Percy S. Mistry

Multilateral Development Banks

An Assessment of their

Financial Structures, Policies and Practices

FONDAD
The Hague

The Author

Percy S. Mistry is presently Chairman of Oxford International Associates, and serves on the Boards of several corporations in the developed and developing worlds, including corporations such as Oxford International Finance, Synergy Power Corporation, and the Industrial Credit and Investment Corporation of India. He was formerly Chief-of-Staff in the Finance Complex of the World Bank. He has been an Advisor on matters of debt, macroeconomic management and structural adjustment to several governments in Africa, Asia, and Europe, as well as a Consultant for a variety of multilateral organisations. He is a member of the Advisory Committee of FONDAD.

Forum on Debt and Development (FONDAD)

FONDAD is an independent policy research centre established in the Netherlands to provide policy-oriented research on North-South problems, primarily international financial issues. Through its international network of experts and its contacts in the worlds of finance, policy research, politics, and the media, FONDAD aims to provide factual background information and practical strategies to policymakers, and other interested groups in industrial as well as developing countries.

Director: Jan Joost Teunissen

CIP-DATA KONINKLIKE BIBLIOTHEEK, DEN HAAG

Mistry, Percy S.

Multilateral development banks : an assessment of their
financial structures, policies and practices / Percy S.
Mistry - The Hague : FONDAD. - Ill.
With ref.
ISBN 90-74208-05-3
Subject heading: development policy ; multilateral
development banks / financial management ; multilateral
development banks.

Additional copies may be ordered from FONDAD at
Noordeinde 107 A, 2514 GE The Hague, the Netherlands
Tel: 31-70-3653820 Fax: 31-70-3463939

To

Banoo & Pauline

(Without whom nothing would have been possible)

Contents

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

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

Text Tables

Figures

Annexes

Abbreviations

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

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

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

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

Glossary of Terms

Allocation Criteria: These determine the amount of MDF resources that a particular country should get in a given year or over an MDF replenishment cycle.

Arbitrage: To take advantage of differences in the price/cost of the same type of security or commodity or credit risk that may be reflected on different markets at the same time. As used in this book the term generally implies the inclination of MDBs to take advantage of their ability to borrow at very low costs and to re-invest those funds in money/capital markets at a higher yield while still maintaining an acceptable risk profile.

Arrears: Amounts due by way of interest and principal payments on MDB loans, which have not been paid by borrowers on time.

Articles of Agreement: These are the basic "constitutional charters" of the MDBs and MDFs. They specify their purposes, how they are to be financed and how they are to be managed.

B-Loan: A conjoined facility offered by the IBRD between 1983-88 in conjunction with a regular IBRD loan to facilitate co-financing by the private sector through direct funding or partial guarantees.

Basis Point (bp): One basis point is equal to one-hundredth of one per cent i.e. it is 0.01%. Thus 35 bp = 0.35%.

Bilateral Assistance (or flows): Aid flows or capital transfers from governments to governments, usually from OECD and Arab-OPEC to developing country governments but, increasingly also from richer developing country governments to poorer ones.

Brady Bonds: The syndicated loans of commercial banks to indebted developing countries which have been restructured as bonds. These bonds can be either 'par bonds' (which have the same face value as the original loan but a long maturity period and an interest rate which is below the market rate at the time of conversion) or 'discount bonds' (which have the face value discounted by between 25-40% but which carry shorter maturities and market rates of interest). Such loan-to-bond restructuring is usually achieved through overall debt reduction negotiations under the framework of the Brady Initiative of 1989 - named after the US Treasury Secretary Nicholas Brady - which aimed to achieve sufficiently large reductions in the debt overhangs of indebted countries to permit their economies to recover.

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

Callable Capital: The portion of the share capital of MDBs which is *not* paid in but is provided in the form of a guarantee to pay should the need for such a payment materialise. Callable capital is also sometimes referred to as "guarantee capital".

Cofinancing: An operation which involves joint lending by an MDB and other financiers - official and/or private - for a project or programme.

Conditionality: A general term used to depict the conditions that MDBs or the IMF impose on borrowers as an essential part of their loan obligations. These conditions may concern changes borrowers must make in economic policies, sector policies, institutional changes, tariffs etc. which MDBs deem necessary for their loans to generate developmental returns.

Credit Rating: As used in this book, this term refers to the ratings given by the major international issuers of debt on capital markets. The highest rating is a 'triple A' (or AAA or Aaa) and the lowest is a 'D' rating which signifies that the issue is of speculative grade subject to a higher risk of capital loss.

Currency Pooling: A system whereby the MDBs place all the currencies they borrow into a single currency pool (or two separate pools, one for lending the other for investments) and average out the cost of the whole pool as a basis for pricing their loans. Thus though the composition of the pool changes with each new borrowing made or every old borrowing retired the cost of the pool changes relatively slowly and is much more robust and stable than the changes in the marginal cost of borrowing in any given currency or maturity.

Derivatives or Derivative instruments: This term usually refers to financial transactions which involve a 'derived transaction' around a core security. Such derived transactions may be in the form of *options* to buy or sell a particular security on or before a particular date at a particular price; *futures* which involve a commitment to buy or sell a particular commodity or security at some date in the future at a premium or discount to the current market price; *swaps*, which involve an agreement to exchange a stream of cash flows in one currency for a stream of cash flows in another currency at a pre-agreed exchange rate. Derivatives also include combinations of options and swaps (known as swaptions) for a particular transaction. For a detailed understanding of how derivatives work the reader is referred to specialised textbooks on these types of transactions.

Eligibility Criteria: Since MDF resources are scarce they are rationed out to the poorest countries with limited access to other types of resources. These countries must meet eligibility criteria usually based on their income levels and credit-worthiness.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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