8 Summary

The previous seven chapters have dealt with a host of issues raised by the financial structures, policies and practices of the multilateral development banks (MDBs) along with suggestions and recommendations for dealing with some of their consequences. At the risk of repetition, this final chapter pulls together major points, and several suggestions for change, which have been made in previous chapters in summary form for ease of reference. The order in which these are presented is the same order as the chapters.

The Role and Financial Intermediation Functions of the MDBs

From a period of relative stability between 1945-73, MDBs have in the last two decades had to respond to different and shifting demands from their clientele caused by the *oil shocks* of the 1970s, the *debt shock* of the 1980s, and the *transition shock* of the 1990s, resulting in the emergence of a large number of new claimants along with a shifting basis of demand for their products and services. Although these successive impulses have created a series of new demands on the MDBs, the recent emergence of private sources of capital as increasingly important financiers of a wide range of investments in *emerging markets* is now overshadowing the role that MDBs are likely to play in the 1990s and beyond. Consequently, the *financial* importance of MDBs might be expected to diminish in *relative* if not in *absolute* terms, as private markets penetrate terrain which was formerly the exclusive preserve of MDBs; e.g. infrastructure financing, and even the financing of education and health (e.g. private hospitals and universities).

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

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This focus apart, in their traditional areas of activity MDBs may need to consider a shift from financing governments and their agencies to financing investments undertaken directly by the private sector. This may become an important line of activity especially for catalysing investments involving the kind of risks and gestation periods which may require MDB participation to provide comfort to private market financiers. As *private* international capital market conditions and propensities change so should the functions and resource transfers of *public* institutions which were designed initially to overcome the shortcomings of imperfect capital markets. Not unexpectedly, however, the environment has changed far more rapidly than the MDBs have adapted. As specialised intermediaries with a critical *financial intermediation function* to perform (which is ultimately their only raison d'être) MDBs need to be assessed on their performance in affecting real resource flows and net monetary transfers between developed and developing countries.

Against total MDB commitments of nearly US$40 billion in 1993/94 (with US$21 billion from the World Bank in FY94) *gross* resource transfers in 1993 were estimated at US$15 billion. But *net* transfers were much lower. The IBRD has recorded *negative net transfers* since 1987. In other words, after taking interest payments into account, it has been *extracting* real resources from its borrowers. These negative transfers have escalated from about -US$1.5 billion in 1987 to over -US$8.5 billion in 1993/94. Between 1987-91, the three regional MDBs for Africa, Asia and Latin America managed to maintain positive net transfers to their borrowers averaging US$1 billion annually. But these were not sufficient to offset negative transfers from the IBRD, resulting in the multilateral banks as a whole achieving a *negative* net transfer averaging -US$2.27 billion annually over that period. Overall net transfers from their soft windows (including IDA) over the same period averaged US$5 billion annually resulting in total combined net transfers (from the hard and soft windows) averaging a positive but desultory US$2.73 billion in that 5-year period. In 1992 and 1993, however, dragged down by the very large negative net transfers on the IBRD's accounts, the MDB system as a whole (including the soft-windows) recorded a negative net transfer of -US$0.43 billion and -US$2.28 billion respectively despite the fact that the other MDBs (and IDA) recorded positive net transfers of nearly US$7.3 billion and US$6.3 billion respectively.

When it comes to effecting net transfers of financial resources, the unfortunate reality is that once hard-loan portfolios reach a size where annual principal and interest repayments to MDBs by their developing country borrowers become structurally very large, the hard-windows of MDBs become inefficient and inflexible devices as *financial* intermediaries. *Interest payments* by developing countries to MDBs (on both hard and soft window

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accounts) have increased from $0.3 billion in 1970 to over US$13 billion in 1993. That *annual* level will increase to US$16 billion between 1994-97 and, on present trajectories of lending, to US$20 billion towards the end of this century. Annual *principal repayments* to MDBs reached US$17 billion in 1993 and will escalate to over US$25 billion by the end of the century. To maintain ***zero*** net transfers therefore, the MDBs as a system will need to increase gross disbursements from US$28 billion in 1992 to over US$45 billion by the end of the century. If they focus on slow-disbursing project lending (which experience suggests remains their real *forte*) this would require them to commit between US$100-120 billion annually by the year 1999. Against the need to increase gross disbursements by US$17 billion between 1994-99, the MDBs as a whole increased gross disbursements by only US$3.5 billion between 1987-92. If that track record is not improved substantially, the MDBs are likely to become much less significant as resource transfer agents to the developing world. Since, in the final analysis, it is the financial dimension that governs relationships between MDBs and their borrowing countries, the influence of MDBs as a whole – even as agents of development and purveyors of policy prescriptions – is bound to diminish except in those countries which are dependent on borrowing from MDB soft-windows.

Capital Structure of the MDBs

The conceptual architecture common to the equity (i.e. ownership) capital construction of all the MDBs was established with the formation of the IBRD – i.e. the core of the World Bank. Its initial authorised capitalisation of US$10 billion (of which US$9.1 billion was subscribed) consisted of: (a) 20% *paid-in capital* [2% of which was to be provided in convertible form i.e. in gold or US dollars, and 18% was to be paid in the domestic currencies of member countries] and (b) 80% in the form of *callable* or *guarantee* capital. The Bank's Articles of Agreements required it to limit its outstanding loans to the total amount of its subscribed capital (i.e. both paid-in and callable) i.e. a 1:1 loans to capital ratio. By the time the IDB was established in 1959 this capital structure had proven its durability and has been replicated in every MDB that has been set up since. All the MDBs therefore have their financial edifices constructed on the notion of *callable capital*. This feature assures the creditors of these institutions that each dollar lent is fully backed by a dollar of shareholders' equity, given the 1:1 limitation on the loan assets to capital ratio. Allowing for the cash equity and *reserves* components of MDB liabilities, that assurance enables the borrowings undertaken by the MDBs to be fully covered by total net worth. However, only a small fraction of the *equity dollar* in MDBs is paid up-front in cash. The bulk is subscribed in the form of a guarantee provided by shareholder governments which could be

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called in the event that repayments from MDB borrowers' and available liquidity are insufficient to cover the MDB's own obligations to its creditors.

MDB managements and their shareholders have over the years emphasised building up large reserves through *internally generated* capital resources to minimise any risk that callable capital might actually be called. Until the mid-1980s, confidence in the financial strength and backing of the MDBs was rarely questioned in global capital markets. But, since the developing country debt crisis of the 1980s, their financial standing and performance has come under increasing scrutiny. Yet, despite a discernible deterioration in the intrinsic quality of their portfolios during the 1980s, all the MDBs have managed to maintain the highest ratings for their debt issues in international capital markets, enabling them to borrow at extremely fine spreads. These credit ratings appear now to rely less on the financial performance and standing of the MDBs themselves and much more on the *callable capital* guarantee.

The *quality* of the capital provided by all member governments in the form of domestic currency payments and in callable form is not uniform or equal. The callable capital of a severely-indebted, low-income country cannot be given the same weight as the callable capital of an OECD country or of a newly industrialised country. Hence the notion of *usable capital* is the more relevant dimension against which comfortable levels of borrowing and lending must be gauged. Prudence dictates that MDB borrowing and lending should be more appropriately measured against limits of *readily usable capital* and that capital increases should be negotiated and concluded before borrowings or outstanding loans approached the limits of such usable capital.

The capital base of the MDB hard-windows has, since their inception, been increased several times (except in the EBRD which is a new Bank) through both *general* and *selective* (or special) capital increases. The purpose of a *general capital increase* (GCI) is to increase the share capital of the Bank concerned when it approaches the limits of its present capital base in expanding its lending capacity further. Under a GCI such an increase in capital is spread proportionately among existing shareholders on a *pari passu* basis i.e. relative to their extant weight in share ownership. *Selective capital increases* (SCIs) on the other hand are not intended primarily to provide additional capital for an MDB. Instead, they are aimed principally at adjusting the relative weight and voting power of one or a few members in the shareholding structure of a particular MDB.

The **IBRD** has had six GCIs and several SCIs which have increased its authorised share capital from US$10 billion in 1947 to US$184 billion in 1993/94. Subscribed capital has increased from US$9.1 billion to US$170 billion over the same period. As a general rule, the allocation of IBRD shares among its now 178 members is based on the principle that their relative shareholdings in the IBRD should, by-and-large, reflect their relative positions in the world economy. But there are no completely objective set of criteria or measurements which can translate a *theoretical* concept of "relative standing in the world economy" in concrete, mathematical terms that everyone can readily accept. In its *practical* application this principle of relative standing has therefore been translated to imply that members' shareholding in the IBRD should be *parallel* to their relative quotas in the IMF. The other justification for this *principle of parallelism* to the IMF, of course, is that countries cannot become of the World Bank unless they are already members of the Fund. Despite attempts by ad hoc committees of the IBRD's Executive Directors to establish a clear set of common criteria for the allocation of shares in the IBRD, no such criteria have as yet been established and no consensus has been reached on deriving or applying them. In the *regional banks*, similar complications and contentions apply in determining the share allocations of individual members. In these cases, the basis for allocation is more the weight of member countries in the regional (rather than the global) economy and further complications apply when the relative weights and share allocations of *non-regional* members has to be negotiated.

The capital of the **AfDB** has been increased through four GCIs and eight special increases from the US$215 million which was subscribed initially in 1965 to US$22.25 billion at the end of 1993 although it has a problem of chronic arrears in capital subscriptions. As of March 1994, over 93,000 allocated shares amounting to US$1.3 billion in capital remained unsubscribed. The rapidly deteriorating creditworthiness of most African borrowers has resulted in AfDB's last capital increase (GCI-4) being stretched out to meet AfDB's capital needs upto 1996. With annual lending now approaching its sustainable limit under the present capital base, and with the prospective entry of a major new borrower – South Africa – in its membership, the management has just initiated discussions on GCI-5. By May 1994, the **AsDB,** originally capitalised at US$1 billion at its formation in 1966, had raised its authorised capital base to around US$48 billion providing sufficient capital for that institution to expand lending into the next century. Also starting with an initial capital base of US$1 billion in its Ordinary Capital Resources (OCR) when it was established in 1959, the **IDB** has had eight General Increases in Resources (GIRs) increasing its OCR capital base to over US$101 billion with over 90% of the existing capital base of the IDB having been contributed in just the last 15 years. The **EBRD,** which was established in record time in mid-1990 and began operations in 1991 has an initial capital base of ECU 10 billion (over US$11.5 billion) with a paid-in capital requirement of 30% making it the most budgetarily expensive of the MDBs for member governments to have financed in recent times. By comparison, the paid-in capital requirements for the last GCI's of all the other MDBs together amounted to only US$3.7 billion.

The capital structures of the MDBs and their substantial expansion especially in the last two decades, raise three particular issues which are worth exploring. These concern: (i) the consequences of diminishing amounts of paid-in capital in successive GCIs; (ii) the valuation of MDB share capital and (iii) the need to maintain the value of such capital in terms of an acceptable *numeraire*. To begin with, the *proportion of paid-in capital* which member governments are willing to provide successive GCIs has been diminishing relentlessly. On the other hand, the strong financial performance of the MDBs (except the AfDB and, for the time being, the EBRD) has resulted in a steady accretion of retained earnings and reserves on their balance sheets. Because MDBs do not pay out any dividends to their shareholders, these retained earnings/reserves are, in effect, almost perfect substitutes for paid-in capital. Smaller paid-in capital contributions, especially when only a part of them have to be paid in convertible form by the borrowing member countries, reduce the budgetary and foreign exchange burdens on the *poorer* members in subscribing to their shares. For these reasons, it is possible to envisage future GCIs (especially for the World Bank, AsDB and IDB) which involve *no* paid-in capital.

There is one possibility which might be considered in modifying the financial architecture of the MDBs to address future needs. That prospect concerns the *automatic* attachment of a callable capital component to the retained earnings of MDBs. Such a measure would do away with protracted and contentious negotiations every five years or so for the GCIs of individual MDBs. An automatic increase in callable capital, which increases total capital each year by a multiple of retained earnings accumulated in that year, might also have the salutary effect of imposing discipline on both MDB *borrowers* as well as MDB *managements*. Seen from the viewpoint of shareholders, and especially the *donor shareholders*, the major *dis*advantage of introducing *automacity* in increasing the capital base of MDBs would be the *perceived* diminution of political power and control over these institutions. Therefore, such a proposal – if it is ever considered – is bound to raise profound objections. Nonetheless, as what is politically impossible today often becomes political reality tomorrow, this suggestion needs to be reconsidered when the time is ripe for its adoption and implementation. Indeed, it is the logical consequence of a trend which can only culminate in a regime of zero paid-in capital for the GCIs of MDBs in the not too distant future.

In valuing MDB share capital, a *standard-of-value (SOV)* is a central feature in the Articles of all the MDBs. It is the unit which determines both the price of the MDBs' shares and the mutual rights and obligations of the MDB to and among its members with respect to their relative shareholdings. Except for the EBRD, which has valued its share capital in ECUs, the Articles of the

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other MDBs all establish their capital stock and the par value of their shares in terms of US dollars of the weight and fineness of gold in effect on a date close to that on which the Articles of the MDB concerned were agreed. With the Second Amendment of the Articles of the IMF there was no longer any basis for translating *gold* dollars into *current* US dollars. As a matter of practical expediency, the AfDB and AsDB have decided temporarily to value its capital in terms of the *current* SDR. But the IBRD and the IDB have opted to value their share capital temporarily at the US dollar value of the *1974* SDR. Effectively, this means that the IBRD and IDB have agreed to fix *for now* the value of their shares in terms of *US dollars* while the AfDB and AsDB have done so in terms of *SDRs*. These interim arrangements do not provide a definitive basis for determining members' obligations with respect to *callable* capital. This too has been indefinitely deferred, but with no practical consequence because of the extremely unlikely eventuality that a call might actually materialise in the interim. Till the SOV issue is resolved definitively, the capital of the MDBs (and therefore the structure of their balance sheets) remains vulnerable to exchange rate fluctuations. In particular, any major appreciation of the SDR vis-à-vis the US dollar would affect the *lending* headroom which the IBRD and IDB might have because of the effective resultant shrinkage of their capital base.

Vulnerability to exchange rate fluctuations on the value of capital because of the expedient choice of a transient SOV also leaves MDBs exposed to risk on inadvertently and suddenly breaching their *borrowing* limits. If the outstanding borrowings of MDBs have a different currency composition to capital, and exchange rate movements affect them in the opposite direction to the way in which they affect the capital base, then the MDB could be exposed to a technical default on its undertakings for bond issues. It is therefore essential that the SOV issue is resolved in favour of adopting the *current* SDR as the successor SOV to the gold dollar in all the MDBs. The inability of the US to agree with all of the other members on resolving the SOV issue remains a serious stumbling block to resolution. The right solution would be for all the MDBs to adopt the same policy with respect to the *interim* SOV; with that policy favouring adoption of an interim SOV which all member countries except the US favour i.e. the *current* SDR.

Maintenance-of-Value Obligations (MOV): Logically connected to the concept of a SOV for the share capital of an MDB is the need for members to *maintain* the value of their payments for MDB shares in terms of the chosen SOV. This requires periodic payments to be made either from a member to the MDB, or *vice-versa*, an amount of that member's currency sufficient to maintain the value of its paid-in capital subscription against the applicable SOV. The MOV requirement applies to both the *convertible* and *domestic* *currency* portions of the paid-in amount in order to protect the value of the MDBs' capital over time from the depradations of currency devaluations. While the status of the SOV has remained unresolved MOV provisions have effectively been suspended. In theory the concept of MOV is understandable and generally unarguable. The operating rules and procedures required to translate that theory into practice have posed some difficult technical issues and choices for the MDBs, especially in determining the amounts and the appropriate periodicity of MOV settlements.

Resource Mobilisation Policies & Effectiveness

All the MDBs are now established borrowers in all the world's open or quasi-open capital markets, most of which they tap regularly. The debt instruments they issue (mainly long-term bonds) are well-regarded and carry the highest available credit ratings i.e. AAA. Despite their relatively unconstrained capacity to mobilise resources from international capital markets, the MDBs as a whole, and the World Bank in particular, have fallen short in fulfilling their resource transfer functions especially since 1989. With a much greater quantum and proportion of resources now flowing directly from established international capital markets to a much larger number of *emerging markets*, without the benefit of either direct or indirect MDB intermediation, some uncomfortable questions arise about whether the future resource mobilisation capacity of the MDBs will or should remain as strong (in both relative and absolute terms) as it has been in the past. Upto now, however, the unquestionable success that MDBs have enjoyed in mobilising loanable resources from capital markets is due in large measure to the astute manner in which they have undertaken their borrowing policies and programmes.

Apart from the national governments of the G-7 countries themselves, MDBs are among the largest issuers of long-term debt instruments in international capital markets. In those markets they constitute a special category of issuers i.e. the *supranationals*. In 1993 the five MDBs together borrowed US$21 billion from capital markets and repaid US$16 billion, resulting in *net* borrowings of US$5 billion. On their outstanding borrowings of US$144 billion, MDBs paid US$12 billion in interest payments and other charges. The two-way flow of financial transactions between MDBs and capital markets thus amounted to US$49 billion. The amount of their outstanding debt, however, was significantly lower than the amount of their subscribed capital base.

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

The ability of MDBs to pass on these costs entirely to borrowers has had two unfortunate effects. First, it has led MDBs to borrow and hold liquid investments substantially in excess of purely *operational* funding needs. There is now a strong bias within MDBs towards *overstating* their real liquidity needs because of the importance of MDB liquid investments as profit centres. Second, it may, in the past, have obscured many borrowing misjudgements which have rarely been identified or assessed independently in the same way that the lending decisions and judgements of MDBs have been scrutinised; even though such misjudgements might have required borrowing developing countries to pay a higher than necessary cost for their loans. Through techniques such as refinancings, prepayments and debt repurchases when market conditions improve (which results in refunding former high-cost issues with lower cost new issues) the MDBs can recover to some degree the excess costs incurred from too much premature high-cost borrowing when it was not strictly necessary.

Though different MDBs may articulate their borrowing policies in different ways these are, in essence, driven by the same considerations for all MDBs and have the same three basic broad objectives: (i) ensuring the availability, *without interruption*, of funds for development lending purposes; (ii) minimising borrowing costs, both for the MDB and (ostensibly) its borrowers; and (iii) assuring the predictability of such costs; or, in other words, controlling their volatility – in terms of both the frequency and the magnitude of changes in them. The MDBs employ, in some form or another, a *borrowing limit* which is usually lower than their lending limit. Whereas under their respective charters lending is limited to the value of subscribed capital, in most MDBs borrowings are limited to their usable capital.

No MDB is as experienced or as proficient at borrowing as the **IBRD**. This is mainly because no other MDB has borrowing needs which are as large or diverse. Usually the pattern has been for the IBRD to break new ground in its borrowing strategy and operations which the other MDBs then explore. It has deliberately sought to develop flexibility and range in its approach to frequent global borrowing in order to reduce its susceptibility to the inappropriate exertion of influence by one or two of its major shareholders who have attempted to misuse the leverage of *market access*. In all the Articles

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of the MDBs there is a provision which requires them to obtain the permission of members in whose markets or currencies they might borrow. That provision serves no useful purpose any longer. Short of amending the Articles of Agreement to delete it altogether, member countries which do not borrow from MDBs should reach agreement among themselves that they will no longer regard this particular Article as being in force to avoid any future prospect of MDBs being improperly restrained from access to either their domestic or international markets or to their currencies by one or two large shareholders with motives in mind which have little to do with the reasons which this Article was originally meant to accommodate.

To minimise their cost of funds MDBs resort to variable-rate long-term borrowing, and, more importantly, the use of derivatives i.e. *currency and interest rate swaps* to allow for currency diversification and for changing the cost basis of borrowings. To minimise costs, MDBs have also resorted to exercising their *pre-payment* options more regularly, especially when such prepayments do not adversely affect their standing in financial markets. Since 1992, some MDBs have refinanced previously higher-cost borrowings through *debt-repurchase* programmes when the efficiency gains of such transactions in terms of overall cost reduction are significant, and when market conditions permit such operations to be undertaken without influencing market sentiment adversely. Controlling the *volatility of borrowing costs* and loan charges is an objective which MDBs attempts to achieve by: (i) limiting *variable rate* borrowings; (ii) targeting the proportionate *currency composition* in their currency pools within limits which reduce the volatility of the effective cost of loans in US dollar terms; and (iii) excluding from the loan currency pool those borrowings which are used primarily to fund liquidity. The IBRD's after-swap borrowings are presently aimed at achieving a currency composition in its loan currency pool which is divided into equal thirds of: US dollars; the DM group of currencies; and Japanese Yen.

Unlike other MDBs, the **AfDB** has complicated matters by issuing two different types of debt: (i) *senior debt* and (ii) *subordinated debt*. As a matter of Board policy (and not a charter limitation) the AfDB's *senior debt*, together with any outstanding guarantees is formally limited to 80% of the callable capital of *non-borrowing members*. As things stand under present capital constraints, the 60:40 ratio of senior-to-subordinated debt and the 80% of total debt to total callable capital limit are incompatible. Changes in the senior-to-subordinated debt ratio will need to be made.

The **AsDB's** borrowing policies are similar in virtually all respects to those of the IBRD and are therefore influenced by the same considerations. Like other MDBs, the AsDB has been using derivatives to lower its borrowing costs and to manage its liability exposure actively. It has also resorted to refinancing operations and to prepayments to restructure the cost base of its

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debt portfolio while attempting to stretch its average maturity as far as it can, keeping in mind the cost-maturity trade-off in doing so. The **IDB's** borrowing strategy has evolved in stages over time, reflecting a conservatism based on self-imposed (though originally market-induced) borrowing limits which have changed with circumstances. They are now more closely in line with those of the IBRD; although the attempts of its management to convince its Board to undertake short-term borrowings in a fashion similar to the World Bank do not as yet appear to have been successful. As the newest of the regional MDBs, the **EBRD** does not have much of a track record to assess although it has the advantage of assessing the borrowing experience of the other MDBs and selecting the most efficacious, proven approaches and options in formulating its own borrowing policies, strategies and programmes. Unlike its predecessors the EBRD appears to have geared up its borrowings much earlier and to a larger extent than its lending operations warrant. To achieve *cost-effectiveness*, the EBRD proposes to: (i) use established underwriters and syndicates for its issues; (ii) select borrowing instruments and techniques to match investor preferences; (iii) use currency and interest rate swaps; and (iv) to resort to short-term and variable rate borrowings.

Issues Raised by MDB Borrowing Policies and Strategies

Sophistication and Complexity: The borrowing programmes and strategies of MDBs have become increasingly sophisticated and complex in response to the increasing sophistication of financial markets themselves. The degree of complexity, however, is beginning to convey the impression of being contrived rather than essential; perhaps driven more by the professional aspirations and ambitions of MDB financial officers, and the fee-generating imperatives of their investment banking advisors, than by the real needs of the MDBs' borrowing clientele. All the MDBs now appear to operate on the belief that, having spent money on large advisory fees, on building up sophisticated financial expertise, and on sophisticated technology, they have a vested interest in *churning* their financial operations to justify their existence on the ostensible grounds of cost-efficiency and maximising market access as objectives in their own right.

The Possibility of Churning: Whether all of the financial operations MDBs undertake are really necessary, and whether they are cost-effective, is becoming difficult (if not nearly impossible) even for experts to judge without careful scrutiny of the way in which these financial operations are triggered and managed. What is clear is that the senior managers and most Board members of MDBs are overwhelmed when their financial managers dazzle

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them with science. Not wishing to appear uninformed, they generally go along with approving complex financial operations when they have no way of evaluating whether these transactions make sense or not. There is certainly a case to be investigated as to whether, in retrospect: (i) the high-cost borrowings that MDBs undertook at the wrong times (when such borrowings could have been deferred since liquidity was more than adequate) and which were later unwound, through prepayments, refinancings and debt repurchases, when market conditions were more propitious, in fact amount to a form of *churning* and covering-up for previous misjudgements; or (ii) whether each of these transactions could, in fact, be justified in its own right. Relative to their concerns about the efficacy of MDB lending, shareholders appear quite sanguine about assuming that the quality of *financial management* in MDBs is so intrinsically sound as to be beyond the need for similar monitoring or examination. That sanguinity may now be in need of more careful consideration.

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

Currency of Borrowing: Similarly, in considering the before-and-after swap composition of the currency mix being borrowed, questions arise about the long-established emphasis that MDBs have placed on maximising borrowings of low nominal cost currencies. They have justified doing so on the grounds that such borrowings keeps their borrowing costs, and therefore their nominal loan charges low. Such borrowing (especially in JPY) may have increased exchange risks and costs for MDB borrowers far beyond a tolerable level. The IBRD has now shifted its stance on currency management quite radically. The AsDB has followed suit. The AfDB and its borrowers (who can afford to bear such costs the least) remain too heavily exposed to JPY. Clearly, MDBs need to gravitate towards a more consistent policy involving a balanced evaluation of what is most in the long-run interests of their borrowers and not what is most expedient to do in order to minimise, only ostensibly, a *visible* cost while obscuring the possibly higher *invisible* costs of their borrowing and currency management practices.

Maturity Matching: That most MDBs attempt to match the average maturity and durations of their *long-term* assets and liabilities is sensible and laudable. All the MDBs have taken advantage of the highly propitious borrowing environment that has persisted between 1991-93 to stretch their maturities outwards. But, except for the IBRD and EBRD, the other MDBs do not yet match the maturities of their *short-term* assets and liabilities. The experience of the IBRD and EBRD suggests that access to short-term markets, wisely and judiciously used, can be of significant benefit. It can lower overall borrowing costs and provide another line of defence to avoid *forced* borrowing in long-term markets when these markets are, for whatever reason, undergoing temporary bouts of turbulence (a phenomenon which is becoming more, not less, frequent). Access to short-term borrowings would enable all MDBs to ride out these periods with equanimity without necessarily having to run down their levels of liquidity below prudent limits.

Timing of Borrowings: Though MDBs usually justify high levels of liquidity to cope with disruptions in access to markets or to avoid *forced* untimely borrowings, they have nevertheless gone ahead with agreed annual borrowing programmes even when market conditions have been poor. Paradoxically, their behaviour often argues against the reasons which they cite for justifying the levels of liquidity they want to hold. It almost seems as if MDBs – having become accustomed to holding a certain level of liquidity, and to making an attractive level of profit out of those holdings – are reluctant to diminish those levels of liquid holdings for whatever reason. Since they can pass on the full cost of their borrowing, and the full exchange risk on such borrowing, to their own borrowers there is little incentive for them to hold back on borrowing even under unfavourable conditions or to run down liquidity. Levels of borrowings and liquidity should be managed within broader, more flexible bands to permit greater expansion or contraction of borrowing programmes than is the case now. Such flexibility should be exercised on the basis of market conditions. But it should not run the risk of damaging the reputation of MDBs in financial markets (by belatedly pulling out from issues which are almost fully cooked) or, on the other hand, run undue risks in letting liquidity fall below prudential levels.

Member's Permission to Borrow in their Markets and Currencies: As already observed, the Article requiring MDBs to seek the permission of their members to borrow in those members' currencies or markets, or to exchange those members' currencies into other currencies was designed at a time and for a purpose which no longer exists. That Article is now anachronistic and provides members with the power to misuse the authority it gives them. It should, in the interests of fairness and MDBs' financial soundness, be

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declared invalid for application in some way which does not involve the painful and unmanageable process of amending MDBs' Articles of Agreement.

The Role of Rating Agencies: The key international rating agencies which continually analyse the credit quality of debt paper issued by governments, their agencies, supranationals and corporates, have played a significant role in the success enjoyed by MDBs in borrowing on international capital markets. With the onset of the debt crisis and the emergence of unprecedentedly difficult circumstances arising for the portfolios of the IBRD and IDB, all the rating agencies have insisted on more intensive reviews of the strength of MDB portfolio quality, callable capital, and of the political support of their OECD members. The passage of the Latin American debt crisis has eased somewhat the concern of rating agencies about the quality of the portfolios of the IBRD and IDB. But the AfDB now faces unusually difficult circumstances with the continuing deterioration of its loan portfolio, the persistence of the debt crisis in Africa with too large a hard-window MDB debt exposure, and the intense shareholder scrutiny that it has come under as arrears have increased. Current ratings of the quality of AfDB's debt paper raise some fundamental questions. A recent evaluation of the financial condition of the AfDB suggested that deteriorating trends in its key financial indicators would have justified a proactive position being taken by the rating agencies to downgrade AfDB's debt in 1992. Such a step would have caused the management and the regional membership of that institution to be less sanguine about market and rating agency perceptions of the AfDB's strength and move more swiftly than they actually did in making essential changes to certain financial policies in order to safeguard the strength of that institution.

Rating agencies no longer base their rating of the MDBs on the sophisticated (and often confusing if not sometimes almost irrelevant) financial ratio analysis they undertake. Instead, they now appear to be basing their rating judgements solely on the strength of *usable* callable capital and the extent to which this guarantee *on the part of mainly the OECD governments* ensures the safety of the MDBs' outstanding debt. Excessively heavy reliance on that one factor alone poses serious dangers in terms of the signals that it sends to the managements of these institutions. It places unnecessarily onerous burdens on the OECD shareholders to enforce sound financial management by holding out the threat of exercising the ultimate sanction: i.e. withholding further capital support. Given the political complexities involved with OECD shareholders getting regional MDB managements to respond to their concerns, these shareholders ought not to be backed into the job that rating agencies and markets should be doing; especially when deterioration in the quality of an MDB's financial position clearly warrants markets rather than shareholders to signal that something is wrong and needs to be corrected.

The Use of MDB Guarantee Powers

The Articles of all the MDBs were framed with the clear idea in mind that these institutions would use extensively their powers to *guarantee* loans and investments made by private lenders to borrowing member countries. However, the IBRD did not guarantee either a foreign loan of a private investor to a developing country for nearly forty years nor did it consider guaranteeing the public offering of a member government. The same reticence was exhibited by the AfDB, AsDB and IDB. The reasons that the MDBs' powers of guarantee have not been widely exercised are that:

- the use of the MDB guarantee added no value to the international flow of financial resources because the guarantee competed directly with the MDBs' own borrowing capacity in being a direct substitute for borrowings under the capital limit set;

- the cost to most borrowers would have been higher if the MDBs had provided guarantees for private credit than if the MDBs borrowed and lent directly; the guarantee cost would have been an add-on and the legal issues involved between the borrower, primary lender and guarantor were complicated and involved further costs;

- even if the MDB guarantee had carried a uniform cost for all members, the overall cost of funds with a guarantee would have been different for different members based on how private investors perceived their individual credit quality; that would have made matters politically difficult since the MDBs chose to operate from the outset as multilateral credit cooperatives which spread their costs among all members equally.

It was not till 1983 that interest was revived in the IBRD – and, through a ripple effect, in the AsDB and EBRD, but *not* yet in the AfDB and IDB – in *cofinancing and guarantees* as ways of enhancing the credit of borrowers to support either private bank lending to a particular developing country or to support a borrowing in the international capital market. After two abortive attempts at reviving the use of guarantees through its B-loan programme followed by its expanded cofinancing operations (ECO), the World Bank has, in late 1994, made a third attempt to revive the use of guarantees as part of its mainstream operations. Only the AsDB and EBRD have followed suit in opening their guarantee windows for borrowers to use. The AsDB guarantee

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programme has barely begun. The EBRD's policies permit guarantees to be tailored to requirements ranging from *all-risk financial guarantees* to *partial risk-specific contingent guarantees* for debt instruments (loans, bonds or commercial paper) issued by its borrowers in their domestic, or in international, capital markets. The EBRD has made extensive use of its guarantee powers in a manner which exhibits greater flexibility, imagination and innovativeness of approach than in the other MDBs; perhaps demonstrating what is possible in a nascent institution whose internal culture is not yet quite as rigid as that of its more established peers. So far, the EBRD has provided guarantees both for a local currency private placement as well as a partial guarantee for a local currency public debt issue.

Concessional Resource Mobilisation by MDFs

When it became clear that the MDBs would require concessional funds to cater adequately to the development financing needs of their memberships, and especially of low-income countries, a series of multilateral development funds (MDFs) were established beginning with *IDA* in 1960. Its creation was a major step in the evolution of the World Bank itself, marking the beginning of the transformation of that institution from something resembling a *bank* into a *development agency*. Upto mid-1994, the donor countries had provided nearly twelve times as much money (through budgetary provisions) to IDA as they had to the paid-in capital of the IBRD with far less leverage being exerted from IDA contributions. However, the funds provided by donors and the IBRD to IDA before 1980 are now beginning to revolve in increasing amounts. As time progresses, the proportion of commitment authority funded by reflows relative to new contributions might well increase quite rapidly from the present level of 16% to around 50% or more by the year 2010. IDA has made it possible for the World Bank to remain a *world* bank rather than being reduced to being largely a Latin America and Asia bank.

Though it dwarfs all other MDFs, IDA has its equivalents in all the regional MDBs except the EBRD. In Africa, the *AfDF* was set up in 1972 with contributions from non-regional donors who were not yet involved in the membership of the core AfDB. AfDF's role in Africa remains peripheral to that of IDA with the latter's total commitments to sub-Saharan Africa being three times higher than those of the AfDF. In contrast to the situation in Africa the *Asian Fund's* (AsDF) resources for Asia seem less constrained. Part of the reason lies in the exclusion of China and India from AsDF access. AsDF lending to countries other than India and China is now significantly larger than IDA's. Although Asia is generally regarded as the most rapidly developing region in the third world, the need for AsDF resources is likely to rise because several poor Asian countries to which the AsDF has not been

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able to lend previously are becoming active again. The IDB's *Fund for Special Operations (FSO)* was established in 1960 and among the MDB soft windows, it is unique in that it was created as a built-in feature in the constitution of the IDB. The experience of FSO with declining donor contributions (which were unexpectedly reversed in GIR-8) may be a precursor for all the MDFs which confront the prospect of donor contributions being likely to fall once these revolving funds are seen to have reached a self-sustaining critical mass with *reflows* then becoming the main support for future annual commitment levels. Unlike the other MDFs, FSO makes its loans on terms which vary depending on the development status of the recipient country and the nature of the project being financed. Contrary to the view espoused by the managements of the World Bank and AsDB, that, permitting wide variability in terms of loans and credits would lead to intractable problems for managements and staff the IDB apparently has no significant problems in this connection. The EBRD does not yet have any soft-loan window similar to those of the other MDBs, although its Articles provide for the creation of *Special Funds* which have to be distinguished and managed distinctly from its ordinary capital resources (OCR). At the end of 1993, EBRD was administering four small Special Funds: (i) the Baltic Investment Special Fund; (ii) the Baltic Technical Assistance Special Fund; (iii) the Russia Small Business Investment Special Fund and (iv) the Russia Small Business Technical Cooperation Special Fund.

Issues Raised by MDF Replenishments

Burden-Sharing: All soft window replenishments are funded by donors on the notional principle of *fair burden-sharing*. This concept has bedevilled soft-window replenishment negotiations on many occasions. Some replenishments have been negotiated at levels substantially below what might have been possible had the donor community as a whole been willing to accept reductions in the share of some donors. A particular problem for all MDFs is posed by the US which has perennial difficulties with contributing an appropriate share to MDB soft-windows and paying-in its contributions on time. In the context of strict burden-sharing rules being applied that feature has become a fundamental structural weakness in the processes of soft-window funding. The way in which burden-sharing *rules* have been applied, and the absence of linkage between MDF contributions and *effective* voting power in the MDBs has made it unattractive for some new donors to contribute as much to MDF replenishments as they can afford while inducing other developing country donors to make token contributions.

The principle of burden-sharing has provided a disciplined framework of rules within which MDF replenishments are negotiated. But some large European donors may have been too rigid in attempting to apply that

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framework, to the possible detriment of MDF replenishments and more so to their recipients. Their actions have been guided by the belief that without such discipline the US would have done even less than it has been inclined to. While the burden-sharing framework must continue to be applied in negotiating MDF replenishments, it must be applied with sufficient imagination, flexibility and accommodation to acknowledge circumstantial realities without damaging the size of replenishments. In particular, the way in which the established donor community applies burden-sharing concepts, and de-links soft-window contributions from effective voting power in the core MDBs, provides no particular incentive for new donors to emerge and play a role in financing concessional development assistance though they could afford to.

Pro Rata Note Deposits and Drawdowns: Connected to the burden-sharing principle is that of *pro-rata note deposits* and *drawdowns* of donor contributions. The business of MDB managements negotiating instalment payments and drawdowns with donors has now become quite complex although the idea behind the issue is quite simple. Whereas soft-window replenishments are negotiated every 3-4 years the *commitments* made annually against donor pledges are actually *disbursed* over a period of 10-12 years. MDB managements cannot prudently make commitments against negotiated pledges until they know that donors have legally obligated themselves to make their pledged funds available in cash to the MDB soft-window through *instruments* which convey a binding and irrevocable commitment. Since approval has to go through the normal annual budgetary process in each donor country, most donors prefer their contributions to be divided into three or four annual *instalments* which are not made in *cash* but in *notes* which can be drawn down upon over a much longer period of time as funds are required to meet disbursement and liquidity requirements. This process is conditioned by *pro rata* rules which provide donors with the right to reduce the size of their note deposits or to restrict the amount of their deposits to the same level as any other donor which has so far released less than its proper share. The pro rata rules for note deposits and note encashment procedures are unwieldy and expensive to apply. They do not achieve the intended result of fairness. It would be better and simpler for donors to agree to formulae which would make their contributions more predictable in terms of their own budgetary procedures and make the flow of funds easier for MDB managements to handle.

Soft-Window Service Charges: The service charges which the MDB soft-windows levy are intended to cover their costs rather than to generate high levels of income. Depending on the concessional window concerned, these

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charges may include: a front-end processing fee; an annual service charge on disbursed and outstanding balances; a low or intermediate interest rate charge; and an annual commitment fee on undisbursed balances. Whereas IDA and AsDF levy standard charges on all their soft-window loans the AsDF and IDB levy variable charges and terms depending on the country and project being financed. At different times for different funds, the income derived from charges applied has proven insufficient to cover costs and income levels have had to be augmented through a change in either the levels of charges or the introduction of new charges. When income levels have been restored to adequate levels, these charges have been reviewed and reversed. In the FSO, where interest rates are also levied, the income generated is now becoming an important source of funding for future commitment authority.

MDF Liquidity: Related to the issue of cost recovery, is the maintenance of sufficient *liquidity* in MDFs in order to: meet expanding disbursement requirements; generate investment income; and/or to provide a cushion for protecting commitment authority from suffering an excessively sharp fall. Donors have now taken a more relaxed view on early encashments in advance of disbursement needs to permit a greater amount of liquidity to be held by the soft-windows themselves and to permit earnings generated from such liquidity to be used to keep service charges in check or to fund additional commitment authority. IDA's liquidity at the end of FY93 amounted to US$2.7 billion (versus disbursement requirements of about US$5 billion) while that of the AsDB was about US$725 million, FSO's was US$2 billion and AfDF's was US$400 million.

Administrative Cost-Sharing between MDB Hard and Soft Windows: As the concessional windows of the MDBs are operated as separate funds rather than as separate institutions the issue arises of apportioning administrative costs for the MDB as a whole between its hard and soft-windows. In the case of IDA and the AsDB the apportionment is done on the basis of costings which appear to bear some justifiable relationship to the identifiable costs of their hard and soft windows. In the case of the AfDF and IDB the basis of cost-sharing is more difficult to comprehend. Neither institution applies a cost accounting system of the same sophistication as the IBRD and AsDB. The basis for apportionment in the AfDF and IDB is more arbitrary and political with an unfairly high burden of cost seemingly being borne by the soft window and with the hard window thus appearing to be more profitable than it actually is. Also, the overloading of costs onto the soft window results in depleting donor provided resources and depriving potential recipients of scarce commitment authority. In both institutions the basis for cost apportionment was reviewed in 1993-94 and a new formula is to be adopted to reflect a more appropriate division of administrative expenses.

Concessional Resource Eligibility & Allocation: Among the issues which arise during MDF replenishment negotiations are the criteria applied to determine: (i) the *eligibility* of recipient countries for access to MDFs; and (ii) the annual and cumulative *allocation* of concessional resources across eligible recipients under any given MDF. Since concessional multilateral resources are scarce they need to be rationed out in a way which is fair and acceptable. These criteria, have undergone continuous evolution in but differ across the MDBs at any given point in time with inconsistencies emerging in the treatment of the same country by two different MDBs. There are thus no clear, consistent guiding principles governing eligibility for MDF resources *across the multilateral system as a whole* even though the funds are provided largely in the same way, by more or less the same group of key donor countries. Nor do MDBs classify their borrowers in the same way. Per capita incomes alone cannot be the sole determinant of eligibility. Moreover, the GNP/capita indicator is subject to methodological error and sensitive to exchange rate distortions. It would clearly be better to use the *Purchasing Power Parity (PPP)* based GNP/capita figures which are now published annually in the UNDP Human Development Report as a basis for determining eligibility. The MDBs should contribute to developing jointly with UNDP and the IMF, a more acceptable common methodology for deriving PPP figures for country classification and differentiation purposes.

Eligibility for concessional resources is linked to their scarcity which a uni-product approach of the type followed by IDA and the AsDB exacerbates. The question therefore arises as to whether all MDB concessional resources should be provided on more *variable terms* (as in FSO) and whether, as a result, eligibility could be loosened. Intermediate terms can be derived through a *blend*; but this is a blunt device unamenable to fine-tuning or to a quick adaptive response to changed circumstances. Moreover, there is a case for the *type of project* being financed also to influence both the type of resource (and its terms) which an MDB might choose to provide rather than having it be determined exclusively by country income circumstances. Another factor to consider is that some of the larger *blend* countries such as China, India, Indonesia, Pakistan, the Philippines etc., are now able to access *private* external flows of both debt and equity on an unprecedented scale giving them alternatives for external resource mobilisation which other IDA recipients presently do not have. Many IDA-eligible countries also spend an inordinately large proportion of their public resources on military expenditures. At a time when concessional resource scarcity is growing it may be appropriate to reconsider whether military expenditures should be included as a criterion for eligibility especially when the provision of scarce MDF resources indirectly supports a country's ability to expend its own resources in non-productive ways. Also, new claimants are emerging for concessional resources whose incremental demands are unlikely to be matched by expansion of supply.

Taking into account all these changing contextual factors in a post-Cold War world, with private external flows dominating official flows, the issue of eligibility for MDF resources should be thoroughly reconsidered in the next IDA replenishment. The aim of such a review should be to make concessional resources *more variable* and *more accessible* especially to the neediest countries for a wider variety of social investments. The FSO provides an interesting model, in terms of the way in which it has evolved both operationally and financially, for the other MDBs and their donors to examine more carefully before considering similar evolutionary changes in their own soft-window facilities.

The Allocation of MDF Resources: If *eligibility* criteria are more judgmental, less transparent and less rigid than they are often portrayed to be, then the *allocation* criteria, and the way in which they are applied within and across the different MDFs, for annual and cumulative soft-window allocations to particular countries are even more so. MDBs strive to make their decision-making on concessional resource allocations *appear* to be as impartial, objective, formula-based, and transparent as possible, with the appropriate genuflections to whatever developmental priorities or fashions happen to be in vogue with donors at the time. The reality, however, is that allocations among the major concessional resource recipients (or groups of recipients) are often determined in broad terms by the senior managements of MDBs and the representatives of major donor countries exercising their judgements at the start of an MDF replenishment cycle. In addition, the policy and economic *performance* of recipient countries *as perceived by MDB managements* has an influence on MDF allocations. Almost the same allocation criteria apply to recipient countries in all the MDBs. Broadly, these include: (i) willingness to engage in *policy dialogue*; (ii) emphasis on *poverty reduction*; (iii) sensitivity to *environmental sustainability*; (iv) responsiveness to *gender* issues; (v) *good governance*; (vi) emphasis on *human resource development*; and (vii) emphasis on *institutional development* to support the functioning of market economies and of open transparent democracies. In all the MDFs, donors placed a limit of between 25-30% of the resources provided under recent replenishments for adjustment lending.

Reflows: The *revolving* nature of donor funds was always an in-built feature of the MDFs. Donors foresaw that, at some future point in time, the corpus of their cumulative contributions would become sufficiently large, and the demands made on it would become sufficiently small when no further budgetary contributions from donors would be needed to sustain the *annual commitment authority* of the MDFs. At that point annual commitment authority would be fully funded by *reflows* from previous credits and, to a lesser extent, by the income earned on MDF liquidity. That state is closest to occurring in FSO although reflows now feature in supporting IDA's annual commitment authority as well. Though increasing reliance on reflows should indicate development success, at the present time it is more indicative of donor resistance to continually expanding aid allocations to MDFs from overstrained budgets. At the same time, recipient countries are giving donors more than sufficient cause for adopting this posture by wasting scarce resources to an intolerable degree. In addition to reflows, the investment income being generated by soft-window liquidity is also reaching significant proportions. The large and growing amounts earned from MDF liquidity are being earmarked for specific purposes which include: financing increases in commitment authority; funding interest subsidy funds; or funding technical assistance facilities. In looking to MDFs to generate income from liquidity a reasonable view has to be taken, given the particular circumstances of the MDF in question, on where the overall balance of interest lies.

The Role of MDF Replenishment Negotiators (the Deputies): A final issue which needs to be touched upon concerns the role that representatives of donor governments involved in negotiating MDF replenishments (*MDF Deputies*) play in influencing the operational and financial policies not just of the soft-window that they are funding at that particular time but of the entire MDB. Deputies constitute a group of *donor* government officials who represent only a part of the ownership of any MDB and have no constitutional standing in the governance of the MDBs. Their intervention usurps the roles of the Boards of Governors and Executive Directors. MDF Deputies exert far more influence over MDB policies and far more *effective* power over MDB management behaviour than do Boards of Executive Directors. The development priorities that have crept into MDB agendas have been pushed through less by Executive Boards than by the MDF Deputies. More recently, in one MDB the Deputies intervened to shore up its rapidly eroding financial foundations by requiring emergency remedial action to be taken. Thus MDF Deputies can be a force for the good of the institutions just as there are times when they can do much to incapacitate and diminish the MDBs. The real issue is not whether MDF Deputies exert their power and influence in the interests of the good or the bad. It is whether they can or should legitimately exert that sort of power at all. Their role diminishes the credibility of the Executive Boards of the MDBs especially vis-à-vis the MDB's senior management and staff. It also disenfranchises developing country members of MDBs from representing their interests properly. A tradition has now been established of increasing MDF Deputy intervention in all aspects of MDB functioning. That encroachment on Executive Board rights is virtually impossible to roll back. MDF Deputies are able to intervene so effectively partly because Executive Boards have become impotent devices for effective MDB governance. Unless the governance role of MDF Deputies, which has evolved by exigency than design, is thoroughly re-examined and formalised, day-to-day MDB governance may well be weakened not strengthened.

Liquidity and Investment Policies

MDBs usually lend for projects and programmes which take 2-10 years to implement. While these are being implemented, the MDBs play an active role in monitoring and supervising these projects. Funds are released only when the equipment needed has actually been shipped by suppliers or is being installed, or when certain performance conditions and commitments have been met. Thus the MDBs disburse against their loans on a continuous basis over periods of time that may vary from 2-10 years. Given that *modus operandi* it is self-evident that the MDBs need to keep a sufficient amount of liquid funds on hand to meet disbursements against their loan commitments. The timing of such disbursements cannot be easily predicted in advance for individual projects but aggregate disbursement patterns for the portfolio as a whole can be anticipated over time. Secondly, MDBs cannot always time their borrowings to suit themselves. They must borrow opportunistically to take advantage of the best market conditions in different markets and currencies over any given period. A time lag therefore results between the inflow of funds from borrowings and the outflow of funds for: disbursements, repayment of previous borrowings, and for other expenditures. For those reasons, liquidity is a *sine qua non* for effective financial resource management.

The key question therefore is not whether MDBs should hold liquidity but *how much liquidity do the MDBs need to keep at any given point in time*? This question assumes particular relevance because the investment of liquid funds has now become an important profit centre in its own right in all the MDBs. Investment income has become a useful safety-valve for releasing internal financial pressures that might otherwise have built up in the MDBs. MDBs have therefore developed a vested interest in retaining and strengthening their roles as *financial arbitrageurs* by keeping their liquidity levels as high as possible. Policies are devised to justify maintaining liquidity at higher levels than is actually necessary in present financial market conditions. Although the liquidity requirements of all the MDBs are predicated on much the same concerns, and their operations justify the same approach to liquidity

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management, the MDBs use two quite distinct approaches to determine their liquidity levels.

The IBRD and EBRD base their liquidity requirements on the concept of estimated *net cash requirements (NCR) over the next three-year period.* The three other regional banks (AfDB, AsDB and IDB) prefer to use the concept of estimated *future loan disbursement requirements (LDR) for the following year (or two)* in determining their liquidity. The NCR concept makes the most sense, from an intellectual and practical viewpoint. Both the IBRD and EBRD use a ratio of 45% of their NCR over the next three years to determine their liquidity requirements although that ratio is used as a guide target rather than an absolute ceiling; in practice the World Bank manages its liquidity within a 45-50% of the 3-year NCR range. Liquid holdings above the 45% ratio are reviewed by their Boards and the excess is regarded in both MDBs as *discretionary liquidity.*

In contrast, the AfDB presently has a policy of maintaining liquidity at a level equivalent to 1.5 times the LDR for the following year. The AsDB's liquidity policy is also based indirectly on the LDR concept with its *minimum liquidity target* is set at 40% of its (previous) year-end undisbursed balance of committed loans which avoids making any estimates or judgements about future NCR. The AsDB is in the midst of shifting from the passive, ratio-driven approach based on LDR to a more active NCR based approach to liquidity management. The IDB's present liquidity formula, establishes a *ceiling for liquidity equal to the sum of 50% of undisbursed amounts from effective loans, plus 33% of NCR for the next 2 years* thus combining the LDR and NCR approaches. The IDB has opted for combining the LDR and NCR approaches to liquidity management on the grounds that the LDR component would provide *stability* in an environment of rapid lending growth while the NCR component would be more *responsive* to sudden changes in the Bank's contractually determined cash flows caused, for example, by sudden and large exchange rate fluctuations.

Revisiting Liquidity Requirements: As the different policies adopted by different MDBs suggest, the issue of how much liquidity an MDB should carry is largely a matter of judgement despite the apparent sophistication of analysis which underpins the different policies which various MDBs choose to pursue. Given that they operate in largely the same way, and need liquidity for essentially the same purposes, it is surprising that the MDBs take such different approaches to justifying how much liquidity they need. If the essence of keeping liquidity is to protect against various risks which might interrupt cash flows (and especially *inward* cash flows) then conceptually the soundest approach to formulating liquidity policy is on the basis of NCR over some future period; mainly because LDR deals with only one dimension of *outward* cash flows to which the MDBs are contractually committed. Indeed, in the mature MDBs, the debt service on their own bonds is now becoming as important a form of contractual outward cash flows as disbursements on loans. There is a strong case to be made for all the MDBs to move towards a more consistent NCR basis for formulating their policies and managing their liquidity. It is clear that the current levels of liquidity which MDBs are carrying are significantly higher than they need to be if the *only* purpose of carrying liquidity were to cover various cash-flow risks and uncertainties.

The MDBs could operate quite comfortably with a level of liquidity which was equivalent to around 30-35% of NCR for the next three years or 100% of NCR for the next 12-month period (on a rolling monthly basis). Such a reduction would, however, almost certainly have the effect of lowering current levels of investment income by around 30-35%. The real reason for MDBs maintaining a much higher level of liquidity than is necessary (for risk coverage purposes) is to generate sufficient investment income. Given that the *income imperative* drives the need to keep liquidity levels as high as they are, it would be wiser for MDB managements to justify their liquidity policies on the basis of both their need to maintain income levels and to cover cash-flow risks rather than putting the burden of the argument entirely on the latter. The present approach only fosters the suspicion that MDB managements are now generally pre-disposed to being opaque and disingenuous, when they can just as easily be transparent and straightforward and still attract support for the positions they wish to convince their shareholders to take. The problem with admitting openly that higher than necessary liquidity levels are necessary simply to generate income is that MDBs are likely to become subject to close scrutiny on their risk exposure putting more pressure on MDB treasurers and exposing them to greater accountability and transparency than they might be comfortable with.

Allowable Investments & Investment Authority: Apart from the issue of *how much liquidity* should MDBs keep, there arises the question of *what kind of investments* and instruments should MDBs be permitted to invest their liquid funds in. All the MDBs have explicit policies on this matter and all such policies are fairly similar. The investment authorities granted by MDB Boards specify the types of instruments in which liquid funds can be kept by issuer and by credit rating and set exposure limits on: portfolio *durations* and the maximum maturity allowable for certain types of transactions; the minimum permissible credit ratings of issuers of securities in which MDBs are allowed to invest; the types of issuers whose securities are eligible; and the extent of risk that can be taken in specific markets, and for specific types of credits. The average duration of MDB portfolios is not permitted to exceed

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48 months. All the MDBs have exposure limits for investments in any single security. There are also limits on the proportion of any single issue that a given MDB can purchase for its own investment purposes as well as limits on the proportion of the total amount of liquidity that can be invested in any single type of security or in the paper of a particular category of issuer.

Currency Management Policies

Among the most technically difficult MDB financial policies to explain in practical terms are those concerning *currency management*. Simply put the problem arises because the MDBs, by their Articles, are required not to assume any *exchange risk* on their financial activities which they have interpreted to mean passing it on to their borrowers. As seen earlier, MDBs are capitalised in a variety of convertible and non-convertible currencies. They have to borrow from various capital markets in a different variety of currencies. Moreover, they prefer to use only certain currencies from their borrowing and capital pools for investment purposes. Upto now the MDBs have seen themselves as credit co-operatives, rather than as banks which can discriminate among their borrowers in pricing their loans or offering a wide variety of *loan products*. On the grounds of *equity* and *uniformity* the MDBs (except the EBRD) have chosen to lend in a way which distributes all the exchange and interest risks inherent in their borrowing operations to all their borrowers equitably in loans with roughly similar characteristics.

Accordingly *currency pooling* systems have been designed by the MDBs which attempt to distribute the interest cost and exchange risk equally among all loans in the system by assigning all loans the same currency composition as the composition of the MDB's entire loan portfolio. All loans funded out of the currency pool share equally with the cumulative exchange risk associated with the currency composition of the pool. The currency pool does not *eliminate* exchange risk for the borrowers; it only *spreads the risk* out equally among all borrowers and all loans. The AsDB now offers borrowers a choice of loans in USD while the IBRD recently introduced the option of offering its *non-sovereign* borrowers (i.e. agencies and DFIs) single currency loans in USD, JPY, DEM, GBP or FFR. Neither the AfDB nor IDB have yet moved towards offering single currency loans although the IDB is considering this possibility with the suggested establishment of a separate USD window. The EBRD has decided from the outset to offer its borrowers either fixed or variable rate loans in USD, JPY, ECU or any other convertible currency in which funding is available to the EBRD. The EBRD has also experimented with borrowing and lending operations in the *local currency* of borrowing members which could be a precursor to a whole new approach in MDB borrowing and lending in the future.

The EBRD has broken new ground in acting more like a commercial or merchant bank in offering loan products which are *demand-driven* – i.e. by the particular needs of the borrower and the project – rather than *supply-driven* by the strictures of MDBs concerned about homogenising their loan products, largely to simplify life for themselves rather than their borrowers, by pooling all risks and spreading them across all borrowers. The more established MDBs are now entering difficult and unfamiliar territory. They face a future in which they will, inevitably, have to cope much greater complexity and risk in portfolio and balance-sheet management; especially as they move away from providing more-or-less homogeneous loan products to a much more heterogeneous range of loan, quasi-equity, and guarantee products (some with built-in derivatives to cap or contain risk) in different currencies, with different prices and terms, which are tailored to meet the needs of specific borrowers for specific projects. Their present management and staff are perhaps not fully qualified nor competent to handle such heterogeneity, nor are they as client-oriented as they will need to be. These pressures to adjust to a more competitive environment will place a weak MDB, such as the AfDB, at an even greater disadvantage than it is at now to keep up with the other MDBs as they evolve and change.

Lending Rates, Terms and other Loan Charge Policies

All MDBs charge an interest rate on the loan balances disbursed and outstanding. In addition some MDBs charge commitment fees on undisbursed loan balances and front-end service fees although the levels of these differ. The **World Bank** is the market leader in terms of price setting and in determining the evolution of MDB lending rate policies in general. In the IBRD loans signed before 1982 have *fixed* interest rates determined at the time the loan was contracted. Loans signed between 1982-89 were made at variable lending rates (VLR) from a composite lending pool. Loans signed after 1989 a modified variable lending rate (MVLR) was formulated with borrowers whose loans were signed before that date being given the option of converting to the modified rate. Under the VLR system the IBRD's lending rates have declined almost continually reaching their lowest point so far in 1994. On its new programmes of *single currency loans* the IBRD charges a SC-VLR which is reset every semester. In calculating its MVLR, the IBRD adds a spread of 50 bp over the weighted average cost of borrowings in the pool to cover its own overhead and administrative costs. To encourage borrowers to make their debt service payments on time, the IBRD has a policy of interest spread waivers. Borrowers making their payments on time are eligible to a waiver of 25 bp on the interest spread charged. Borrowers who do not make timely payments are ineligible for the waiver and are subject to the application of progressive sanctions and penalties.

In the **AfDB,** a pool-based system also applies with the VLR calculated on more-or-less the same basis as in the IBRD with a 50 bp spread applied to the weighted average cost of funds in the loan currency-pool. However, given the large weight of fixed rate loans in its portfolio along the high level of non-performing loans the 50 bp spread is inadequate for AfDB to meet its minimum net income requirements or its targets for adequate *interest coverage* and *reserves-to-loans* ratios. Consequently, the AfDB has contemplated applying a *variable spread* above the Bank's average cost of borrowings which would be reset each year. The size of the spread would be determined by the AfDB's needs to meet that year's net income targets and to reach minimum interest coverage and reserves to loan ratios of 1.25 and 15% respectively.

The **AsDB** also has a pool-based VLR system. The *spread* is only 40 bp (the lowest of all the MDBs) with the weighted average cost of its borrowings in the loan currency pool being calculated in the same way as in the other MDBs. The AsDB's VLR system has proved even more robust and stable than the IBRD's with interest rate variations being within a range of 130 bp between 1986-93. The VLR on its straight US dollar loans is based on the average cost of USD borrowings undertaken to fund the USD pool with a 40 bp spread applied. The **IDB's** VLR incorporates a *spread* of 58 bp comprising a *fixed component* of 50 bp to cover the Bank's overhead and administrative costs at headquarters plus a *discretionary component* (presently 8 bp but it has been as high as 50 bp) which can adjusted in line with achieving required net income levels. To safeguard its net income, the IDB has been pursuing an approach to its lending charges of the kind that the AfDB's management should follow and for much the same reasons.

Given its different operational orientation and flavour, the **EBRD's** lending rate policies and charges are more variable than those of the other MDBs. Also, the EBRD depends to a much higher extent than the other MDBs, on returns from equity investments, guarantees and lending to the private sector than from sovereign risk lending alone. Thus it does not have any single currency-pool system or bench-mark lending rate similar or equivalent to the semestrally announced VLRs of the other MDBs. Loan pricing is determined according to risk, cost of administration, and contributing to its net income requirements, *with due regard to market terms offered by other lenders for similar loans.* The EBRD thus operates in a different fashion to the other MDBs, less as a credit co-operative and more as a commercially oriented merchant bank. For sovereign loans the EBRD's margin or *spread* over cost of borrowed funds is a 100 bp. For loans to private and non-sovereign borrowers, the margin over the EBRD's cost of funds is variable. In the absence of a sovereign guarantee it is meant to reflect both the country-

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risk as well as the specific project-risk, the latter being decided on a case-by-case basis. The EBRD charges fees and commissions which include: front-end fees, commitment, pre-payment and conversion fees. These fees fluctuate within a range and vary on a case-by-case basis.

Commitment Fees: The **IBRD** specifies a *standard annual commitment fee* of 75 bp on the *undisbursed* balances of contracted loans to be charged 60 days after loan signature and annually thereafter. At present the IBRD waives two-thirds of the contractual commitment fee, charging only 25 bp. The **AfDB's** commitment charge remains at 100 bp with some pressure from borrowers to reduce it but resistance from non-regional shareholders to countenance any reduction in view of the AfDB's precarious financial circumstances. The **AsDB** charges a commitment fee of 75 bp as does the **IDB**. These fees are paid semi-annually on undisbursed balances although accrual of the commitment charges begins 60 days after loan signature. In the **EBRD**, commitment fees are variable, and payable on the committed but undrawn part of a facility and are chargeable from the date of signing. Commitment fees of bank credit lines start to accrue on each tranche as it become active and not the whole facility.

Front-end and other Special Fees: Though they have done so in the past, the **IBRD** and **AfDB** do not levy any front-end fees at the present time although in view of its precarious income position the AfDB may shortly be obliged to do so again. The **AsDB** has not levied any front-end fees in the past and has no plans to do so. The **IDB** levies a front-end fee of 100 bp of the approved amount of each loan for inspection and supervision. The **EBRD** has a policy of levying variable front-end commissions payable at the time of signing of the loan or facility extended but no later than the first disbursement. Front-end fees to the EBRD are payable in a single up-front lump sum; refunds are not offered to borrowers who do not avail of the full extent of a facility which has been approved. Unlike the other MDBs, the EBRD also has a policy of charging a back-end or *wind-up fee* in the event of a pre-payment or cancellation of its fixed-rate loan products. In addition, for both VLR and FLR loans the EBRD charges an administrative fee. It may also charge a *conversion fee* if a borrower chooses to switch the interest rate basis of the facility contracted from VLR to FLR or vice-versa. Such a fee may be charged either at the time of conversion or, in some cases, it is capitalised (i.e. added to the principal outstanding).

Loan Repayment Terms: The maturities and grace periods for the loans of the more established MDBs vary within narrow bands but those of the EBRD vary quite widely. At present a three-tier structure applies to repayment terms

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of **IBRD** loans varying by the income level of its borrowers with terms varying from 15-20 years and grace periods varying from 3-5 years. Repayment terms of **AfDB** loans vary from 12-20 years with grace periods varying from 2-8 years. **AsDB** loans have repayment terms of 10-30 years with grace periods varying between 2-8 years, while those of the **IDB** vary from 15-25 years with grace periods of 4-8 years. In the three regional MDBs the basis for determining the maturity and grace periods depends partly on the income level of the country and partly on the cash-flow profile generated by the project being financed. Decision-making on the repayment terms of particular loans is more discretionary and not quite as well-defined as in the case of the IBRD. The **EBRD's** loans have repayment terms which vary from 3-15 years for state-sector loans and 1-10 years for loans to private enterprises. The EBRD's view on grace periods is more commercial than that of the other MDBs with principal repayments commencing as soon as projects begin to generate positive cash flow. For private enterprises with existing operations the EBRD's grace period can be as little as *3 months* from the start of loan disbursements. For new projects without cash flow from other sources the maximum grace period allowable is 3 years.

Net Income Management Policies

All the MDBs employ some form of net income targeting for each year, bearing in mind that their net income remains vulnerable to several risks including: (i) *interest rate risk*; (ii) *commercial credit risk*; (iii) *exchange rate risk*; and (iv) *portfolio risk*. To cope with these risks, MDBs attempt to retain some flexibility in their loan and service charge structures which enable charges to be geared up or down in response to exigencies which may affect net income. In targeting income, the MDBs pay particular attention to the Reserves-to-Loan Ratio and the Interest Coverage Ratio. They also fund other desirable activities through special allocations of net income such as their MDFs or Technical Assistance funds through annual or occasional allocations of a percentage of net income.

Meeting the Reserves to Loan Ratio (RLR): The key measure of the adequacy of MDB net income is its contribution to *reserves* relative to the portfolio as reflected in the RLR. In the **IBRD** the RLR target is now 13-14% of the outstanding loan portfolio and its present RLR is 13.8%. The net income and reserves position of the **AfDB** is far less comfortable. Net income has fallen to an unacceptably low level and reserves are inadequate relative to AfDB's deteriorating portfolio quality. The main failure of the AfDB has been the inability of the Bank's management and Board to come to grips with its rising arrears, non-accruals and escalating loan-loss provisions. It has now become

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imperative to arrest and reverse the decline in AfDB's net income. If urgent actions are not taken the AfDB faces the prospect of losing its credit rating, seeing an increase in its borrowing costs and, at worst, risking the prospect of a call on callable capital. If that were to happen, the AfDB risks endangering the entire MDB system by calling into question the very basis of confidence in the preferred creditor relationship between MDBs and their borrowers, and between MDBs and their donor shareholders, on which the system has been built.

In contrast, the picture at the **AsDB** is the opposite to that of the AfDB with an overly prudent and cautious approach to the RLR being adopted from the outset. The AsDB has a minimum RLR of 25% which, by any standards is extremely prudent. Like the AsDB, the **IDB** has also adopted a target RLR of 25%. With its portfolio position having improved significantly since 1989 and the economic circumstances of several major borrowers having improved substantially, the IDB's present reserves are adequate.

The **EBRD's** reserves in 1993 stood at 3.4% of the total portfolio; inadequate by any standard, and in a relative sense even worse than the AfDB. The inadequacy of EBRD's reserves results from the inadequacy of net income in the start-up phase of the institution. It is compensated for by the over-adequacy of liquidity and paid-in capital. Given the concentration of EBRD's portfolio in nascent private sectors and in countries where the transition to becoming market economies is far from complete, its vulnerability to portfolio shocks provides cause for concern. The EBRD's overall target for total reserves and retained earnings, together with special provisions for losses on loans and equity investments has been set initially at 10% of outstanding loans and 25% of equity investments. While the reserves level for the equity portfolio seems uncontroversial, the RLR target for the loan portfolio is well below that of its cohorts. Given the particularities of the EBRD's operating environment, it seems imprudently low.

Meeting the Interest Coverage Ratio (ICR): The second major test of the adequacy of an MDB's underlying income generating capacity is the ICR. It reflects the capacity of an MDB to continue generating income and maintain an adequate level of reserves under unexpectedly adverse conditions and measures the excess by which net income covers the level of interest expense.[1] A sudden drop in an MDB's ICR could indicate to markets an erosion of its capacity to service its own debt. In the **IBRD**, the ICR is presently at 1.16 and is regarded as being satisfactory. The **AfDB** has an explicit ICR *floor*

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

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

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target of 1.25. Its ICR has fallen precipitately to 1.19 in 1993 and it does not appear as if the ICR target be met in the 1994-97 period. If nothing changes, the ICR is projected to drop further to a disconcerting 1.07 by 1997 unless net income is raised substantially or, alternatively, borrowings are sharply curtailed temporarily. The **AsDB** and **IDB** also have ICR floor targets of 1.25. The AsDB is comfortably above that floor level with an ICR of 1.66 in 1993 whereas the IDB had an ICR of 1.24. The **EBRD's** main objective has been to achieve a positive level of net income, which it managed to do in 1993. Hence an ICR comparison at the present time would be invidious (the ICR in 1993 was 1.02).

MDB Policies for the Allocation of Net Income: MDBs have policies for the *allocation* of their net income especially in years when income exceeds amounts expected. Excess income, is allocated for special purposes after the basic purposes of adding sufficiently to reserves and making prudent provisions have been fully satisfied. The **IBRD** has a *medium term policy framework* for the allocation of net income. While giving first priority to the continued accretion of reserves at an acceptable rate, that framework outlines three broad uses for surplus net income: (i) reducing the burden of loan charges on borrowers; (ii) strengthening the Bank's financial position; and (iii) promoting development through special transfers outside of the Bank. The case for reducing loan charges is obvious. The argument for the two other uses of income rests on the notion that the Bank's income is earned in large part from the *cost-free* usable capital, and the privileged access to their capital markets, which donor shareholders provide. The IBRD's priorities in the allocation of net income are: (i) strengthening reserves; (ii) reducing loan charges; and (iii) transfers for special purposes. Thus, after the target RLR requirement is satisfied, any remaining net income is applied first to prefund waivers of loan interest charges for the following fiscal year. If additional income still remains after this application, it is transferred to a *surplus* account in the Bank's reserves or put to other uses which are consistent with the Bank's Articles of Agreement, and agreed to by the Executive Board subject to approval by the Board of Governors.

The **AfDB**, has no clear policy on the allocation of its net income. With its present problem of not being able to generate sufficient net income to meet even the minimum RLR and ICR targets any discussion about allocating surplus net income would be superfluous for the foreseeable future. Neither the **AsDB** nor the **IDB**, have specific policies for the allocation or distribution of net income. In most years, annual net income is allocated between the Special Reserve and the General Reserve. The income attributable to special commissions (1% on OCR loans) is required by the IDB's statutes to be allocated to the Special Reserve established for the sole purpose of

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meeting obligations created by its own borrowings or by guaranteeing loans. The **EBRD** still has to build up its net income to acceptable levels relative to its portfolio; the issue of special allocations from net income will not, therefore arise for some time to come.

Policies on Reserves and Provisions

All the MDBs generally have three types of reserves, all funded either as charges against gross income (*above the line*) or allocations from net income (*below the line*) which can all be used as a buffer against the impairment of their capital resulting from either loan losses or from any other financial shock. Assuming that loan losses trigger the process of liquidating these different reserves, the order in which they can be depleted is that: (i) Loan Loss Provisions are charged first, followed by a drawdown of (ii) the Special Reserve, and finally (iii) the Ordinary or General Reserve, which is effectively a paid-in capital substitute. Whether or not MDBs create loan loss reserves, and irrespective of the accounting conventions which determine the order in which different types of reserves are to be drawn down, in the final analysis it is the total amount of all three reserves which protect the MDB's capital from being impaired. All three reserves thus serve essentially the same purpose of insulating MDB capital from the shock of any financial disturbance.

Loan-Loss Provisions: These provisions are funded annually by charges against gross income from loans determined on the basis of estimates about the probable amount of future losses. The *cumulative* amount of such annual provisions are known as loan loss reserves. Loan loss provisions can be of two types: *specific* or *general*. Specific provisions are those which are determined on the basis of the probability that specific loans to a country which have been in non-accrual status for a period of time, may not be collected and therefore need to be provided for against the risk of capital loss. General provisions are established on the basis of the overall probability that some as yet unidentifiable part of the loan portfolio may not be collected.

Special Reserves: All the MDBs have Special Reserves as a statutory feature. These are embedded in their Articles and are required to be funded by special loan commissions or guarantee fees and held in the form of readily available liquid assets. Such assets are set aside to be used as a first line of defence against the impairment of paid-in capital, or to forestall a call on callable capital. Special Reserves can only be used for the purposes of meeting MDB liabilities on their borrowings or guarantees in the event of default on loans made, participated in, or guaranteed by the MDB. They were intended as a bulwark against the risk of capital impairment in the early stages of an MDB's

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life. Most of the MDBs' Articles require these Special Reserves to be funded through a 1% front-end charge for at least the first five years of operation, after which the front-end fee could be reduced or eliminated at the discretion of the Executive Board.

In the **IBRD**, the allocation of commissions to the Special Reserve was discontinued in 1964. The *regional* banks, however, continue to fund and build up their Special Reserves. The **AsDB** discontinued funding the Special Reserve with loan commissions in 1985 but still funds it with the small amount of guarantee fees it collects. The **AfDB** stopped charging its special front-end commission and funding the Special Reserve in 1989. In view of its precarious income position it urgently needs to reinstitute the practice of replenishing its Special Reserve especially if it proves easier to reactivate the Special Reserve on constitutional grounds. The **IDB** still funds its Special Reserve with a 1% commission charged on all loans approved. The **EBRD** is funding its Special Reserve with all of its front-end fees, and other fees (excluding commitment fees) associated with loans, guarantees and underwritings. It will continue to do so till a sufficient amount has been built up in the Special Reserve. Although the proportion of total reserves accounted for by the Special Reserve in the regional banks is high, the distinction between the Special and General Reserve is becoming moot even in these banks.

Ordinary or General Reserves: While loan provisions are funded by deductions from gross income above the line, and Special Reserves are funded by specifically designated fees and commissions above the line, Ordinary or General Reserves are funded entirely from allocations of net income below the line. They simply represent an accumulation of the net earnings of the MDBs which have not been allocated to other purposes but have been retained internally to support the growth of the MDB's operations by augmenting its equity base. In essence they have proved to be the most effective means of MDBs' accumulating convertible, usable paid-in capital. They belong to all the shareholders in proportion to their shareholdings as undistributed dividends, which would be distributed in the event of the MDBs being wound up after their creditors had been fully satisfied. The Articles of the MDB's, while requiring priority to be given to building up reserves through the allocation of net earnings, do not specify any uses of these Reserves nor do they impose any restrictions on their use.

Country and Portfolio Risk Exposure Management

Sovereign (Country) Risk & MDB Portfolio Risk: All the MDBs now have systems for assessing, on a rigorous annual basis, the risk of protracted arrears

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and non-payment on debt owed to them by their borrowers. These systems vary in their degree of sophistication. Borrowers are classified in MDB portfolios in different risk categories on the basis of various income and debt indicators. Individual country risk assessments are aggregated into an overall assessment of portfolio risk each year through the application of techniques which are refined continually with experience. Such portfolio assessments combine the judgement of the MDB's operational staff dealing with each country as well as financial staff experienced in assessing portfolio risk.

Country Exposure Limits: All the MDBs have formal or informal country exposure limits of one sort or another. The **IBRD**, which has the most globally diversified, and therefore the least concentrated portfolio of all the MDBs, also has the most sophisticated country exposure risk management system. Its guidelines are applied with flexibility and discretion on the part of IBRD's management rather than serving as rigid cut-offs which are mechanically applied. Supplementary qualitative analysis is undertaken to make a judgement as to whether the IBRD needs to adjust its assistance strategy to a particular country sufficiently early to stop a problem from becoming a crisis. The IBRD's exposure increases are then calibrated carefully to avoid increasing exposure too rapidly in difficult situations while ensuring, at the same time, that resources are not withheld too hastily so as to precipitate, rather than avert, a debt-service problem.

The **AfDB's** country exposure guidelines are presently honoured more in the breach that in the keeping. There is a question as to how realistic and applicable these guidelines actually are. There may be a need to redesign them. It is now essential to introduce greater automaticity in requiring the AfDB to reduce country exposure levels rapidly, especially in patently uncreditworthy countries, unless there are sound reasons for doing otherwise. For the same reason there might also be grounds for having a small sub-committee of the Board (comprising mainly its non-regional members), or even the Audit Committee, participate in the portfolio review exercise, without usurping the prerogatives of the Bank's management, to ensure a needed degree of transparency in the application of an overdue and critically important country exposure policy. Both the **IDB** and **AsDB** have country risk assessment systems with provision for annual reviews. Their approach to country exposure risk management has changed recently. The AsDB has opted for a country risk exposure management approach similar to the IBRD's. The IDB's plans to go down the same route are quite advanced. Given the limited number of sovereign borrowers that it deals with, the **EBRD's** start-up approach to country risk exposure focuses on the extent to which these individual borrowing countries have the capacity to service external debt obligations in general and EBRD debt in particular; and

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whether the EBRD's status as a preferred creditor, relative to other preferred creditors, is honoured. As in the other MDBs, the EBRD's country lending limits reflect its concerns about risk diversification and are not used as a lending allocation or rationing device.

Private Sector Exposure Risk Management

Except for the IDB, the other regional MDBs finance *private sector operations* directly through their own hard-windows rather than through separate affiliated corporations. The IBRD, finances the private sector through IFC, and the IDB does so through IIC. In the former case, risk assessments of loans to *private* borrowers must also be made by the three MDBs for portfolio risk management purposes. In dealing with private borrowers, MDBs may need to engage in normal *debt* rescheduling, refinancing and restructuring arrangements alongside other creditors. If indulged in on a large scale, this could endanger an MDB's own credit rating on international capital markets and increase its cost of borrowing and/or constrain its market access. Three issues arise in ensuring that the impact of private sector lending/investment on adding to an MDB's portfolio risk is contained: (i) the size and nature of its private sector operations; (ii) the loan restructuring and rescheduling practices to be employed for such operations and (iii) the separate provisions set-aside for such operations to ensure that losses on *private* lending do not contaminate the MDBs' *sovereign* portfolio.

In the **AfDB** and **AsDB** direct lending to, and investment operations in, the private sector are small in relation to their total operations. These operations are not yet a part of their mainstream activities. Both MDBs employ different credit policies for their private sector lending and investment operations to assure strong asset quality. Unlike their sovereign loans, MDB loans to the private sector are fully secured and closely monitored. Though both MDBs have taken firm positions on *not* rescheduling, refinancing or restructuring *sovereign* debt, they can engage in such rescheduling, under strict guidelines for loans and investments in their private sector portfolio. Unlike the AfDB and AsDB, lending to the private sector is a mainline activity of the **EBRD**. At the end of 1993, the private sector accounted for 89% of its disbursed and outstanding loans/investments. The EBRD's private sector portfolio is limited by a series of guidelines. Like the other MDBs, the EBRD has a general policy of not rescheduling, refinancing or restructuring its loans to *sovereign* borrowers or state enterprises but it can engage in such practices in its lending to the private sector. Its policy posture is to undertake loan rescheduling where such a course of action provides the best means of protecting its own interests.

To avoid the risk that problems with their private sector portfolios might

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contaminate their sovereign loan portfolios, it would appear wiser for the AfDB and AsDB to consider financing their private sector operations through a separate corporate entity with limited liability and a different *modus operandi* with different policies, rules and regulations applying to its management and staff. For that reason it may be more appropriate for the AfDB and AsDB to follow the route taken by the IBRD and IDB in establishing the IFC and IIC respectively. The AsDB has already participated in the establishment of the Asian Finance and Investment Corporation (AFIC) to which all of its private sector operations could easily be shifted. The AfDB may need to either participate in, or establish its own, African Finance Corporation. In the absence of such an approach, there is a real danger that any significant losses on the institution's private sector portfolio could impair the market image and operations of the MDB as a whole. The suggestion to take a separate corporate route in handling private sector operations is to safeguard the prudential interests of these institutions and to permit more flexibility to be applied in the way these operations are handled, and the way in which remedial measures can be applied when portfolio problems occur.

Policies for Arrears, Non-Accruals and Provisioning

Despite their best efforts at trying to anticipate potential debt servicing problems through their country and private sector risk exposure management practices, different MDBs have, since the mid-1980s, experienced *arrears* on the servicing of debt owed to them by their sovereign and non-sovereign borrowers. Since 1993 there has been a trend towards all the MDBs adopting convergent policies and approaches with the IBRD setting the pace. All the financial managements of MDBs (usually their Controller's Departments) monitor debt service payments on a continuous basis. When payments are overdue for more than 180 days they are referred to as *protracted arrears*; at that point, they trigger *non-accrual* of income and *specific provisions* for possible losses on the loan.

Sanctions Policies: In the difficult interregnum between a country going into arrears and going into non-accrual status, different MDBs apply, as aforementioned, a number of incentives and disincentives to induce borrowers to avoid arrears if possible, or alternatively to mitigate their impact. These sanctions differ across the MDBs depending on their particular policies and whether or not they provide certain incentives (e.g. interest spread waivers) to borrowers that make timely payments. By and large sanctions include measures such as: (i) loss of eligibility for interest spread waivers; (ii) dissemination of borrowers identity; (iii) suspension of board presentation and loan signature suspension; (iv) suspension of disbursements;

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(v) suspension of new loan processing; (vi) cross-effective sanctions; (vii) notification to cofinanciers and suppliers.

Controlling the Administrative Costs of the MDBs

The five MDBs taken together cost over US$2.1 billion to run in 1993/94 compared with substantially less than US$1 billion in 1983. The World Bank alone accounted for over 66% of that amount. The new EBRD already costs more to run than the older and more established AsDB even though it has only 40% of the number of staff and its present operational output is far lower. Average staff costs per staff member employed are much higher in the Washington and London based institutions than in the Abidjan and Manila based institutions. The overheads of the IBRD are much higher than those of the other banks other than the EBRD. Staff costs and benefits absorb around 70% of the total administrative expenditures of the established MDBs. Institutional overheads account for between 15-20% with other directly related operating costs (e.g. travel and communications) accounting for the remaining 10-15%. An analysis of MDB administrative costs makes it clear that there is little scope for achieving significant reductions in the operating cost structure of MDBs unless fundamentally different approaches to the use of human resources are considered. Budgeting systems which add incrementally to previous year programmes are not particularly useful in controlling MDB costs; *zero-based budgeting* would perhaps be more appropriate in reconsidering entire categories of expenditure which the MDBs presently take for granted.

The main reason for its much higher overheads is that the World Bank has a more wide ranging *non-operational* programme of activities than the other MDBs. This includes its extensive research work and publications on development issues, its data and information services. The Bank has also taken over much of the technical assistance work that was once undertaken by agencies in the UN system. Not all the elements of its expanding non-operational programmes are critical or essential. A major independent *external* review needs to be undertaken to examine which activities are critical and those which are peripheral. In many instances it would appear that such programmes are being funded for internal reasons rather than because of legitimate broadly-based demands for such output. Many of the non-operational activities (especially of the Washington-based institutions) could be rationalised and done jointly rather than singly in order to achieve significant budgetary savings within the multilateral system. The same thought could be extended to the UN agencies as well. This important issue needs to be explored thoroughly with more systematic, in-depth thinking about these issues by the MDB shareholding community. The World Bank is

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not the only MDB whose non-operational programmes should be reviewed, but its relative high overhead cost ratios and the fact that it accounts for two-thirds of the total annual administrative costs of the MDB system suggest that the greatest scope for pruning lies there.

From a *strategic* viewpoint achieving significant cost-reductions and efficiencies in MDB budgets and in the way that MDBs presently operate, requires attention on issues that are not really concerned with the administrative processes and protocols governing budget formulation and implementation. Tightening up the nuts and bolts of *budgeting systems* in the MDBs yields insignificant results. Despite pressures to control its budget and the annual refinement of its budgeting systems and procedures, the World Bank's annual operating budget in nominal (current) dollars has increased from US$406 million in FY81 to US$1,420 million for FY95. The compound annual rate of growth in nominal dollars between FY81-94 was 10% at a time when: the average inflation rate was 4%; staff grew at a rate of 1.5%, the overall volume of lending grew at a rate of 4%, the number of annual operations remained level and net transfers declined dramatically. The story is similar in the other MDBs although not quite as dramatic.

The strategic measures needed to restructure the nature of MDB operations and expenses raise several key issues: (i) *decentralising and localising* MDB activities; (ii) coping with a *changing operational and non-operational output mix*; (iii) coping with a *changing staff mix* demanded by the above two propelling forces; (iv) the *apportionment of administrative costs* between MDBs and MDFs; and (v) dealing with the issue of institutional *management of the budget process*. Shareholder concern needs to be more sharply focused on the future role MDBs should play in a global financial system whose complexion and capacity is changing at a speed well beyond the capacity of most governments and MDB managers to comprehend, leave alone operate in, or regulate. The operating frame of reference for the MDBs is now characterised by a world in which: (i) private capital markets (both international and domestic) are playing a rapidly growing and significant role in financing an increasing number of developing countries; (ii) MDB hard-window portfolios are maturing rapidly with an adverse impact on their resource transfer functions; and (iii) MDF soft-window resources are becoming increasingly constrained.

In such a world the main question is how MDB operations should change so as to: (i) achieve symbiotic and synergistic combinations with sources of private finance in areas where such finance is willing to go voluntarily (e.g. in industry, capital markets, infrastructure and key services); while (ii) mobilising the right kinds of financial packages, involving much less reliance on foreign resources and much greater emphasis on *local currency resource mobilisation*, for social investments in human capital, institution building in its

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widest sense, and in those supporting functions (accounting, legal, business support, media and information dissemination, governance and regulatory) which are crucial to making markets work competitively and efficiently. The operating vista for MDBs has changed from traditional concentration on particular types of projects and sectors and on standardised currency-pooled, variable rate loans. Under new operating conditions MDBs will need to gear themselves (as the EBRD is doing) to:

- Transforming their *hard-window* financial operations so as to able to lend in any number of single convertible currencies, or any combination of currencies at the choice of the borrower (rather than that of the MDB). MDBs must be able to lend at fixed or floating rates, with switching facilities from one to the other and vice-versa. Their loans may need to be packaged with or without attached derivatives (interest and currency caps, collars, options) to meet the particular risk profile chosen by the borrower for a particular purpose. MDBs should be prepared to lend for maturities ranging from 5-30 years from their hard windows.

- Being *demand-driven* rather than supply-driven, shifting away from operating as universal credit cooperatives which attempt to equalise everything across all borrowers in the name of equity and to act more as responsive financial intermediaries which tailor their financial products according to the specific needs and characteristics of borrowers and purposes.

- Transforming their *soft-window* facilities into much more flexible instruments which can finance credits of between 15-50 years at interest costs of 0-5% depending on the type of project, type of borrower and general development level of the country in which a project or programme is being financed.

- Loosening their eligibility and allocation criteria substantially to permit soft or intermediate term lending to a much wider range of low and lower-middle income countries and for high value social investments which are not best financed through hard-window loans.

- Mobilising *local currency resources* and lending in a manner compatible with: (a) the development of local and regional capital markets, especially local and regional debt markets; and (b) the progressive liberalisation of exchange controls over a borrower's current and capital accounts.

- Operating *in real-time* in cofinancing operations with private sector partners from OECD and developing countries, rather than behaving as the ultimate founts of knowledge and wisdom on project financing, yet being incapable of making a decision or reverting to their partners in the spans of time which are normally acceptable in the commercial marketplace.

- Using their *guarantee powers* much more extensively than their lending powers in order to catalyse a volume of resource flows which more than compensate for their own negative net transfers which will inevitably grow rapidly.

- Focusing on what they can do directly and usefully i.e. financing hard and soft projects, human capital development, institutional development and market development, as well as adjustment programmes under certain types of conditions in which these programmes are likely to succeed.

- Disengaging from what they cannot do directly with any proficiency despite their best intentions and confining themselves to using their considerable influence with borrowing governments to ensure that critically important matters for balanced and sustainable development are dealt with in a manner which develops, enfranchises and empowers all citizens (regardless of gender, race colour or creed).

- Doing much more to support those institutions (such as NGOs and local levels of governments) which have the capacity to do some things better. Unfortunately, MDB attempts at working productively with NGOs and with local levels of governments have so far had limited and mixed success largely because of incompatible staff attitudes between MDBs and NGOs.

- Curbing sharply their different *non-operational programmes*, spinning them off and privatising these to the extent possible while providing continuing symbiotic support to private providers of these services in terms of data and information.

- Working out a more appropriate balance between themselves and the UN system on *technical assistance activities* so as to lessen the present overload on their management systems in coping with these functions.

For MDBs to change in the directions suggested by the foregoing axioms they will clearly need changes in the quality and skill mixes of their staff along with the overhaul of their present managements. Fundamental changes will need to be made in the nexus between MDB managements and Executive

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Boards to ensure more effective institutional governance. These changes need to be accompanied by a different approach to human resource acquisition and development. Such a strategy will require new frameworks to be developed for MDB governance and for budget monitoring and control as well as for objective-setting and ensuring greater responsiveness to client needs. If MDB budgets are to be brought under proper control staff costs need to be tackled in three ways: (i) a review and revision of compensation and benefit levels; (ii) cutbacks in levels of staffing through cutbacks in non-operational programmes and changes in the skill-mix; and (iii) greater decentralisation and localisation of staff (with substantially reduced reliance on the use of expatriate staff from headquarters in field locations and curtailment of expatriate benefits) and much more extensive use of nationals in borrowing countries.

A concerted drive to reduce MDB staff is now essential and long overdue. Headquarters staff need to be reduced to about 33% of their present levels to perform only core headquarters management functions. Such a measure needs to be coupled with a drive to increase field staff to about 40-50% of total MDB staff at current levels. This would permit a scale-back (achieved mainly through natural attrition) of about 17-27% in current levels of staffing across all MDBs other than the EBRD. Since their managements seem unwilling and incapable of addressing the fundamental issues which continually rising MDB budgets raise, it falls on shareholders who mean well to take these issues up and deal with them in a way which secures the longer-term interests of the MDBs.

A Systemic View of the MDBs

Finally, MDB shareholders, and particularly the OECD shareholders who are involved in virtually every MDB, need to take a more systemic overall view of the official multilateral financing system, rather than the partial, institution-by-institution views that they take now. They need to ask themselves more fundamental questions about where the system as a whole is going, whether it is continuing to perform useful developmental and resource intermediation functions, and how it should be made to change in keeping with new shifts in global capital markets. There is a considerable amount of unjustifiable inconsistency and duplication within the MDB system which is being operated at considerable cost. There are also significant differences between the role that a *global* MDB like the World Bank should be performing and the roles that the *regional* banks should be performing which have not yet been fully explored or exploited.

Upto now, until the creation of the EBRD which is cutting its own swath, the regional banks have tended to be clones of the World Bank. There is a need now to shape them more as regionally focused institutions which are more like the European Investment Bank (EIB). These and other questions need to be explored more thoroughly than they have been so far through a counterpart to the Nordic-UN Project which undertook an exhaustive examination of the UN system and came up with powerful recommendations for change which, unfortunately, have become entangled in the byzantine web of the UN's bureaucracy. At the very least, some effort needs to be made for annual reviews, through an appropriately constituted body, of how the MDB system is performing as a whole with a view to setting new directions and monitoring progress being made toward getting there in some systematic fashion. Left to their own devices, and their self-absorbed managements, there is a serious risk that the MDBs will, before too long, atrophy as constructive institutional forces in promoting the cause of development.

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Annex 1.1 Comparative Balance Sheets of the MDBs - 1993/94
(billions of US dollars)

	IBRD	AfDB	AsDB	IDB	EBRD
ASSETS					
Liquid Funds	22.66	2.50	5.81	9.41	4.52
Notes Receivable for Capital Subscriptions	1.51	0.43	0.29	0.42	0.31
Other Receivables	5.30	0.43	4.32	0.52	1.00
Loans					
Approved	*164.30*	*15.46*	*26.39*	*37.16*	*3.69*
Not yet Effective	*11.35*	*1.24*	*3.14*	*n.a.*	*0.89*
Undisbursed	*43.66*	*5.91*	*10.04*	*14.98*	*2.40*
Outstanding	109.29	8.31	13.70	22.18	0.40
Equity Investments	–	0.18	0.11	–	0.22
Other Assets	1.74	0.07	0.34	0.45	0.08
Total Assets	**140.50**	**11.92**	**24.57**	**32.98**	**6.53**
LIABILITIES					
Short-Term Borrowings/Repos	5.23	–	–	–	1.06
Long-Term Borrowings	95.62	8.18	12.54	24.07	2.43
Other Liabilities/Payables	10.51	0.41	4.62	0.27	1.05
Provisions for Loan Losses	3.32	0.21	0.01	0.71	0.02
Provisions for Equity Losses	–	..	0.01	–	0.03
Capital					
Authorised	*184.00*	*22.25*	*23.20*	*60.99*	*11.16*
Subscribed	*170.00*	*20.97*	*23.08*	*54.20*	*11.02*
Callable	*159.34*	*18.41*	*20.29*	*51.03*	*7.71*
Paid In	10.66	2.56	2.79	3.17	3.30
Net Advance Payments	0.09	(0.02)	(0.07)	..	(1.36)
Total Paid-In Capital	**10.75**	**2.54**	**2.72**	**3.17**	**1.94**
MOV Translation Losses/Gains	(0.80)	(0.36)	(0.24)	..	..
Retained Earnings/Reserves	14.47	1.21	4.93	4.76	..
Currency Translation Adjustment	1.39	(0.27)	(0.02)	..	..
Total Net Worth (NW)	25.81	3.12	7.39	7.93	1.94
TOTAL LIABILITIES + NW	**140.50**	**11.92**	**24.57**	**32.98**	**6.53**

Notes:
Balance Sheets have been reconfigured to be comparable and hence may not reconcile with the total asset/liability figures drawn on the MDB Annual Reports.
Figures for IBRD are as of June 30, 1994, for the other MDBs they are as of October 31, 1994.

Annex 1.2 Comparative Income Statements of MDBs - 1993/94
(millions of U.S. dollars)

	IBRD	AfDB	AsDB	IDB	EBRD
INCOME					
From Loans					
Interest	7,707	527	1,030	1,522	16
Charges	115	75	45	342	22
Sub Total	**7,822**	**602**	**1,075**	**1,864**	**38**
From Liquid Investments	721	197	410	482	350
From Equity Investments	–	n.a.	n.a.	–	1
Other Income	11	3	24	(16)	1
Total Gross Income	**8,554**	**802**	**1,509**	**2,330**	**390**
EXPENSES					
of Borrowings					
Interest	6,549	544	800	n.a.	n.a.
Other	107	9	31	n.a.	n.a.
Sub Total	**6,656**	**553**	**831**	**1,657**	**177**
Provisions for Loan Losses	–	82	13	98	17
Provisions for Equity Losses	–	3	7	–	21
Administrative Expenses	731	55	89	179	153
Other Expenses	6	7	–	–	17
Total Expenses	**7,393**	**700**	**940**	**1,934**	**385**
OPERATING INCOME	1,161	102	569	396	5
Contribution to Sp. Programmes	110	–	–	–	–
NET INCOME	**1,051**	**102**	**569**	**396**	**5**

Notes:
Income Statements have been simplified and reconfigured to be comparable across MDBs and hence may not reconcile with the figures shown in the MDB Annual Reports.
The Income Statement for IBRD is for the period July 1, 1993 to June 30, 1994.
The Income Statement for other MDBs is for the period January 1, 1993 to December 31, 1993.

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

Annex 1.3 Comparative Cash Flow Statements of MDBs - 1993/94
(millions of U.S. dollars)

	IBRD	AfDB	AsDB	IDB	EBRD
CASH FLOWS FROM					
Lending Operations (LO)					
Loan/Equity Disbursements	(10,502)	(1,434)	(1,870)	(3,336)	(487)
Principal Repayments	11,320	360	1,083	1,788	15
Payments to MDF	(452)	–	(68)	–	–
Other/Equity Sales (Net)	(23)	(7)	16	–	–
Net Cash from LO:	**343**	**(1,081)**	**(839)**	**(1,548)**	**(472)**
Borrowing Operations (BO)					
Receipts from Borrowings	8,178	854	1,722	3,941	1,469
Retirement of Borrowings	(9,625)	(198)	(955)	(2,400)	(56)
Net flows from Swaps	(176)	23	(10)	n.a.	n.a.
Net Flows from Capital, and other Financial Transactions	199	80	(278)	127	542
Net Cash from BO	**(1,424)**	**759**	**479**	**1,668**	**1,955**
International Financial Adjustments					
ADJUSTMENT					
Net Income	1,051	102	569	396	5
Non-Cash Charges/Other	170	107	(138)	109	50
Net Cash from Operations	1,221	209	431	505	55
NET EXCHANGE RATE CHANGE EFFECTS	+ 586	(54)	(25)	82	(200)
NET INCREASES/(DECREASES) IN CASH & LIQUIDITY	726	167	(46)	707	1,738

Notes:
The Cash Flow Statements have been simplified and reconstructed to be comparable across MDBs and hence may not reconcile exactly with the figures shown in the MDB Annual Reports.
The Cash Flow Statement for IBRD is for the period July 1, 1993 to June 30, 1994.
The Cash Flow Statement for other MDBs is for January 1, 1993 to December 31, 1994.

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

Annex 2.1 Summary Presentation of Policies and Procedures for Handling Overdue Service Payments

	IBRD	AsDB
I. Billing Practices and Assistance to Borrowers		
Billing practices, general	Debt service is due semi-annually at due dates on the 1st or 15th of the particular months specified in loan/credit agreements. Billing statements are generated within one or two days after each semi-monthly closing date, for due dates two months in advance. Bills are sent to borrower by mail, courier or pouch about six weeks prior to due date. One month prior to due date, a summary of payments required is telexed to the Ministry of Finance for information.	Debt service is due semi-annually. Interest and other charges are computed two months before due date; principal repayment is equivalent to the amount specified in the amortization schedule of the relevant loan agreement. Billing statements are sent by ordinary mail/courier service/diplomatic pouch to borrowers at least three weeks prior to due date.
Overdues, definition	Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due-date.	Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due date. However, the AsDB allows a 30-day grace period before reporting arrears and initiating action to collect overdue payments.
Overdue Charges	No interest is charged on overdue interest.	No interest is charged on overdue interest.

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

Annex 2.1 (continued)

AfDB	IDB	EBRD
Debt service is due semi-annually on due dates of January 1 and July 1. (Management is currently considering the possibility of adding two more due dates on April 1 and October 1). Borrowers are sent bills via courier at least 45 days before the due date and requested to settle payment on or before the due date.	Debt service is due semi-annually according to a schedule set in the individual loan agreements. Billing statements are mailed to the borrower at least 60 days prior to date due, with copies to the Central Bank of the country concerned and to the IDB Field Office.	Same as IBRD
Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due date.	Payments are considered overdue if not credited to designated account of the Bank by the close of business on the due date.	Same as other MDBs
No interest is charged on overdue interest	No interest is charged on overdue interest.	Sames as other MDBs

Annex 2.1 (continued)

	IBRD	AsDB
Currency conversion	The World Bank will negotiate a "purchase of currency agreement" at no charge at any time for payments on any loan or group of loans with the proviso that the agreement must be in place at least three months prior to the due date. When such an agreement is in place, the payment is requested five days in advance of the due date, and an increment of 5-8% is added to the amount billed as a contingency against exchange rate movements.	The AsDB will purchase any currency needed by the borrower for payment of principal, interest, and other charges due to the bank. The borrower will be required to remit the US$/other convertible currencies for the purchase transaction with a 5% contingency margin six calendar days prior to payment due date.
Other assistance	Bank staff offer a range of assistance for debt management, debt accounting and reporting systems, and for specific countries on a case-by-case basis, for management of debt service to the Bank itself.	No technical assistance was found necessary. Bank staff on mission assist the borrower in clearing bottlenecks mostly due to transaction delays in the commercial banks' fund transfer system.

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Annex 2.1 (continued)

AfDB	IDB	EBRD
Under the Unit of Account-based billing system, there was no need to provide any such assistance, since Borrowers were billed in a single currency which they normally paid. Under the currency-based billing system, if payment is made in a currency other than that billed, the Bank will purchase the currencies billed on behalf of the borrower, using the currency of payment; any difference resulting from such exchange operation, being for the account of the Borrower.	The Bank does not formally assist the borrower in acquiring the necessary currencies for payment. The billing letter specifically indicates amounts due by currency and the depository bank to which funds should be credited. On a few occasions, at the request of the borrower the Bank has accepted payment in US dollars with the appropriate authorization to convert into the currencies needed for settlement of the debt service. Consideration is being given to offering this service more broadly in the future.	Same as IBRD
The Bank has started to provide grants to assist in setting up debt management units in borrowing member countries, designed to help borrowers improve their debt management capabilities. The Bank also advises Borrowers on fund-raising arrangements undertaken by them to meet their debt obligations.	30 days prior to due date, the Field Office, based on discussion with the borrower, executing agency and/or government financial official will report to the Bank's Country Coordinator with a copy to the Finance Department the likelihood of receiving payment on the due date. If there is a strong probability of non-payment on the due date, the Country Coordinator, in consultation with his Division Chief and Deputy General Manager, will initiate an action plan with a view to receiving payment within 30 days of due date.	Same as IBRD

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	IBRD	AsDB
II. Arrears Monitoring & Reporting		
Reports produced, distribution	1) Summary data available daily on internal electronic mail system to authorized staff. 2) Details by country, region, due date, loan and currency provided twice monthly in hard copy to management, Operations Legal and Financial staff and Executive Director for country concerned. 3) Country-by-country summary of all arrears over 30 days provided to all Executive Directors twice monthly. 4) Weekly summary by country and maturity, together with actions taken provided to senior operations management. 5) Monthly summary by country and maturity, together with review of developments in countries with longer overdues provided to senior financial management.	Reports routinely produced are: 1) Outstanding loan service payments report to management, once a month. 2) Delay in loan service payments report to the Executive Director representing the country if payments are not received 30 days after due date. 3) Outstanding loan service payments report to the Board of Directors if no payments are received 60 days after due date. 4) Receipt of outstanding loan service payments report to the Board of Directors if payments are received after reporting to the Board of Directors. Exceptional reports are also produced on request and as required.

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Annex 2.1 (continued)

AfDB	IDB	EBRD
A statement on the arrears status of all borrowing Member Countries is produced fortnightly. Monthly reports (Information Notes) are also prepared for the Board of Directors. Specific briefs and reports on arrears on individual countries are prepared, from time to time, on request from Management. 30 days after arrears emerge, the Board and Management are informed through the statement of arrears referred to above. Heads of concerned Projects and Country Programs Department, the Legal Department and Heads of Regional Offices concerned, are informed within one month after the due date.	Each Friday, the Finance Dept. issues a report of loans in arrears as of Wednesday of the previous week and for which evidence of payment has not been received at c.o.b. on Thursday of the week of the report. The report is distributed to the Board of Executive Directors, the Coordination Committee, the Operations and Legal Departments, and the Auditor General. A summary report is also prepared showing the age of the overdue payments.	Same as IBRD

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Annex 2.1 (continued)

	IBRD	AsDB
Cofinanciers	Under joint cofinancing arrangements, cofinanciers are informed at least five working days before (1) disbursements to a country are to be suspended due to arrears and (2) at least five working days before a borrower is placed in non-accrual status.	Cofinanciers are informed of arrears when the Bank is under contractual obligation to do so.
Financial statements and other public documents	Arrears of three months or more for borrowers other than those in non-accrual status are reported in the aggregate without naming the specific countries involved in the notes to all published financial documents; these data also include the aggregate amount of loans outstanding to the same borrowers.	For disclosure of information on loans in non-accrual status and on loan loss provisioning see below, Sections IV and V.
III. Measures for Dealing with Arrears		
Initial activities	Within two working days after arrears emerge, operations staff for the country concerned initiate action, normally by telex but also through IBRD representatives resident in the country, to obtain prompt payment of overdues.	Follow-up telexes would be sent if payments were not received within one to two weeks after due date.

AfDB	IDB	EBRD
At their request, cofinanciers and suppliers of goods and services under AfDB/AfDF projects and programs are duly informed when suspension of disbursements to a borrower or guarantor is imposed at described below in Section III.	For loans cofinanced through the Complementary Financing Program, participating commercial banks are informed as soon as arrears emerge on the loan(s) concerned. Other cofinanciers are informed if contractual obligations so require.	Same as IBRD
For disclosure of information on loans in non-accrual status and on loan loss provisioning see below, Sections IV and V.	For disclosure of information on loans in non-accrual status and on loan loss provisioning, see below, Sections IV and V. No disclosure of arrears is made prior to non-accrual status.	Same as IBRD
Reminders are sent 15 days before the due date and thereafter on a monthly basis. Under current policy loan signature is suspended after arrears reach 30 days. This prohibition is extended to the **guarantor** 15 days after the sanction is imposed on the borrower.	As soon as possible after the weekly Friday report on arrears is produced, the IDB sends the borrower a notice of intent to suspend disbursements, to become effective 30 days from the due date. A copy of the telex is also sent to the Guarantor. Cables are sent to Field Offices each Monday thereafter, advising them of the status of pending payments.	Same as IBRD

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	IBRD	AsDB
Suspension of disbursements	When arrears reach 45 days, the country's authorities are informed that if payment is not received on all overdues disbursements will be suspended on all loans to or guaranteed by the country on a specific date within 15 days. Suspension is thus effected when the longest overdue payment reaches 60 days. This information is sent by telex in a standardized format, with a copy to the Executive Director for the country concerned.	The AsDB has set no criteria that would serve as a basis to suspend disbursements. The only relevant condition of its Loan Regulations is the Borrower's continuing failure to pay its overdue payments. Whether a particular arrear would fit this requirement is decided on a case to case basis. The AsDB would inform the Borrower by telex followed by a formal letter stating the reason for the suspension.
Notification and disclosure	At the time of a suspension the Executive Directors and senior management are sent a formal notice to that effect. As noted above, cofinanciers are also informed.	The Board of Directors, management and staff, executing agencies, and cofinanciers (where the Bank is contractually obliged) would be informed.

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Annex 2.1 (continued)

AfDB	IDB	EBRD
Under current policy, disbursements are suspended on loans when arrears pass 60 days. This suspension is be applied on all loans to the **guarantor** 15 days later if payments are not received (i.e. at 75 days). Borrowers and executing agencies are informed by telex when suspension is imposed	The IDB suspends disbursements after 30 days on all loans to the **borrower** and simultaneously sends a notice to the guarantor requesting prompt payment of the amounts in arrears. Disbursements may continue on sectoral loans cofinanced with the World Bank for up to 75 days after arrears to the IDB are incurred. If payments are not received, specific analytical and planning actions for dealing with the problem are required of staff and management at 60 and 90 days. When arrears reach 120 days, disbursements to the **guarantor** on all loans to the guarantor are also suspended. Further, if required by the specific loan contract, disbursements may also be suspended on loans to other borrowers not in arrears but with the same guarantor when the guarantor is in arrears for more than 120 days.	Same as IBRD
Information on sanctions is announced inside the Bank by memorandum to management, Board members, the concerned Heads of Departments in the Projects and Country Programs Department, the Legal Department and the concerned Regional Offices.	Copies of suspension notices and guarantor notification are sent to the Executive Vice President (EVP), and to the Operations and Legal Departments, and the Executive Director of the country concerned.	Same as IBRD

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

Annex 2.1 (continued)

	IBRD	AsDB
Exceptions	The Regional Vice President for the country concerned may temporarily defer issuing disbursement suspension warning notices when: (1) payments are owed in currencies not readily available in international financial markets on the due date; (2) the amount overdue does not exceed $50,000; (3) payments are being processed; or (4) the Bank decides that queries on the billing statement need investigation.	The AsDB has no policy in this respect.
Exemptions	Items normally exempt from suspension include special commitments (including Guaranteed Letters of Credit); payments for goods shipped and services rendered before suspension; technical/consultant services or training/fellowships where interruption would cause personal hardship or disrupt critical work; interest and other charges payable to the Bank out of loan proceeds; and advances for Project Preparation Facilities.	The AsDB has no policy in this respect.

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

Annex 2.1 (continued)

AfDB	IDB	EBRD
Sanctions are not applied if arrears total less than 25,000 Bank or Fund Units of Account as the case may be. Further, as long as a specific borrower remains current in its debt service sanctions are not imposed, the extension of general sanctions to the guarantor notwithstanding.	Exceptions to a decision to suspend disbursements may be granted when: (1) payments are owed in currencies not readily available in international finance markets on the due date; (2) the overdue amount does not exceed $50,000; (3) payments are being processed; or (4) the Bank decides that queries on the billing statement need investigation	No Policy
Exceptions to these sanctions include multinational projects, training fees and fellowships; payments for goods shipped and services rendered before suspension; payments for technical assistance services financed from resources of the AfDF which are allocated to the Technical Assistance Fund, especially if they relate to pre-investment studies and institutional strengthening; and expenditure which is reimbursable to AfDB or AfDF from bilateral resources.	Outstanding reimbursement guarantees under letters of credit are exempted from suspension. However, there could be no additional letters of credit, no increase in amounts of outstanding LCs, no extension in dates of outstanding reimbursement of LCs, and no approval of new obligations to pay fixed amounts to suppliers. Other exemptions include specific obligations to pay fixed amounts to suppliers pursuant to written Bank undertakings; payment for services rendered and goods shipped before suspension; consultant services or training/fellowships where interruption would disrupt critical work; and non-reimbursable and contingent recovery technical cooperation along with small projects and direct credits to the Bank from loan proceeds.	Same as IBRD

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

Annex 2.1 (continued)

	IBRD	AsDB
Other sanctions	The IBRD does not present new operations for approval by the Executive Board if arrears on any loan are expected to reach 60 days or more overdue on the date scheduled for Board consideration. The dialogue with country authorities continues, however, as do other operational activities including project preparations. The Bank's procedures provide that if disbursements have been suspended for a continuous period of 30 days or more, the Bank may cancel either the entire loan balance or (in the case of project-related defaults) that part of the balance which was subject to suspension.	The AsDB has no policy in this respect.

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

Annex 2.1 (continued)

AfDB	IDB	EBRD
Under current policy loan **approval** (as opposed to signature) is suspended after arrears pass 30 days. No new loans to the **guarantor** may be approved starting 15 days after suspension of disbursements to a **borrower** (i.e.) after arrears to a borrower reach 45 days). Generally, AfDB/AfDF will not participate in financing cost overruns under projects or programs which would result from the application of sanctions due to arrears. However, in exceptional cases the Boards of Directors may authorize such financing on the recommendation of management in the interest of efficiency in specific operations.	The IDB does not sign contracts or present new operations for approval by the Executive Board if arrears on any loan have reached 30 days or more overdue on the date scheduled for Board consideration. When arrears pass 120 days loan proposals are no longer submitted to the Loan Committee or the Committee of Whole of the Board of Executive Directors. After arrears pass 180 days and all loans to the country concerned are placed in non-accrual status, all missions related to loan programming and processing are suspended and may be resumed only when it has been determined that arrears will be cleared in the near future. The Bank's loan contracts provide that if payments have been in arrears for more than 60 days, the Bank may terminate the contract with respect to amounts not yet disbursed and/or declare the loan due and payable.	Same as IBRD

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	IBRD	AsDB
Resumption of disbursements	All arrears of principal, interest and other charges must be cleared before disbursements are resumed.	All arrears of principal, interest and other charges must be cleared before disbursements are resume.
IV. Accounting Practices		
Timing of non-accrual status	Non-accrual status is invoked on the first working day after a second consecutive due date is missed for any payment of principal, interest or other charges on any loan (or IDA credit). As noted above, this is about six months after the first payment is missed.	It is the Bank's policy that an ordinary capital loan past due on interest and principal by six months would be placed under non-accrual status. (The Bank has not yet encountered the need to place any loan on non-accrual status).
Coverage	Non-accrual status applies to all loans to or guaranteed by the country concerned.	Non accrual status would apply to all loans to or guaranteed by the country concerned.
Reversal out of income	Income which has been accrued but not received is reversed out of current income when non-accrual status is invoked and thereafter income is not recognized unless actually received.	The Bank would reverse out of current income interest accrued but not yet received when non-accrual status is invoked and thereafter would not recognize income unless actually received.

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

Annex 2.1 (continued)

AfDB	IDB	EBRD
All arrears of principal, interest and other charges must be cleared before disbursements are resumed.	All arrears of principal, interest and other charges must be cleared before disbursements are resumed.	Same as other MDBs
Loans to borrower are placed in non-accrual status on the first working day after reaching 6 months overdue.	Non-accrual policy goes into effect when arrears from any borrower pass 180 days.	Same as IBRD
Non-accrual status applies to all loans to or guaranteed by the country concerned.	Non-accrual status applies to all loans to or guaranteed by the country concerned.	Same as other MDBs
Income which has been accrued but not received is reversed out of current income when non-accrual status is invoked and thereafter income is not recognized unless actually received.	Income which has been accrued but not received is reversed out of current income when non-accrual status is invoked and thereafter income is not recognized unless actually received.	Same as other MDBs

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

Annex 2.1 (continued)

	IBRD	AsDB
Disclosure	The notes to Financial Statements contain summary information for each country in non-accrual status including the name of the country, the date of non-accrual, principal outstanding, total arrears, and the effect of non-accrual policy on income during the reporting period.	Should the need arise, the Bank intends to disclose in the Notes to Financial Statements: (1) a summary of its non-accrual policy; (2) the details of the loans in non-accrual status (borrower's name, date loan placed in non-accrual, total loans outstanding, and the amount by which net income is reduced).
Restoration of accrual status	Accrual status is restored when all arrears of principal, interest and other charges are cleared.	Accrual status would be restored when all arrears of principal, interest and other charges are cleared.
V. Loan Loss Provisioning		
Timing of provisioning	Provisioning starts on the same day that a country is placed in non-accrual status.	The AsDB has no policy in this respect.
Coverage	Provisioning applies to IBRD only. Provisions for losses are not established under IDA policies.	The AsDB has no policy in this respect.

Annex 2.1 (continued)

AfDB	IDB	EBRD
Information on the aggregate amount of non-accrued income is disclosed in the notes to the Financial Statements, both quarterly (unaudited) for Internal use and the annual (audited) published accounts. Names of individual countries involved are not disclosed.	Notes to Financial Statements include the same information as that published by IBRD for countries in non-accrual status. The accumulated provisions are shown in the Balance Sheet as a deduction from loans receivable and each year's provision is shown as a deduction from income.	Same as IBRD
Accrual status is restored when all arrears of principal, interest and other charges are cleared.	Accrual status is restored when all arrears of principal, interest and other charges are cleared.	Same as other MDBs
When loans are 6 months overdue, Management makes an initial determination, on a quarterly basis, on the provisions that should be made.	Provisions are charged to income beginning the month following that in which the country is placed in non-accrual status.	Same as IBRD
Provisioning applies to ordinary capital, the AfDF and the NTF.	Provisioning currently applies to ordinary capital, the Social Progress Trust Fund, and the Venezuelan Trust Fund.	Provisioning applies only to EBRD loans/investments

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

Annex 2.1 (continued)

	IBRD	AsDB
Disclosure	Provisions are charged against current income and are shown in the balance sheet of published Financial Statements. Notes to the Financial Statement disclose the level of provisions for the current and previous reporting periods.	The ADB has no policy in this respect.
Cross-effectiveness	When either the Bank or IDA suspends disbursements, disbursements are automatically suspended by the other institution. Consideration of new operations of IFC and MIGA in the country concerned is decided on a case-by-case basis.	The AsDB has no policy in this respect.

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

Annex 2.1 (continued)

AfDB	IDB	EBRD
Provisions are charged against current income and are recorded in the balance sheet of published Financial Statements. Notes to the Financial Statements disclose the level of provisions for the current and previous reporting periods.	Provisions are charged against current income and are shown in the balance sheet of published Financial Statements. Notes to the Financial Statements disclose the level of provisions for the current and previous reporting periods.	Same as other MDBs
Sanctions imposed under these policies become cross-effective for AfDB/AfDF and the Nigeria Trust Fund (NTF) with respect to an individual **borrower** at the same time under current policy. As with other elements of these sanctions, cross-effectiveness applies only to loans to specific borrowers in arrears and to the guarantor, but not to other borrowers domiciled in the territory of the guarantor which remain current in debt service to AfDB/AfDF/NTF.	When disbursements are suspended on loans to a borrower, sanctions are imposed on all loans regardless of the source of financing. The suspension does not, however, extend to the operations of the Inter-American Investment Corporation.	Not Applicable.

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

Annex 2.2 IBRD Procedures for Dealing with Arrears – Timetable

Days After Payment(s) Due but not Received	Action
2	Country Department concerned initiates action to obtain payment. Key Bank officers and member's ED notified.
30	Executive Board notified through semi-monthly report on Overdue Service Payments, subject to thresholds of $1 million overdue to IBRD, $20,000 to IDA.
60/30 for borrower **45** for guarantor	Formal notice sent to borrower indicating that disbursements will be suspended in 15 days if payment not received. CFSVP and cofinanciers also informed at least one week prior to pending suspension.
75/45 days warning **60** days suspension	Disbursements suspended; Executive Board notified.
90	Amounts of principal and interest overdue for 90 days or more included in all published statements.
180	Specifically, second missed semi-annual payment date for any loan or credit: country placed in non-accrual status; loan loss provisioning initiated. If a member fails to fulfill its obligations to the Bank, the Bank may suspend its membership and upon cessation of membership (one year from the date of suspension) procedures for settlement of account apply.

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

Annex 2.3 EBRD Operational Exposure Limits

CATEGORY	SOVEREIGN RISK OPERATIONAL LIMITS	PRIVATE AND NON-SOVEREIGN RISK ENTERPRISE OPERATIONAL LIMITS
Country Risk	Individually set with a maximum 90% of paid-in capital (currently ECU 2,700 million)	
Country Economic Risk Indicators	A) Annual preferred creditor debt service must be less than 20% of annual foreign currency earnings B) Annual EBRD debt service must be less than 5% of annual foreign currency earnings	
Industry Sector	N/A	Maximum 20% of portfolio (from 1 January 1995)
Single Obligor	Country limit applies	Maximum 5% of paid-in-capital to any one private or non-sovereign risk enterprise obligor (currently ECU 150 million) Maximum 3% of paid-in-capital in any one equity investment (currently ECU 90 million)
Single Project	Maximum 10% of paid-in-capital (currently ECU 300 million)	Maximum 35% of long-term capital required by the project or of project cost; this guideline may be exceeded on an exception basis for smaller projects (e.g. up to about ECU 15 million) and infrastructure projects not guaranteed by a member country (e.g. BOT projects)

Note:
These limits must take into account the project being proposed and any other projects or changes to limits which are being considered at the same time. These limits apply to the amounts at risk by the Bank after syndication, participations or other forms of external financing.

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

Annex 2.4 Loan Portfolio Risk Profiles of MDBs as of End FY 1991
(Per cent)

	AsDB	IBRD	IADB	AfDB	EBRD
1. Share in the Portfolio of Countries whose Securities are Rated Below Investment Grade	42	72	88	100	100
2. Share in the Portfolio of Rescheduling Countries	18	45	70	65	62
3. Share in the Portfolio of Loans in Non-Accrual Status	0	3	2	12	0