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).[1] 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

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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. 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, 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.[2] 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.

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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	12.28	2.40	0.95	0.20	0.05
Net LT Borrowings	0.40	1.54	0.77	0.67	1.47
Net ST Borrowings	-1.60	–	–	–	–
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.[3] 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*[4] 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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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[5] 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.[6] 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

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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.[7] The short-term (ST) borrowing pro-

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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.[8] The Article which

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 →

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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[9] 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*

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.

9 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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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.[10] 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.[11] 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

---

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

marginally higher than those for the IBRD[12] 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.[13] 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

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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.[14]

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

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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 oustanding 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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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.[15] 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

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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 liqudity 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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

billion equivalent had actually been available as of 31 December 1993[16] 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

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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 paticularly effective or useful, Operations Evaluation departments in the MDBs to monitor and evaluate these operations/decisions regularly. They have even occasionally insisted on

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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[17] 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

17 Mason, E. & Asher, R., "The World Bank since Bretton Woods", The Brookings Institution, Washington DC, 1973, pp. 132.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

acceptable to the rating agencies.[18] 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)

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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[19] 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 witholding 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

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

financial management by holding out the threat of exercising the ultimate sanction: i.e. witholding 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.[20] 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:

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

- 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 borrwer, 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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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*;[21] 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.[22] 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.

---

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

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[23] 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

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

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org

a *local currency* private placement as well as a partial guarantee for a *local currency* public debt issue.[24]

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.

From: Multilateral Development Banks: An Assessment of their Financial Structures, Policies and Practices, FONDAD, The Hague, 1995, www.fondad.org