5 Financial Resource Management Policies

Introduction

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

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

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

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

The Liquidity and Investment Policies of the MDBs

Why is Liquidity Necessary?

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

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

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

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

How Much Liquidity?

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

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

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

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

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

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

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

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

> "Liquidity plays a key role in managing and controlling funding risk. There are two fundamental aspects of funding risk: (i) the risk of not having sufficient funds to cover net cash flow obligations resulting from an excess of debt retirement over loan repayments; and (ii) the risk of not having sufficient funds to cover the Bank's contractual obligations determined by undisbursed loan commitments. The level of liquidity should be an outcome of borrowing decisions based on prudent management of these risks. The liquidity policy should also provide flexibility to smooth undesirable variations in annual borrowings and to adjust borrowing to take advantage of market opportunities.
>
> The primary objective of holding liquidity is to provide protection against voluntary or involuntary interruptions in cash flow, especially against possible borrowing shortfalls. There are five principal components of the Bank's cash flow: on the *sources* side (i) cash from operations; (ii) repayment of loans; (iii) new borrowings; and on the *applications* side, (iv) disbursements; and (v) debt retirement. Borrowings are the single largest component of cash flow and differ from other large components in that they are not contractual. Disbursements, debt retirement, and loan repayments are contractual, and to the extent the Bank chooses not to fund all of its contractual obligations at the time they are made, there is a funding gap (i.e. the difference between committed cash outflows and contractually committed inflows). The concept of "net cash requirements" which underlies the (World Bank's) current liquidity policy takes into account the net contractual obligations by year, but also the other elements of cash inflow and outflow such as cash from operations (net income) and additions to usable capital, and projected cash outflow from future contractual commitments."

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Revisiting Liquidity Requirements

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

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

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

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

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

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

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

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

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

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

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

Current Liquidity Levels of the MDBs

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

Allowable Investments & Investment Authority

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

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

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

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

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

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

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

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

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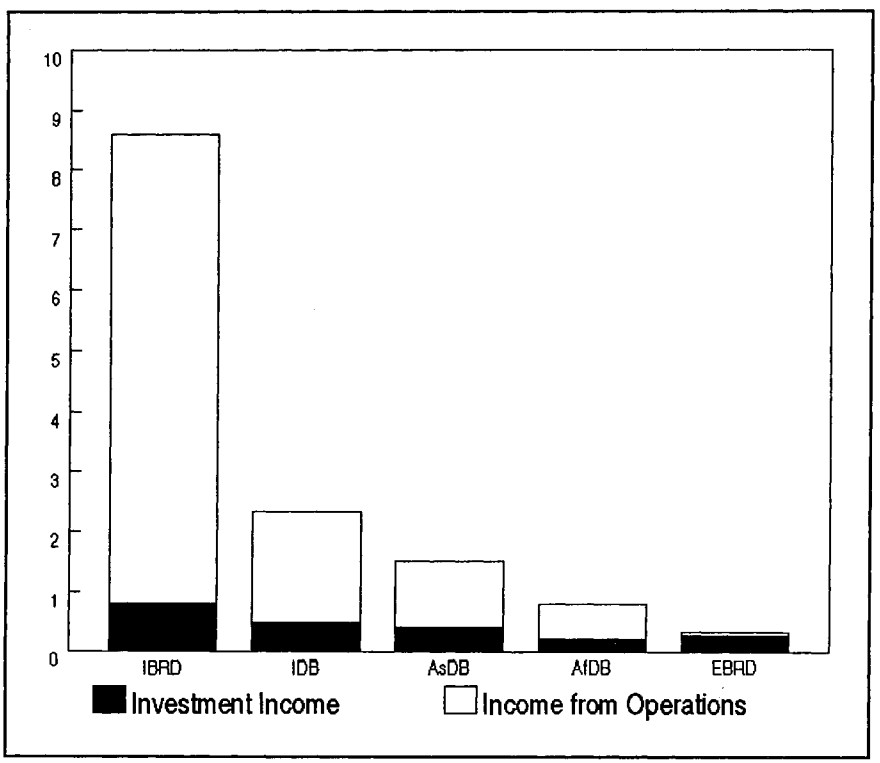
and the characteristics which MDB liquidity must have. By and large the range of instruments in which MDBs can invest has expanded to permit greater diversification and improved risk management. That change has been accompanied by a commensurate change in the roles of Executive Boards which have moved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

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

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



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

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

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

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

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

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

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

Currency Management Policies of the MDBs

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

From the Past to the Future

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

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

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

The Particular Problem of the AfDB with Currency Risk

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

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

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

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

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

Policies on Lending Rates, Terms and other Loan Charges

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

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

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

MDB Interest Charges

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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Commitment Fees

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

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

Front-end and other Special Fees

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

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

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

Loan Repayment Terms

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

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

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

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

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

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

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

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

Net Income Management Policies

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

The Importance of Key Ratios

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

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

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

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

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

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

Meeting the Reserves to Loan Ratio (RLR) Test

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

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

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

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

As the AfDB's management itself acknowledges,[24] the present situation:

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

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

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

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

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

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

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

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Asian borrowers in handling their debt-servicing difficulties. During the1980s, when the debt crisis was at its peak, Asian borrowers avoided any possibility of defaulting, even temporarily, on their payment obligations to preferred creditors, leave alone entering into protracted arrears or requiring non-accruals of income or provisions to be made.

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

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

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

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

Meeting the Interest Coverage Ratio (ICR) Test

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

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

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

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

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

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

MDB Policies for the Allocation of Net Income

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

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

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

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

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

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

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

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

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

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

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

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

Policies on Reserves and Provisions

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

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

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

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

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

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

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

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

Loan-Loss Provisions

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

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

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

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

Special Reserves

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

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

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

Ordinary or General Reserves

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

For footnote 31, see next page.

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

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

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