then cause secondary concerns in the academic research community about relative data quality and create problems of information reconciliation. Similarly, there is little need for these multilateral institutions along with their cohorts in the UN system to produce their own individual reports on global economic outlooks, on debt, on trade and commodity prices and perspectives etc. Their research as well as their training activities (e.g. the EDI, the IMF Institute and similar undertakings by the IDB) could easily be rationalised and delivered perhaps even more effectively than is the case now.

net income was actually US\$338 million less than total World Bank Group administrative expenses with the net income-to-expenses ratio falling to 0.75 or less than half the ratio in FY81. These broad aggregates will be challenged by the World Bank's management as comparing apples and oranges. To the extent that a whole new range of non-operational activities have crept into the Bank's budget to cause its expenses to balloon, whereas the number of operations undertaken have declined for well over a decade, obviously inflates the cost per operation in a misleading fashion. But, nevertheless, the cost per operation is still useful indicator of the extent to which non-operational activities are intruding into the Bank's work programme and deflecting it from its core functions. The same general phenomenon of non-operational activities inflating budgets has occurred across all the MDBs but not to the same egregious extent.

The above example shows that tightening budgeting systems will not by itself enable administrative expenditures to be effectively controlled. Instead strategic measures are needed to restructure the nature of MDB operations and expenses. The issues which such measures might raise are the following: (i) *decentralising and localising* MDB activities as far into the field as possible and reducing the overhead burden of tiered headquarters organisations with unnecessary layers of middle-management; (ii) coping with a *changing operational and non-operational output mix*, especially in accommodating a better modus vivendi with private financiers and in *using MDB guarantee powers* much more extensively than relying on borrowing and lending powers; (iii) coping with a changing staff mix demanded by the above two propelling forces; (iv) correcting the apportionment of administrative costs between the hard and soft loan windows of the MDBs; and (v) dealing with the issue of institutional management of the budget process. The last point requires considering, in particular, the overlapping roles of the Executive Board, senior management and, increasingly, an intrusive group of Deputies from shareholder governments who convene on a regular basis to negotiate soft-window resource replenishments but use that opportunity (and power) to intervene in institution-wide matters including, not least, their unrelenting efforts to induce a greater degree of budget and cost-consciousness on the part of MDB managers. The first four of these issues will be elaborated upon further below while the fifth has already been dealt with at some length at the end of Chapter 4.

### ***Decentralising and Localising the MDBs***

The most significant way of achieving greater cost efficiency and operating effectiveness in the MDBs could lie in resorting to far greater decentralisation and *localisation* of the professional and support staff of the MDBs and in

particular that of the World Bank. As can be seen from Table 6, there is a striking difference in the cost structure of the two MDBs based outside Washington and London and the three located in those cities. Cynics in the IBRD would argue that this difference shows up in the *quality* of the staff and output of these institutions. While that line of argument may have some validity in the case of the AfDB, it is certainly not valid in the case of the AsDB whose quality of staff and output is rapidly approaching (if not now in certain cases exceeding) that of the World Bank, and whose effectiveness in its region (outside of India and China where the AsDB is artificially constrained) is arguably at least as great. That is also true of the IDB whose staff cost structure (given its Washington based location) is higher than the AsDB but still significantly lower than that of the World Bank. The regional banks already resort to higher levels of decentralisation and localisation than the World Bank. The IDB and EBRD now have offices in every one of the countries in which they operate; but they do not go far enough and still rely much too heavily on the expatriation of headquarters staff.

When this issue has been raised before, the retort of the MDBs, and in particular the World Bank, has been that decentralisation and localisation would actually be *more* rather than *less* costly. That would certainly be true if the Bank and other MDBs continued to adhere to the operating postures of ex-colonial governments whose former foreign-service mentalities they occasionally emulate quite successfully if unwittingly. Those governments sent expatriate staff abroad to live in very favourable conditions. The MDBs have tried to do no less. But the Bank's argument would not be valid if the MDBs were to adopt the practices of normal transnational corporations operating around the globe which focus on maximising *local hiring* for both professional and support staff (and for senior managerial staff) to save on costs and resort to expatriation only if absolutely necessary. The current expatriate compensation and benefits packages provided to MDB staff are certainly not conducive to cost savings if the MDBs resorted simply to placing more headquarters staff in the field. Moreover in selecting staff for field assignments MDBs have in the past resorted to sending out their least competent staff treating field assignments as little more than convenient parking spaces. Fortunately this practice has become less common with time.

Greater decentralisation and localisation would have collateral benefits that would go beyond mere cost savings and operating efficiencies. These measures would expose MDB staff much more to the day-to-day realities of their operating environments and perhaps make their policy recommendations, their adjustment programme designs, their projects and their perspectives more pragmatic and realistic. It might prevent them from developing the inapt mentality which most of their staff unfortunately now have as a result of being in environs which seem almost disconnected from

the reality they are to serve. It would attune them more to local political sensitivities, and subject them to a much wider variety of local views than those they are normally exposed to on quick, artificial visits. Most importantly, greater decentralisation and localisation could be effective ways of flattening out multi-tiered MDB organisation structures. Greater savings as well as greater efficiencies would result from eliminating levels of unnecessary intermediate management and the excessive inflation of vice-presidencies throughout the MDB system; but most especially in the World Bank where several functional Vice-Presidencies have recently been created with those Vice-Presidents doing jobs which were formerly handled quite adroitly at the division level.

There are of course downsides to localisation, especially if MDB staff were to become subject to local government pressures of an inappropriate sort and to become partial in their perspectives because of their local sympathies (the *going native syndrome*). Private transnational corporations have managed to avoid these tendencies while capturing the strengths of a strong local presence. In theory, there is no reason why the MDBs cannot do the same. But, just as global multinationals had to transform their internal management cultures dramatically over time in order to cope with the necessities of decentralisation and localisation in the emerging global economy, so to will the present management structures and proclivities of the MDBs need to change and adapt in more fundamental ways than they are presently willing to contemplate. Given their entrenched views, and the resistance to change on the part of the tenacious personalities which have dominated the managements of these institutions for perhaps too long, it is unlikely that the reforms which are necessary in MDB management thinking and operating styles can be achieved without sweeping changes in their top managements. These changes are perhaps needed most in the World Bank where they are long overdue. Where the World Bank goes other MDBs are likely to follow; although, in this area as in some others it may be that the fledgling EBRD may lead the way in pointing to the future.

### *Accommodating the Changing MDB Output Mix*

A second strategic factor which influences MDB budgets in fundamental ways is the relative thoughtlessness with which shareholders – responding to the domestic political pressures placed on them by single-issue pressure groups – have piled a number of conflicting operational and non-operational priorities and objectives on these institutions resulting in both *mission overload* and *circuit failure* on their part. In turn, MDB managements, anxious to please in order to protect the funding of their particular soft-window replenishments, have been somewhat supine in accepting these responsibilities without

sufficient regard for their operational or cost implications, or for their effects on staff capacity, institutional resilience and staff morale. The result has been a combination of burgeoning MDB budgets coupled with an increasingly obvious incapacity on the part of MDBs to perform in achieving this plethora of confused developmental objectives; many of which often have less to do with development *per se* and more to do with pandering continually to changing fashions and fads in development theory and practice.

The excessive concern of shareholders and donors with relatively trivial issues is obscuring the fundamental question about what future role MDBs should play in global capital markets whose complexion and capacity is changing at a speed well beyond the capacity of most governments and MDB managers to comprehend, leave alone operate in, or regulate. That question remains unanswered. The operating frame of reference for the MDBs is now characterised by a world in which: (i) private capital markets, both international and domestic are playing a rapidly growing and significant role in financing an increasing number of developing countries; (ii) MDB hard-window portfolios are maturing rapidly with an adverse impact on their resource transfer functions; and (iii) MDF soft-window resources are becoming increasingly constrained.

In such a world the main question is how MDB operations should change so as to: (i) achieve symbiotic and synergistic combinations with sources of private finance in areas where such finance is willing to go voluntarily, e.g. in industry, capital markets, infrastructure and key services; while (ii) mobilising the right kinds of financial packages, involving much less reliance on foreign resources and much greater emphasis on *local currency resource mobilisation*, for social investments in human capital, institution building (in its widest sense), and in those supporting functions (accounting, legal, business support, media and information dissemination, governance and regulatory) which are crucial to making markets work competitively and efficiently.

Put that way, the operating vista for MDBs changes significantly from the sterile traditional concentration of MDBs on particular types of projects and sectors and on standardised currency-pooled, variable rate loans. Under new operating conditions MDBs will need to gear themselves (as the EBRD is doing) to:

- Transforming their *hard-window* financial operations so as to be able to lend in any number of single convertible currencies, or any combination of currencies at the choice of the borrower rather than that of the MDB. MDBs must be able to lend at fixed or floating rates, with switching facilities from one to the other and vice-versa. Their loans may need to be packaged with or without attached derivatives (interest and currency caps, collars, options) to meet the particular risk profile chosen by the borrower

for a particular purpose. MDBs should be prepared to lend for maturities ranging from 5-30 years from their hard windows.

- Being *demand-driven* rather than supply-driven, shifting away from operating as universal credit cooperatives which attempt to equalise everything across all borrowers in the name of equity and to act more as responsive financial intermediaries which tailor their financial products according to the specific needs and characteristics of borrowers and purposes.
- Transforming their *soft-window* facilities into much more flexible instruments which can finance credits of between 15-50 years at interest costs of 0-5% depending on the type of project, type of borrower and general development level of the country in which a project or programme is being financed.
- Loosening their eligibility and allocation criteria substantially to permit soft or intermediate term lending to a much wider range of low and lower-middle income countries and for high value social investments which are not best financed through hard-window loans.
- Undertaking *local currency resource mobilisation* and lending in a manner compatible with: (a) the development of local and regional capital markets, especially local and regional debt markets; and (b) the progressive liberalisation of exchange controls over a borrower's current and capital accounts.
- Operating *in real-time* in co-financing operations with private sector partners from OECD and developing countries, rather than behaving as the ultimate founts of knowledge and wisdom on project financing, yet being incapable of making a decision or reverting to their partners in the spans of time which are normally acceptable in the commercial marketplace.
- Using their *guarantee powers* much more extensively than their lending powers in order to catalyse a volume of resource flows which more than compensate for their own negative net transfers which will inevitably grow rapidly.
- Focusing on what they can do directly and usefully i.e. financing hard and soft projects, human capital development, institutional development and market development, as well as adjustment programmes under certain types of conditions in which these programmes are likely to succeed. At the

same time MDBs need to disengage from what they cannot do directly with any proficiency despite their best intentions.

- Confining themselves to using their considerable influence with borrowing governments to ensure that critically important policies for balanced and sustainable development are dealt with in a manner which develops, enfranchises and empowers all citizens (regardless of gender, race colour or creed).
- Doing much more to support those institutions (such as NGOs and local levels of governments) which have the capacity to do some things much better than the MDBs. Unfortunately, MDB attempts at working productively with NGOs and with local levels of governments have so far had limited and mixed success largely because of incompatible staff attitudes between MDBs and NGOs.
- Curbing sharply their different *non-operational programmes*, spinning them off and privatising these to the extent possible while providing continuing symbiotic support to private providers of these services in terms of data and information.
- Working out a more appropriate balance between themselves and the UN system on *technical assistance activities* so as to lessen the present overload on their management systems in coping with these functions.

For MDBs to change their output mix in the directions suggested by the foregoing general axioms they will clearly need to make major changes in the quality and skill mixes of their staff and to overhaul the quality of their managements. Fundamental changes will also need to be made in the nexus between MDB managements and Executive Boards to ensure more effective institutional governance. For that to occur successfully, shareholders will need to be much more responsible and careful in their choices of the Executive Directors representing their interests. These critical positions cannot be looked upon as sinecures for the loyal, or be filled by governments making compromises among themselves which result in the election of EDs who are not sufficiently competent nor substantively accomplished in fields concerning the business of the MDBs to command the respect and attention of senior management and staff in these institutions. It is odd that in selecting EDs or even the Presidents of these institutions less thought is given to the qualifications, competence and relevant experience of prospective incumbents than is routinely given to hiring the lowest levels of support staff in these institutions. A continuation of that mode of ED and Presidential selection can only

diminish both the quality and effectiveness of Executive Boards and the institutions they are supposed to direct. As suggested earlier, these changes need to be accompanied by a fundamentally different approach to human resource acquisition and development through decentralisation and localisation. Such a strategy will require entirely new frameworks to be developed for MDB governance and for budget monitoring and control as well as for objective-setting and ensuring greater responsiveness to client needs.

### *Coping with a Changing Staff Mix*

If MDB budgets are ever to be brought under proper control staff costs need to be tackled in three ways, one of which has already been dealt with: (i) a review and revision of compensation and benefit levels to align them better with comparable private and public institutions; (ii) cutbacks in levels of staffing through cutbacks in non-operational programmes as well as changes in the skill-mix of professional and support staff; and (iii) greater decentralisation and localisation of professional and support staff with substantially reduced reliance on the use of expatriate staff from headquarters in field locations (with curtailment of expatriate benefits) and much more extensive use of nationals in borrowing countries. A concerted drive to reduce MDB staff is now essential and long overdue. Headquarters staff need to be reduced to about one-third of their present levels to perform only core headquarters management functions. Such a measure needs to be coupled with a drive to increase field staff to between 40-50% of total MDB staff at current levels. This would permit a scale-back, which should be achieved mainly through natural attrition, of between 17-27% in current levels of staffing across all MDBs other than the EBRD. Because it has just been established that institution may need a continuing staff build-up. Given how critically they rely on their professional staff, it is surprising how little effort MDBs make to renew and refresh their professional staff skills and knowledge. For example, despite having had financial analysts with expertise in creating development finance institutions for several decades it is astonishing how few staff MDBs have with all-round expertise in capital market development. Hence cutbacks in staffing levels by MDBs should be accompanied by much better efforts at developing and maintaining their human resources.

Such measures are essential to streamline and reshape MDBs into institutions which are more capable of addressing future realities. In addition to such aggregate cutbacks and realignments MDBs need to change their staff skill mix. For example, they need to consider reducing the number of general macroeconomists they employ and increasing the number of financial experts with direct experience in project financing, capital market operations and institutional development. They also need to lighten their technical staff in

their traditional sectors of project financing activity and in those areas from which they ought to disengage, while increasing staff with expertise in developing and regulating regulatory regimes in various sectors to guide market functioning and institution-building in key areas which are critical in supporting the functioning of markets. The MDBs need a dispersion of fewer, but more tactile and more flexible staff with a much greater diversity of skills and with multi-disciplinary capabilities rather than continue to suffer from the often too narrow perspective of well-trained macroeconomists who have so far been incapable of interacting effectively with other disciplines in an effective manner.

To effect the needed changes, MDBs need to develop imaginative staff-exchange programmes with public and private agencies across a wide spectrum, both to facilitate effective MDB interaction with the outside world but also to make the strong and rigid internal cultures of these organisations more open, accommodating and resilient. This approach is far more difficult to design and implement than to conceive; but it can be done and done effectively. Internal MDB cultures have now become far too closed and tight for their own survival in a world that is changing much faster than their ability or willingness to adapt. They do not easily accommodate the entry of senior level management personnel from outside their organisations. And, increasingly, they are being managed almost entirely by staff developed under the *young professionals programmes* of the MDBs who have virtually no working experience outside the MDB nor any interest in acquiring it. Most institutions in the private sector with these types of characteristics come to grief sooner or later in a competitive marketplace. But, the unusual positions of the MDBs with their high degrees of *internal protection* sustained by their relative independence in deciding what they can spend to insulate themselves from reality has cushioned them from adjusting to changing external circumstances rapidly enough. Hence the pace of essential change, which the MDBs have understandably resisted, needs to be forced by external pressures and in particular by the more responsible shareholders who are less interested in using the MDBs for their own ends and more interested in enabling these institutions to confront the future more capably than they seem to be coping with the present.

### ***Apportioning Costs between Hard and Soft Loan Windows***

A further issue that arises in connection with the administrative costs of the MDBs concerns the manner in which they are apportioned between the major hard and soft-loan windows of these institutions. If improperly biased in one direction or the other, the basis of apportionment may give a misleading impression of the true costs of certain types of operations in

certain countries. In assessing the overall financial performance of MDBs, it also raises questions about whether their net income is being overstated or understated by artificial if inadvertent arbitrariness in allocating costs. For example, in a recent study of the financial condition of the AfDB<sup>12</sup> it was noted that the basis of cost apportionment appeared to understate the true administrative costs in running the AfDB while concomitantly inflating the costs apportioned to AfDF. As that indeed proved to be the case when a separate study was undertaken on this specific issue, it became apparent that the financial performance of the AfDB was actually worse than the published figures depicted. Conversely the AfDB's published profit position appeared to be better than it was because of inadequate cost accounting while, by the same token, the AfDF's income position was worse.<sup>13</sup> The cost-sharing formula between the AfDB and AfDF is negotiated with donors during AfDF replenishments rather than being determined by proper costings. As the study into cost apportionment established, it was an inappropriate formula because it shifted too large a portion of overall administrative costs to AfDF thus reducing scarce concessional funds available for disbursements.

A simple comparative analysis of the cost apportionment between the hard and soft windows of the MDBs, based on relative outstanding asset sizes, indicates the degree to which cost sharing in the AfDB and IDB may be out of kilter on a prima facie basis.<sup>14</sup> The table below suggests that relative to the proportionate asset sizes of their hard and soft loan windows the apportionment of administrative costs appears to be reasonable and defensible in the case of the IBRD and AsDB.<sup>15</sup> Clearly a perfect matching of the ratios of loans outstanding to ratios of administrative costs would be unlikely and is

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12 See Mistry, P.S., "A Report on the Financial Condition of the African Development Bank", Swedish Ministry for Foreign Affairs, Stockholm, 1993.

13 The rationale for doing so would be that AfDB financial statements need to impress financial markets and net income goes into generating usable reserves while it is not that critical if AfDF is depicted as making a loss.

14 MDBs do not usually apportion their costs on the basis of their *outstanding* portfolios of hard loans and soft credits. The IBRD and AsDB base their cost apportionment on the basis of proportionality between the number of IBRD vs IDA and AsDB vs AsDF loans/credits which are processed and supervised respectively in the fiscal year. These proportions are usually backed by some cost accounting data on a project-by-project basis. The basis for the division of administrative costs in the case of the AfDB and AfDF, and even more so in the case of the IDB and FSO, is less transparent. A common sense initial judgement suggests that in both these latter institutions the actual administrative costs involved in developing and managing the hard loan portfolio may be significantly *understated*.

15 This would be particularly true if one allowed for the fact that administrative costs per operation in IDA-only or AsDF-only countries may actually be higher than that for operations in blend countries or in IBRD or AsDB only countries given the generally higher level of sophistication in the more developed countries in this spectrum involving less expenditure of staff time on preparatory work prior to appraisal and less work in the supervision stage.

not being suggested. But, in the case of the AfDB the ratios of apportioned costs to relative distribution of outstanding assets between AfDB and AfDF are sufficiently imbalanced as to raise concerns about misimpressions being conveyed to financial markets of AfDB's and IDB's true administrative costs. In the AfDB and IDB the issue of administrative costs, which should be an issue of straightforward cost accounting and good record keeping, was until recently a *political* issue involving compromises between the main providers of concessional funds and the borrowing members. As the basis of cost apportionment has implications for MDB net incomes, which is a financial matter of material importance to financial markets, both institutions have now decided that this matter should be depoliticised and settled with improved cost accounting.

**Table 9 Administrative Cost Apportionment Indicators at the end of FY93/94**  
(billions of U.S. dollars)

	<b>IBRD</b>	<b>AfDB</b>	<b>IDB</b>	<b>AsDB</b>
A. Bank Loans Outst.	109.29	8.31	22.18	13.71
B. Fund Credits Outst.	62.81	4.96	5.93	9.38
C. Ratio of B:A	37:63	37:63	21:79	41:59
D. Bank Admin. Exp.	731.00	54.50	178.60	88.90
E. Fund Admin. Exp.	545.00	76.80	93.20	74.70
F. Ratio of E:D	43:57	58:42	34:66	46:54

Finally, reverting again to Table 8, some interesting results emerge from inter-MDB comparisons among the four established banks (leaving out the EBRD which, because of its start-up position, is something of an outlier at the present time although its administrative expenses for its level of operations are far too high). As the Table indicates, total administrative expenses for the IBRD are by far the highest of any MDB while those for the AsDB are generally the lowest. Total administrative expenses per permanent staff member come to over US\$219,000 for the IBRD compared to a low for the AsDB of US\$80,000 reflecting, as observed earlier, the IBRD's very large non-operational programme of activities. Salary costs and benefits expenses per staff member at the IBRD are also higher than for any other MDB at over US\$134,000 compared to a low of US\$56,000 for the AsDB and US\$76,500 for the AfDB. Taking into account the IBRD's much more extensive non-operational programme, the number of total staff required to

support operations seem to be roughly equivalent across all the established MDBs varying from (27.8 per operation in the IBRD to 17.7 in the AfDB, 24.3 in the AsDB and 19.8 in the IDB) – although this crude ratio needs to be interpreted with caution given the extensive but different patterns in the use of long-term consultants by these institutions.

There are also significant differences in the costs of these institutions per dollar lent or disbursed. Under its present cost structure, it costs the World Bank 5.1¢ for each IBRD dollar it lends and 7.0¢ for each dollar it disburses whereas IDA credits cost even more. The tendency for the soft-windows to be more expensive than the hard windows in terms of costs per dollar lent is generalised across all the MDBs although these costs are exaggeratedly high in the case of the AfDB and IDB because they apportion too large a proportion of their administrative costs to their soft windows. The IBRD on the other hand loads its non-operational programme costs more to the IBRD than to IDA which shows up in the relatively different costs per operation between the two. To the extent that soft windows genuinely do cost more to operate (per dollar lent) this reflects the additional staff inputs required to work in difficult low-income environments which absorb relatively smaller loans and credits (thus raising the costs per dollar lent).

As observed earlier, the temptation to read too much into these crude ratios needs to be eschewed although they are broadly indicative of the key problems associated with MDB cost structures. This chapter makes clear, however, that the whole question of MDB administrative costs, which are continuing to escalate even as the utility and resource intermediation role of these institutions diminishes, needs to be reviewed from a fundamental strategic perspective. Since their managements seem unwilling and incapable of addressing the more fundamental troubling issues which continually rising MDB budgets raise, it falls on those shareholders who mean well to take these issues up and deal with them in a way which secures the longer-term interests of the MDBs.

## 8 Summary

The previous seven chapters have dealt with a host of issues raised by the financial structures, policies and practices of the multilateral development banks (MDBs) along with suggestions and recommendations for dealing with some of their consequences. At the risk of repetition, this final chapter pulls together major points, and several suggestions for change, which have been made in previous chapters in summary form for ease of reference. The order in which these are presented is the same order as the chapters.

### *The Role and Financial Intermediation Functions of the MDBs*

From a period of relative stability between 1945-73, MDBs have in the last two decades had to respond to different and shifting demands from their clientele caused by the *oil shocks* of the 1970s, the *debt shock* of the 1980s, and the *transition shock* of the 1990s, resulting in the emergence of a large number of new claimants along with a shifting basis of demand for their products and services. Although these successive impulses have created a series of new demands on the MDBs, the recent emergence of private sources of capital as increasingly important financiers of a wide range of investments in *emerging markets* is now overshadowing the role that MDBs are likely to play in the 1990s and beyond. Consequently, the *financial* importance of MDBs might be expected to diminish in *relative* if not in *absolute* terms, as private markets penetrate terrain which was formerly the exclusive preserve of MDBs; e.g. infrastructure financing, and even the financing of education and health (e.g. private hospitals and universities).

Present trends suggest that the role of MDBs in the next century may be focused progressively on: (i) the *poorest developing economies* (e.g. those in Africa and South Asia) which global capital markets are unprepared to finance until higher levels of economic, financial, institutional and social development have been achieved; (ii) *social investment in human capital* of the non-cash flow generating kind which capital markets do not finance (e.g. public primary and secondary education and rural health care); and (iii) investments in the basic *institutional infrastructure* essential for market economies to function properly (e.g. in legal and judicial systems and institutions, enforcement of property rights, transparent accounting systems, essential business support systems and services, improved systems of public administration and of political governance etc.).

This focus apart, in their traditional areas of activity MDBs may need to consider a shift from financing governments and their agencies to financing investments undertaken directly by the private sector. This may become an important line of activity especially for catalysing investments involving the kind of risks and gestation periods which may require MDB participation to provide comfort to private market financiers. As *private* international capital market conditions and propensities change so should the functions and resource transfers of *public* institutions which were designed initially to overcome the shortcomings of imperfect capital markets. Not unexpectedly, however, the environment has changed far more rapidly than the MDBs have adapted. As specialised intermediaries with a critical *financial intermediation function* to perform (which is ultimately their only *raison d'être*) MDBs need to be assessed on their performance in affecting real resource flows and net monetary transfers between developed and developing countries.

Against total MDB commitments of nearly US\$40 billion in 1993/94 (with US\$21 billion from the World Bank in FY94) *gross* resource transfers in 1993 were estimated at US\$15 billion. But *net* transfers were much lower. The IBRD has recorded *negative net transfers* since 1987. In other words, after taking interest payments into account, it has been *extracting* real resources from its borrowers. These negative transfers have escalated from about -US\$1.5 billion in 1987 to over -US\$8.5 billion in 1993/94. Between 1987-91, the three regional MDBs for Africa, Asia and Latin America managed to maintain positive net transfers to their borrowers averaging US\$1 billion annually. But these were not sufficient to offset negative transfers from the IBRD, resulting in the multilateral banks as a whole achieving a *negative* net transfer averaging -US\$2.27 billion annually over that period. Overall net transfers from their soft windows (including IDA) over the same period averaged US\$5 billion annually resulting in total combined net transfers (from the hard and soft windows) averaging a positive but desultory US\$2.73 billion in that 5-year period. In 1992 and 1993, however, dragged down by the very large negative net transfers on the IBRD's accounts, the MDB system as a whole (including the soft-windows) recorded a negative net transfer of -US\$0.43 billion and -US\$2.28 billion respectively despite the fact that the other MDBs (and IDA) recorded positive net transfers of nearly US\$7.3 billion and US\$6.3 billion respectively.

When it comes to effecting net transfers of financial resources, the unfortunate reality is that once hard-loan portfolios reach a size where annual principal and interest repayments to MDBs by their developing country borrowers become structurally very large, the hard-windows of MDBs become inefficient and inflexible devices as *financial* intermediaries. *Interest payments* by developing countries to MDBs (on both hard and soft window

accounts) have increased from \$0.3 billion in 1970 to over US\$13 billion in 1993. That *annual* level will increase to US\$16 billion between 1994-97 and, on present trajectories of lending, to US\$20 billion towards the end of this century. Annual *principal repayments* to MDBs reached US\$17 billion in 1993 and will escalate to over US\$25 billion by the end of the century. To maintain *zero* net transfers therefore, the MDBs as a system will need to increase gross disbursements from US\$28 billion in 1992 to over US\$45 billion by the end of the century. If they focus on slow-disbursing project lending (which experience suggests remains their real *forte*) this would require them to commit between US\$100-120 billion annually by the year 1999. Against the need to increase gross disbursements by US\$17 billion between 1994-99, the MDBs as a whole increased gross disbursements by only US\$3.5 billion between 1987-92. If that track record is not improved substantially, the MDBs are likely to become much less significant as resource transfer agents to the developing world. Since, in the final analysis, it is the financial dimension that governs relationships between MDBs and their borrowing countries, the influence of MDBs as a whole – even as agents of development and purveyors of policy prescriptions – is bound to diminish except in those countries which are dependent on borrowing from MDB soft-windows.

### ***Capital Structure of the MDBs***

The conceptual architecture common to the equity (i.e. ownership) capital construction of all the MDBs was established with the formation of the IBRD – i.e. the core of the World Bank. Its initial authorised capitalisation of US\$10 billion (of which US\$9.1 billion was subscribed) consisted of: (a) 20% *paid-in capital* [2% of which was to be provided in convertible form i.e. in gold or US dollars, and 18% was to be paid in the domestic currencies of member countries] and (b) 80% in the form of *callable* or *guarantee* capital. The Bank's Articles of Agreements required it to limit its outstanding loans to the total amount of its subscribed capital (i.e. both paid-in and callable) i.e. a 1:1 loans to capital ratio. By the time the IDB was established in 1959 this capital structure had proven its durability and has been replicated in every MDB that has been set up since. All the MDBs therefore have their financial edifices constructed on the notion of *callable capital*. This feature assures the creditors of these institutions that each dollar lent is fully backed by a dollar of shareholders' equity, given the 1:1 limitation on the loan assets to capital ratio. Allowing for the cash equity and *reserves* components of MDB liabilities, that assurance enables the borrowings undertaken by the MDBs to be fully covered by total net worth. However, only a small fraction of the *equity dollar* in MDBs is paid up-front in cash. The bulk is subscribed in the form of a guarantee provided by shareholder governments which could be

called in the event that repayments from MDB borrowers' and available liquidity are insufficient to cover the MDB's own obligations to its creditors.

MDB managements and their shareholders have over the years emphasised building up large reserves through *internally generated* capital resources to minimise any risk that callable capital might actually be called. Until the mid-1980s, confidence in the financial strength and backing of the MDBs was rarely questioned in global capital markets. But, since the developing country debt crisis of the 1980s, their financial standing and performance has come under increasing scrutiny. Yet, despite a discernible deterioration in the intrinsic quality of their portfolios during the 1980s, all the MDBs have managed to maintain the highest ratings for their debt issues in international capital markets, enabling them to borrow at extremely fine spreads. These credit ratings appear now to rely less on the financial performance and standing of the MDBs themselves and much more on the *callable capital* guarantee.

The *quality* of the capital provided by all member governments in the form of domestic currency payments and in callable form is not uniform or equal. The callable capital of a severely-indebted, low-income country cannot be given the same weight as the callable capital of an OECD country or of a newly industrialised country. Hence the notion of *usable capital* is the more relevant dimension against which comfortable levels of borrowing and lending must be gauged. Prudence dictates that MDB borrowing and lending should be more appropriately measured against limits of *readily usable capital* and that capital increases should be negotiated and concluded before borrowings or outstanding loans approached the limits of such usable capital.

The capital base of the MDB hard-windows has, since their inception, been increased several times (except in the EBRD which is a new Bank) through both *general* and *selective* (or special) capital increases. The purpose of a *general capital increase* (GCI) is to increase the share capital of the Bank concerned when it approaches the limits of its present capital base in expanding its lending capacity further. Under a GCI such an increase in capital is spread proportionately among existing shareholders on a *pari passu* basis i.e. relative to their extant weight in share ownership. *Selective capital increases* (SCIs) on the other hand are not intended primarily to provide additional capital for an MDB. Instead, they are aimed principally at adjusting the relative weight and voting power of one or a few members in the shareholding structure of a particular MDB.

The **IBRD** has had six GCIs and several SCIs which have increased its authorised share capital from US\$10 billion in 1947 to US\$184 billion in 1993/94. Subscribed capital has increased from US\$9.1 billion to US\$170 billion over the same period. As a general rule, the allocation of IBRD shares among its now 178 members is based on the principle that their relative shareholdings in the IBRD should, by-and-large, reflect their relative

positions in the world economy. But there are no completely objective set of criteria or measurements which can translate a *theoretical* concept of “relative standing in the world economy” in concrete, mathematical terms that everyone can readily accept. In its *practical* application this principle of relative standing has therefore been translated to imply that members’ shareholding in the IBRD should be *parallel* to their relative quotas in the IMF. The other justification for this *principle of parallelism* to the IMF, of course, is that countries cannot become of the World Bank unless they are already members of the Fund. Despite attempts by ad hoc committees of the IBRD’s Executive Directors to establish a clear set of common criteria for the allocation of shares in the IBRD, no such criteria have as yet been established and no consensus has been reached on deriving or applying them. In the *regional banks*, similar complications and contentions apply in determining the share allocations of individual members. In these cases, the basis for allocation is more the weight of member countries in the regional (rather than the global) economy and further complications apply when the relative weights and share allocations of *non-regional* members has to be negotiated.

The capital of the **AfDB** has been increased through four GCIs and eight special increases from the US\$215 million which was subscribed initially in 1965 to US\$22.25 billion at the end of 1993 although it has a problem of chronic arrears in capital subscriptions. As of March 1994, over 93,000 allocated shares amounting to US\$1.3 billion in capital remained unsubscribed. The rapidly deteriorating creditworthiness of most African borrowers has resulted in AfDB’s last capital increase (GCI-4) being stretched out to meet AfDB’s capital needs upto 1996. With annual lending now approaching its sustainable limit under the present capital base, and with the prospective entry of a major new borrower – South Africa – in its membership, the management has just initiated discussions on GCI-5. By May 1994, the **AsDB**, originally capitalised at US\$1 billion at its formation in 1966, had raised its authorised capital base to around US\$48 billion providing sufficient capital for that institution to expand lending into the next century. Also starting with an initial capital base of US\$1 billion in its Ordinary Capital Resources (OCR) when it was established in 1959, the **IDB** has had eight General Increases in Resources (GIRs) increasing its OCR capital base to over US\$101 billion with over 90% of the existing capital base of the IDB having been contributed in just the last 15 years. The **EBRD**, which was established in record time in mid-1990 and began operations in 1991 has an initial capital base of ECU 10 billion (over US\$11.5 billion) with a paid-in capital requirement of 30% making it the most budgetarily expensive of the MDBs for member governments to have financed in recent times. By comparison, the paid-in capital requirements for the last GCI’s of all the other MDBs together amounted to only US\$3.7 billion.

The capital structures of the MDBs and their substantial expansion especially in the last two decades, raise three particular issues which are worth exploring. These concern: (i) the consequences of diminishing amounts of paid-in capital in successive GCIs; (ii) the valuation of MDB share capital and (iii) the need to maintain the value of such capital in terms of an acceptable *numeraire*. To begin with, the *proportion of paid-in capital* which member governments are willing to provide successive GCIs has been diminishing relentlessly. On the other hand, the strong financial performance of the MDBs (except the AfDB and, for the time being, the EBRD) has resulted in a steady accretion of retained earnings and reserves on their balance sheets. Because MDBs do not pay out any dividends to their shareholders, these retained earnings/reserves are, in effect, almost perfect substitutes for paid-in capital. Smaller paid-in capital contributions, especially when only a part of them have to be paid in convertible form by the borrowing member countries, reduce the budgetary and foreign exchange burdens on the *poorer* members in subscribing to their shares. For these reasons, it is possible to envisage future GCIs (especially for the World Bank, AsDB and IDB) which involve *no* paid-in capital.

There is one possibility which might be considered in modifying the financial architecture of the MDBs to address future needs. That prospect concerns the *automatic* attachment of a callable capital component to the retained earnings of MDBs. Such a measure would do away with protracted and contentious negotiations every five years or so for the GCIs of individual MDBs. An automatic increase in callable capital, which increases total capital each year by a multiple of retained earnings accumulated in that year, might also have the salutary effect of imposing discipline on both MDB *borrowers* as well as MDB *managements*. Seen from the viewpoint of shareholders, and especially the *donor shareholders*, the major *disadvantage* of introducing *automacity* in increasing the capital base of MDBs would be the *perceived* diminution of political power and control over these institutions. Therefore, such a proposal – if it is ever considered – is bound to raise profound objections. Nonetheless, as what is politically impossible today often becomes political reality tomorrow, this suggestion needs to be reconsidered when the time is ripe for its adoption and implementation. Indeed, it is the logical consequence of a trend which can only culminate in a regime of zero paid-in capital for the GCIs of MDBs in the not too distant future.

In valuing MDB share capital, a *standard-of-value (SOV)* is a central feature in the Articles of all the MDBs. It is the unit which determines both the price of the MDBs' shares and the mutual rights and obligations of the MDB to and among its members with respect to their relative shareholdings. Except for the EBRD, which has valued its share capital in ECUs, the Articles of the

other MDBs all establish their capital stock and the par value of their shares in terms of US dollars of the weight and fineness of gold in effect on a date close to that on which the Articles of the MDB concerned were agreed. With the Second Amendment of the Articles of the IMF there was no longer any basis for translating *gold* dollars into *current* US dollars. As a matter of practical expediency, the AfDB and AsDB have decided temporarily to value its capital in terms of the *current* SDR. But the IBRD and the IDB have opted to value their share capital temporarily at the US dollar value of the 1974 SDR. Effectively, this means that the IBRD and IDB have agreed to fix *for now* the value of their shares in terms of *US dollars* while the AfDB and AsDB have done so in terms of *SDRs*. These interim arrangements do not provide a definitive basis for determining members' obligations with respect to *callable* capital. This too has been indefinitely deferred, but with no practical consequence because of the extremely unlikely eventuality that a call might actually materialise in the interim. Till the SOV issue is resolved definitively, the capital of the MDBs (and therefore the structure of their balance sheets) remains vulnerable to exchange rate fluctuations. In particular, any major appreciation of the SDR vis-à-vis the US dollar would affect the *lending* headroom which the IBRD and IDB might have because of the effective resultant shrinkage of their capital base.

Vulnerability to exchange rate fluctuations on the value of capital because of the expedient choice of a transient SOV also leaves MDBs exposed to risk on inadvertently and suddenly breaching their *borrowing* limits. If the outstanding borrowings of MDBs have a different currency composition to capital, and exchange rate movements affect them in the opposite direction to the way in which they affect the capital base, then the MDB could be exposed to a technical default on its undertakings for bond issues. It is therefore essential that the SOV issue is resolved in favour of adopting the *current* SDR as the successor SOV to the gold dollar in all the MDBs. The inability of the US to agree with all of the other members on resolving the SOV issue remains a serious stumbling block to resolution. The right solution would be for all the MDBs to adopt the same policy with respect to the *interim* SOV; with that policy favouring adoption of an interim SOV which all member countries except the US favour i.e. the *current* SDR.

*Maintenance-of-Value Obligations (MOV)*: Logically connected to the concept of a SOV for the share capital of an MDB is the need for members to *maintain* the value of their payments for MDB shares in terms of the chosen SOV. This requires periodic payments to be made either from a member to the MDB, or *vice-versa*, an amount of that member's currency sufficient to maintain the value of its paid-in capital subscription against the applicable SOV. The MOV requirement applies to both the *convertible* and *domestic*

*currency* portions of the paid-in amount in order to protect the value of the MDBs' capital over time from the deprecations of currency devaluations. While the status of the SOV has remained unresolved MOV provisions have effectively been suspended. In theory the concept of MOV is understandable and generally unarguable. The operating rules and procedures required to translate that theory into practice have posed some difficult technical issues and choices for the MDBs, especially in determining the amounts and the appropriate periodicity of MOV settlements.

### ***Resource Mobilisation Policies & Effectiveness***

All the MDBs are now established borrowers in all the world's open or quasi-open capital markets, most of which they tap regularly. The debt instruments they issue (mainly long-term bonds) are well-regarded and carry the highest available credit ratings i.e. AAA. Despite their relatively unconstrained capacity to mobilise resources from international capital markets, the MDBs as a whole, and the World Bank in particular, have fallen short in fulfilling their resource transfer functions especially since 1989. With a much greater quantum and proportion of resources now flowing directly from established international capital markets to a much larger number of *emerging markets*, without the benefit of either direct or indirect MDB intermediation, some uncomfortable questions arise about whether the future resource mobilisation capacity of the MDBs will or should remain as strong (in both relative and absolute terms) as it has been in the past. Upto now, however, the unquestionable success that MDBs have enjoyed in mobilising loanable resources from capital markets is due in large measure to the astute manner in which they have undertaken their borrowing policies and programmes.

Apart from the national governments of the G-7 countries themselves, MDBs are among the largest issuers of long-term debt instruments in international capital markets. In those markets they constitute a special category of issuers i.e. the *supranationals*. In 1993 the five MDBs together borrowed US\$21 billion from capital markets and repaid US\$16 billion, resulting in *net* borrowings of US\$5 billion. On their outstanding borrowings of US\$144 billion, MDBs paid US\$12 billion in interest payments and other charges. The two-way flow of financial transactions between MDBs and capital markets thus amounted to US\$49 billion. The amount of their outstanding debt, however, was significantly lower than the amount of their subscribed capital base.

The level of borrowing undertaken by any MDB at a given time is closely linked to: its *liquidity* policy, its *net disbursement* trends and the amount of its own *debt service* in forthcoming months. These factors are the three main determinants of how much any MDB needs to borrow. When market

conditions are particularly propitious for locking in long-term, low-cost borrowings, MDBs may, in the interests of their own borrowers, occasionally *overborrow* in anticipation of future needs. Since all the MDBs earn positive spreads on their liquidity holdings (i.e. their *investments*) such *over-borrowing* can be quite profitable, carrying no real additional cost or risk for the MDB, because it can immediately pass on to their borrowers: (i) all the *exchange risks* on the currency composition of their borrowings; and (ii) the *full cost* of their borrowings, with a spread.

The ability of MDBs to pass on these costs entirely to borrowers has had two unfortunate effects. First, it has led MDBs to borrow and hold liquid investments substantially in excess of purely *operational* funding needs. There is now a strong bias within MDBs towards *overstating* their real liquidity needs because of the importance of MDB liquid investments as profit centres. Second, it may, in the past, have obscured many borrowing misjudgements which have rarely been identified or assessed independently in the same way that the lending decisions and judgements of MDBs have been scrutinised; even though such misjudgements might have required borrowing developing countries to pay a higher than necessary cost for their loans. Through techniques such as refinancings, prepayments and debt repurchases when market conditions improve (which results in refunding former high-cost issues with lower cost new issues) the MDBs can recover to some degree the excess costs incurred from too much premature high-cost borrowing when it was not strictly necessary.

Though different MDBs may articulate their borrowing policies in different ways these are, in essence, driven by the same considerations for all MDBs and have the same three basic broad objectives: (i) ensuring the availability, *without interruption*, of funds for development lending purposes; (ii) minimising borrowing costs, both for the MDB and (ostensibly) its borrowers; and (iii) assuring the predictability of such costs; or, in other words, controlling their volatility – in terms of both the frequency and the magnitude of changes in them. The MDBs employ, in some form or another, a *borrowing limit* which is usually lower than their lending limit. Whereas under their respective charters lending is limited to the value of subscribed capital, in most MDBs borrowings are limited to their usable capital.

No MDB is as experienced or as proficient at borrowing as the **IBRD**. This is mainly because no other MDB has borrowing needs which are as large or diverse. Usually the pattern has been for the IBRD to break new ground in its borrowing strategy and operations which the other MDBs then explore. It has deliberately sought to develop flexibility and range in its approach to frequent global borrowing in order to reduce its susceptibility to the inappropriate exertion of influence by one or two of its major shareholders who have attempted to misuse the leverage of *market access*. In all the Articles

of the MDBs there is a provision which requires them to obtain the permission of members in whose markets or currencies they might borrow. That provision serves no useful purpose any longer. Short of amending the Articles of Agreement to delete it altogether, member countries which do not borrow from MDBs should reach agreement among themselves that they will no longer regard this particular Article as being in force to avoid any future prospect of MDBs being improperly restrained from access to either their domestic or international markets or to their currencies by one or two large shareholders with motives in mind which have little to do with the reasons which this Article was originally meant to accommodate.

To minimise their cost of funds MDBs resort to variable-rate long-term borrowing, and, more importantly, the use of derivatives i.e. *currency and interest rate swaps* to allow for currency diversification and for changing the cost basis of borrowings. To minimise costs, MDBs have also resorted to exercising their *pre-payment* options more regularly, especially when such prepayments do not adversely affect their standing in financial markets. Since 1992, some MDBs have refinanced previously higher-cost borrowings through *debt-repurchase* programmes when the efficiency gains of such transactions in terms of overall cost reduction are significant, and when market conditions permit such operations to be undertaken without influencing market sentiment adversely. Controlling the *volatility of borrowing costs* and loan charges is an objective which MDBs attempts to achieve by: (i) limiting *variable rate* borrowings; (ii) targeting the proportionate *currency composition* in their currency pools within limits which reduce the volatility of the effective cost of loans in US dollar terms; and (iii) excluding from the loan currency pool those borrowings which are used primarily to fund liquidity. The IBRD's after-swap borrowings are presently aimed at achieving a currency composition in its loan currency pool which is divided into equal thirds of: US dollars; the DM group of currencies; and Japanese Yen.

Unlike other MDBs, the AfDB has complicated matters by issuing two different types of debt: (i) *senior debt* and (ii) *subordinated debt*. As a matter of Board policy (and not a charter limitation) the AfDB's *senior debt*, together with any outstanding guarantees is formally limited to 80% of the callable capital of *non-borrowing members*. As things stand under present capital constraints, the 60:40 ratio of senior-to-subordinated debt and the 80% of total debt to total callable capital limit are incompatible. Changes in the senior-to-subordinated debt ratio will need to be made.

The AsDB's borrowing policies are similar in virtually all respects to those of the IBRD and are therefore influenced by the same considerations. Like other MDBs, the AsDB has been using derivatives to lower its borrowing costs and to manage its liability exposure actively. It has also resorted to refinancing operations and to prepayments to restructure the cost base of its

debt portfolio while attempting to stretch its average maturity as far as it can, keeping in mind the cost-maturity trade-off in doing so. The **IDB's** borrowing strategy has evolved in stages over time, reflecting a conservatism based on self-imposed (though originally market-induced) borrowing limits which have changed with circumstances. They are now more closely in line with those of the **IBRD**; although the attempts of its management to convince its Board to undertake short-term borrowings in a fashion similar to the World Bank do not as yet appear to have been successful. As the newest of the regional MDBs, the **EBRD** does not have much of a track record to assess although it has the advantage of assessing the borrowing experience of the other MDBs and selecting the most efficacious, proven approaches and options in formulating its own borrowing policies, strategies and programmes. Unlike its predecessors the EBRD appears to have geared up its borrowings much earlier and to a larger extent than its lending operations warrant. To achieve *cost-effectiveness*, the EBRD proposes to: (i) use established underwriters and syndicates for its issues; (ii) select borrowing instruments and techniques to match investor preferences; (iii) use currency and interest rate swaps; and (iv) to resort to short-term and variable rate borrowings.

### ***Issues Raised by MDB Borrowing Policies and Strategies***

*Sophistication and Complexity:* The borrowing programmes and strategies of MDBs have become increasingly sophisticated and complex in response to the increasing sophistication of financial markets themselves. The degree of complexity, however, is beginning to convey the impression of being contrived rather than essential; perhaps driven more by the professional aspirations and ambitions of MDB financial officers, and the fee-generating imperatives of their investment banking advisors, than by the real needs of the MDBs' borrowing clientele. All the MDBs now appear to operate on the belief that, having spent money on large advisory fees, on building up sophisticated financial expertise, and on sophisticated technology, they have a vested interest in *churning* their financial operations to justify their existence on the ostensible grounds of cost-efficiency and maximising market access as objectives in their own right.

*The Possibility of Churning:* Whether all of the financial operations MDBs undertake are really necessary, and whether they are cost-effective, is becoming difficult (if not nearly impossible) even for experts to judge without careful scrutiny of the way in which these financial operations are triggered and managed. What is clear is that the senior managers and most Board members of MDBs are overwhelmed when their financial managers dazzle

them with science. Not wishing to appear uninformed, they generally go along with approving complex financial operations when they have no way of evaluating whether these transactions make sense or not. There is certainly a case to be investigated as to whether, in retrospect: (i) the high-cost borrowings that MDBs undertook at the wrong times (when such borrowings could have been deferred since liquidity was more than adequate) and which were later unwound, through prepayments, refinancings and debt repurchases, when market conditions were more propitious, in fact amount to a form of *churning* and covering-up for previous misjudgements; or (ii) whether each of these transactions could, in fact, be justified in its own right. Relative to their concerns about the efficacy of MDB lending, shareholders appear quite sanguine about assuming that the quality of *financial management* in MDBs is so intrinsically sound as to be beyond the need for similar monitoring or examination. That sanguinity may now be in need of more careful consideration.

*Borrowing Market Diversification:* In formulating their borrowing strategies and undertaking their borrowing programmes, all the MDBs seem intent on *diversifying* their source *markets* as much as possible. This is true even when it is not entirely clear, for the MDBs with smaller and less regular funding needs, as to whether diversification for its own sake is necessarily the correct pursuit. Clearly, the AsDB's sensitivity to developing exposure in regional markets is one positive dimension of its borrowing strategy which other regional MDBs should explore more thoroughly and possibly emulate, although the AfDB may need to defer that emphasis for some time yet.

*Currency of Borrowing:* Similarly, in considering the before-and-after swap composition of the currency mix being borrowed, questions arise about the long-established emphasis that MDBs have placed on maximising borrowings of low nominal cost currencies. They have justified doing so on the grounds that such borrowings keeps their borrowing costs, and therefore their nominal loan charges low. Such borrowing (especially in JPY) may have increased exchange risks and costs for MDB borrowers far beyond a tolerable level. The IBRD has now shifted its stance on currency management quite radically. The AsDB has followed suit. The AfDB and its borrowers (who can afford to bear such costs the least) remain too heavily exposed to JPY. Clearly, MDBs need to gravitate towards a more consistent policy involving a balanced evaluation of what is most in the long-run interests of their borrowers and not what is most expedient to do in order to minimise, only ostensibly, a *visible* cost while obscuring the possibly higher *invisible* costs of their borrowing and currency management practices.

*Maturity Matching:* That most MDBs attempt to match the average maturity and durations of their *long-term* assets and liabilities is sensible and laudable. All the MDBs have taken advantage of the highly propitious borrowing environment that has persisted between 1991-93 to stretch their maturities outwards. But, except for the IBRD and EBRD, the other MDBs do not yet match the maturities of their *short-term* assets and liabilities. The experience of the IBRD and EBRD suggests that access to short-term markets, wisely and judiciously used, can be of significant benefit. It can lower overall borrowing costs and provide another line of defence to avoid *forced* borrowing in long-term markets when these markets are, for whatever reason, undergoing temporary bouts of turbulence (a phenomenon which is becoming more, not less, frequent). Access to short-term borrowings would enable all MDBs to ride out these periods with equanimity without necessarily having to run down their levels of liquidity below prudent limits.

*Timing of Borrowings:* Though MDBs usually justify high levels of liquidity to cope with disruptions in access to markets or to avoid *forced* untimely borrowings, they have nevertheless gone ahead with agreed annual borrowing programmes even when market conditions have been poor. Paradoxically, their behaviour often argues against the reasons which they cite for justifying the levels of liquidity they want to hold. It almost seems as if MDBs – having become accustomed to holding a certain level of liquidity, and to making an attractive level of profit out of those holdings – are reluctant to diminish those levels of liquid holdings for whatever reason. Since they can pass on the full cost of their borrowing, and the full exchange risk on such borrowing, to their own borrowers there is little incentive for them to hold back on borrowing even under unfavourable conditions or to run down liquidity. Levels of borrowings and liquidity should be managed within broader, more flexible bands to permit greater expansion or contraction of borrowing programmes than is the case now. Such flexibility should be exercised on the basis of market conditions. But it should not run the risk of damaging the reputation of MDBs in financial markets (by belatedly pulling out from issues which are almost fully cooked) or, on the other hand, run undue risks in letting liquidity fall below prudential levels.

*Member's Permission to Borrow in their Markets and Currencies:* As already observed, the Article requiring MDBs to seek the permission of their members to borrow in those members' currencies or markets, or to exchange those members' currencies into other currencies was designed at a time and for a purpose which no longer exists. That Article is now anachronistic and provides members with the power to misuse the authority it gives them. It should, in the interests of fairness and MDBs' financial soundness, be

declared invalid for application in some way which does not involve the painful and unmanageable process of amending MDBs' Articles of Agreement.

*The Role of Rating Agencies:* The key international rating agencies which continually analyse the credit quality of debt paper issued by governments, their agencies, supranationals and corporates, have played a significant role in the success enjoyed by MDBs in borrowing on international capital markets. With the onset of the debt crisis and the emergence of unprecedentedly difficult circumstances arising for the portfolios of the IBRD and IDB, all the rating agencies have insisted on more intensive reviews of the strength of MDB portfolio quality, callable capital, and of the political support of their OECD members. The passage of the Latin American debt crisis has eased somewhat the concern of rating agencies about the quality of the portfolios of the IBRD and IDB. But the AfDB now faces unusually difficult circumstances with the continuing deterioration of its loan portfolio, the persistence of the debt crisis in Africa with too large a hard-window MDB debt exposure, and the intense shareholder scrutiny that it has come under as arrears have increased. Current ratings of the quality of AfDB's debt paper raise some fundamental questions. A recent evaluation of the financial condition of the AfDB suggested that deteriorating trends in its key financial indicators would have justified a proactive position being taken by the rating agencies to downgrade AfDB's debt in 1992. Such a step would have caused the management and the regional membership of that institution to be less sanguine about market and rating agency perceptions of the AfDB's strength and move more swiftly than they actually did in making essential changes to certain financial policies in order to safeguard the strength of that institution.

Rating agencies no longer base their rating of the MDBs on the sophisticated (and often confusing if not sometimes almost irrelevant) financial ratio analysis they undertake. Instead, they now appear to be basing their rating judgements solely on the strength of *usable* callable capital and the extent to which this guarantee *on the part of mainly the OECD governments* ensures the safety of the MDBs' outstanding debt. Excessively heavy reliance on that one factor alone poses serious dangers in terms of the signals that it sends to the managements of these institutions. It places unnecessarily onerous burdens on the OECD shareholders to enforce sound financial management by holding out the threat of exercising the ultimate sanction: i.e. withholding further capital support. Given the political complexities involved with OECD shareholders getting regional MDB managements to respond to their concerns, these shareholders ought not to be backed into the job that rating agencies and markets should be doing; especially when deterioration in the

quality of an MDB's financial position clearly warrants markets rather than shareholders to signal that something is wrong and needs to be corrected.

### *The Use of MDB Guarantee Powers*

The Articles of all the MDBs were framed with the clear idea in mind that these institutions would use extensively their powers to *guarantee* loans and investments made by private lenders to borrowing member countries. However, the IBRD did not guarantee either a foreign loan of a private investor to a developing country for nearly forty years nor did it consider guaranteeing the public offering of a member government. The same reticence was exhibited by the AfDB, AsDB and IDB. The reasons that the MDBs' powers of guarantee have not been widely exercised are that:

- the use of the MDB guarantee added no value to the international flow of financial resources because the guarantee competed directly with the MDBs' own borrowing capacity in being a direct substitute for borrowings under the capital limit set;
- the cost to most borrowers would have been higher if the MDBs had provided guarantees for private credit than if the MDBs borrowed and lent directly; the guarantee cost would have been an add-on and the legal issues involved between the borrower, primary lender and guarantor were complicated and involved further costs;
- even if the MDB guarantee had carried a uniform cost for all members, the overall cost of funds with a guarantee would have been different for different members based on how private investors perceived their individual credit quality; that would have made matters politically difficult since the MDBs chose to operate from the outset as multilateral credit cooperatives which spread their costs among all members equally.

It was not till 1983 that interest was revived in the IBRD – and, through a ripple effect, in the AsDB and EBRD, but *not* yet in the AfDB and IDB – in *cofinancing and guarantees* as ways of enhancing the credit of borrowers to support either private bank lending to a particular developing country or to support a borrowing in the international capital market. After two abortive attempts at reviving the use of guarantees through its B-loan programme followed by its expanded cofinancing operations (ECO), the World Bank has, in late 1994, made a third attempt to revive the use of guarantees as part of its mainstream operations. Only the AsDB and EBRD have followed suit in opening their guarantee windows for borrowers to use. The AsDB guarantee

programme has barely begun. The EBRD's policies permit guarantees to be tailored to requirements ranging from *all-risk financial guarantees* to *partial risk-specific contingent guarantees* for debt instruments (loans, bonds or commercial paper) issued by its borrowers in their domestic, or in international, capital markets. The EBRD has made extensive use of its guarantee powers in a manner which exhibits greater flexibility, imagination and innovativeness of approach than in the other MDBs; perhaps demonstrating what is possible in a nascent institution whose internal culture is not yet quite as rigid as that of its more established peers. So far, the EBRD has provided guarantees both for a local currency private placement as well as a partial guarantee for a local currency public debt issue.

### ***Concessional Resource Mobilisation by MDFs***

When it became clear that the MDBs would require concessional funds to cater adequately to the development financing needs of their memberships, and especially of low-income countries, a series of multilateral development funds (MDFs) were established beginning with *IDA* in 1960. Its creation was a major step in the evolution of the World Bank itself, marking the beginning of the transformation of that institution from something resembling a *bank* into a *development agency*. Up to mid-1994, the donor countries had provided nearly twelve times as much money (through budgetary provisions) to *IDA* as they had to the paid-in capital of the *IBRD* with far less leverage being exerted from *IDA* contributions. However, the funds provided by donors and the *IBRD* to *IDA* before 1980 are now beginning to revolve in increasing amounts. As time progresses, the proportion of commitment authority funded by reflows relative to new contributions might well increase quite rapidly from the present level of 16% to around 50% or more by the year 2010. *IDA* has made it possible for the World Bank to remain a *world bank* rather than being reduced to being largely a Latin America and Asia bank.

Though it dwarfs all other MDFs, *IDA* has its equivalents in all the regional MDBs except the EBRD. In Africa, the *AfDF* was set up in 1972 with contributions from non-regional donors who were not yet involved in the membership of the core *AfDB*. *AfDF*'s role in Africa remains peripheral to that of *IDA* with the latter's total commitments to sub-Saharan Africa being three times higher than those of the *AfDF*. In contrast to the situation in Africa the *Asian Fund's* (*AsDF*) resources for Asia seem less constrained. Part of the reason lies in the exclusion of China and India from *AsDF* access. *AsDF* lending to countries other than India and China is now significantly larger than *IDA*'s. Although Asia is generally regarded as the most rapidly developing region in the third world, the need for *AsDF* resources is likely to rise because several poor Asian countries to which the *AsDF* has not been

able to lend previously are becoming active again. The IDB's *Fund for Special Operations (FSO)* was established in 1960 and among the MDB soft windows, it is unique in that it was created as a built-in feature in the constitution of the IDB. The experience of FSO with declining donor contributions (which were unexpectedly reversed in GIR-8) may be a precursor for all the MDFs which confront the prospect of donor contributions being likely to fall once these revolving funds are seen to have reached a self-sustaining critical mass with *reflows* then becoming the main support for future annual commitment levels. Unlike the other MDFs, FSO makes its loans on terms which vary depending on the development status of the recipient country and the nature of the project being financed. Contrary to the view espoused by the managements of the World Bank and AsDB, that, permitting wide variability in terms of loans and credits would lead to intractable problems for managements and staff the IDB apparently has no significant problems in this connection. The EBRD does not yet have any soft-loan window similar to those of the other MDBs, although its Articles provide for the creation of *Special Funds* which have to be distinguished and managed distinctly from its ordinary capital resources (OCR). At the end of 1993, EBRD was administering four small Special Funds: (i) the Baltic Investment Special Fund; (ii) the Baltic Technical Assistance Special Fund; (iii) the Russia Small Business Investment Special Fund and (iv) the Russia Small Business Technical Cooperation Special Fund.

### ***Issues Raised by MDF Replenishments***

*Burden-Sharing:* All soft window replenishments are funded by donors on the notional principle of *fair burden-sharing*. This concept has bedevilled soft-window replenishment negotiations on many occasions. Some replenishments have been negotiated at levels substantially below what might have been possible had the donor community as a whole been willing to accept reductions in the share of some donors. A particular problem for all MDFs is posed by the US which has perennial difficulties with contributing an appropriate share to MDB soft-windows and paying-in its contributions on time. In the context of strict burden-sharing rules being applied that feature has become a fundamental structural weakness in the processes of soft-window funding. The way in which burden-sharing *rules* have been applied, and the absence of linkage between MDF contributions and *effective* voting power in the MDBs has made it unattractive for some new donors to contribute as much to MDF replenishments as they can afford while inducing other developing country donors to make token contributions.

The principle of burden-sharing has provided a disciplined framework of rules within which MDF replenishments are negotiated. But some large European donors may have been too rigid in attempting to apply that

framework, to the possible detriment of MDF replenishments and more so to their recipients. Their actions have been guided by the belief that without such discipline the US would have done even less than it has been inclined to. While the burden-sharing framework must continue to be applied in negotiating MDF replenishments, it must be applied with sufficient imagination, flexibility and accommodation to acknowledge circumstantial realities without damaging the size of replenishments. In particular, the way in which the established donor community applies burden-sharing concepts, and de-links soft-window contributions from effective voting power in the core MDBs, provides no particular incentive for new donors to emerge and play a role in financing concessional development assistance though they could afford to.

*Pro Rata Note Deposits and Drawdowns:* Connected to the burden-sharing principle is that of *pro-rata note deposits* and *drawdowns* of donor contributions. The business of MDB managements negotiating instalment payments and drawdowns with donors has now become quite complex although the idea behind the issue is quite simple. Whereas soft-window replenishments are negotiated every 3-4 years the *commitments* made annually against donor pledges are actually *disbursed* over a period of 10-12 years. MDB managements cannot prudently make commitments against negotiated pledges until they know that donors have legally obligated themselves to make their pledged funds available in cash to the MDB soft-window through *instruments* which convey a binding and irrevocable commitment. Since approval has to go through the normal annual budgetary process in each donor country, most donors prefer their contributions to be divided into three or four annual *instalments* which are not made in *cash* but in *notes* which can be drawn down upon over a much longer period of time as funds are required to meet disbursement and liquidity requirements. This process is conditioned by *pro rata* rules which provide donors with the right to reduce the size of their note deposits or to restrict the amount of their deposits to the same level as any other donor which has so far released less than its proper share. The *pro rata* rules for note deposits and note encashment procedures are unwieldy and expensive to apply. They do not achieve the intended result of fairness. It would be better and simpler for donors to agree to formulae which would make their contributions more predictable in terms of their own budgetary procedures and make the flow of funds easier for MDB managements to handle.

*Soft-Window Service Charges:* The service charges which the MDB soft-windows levy are intended to cover their costs rather than to generate high levels of income. Depending on the concessional window concerned, these

charges may include: a front-end processing fee; an annual service charge on disbursed and outstanding balances; a low or intermediate interest rate charge; and an annual commitment fee on undisbursed balances. Whereas IDA and AsDF levy standard charges on all their soft-window loans the AsDF and IDB levy variable charges and terms depending on the country and project being financed. At different times for different funds, the income derived from charges applied has proven insufficient to cover costs and income levels have had to be augmented through a change in either the levels of charges or the introduction of new charges. When income levels have been restored to adequate levels, these charges have been reviewed and reversed. In the FSO, where interest rates are also levied, the income generated is now becoming an important source of funding for future commitment authority.

*MDF Liquidity:* Related to the issue of cost recovery, is the maintenance of sufficient *liquidity* in MDFs in order to: meet expanding disbursement requirements; generate investment income; and/or to provide a cushion for protecting commitment authority from suffering an excessively sharp fall. Donors have now taken a more relaxed view on early encashments in advance of disbursement needs to permit a greater amount of liquidity to be held by the soft-windows themselves and to permit earnings generated from such liquidity to be used to keep service charges in check or to fund additional commitment authority. IDA's liquidity at the end of FY93 amounted to US\$2.7 billion (versus disbursement requirements of about US\$5 billion) while that of the AsDB was about US\$725 million, FSO's was US\$2 billion and AfDF's was US\$400 million.

*Administrative Cost-Sharing between MDB Hard and Soft Windows:* As the concessional windows of the MDBs are operated as separate funds rather than as separate institutions the issue arises of apportioning administrative costs for the MDB as a whole between its hard and soft-windows. In the case of IDA and the AsDB the apportionment is done on the basis of costings which appear to bear some justifiable relationship to the identifiable costs of their hard and soft windows. In the case of the AfDF and IDB the basis of cost-sharing is more difficult to comprehend. Neither institution applies a cost accounting system of the same sophistication as the IBRD and AsDB. The basis for apportionment in the AfDF and IDB is more arbitrary and political with an unfairly high burden of cost seemingly being borne by the soft window and with the hard window thus appearing to be more profitable than it actually is. Also, the overloading of costs onto the soft window results in depleting donor provided resources and depriving potential recipients of scarce commitment authority. In both institutions the basis for cost

apportionment was reviewed in 1993-94 and a new formula is to be adopted to reflect a more appropriate division of administrative expenses.

*Concessional Resource Eligibility & Allocation:* Among the issues which arise during MDF replenishment negotiations are the criteria applied to determine: (i) the *eligibility* of recipient countries for access to MDFs; and (ii) the annual and cumulative *allocation* of concessional resources across eligible recipients under any given MDF. Since concessional multilateral resources are scarce they need to be rationed out in a way which is fair and acceptable. These criteria, have undergone continuous evolution in but differ across the MDBs at any given point in time with inconsistencies emerging in the treatment of the same country by two different MDBs. There are thus no clear, consistent guiding principles governing eligibility for MDF resources *across the multilateral system as a whole* even though the funds are provided largely in the same way, by more or less the same group of key donor countries. Nor do MDBs classify their borrowers in the same way. Per capita incomes alone cannot be the sole determinant of eligibility. Moreover, the GNP/capita indicator is subject to methodological error and sensitive to exchange rate distortions. It would clearly be better to use the *Purchasing Power Parity (PPP)* based GNP/capita figures which are now published annually in the UNDP Human Development Report as a basis for determining eligibility. The MDBs should contribute to developing jointly with UNDP and the IMF, a more acceptable common methodology for deriving PPP figures for country classification and differentiation purposes.

Eligibility for concessional resources is linked to their scarcity which a uni-product approach of the type followed by IDA and the AsDB exacerbates. The question therefore arises as to whether all MDB concessional resources should be provided on more *variable terms* (as in FSO) and whether, as a result, eligibility could be loosened. Intermediate terms can be derived through a *blend*; but this is a blunt device unamenable to fine-tuning or to a quick adaptive response to changed circumstances. Moreover, there is a case for the *type of project* being financed also to influence both the type of resource (and its terms) which an MDB might choose to provide rather than having it be determined exclusively by country income circumstances. Another factor to consider is that some of the larger *blend* countries such as China, India, Indonesia, Pakistan, the Philippines etc., are now able to access *private* external flows of both debt and equity on an unprecedented scale giving them alternatives for external resource mobilisation which other IDA recipients presently do not have. Many IDA-eligible countries also spend an inordinately large proportion of their public resources on military expenditures. At a time when concessional resource scarcity is growing it may be appropriate to reconsider whether military expenditures should be included as a criterion

for eligibility especially when the provision of scarce MDF resources indirectly supports a country's ability to expend its own resources in non-productive ways. Also, new claimants are emerging for concessional resources whose incremental demands are unlikely to be matched by expansion of supply.

Taking into account all these changing contextual factors in a post-Cold War world, with private external flows dominating official flows, the issue of eligibility for MDF resources should be thoroughly reconsidered in the next IDA replenishment. The aim of such a review should be to make concessional resources *more variable* and *more accessible* especially to the neediest countries for a wider variety of social investments. The FSO provides an interesting model, in terms of the way in which it has evolved both operationally and financially, for the other MDBs and their donors to examine more carefully before considering similar evolutionary changes in their own soft-window facilities.

*The Allocation of MDF Resources:* If eligibility criteria are more judgmental, less transparent and less rigid than they are often portrayed to be, then the allocation criteria, and the way in which they are applied within and across the different MDFs, for annual and cumulative soft-window allocations to particular countries are even more so. MDBs strive to make their decision-making on concessional resource allocations *appear* to be as impartial, objective, formula-based, and transparent as possible, with the appropriate genuflections to whatever developmental priorities or fashions happen to be in vogue with donors at the time. The reality, however, is that allocations among the major concessional resource recipients (or groups of recipients) are often determined in broad terms by the senior managements of MDBs and the representatives of major donor countries exercising their judgements at the start of an MDF replenishment cycle. In addition, the policy and economic *performance* of recipient countries *as perceived by MDB managements* has an influence on MDF allocations. Almost the same allocation criteria apply to recipient countries in all the MDBs. Broadly, these include: (i) willingness to engage in *policy dialogue*; (ii) emphasis on *poverty reduction*; (iii) sensitivity to *environmental sustainability*; (iv) responsiveness to *gender issues*; (v) *good governance*; (vi) emphasis on *human resource development*; and (vii) emphasis on *institutional development* to support the functioning of market economies and of open transparent democracies. In all the MDFs, donors placed a limit of between 25-30% of the resources provided under recent replenishments for adjustment lending.

*Reflows:* The *revolving* nature of donor funds was always an in-built feature of the MDFs. Donors foresaw that, at some future point in time, the corpus

of their cumulative contributions would become sufficiently large, and the demands made on it would become sufficiently small when no further budgetary contributions from donors would be needed to sustain the *annual commitment authority* of the MDFs. At that point annual commitment authority would be fully funded by *reflows* from previous credits and, to a lesser extent, by the income earned on MDF liquidity. That state is closest to occurring in FSO although reflows now feature in supporting IDA's annual commitment authority as well. Though increasing reliance on reflows should indicate development success, at the present time it is more indicative of donor resistance to continually expanding aid allocations to MDFs from overstrained budgets. At the same time, recipient countries are giving donors more than sufficient cause for adopting this posture by wasting scarce resources to an intolerable degree. In addition to reflows, the investment income being generated by soft-window liquidity is also reaching significant proportions. The large and growing amounts earned from MDF liquidity are being earmarked for specific purposes which include: financing increases in commitment authority; funding interest subsidy funds; or funding technical assistance facilities. In looking to MDFs to generate income from liquidity a reasonable view has to be taken, given the particular circumstances of the MDF in question, on where the overall balance of interest lies.

*The Role of MDF Replenishment Negotiators (the Deputies):* A final issue which needs to be touched upon concerns the role that representatives of donor governments involved in negotiating MDF replenishments (*MDF Deputies*) play in influencing the operational and financial policies not just of the soft-window that they are funding at that particular time but of the entire MDB. Deputies constitute a group of *donor* government officials who represent only a part of the ownership of any MDB and have no constitutional standing in the governance of the MDBs. Their intervention usurps the roles of the Boards of Governors and Executive Directors. MDF Deputies exert far more influence over MDB policies and far more *effective* power over MDB management behaviour than do Boards of Executive Directors. The development priorities that have crept into MDB agendas have been pushed through less by Executive Boards than by the MDF Deputies. More recently, in one MDB the Deputies intervened to shore up its rapidly eroding financial foundations by requiring emergency remedial action to be taken. Thus MDF Deputies can be a force for the good of the institutions just as there are times when they can do much to incapacitate and diminish the MDBs. The real issue is not whether MDF Deputies exert their power and influence in the interests of the good or the bad. It is whether they can or should legitimately exert that sort of power at all. Their role diminishes the credibility of the Executive Boards of the MDBs especially vis-à-vis the MDB's senior

management and staff. It also disenfranchises developing country members of MDBs from representing their interests properly. A tradition has now been established of increasing MDF Deputy intervention in all aspects of MDB functioning. That encroachment on Executive Board rights is virtually impossible to roll back. MDF Deputies are able to intervene so effectively partly because Executive Boards have become impotent devices for effective MDB governance. Unless the governance role of MDF Deputies, which has evolved by exigency than design, is thoroughly re-examined and formalised, day-to-day MDB governance may well be weakened not strengthened.

### ***Liquidity and Investment Policies***

MDBs usually lend for projects and programmes which take 2-10 years to implement. While these are being implemented, the MDBs play an active role in monitoring and supervising these projects. Funds are released only when the equipment needed has actually been shipped by suppliers or is being installed, or when certain performance conditions and commitments have been met. Thus the MDBs disburse against their loans on a continuous basis over periods of time that may vary from 2-10 years. Given that *modus operandi* it is self-evident that the MDBs need to keep a sufficient amount of liquid funds on hand to meet disbursements against their loan commitments. The timing of such disbursements cannot be easily predicted in advance for individual projects but aggregate disbursement patterns for the portfolio as a whole can be anticipated over time. Secondly, MDBs cannot always time their borrowings to suit themselves. They must borrow opportunistically to take advantage of the best market conditions in different markets and currencies over any given period. A time lag therefore results between the inflow of funds from borrowings and the outflow of funds for: disbursements, repayment of previous borrowings, and for other expenditures. For those reasons, liquidity is a *sine qua non* for effective financial resource management.

The key question therefore is not whether MDBs should hold liquidity but *how much liquidity do the MDBs need to keep at any given point in time?* This question assumes particular relevance because the investment of liquid funds has now become an important profit centre in its own right in all the MDBs. Investment income has become a useful safety-valve for releasing internal financial pressures that might otherwise have built up in the MDBs. MDBs have therefore developed a vested interest in retaining and strengthening their roles as *financial arbitrageurs* by keeping their liquidity levels as high as possible. Policies are devised to justify maintaining liquidity at higher levels than is actually necessary in present financial market conditions. Although the liquidity requirements of all the MDBs are predicated on much the same concerns, and their operations justify the same approach to liquidity

management, the MDBs use two quite distinct approaches to determine their liquidity levels.

The IBRD and EBRD base their liquidity requirements on the concept of estimated *net cash requirements (NCR) over the next three-year period*. The three other regional banks (AfDB, AsDB and IDB) prefer to use the concept of estimated *future loan disbursement requirements (LDR) for the following year (or two)* in determining their liquidity. The NCR concept makes the most sense, from an intellectual and practical viewpoint. Both the IBRD and EBRD use a ratio of 45% of their NCR over the next three years to determine their liquidity requirements although that ratio is used as a guide target rather than an absolute ceiling; in practice the World Bank manages its liquidity within a 45-50% of the 3-year NCR range. Liquid holdings above the 45% ratio are reviewed by their Boards and the excess is regarded in both MDBs as *discretionary liquidity*.

In contrast, the AfDB presently has a policy of maintaining liquidity at a level equivalent to 1.5 times the LDR for the following year. The AsDB's liquidity policy is also based indirectly on the LDR concept with its *minimum liquidity target* is set at 40% of its (previous) year-end undisbursed balance of committed loans which avoids making any estimates or judgements about future NCR. The AsDB is in the midst of shifting from the passive, ratio-driven approach based on LDR to a more active NCR based approach to liquidity management. The IDB's present liquidity formula, establishes a *ceiling for liquidity equal to the sum of 50% of undisbursed amounts from effective loans, plus 33% of NCR for the next 2 years* thus combining the LDR and NCR approaches. The IDB has opted for combining the LDR and NCR approaches to liquidity management on the grounds that the LDR component would provide *stability* in an environment of rapid lending growth while the NCR component would be more *responsive* to sudden changes in the Bank's contractually determined cash flows caused, for example, by sudden and large exchange rate fluctuations.

*Revisiting Liquidity Requirements:* As the different policies adopted by different MDBs suggest, the issue of how much liquidity an MDB should carry is largely a matter of judgement despite the apparent sophistication of analysis which underpins the different policies which various MDBs choose to pursue. Given that they operate in largely the same way, and need liquidity for essentially the same purposes, it is surprising that the MDBs take such different approaches to justifying how much liquidity they need. If the essence of keeping liquidity is to protect against various risks which might interrupt cash flows (and especially *inward* cash flows) then conceptually the soundest approach to formulating liquidity policy is on the basis of NCR over some future period; mainly because LDR deals with only

one dimension of *outward* cash flows to which the MDBs are contractually committed. Indeed, in the mature MDBs, the debt service on their own bonds is now becoming as important a form of contractual outward cash flows as disbursements on loans. There is a strong case to be made for all the MDBs to move towards a more consistent NCR basis for formulating their policies and managing their liquidity. It is clear that the current levels of liquidity which MDBs are carrying are significantly higher than they need to be if the *only* purpose of carrying liquidity were to cover various cash-flow risks and uncertainties.

The MDBs could operate quite comfortably with a level of liquidity which was equivalent to around 30-35% of NCR for the next three years or 100% of NCR for the next 12-month period (on a rolling monthly basis). Such a reduction would, however, almost certainly have the effect of lowering current levels of investment income by around 30-35%. The real reason for MDBs maintaining a much higher level of liquidity than is necessary (for risk coverage purposes) is to generate sufficient investment income. Given that the *income imperative* drives the need to keep liquidity levels as high as they are, it would be wiser for MDB managements to justify their liquidity policies on the basis of both their need to maintain income levels and to cover cash-flow risks rather than putting the burden of the argument entirely on the latter. The present approach only fosters the suspicion that MDB managements are now generally pre-disposed to being opaque and disingenuous, when they can just as easily be transparent and straightforward and still attract support for the positions they wish to convince their shareholders to take. The problem with admitting openly that higher than necessary liquidity levels are necessary simply to generate income is that MDBs are likely to become subject to close scrutiny on their risk exposure putting more pressure on MDB treasurers and exposing them to greater accountability and transparency than they might be comfortable with.

*Allowable Investments & Investment Authority:* Apart from the issue of *how much liquidity* should MDBs keep, there arises the question of *what kind of investments* and instruments should MDBs be permitted to invest their liquid funds in. All the MDBs have explicit policies on this matter and all such policies are fairly similar. The investment authorities granted by MDB Boards specify the types of instruments in which liquid funds can be kept by issuer and by credit rating and set exposure limits on: portfolio *durations* and the maximum maturity allowable for certain types of transactions; the minimum permissible credit ratings of issuers of securities in which MDBs are allowed to invest; the types of issuers whose securities are eligible; and the extent of risk that can be taken in specific markets, and for specific types of credits. The average duration of MDB portfolios is not permitted to exceed

48 months. All the MDBs have exposure limits for investments in any single security. There are also limits on the proportion of any single issue that a given MDB can purchase for its own investment purposes as well as limits on the proportion of the total amount of liquidity that can be invested in any single type of security or in the paper of a particular category of issuer.

### *Currency Management Policies*

Among the most technically difficult MDB financial policies to explain in practical terms are those concerning *currency management*. Simply put the problem arises because the MDBs, by their Articles, are required not to assume any *exchange risk* on their financial activities which they have interpreted to mean passing it on to their borrowers. As seen earlier, MDBs are capitalised in a variety of convertible and non-convertible currencies. They have to borrow from various capital markets in a different variety of currencies. Moreover, they prefer to use only certain currencies from their borrowing and capital pools for investment purposes. Upto now the MDBs have seen themselves as credit co-operatives, rather than as banks which can discriminate among their borrowers in pricing their loans or offering a wide variety of *loan products*. On the grounds of *equity* and *uniformity* the MDBs (except the EBRD) have chosen to lend in a way which distributes all the exchange and interest risks inherent in their borrowing operations to all their borrowers equitably in loans with roughly similar characteristics.

Accordingly *currency pooling* systems have been designed by the MDBs which attempt to distribute the interest cost and exchange risk equally among all loans in the system by assigning all loans the same currency composition as the composition of the MDB's entire loan portfolio. All loans funded out of the currency pool share equally with the cumulative exchange risk associated with the currency composition of the pool. The currency pool does not *eliminate* exchange risk for the borrowers; it only *spreads the risk* out equally among all borrowers and all loans. The AsDB now offers borrowers a choice of loans in USD while the IBRD recently introduced the option of offering its *non-sovereign* borrowers (i.e. agencies and DFIs) single currency loans in USD, JPY, DEM, GBP or FFR. Neither the AfDB nor IDB have yet moved towards offering single currency loans although the IDB is considering this possibility with the suggested establishment of a separate USD window. The EBRD has decided from the outset to offer its borrowers either fixed or variable rate loans in USD, JPY, ECU or any other convertible currency in which funding is available to the EBRD. The EBRD has also experimented with borrowing and lending operations in the *local currency* of borrowing members which could be a precursor to a whole new approach in MDB borrowing and lending in the future.

The EBRD has broken new ground in acting more like a commercial or merchant bank in offering loan products which are *demand-driven* – i.e. by the particular needs of the borrower and the project – rather than *supply-driven* by the strictures of MDBs concerned about homogenising their loan products, largely to simplify life for themselves rather than their borrowers, by pooling all risks and spreading them across all borrowers. The more established MDBs are now entering difficult and unfamiliar territory. They face a future in which they will, inevitably, have to cope much greater complexity and risk in portfolio and balance-sheet management; especially as they move away from providing more-or-less homogeneous loan products to a much more heterogeneous range of loan, quasi-equity, and guarantee products (some with built-in derivatives to cap or contain risk) in different currencies, with different prices and terms, which are tailored to meet the needs of specific borrowers for specific projects. Their present management and staff are perhaps not fully qualified nor competent to handle such heterogeneity, nor are they as client-oriented as they will need to be. These pressures to adjust to a more competitive environment will place a weak MDB, such as the AfDB, at an even greater disadvantage than it is at now to keep up with the other MDBs as they evolve and change.

### *Lending Rates, Terms and other Loan Charge Policies*

All MDBs charge an interest rate on the loan balances disbursed and outstanding. In addition some MDBs charge commitment fees on undisbursed loan balances and front-end service fees although the levels of these differ. The **World Bank** is the market leader in terms of price setting and in determining the evolution of MDB lending rate policies in general. In the IBRD loans signed before 1982 have *fixed* interest rates determined at the time the loan was contracted. Loans signed between 1982-89 were made at variable lending rates (VLR) from a composite lending pool. Loans signed after 1989 a modified variable lending rate (MVLRL) was formulated with borrowers whose loans were signed before that date being given the option of converting to the modified rate. Under the VLR system the IBRD's lending rates have declined almost continually reaching their lowest point so far in 1994. On its new programmes of *single currency loans* the IBRD charges a SC-VLR which is reset every semester. In calculating its MVLRL, the IBRD adds a spread of 50 bp over the weighted average cost of borrowings in the pool to cover its own overhead and administrative costs. To encourage borrowers to make their debt service payments on time, the IBRD has a policy of interest spread waivers. Borrowers making their payments on time are eligible to a waiver of 25 bp on the interest spread charged. Borrowers

who do not make timely payments are ineligible for the waiver and are subject to the application of progressive sanctions and penalties.

In the **AfDB**, a pool-based system also applies with the VLR calculated on more-or-less the same basis as in the IBRD with a 50 bp spread applied to the weighted average cost of funds in the loan currency-pool. However, given the large weight of fixed rate loans in its portfolio along the high level of non-performing loans the 50 bp spread is inadequate for AfDB to meet its minimum net income requirements or its targets for adequate *interest coverage* and *reserves-to-loans* ratios. Consequently, the AfDB has contemplated applying a *variable spread* above the Bank's average cost of borrowings which would be reset each year. The size of the spread would be determined by the AfDB's needs to meet that year's net income targets and to reach minimum interest coverage and reserves to loan ratios of 1.25 and 15% respectively.

The **AsDB** also has a pool-based VLR system. The *spread* is only 40 bp (the lowest of all the MDBs) with the weighted average cost of its borrowings in the loan currency pool being calculated in the same way as in the other MDBs. The AsDB's VLR system has proved even more robust and stable than the IBRD's with interest rate variations being within a range of 130 bp between 1986-93. The VLR on its straight US dollar loans is based on the average cost of USD borrowings undertaken to fund the USD pool with a 40 bp spread applied. The **IDB's** VLR incorporates a *spread* of 58 bp comprising a *fixed component* of 50 bp to cover the Bank's overhead and administrative costs at headquarters plus a *discretionary component* (presently 8 bp but it has been as high as 50 bp) which can adjusted in line with achieving required net income levels. To safeguard its net income, the IDB has been pursuing an approach to its lending charges of the kind that the AfDB's management should follow and for much the same reasons.

Given its different operational orientation and flavour, the **EBRD's** lending rate policies and charges are more variable than those of the other MDBs. Also, the EBRD depends to a much higher extent than the other MDBs, on returns from equity investments, guarantees and lending to the private sector than from sovereign risk lending alone. Thus it does not have any single currency-pool system or bench-mark lending rate similar or equivalent to the semestrally announced VLRs of the other MDBs. Loan pricing is determined according to risk, cost of administration, and contributing to its net income requirements, *with due regard to market terms offered by other lenders for similar loans*. The EBRD thus operates in a different fashion to the other MDBs, less as a credit co-operative and more as a commercially oriented merchant bank. For sovereign loans the EBRD's margin or *spread* over cost of borrowed funds is a 100 bp. For loans to private and non-sovereign borrowers, the margin over the EBRD's cost of funds is variable. In the absence of a sovereign guarantee it is meant to reflect both the country-

risk as well as the specific project-risk, the latter being decided on a case-by-case basis. The EBRD charges fees and commissions which include: front-end fees, commitment, pre-payment and conversion fees. These fees fluctuate within a range and vary on a case-by-case basis.

*Commitment Fees:* The **IBRD** specifies a *standard annual commitment fee* of 75 bp on the *undisbursed* balances of contracted loans to be charged 60 days after loan signature and annually thereafter. At present the IBRD waives two-thirds of the contractual commitment fee, charging only 25 bp. The **AfDB's** commitment charge remains at 100 bp with some pressure from borrowers to reduce it but resistance from non-regional shareholders to countenance any reduction in view of the AfDB's precarious financial circumstances. The **AsDB** charges a commitment fee of 75 bp as does the **IDB**. These fees are paid semi-annually on undisbursed balances although accrual of the commitment charges begins 60 days after loan signature. In the **EBRD**, commitment fees are variable, and payable on the committed but undrawn part of a facility and are chargeable from the date of signing. Commitment fees of bank credit lines start to accrue on each tranche as it become active and not the whole facility.

*Front-end and other Special Fees:* Though they have done so in the past, the **IBRD** and **AfDB** do not levy any front-end fees at the present time although in view of its precarious income position the AfDB may shortly be obliged to do so again. The **AsDB** has not levied any front-end fees in the past and has no plans to do so. The **IDB** levies a front-end fee of 100 bp of the approved amount of each loan for inspection and supervision. The **EBRD** has a policy of levying variable front-end commissions payable at the time of signing of the loan or facility extended but no later than the first disbursement. Front-end fees to the EBRD are payable in a single up-front lump sum; refunds are not offered to borrowers who do not avail of the full extent of a facility which has been approved. Unlike the other MDBs, the EBRD also has a policy of charging a back-end or *wind-up fee* in the event of a pre-payment or cancellation of its fixed-rate loan products. In addition, for both VLR and FLR loans the EBRD charges an administrative fee. It may also charge a *conversion fee* if a borrower chooses to switch the interest rate basis of the facility contracted from VLR to FLR or vice-versa. Such a fee may be charged either at the time of conversion or, in some cases, it is capitalised (i.e. added to the principal outstanding).

*Loan Repayment Terms:* The maturities and grace periods for the loans of the more established MDBs vary within narrow bands but those of the EBRD vary quite widely. At present a three-tier structure applies to repayment terms

of **IBRD** loans varying by the income level of its borrowers with terms varying from 15-20 years and grace periods varying from 3-5 years. Repayment terms of **AfDB** loans vary from 12-20 years with grace periods varying from 2-8 years. **AsDB** loans have repayment terms of 10-30 years with grace periods varying between 2-8 years, while those of the **IDB** vary from 15-25 years with grace periods of 4-8 years. In the three regional MDBs the basis for determining the maturity and grace periods depends partly on the income level of the country and partly on the cash-flow profile generated by the project being financed. Decision-making on the repayment terms of particular loans is more discretionary and not quite as well-defined as in the case of the IBRD. The **EBRD's** loans have repayment terms which vary from 3-15 years for state-sector loans and 1-10 years for loans to private enterprises. The EBRD's view on grace periods is more commercial than that of the other MDBs with principal repayments commencing as soon as projects begin to generate positive cash flow. For private enterprises with existing operations the EBRD's grace period can be as little as *3 months* from the start of loan disbursements. For new projects without cash flow from other sources the maximum grace period allowable is 3 years.

### ***Net Income Management Policies***

All the MDBs employ some form of net income targeting for each year, bearing in mind that their net income remains vulnerable to several risks including: (i) *interest rate risk*; (ii) *commercial credit risk*; (iii) *exchange rate risk*; and (iv) *portfolio risk*. To cope with these risks, MDBs attempt to retain some flexibility in their loan and service charge structures which enable charges to be geared up or down in response to exigencies which may affect net income. In targeting income, the MDBs pay particular attention to the Reserves-to-Loan Ratio and the Interest Coverage Ratio. They also fund other desirable activities through special allocations of net income such as their MDFs or Technical Assistance funds through annual or occasional allocations of a percentage of net income.

*Meeting the Reserves to Loan Ratio (RLR)*: The key measure of the adequacy of MDB net income is its contribution to *reserves* relative to the portfolio as reflected in the RLR. In the **IBRD** the RLR target is now 13-14% of the outstanding loan portfolio and its present RLR is 13.8%. The net income and reserves position of the **AfDB** is far less comfortable. Net income has fallen to an unacceptably low level and reserves are inadequate relative to AfDB's deteriorating portfolio quality. The main failure of the AfDB has been the inability of the Bank's management and Board to come to grips with its rising arrears, non-accruals and escalating loan-loss provisions. It has now become

imperative to arrest and reverse the decline in AfDB's net income. If urgent actions are not taken the AfDB faces the prospect of losing its credit rating, seeing an increase in its borrowing costs and, at worst, risking the prospect of a call on callable capital. If that were to happen, the AfDB risks endangering the entire MDB system by calling into question the very basis of confidence in the preferred creditor relationship between MDBs and their borrowers, and between MDBs and their donor shareholders, on which the system has been built.

In contrast, the picture at the **AsDB** is the opposite to that of the AfDB with an overly prudent and cautious approach to the RLR being adopted from the outset. The AsDB has a minimum RLR of 25% which, by any standards is extremely prudent. Like the AsDB, the **IDB** has also adopted a target RLR of 25%. With its portfolio position having improved significantly since 1989 and the economic circumstances of several major borrowers having improved substantially, the IDB's present reserves are adequate.

The **EBRD's** reserves in 1993 stood at 3.4% of the total portfolio; inadequate by any standard, and in a relative sense even worse than the AfDB. The inadequacy of EBRD's reserves results from the inadequacy of net income in the start-up phase of the institution. It is compensated for by the over-adequacy of liquidity and paid-in capital. Given the concentration of EBRD's portfolio in nascent private sectors and in countries where the transition to becoming market economies is far from complete, its vulnerability to portfolio shocks provides cause for concern. The EBRD's overall target for total reserves and retained earnings, together with special provisions for losses on loans and equity investments has been set initially at 10% of outstanding loans and 25% of equity investments. While the reserves level for the equity portfolio seems uncontroversial, the RLR target for the loan portfolio is well below that of its cohorts. Given the particularities of the EBRD's operating environment, it seems imprudently low.

*Meeting the Interest Coverage Ratio (ICR):* The second major test of the adequacy of an MDB's underlying income generating capacity is the ICR. It reflects the capacity of an MDB to continue generating income and maintain an adequate level of reserves under unexpectedly adverse conditions and measures the excess by which net income covers the level of interest expense.<sup>1</sup> A sudden drop in an MDB's ICR could indicate to markets an erosion of its capacity to service its own debt. In the **IBRD**, the ICR is presently at 1.16 and is regarded as being satisfactory. The **AfDB** has an explicit ICR *floor*

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1 The ICR for an MDB is defined by the formula:

$$\frac{(\text{Net Income} + \text{Interest Expenses} + \text{Financial Charges})}{(\text{Interest Expenses} + \text{Financial Charges})}$$

target of 1.25. Its ICR has fallen precipitately to 1.19 in 1993 and it does not appear as if the ICR target be met in the 1994-97 period. If nothing changes, the ICR is projected to drop further to a disconcerting 1.07 by 1997 unless net income is raised substantially or, alternatively, borrowings are sharply curtailed temporarily. The **AsDB** and **IDB** also have ICR floor targets of 1.25. The **AsDB** is comfortably above that floor level with an ICR of 1.66 in 1993 whereas the **IDB** had an ICR of 1.24. The **EBRD's** main objective has been to achieve a positive level of net income, which it managed to do in 1993. Hence an ICR comparison at the present time would be invidious (the ICR in 1993 was 1.02).

*MDB Policies for the Allocation of Net Income:* MDBs have policies for the *allocation* of their net income especially in years when income exceeds amounts expected. Excess income, is allocated for special purposes after the basic purposes of adding sufficiently to reserves and making prudent provisions have been fully satisfied. The **IBRD** has a *medium term policy framework* for the allocation of net income. While giving first priority to the continued accretion of reserves at an acceptable rate, that framework outlines three broad uses for surplus net income: (i) reducing the burden of loan charges on borrowers; (ii) strengthening the Bank's financial position; and (iii) promoting development through special transfers outside of the Bank. The case for reducing loan charges is obvious. The argument for the two other uses of income rests on the notion that the Bank's income is earned in large part from the *cost-free* usable capital, and the privileged access to their capital markets, which donor shareholders provide. The **IBRD's** priorities in the allocation of net income are: (i) strengthening reserves; (ii) reducing loan charges; and (iii) transfers for special purposes. Thus, after the target RLR requirement is satisfied, any remaining net income is applied first to prefund waivers of loan interest charges for the following fiscal year. If additional income still remains after this application, it is transferred to a *surplus* account in the Bank's reserves or put to other uses which are consistent with the Bank's Articles of Agreement, and agreed to by the Executive Board subject to approval by the Board of Governors.

The **AfDB**, has no clear policy on the allocation of its net income. With its present problem of not being able to generate sufficient net income to meet even the minimum RLR and ICR targets any discussion about allocating surplus net income would be superfluous for the foreseeable future. Neither the **AsDB** nor the **IDB**, have specific policies for the allocation or distribution of net income. In most years, annual net income is allocated between the Special Reserve and the General Reserve. The income attributable to special commissions (1% on OCR loans) is required by the **IDB's** statutes to be allocated to the Special Reserve established for the sole purpose of

meeting obligations created by its own borrowings or by guaranteeing loans. The **EBRD** still has to build up its net income to acceptable levels relative to its portfolio; the issue of special allocations from net income will not, therefore arise for some time to come.

### ***Policies on Reserves and Provisions***

All the MDBs generally have three types of reserves, all funded either as charges against gross income (*above the line*) or allocations from net income (*below the line*) which can all be used as a buffer against the impairment of their capital resulting from either loan losses or from any other financial shock. Assuming that loan losses trigger the process of liquidating these different reserves, the order in which they can be depleted is that: (i) Loan Loss Provisions are charged first, followed by a drawdown of (ii) the Special Reserve, and finally (iii) the Ordinary or General Reserve, which is effectively a paid-in capital substitute. Whether or not MDBs create loan loss reserves, and irrespective of the accounting conventions which determine the order in which different types of reserves are to be drawn down, in the final analysis it is the total amount of all three reserves which protect the MDB's capital from being impaired. All three reserves thus serve essentially the same purpose of insulating MDB capital from the shock of any financial disturbance.

*Loan-Loss Provisions:* These provisions are funded annually by charges against gross income from loans determined on the basis of estimates about the probable amount of future losses. The *cumulative* amount of such annual provisions are known as loan loss reserves. Loan loss provisions can be of two types: *specific* or *general*. Specific provisions are those which are determined on the basis of the probability that specific loans to a country which have been in non-accrual status for a period of time, may not be collected and therefore need to be provided for against the risk of capital loss. General provisions are established on the basis of the overall probability that some as yet unidentifiable part of the loan portfolio may not be collected.

*Special Reserves:* All the MDBs have Special Reserves as a statutory feature. These are embedded in their Articles and are required to be funded by special loan commissions or guarantee fees and held in the form of readily available liquid assets. Such assets are set aside to be used as a first line of defence against the impairment of paid-in capital, or to forestall a call on callable capital. Special Reserves can only be used for the purposes of meeting MDB liabilities on their borrowings or guarantees in the event of default on loans made, participated in, or guaranteed by the MDB. They were intended as a bulwark against the risk of capital impairment in the early stages of an MDB's

life. Most of the MDBs' Articles require these Special Reserves to be funded through a 1% front-end charge for at least the first five years of operation, after which the front-end fee could be reduced or eliminated at the discretion of the Executive Board.

In the **IBRD**, the allocation of commissions to the Special Reserve was discontinued in 1964. The *regional* banks, however, continue to fund and build up their Special Reserves. The **AsDB** discontinued funding the Special Reserve with loan commissions in 1985 but still funds it with the small amount of guarantee fees it collects. The **AfDB** stopped charging its special front-end commission and funding the Special Reserve in 1989. In view of its precarious income position it urgently needs to reinstitute the practice of replenishing its Special Reserve especially if it proves easier to reactivate the Special Reserve on constitutional grounds. The **IDB** still funds its Special Reserve with a 1% commission charged on all loans approved. The **EBRD** is funding its Special Reserve with all of its front-end fees, and other fees (excluding commitment fees) associated with loans, guarantees and underwritings. It will continue to do so till a sufficient amount has been built up in the Special Reserve. Although the proportion of total reserves accounted for by the Special Reserve in the regional banks is high, the distinction between the Special and General Reserve is becoming moot even in these banks.

*Ordinary or General Reserves:* While loan provisions are funded by deductions from gross income above the line, and Special Reserves are funded by specifically designated fees and commissions above the line, Ordinary or General Reserves are funded entirely from allocations of net income below the line. They simply represent an accumulation of the net earnings of the MDBs which have not been allocated to other purposes but have been retained internally to support the growth of the MDB's operations by augmenting its equity base. In essence they have proved to be the most effective means of MDBs' accumulating convertible, usable paid-in capital. They belong to all the shareholders in proportion to their shareholdings as undistributed dividends, which would be distributed in the event of the MDBs being wound up after their creditors had been fully satisfied. The Articles of the MDB's, while requiring priority to be given to building up reserves through the allocation of net earnings, do not specify any uses of these Reserves nor do they impose any restrictions on their use.

### ***Country and Portfolio Risk Exposure Management***

*Sovereign (Country) Risk & MDB Portfolio Risk:* All the MDBs now have systems for assessing, on a rigorous annual basis, the risk of protracted arrears

and non-payment on debt owed to them by their borrowers. These systems vary in their degree of sophistication. Borrowers are classified in MDB portfolios in different risk categories on the basis of various income and debt indicators. Individual country risk assessments are aggregated into an overall assessment of portfolio risk each year through the application of techniques which are refined continually with experience. Such portfolio assessments combine the judgement of the MDB's operational staff dealing with each country as well as financial staff experienced in assessing portfolio risk.

*Country Exposure Limits:* All the MDBs have formal or informal country exposure limits of one sort or another. The **IBRD**, which has the most globally diversified, and therefore the least concentrated portfolio of all the MDBs, also has the most sophisticated country exposure risk management system. Its guidelines are applied with flexibility and discretion on the part of IBRD's management rather than serving as rigid cut-offs which are mechanically applied. Supplementary qualitative analysis is undertaken to make a judgement as to whether the IBRD needs to adjust its assistance strategy to a particular country sufficiently early to stop a problem from becoming a crisis. The IBRD's exposure increases are then calibrated carefully to avoid increasing exposure too rapidly in difficult situations while ensuring, at the same time, that resources are not withheld too hastily so as to precipitate, rather than avert, a debt-service problem.

The **AfDB's** country exposure guidelines are presently honoured more in the breach than in the keeping. There is a question as to how realistic and applicable these guidelines actually are. There may be a need to redesign them. It is now essential to introduce greater automaticity in requiring the AfDB to reduce country exposure levels rapidly, especially in patently uncreditworthy countries, unless there are sound reasons for doing otherwise. For the same reason there might also be grounds for having a small sub-committee of the Board (comprising mainly its non-regional members), or even the Audit Committee, participate in the portfolio review exercise, without usurping the prerogatives of the Bank's management, to ensure a needed degree of transparency in the application of an overdue and critically important country exposure policy. Both the **IDB** and **AsDB** have country risk assessment systems with provision for annual reviews. Their approach to country exposure risk management has changed recently. The AsDB has opted for a country risk exposure management approach similar to the IBRD's. The IDB's plans to go down the same route are quite advanced. Given the limited number of sovereign borrowers that it deals with, the **EBRD's** start-up approach to country risk exposure focuses on the extent to which these individual borrowing countries have the capacity to service external debt obligations in general and EBRD debt in particular; and

whether the EBRD's status as a preferred creditor, relative to other preferred creditors, is honoured. As in the other MDBs, the EBRD's country lending limits reflect its concerns about risk diversification and are not used as a lending allocation or rationing device.

### *Private Sector Exposure Risk Management*

Except for the IDB, the other regional MDBs finance *private sector operations* directly through their own hard-windows rather than through separate affiliated corporations. The IBRD, finances the private sector through IFC, and the IDB does so through IIC. In the former case, risk assessments of loans to *private* borrowers must also be made by the three MDBs for portfolio risk management purposes. In dealing with private borrowers, MDBs may need to engage in normal *debt* rescheduling, refinancing and restructuring arrangements alongside other creditors. If indulged in on a large scale, this could endanger an MDB's own credit rating on international capital markets and increase its cost of borrowing and/or constrain its market access. Three issues arise in ensuring that the impact of private sector lending/investment on adding to an MDB's portfolio risk is contained: (i) the size and nature of its private sector operations; (ii) the loan restructuring and rescheduling practices to be employed for such operations and (iii) the separate provisions set-aside for such operations to ensure that losses on *private* lending do not contaminate the MDBs' *sovereign* portfolio.

In the **AfDB** and **AsDB** direct lending to, and investment operations in, the private sector are small in relation to their total operations. These operations are not yet a part of their mainstream activities. Both MDBs employ different credit policies for their private sector lending and investment operations to assure strong asset quality. Unlike their sovereign loans, MDB loans to the private sector are fully secured and closely monitored. Though both MDBs have taken firm positions on *not* rescheduling, refinancing or restructuring *sovereign* debt, they can engage in such rescheduling, under strict guidelines for loans and investments in their private sector portfolio. Unlike the AfDB and AsDB, lending to the private sector is a mainline activity of the **EBRD**. At the end of 1993, the private sector accounted for 89% of its disbursed and outstanding loans/investments. The EBRD's private sector portfolio is limited by a series of guidelines. Like the other MDBs, the EBRD has a general policy of not rescheduling, refinancing or restructuring its loans to *sovereign* borrowers or state enterprises but it can engage in such practices in its lending to the private sector. Its policy posture is to undertake loan rescheduling where such a course of action provides the best means of protecting its own interests.

To avoid the risk that problems with their private sector portfolios might

contaminate their sovereign loan portfolios, it would appear wiser for the AfDB and AsDB to consider financing their private sector operations through a separate corporate entity with limited liability and a different *modus operandi* with different policies, rules and regulations applying to its management and staff. For that reason it may be more appropriate for the AfDB and AsDB to follow the route taken by the IBRD and IDB in establishing the IFC and IIC respectively. The AsDB has already participated in the establishment of the Asian Finance and Investment Corporation (AFIC) to which all of its private sector operations could easily be shifted. The AfDB may need to either participate in, or establish its own, African Finance Corporation. In the absence of such an approach, there is a real danger that any significant losses on the institution's private sector portfolio could impair the market image and operations of the MDB as a whole. The suggestion to take a separate corporate route in handling private sector operations is to safeguard the prudential interests of these institutions and to permit more flexibility to be applied in the way these operations are handled, and the way in which remedial measures can be applied when portfolio problems occur.

### ***Policies for Arrears, Non-Accruals and Provisioning***

Despite their best efforts at trying to anticipate potential debt servicing problems through their country and private sector risk exposure management practices, different MDBs have, since the mid-1980s, experienced *arrears* on the servicing of debt owed to them by their sovereign and non-sovereign borrowers. Since 1993 there has been a trend towards all the MDBs adopting convergent policies and approaches with the IBRD setting the pace. All the financial managements of MDBs (usually their Controller's Departments) monitor debt service payments on a continuous basis. When payments are overdue for more than 180 days they are referred to as *protracted arrears*; at that point, they trigger *non-accrual* of income and *specific provisions* for possible losses on the loan.

*Sanctions Policies:* In the difficult interregnum between a country going into arrears and going into non-accrual status, different MDBs apply, as aforementioned, a number of incentives and disincentives to induce borrowers to avoid arrears if possible, or alternatively to mitigate their impact. These sanctions differ across the MDBs depending on their particular policies and whether or not they provide certain incentives (e.g. interest spread waivers) to borrowers that make timely payments. By and large sanctions include measures such as: (i) loss of eligibility for interest spread waivers; (ii) dissemination of borrowers identity; (iii) suspension of board presentation and loan signature suspension; (iv) suspension of disbursements;

(v) suspension of new loan processing; (vi) cross-effective sanctions; (vii) notification to cofinanciers and suppliers.

### ***Controlling the Administrative Costs of the MDBs***

The five MDBs taken together cost over US\$2.1 billion to run in 1993/94 compared with substantially less than US\$1 billion in 1983. The World Bank alone accounted for over 66% of that amount. The new EBRD already costs more to run than the older and more established AsDB even though it has only 40% of the number of staff and its present operational output is far lower. Average staff costs per staff member employed are much higher in the Washington and London based institutions than in the Abidjan and Manila based institutions. The overheads of the IBRD are much higher than those of the other banks other than the EBRD. Staff costs and benefits absorb around 70% of the total administrative expenditures of the established MDBs. Institutional overheads account for between 15-20% with other directly related operating costs (e.g. travel and communications) accounting for the remaining 10-15%. An analysis of MDB administrative costs makes it clear that there is little scope for achieving significant reductions in the operating cost structure of MDBs unless fundamentally different approaches to the use of human resources are considered. Budgeting systems which add incrementally to previous year programmes are not particularly useful in controlling MDB costs; *zero-based budgeting* would perhaps be more appropriate in reconsidering entire categories of expenditure which the MDBs presently take for granted.

The main reason for its much higher overheads is that the World Bank has a more wide ranging *non-operational* programme of activities than the other MDBs. This includes its extensive research work and publications on development issues, its data and information services. The Bank has also taken over much of the technical assistance work that was once undertaken by agencies in the UN system. Not all the elements of its expanding non-operational programmes are critical or essential. A major independent *external* review needs to be undertaken to examine which activities are critical and those which are peripheral. In many instances it would appear that such programmes are being funded for internal reasons rather than because of legitimate broadly-based demands for such output. Many of the non-operational activities (especially of the Washington-based institutions) could be rationalised and done jointly rather than singly in order to achieve significant budgetary savings within the multilateral system. The same thought could be extended to the UN agencies as well. This important issue needs to be explored thoroughly with more systematic, in-depth thinking about these issues by the MDB shareholding community. The World Bank is

252 *From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org*

not the only MDB whose non-operational programmes should be reviewed, but its relative high overhead cost ratios and the fact that it accounts for two-thirds of the total annual administrative costs of the MDB system suggest that the greatest scope for pruning lies there.

From a *strategic* viewpoint achieving significant cost-reductions and efficiencies in MDB budgets and in the way that MDBs presently operate, requires attention on issues that are not really concerned with the administrative processes and protocols governing budget formulation and implementation. Tightening up the nuts and bolts of *budgeting systems* in the MDBs yields insignificant results. Despite pressures to control its budget and the annual refinement of its budgeting systems and procedures, the World Bank's annual operating budget in nominal (current) dollars has increased from US\$406 million in FY81 to US\$1,420 million for FY95. The compound annual rate of growth in nominal dollars between FY81-94 was 10% at a time when: the average inflation rate was 4%; staff grew at a rate of 1.5%, the overall volume of lending grew at a rate of 4%, the number of annual operations remained level and net transfers declined dramatically. The story is similar in the other MDBs although not quite as dramatic.

The strategic measures needed to restructure the nature of MDB operations and expenses raise several key issues: (i) *decentralising and localising* MDB activities; (ii) coping with a *changing operational and non-operational output mix*; (iii) coping with a *changing staff mix* demanded by the above two propelling forces; (iv) the *apportionment of administrative costs* between MDBs and MDFs; and (v) dealing with the issue of institutional *management of the budget process*. Shareholder concern needs to be more sharply focused on the future role MDBs should play in a global financial system whose complexion and capacity is changing at a speed well beyond the capacity of most governments and MDB managers to comprehend, leave alone operate in, or regulate. The operating frame of reference for the MDBs is now characterised by a world in which: (i) private capital markets (both international and domestic) are playing a rapidly growing and significant role in financing an increasing number of developing countries; (ii) MDB hard-window portfolios are maturing rapidly with an adverse impact on their resource transfer functions; and (iii) MDF soft-window resources are becoming increasingly constrained.

In such a world the main question is how MDB operations should change so as to: (i) achieve symbiotic and synergistic combinations with sources of private finance in areas where such finance is willing to go voluntarily (e.g. in industry, capital markets, infrastructure and key services); while (ii) mobilising the right kinds of financial packages, involving much less reliance on foreign resources and much greater emphasis on *local currency resource mobilisation*, for social investments in human capital, institution building in its

widest sense, and in those supporting functions (accounting, legal, business support, media and information dissemination, governance and regulatory) which are crucial to making markets work competitively and efficiently. The operating vista for MDBs has changed from traditional concentration on particular types of projects and sectors and on standardised currency-pooled, variable rate loans. Under new operating conditions MDBs will need to gear themselves (as the EBRD is doing) to:

- Transforming their *hard-window* financial operations so as to be able to lend in any number of single convertible currencies, or any combination of currencies at the choice of the borrower (rather than that of the MDB). MDBs must be able to lend at fixed or floating rates, with switching facilities from one to the other and vice-versa. Their loans may need to be packaged with or without attached derivatives (interest and currency caps, collars, options) to meet the particular risk profile chosen by the borrower for a particular purpose. MDBs should be prepared to lend for maturities ranging from 5-30 years from their hard windows.
- Being *demand-driven* rather than supply-driven, shifting away from operating as universal credit cooperatives which attempt to equalise everything across all borrowers in the name of equity and to act more as responsive financial intermediaries which tailor their financial products according to the specific needs and characteristics of borrowers and purposes.
- Transforming their *soft-window* facilities into much more flexible instruments which can finance credits of between 15-50 years at interest costs of 0-5% depending on the type of project, type of borrower and general development level of the country in which a project or programme is being financed.
- Loosening their eligibility and allocation criteria substantially to permit soft or intermediate term lending to a much wider range of low and lower-middle income countries and for high value social investments which are not best financed through hard-window loans.
- Mobilising *local currency resources* and lending in a manner compatible with: (a) the development of local and regional capital markets, especially local and regional debt markets; and (b) the progressive liberalisation of exchange controls over a borrower's current and capital accounts.
- Operating *in real-time* in cofinancing operations with private sector

partners from OECD and developing countries, rather than behaving as the ultimate founts of knowledge and wisdom on project financing, yet being incapable of making a decision or reverting to their partners in the spans of time which are normally acceptable in the commercial marketplace.

- Using their *guarantee powers* much more extensively than their lending powers in order to catalyse a volume of resource flows which more than compensate for their own negative net transfers which will inevitably grow rapidly.
- Focusing on what they can do directly and usefully i.e. financing hard and soft projects, human capital development, institutional development and market development, as well as adjustment programmes under certain types of conditions in which these programmes are likely to succeed.
- Disengaging from what they cannot do directly with any proficiency despite their best intentions and confining themselves to using their considerable influence with borrowing governments to ensure that critically important matters for balanced and sustainable development are dealt with in a manner which develops, enfranchises and empowers all citizens (regardless of gender, race colour or creed).
- Doing much more to support those institutions (such as NGOs and local levels of governments) which have the capacity to do some things better. Unfortunately, MDB attempts at working productively with NGOs and with local levels of governments have so far had limited and mixed success largely because of incompatible staff attitudes between MDBs and NGOs.
- Curbing sharply their different *non-operational programmes*, spinning them off and privatising these to the extent possible while providing continuing symbiotic support to private providers of these services in terms of data and information.
- Working out a more appropriate balance between themselves and the UN system on *technical assistance activities* so as to lessen the present overload on their management systems in coping with these functions.

For MDBs to change in the directions suggested by the foregoing axioms they will clearly need changes in the quality and skill mixes of their staff along with the overhaul of their present managements. Fundamental changes will need to be made in the nexus between MDB managements and Executive

Boards to ensure more effective institutional governance. These changes need to be accompanied by a different approach to human resource acquisition and development. Such a strategy will require new frameworks to be developed for MDB governance and for budget monitoring and control as well as for objective-setting and ensuring greater responsiveness to client needs. If MDB budgets are to be brought under proper control staff costs need to be tackled in three ways: (i) a review and revision of compensation and benefit levels; (ii) cutbacks in levels of staffing through cutbacks in non-operational programmes and changes in the skill-mix; and (iii) greater decentralisation and localisation of staff (with substantially reduced reliance on the use of expatriate staff from headquarters in field locations and curtailment of expatriate benefits) and much more extensive use of nationals in borrowing countries.

A concerted drive to reduce MDB staff is now essential and long overdue. Headquarters staff need to be reduced to about 33% of their present levels to perform only core headquarters management functions. Such a measure needs to be coupled with a drive to increase field staff to about 40-50% of total MDB staff at current levels. This would permit a scale-back (achieved mainly through natural attrition) of about 17-27% in current levels of staffing across all MDBs other than the EBRD. Since their managements seem unwilling and incapable of addressing the fundamental issues which continually rising MDB budgets raise, it falls on shareholders who mean well to take these issues up and deal with them in a way which secures the longer-term interests of the MDBs.

### *A Systemic View of the MDBs*

Finally, MDB shareholders, and particularly the OECD shareholders who are involved in virtually every MDB, need to take a more systemic overall view of the official multilateral financing system, rather than the partial, institution-by-institution views that they take now. They need to ask themselves more fundamental questions about where the system as a whole is going, whether it is continuing to perform useful developmental and resource intermediation functions, and how it should be made to change in keeping with new shifts in global capital markets. There is a considerable amount of unjustifiable inconsistency and duplication within the MDB system which is being operated at considerable cost. There are also significant differences between the role that a *global* MDB like the World Bank should be performing and the roles that the *regional* banks should be performing which have not yet been fully explored or exploited.

Upto now, until the creation of the EBRD which is cutting its own swath, the regional banks have tended to be clones of the World Bank. There is a

need now to shape them more as regionally focused institutions which are more like the European Investment Bank (EIB). These and other questions need to be explored more thoroughly than they have been so far through a counterpart to the Nordic-UN Project which undertook an exhaustive examination of the UN system and came up with powerful recommendations for change which, unfortunately, have become entangled in the byzantine web of the UN's bureaucracy. At the very least, some effort needs to be made for annual reviews, through an appropriately constituted body, of how the MDB system is performing as a whole with a view to setting new directions and monitoring progress being made toward getting there in some systematic fashion. Left to their own devices, and their self-absorbed managements, there is a serious risk that the MDBs will, before too long, atrophy as constructive institutional forces in promoting the cause of development.

**Annex 1.1 Comparative Balance Sheets of the MDBs - 1993/94**  
(billions of US dollars)

	<b>IBRD</b>	<b>AfDB</b>	<b>AsDB</b>	<b>IDB</b>	<b>EBRD</b>
<b>ASSETS</b>					
Liquid Funds	22.66	2.50	5.81	9.41	4.52
Notes Receivable for Capital Subscriptions	1.51	0.43	0.29	0.42	0.31
Other Receivables	5.30	0.43	4.32	0.52	1.00
<b>Loans</b>					
<i>Approved</i>	<i>164.30</i>	<i>15.46</i>	<i>26.39</i>	<i>37.16</i>	<i>3.69</i>
<i>Not yet Effective</i>	<i>11.35</i>	<i>1.24</i>	<i>3.14</i>	<i>n.a.</i>	<i>0.89</i>
<i>Undisbursed</i>	<u><i>43.66</i></u>	<u><i>5.91</i></u>	<u><i>10.04</i></u>	<u><i>14.98</i></u>	<u><i>2.40</i></u>
Outstanding	109.29	8.31	13.70	22.18	0.40
Equity Investments	–	0.18	0.11	–	0.22
Other Assets	<u>1.74</u>	<u>0.07</u>	<u>0.34</u>	<u>0.45</u>	<u>0.08</u>
<b>Total Assets</b>	<b>140.50</b>	<b>11.92</b>	<b>24.57</b>	<b>32.98</b>	<b>6.53</b>
<b>LIABILITIES</b>					
Short-Term Borrowings/Repos	5.23	–	–	–	1.06
Long-Term Borrowings	95.62	8.18	12.54	24.07	2.43
Other Liabilities/Payables	10.51	0.41	4.62	0.27	1.05
Provisions for Loan Losses	3.32	0.21	0.01	0.71	0.02
Provisions for Equity Losses	–	..	0.01	–	0.03
<b>Capital</b>					
<i>Authorised</i>	<i>184.00</i>	<i>22.25</i>	<i>23.20</i>	<i>60.99</i>	<i>11.16</i>
<i>Subscribed</i>	<i>170.00</i>	<i>20.97</i>	<i>23.08</i>	<i>54.20</i>	<i>11.02</i>
<i>Callable</i>	<u><i>159.34</i></u>	<u><i>18.41</i></u>	<u><i>20.29</i></u>	<u><i>51.03</i></u>	<u><i>7.71</i></u>
Paid In	10.66	2.56	2.79	3.17	3.30
Net Advance Payments	<u>0.09</u>	<u>(0.02)</u>	<u>(0.07)</u>	<u>..</u>	<u>(1.36)</u>
<b>Total Paid-In Capital</b>	<b>10.75</b>	<b>2.54</b>	<b>2.72</b>	<b>3.17</b>	<b>1.94</b>
MOV Translation Losses/Gains	(0.80)	(0.36)	(0.24)	..	..
Retained Earnings/Reserves	14.47	1.21	4.93	4.76	..
Currency Translation Adjustment	<u>1.39</u>	<u>(0.27)</u>	<u>(0.02)</u>	<u>..</u>	<u>..</u>
<b>Total Net Worth (NW)</b>	<b>25.81</b>	<b>3.12</b>	<b>7.39</b>	<b>7.93</b>	<b>1.94</b>
<b>TOTAL LIABILITIES + NW</b>	<b>140.50</b>	<b>11.92</b>	<b>24.57</b>	<b>32.98</b>	<b>6.53</b>

*Notes:*

Balance Sheets have been reconfigured to be comparable and hence may not reconcile with the total asset/liability figures drawn on the MDB Annual Reports.

Figures for IBRD are as of June 30, 1994, for the other MDBs they are as of October 31, 1994.

**Annex 1.2 Comparative Income Statements of MDBs - 1993/94**  
(millions of U.S. dollars)

	IBRD	AfDB	AsDB	IDB	EBRD
<b>INCOME</b>					
From Loans					
Interest	7,707	527	1,030	1,522	16
Charges	<u>115</u>	<u>75</u>	<u>45</u>	<u>342</u>	<u>22</u>
<b>Sub Total</b>	<b>7,822</b>	<b>602</b>	<b>1,075</b>	<b>1,864</b>	<b>38</b>
From Liquid Investments	721	197	410	482	350
From Equity Investments	—	n.a.	n.a.	—	1
Other Income	<u>11</u>	<u>3</u>	<u>24</u>	<u>(16)</u>	<u>1</u>
<b>Total Gross Income</b>	<b>8,554</b>	<b>802</b>	<b>1,509</b>	<b>2,330</b>	<b>390</b>
<b>EXPENSES</b>					
of Borrowings					
Interest	6,549	544	800	n.a.	n.a.
Other	<u>107</u>	<u>9</u>	<u>31</u>	<u>n.a.</u>	<u>n.a.</u>
<b>Sub Total</b>	<b>6,656</b>	<b>553</b>	<b>831</b>	<b>1,657</b>	<b>177</b>
Provisions for Loan Losses	—	82	13	98	17
Provisions for Equity Losses	—	3	7	—	21
Administrative Expenses	731	55	89	179	153
Other Expenses	<u>6</u>	<u>7</u>	<u>—</u>	<u>—</u>	<u>17</u>
<b>Total Expenses</b>	<b>7,393</b>	<b>700</b>	<b>940</b>	<b>1,934</b>	<b>385</b>
<b>OPERATING INCOME</b>	<b>1,161</b>	<b>102</b>	<b>569</b>	<b>396</b>	<b>5</b>
Contribution to Sp. Programmes	<u>110</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
<b>NET INCOME</b>	<b>1,051</b>	<b>102</b>	<b>569</b>	<b>396</b>	<b>5</b>

*Notes:*

Income Statements have been simplified and reconfigured to be comparable across MDBs and hence may not reconcile with the figures shown in the MDB Annual Reports.

The Income Statement for IBRD is for the period July 1, 1993 to June 30, 1994.

The Income Statement for other MDBs is for the period January 1, 1993 to December 31, 1993.

**Annex 1.3 Comparative Cash Flow Statements of MDBs - 1993/94**  
(millions of U.S. dollars)

	IBRD	AfDB	AsDB	IDB	EBRD
<b>CASH FLOWS FROM</b>					
<b>Lending Operations (LO)</b>					
Loan/Equity Disbursements	(10,502)	(1,434)	(1,870)	(3,336)	(487)
Principal Repayments	11,320	360	1,083	1,788	15
Payments to MDF	(452)	-	(68)	-	-
Other/Equity Sales (Net)	<u>(23)</u>	<u>(7)</u>	<u>16</u>	<u>-</u>	<u>-</u>
Net Cash from LO:	<b>343</b>	<b>(1,081)</b>	<b>(839)</b>	<b>(1,548)</b>	<b>(472)</b>
<b>Borrowing Operations (BO)</b>					
Receipts from Borrowings	8,178	854	1,722	3,941	1,469
Retirement of Borrowings	(9,625)	(198)	(955)	(2,400)	(56)
Net flows from Swaps	(176)	23	(10)	n.a.	n.a.
Net Flows from Capital, and other Financial Transactions	<u>199</u>	<u>80</u>	<u>(278)</u>	<u>127</u>	<u>542</u>
Net Cash from BO	<b>(1,424)</b>	<b>759</b>	<b>479</b>	<b>1,668</b>	<b>1,955</b>
<b>International Financial Adjustments</b>					
<b>ADJUSTMENT</b>					
Net Income	1,051	102	569	396	5
Non-Cash Charges/Other	<u>170</u>	<u>107</u>	<u>(138)</u>	<u>109</u>	<u>50</u>
Net Cash from Operations	1,221	209	431	505	55
NET EXCHANGE RATE CHANGE EFFECTS	+ 586	(54)	(25)	82	(200)
NET INCREASES/(DECREASES) IN CASH & LIQUIDITY	726	167	(46)	707	1,738

*Notes:*

The Cash Flow Statements have been simplified and reconstructed to be comparable across MDBs and hence may not reconcile exactly with the figures shown in the MDB Annual Reports.

The Cash Flow Statement for IBRD is for the period July 1, 1993 to June 30, 1994. The Cash Flow Statement for other MDBs is for January 1, 1993 to December 31, 1994.

**Annex 2.1 Summary Presentation of Policies and Procedures for Handling Overdue Service Payments**

	<b>IBRD</b>	<b>AsDB</b>
<i>I. Billing Practices and Assistance to Borrowers</i>		
<b>Billing practices, general</b>	Debt service is due semi-annually at due dates on the 1st or 15th of the particular months specified in loan/credit agreements. Billing statements are generated within one or two days after each semi-monthly closing date, for due dates two months in advance. Bills are sent to borrower by mail, courier or pouch about six weeks prior to due date. One month prior to due date, a summary of payments required is telexed to the Ministry of Finance for information.	Debt service is due semi-annually. Interest and other charges are computed two months before due date; principal repayment is equivalent to the amount specified in the amortization schedule of the relevant loan agreement. Billing statements are sent by ordinary mail/courier service/diplomatic pouch to borrowers at least three weeks prior to due date.
<b>Overdues, definition</b>	Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due-date.	Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due date. However, the AsDB allows a 30-day grace period before reporting arrears and initiating action to collect overdue payments.
<b>Overdue Charges</b>	No interest is charged on overdue interest.	No interest is charged on overdue interest.

**Annex 2.1** (continued)

AfDB	IDB	EBRD
<p>Debt service is due semi-annually on due dates of January 1 and July 1. (Management is currently considering the possibility of adding two more due dates on April 1 and October 1). Borrowers are sent bills via courier at least 45 days before the due date and requested to settle payment on or before the due date.</p>	<p>Debt service is due semi-annually according to a schedule set in the individual loan agreements. Billing statements are mailed to the borrower at least 60 days prior to date due, with copies to the Central Bank of the country concerned and to the IDB Field Office.</p>	<p>Same as IBRD</p>
<p>Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due date.</p>	<p>Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due date.</p>	<p>Same as other MDBs</p>
<p>No interest is charged on overdue interest</p>	<p>No interest is charged on overdue interest.</p>	<p>Sames as other MDBs</p>

**Annex 2.1** (continued)

	<b>IBRD</b>	<b>AsDB</b>
<b>Currency conversion</b>	<p>The World Bank will negotiate a “purchase of currency agreement” at no charge at any time for payments on any loan or group of loans with the proviso that the agreement must be in place at least three months prior to the due date. When such an agreement is in place, the payment is requested five days in advance of the due date, and an increment of 5-8% is added to the amount billed as a contingency against exchange rate movements.</p>	<p>The AsDB will purchase any currency needed by the borrower for payment of principal, interest, and other charges due to the bank. The borrower will be required to remit the US\$/other convertible currencies for the purchase transaction with a 5% contingency margin six calendar days prior to payment due date.</p>
<b>Other assistance</b>	<p>Bank staff offer a range of assistance for debt management, debt accounting and reporting systems, and for specific countries on a case-by-case basis, for management of debt service to the Bank itself.</p>	<p>No technical assistance was found necessary. Bank staff on mission assist the borrower in clearing bottlenecks mostly due to transaction delays in the commercial banks’ fund transfer system.</p>

Annex 2.1 (continued)

AfDB	IDB	EBRD
<p>Under the Unit of Account-based billing system, there was no need to provide any such assistance, since Borrowers were billed in a single currency which they normally paid. Under the currency-based billing system, if payment is made in a currency other than that billed, the Bank will purchase the currencies billed on behalf of the borrower, using the currency of payment; any difference resulting from such exchange operation, being for the account of the Borrower.</p>	<p>The Bank does not formally assist the borrower in acquiring the necessary currencies for payment. The billing letter specifically indicates amounts due by currency and the depository bank to which funds should be credited. On a few occasions, at the request of the borrower the Bank has accepted payment in US dollars with the appropriate authorization to convert into the currencies needed for settlement of the debt service. Consideration is being given to offering this service more broadly in the future.</p>	<p>Same as IBRD</p>
<p>The Bank has started to provide grants to assist in setting up debt management units in borrowing member countries, designed to help borrowers improve their debt management capabilities. The Bank also advises Borrowers on fund-raising arrangements undertaken by them to meet their debt obligations.</p>	<p>30 days prior to due date, the Field Office, based on discussion with the borrower, executing agency and/or government financial official will report to the Bank's Country Coordinator with a copy to the Finance Department the likelihood of receiving payment on the due date. If there is a strong probability of non-payment on the due date, the Country Coordinator, in consultation with his Division Chief and Deputy General Manager, will initiate an action plan with a view to receiving payment within 30 days of due date.</p>	<p>Same as IBRD</p>

	IBRD	AsDB
<p><b>II. Arrears Monitoring &amp; Reporting</b></p> <p><b>Reports produced, distribution</b></p>	<ol style="list-style-type: none"> <li>1) Summary data available daily on internal electronic mail system to authorized staff.</li> <li>2) Details by country, region, due date, loan and currency provided twice monthly in hard copy to management, Operations Legal and Financial staff and Executive Director for country concerned.</li> <li>3) Country-by-country summary of all arrears over 30 days provided to all Executive Directors twice monthly.</li> <li>4) Weekly summary by country and maturity, together with actions taken provided to senior operations management.</li> <li>5) Monthly summary by country and maturity, together with review of developments in countries with longer overdues provided to senior financial management.</li> </ol>	<p>Reports routinely produced are:</p> <ol style="list-style-type: none"> <li>1) Outstanding loan service payments report to management, once a month.</li> <li>2) Delay in loan service payments report to the Executive Director representing the country if payments are not received 30 days after due date.</li> <li>3) Outstanding loan service payments report to the Board of Directors if no payments are received 60 days after due date.</li> <li>4) Receipt of outstanding loan service payments report to the Board of Directors if payments are received after reporting to the Board of Directors. Exceptional reports are also produced on request and as required.</li> </ol>

**Annex 2.1** (continued)

<b>AfDB</b>	<b>IDB</b>	<b>EBRD</b>
<p>A statement on the arrears status of all borrowing Member Countries is produced fortnightly. Monthly reports (Information Notes) are also prepared for the Board of Directors. Specific briefs and reports on arrears on individual countries are prepared, from time to time, on request from Management. 30 days after arrears emerge, the Board and Management are informed through the statement of arrears referred to above. Heads of concerned Projects and Country Programs Department, the Legal Department and Heads of Regional Offices concerned, are informed within one month after the due date.</p>	<p>Each Friday, the Finance Dept. issues a report of loans in arrears as of Wednesday of the previous week and for which evidence of payment has not been received at c.o.b. on Thursday of the week of the report. The report is distributed to the Board of Executive Directors, the Coordination Committee, the Operations and Legal Departments, and the Auditor General. A summary report is also prepared showing the age of the overdue payments.</p>	<p>Same as IBRD</p>

	<b>IBRD</b>	<b>AsDB</b>
<b>Cofinanciers</b>	Under joint cofinancing arrangements, cofinanciers are informed at least five working days before (1) disbursements to a country are to be suspended due to arrears and (2) at least five working days before a borrower is placed in non-accrual status.	Cofinanciers are informed of arrears when the Bank is under contractual obligation to do so.
<b>Financial statements and other public documents</b>	Arrears of three months or more for borrowers other than those in non-accrual status are reported in the aggregate without naming the specific countries involved in the notes to all published financial documents; these data also include the aggregate amount of loans outstanding to the same borrowers.	For disclosure of information on loans in non-accrual status and on loan loss provisioning see below, Sections IV and V.
<b>III. Measures for Dealing with Arrears</b>		
<b>Initial activities</b>	Within two working days after arrears emerge, operations staff for the country concerned initiate action, normally by telex but also through IBRD representatives resident in the country, to obtain prompt payment of overdues.	Follow-up telexes would be sent if payments were not received within one to two weeks after due date.

Annex 2.1 (continued)

AfDB	IDB	EBRD
<p>At their request, cofinanciers and suppliers of goods and services under AfDB/AfDF projects and programs are duly informed when suspension of disbursements to a borrower or guarantor is imposed at described below in Section III.</p>	<p>For loans cofinanced through the Complementary Financing Program, participating commercial banks are informed as soon as arrears emerge on the loan(s) concerned. Other cofinanciers are informed if contractual obligations so require.</p>	<p>Same as IBRD</p>
<p>For disclosure of information on loans in non-accrual status and on loan loss provisioning see below, Sections IV and V.</p>	<p>For disclosure of information on loans in non-accrual status and on loan loss provisioning, see below, Sections IV and V. No disclosure of arrears is made prior to non-accrual status.</p>	<p>Same as IBRD</p>
<p>Reminders are sent 15 days before the due date and thereafter on a monthly basis. Under current policy loan signature is suspended after arrears reach 30 days. This prohibition is extended to the <b>guarantor</b> 15 days after the sanction is imposed on the borrower.</p>	<p>As soon as possible after the weekly Friday report on arrears is produced, the IDB sends the borrower a notice of intent to suspend disbursements, to become effective 30 days from the due date. A copy of the telex is also sent to the Guarantor. Cables are sent to Field Offices each Monday thereafter, advising them of the status of pending payments.</p>	<p>Same as IBRD</p>

	IBRD	AsDB
<b>Suspension of disbursements</b>	<p>When arrears reach 45 days, the country's authorities are informed that if payment is not received on all overdues disbursements will be suspended on all loans to or guaranteed by the country on a specific date within 15 days. Suspension is thus effected when the longest overdue payment reaches 60 days. This information is sent by telex in a standardized format, with a copy to the Executive Director for the country concerned.</p>	<p>The AsDB has set no criteria that would serve as a basis to suspend disbursements. The only relevant condition of its Loan Regulations is the Borrower's continuing failure to pay its overdue payments. Whether a particular arrear would fit this requirement is decided on a case to case basis. The AsDB would inform the Borrower by telex followed by a formal letter stating the reason for the suspension.</p>
<b>Notification and disclosure</b>	<p>At the time of a suspension the Executive Directors and senior management are sent a formal notice to that effect. As noted above, cofinanciers are also informed.</p>	<p>The Board of Directors, management and staff, executing agencies, and cofinanciers (where the Bank is contractually obliged) would be informed.</p>

Annex 2.1 (continued)

AfDB	IDB	EBRD
<p>Under current policy, disbursements are suspended on loans when arrears pass 60 days. This suspension is applied on all loans to the <b>guarantor</b> 15 days later if payments are not received (i.e. at 75 days). Borrowers and executing agencies are informed by telex when suspension is imposed</p>	<p>The IDB suspends disbursements after 30 days on all loans to the <b>borrower</b> and simultaneously sends a notice to the guarantor requesting prompt payment of the amounts in arrears. Disbursements may continue on sectoral loans cofinanced with the World Bank for up to 75 days after arrears to the IDB are incurred. If payments are not received, specific analytical and planning actions for dealing with the problem are required of staff and management at 60 and 90 days. When arrears reach 120 days, disbursements to the <b>guarantor</b> on all loans to the guarantor are also suspended. Further, if required by the specific loan contract, disbursements may also be suspended on loans to other borrowers not in arrears but with the same guarantor when the guarantor is in arrears for more than 120 days.</p>	<p>Same as IBRD</p>
<p>Information on sanctions is announced inside the Bank by memorandum to management, Board members, the concerned Heads of Departments in the Projects and Country Programs Department, the Legal Department and the concerned Regional Offices.</p>	<p>Copies of suspension notices and guarantor notification are sent to the Executive Vice President (EVP), and to the Operations and Legal Departments, and the Executive Director of the country concerned.</p>	<p>Same as IBRD</p>

Annex 2.1 (continued)

	<b>IBRD</b>	<b>AsDB</b>
<b>Exceptions</b>	<p>The Regional Vice President for the country concerned may temporarily defer issuing disbursement suspension warning notices when: (1) payments are owed in currencies not readily available in international financial markets on the due date; (2) the amount overdue does not exceed \$50,000; (3) payments are being processed; or (4) the Bank decides that queries on the billing statement need investigation.</p>	<p>The AsDB has no policy in this respect.</p>
<b>Exemptions</b>	<p>Items normally exempt from suspension include special commitments (including Guaranteed Letters of Credit); payments for goods shipped and services rendered before suspension; technical/consultant services or training/fellowships where interruption would cause personal hardship or disrupt critical work; interest and other charges payable to the Bank out of loan proceeds; and advances for Project Preparation Facilities.</p>	<p>The AsDB has no policy in this respect.</p>

**Annex 2.1** (continued)

<b>AfDB</b>	<b>IDB</b>	<b>EBRD</b>
<p>Sanctions are not applied if arrears total less than 25,000 Bank or Fund Units of Account as the case may be. Further, as long as a specific borrower remains current in its debt service sanctions are not imposed, the extension of general sanctions to the guarantor notwithstanding.</p>	<p>Exceptions to a decision to suspend disbursements may be granted when: (1) payments are owed in currencies not readily available in international finance markets on the due date; (2) the overdue amount does not exceed \$50,000; (3) payments are being processed; or (4) the Bank decides that queries on the billing statement need investigation</p>	<p>No Policy</p>
<p>Exceptions to these sanctions include multinational projects, training fees and fellowships; payments for goods shipped and services rendered before suspension; payments for technical assistance services financed from resources of the AfDF which are allocated to the Technical Assistance Fund, especially if they relate to pre-investment studies and institutional strengthening; and expenditure which is reimbursable to AfDB or AfDF from bilateral resources.</p>	<p>Outstanding reimbursement guarantees under letters of credit are exempted from suspension. However, there could be no additional letters of credit, no increase in amounts of outstanding LCs, no extension in dates of outstanding reimbursement of LCs, and no approval of new obligations to pay fixed amounts to suppliers. Other exemptions include specific obligations to pay fixed amounts to suppliers pursuant to written Bank undertakings; payment for services rendered and goods shipped before suspension; consultant services or training/fellowships where interruption would disrupt critical work; and non-reimbursable and contingent recovery technical cooperation along with small projects and direct credits to the Bank from loan proceeds.</p>	<p>Same as IBRD</p>

Annex 2.1 (continued)

	IBRD	AsDB
<b>Other sanctions</b>	<p>The IBRD does not present new operations for approval by the Executive Board if arrears on any loan are expected to reach 60 days or more overdue on the date scheduled for Board consideration. The dialogue with country authorities continues, however, as do other operational activities including project preparations. The Bank's procedures provide that if disbursements have been suspended for a continuous period of 30 days or more, the Bank may cancel either the entire loan balance or (in the case of project-related defaults) that part of the balance which was subject to suspension.</p>	<p>The AsDB has no policy in this respect.</p>

Annex 2.1 (continued)

AfDB	IDB	EBRD
<p>Under current policy loan <b>approval</b> (as opposed to signature) is suspended after arrears pass 30 days. No new loans to the <b>guarantor</b> may be approved starting 15 days after suspension of disbursements to a <b>borrower</b> (i.e.) after arrears to a borrower reach 45 days). Generally, AfDB/AfDF will not participate in financing cost overruns under projects or programs which would result from the application of sanctions due to arrears. However, in exceptional cases the Boards of Directors may authorize such financing on the recommendation of management in the interest of efficiency in specific operations.</p>	<p>The IDB does not sign contracts or present new operations for approval by the Executive Board if arrears on any loan have reached 30 days or more overdue on the date scheduled for Board consideration. When arrears pass 120 days loan proposals are no longer submitted to the Loan Committee or the Committee of Whole of the Board of Executive Directors. After arrears pass 180 days and all loans to the country concerned are placed in non-accrual status, all missions related to loan programming and processing are suspended and may be resumed only when it has been determined that arrears will be cleared in the near future. The Bank's loan contracts provide that if payments have been in arrears for more than 60 days, the Bank may terminate the contract with respect to amounts not yet disbursed and/or declare the loan due and payable.</p>	<p>Same as IBRD</p>

**Annex 2.1** (continued)

	<b>IBRD</b>	<b>AsDB</b>
<b>Resumption of disbursements</b>	All arrears of principal, interest and other charges must be cleared before disbursements are resumed.	All arrears of principal, interest and other charges must be cleared before disbursements are resumed.
<i>IV. Accounting Practices</i>		
<b>Timing of non-accrual status</b>	Non-accrual status is invoked on the first working day after a second consecutive due date is missed for any payment of principal, interest or other charges on any loan (or IDA credit). As noted above, this is about six months after the first payment is missed.	It is the Bank's policy that an ordinary capital loan past due on interest and principal by six months would be placed under non-accrual status. (The Bank has not yet encountered the need to place any loan on non-accrual status).
<b>Coverage</b>	Non-accrual status applies to all loans to or guaranteed by the country concerned.	Non-accrual status would apply to all loans to or guaranteed by the country concerned.
<b>Reversal out of income</b>	Income which has been accrued but not received is reversed out of current income when non-accrual status is invoked and thereafter income is not recognized unless actually received.	The Bank would reverse out of current income interest accrued but not yet received when non-accrual status is invoked and thereafter would not recognize income unless actually received.

**Annex 2.1** (continued)

<b>AfDB</b>	<b>IDB</b>	<b>EBRD</b>
<p>All arrears of principal, interest and other charges must be cleared before disbursements are resumed.</p>	<p>All arrears of principal, interest and other charges must be cleared before disbursements are resumed.</p>	<p>Same as other MDBs</p>
<p>Loans to borrower are placed in non-accrual status on the first working day after reaching 6 months overdue.</p>	<p>Non-accrual policy goes into effect when arrears from any borrower pass 180 days.</p>	<p>Same as IBRD</p>
<p>Non-accrual status applies to all loans to or guaranteed by the country concerned.</p>	<p>Non-accrual status applies to all loans to or guaranteed by the country concerned.</p>	<p>Same as other MDBs</p>
<p>Income which has been accrued but not received is reversed out of current income when non-accrual status is invoked and thereafter income is not recognized unless actually received.</p>	<p>Income which has been accrued but not received is reversed out of current income when non-accrual status is invoked and thereafter income is not recognized unless actually received.</p>	<p>Same as other MDBs</p>

	IBRD	AsDB
<b>Disclosure</b>	The notes to Financial Statements contain summary information for each country in non-accrual status including the name of the country, the date of non-accrual, principal outstanding, total arrears, and the effect of non-accrual policy on income during the reporting period.	Should the need arise, the Bank intends to disclose in the Notes to Financial Statements: (1) a summary of its non-accrual policy; (2) the details of the loans in non-accrual status (borrower's name, date loan placed in non-accrual, total loans outstanding, and the amount by which net income is reduced).
<b>Restoration of accrual status</b>	Accrual status is restored when all arrears of principal, interest and other charges are cleared.	Accrual status would be restored when all arrears of principal, interest and other charges are cleared.
<i>V. Loan Loss Provisioning</i>		
<b>Timing of provisioning</b>	Provisioning starts on the same day that a country is placed in non-accrual status.	The AsDB has no policy in this respect.
<b>Coverage</b>	Provisioning applies to IBRD only. Provisions for losses are not established under IDA policies.	The AsDB has no policy in this respect.

**Annex 2.1** (continued)

<b>AfDB</b>	<b>IDB</b>	<b>EBRD</b>
<p>Information on the aggregate amount of non-accrued income is disclosed in the notes to the Financial Statements, both quarterly (unaudited) for Internal use and the annual (audited) published accounts. Names of individual countries involved are not disclosed.</p>	<p>Notes to Financial Statements include the same information as that published by IBRD for countries in non-accrual status. The accumulated provisions are shown in the Balance Sheet as a deduction from loans receivable and each year's provision is shown as a deduction from income.</p>	<p>Same as IBRD</p>
<p>Accrual status is restored when all arrears of principal, interest and other charges are cleared.</p>	<p>Accrual status is restored when all arrears of principal, interest and other charges are cleared.</p>	<p>Same as other MDBs</p>
<p>When loans are 6 months overdue, Management makes an initial determination, on a quarterly basis, on the provisions that should be made.</p>	<p>Provisions are charged to income beginning the month following that in which the country is placed in non-accrual status.</p>	<p>Same as IBRD</p>
<p>Provisioning applies to ordinary capital, the AfDF and the NTF.</p>	<p>Provisioning currently applies to ordinary capital, the Social Progress Trust Fund, and the Venezuelan Trust Fund.</p>	<p>Provisioning applies only to EBRD loans/investments</p>

**Annex 2.1** (continued)

	<b>IBRD</b>	<b>AsDB</b>
<b>Disclosure</b>	Provisions are charged against current income and are shown in the balance sheet of published Financial Statements. Notes to the Financial Statement disclose the level of provisions for the current and previous reporting periods.	The ADB has no policy in this respect.
<b>Cross-effectiveness</b>	When either the Bank or IDA suspends disbursements, disbursements are automatically suspended by the other institution. Consideration of new operations of IFC and MIGA in the country concerned is decided on a case-by-case basis.	The AsDB has no policy in this respect.

Annex 2.1 (continued)

AfDB	IDB	EBRD
<p>Provisions are charged against current income and are recorded in the balance sheet of published Financial Statements. Notes to the Financial Statements disclose the level of provisions for the current and previous reporting periods.</p>	<p>Provisions are charged against current income and are shown in the balance sheet of published Financial Statements. Notes to the Financial Statements disclose the level of provisions for the current and previous reporting periods.</p>	<p>Same as other MDBs</p>
<p>Sanctions imposed under these policies become cross-effective for AfDB/AfDF and the Nigeria Trust Fund (NTF) with respect to an individual <b>borrower</b> at the same time under current policy. As with other elements of these sanctions, cross-effectiveness applies only to loans to specific borrowers in arrears and to the guarantor, but not to other borrowers domiciled in the territory of the guarantor which remain current in debt service to AfDB/AfDF/NTF.</p>	<p>When disbursements are suspended on loans to a borrower, sanctions are imposed on all loans regardless of the source of financing. The suspension does not, however, extend to the operations of the Inter-American Investment Corporation.</p>	<p>Not Applicable.</p>

## Annex 2.2 IBRD Procedures for Dealing with Arrears – Timetable

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<b>Days After Payment(s) Due but not Received</b>	<b>Action</b>
<b>2</b>	Country Department concerned initiates action to obtain payment. Key Bank officers and member's ED notified.
<b>30</b>	Executive Board notified through semi-monthly report on Overdue Service Payments, subject to thresholds of \$1 million overdue to IBRD, \$20,000 to IDA.
<b>60/30</b> for borrower <b>45</b> for guarantor	Formal notice sent to borrower indicating that disbursements will be suspended in 15 days if payment not received. CFSVP and cofinanciers also informed at least one week prior to pending suspension.
<b>75/45</b> days warning <b>60</b> days suspension	Disbursements suspended; Executive Board notified.
<b>90</b>	Amounts of principal and interest overdue for 90 days or more included in all published statements.
<b>180</b>	Specifically, second missed semi-annual payment date for any loan or credit: country placed in non-accrual status; loan loss provisioning initiated.  If a member fails to fulfill its obligations to the Bank, the Bank may suspend its membership and upon cessation of membership (one year from the date of suspension) procedures for settlement of account apply.

## Annex 2.3 EBRD Operational Exposure Limits

CATEGORY	SOVEREIGN RISK OPERATIONAL LIMITS	PRIVATE AND NON-SOVEREIGN RISK ENTERPRISE OPERATIONAL LIMITS
<b>Country Risk</b>	Individually set with a maximum 90% of paid-in capital (currently ECU 2,700 million)	
<b>Country Economic Risk Indicators</b>	<p>A) Annual preferred creditor debt service must be less than 20% of annual foreign currency earnings</p> <p>B) Annual EBRD debt service must be less than 5% of annual foreign currency earnings</p>	
<b>Industry Sector</b>	N/A	Maximum 20% of portfolio (from 1 January 1995)
<b>Single Obligor</b>	Country limit applies	<p>Maximum 5% of paid-in-capital to any one private or non-sovereign risk enterprise obligor (currently ECU 150 million)</p> <p>Maximum 3% of paid-in-capital in any one equity investment (currently ECU 90 million)</p>
<b>Single Project</b>	Maximum 10% of paid-in-capital (currently ECU 300 million)	Maximum 35% of long-term capital required by the project or of project cost; this guideline may be exceeded on an exception basis for smaller projects (e.g. up to about ECU 15 million) and infrastructure projects not guaranteed by a member country (e.g. BOT projects)

*Note:*

These limits must take into account the project being proposed and any other projects or changes to limits which are being considered at the same time. These limits apply to the amounts at risk by the Bank after syndication, participations or other forms of external financing.

**Annex 2.4 Loan Portfolio Risk Profiles of MDBs as of End FY 1991**  
(Per cent)

	AsDB	IBRD	IADB	AfDB	EBRD
1. Share in the Portfolio of Countries whose Securities are Rated Below Investment Grade	42	72	88	100	100
2. Share in the Portfolio of Rescheduling Countries	18	45	70	65	62
3. Share in the Portfolio of Loans in Non-Accrual Status	0	3	2	12	0