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L.B. Rist: memorandum on loan charges and relevant documentation
1963
(2)

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Document Date 08 January, 1957	**Document Type** Board Paper	

Correspondents / Participants
From : The General Counsel

Subject / Title
Article IV, Section 4(a) of the Articles of Agreement

Exception(s)
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Mr. Geoffrey M. Wilson January 2, 1964

Leonard Rist

Some policy implications of the study on loan charges.-

1. The study on loan charges is intended to spell out the issues but not to make specific recommendations. I would, however, like to submit to you some of the conclusions I have drawn from our discussion in the Committee.

2. There is ample justification for slowing down on reserve accumulation by the Bank. This means that loan charges could be reduced. On the other hand, there seems to be a good chance that another alternative will be adopted, namely the allocation of part of the surplus earnings to the neediest developing countries, probably through IDA. Assuming the amount thus transferred at the end of the fiscal year 1963-64 is around \$50 million, this would mean that additions to reserves out of net income would be reduced by a sizeable amount.

3. Two other factors will affect additions to reserves. First, according to the administrative budget, expenses plus services to member countries may well rise by some \$4 to \$5 million this year. Second, the President's memorandum of July 18, 1963 to FPC recommends that the commitment charge be lowered by one-half. This point is discussed in para.62 of the memorandum on loan charges. If action is taken on it, the decline in earnings should be of the order of roughly \$5 million a year.

4. These three factors taken together would result in a reduction of the amount of earnings available for reserves (and lending) from \$83 million in 1962-63 to perhaps around \$20 million. This would seem to be a minimum if the Bank is to adhere to its policy of showing a "satisfactory" rise in reserves from year to year. It would appear to preclude for some time at least any consideration of a largertransfer to IDA or any lowering of Bank charges.

5. There is, however, an element of artificiality in the manner in which the Bank's profit and loss account is established. The income from the special commission, which was \$32 million in 1962-63, and should be around \$35 million or more this year, is set aside in the special reserve and not included in net income. In my view, this practice could be discontinued, the special commission should be abolished and incorporated in the rate of interest. This would

mean that there would be no further increase of the special reserve but, as pointed out in para.57 of the memorandum on loan charges, this special reserve cannot be used for Bank operations. Although kept in liquid form, it can only assist in servicing the Bank debt in case of default on the outstanding loans. Except in this case, it cannot even contribute to the Bank's overall liquidity. On the other hand, if the 1% special commission were simply merged with the interest charge, all the income arising from loan operations would accrue to earnings. Net earnings would amount to at least $55 million or more - after transfer of $50 million to IDA - instead of $20 million as forecast in the preceding paragraph. That amount would be available for allocations to free reserves or surplus, and therefore for Bank operations. Moreover, such a level of net earnings would restore a certain fredom of action to the Bank and could allow for a further expansion of services to member countries, or for increased transfers to other institutions, or even for a lowering of Bank charges.

6. It is my personal feeling that once this step has been taken, serious consideration should be given to lowering the interest charge by say 1/2% on new loans to Part II countries which have no prospect of calling on the market within the foreseeable future. Para.35 and following of the memorandum deal with this subject. The resulting sacrifice to the Bank in terms of earnings would be small. On the basis of $700 million lending a year and assuming full disbursement, the loss in earnings would be $3.5 million a year. This would of course increase as years go by, but even if $4.000 million of loans were outstanding at the new rate, the loss in earnings would only be $20 million a year (1).

7. The tone of the preceding paragraph indicates some hesitancy on my part. This is due to the fact that two important factors involved are matters of judgment rather than computation. One is the market reaction to a lowering of the rate. Would even a modest change as suggested above be construed as an indication that the Bank is indulging in "soft lending"? With an equity debt ratio not far from 1 to 1, with an earnings coverage of fixed charges well above 1.5, this may seem unduly conservative, but it is not possible to reach a conclusion on this point from behind a desk. The other factor is the uncertainty as to the future trend of long-term rates. Timing is therefore most important. If long-term rates were to rise over the next two years, it would be preferable to keep the Bank lending rate stable in the face of a tightening market and let the spread between borrowing and lending rates narrow progressively, rather

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(1) One may add that in the long run the borrowing countries would benefit more by a modest lowering of the interest rate than by a reduction of the commitment fee.

than lowering the lending rate now and raising it again later.

8. Irrespective of the level of the Bank lending rate, I would like to draw attention to the "Swiss scheme" mentioned in para.76 of the memorandum. No information is available on the reception which this scheme may have had in the OECD. But in spite of the numerous questions, practical, legal and perhaps political, which it would be bound to raise, cases may well occur where such a system would facilitate Bank lending. It is much more practical than the Horowitz' scheme and could constitute positive assistance to some of the Bank member countries. If therefore the Bank were invited to give its views on this subject, I would suggest that it should express its sympathetic interest.

Cc. Messrs. R. Cavanaugh
R. Cope

Messrs G. Woods, B. Knapp, G. Wilson		January 2, 1964

Leonard Rist

Memorandum on loan charges.-

The attached memorandum was prepared by the Committee on loan charges, organized under Mr. G. Wilson's instructions, dated October 31, 1963, and composed of Messrs. L. Rist, chairman, R. Cavanaugh and R. Cope.

In drafting it the Committee had the benefit of the comments of Messrs. D. Avramovic and P. Hayes (Economic Staff) and L. Nurik (Legal Department).

att.

Cc: Messrs. R. Cavanaugh, R. Cope
D. Avramovic, L. Nurik, P. Hayes

Leonard B. Rist

December 24, 1963

LOAN CHARGES

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Leonard B. Rist

Draft

December 24, 1963

LOAN CHARGES

INTRODUCTION

1. The purpose of this memorandum is to describe the charges imposed on borrowers either for IBRD loans or for IDA credits, how these charges have varied in the history of the Bank, and the discussions which in the past have led to the determination of the level of these charges or to changes in their level. This will be the subject of Part I. Part II describes the suggestions which have been made to modify the present loan or credit charges and sets forth the arguments for and against.

PART I - PRESENT SITUATION

Chapter I - IBRD - Definition and History of Loan Charges

2. The Bank requests its borrowers to pay a number of different charges. In this chapter these charges will be defined and their history reviewed. In Chapter II the past discussions relating to them will be summarized.

3. As a preliminary, it may be relevant to point out that the Bank does not charge its borrowers certain fees or expenses which they would have to pay if they were floating a public issue. First, the Bank has never charged its borrowers for expenses incurred by it for the preparation of the loans or for end-use supervision. There was some discussion at the very outset (1946) as to whether some compensation should be paid for these services, and the question was left open. It has not been referred to since that time, however, and all such outlays are treated as general administrative expenses of the Bank. Second, interest becomes due at the full rate not at the time of the contract, but only when the money is actually disbursed. Third, there is no bankers' commission payable at the time of the contract.

4. The charges incumbent upon the Bank borrowers include:

a) interest,
b) the special commission,
c) the commitment charge,
d) a special charge on "unqualified agreement to reimburse",
e) a premium on prepayment of loans.

The last two items listed can hardly be considered charges materially affecting the recurrent cost of borrowing from the Bank. The special charge on "unqualified agreement to reimburse" is only levied when the Bank commits itself irrevocably to a manufacturer or a Bank which then can issue an irrevocable letter of credit with respect to specific disbursements. The level of this service charge is now 1/2% and its history is summarized in Annex I. As to the premiums payable in case of anticipated redemption, their rates are comparable to those prevailing in the financial market, and their main purpose is to assure private holders who may purchase the borrowers obligations that prepayment will carry a premium as is currently done in public issues. Hitherto the Bank has always agreed to waive these premiums when obligations held by it were prematured. The discussion will, therefore, concentrate around the first three items. Their history is summarized below.

5. The Articles of Agreement give no other guidance as to what should be the interest rate charged by the Bank. They just say that its conditions should be "suitable" and "reasonable". It is therefore a matter of policy to be determined by the Board of Executive Directors. This policy was defined on the occasion of the first Bank loan (May 1947) as follows: the interest charged by the Bank will be "approximately 1/4 of 1% per annum higher than the one which the Bank estimates to be the rate of interest that it would have to pay for money at a term similar to that of the loan." (1)

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(1) R-97, April 1947 and revision of February 1948.

The margin of 1/4% was originally intended to assist the Bank in covering administrative expenses. It has, however, not always been applied rigorously and the 1/4% has in fact played the role of a safety margin to ensure that the rate charged would not be below the assumed cost of the money to the Bank. Attached as Annex II is a chart which compares the interest charged by the Bank for long-term loans with the cost to the Bank of borrowing at long term in New York. It reflects the fact that the Bank usually raised loan interest rates more slowly and lowered them more rapidly than a strict application of the policy mentioned above would have required. As a result quite frequently the Bank has not charged a full 1/4% over the rate it would have paid at the time of lending.

6. The rate of interest - including the margin of 1/4% - was, early in 1947, 3 1/4% for long-term loans. Following market fluctuations, it reached a peak of 5 1/4% between February and March 1960. It now stands at 4 1/2% effective since September 1962. Shorter term loans commanded a slightly lower rate than long-term ones until December 1956. Since then, in line with market conditions, lending rates have been uniform irrespective of the maturity of the loan.

Annex III gives in tabular form the full history of the interest rate charged by the Bank over the years. It should be noted, however, that the figures quoted in this Annex include the special commission of 1% discussed in the next paragraph.

7. The <u>Special Commission</u> is provided for by Article IV, Section 4 (a) for a period of ten years. Its proceeds are to be set aside in liquid form as a "special reserve". The rate provided for by the Articles was to be between 1 and 1 1/2% p.a. and the ten year period lapsed June 26, 1956. Since the beginning of its operations and continuing after the expiration of the ten year period, the Bank has charged 1%.

8. The <u>Commitment Charge</u> is not mentioned in the Articles of Agreement but is common banking practice. It is levied on amounts not withdrawn from the loan account, full interest being charged only as of the date when actual disbursement takes place. The rate had originally been 1 1/2%. Then, during a period extending from February 1948 to August 1950, the commitment fee, at 1 1/2%, was charged from the date when the contract became effective to six months thereafter; full interest (including special commission) became due after six months on the full amount of the loan, even if a part of it had not been disbursed. But the Bank undertook

to refund to the borrower the interest earned by it on its liquid assets held against the undisbursed commitments. This complicated system was dropped in August 1950, when the rate was fixed at 3/4 of 1%. It has not been changed since then (1). It is slightly lower than the rate of 1% usually quoted by commercial banks and also applied by I.F.C.

Chapter II - Past Discussions relating to Bank Charges

9. Past discussions concerning Bank charges can be divided in two distinct categories: those relating to specific technical problems and those relating to their overall level, even though they may have arisen in connection with one or the other specific component of the charges, interest, special commission or commitment charge. Specific technical problems will be dealt with first.

A - Specific Technical Problems

a) Discrimination among sources of funds:

10. Right from the beginning (1946), it was agreed that it would be impossible to charge different rates according to whether the Bank was using its own capital funds or

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(1) It comes into effect 60 days after the signing of the loan contract.

borrowed money to finance the borrower. This would have amounted to treating the borrowers differently according to the source of funds, and could have allowed for a system of "first come, best served" which could not be justified in a cooperative organization. For the same reason, the special commission which, according to the Articles, could have been levied only on loans made out of borrowed funds, was levied on all borrowers, irrespective of the source of funds.

b) Discrimination among borrowers:

11. The Articles of Agreement do not refer to that particular problem. Like the previous one this was strictly a policy issue to be decided upon by the Executive Directors. Their answer (1) was that there should be no discrimination among borrowers, either as to interest rates or commission. At that time the problem was whether the countries considered as greater risks should be charged higher rates than those with better prospects. The arguments against discrimination were two. First, it is practically impossible to appraise the risk differential, this being a matter of judgment rather than computation. Second, and this is slightly

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(1) Committee on Financial Policy, R-44, November 7, 1946.

contradictory with the previous argument, the pre-war practice of the private market had been to charge more for higher risks. It had proved self-defeating, as it is dangerous to impose too high a rate on a weak borrower.

c) <u>Differentiation as between maturities</u>:

12. This was originally taken for granted on the basis that it reflected market conditions. As pointed out in para. 5, such a differentiation lost its significance after 1956.

d) <u>Differentiation as between currencies lent</u>:

13. There were some discussions in 1946, 1947 and 1948 as to whether the Bank should apply different rates according to the currency in which it was lending. In line with the principle that the lending rate is to be adjusted to the borrowing rate, it seemed natural at the time to conclude that in the cases where currencies other than dollars become available, the lending rate should be adapted to the conditions prevailing in that currency's financial market. This has, however, not been the policy. Discrimination among borrowers according to the currency borrowed has been avoided. The reasons are the same as those which made it impossible to discriminate between loans made out of the Bank's own funds

and those made out of borrowed funds (para. 10 above). In practice it makes no difference from the point of view of the financial position of the Bank. Borrowing in high rate financial markets has been kept to a minimum, bonds were mainly issued in U.S. dollars, and the average cost of all borrowings has generally been equal to the average rate on U.S. $ bonds.

14. Similarly, the special commission was the subject of some technical discussions - quite aside from the problems of its level or of its continuance after 1956, which will be dealt with under "General level of charges". The main technical issues were:

a) should the commission apply to loans made out of capital as well as to those made out of borrowed funds? As indicated in para. 10, both categories of loans were treated on the same basis.

b) if the commission came to be changed or eliminated, should these changes be retroactive? The Articles of Agreement on this point are not mandatory (1) and no decision has been necessary since the commission has not been modified, but past discussions in the Board suggest that several

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(1) See Memorandum of the General Counsel, R-57-4 of Jan.8, 1957.

directors were inclined to make any changes in the commission applicable to past as well as to future loans.

c) can the commission still be charged after an obligation is sold out of the portfolio? The answer is unequivocally affirmative, but as long as the loan contracts clearly distinguished between interest rate and special commission, it was necessary to obtain the agreement of the borrower to a continuance of the commission. Since January 1949, however, the loan contracts have merged interest and commission into one single figure and no question has arisen in this respect.

15. With regard to the commitment charge, the history related in para. 8 underlines the fact that the Bank has modified its policy as concerns this item on several occasions. The principle of a commitment fee has, however, never been disputed. It rests not only on traditional banking practice but on the wish

a) to find a substitute for charging full interest from the date of effectiveness, since it was recognized that disbursements might often be fairly slow;

b) nevertheless to afford the Bank some compensation for paying interest on the funds borrowed by it for lending purposes;

c) to induce borrowers to withdraw funds from the loan account at the earliest possible date.

Most discussions about the commitment fee have centered around its level. Except in 1947, when the argument was made by some directors that a high commitment fee would not be justified for "development loans" because slow disbursements were inevitable, and that a high fee would not be an effective incentive, past discussions have usually not been on the technical aspects. Looking backwards, it is somewhat surprising to find that when in 1950 (1) the rate was reduced to its present level, the argument rested mainly on considerations relating to the Bank's earnings. Since then, there seems to have been little discussion on either the principle of a commitment charge or its level.

B - General Level of Charges

16. Most discussions relating to the three main charges (interest, special commission and commitment charge) revolved around their aggregate level and their impact on the Bank's borrowers on the one hand, and on the Bank's earnings and

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(1) See R-367 of August 11, 1950.

reserves on the other. These two aspects of the problem will be treated separately.

i) Effect of Bank charges on borrowers:

17. It is only natural that the level of service charges be a matter of serious concern to the borrowing countries. The increase in the foreign debt service burden of many developing countries over the last 10 years has been noted on several occasions and hardly needs to be commented on any further here. Servicing a foreign debt means both setting aside a fraction of the foreign exchange earnings and giving up part of the national income (and in case of a government loan, part of the national revenue). It is good policy for a borrowing country to try to reduce to a minimum these deductions from current availabilities. Furthermore, a reduction in interest rates is in general even more effective in this respect than an extension of redemption terms. In FPC/63-13 comparisons have been made as between various type loans by discounting the present value of all annual payments at 10%. Applying a reduction of 1% on interest rate (from 5 1/2% to 4 1/2%) has a sizeable effect on the total charge. Using the same examples as in FPC/63-13, the figures are as follows:

Type	Term of loan	Grace period after full disbursement	Interest rate	Present value	Peak annual service
A IBRD loan	20	none	5 1/2%	617	96
			4 1/2%	561	89 - 7,8%
B IBRD loan, interest payable from date of disbursement	40	6 years	5 1/2%	519	69
			4 1/2%	421	62 - 10%
C IBRD loan, interest capitalized over grace period	40	6 years	5 1/2%	396	109
			4 1/2%	293	90 - 17,4%

18. True, the return on newly invested capital is generally higher than the interest (including commission) charged by the Bank and this is valid both in advanced and in developing countries. But the purpose of the Bank is to foster development and its contribution is all the greater if it not only makes capital available to its borrowers but also allows them to take advantage of this differential to hasten their development. The greater the margin between cost of capital and return on capital, the greater the service rendered to the borrower. The borrowing countries would therefore benefit by lower charges on loans.

19. Conversely, it is equally to the interest of the borrowing member countries of the Bank that <u>continuity</u>

of Bank operations be fully ensured. The Bank should always be in a position to commit itself to further and perhaps increased lending operations. An increase in its own funds available for lending and a well assured market for its bonds are clearly to the advantage of its borrowing members as well as of all its shareholders or of its existing bondholders. This implies a reasonable level of earnings and reserves, and the charges are the main source of earnings.

ii) Earnings and Reserves Policy:

20. The determination of an appropriate level of earnings and reserves has been a constant preoccupation of the Bank. Ever since 1946, the need to accumulate some reserves was recognised; in 1947 the Committee on Financial Policy mentioned the desirability of accumulating reserves and possibly of distributing a small dividend (1). In January 1950 - in connection not with interest rates but with the commitment fee - a target was mentioned for illustrative purposes of 2% net earnings on the Bank's own capital used. Again in 1956/57, when the decision was taken to continue the special commission after June 26, 1956, the level of reserves was the main consideration (2).

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(1) R-71 of January 17, 1947.
(2) Two important papers were distributed at the time, one by Mr. Machado, dated January 24, 1957 (Sec.Memo.57-16), the other from the Management, dated June 4, 1957 (R-57-39).

21. The need for a satisfactory level of earnings and reserves arises in the first place out of the need to protect the Bank's shareholders. The greater the reserve accumulation, the less the risk that their 80% (now 90%) guarantee capital will be called upon to meet the Bank's obligations. True, it was recognized that "neither the risks confronting the Bank nor the practices of the most comparable institutions afford any basis for devising a formula to determine the "proper" level of reserves for the Bank" and "the level of reserves is of less importance than the fact of their continued accumulation... at what may be considered a satisfactory rate." In other words, it was not possible to assign an ideal level to the reserves. Various formulas had been tentatively examined. One of them (1) suggested that the ideal level could be 30% to 50% of the obligations of the Bank's biggest debtor or of the economic area which owes the Bank the biggest debt. Admittedly, however, such formulas could only be indicative. They could not be considered either rigid or permanent. The more the Bank lent out of its own funds, capital or reserves, the less the risk for its bondholders and therefore

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(1) Mr. Machado's Memorandum (Sec.Memo.57-16).

for the shareholders themselves.

22. At least as important as the protection of the Bank's shareholders was the need to establish and maintain its credit standing. All along one of the Bank's aims was to convince the market that it was following a reasonable financial policy and doing its utmost to prevent an impairment of its own capital. It was important to show that "the earnings coverage available for the service of Bank bonds" was being extended. Building up reserves was also evidence of "financial soundness and of (the Bank's) ability to ride out periods of payment difficulties or even defaults on the part of its borrowers."

23. In addition, something new had emerged in 1957. The market for foreign bonds was experiencing a revival. It was important that the Bank should not deter borrowers from calling on the market by offering rates far below those which the market would have been able to offer. True, the number of countries involved was not very great. Only European industrialized countries, Australia and Japan were in a position to revert to this classical method of financing but the Bank was encouraging them to meet their

needs through "joint operations" and later through recourse to the market without World Bank assistance. A decision as to whether the conditions under which foreign bond issues could be sold were "reasonable" compared with Bank terms was of course a matter of judgment.

24. In short, the general level of loan charges has been determined by taking into account three important considerations: a) showing a satisfatory earnings coverage, b) accumulating reserves, c) staying in step with the market. True, other factors than loan charges have a direct influence on net earnings and reserves. Such are the Bank's administrative expenses - including outlays for services to member countries. Another one is the liquidity policy; the greater the amount of quick assets held by the Bank, the lower the earnings at the full loan rate. Also relevant are the types of investment opportunities the Bank finds for its quick assets, the blend of bonds and notes it has outstanding at any given time, the conditions under which sales out of portfolio can be made and, of course, the dividend policy. It is not, however, the purpose of this memorandum to go into these aspects of the Bank's financial policy. It is concerned with loan charges, and they have a direct influence on earnings and reserves.

Chapter III - The International Development Association

25. As pointed out in para. 18, the amount of the service charge assumed by the borrowing country is inversely related to the benefit which it can draw from foreign capital imports. During the last war, beginning with Lend-Lease, and since then, lightening the service burden imposed on the capital recipient countries has been a matter of major concern. Grants have been a constant feature of bilateral assistance both for reconstruction and for development. Special loan conditions were granted by the U.S. as early as 1946 (1). Various European countries have also on many occasions granted terms distinctly below the cost of the money to them. Finally, the organization of IDA was a clear recognition that the availability of capital at low rates and on long repayment terms was needed by a number of developing countries.

26. The Articles of Agreement of IDA, which came into force in September 1960, provide for a considerable amount of flexibility. According to Article I, the purpose of

(1) The 2% interest rate applying to the $3,750 million loan to the U.K. in 1946 was, however, not far below the long-term rate paid at the time by the U.S. Government (2 3/8%).

the organization is to provide "finance to meet the important developmental requirements (of the less developed areas included within its membership) and bear less heavily on the balance of payments than those of conventional loans". Article V provides that the financing out of initial subscriptions "shall take the form of loans" but the report of the Executive Directors accompanying the Articles specifically points out that the broad language of this Article allows for "lenient terms of repayment" and "lending free of interest or at a low rate of interest", or "some combination of the foregoing".

27. The loans or, as they are currently called, the "credits" of IDA have all been on the same basis: 50 years with ten years of grace. They carry no interest and no commitment charge. However, a "service charge" of 3/4 of 1% p.a. is payable in foreign exchange on the disbursed and outstanding amount. When these terms were discussed by the Executive Directors (1) it was made clear that the service charge is designed to provide IDA with income with which to meet administrative expenses. There was some discussion as to whether a charge of 3/4% would be sufficient or excessive

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(1) February 1961.

for this purpose and it was agreed that its level would be reviewed from time to time in the light of experience.

28. In the three years of operations, administrative expenses allocated to IDA have actually been far in excess of the income arising from the service charge. The coverage was nil the first year, 1.4% the second, and 14.4% in 1962/63. Income from liquid funds was, however, large enough to allow IDA to operate at a profit. No suggestions have been made to review the level of the service charge.

Chapter IV - Recent Changes in Financial Position of IBRD

29. Before discussing in detail the various suggestions which have been made recently with respect to possible changes in Bank loan charges, it may be well to review the present financial position of the Bank. It reveals some substantial changes since the last thorough examination of the level of charges was undertaken in 1956. The expiration of the first ten years of operations of the Bank (June 1956) was the occasion for this discussion. Two main questions were considered at the time. One was whether

the 1% commission should be reduced or even eliminated. This would have decreased or even stopped the growth of the special reserve but would have left the supplemental reserve virtually unaffected. The other one was whether a dividend should not be distributed, which would have reduced the growth of the supplemental reserve or of whatever reserve or surplus account net earnings could be allocated to. No change in policy was, however, made at the time.

30. Since then one thing certainly has not changed. The Bank must rely on the bond market if it is to continue lending. No substantial or quick increase in its own funds can be counted on from 18% (now 9%) capital which can be made available only very slowly. Reserves accumulation and repayments on outstanding loans are far from sufficient even to maintain the level of lending. It is, therefore, just as important as in the past to convince the potential subscribers to the institution's bond issues that its earnings coverage is satisfactory and that it does not undertake financing which could be undertaken by private investors. Nevertheless, the accounts of the Bank as of now are in such a shape that it can only inspire confidence.

31. In the last six years the changes have indeed been quite substantial. First, the capital of the Bank was doubled in September 1959, thus raising the guarantee capital more than twice and the U.S. 80% (now 90%) which was $2,540 m. is now $5,715 million. Second, a number of other countries have improved their credit to the point where, in the eyes of the market, the U.S. would be supported by ~~xxx~~ other countries if the guarantee capital had to be called. As a result of these two factors, the funded debt which has more than doubled, increasing from $1,200 m. to over $2,500 m., still seems quite modest in relation to the guarantee capital, which was not the case in 1957. Third, the amount of so-called 18% (now 9%) capital made available for lending has increased from $1,000 m. in June 1957 to $,1,500 m. in June 1963. For this reason alone, the earning capacity of the Bank would have increased. Fourth, during the same period, reserves have risen from $289 m. (of which about $94 m. special reserve) to $813 m. (of which $235 m. special reserve). Thus the ~~xxx~~ Bank's own funds available for lending, and consequently its earning capacity out of its own funds, have almost doubled. Fifth, since administrative expenses - even including technical assistance to member countries - have

only risen at the same pace, the rhythm at which reserves are accumulating has accelerated. They increased by about $50 m. in fiscal year 1957 but by over $110 m. in 1963. According to the projections prepared in December 1962 - which assume no change in the present financial policies of the Bank - total reserves could rise by some $140 million in 1967/68 and by some $180 million in 1972/73. Finally, IDA has been organized. Since its very purpose is to assist in financing the poorer countries, it can either substitute for the World Bank in undertaking what may have been considered riskier types of financing or participate with the Bank in lending in that area.

32. According to the same forecast, if the Bank maintains its present policies, continues to lend at the rate of $700 million p.a. and to sell out of portfolio at the rate of $200 m, total reserves would reach ~~the~~ $1,000 million by 1965 and the $2,000 million mark by 1972. As shown in Annex IV, it also means that over the next ten years, just as today, the Bank's own funds (capital available for lending plus all reserves (1)) would remain roughly equgl to total indebtedness (1 to 1 equity debt ratio) and would still represent about one-half

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(1) i.e. including the spracial reserve which is, however, not available for lending.

of all loans outstanding. This prospect seems to open up an opportunity to reexamine both the rate of reserve accumulation and the level of earnings.

33. A number of suggestions have been made concerning the use to which earnings can be put. They all imply that reserves would rise more slowly and include such proposals as dividend distribution, subsidies for various useful purposes (e.g. education) and allocations to IDA or IFC or to a special Fund for general grants and technical assistance. All these have been or are being discussed elsewhere and will not be reviewed here. A number of other suggestions have been made which would affect the level of earnings of the Bank or at least the service payments to be made by Bank or IDA borrowers. They will be reviewed in Part II.

PART II - SUGGESTIONS AFFECTING CHARGES PAYABLE BY BORROWERS

34. A number of ideas have come to the attention of the Bank over the recent months or years tending to modify the pattern of loan charges as described in Part I. They fall into several categories. A first set of proposals would affect the interest rates (including commission)

charged by the Bank, either by an across the board lowering of these rates, or by discriminating among borrowers or projects. (Chapters I to IV). Most of them would entail a reduction in earnings, except for one group of suggestions which entails the assumption by third parties of some of the service burden of the borrower (Chapter VIII). A second type of proposal concerns specifically the level of the commitment charge (Chapter V). Finally, a third type suggests that a "Special Fund" could make assistance available to member countries on lenient terms (Chapter VI), or that IDA terms of lending could vary according to circumstances (Chapter VII).

Chapter I - Reduction in Interest Rates across the board

35. The case in favor of a reduction of interest rates (including commission) rests on two grounds. First, as discussed in paras. 17 and 18, it is to the interest of the borrowing countries to reduce the annual burden of their foreign debt. By placing their credit at the disposal of the institution through the 80% (now 90%) guarantee capital, the shareholders have stated their intention to allow all members to benefit by the credit of the most prosperous

ones. Moreover, by organizing IDA and blending IDA credits with its own loans, the Bank recognized the importance of reducing debt burdens. Should the Bank not contribute to it in its own operations? Second, the Bank could afford a reduction. Present rates imply a margin of 1% to 1 1/4% over the assumed cost of the money to the Bank, while one half of the funds engaged in operations are the Bank's own capital and reserves and represent no cost to it. Reducing the rate by 1%, for instance, would still allow the Bank to earn enough to accumulate reserves.

36. The arguments against a reduction in rates relate first to the market reaction to such a policy. Present lending rates can hardly be called excessive. They are below the rate of return on capital in the borrowing countries. They are certainly below the rate at which underdeveloped countries could borrow in the financial markets. More important even, they are below the rate which the governments of most advanced countries must pay in their own markets (1). It would be unfortunate if the Bank coul be accused of indulging in

(1) The fact that external borrowing rates are lower than internal interest rates in developing countries is nor really relevant. Even discounting the cases where concern about the future of the local currency makes for high internal rates, or the cases where an inádequate internal market could possibly be improved, borrowing abroad is induced by a lack of sufficient local savings in relation to investment needs or opportunities. It is natural that this be reflected in differential interest rates.

"give aways". In the second place, the earnings of the Bank would be affected perhaps more severely than the preceding paragraph assumes. A one point reduction in interest would mean a $40 million decline in net earnings. This would reduce the net earnings coverage of fixed charges from over 2 to around 1.7 times. True, the reserve accumulation would still be important (about $70 million), but only on the assumption that this balance is not otherwise allocated. In addition, projections show that, still assuming that all net earnings are allocated to reserves, a one point reduction in interest would mean a reduction of about $60 to 70 million in 1973 earnings, while the coverage of fixed charges by net earnings might be around 1.5 times or a little more. A third objection arises from the fact that sales out of portfolio might be seriously impeded. The lower the lending rate, the less attractive the borrowers' obligations are to the market unless the Bank is prepared to take severe losses at the time of the sale. Finally, a subsidiary point should be mentioned. Reducing the lending rate on all outstanding loans would benefit all present debtors on the basis of their past ability to borrow from the Bank and without regard to their development needs.

37. The arguments mentioned in the preceding paragraph would of course carry less weight if the reduction in rates were small, say 1/4% or 1/2%, instead of 1% or 1 1/4% as assumed earlier. Even allowing for the danger that the market might interpret this as a first step leading to a further decline, the word "give away" could hardly be used and the impact on earnings and reserves would be much less. Similarly, one could conceive of a reduction in rates which would affect only new loans and leave the past ones unchanged. While over the years the effect on earnings would become heavier, in the first year the impact would be negligible (roughly $7 million for a one point reduction and $3 to 4 million for a 1/2 point reduction). Again, the impact on earnings and on the market would be reduced if certain borrowers only benefitted by a reduction. This brings up the problem of discrimination which is discussed in the next chapter.

Chapter II - Proposals involving Discrimination among Borrowers

38. Two factors have come to light recently which have an important bearing on the external borrowing policy of member countries. One is that several countries which were able

to float public issues today find it impossible to raise all the external capital they could justifiably borrow. European markets are narrow compared with the needs of these countries and New York is not as receptive as it used to be to foreign issues. Hence a natural tendency on the part of certain industrialized countries of Europe, Australia or Japan to turn to the World Bank for assistance. The question thus arises whether the Bank should not charge them higher rates than it charges developing countries which have no access to the market. The other factor is that it is increasingly recognized that several developing countries may be threatened by a diminishing borrowing capacity, either because their foreign debt service is growing too fast or because external payments difficulties may be foreseen, or both. Here another question arises, namely whether the Bank should not charge them lower rates than its current ones, in order to alleviate the burden of the new debt.

39. Both these suggestions tend to create a discrimination among borrowers. It will be recalled that in 1946 the principle of no discrimination had been adopted. The issue at the time was, however, quite a different one, namely whether the countries which were the most likely to experience

payment difficulties should not pay higher rates than countries which apparently presented less risk. The discussions concerning this issue are summarized in para. 11 and following. Today the problem is exactly reversed and the question is whether the countries which the market is not ready to finance should not be treated more favorably. Nevertheless, some, though not all, of the arguments brought forth in the earlier days are again relevant. For instance, it had been pointed out at the time (a) that comparing the prospects of several countries over periods of say 10 or 20 years involved a considerable margin for error, and (b) that the Bank was a cooperative institution and should therefore treat all its members alike. These two points are generally speaking still valid.

40. They may, however, be somewhat less forceful than they were 15 years ago. The operations of the Bank are now combined with those of IDA. Not only have a certain number of countries (Part I) accepted the thought that they would only contribute to, but not benefit by IDA credits, but also the task of distinguishing between "Bank countries" and "IDA countries" is not frowned upon by the Board or the staff. Furthermore, certain Bank borrowers receive additional

assistance through IDA credits and the measure in which such "blending" is taking place has created a fourth category among members. It may therefore be argued that discrimination is a fact and could be carried one step further without doing harm to the institution. Uniformity does not take account of varying circumstances among member countries.

41. On the other side, the view is held that, whatever their relationship, the two institutions remain separate. The Bank cooperates with private lenders and government institutions which do not apply Bank terms, just as it organizes the cooperation between itself and IDA. But Bank terms are uniform. Abandoning that principle may create problems among members and worse, may give the market the feeling that Bank terms are variable and its policy unpredictable. The proposals discussed below assume that this argument is not considered valid and that discrimination as such could be Bank policy.

i) <u>Charging more to Countries which used to have access to the market</u>:

42. The arguments <u>in favor</u> of this procedure run as follows. The countries in question find themselves from time to time unable to float public bond issues. They feel that they are justified in calling on foreign capital. If the Bank shares that feeling, it cannot refuse to assist them. But

since the call on the Bank is due to the fact that the market is temporarily unable to satisfy their needs, they should and can pay the same charges which they would have paid for a public issue. Granting them the somewhat lower rates which the Bank normally offers would constitute an undesirable encouragement for them to reduce their efforts to get free access to the market or to avoid the trouble of distributing their borrowing among several markets. In addition the market should never have the impression that the Bank is competing with it. The borrowers in question are precisely those whom the market would normally be interested in financing. The terms offered to them should be close to those which the market would have accepted. Finally, since the signature of these borrowers may be attractive fo the market, the higher the rate charged, the better the chance that sales out of the portfolio can be handled without loss to the Bank.

43. Against this suggestion, however, it can be said that the real question is whether lending is justified or not. True, this is particularly difficult to ascertain for advanced countries which understandably tend to borrow abroad rather than internally where the interest differential

makes it attractive. But once the Bank is convinced that for lack of internal savings and for lack of access to international markets vital investment needs would remain in abeyance, it is one of the Bank's functions to satisfy these needs. This places the country in the same position as any other member. It does not justify a discrimination against it.

44. A <u>variant</u> (1) of this suggestion would envisage the purchase by the Bank of a bond issue of the borrower at a price corresponding to the real cost which this issue would entail if it were floated in the market. To take account of the fact that the borrower is by definition an advanced country and that market issues do not usually link borrowing with specific projects or imports, the loans could be for general purposes and be spent in local currency. Selling arrangements would be the same as in ordinary IBRD loans, i.e. consultation with the borrower would be necessary before a sale is effected. This proposal will not be discussed here at this stage.

ii) <u>Charging less to a developing country</u>:

45. In its simplest form (2) the proposal is to distinguish between IDA Part I and Part II members. Part I countries

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(1) Mr. R. Cope's internal memorandum of November 18, 1963.
(2) Mr. Moussa's memorandum dated September 19, 1963.

would continue to pay interest computed as at present, or at an even higher rate as discussed in paras. 40 and 41. But Part II countries could have the benefit of a sizeable reduction of interest from say 5 1/2% to 4 1/2% or even 4%.

46. This proposal could be applied in several ways. First the reduction could affect new loans only, and not old loans. In this way it might perhaps be easier to obtain for it the support of ~~the~~ those Part I countries which are heavy debtors of the Bank and would themselves be excluded from the benefit of a rate reduction anyhow. This would also have a much lighter impact on Bank earnings. On the other hand, it must be recognized that this solution implies a slight inconsistency. If lending rates are changed without relation to fluctuations in the Bank's borrowing rates, the only rationale applicable relates to the propsective debt position of the borrowers. This should logically induce the Bank to reconsider past rates as well as future rates.

47. Another question would be whether the reduction in rates should be uniform for all Part II countries, or variable according to their prospects. The first solution has the great advantage of being simple and clear cut. It

allows for fairly easy earnings forecast and creates less uncertainty in the market. The second solution, however, would allow for more flexibility and probably entail a smaller absolute decline in the earning capacity of the Bank.

48. The argument in favor of the general proposition that some or all Part II countries should enjoy lower rates than those prevailing at present are the following: first, all the arguments in favor or an across the board reduction in charges apply here also (see para.35). Second, the sacrifice in terms of earnings would be less than if the reduction applied to all borrowers. Third a comparison with the market rate is meaningless for Part II countries.

49. The main arguments against the proposal relate of course to discrimination in general (see para.39 and following) and to a reduction in rates (see para.36). It should be added that anything that could be called a "low rate" might have an unfavorable effect on the market, even if it did not apply to all borrowers.

Chapter III - Varying the Charges on Bank loans according to the type of projects

50. Some of the suggestions made would tend to discriminate not among borrowing countries but among projects. Certain

projects financed by the Bank are not self-liquidating in financial terms. Roads -- unless they are toll roads -- are a case in point. IDA terms are such that certain projects can be financed by it without entailing an additional subsidy from the borrowing government. Such are education and slow-yielding agricultural schemes, including irrigation schemes. Since it is likely that more and more similar projects will also be presented to the Bank, should one not allow for especially low rates of interest in these cases?

51. The <u>advantage</u> to the borrowing country would be that a subsidy would be avoided. It would not have to provide out of general public funds the amount required to cover the differential between the financial yield of the project and the cost of borrowing. At least this burden could be minimized. Similar discrimination is currently being practiced by several bilateral aid agencies. In the case of "blend" member countries, IDA will tend to finance the low-yielding projects. The proposal merely tends to broaden the flexibility of the two institutions taken together.

52. The main argument <u>against</u> this suggestion is based on slightly broader concepts. The Bank finances countries

through projects. It makes capital inflows possible to facilitate investments of a productive character. True, economic yield and financial yields do not always coincide. From the Bank's point of view, if it wishes to act as a development agency, it is the former rather than the latter which matters most. Furthermore, the Bank finances only part of the investment undertaken year to year in any given country. It agrees - and the whole proposal is based on that premise - that non self-liquidating projects may be important enough to warrant its support. It is therefore more interested in the aggregate yield of all investments than in the specific yield of the projects it finances itself. It will logically rely on the future aggregate income - real income or public revenue - of the country for the service of its loans. Thus, there seems to be no particular reason to distinguish among projects. Distinguishing among countries is an entirely different proposition; it was discussed in the preceding chapter. An additional consideration may be adduced here. It seems unavoidable that a policy which would tend to reduce loan charges on low-yielding projects would result in the member countries calling more and more on the Bank for that type of financing.

They may disregard real priority investment for the purpose of borrowing cheaply for low priority projects.

53. It may properly be pointed out that the proposal could be double-edged. For instance, high-yielding self-liquidating projects could be charged a higher interest rate than low-yielding ones. The same objections could, however, still be offered in this case, mutatis mutandis. In the previous instance it was proposed that the Bank help the country bear an unfavorable differential in rates of return. Here, the idea would be to cut back part of a favorable differential. It is, however, still the aggregate yield of all investments that matters most. Such considerations have of course no bearing on private investment but they apply where public investment or investment through the agency of government are concerned.

Chapter IV - Methods by which a reduction in rates could be carried out

54. If a reduction in Bank charges were considered desirable - either for all loans, or for certain loans - various methods could be applied to carry this out. Since the special commission of 1% has not been compulsory since 1956, one of them would be to reduce this commission. Another would

be to eliminate it. A third one would be to eliminate the special commission by merging it into the aggregate interest rate and then reducing the interest. Finally, a fourth suggestion is to leave charges unchanged but to allow for a refunding of the special commission to borrowers.

55. The first system - a reduction of the special commission by say 1/4 or 1/2% - would result in a decline in total earnings and in a slow down in the build up of the special reserve. The earnings arising from the investment of that special reserve would increase less rapidly than if the present rate were maintained and to that extent, but to that extent only, the borrowing needs of the Bank would increase. The coverage of Bank liabilities by the special reserve would likewise increase more slowly in absolute terms. In percentage terms, it could easily decline from the present 10%, instead of increasing by roughly o,5% p.a. as is forecast if no change were made in the Bank's financial policy.

56. The second system - complete elimination of the special commission @ has identically the same results except that the impact on earnings would be greater and that the special reserve would stop growing altogether.

57. The third system allows perhaps for more flexibility than the two preceding ones. It does not presume the amount of the margin which the Bank may maintain between the cost of the money to it and the lending rate. The commission is abolished but incorporated in the interest rate. As a consequence, the

special reserve cannot increase any further, but earnings are affected only to the extent that the aggregate interest rate is reduced from its present level of 5 1/2%. There is no particular point, at this stage, in increasing the special reserve further. It constitutes a block of liquid assets which cannot be used for Bank operations (except to meet liabilities in case of default on the Bank loans). Moreover, if a reduction in interest is effected and appears at a later date to have been unwarranted, it would be easier to increase the general rate of interest than to reinstitute part or all of the special commission (1). A merger of the commission into the interest rate thus seems to be simpler and th leave more room for future changes than either of the two other systems.

58. Still another suggestion is that part or all of the special commission <u>be refunded</u> to the borrowers as, when and if contractual service payments are regularly met (2). This could be done in two ways, either by paying back the commission to the borrower after full repayment of the loan, or by refunding year by year the amount received as 1% commission the year before. Whether this would be done across the board for all borrowers or limited to new borrowers does not materially affect the relative merits of the proposal.

59. The <u>advantage</u> of such a method is of course that nominally the Bank charged do not appear to be changed, while in effect the borrower is given an important discount

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(1) It can also be said that the need to set aside part of the income from loans for the special reserve tends to give an artificially low picture of the Bank's earnings. (2) Mr. Rajan, E.D.s Meetings, 1963.

on service charges. Furthermore, since the commission was originally conceived as providing a liquidity reserve against losses, it seems logical that the contributors be compensated as long as they do not default.

60. The objections are the following. First, withdrawing funds from the reserve to pay back to the borrowers may entail some difficult legal and accounting problems. But even if these were not insuperable - if for instance earnings from the commission were kept unallocated until the end of the fiscal year - a question of principle seems to arise. The commission was not conceived as a sum put up by each borrower to guarantee due payment on its own loans. It is rather in the nature of an insurance premium contributed by all beneficiaries of the loans of the institution. One may reduce the premium if the number of casualties is not as great as originally feared, but a straight refund year by year to those who have not encountered difficulties would leave the Bank uncovered with respect to other borrowers, or with respect to future defaults.

<u>Chapter V - Possible Changes in the Commitment Charge</u>

61. Several suggestions were made recently with regard to the commitment fee. The first (1) would be to reduce it by one-half (from 3/4 of 1% to 3/8 of 1%). A second one was to the effect that a sliding scale be introduced instead of a single rate, which would increase from time to time to a level probably higher than 3/4% (2). The third (3) is also based on the sliding scale principle. It would relate the charge not to the interval between the origin of the loan and the withdrawal but to the delays occurring after a likely drawing date estimated in advance. An example given was a nominal (1/4%) rate up to the time when it is originally estimated that a drawing will take place; 1/2% for the first three months after the estimated date; 3/4% for the second three months and 1% thereafter.

62. One <u>advantage</u> of the first proposal is its simplicity. As to the impact on the Bank's earnings, it would have been in the order of $5 million only in 1962/63. It could be somewhat more thereafter. Such a loss in revenue could in

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(1) President's Memorandum July 18, 1963 (FPC/63-8)
(2) Mr. Machado - Directors' Meeting - Aug.2, 1963 (FPC/63-11)
(3) Mr. Miller's Memorandum to Mr. Wilson, Oct.21, 1963

no way be harmful to the Bank. It is true that the incentive to withdraw from the loan account would theoretically be less, but it would seem that the principle of a committment fee is perhaps more important than its level. Disbursement and end use supervision procedures make it possible to detect abuses and stop undue delays.

63. The objections raised stem from another interpretation of the effectiveness of a fixed (and low) commitment fee. The higher the fee, it is said, the less the chance that borrowers will either neglect their own interest or the interest of the Bank. Delays have occurred for periods longer than had been reasonably anticipated. There have even been cases where the borrower was able to find short-term financing which, added to the 3/4% fee, remained lower than the Bank loan rates. True, such occurrences were remedied in time but at the expense of an added burden for disbursement and end use supervisors. In such cases even 3/4% may not be high enough.

64. The suggestion of a sliding scale is an attempt to reconcile these two points of view. Insofar as earnings are concerned, its effect would not be very different from

that of a simple reduction of the rate; perhaps a little smaller in the second suggestion listed in para. 61 (rates growing year by year), perhaps a little bigger in the third one.

65. The advantage to the borrowers would be about the same too. The purpose of the sliding scale idea is of course to provide an incentive to the borrower to withdraw, and a careful borrower should respond to it in cases where the disbursement and end use procedures of the Bank are not considered quite effective enough. It is, however, difficult to imagine that the borrower could speed up deliveries which have from the beginning been staged over a period. The more elaborate scheme takes account of this circumstance and provides a penalty only if delays are longer than originally anticipated. The incentive element is therefore much stronger. Its disadvantage might be precisely that it is complicated: the exact timing of a program of deliveries is difficult to estimate in advance with complete fairness, and controversies may well arise between the Bank and the borrowing country if the latter finds that delays are not due to its own negligence but, for instance, to the manufacturers.

Chapter VI - Special Conditions for Loans made out of a Special Fund

66. In a number of suggestions made recently the basic assumption is that the present earnings of the Bank should remain unaffected. Their allocation would, however, be different from what it has been in the past. Out of its own earnings the Bank would set aside certain amounts for specific lending purposes. It has already been decided to discontinue allocations to supplemental reserves. In the future the allocation of earnings will be decided annually by the Board of Governors. One possible use of the surplus could be assistance to IDA or IFC. Another suggestion is that a substantial fraction of the income be set aside in a "general development assistance grant and loan account" (1) or "Special Fund". Allocations to this "Fund" would be in substantial amounts and it would grow fairly quicly over the years. Out of this fund financing of operations related to the Bank's activities but not normal for it, grants for expanded technical assistance and loans on easier terms in specific fields (such as agriculture or education) could be made. Both longer terms and lower interest rates than usual in IBRD normal operations

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(1) Dr. Lieftinck, July 30, 1963 (FPC/63-11)
Dr. Donner, August 1, 1963 (FPC/63-12)

could be granted by the Fund (1).

67. From the operational standpoint, one of the <u>advantages</u> is that it allows for assistance on special terms to certain individual countries. It also tends to separate operations on lenient terms carried out by the Fund from the Bank's own operations which could continue to be made on conventional terms.

68. One of the <u>difficulties</u> relates to the discrimination suggested in favor of certain types of projects. This has been discussed in Chapter III. Another difficulty might be in administering still a third source of funds in addition to IBRD proper and IDA. This, however, may not be insuperable, a simple transfer to IDA would make matters simpler.

Chapter VII - Proposed Amendments to IDA Procedures

69. IDA credits have until now all been on the same pattern: no interest, service charge of 3/4 of 1%, 50 years term with 10 years of grace and 10 years low amortization. It has been suggested on several occasions that terms could be more flexible with respect to service charge or interest and period of repayment.

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(1) Mr. Tasi, on November 26, 1963, made a similar proposal, except that he included infrastructure among the types of projects suitable for financing out of reserve funds.

70. As concerns the service charge, it was pointed out in paras. 27 and 28 that its level was to be kept under review but that the time when the income from the service charge would exceed the administrative expenses of the Association was not yet in sight. A lowering of the charge is therefore not under discussion. Another suggestion, however, might entail the payment of interest on certain credits. It is discussed in the next paragraph.

71. It has been proposed that in certain cases IDA should charge interest (say 2%) and reduce the periods of grace and repayment (say 30 or 40 years for the latter). This could apply if a project promises to yield quick financial or economic returns, or if the borrowing country has fair development or balance of payment prospects. Possible discrimination as between projects in the Bank was discussed in para. 50. If the arguments offered against such a course are considered valid, they should be even more compelling here, since eligibility to IDA is determined country by country on the basis of economic prospects. Conversely, making a distinction as among countries would meet with no theoretical objections, especially if the Bank itself should feel inclined to distinguish among its own members.

But it seems hardly likely that in practice there would be much opportunity to make such distinctions at the present stage, i.e. as long as IDA resources remain so limited that the number of eligible members has to be kept low (1).

72. Still another suggestion has been made with regard to IDA. In cases where it is felt that a country's prospects might well improve over a period, a clause would be inserted providing for a reexamination of its position at intervals, say every ten years, whereupon the credit could be converted into an IBRD loan on conventional terms (or into an IDA loan on more onerous terms than the original ones).

73. Assuming discrimination among borrowers is an acceptable policy, this proposal has the advantage of giving lenient terms only for the period when they are really necessary. Fifty years, the argument goes, is a long period of time. Some countries which are today laboring under great difficulties may, within that period, undergo quite some improvement, particularly if their development efforts are well directed.

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(1) Hardening IDA terms might also have unfavorable outside effects, at this particular time. Recent congressional discussions have revealed a tendency to render AID terms perhaps more onerous. A change in IDA charges and terms could induce a renewal of these efforts. In many cases the effectiveness of IDA assistance depends on the terms on which bilateral aid is obtained by the recipient country. It is therefore to the interest of the Association that bilateral assistance should remain on lenient terms.

They themselves, at a certain stage, may wish to be considered creditworthy for conventional loans. This might open up new sources of financing for them. In addition, this would allow for a certain turnover of IDA funds, which would be to the advantage of the institution.

74. It should be recognized, however, that serious practical difficulties might be encountered at the time of the review. The prospects of the country might well be interpreted differently by IDA and by the debtor, which would make for very delicate negotiations. It might also be found at the time that new investments would be required to push the country's development further and that an increased debt service makes its external financing more difficult. Finally, a review clause might work as an incentive to the country to overburden itself with debt from other than IBRD/IDA sources in anticipation of a review.

Chapter VIII - Subsidization by third parties of rates payable to the Bank (or IDA)

75. Two suggestions have been made which would tend to subsidize the borrowers from outside sources. They are based on following assumptions:

a) that the Bank can easily float new bond issues in the private market and therefore fully satisfy growing needs for Bank/IDA financing;

b) that the lending rates (including commission) of the Bank cannot be reduced;

c) that it is, however, imperative for underdeveloped countries to pay lower rates than Bank rates;

d) that Part I governments will find it less expensive and will prefer to finance interest differentials rather than to prövide capital contributions to IDA or make bilateral credits.

i.) <u>The Swiss Scheme</u>:

76. Under this proposal (1), a number of countries - presumably Part I plus Switzerland - would agree to form a pool to pay part of the interest on IBRD loans. The pool could, for instance, pay 3 1/2% out of the 5 1/2% owed by the borrower, and thus reduce the latter's burden to only 2%.

77. The <u>advantages</u> to the countries participating in the pool are that they could assist development by way of a

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(1) See Mr. Karasz' memorandum to Files of March 18, 1963, Mr. Knapp's memorandum of March 28, 1963 and Mr. Karasz' memo to Mr. Miller of Sept.18, 1963.

modest contribution only, although it would be repeated yearly and thus imply a long-term commitment on their part. The developing countries would see their service burden lightened and could therefore borrow more for the same cost. As to the Bank, its income would be better assured since part of the interest charges would be borne by Part I countries. Finally, it would tend to develop multilateral assistance as against bilateral loans. Having contributed to the pool, the donor countries would be less inclined to assume direct financing.

78. The objections to the scheme would be partly psychological, partly practical. First, the scheme assumes that the interest charges of the Bank are detrimental to development. This has not been demonstrated and is largely a matter of opinion, as was discussed in para. 36. Second, the market might wonder whether the Bank is not assuming unduly high risks since it has to rely on sources other than the debtors themselves to meet service charges. This might be detrimental to the Bank's borrowings. Third, it is not clear whether the benefits of the pool would be available to all Part II countries indiscriminately. It would seem

perhaps unnecessary, and some of the debtor countries might well prefer to establish their own credit without recourse to a pool. Alternatively, the Bank itself might wish to induce some countries to shoulder fully their own obligations. This would again raise the problem of discrimination discussed before. Fourth, an increase in multilateral as compared with bilateral financing would be welcome. But could one safeguard the Bank against undue pressure on the part of the members of the pool in favor of certain projects rather than others? Fifth, is there not a danger that the countries contributing to the pool would at some stage put pressure on the Bank to reduce its own rate of interest? Finally, the scheme assumes that the Bank would in effect substantially increase its volume of lending since it would be expected to substitute for some bilateral operations. It can be doubted whether it would be easier for the Bank to issue more bonds than it would be for the Part I countries to issue their own.

ii.) Mr. Horowitz' Scheme (1)

79. This plan is based on identically the same premises

(1) His statement at Board of Governors, Oct.2, 1963 (Press Release Nr.55) - His note to Mr. Black, dated Sept.25, 1962 - Mr. Black's reply dated Dec.4, 1963 and Mr. Horowitz' letter to Mr. Woods, dated Oct.25, 1963.

as the previous one, but assumes that development assistance at low rate will be given through IDA rather than the Bank. Two alternatives are suggested. In the first, the Bank would borrow on the market and lend the proceeds to IDA at say 5 1/2%. IDA in turn would relend the money on lenient terms (say 1%). The difference would be covered by an "Interest Equalization Fund" contributed by Part I countries. In the author's example $3,000 million could be lent in this way by IDA in 5 years and the "Fund" would provide $135 million per annum after 5 years. If the present contributions to IDA were kept invested in Part I countries instead of being lent out, this could constitute a guarantee Fund of roughly $1,000 million and bring an income of say $30 million, thus reducing the yearly payments by the Equalization Fund to say $105 million per annum. One could even consider, if necessary, that IDA obligations to the Bank be guaranteed by the members contributing to the Fund or that the bonds issued by the Bank to finance IDA carry a special guarantee from the same countries (presumably substituting for the 80% - now 90% - guarantee capital).

80. The other alternative proposed is that IDA itself should issue bonds. The interest differential would again

be covered by the Equalization Fund and the IDA bonds would be guaranteed by the Part I nations, plus the subscriptions still available to IDA, say $1,000 million.

81. The advantages would be the same for both alternative plans. If successful, they would allow for more IDA lending than its capital subscriptions would permit. Mr. Horowitz assumes $3,000 m. instead of the $1,000 m. now available. At the same time it would eliminate for quite some time the need for new subscriptions by Part I countries in the capital of IDA. Moreover, all the points made in para. 77 concerning the Swiss scheme would also be relevant here.

82. The objections which the plan would encounter are the following. Some have already been mentioned in para.78 concerning the Swiss scheme. As regards the first alternative and barring an amendment to the Charter, a serious difficulty would arise from the terms of Article VI, Section 6, of IDA which specifically provides that "the Association shall not borrow from or lend to the Bank". The purpose of this provision was to ensure a complete separation between Bank and IDA funds and credits so as not to "prejudice the Bank's credit standing in the community".(1) As to the second alternative, it raises the problem of

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(1) Mr. Black's letter to Mr. Horowitz, Dec. 4, 1962.

creating a market for IDA bonds. This assumes not only that Part I governments undertake to contribute to the Equalization Fund for a long period and to guarantee IDA bonds but also that it will be possible to convince bondholders to purchase obligations of an institution "whose avowed purpose is to lend long to borrowers who would by definition be uncreditworthy for normal lending" (1). Even assuming that these legal and market obstacles could be overcome, the question as to whether considerable amounts of international organizations' bonds could be floated is a moot one. Except for the New York market, the others are relatively narrow and they are not likely to absorb amounts which might reach well over $1,000 m. a year if IBRD needs and increased IDA needs are to be satisfied, i.e. if the scheme is to succeed. And even if the markets could absorb such large amounts, there is no assurance that the financial authorities would look with favor upon extensive borrowings in their countries for capital exporting purposes.

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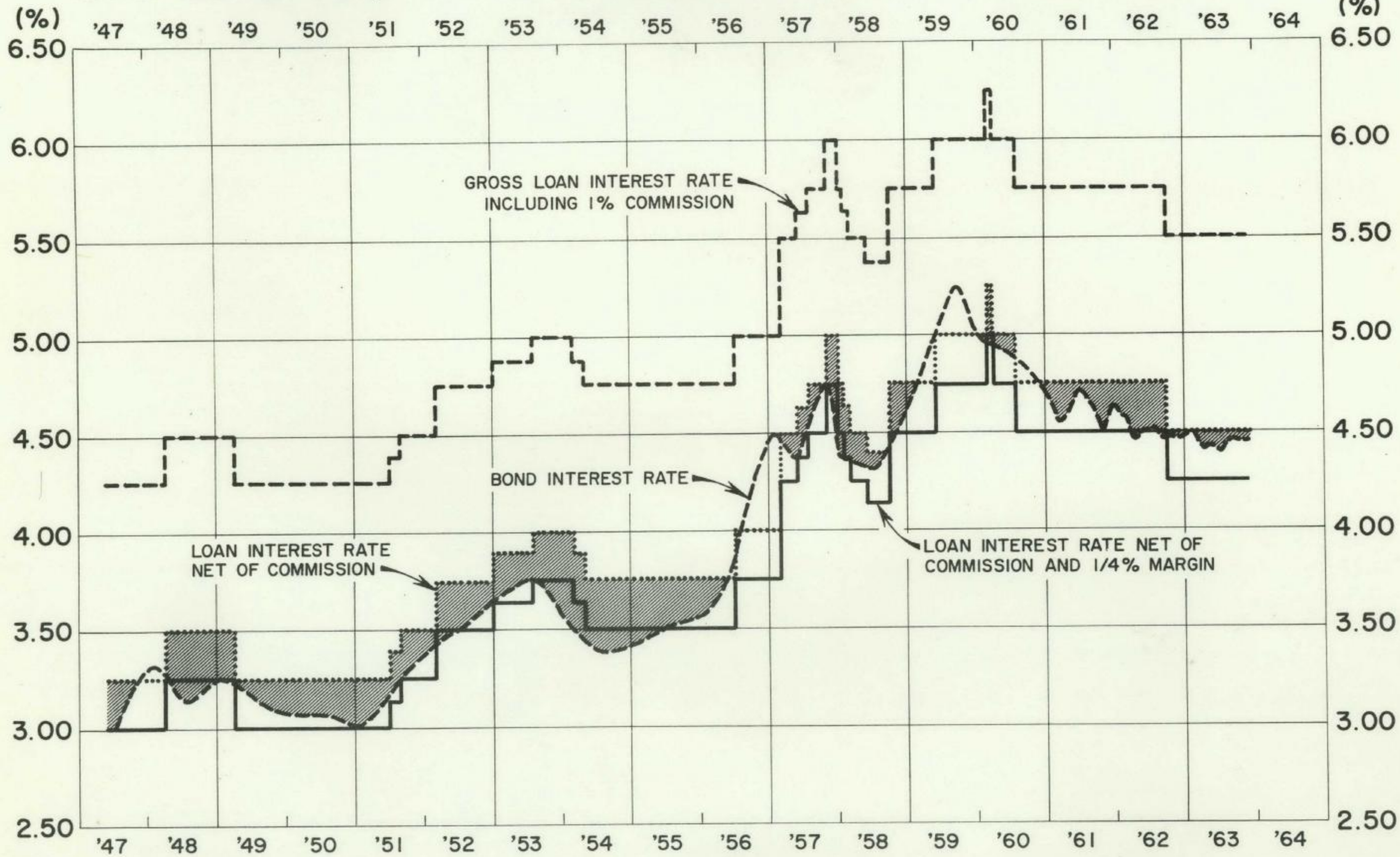
(1) Mr. Black's letter to Mr. Horowitz of Dec.4, 1962.

ANNEX I

Charge on "Unqualified Agreement to Reimburse"

The Bank is committed when a loan contract becomes effective, but still has the right to suspend disbursements or cancel the loan if the borrower does not abide by certain provisions of the loan contract. For practical reasons, the Bank from time to time found it necessary to give an "unqualified agreement to reimburse", either directly to the manufacturer or to a bank which then issued an irrevocable letter of credit. Originally the Bank charged full interest and commission for such firm commitments, as if actual disbursement had taken place. In July 1949, a new policy was inaugurated. The amount undisbursed but irrevocably committed was charged the regular commitment fee (then 1½%) plus a special charge of 1%. In August 1950, it was agreed that the special charge for irrevocable commitments would in each case be agreed between the Bank and the borrower. Any reduction allowed one borrower automatically benefited the others. Finally, on December 19, 1950, it was decided that the special charge for firm commitment would be at the uniform rate of ½%, to be added to the commitment charge. It has remained at that level ever since.

IBRD LOAN AND BOND INTEREST RATES



NOTES: BOND INTEREST RATE: Based on rate on new long-term dollar issues and, between issues, yield on outstanding bonds.

Shading indicates spread between loan interest rate net of commission but including 1/4% margin and interest paid (or payable) by Bank on long-term dollar issues.

IBRD-Economic Staff

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ANNEX II

SCHEDULE OF I.B.R.D. LOAN INTEREST RATES
(Including 1% Loan Commission)

Years to Final Maturity	May 1947	March 1948	July 1948 to March 1949	March 1949 to April 1950	April 1950 to April 1951	April to June 1951	June to Aug. 1951	Aug. to Oct. 1951	Oct. 1951 to Feb. 1952	Feb. to Dec. 1952
1								4%	4-1/8%	4-1/8%
2				3%				"	"	"
3								"	"	"
4								"	"	"
5								"	"	"
6								"	"	4-1/4%
7		3-3/4%		3-1/2%	3-1/2%		4%	"	"	"
8								"	"	4-3/8%
9								"	4-3/8%	4-1/2%
10			3-9/16%			3-7/8%	4-1/8%	4-1/4%	"	"
11								"	"	"
12							4-3/8%	"	"	"
13								"	"	"
14								"	"	"
15				4%	3-3/4%			4-3/8%	4-1/2%	4-5/8%
16								"	"	"
17								"	"	"
18					3-7/8%			"	"	"
19								"	"	"
20		4-1/2%	4-1/2%	4-1/4%	4%			4-1/2%	"	4-3/4%
25	4-1/4%				4-1/4%			"	"	"

Note: Until 1951 the loan interest rate was established for each loan as it was made. Thereafter, schedules of rates were announced from time to time within the Bank as general guides. However, a rate only becomes final on any particular loan when approved by the Board.

SCHEDULES OF I.B.R.D. LOAN INTEREST RATES
(Including 1% Loan Commission)

Years to Final Maturity	Dec. 1952 to July 1953	July 1953	Aug. 1953 to Feb. 1954	Feb. to April 1954	April 1954 to Dec. 1955	Dec. 1955 to June 1956	June 1956 to Dec. 1956	Dec. 1956 to Feb. 1957	Feb. 1957 to May 1957
1	4-1/8%	4-1/2%	4-1/2%	4-1/4%	4%	4-1/4%	4-3/4%	5%	5-1/2%
2	"	"	"	"	"	"	"	"	"
3	"	"	"	"	"	"	"	"	"
4	"	"	"	"	"	"	"	"	"
5	"	"	"	"	"	"	"	"	"
6	"	4-5/8%	4-5/8%	4-1/2%	4-1/4%	4-1/2%	"	"	"
7	4-1/4%	"	"	"	"	"	"	"	"
8	"	"	"	"	"	"	"	"	"
9	4-3/8%	"	"	"	"	"	"	"	"
10	4-1/2%	"	4-3/4%	4-5/8%	4-1/2%	"	"	"	"
11	"	4-7/8%	"	"	"	4-3/4%	"	"	"
12	"	"	"	"	"	"	"	"	"
13	4-5/8%	"	4-7/8%	4-3/4%	4-5/8%	"	"	"	"
14	"	"	"	"	"	"	"	"	"
15	4-3/4%	"	"	"	"	"	"	"	"
16	"	5%	5%	4-7/8%	4-3/4%	"	5%	"	"
17	"	"	"	"	"	"	"	"	"
18	"	"	"	"	"	"	"	"	"
19	"	"	"	"	"	"	"	"	"
20	4-7/8%	"	"	"	"	"	"	"	"
25	"	"	"	"	"	"	"	"	"

SCHEDULES OF I.B.R.D. LOAN INTEREST RATES
(Including 1% Loan Commission)

Years to Final Maturity	May 1957 to July 1957	July 1957 to Oct. 1957	Oct. 1957 to Nov. 1957	Dec. 1957 to Dec. 1957	Jan. 1958 to Jan. 1958	Feb. 1958 to Apr. 1958	May 1958 to Aug. 1958	Sept. 1958 to April 1959
1	5-5/8%	5-3/4%	6%	5-3/4%	5-5/8%	5-1/2%	5-3/8%	5-3/4%
2	"	"	"	"	"	"	"	"
3	"	"	"	"	"	"	"	"
4	"	"	"	"	"	"	"	"
5	"	"	"	"	"	"	"	"
6	"	"	"	"	"	"	"	"
7	"	"	"	"	"	"	"	"
8	"	"	"	"	"	"	"	"
9	"	"	"	"	"	"	"	"
10	"	"	"	"	"	"	"	"
11	"	"	"	"	"	"	"	"
12	"	"	"	"	"	"	"	"
13	"	"	"	"	"	"	"	"
14	"	"	"	"	"	"	"	"
15	"	"	"	"	"	"	"	"
16	"	"	"	"	"	"	"	"
17	"	"	"	"	"	"	"	"
18	"	"	"	"	"	"	"	"
19	"	"	"	"	"	"	"	"
20	"	"	"	"	"	"	"	"
25	"	"	"	"	"	"	"	"

SCHEDULES OF I.B.R.D. LOAN INTEREST RATES
(Including 1% Loan Commission)

Years to Final Maturity	May 1959 to Jan. 1960	Feb. 1960 to March 1960	March 1960 to June 1960	July 1960 to Aug. 1962	Sept. 1962 to
1	6%	6-1/4%	6%	5-3/4%	5-1/2%
2	"	"	"	"	"
3	"	"	"	"	"
4	"	"	"	"	"
5	"	"	"	"	"
6	"	"	"	"	"
7	"	"	"	"	"
8	"	"	"	"	"
9	"	"	"	"	"
10	"	"	"	"	"
11	"	"	"	"	"
12	"	"	"	"	"
13	"	"	"	"	"
14	"	"	"	"	"
15	"	"	"	"	"
16	"	"	"	"	"
17	"	"	"	"	"
18	"	"	"	"	"
19	"	"	"	"	"
20	"	"	"	"	"
25	"	"	"	"	"

Comparison of Some Important Balance Sheet Items
(in millions of dollars)

Fiscal year ending June	Bank's Own Funds: Capital available for lending	Reserves: Special	Reserves: Total (including b.)	Total	Borrowings Outstanding		Loans: Outstanding held by Bank including undisbursed	Undisbursed fraction of loans
	a.	b.	c.	d.	e.	d + e	f.	g.
1948	735	3	6	741	254	995	497	27
1953	867	37	113	980	556	1,436	1,417	398
1958	1,343	114	350	1,693	1,658	3,351	2,830	646
1963	1,690	255	813	2,503	2,519	5,022	4,400	1,245
1968 (forecast*)	1,700**	468	1,440	3,140	3,490	6,630	6,820	1,700
1973 (forecast*)	1,700**	756	2,280	3,920	4,110	8,030	8,000	1,700

* Forecast of December 26, 1962

** Assuming no major change from 1963 figure

Percentages

Fiscal Year ending June 30	Special Reserve to Borrowings Outstanding	Total Reserves to Borrowings Outstanding	Total Reserves to Loans Outstanding	Capital Available for Lending plus Reserves to Borrowings Outstanding	Capital Available for Lending plus Reserves to Loans Outstanding
1948	1.2	2.4	1.2	291.7	149.1
1953	6.7	20.3	8.0	176.3	69.2
1958	6.9	21.1	12.4	102.1	59.8
1963	10.1	32.3	18.7	99.3	56.8
1968*	13.4	41.3	28.2	89.8	45.9
1973*	18.4	55.5	36.3	95.4	49.1

* Forecast of December 26, 1962

Leonard Rist

DRAFT - December 4, 1963

LOAN CHARGES

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Leonard B. Rist

Draft

December 4, 1963

LOAN CHARGES

INTRODUCTION

1. In the present memorandum an attempt is made to describe the charges imposed on borrowers either for IBRD loans or for IDA credits, how and for what reasons these charges have varied in the history of the Bank, as well as the past discussions which have accompanied either the determination of these charges or these variations. This will be the subject of Part I. Part II is an attempt to describe the various suggestions tending to modify the present loan or credit charges and to weigh the arguments pro and con.

PART I - PRESENT SITUATION

Chapter I - IBRD - Definition and History of Loan Charges

2. The Bank requests its borrowers to pay a number of different charges. In this chapter these charges will be defined and their history reviewed. In Chapter II the past discussions relating to them will be summarized.

3. As a preliminary, it may be relevant to point out that the Bank does not charge its borrowers certain fees or expenses which they would have to pay if they were floating a public issue. First, the Bank has never charged its borrowers for expenses incurred by it for the preparation of the loans or for end-use supervision. There had been some discussion at the very outset (1946) as to whether there whould be some compensation paid for these services, and the question was left open. It was not referred to later, all outlays being treated as general adminstrative expenses of the Bank. Second, interest becomes due at the full rate not at the time of the contract but only when the money is actually disbursed. As will be seen later, there was some hesitation in this respect but in fact this principle has prevailed all along. Third, there is no bankers' commission payable at the time of the contract.

4. The charges incumbent upon the Bank borrowers include:

a) - interest,
b) - the statutory commission,
c) - the commitment charge,
d) - a special charge on "unqualified agreement to reimburse,
e) - a premium on prepayment of loans.

These various charges have changed from time to time in the history of the Bank and their history can be summarized as follows.

5. The <u>interest rate</u> was from the beginning (April 1947) fixed at "approximately 1/4 of 1% per annum higher than the one which the Bank estimated to be the rate of interest that it would have to pay for money at a term similar to that of the loan". (1) This rate (including the margin of 1/4%) was, in 1947, 3 1/2% for long-term loans; following market fluctuations, it reached a peak of 5 1/4% between February and March 1960 and now stands at 4 1/2% since September 1962. Shorter-term loans commanded a slightly lower rate than long-term ones until December 1956. Since then, rates have been uniform, irrespective of the maturity of the loan, to meet market conditions. A full history of the rates actually charged will be found in Table I (Schedule of IBRD loan interest rates"). It should be noted, however, that the figures quoted in that table include the 1% statutory commission.

6. The <u>Statutory Commission</u> is provided for by Article IV, Section 4 (a) for a period of at least ten years and its proceeds are to be set aside in liquid form as a "special reserve". The rate provided for by the Articles was to be between 1 and 1 1/2% per annum and the ten year period lapsed June 26, 1956. Since the beginning of its operations

(1) R-97, April 1947 and revision of February 1948.

and continuing after the expiration of the ten year period, the Bank has charged 1%.

7. A Commitment Charge is levied on amounts not withdrawn from the loan account, full interest being charged only as of the date when actual disbursement takes place. The present rate, effective since August 1950, is 3/4 of 1%. The rate had originally been 1 1/2%. Then, during a period extending from February 1948 to August 1950, the commitment fee at 1 1/2% was charged from the date when the contract became effective to six months thereafter; full interest (including statutory commission) became due after six months on the full amount of the loan, even if a part of it had not been disbursed. But the Bank undertook to refund to the borrower the interest earned by it on its liquid assets held against the undisbursed commitments. This complicated system was dropped in August 1950 when the rate was fixed at 3/4 of 1%.

8. In addition to these three main charges, the Bank also charges a special fee when it enters an "unqualified agreement to reimburse" and the loan contracts provide for a premium to be paid in case the borrower prematures the loan. No suggestion has been made recently to change these

two items and they are mentioned here for the record only. They are descrived in the two following paragraphs but will not be referred to further in this memorandum.

9. The Bank is committed when a loan contract becomes effective but still keeps a right to cancel the loan or suspend disbursement if the borrower does not abide by special provisions of the loan contract. For practical reasons, the Bank found it necessary to give an "unqualified agreement to reimburse" either directly to the manufacturer or to a bank which then issued an irrevocable letter of credit. Originally the Bank charged full interest and commission for such firm commitments as if actual disbursement had taken place. In July 1949, a new policy was inaugurated. The amount undisbursed but irrevocably committed was charged the regular commitment fee (then 1 1/2%) plus a special charge of 1%. In August 1950, it was agreed that the special charge for irrevocable commitments would be in each case agreed between the Bank and the borrower. Any reduction allowed one borrower automatically benefitted the others. Finally, on December 19, 1950 it was decided that the special charge for firm commitment would be at the uniform rate of 1/2% to be added to the commitment charge. It has remained at that level ever since.

10. Premiums on anticipated redemption have been provided for in all loan contracts. Rates have usually been comparable to rates prevailing in the financial market. Hitherto, however, the Bank has always agreed to waive these premiums when obligations held by it were prematured. In practice therefore, their main purpose is to assure private holders who may purchase from or through the Bank the borrowers' obligations, that prepayment will carry a premium, as is currently done in public issues.

Chapter II - Past Discussions relating to Bank Charges

11. Past discussions concerning Bank charges can be divided in two distinct categories: those relating to specific technical problems and those relating to their overall level, even though they may have arisen in connection with one or the other specific component of the charges, interest, statutory commission or commitment charge. Specific technical problems will be dealt with first. The discussion will center only around interest, statutory commission and commitment charge.

A - Specific Technical Problems

12. A number of problems arose in connection with interest

<u>rates.</u> Those relating to the level of rates will be dealt with under "general level of charges". The other ones related to:

a) <u>Discrimination among sources of funds</u>:

Right from the beginning (1946), it was agreed that it would be impossible to charge different rates according to whether the Bank was using its own capital funds or borrowed money to finance the borrower. It would have amounted to treating the borrowers differently according to the source of funds and could have allowed a system of "first come, best served" which was contrary to the spirit of a cooperative association. Incidentally, it is for the same reason that the statutory commission which, according to the Articles, could have been levied only on loans made out of borrowed funds, was levied on all borrowers, irrespective of the source of funds. It is interesting to note that this isue has never been a subject of controversy and that it would be impossible to raise it today in view of the fact that since June 1960 the accounts do not any longer distinguish ~~xxxxxxx~~ between loans made out of our own capital and loans made out of borrowed funds.

b) <u>Discrimination among borrowers</u>:

The Articles of Agreement do not refer to that particular problem. It was strictly a policy issue to be decided upon by the Executive Directors. Their answer (1) was that there should be no discrimination among borrowers, either as to interest rates or commission. At that time the problem was whether the countries considered greater risks should be charged higher rates than those with better prospects. The arguments against discrimination were two. First, it is practically impossible to appraise the risk differential, this being a matter of judgment rather than computation. Second, and this is slightly contradictory with the previous argument, the pre-war practice of the private market had been to charge more for higher risks. It had proved self-defeating as it is dangerous to impose too high a rate on a weak borrower. One may add that the argument that the Bank was a cooperative organization bound to treat all its members on the same basis was implied but was not explicitly discussed.

c) <u>Differentiation as between maturities</u>: This was taken for granted on the basis that it reflected the market conditions. As pointed out in para. 5, such a differentiation lost its significance after 1956.

d) <u>Differentiation as between currencies lent</u>: There ~~was~~ were some discussions in 1946, 1947 and 1948 as to whether the Bank should apply different rates according

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(1) Committee on Financial Policy, R-44, November 7, 1946.

to the currency in which it was lending. In line with the principle that the lending rate is to be adjusted to the borrowing rate, it seemed natural to conclude that in the cases where currencies other than dollars become available, the lending rate should be adapted to the conditions prevailing in that currency's financial market. In practice, however, borrowing in high rate financial markets has been kept to a minimum, bonds were mainly issued in U.S. dollars, and the average cost of all borrowings has generally been equal to the average rate on our U.S. bonds.

13. Similarly, the <u>statutory commission</u> was the subject of some technical discussions - quite aside from the problems of its level or of its continuance after 1956, which will be dealt with under "General level of charges". The main technical issues were:

a) should the commission apply to loans made out of capital as well as to those made our of borrowed funds? As indicated in para. 12 (a), both categories of loans were treated on the same basis.

b) if the commission came to be changed or eliminated, should these changes be retroactive ? The Articles of

Agreement on this point are not mandatory (1) and no decision has been necessary since the commission has not been modified, but past discussions in the Board seem to indicate an inclination to make any change applicable to past as well as to future loans.

c) can the commission still be charged after an obligation is sold out of the portfolio? The answer is unequivocally affirmative but as long as the loan contracts clearly distinguished between interest rate and statutory commission, it was necessary to obtain the agreement of the borrower to a continuance of the commission. Since January 1949 however, the loan contracts have merged interest and commission into one single figure and no question has arisen in this respect.

14. With regard to the commitment charge, the history related in para.7 underlines the fact that the Bank has modified its policy as concerns this item on several occasions. The principle of a commitment fee has, however, never been disputed. It rests not only on traditional banking practice, but on the wish

a) to find a substitute for charging full interest

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(1) See Memorandum of the General Counsel, R-57-4 of Jan.8,1957.

from the date of effectiveness, since it was agreed that "development loans" were likely to be disbursed at a slower pace than "reconstruction loans";

b) to nevertheless afford the Bank some compensation for paying interest on the funds borrowed by it for lending purposes;

c) to induce borrowers to withdraw funds from the loan account at the earliest possible date.

Most discussions about the commitment fee have centrered around its level. Except in 1947, when the argument was made by some directors that a high commitment fee would not be justified for "development loans" because slow disbursements were inevitable and that ~~thus~~ a high fee would not be an effective incentive, past discussions have usually not been on the technical aspects. Looking backward, it is somewhat surprising to find that when in 1950 (1) the rate was reduced to its present level, the argument rested mainly on considerations relating to the Bank's earnings. Since then, there seems to have been little discussion on either the principle of a commitment charge or its level.

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(1) See R-367 of August 11, 1950.

B - General Level of Charges

15. Most discussions relating to the three main charges (interest, statutory commission and commitment charge) have revolved around their aggregate level and its impact on the Bank's earnings and reserves on the one hand, and on the Bank's borrowers on the other. These two aspects of the problem will be treated separately.

i) Earnings and reserve policy

16. The determination of an appropriate level of earnings and reserves has been a constant preoccupation of the Bank. Ever since 1946, the need to accumulate some reserves was recognized ; in 1947 the Committee on Financial Policy mentioned the desirability of accumulating reserves and possibly of distributing a small dividend (1). In January 1950 - in connection not with interest rates but with the commitment fee - a target was mentioned for illustration purposes of 2% net earnings on the Bank's own capital used. Again in 1956/57, when the decision was taken to continue the statutory commission after June 26, 1956, the level of reserves was the main consideration (2).

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(1) R-71 of January 17, 1947.
(2) Two important papers were distributed at the time, one by Mr. Machado, dated January 24, 1957 (Sec.Memo 57/37), the other from the Management, dated June 4, 1957 (R/57-39).

17. The need for a satisfactory level of earnings and reserves arises in the first place out of the need to protect the Bank's shareholders. The greater the reserve accumulation, the less the risk that their 80% (now 90%) guarantee capital would be called upon to meet the Bank's obligations. True, it was recognized that "neither the risks confronting the Bank nor the practices of the most comparable institutions afford any basis for devising a formula to determine the "proper" level of reserves for the Bank" and "the level of reserves is of less importance than the fact of their continued accumulation... at what may be considered a satisfactory rate." In other words, it was not possible to assign to the reserves an ideal level. Various formulas had been tentatively examined. One of them (1) suggested that the ideal level could be 30% to 50% of the obligations of the Bank's biggest debtor or of the economic area which owes the Bank the biggest debt. Admittedly, however, such formulas could only be indicative. They could not be considered either rigid or permanent. The more the Bank lent out of its own funds, capital or reserves, the less the risk for its bondholders and therefore

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(1) Mr. Machado's Memorandum (Sec.Memo. 57-37)

for the shareholders themselves.

18. Just as important as the protection of the Bank's shareholders was the need to establish and maintain its credit standing. All along one of the Bank's aims was clearly to convince the market that it was following a reasonable financial policy and doing its utmost to prevent an impairment of its own capital. Building up reserves was proof that "the earnings coverage available for the service of Bank bonds" was being extended. It was also evidence of "financial soundness and of (the Bank's) ability to ride out periods of payment difficulties or even defaults on the part of its borrowers."

19. In addition, something new had emerged in 1957. The market for foreign bonds was experiencing a revival. It was important that the Bank should not offer to its borrowers rates which were far below those which the market would have been able to offer and would thereby deter borrowers from calling on the market. True, the number of countries involved was not very great. Only European industrialized countries, Australia, and Japan were in a position to revert to this classical method of financing but the Bank was

encouraging them to meet their needs through "joint operations" and later through recourse to the market without World Bank assistance. A decision as to whether the conditions under which foreign bond issues could be sold were "reasonable" compared with Bank terms was of course a matter of judgment.

20. To see reserves increase it was necessary to obtain a satisfactory gross revenue out of reasonable lending rates but also to limit expenses, in particular the service on the outstanding debt of the Bank. The liquidity policy was therefore an important factor. Quite naturally, at the beginning of its operations, the Bank maintained a 100% liquidity. Available cash and short-term investments were kept at a level at least equal to the outstanding commitments. The purpose was to avoid too great ~~a~~ dependence of the Bank on market conditions, both in terms of timing and of rates. However, as years passed ~~past~~ and the Bank debt grew, the market for Bank bonds became better assured and future changes in interest rates could not affect too seriously the average rate paid on the aggregate debts. On November 12, 1952 the Executive Directors ratified the following recommendation of the Financial Policy Committee:

> "That a less rigid policy be adopted under which the Bank would not necessarily have a 100% coverage in liquid funds at time of lending; that for the time being funds available for lending should not be reduced below one year's estimated loan disbursements; and that the Bank's cash holdings and the timing of bond issues should be determined from time to time in the light of market conditions and of the Bank's needs."

In practice, however, the quick assets of the Bank have been kept at a higher level than the ones described above. This is partly to take account of the debt management problems of the Bank (meeting maturities of outstanding bonds) but also due to the wish to keep liquidity high enough to leave the Bank full freedom to choose the timing of its bond issues. As a matter of fact, it could probably be said that strict adherence to the "one year disbursements" liquidity principle could have made for slightly higher earnings. It is not certain that conversely it might not have resulted in raising somewhat the cost of borrowing. (1)

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(1) One side aspect of this whole question is that since legally the 1% commission is still levied as an addition to the interest rate, the proceeds of this commission continue to be segregated in a special reserve which has to be kept in liquid form and cannot be used to finance new loans. The effect of this policy has been to increase overall liquidity but the coverage against losses afforded by this special reserve alone is still not considerable (about 10% of funded debt and about 5,5% of loan commitments.)

ii) Effect of Bank charges on borrowers

21. <u>Continuity of Bank operations</u> is obviously essential to the borrowing member countries. The Bank should always be in a position to commit itself to further and perhaps increased lending operations. An increase in its own funds available for lending and a well assured market for its bonds are clearly to the advantage of its borrowing members as well as of all its shareholders or of its existing bondholders.

22. It is natural, on the other hand, that the <u>level of service charges</u> be a matter of concern to the borrowing countries. The increase in the foreign debt service burden of many developing countries over the last 10 years has been noted on several occasions and hardly needs to be commented on any further here. Servicing a foreign debt means two things, setting aside a fraction of the foreign exchange earnings and giving up part of the national income (and in case of a government loan, part of the national revenue). It is good policy for a borrowing country to try and minimize these deductions from its current availabilities. Furthermore, it is clear that the effect of a reduction in interest rates is in general even more

effective in this respect than an extension of redemption terms. In FPC/63-13 comparisons have been made as between various type loans by discounting the present value of all annual payments at 10%. A reduction of 1% in interest rate (from 5 1/2% to 4 1/2%) has a sizeable effect on the total charge. The figures are as follows:

Type	Term of loan	Grace period after full disbursement	Interest rate	Present value	Peak annual service	
A IBRD loan	20	none	5 1/2%	617	96	
			4 1/2%	561	89	- 7,8%
B IBRD loan, interest payable from date of disbursement	40	6 years	5 1/2%	519	69	
			4 1/2%	421	62	- 10%
C IBRDloan, interest capitalized over grace period	40	6 years	5 1/2%	396	109	
			4 1/2%	293	90	- 17,4%

23. True, the return on capital on new investment is generally higher than the interest (including commission) charged by the Bank and this is valid both in advanced and in developing countries. But the purpose of the Bank was precisely to make capital available to its borrowers and on terms which would be advantageous to the capital importing countries. The greater the margin between cost of capital and return on capital, the greater the service rendered to the borrower.

24. Lightening the service burden imposed on the capital recipient countries has been a matter of major concern since the war. Grants have been a feature of bilateral reconstruction and development assistance. So have loans repayable in local currency. Special loan conditions were granted by the U.S. as early as 1946, beginning with the $3,750 m. loan to the U.K. (1). The various European countries have also on occasion granted terms distinctly below the cost of the money to them. Finally the organization of IDA was a clear recognition that the availability of capital at low rates and long repayment terms was needed by a number of developing countries. Precluded from making grants, IDA has kept its terms unchanged since its organization in 1960 at 3/4% interest (so-called "service charge") and 50 years repayment period, of which 10 years of grace.

PART II - SUGGESTIONS FOR CHANGES IN LOAN CHARGES

Chapter I - Changes in Financial Position of IBRD

25. As indicated above, the expiration of the first 10 years of operation of the Bank in 1956 was an opportunity

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(1) The 2% interest charged on this 53-year loan was, however, not far below the then current 2 3/8% yield of U.S. Government long-term securities.

for a thoroughgoing examination of the Bank's loan charges and financial policy. Two main questions were considered. One was whether the 1% commission should be reduced or even eliminated. This would have tended to decrease earnings and the accumulation of reserves. The other one was whether a dividend should not be distributed, which in turn would have tended to reduce reserves without a decline in earnings. No change in policy was, however, made at the time. Since then the financial position of the Bank has improved so strikingly that it is only natural that in 1963 a new examination of the whole problem should have been undertaken.

26. The Bank of course relies and will always rely on the bond market for any sizeable increase in its lending operations if it wishes to remain a net contributor to the flow of capital to developing countries. It is just as important as in the past to convince the potential subscribers to the institution's bond issues that it is run on sound business lines and that it does not undertake financing which could be undertaken by private investors. Nevertheless, the accounts of the Bank as of now are in such a shape that it can only inspire confidence. In

the last six years the changes have indeed been quite substantial. First, the capital of the Bank was doubled in September 1959, thus raising the guarantee capital more than twice and the U.S. 80% (now 90%) which was $2,540 m. is now $5,715 million. Second, a number of other countries have improved their credit to the point where, in the eyes of the market, the U.S. shares with others the burden of guaranteeing the Bank's obligations. As a result of these two factors, the funded debt which has more than doubled increasing from $1,200 m. to over $2,500 m., still seems quite modest in relation to the guarantee capital, which was not the case in 1957. Third, the amount of so-called 18% (now 9%) capital made available for lending has increased from $1,000 m in June 1957 to $1,500 m in June 1963. For this reason alone, the earning capacity of the Bank would have increased. Fourth, during the same period, reserves have risen from $280 m. (of which about $90 m. statutory reserve) to $810 m. (of which $255 m. statutory reserve). The Bank's own funds available for lending, and consequently its earning capcity out of its own funds, have almost doubled. Fifth, since administrative expenses - even including technical assistance to member countries - have risen at a slower pace, the rhythm at which reserves are accumulating has also accelerated. They increased by about \$50 m. in fiscal year 1957 but by over \$110 m. in 1963. Finally, IDA has been organized. Since its very purpose is to assist in the financing of the poorer countries, it can either substitute for the World Bank in undertaking what may have been considered riskier types of financing or participate with the Bank in carrying them out.

27. In other words, as the total reserves approach the level of \$1,000 m., there does not seem to be any pressing need for a further rapid increase. Irrespective of the proportion these reserves may bear to outstanding debt or to loan commitments, their very size, coupled with a liquidity position which saves the Bank from the necessity of calling on the market, gives a picture of solidity which should reassure both shareholders and bondholders. The freedom of action of the institution is thus considerable and it became possible in 1962/63 to consider new financial policies which might result in a slowing down in the rate of reserve accumulation.

28. Some of the policies which have been discussed recently

relate to the use to which the earnings can be put: distribution of dividends, allocations to IDA or IFC or to a special fund for "general assistance grant and technical operations", subsidies to various useful purposes (e.g. education). All these are being discussed elsewhere and they will not be reviewed here. Other suggestions have been made which would affect the Bank's earnings in one way or the other. They relate directly to Bank's charges. They will be discussed here in the following order:

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a) reduction of interest rate across the board;

b) changes in the commitment charges;

c) various proposals involving a discrimination among borrowers:

   i) a reduction in interest rate for weak borrowers;

   ii) an increase of the rate for "strong" borrowers and an alternative thereto whereby the Bank holds public issues at market prices;

d) proposals concerning loans made out of a "Special Fund";

e) various proposals concerning IDA; finally under

f) various proposals for subsidization of rates payable to the Bank will be reviewed.

Chapter II a) **Reduction in interest rate across the board:**

29. Arguments in favor would be the following. The 1% statutory commission is no longer compulsory, and the true interest rate if related only to the Bank's borrowing rate would be between 1% and 1 1/4% below the rate we actually charge our borrowers. Eliminating the statutory commission and possibly 1/4% more, would simply mean the Bank's borrowing and lending rates would be identical. Second, this would still leave the Bank a considerable earning power from its own funds. Today reducing the lending rate would not impair capital and reserves. Third, the very purpose of the Bank was to allow member countries to borrow not only more than they could on their own, but also more cheaply than they could on their own. The purpose of the 80% guarantee was to make that possible. Fourth, reducing the service charges means lightening the burden on the borrowing country and allows it to absorb more capital at the same cost. This is one of the purposes which combined Bank/IDA financing is fostering.

30. The arguments against a reduction in the rate of interest would be, in the first place, that this might be misunderstood in the market. Present rates cannot be called "excessive"

in the sense that they are still below the normal rate of return in the borrowing countries, they are still below the rate of return on capital in those countries, and they are still below the rate at which underdeveloped countries could borrow in the market (1). It would be unfortunate if the Bank could be accused of indulging in "giveaways". In the second place, an elimination of the 1% commission across the board would entail a loss in earnings of almost $40 m. (?) a year. Even though the rate of reserve accumulation is no longer an important issue, a reduction in earnings of this magnitude might create misunderstandings in the market. This objection would, however, carry less weight if the reduction in rates were only 1/4% or 1/2% in the first instance instead of being 1% or 1 1/4%. Thirdly, eliminating 1% on all outstanding loans would benefit all present debtors of the Bank without regard to their development needs but only on the basis of their past ability to borrow from the Bank. It is of course conceivable that the commission be eliminated only on new loans but it is likely that pressure ~~will~~ would be in favor of a similar treatment for all

(1) The fact that foreign borrowing rates are lower than internal interest rates in developing countries is not really relevant. Even discounting the cases where concern about the future of the local currency makes for high internal rates, or the cases where an inadequate internal market could possibly be improved, borrowing abroad is induced by a lack of sufficient local savings in relation to investment needs or opportunities. It is natural that this be reflected in differential interest rates.

borrowers, past and future. Still another objection arises from the discrepancy which would come to light between IBRD terms and market terms of lending. This is particularly true with respect to industrialized countries which have had access to the market.

31. An important variant of the suggestion that the rate of interest be reduced by modffying or abolishing the 1% commission is the suggestion that this commission be refunded to the borrowers as, when and if contractual service payments are regularly met (1). This could be done in two ways, either by paying back the commission to the borrower after full repayment of the loan, or by refunding year by year the amount received as 1% commission the year before. It is assumed here that this would be done across the board for all borrowers.

32. The advantages of such a method is of course that nominally the Bank charges do not appear to be changed, while in effect the borrower is given an important discount on service charges. Furthermore, since the commission was originally conceived as a premium against losses, it is logical that the contributors be compensated as long as

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(1) Mr. Rajan - ED meeting, November 26, 1963.

they do not cause any losses.

33. The objections to the scheme would stem from the same reasons as those recorded in paragraph 30 in the case of a straight reduction of interest rates. The market might not agree that present rates are "excessive"; it might be concerned by a considerable reduction in earnings; the refund would bear no relation to the development needs of the borrower and a strong discrepancy would appear between effective IBRD rates and market rates.

Chapter III

b) Changes suggested in the commitment charge:

34. Several suggestions were made recently with regard to the commitment fee. The first (1) would be to reduce it by one-half (from 3/4 of 1% to 3/8 of 1%). A second one was to the effect that a sliding scale be introduced instead of a single rate, starting low (perhaps lower than 3/4 of 1%) and increasing from time to time to a level probably higher than 3/4%. (2). The third (3) is also based on the sliding scale principle. It would relate the charge to the delays occurring after a drawing date

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(1) President's Memorandum July 18, 1963 (FPC/63-8)
(2) Mr. Machado - Directors'Meeting - Aug.2, 1963 (FPC/63-11)
(3) Mr. Miller's Memorandum to Mr. Wilson, Oct.21, 1963

estimated in advance. An example given was a nominal (1/4%) rate up to the time when it is originally estimated that a drawing will take place; 1/2% for the first three months after the estimated date; 3/4% for the second three months and 1% thereafter.

35. The simplest proposal is the first. Its justification rests on the fact that delays in withdrawals being a general and inevitable feature of development loans, this would be a welcome lightening of the borrower service burden and this would affect the most recent borrowers, most of them less developed countries. Furthermore, the impact on the Bank's earnings would be in 1963 in the order of $5 m., probably somewhat more thereafter. Such a loss in revenue could in no way be harmful to the Bank. From a practical standpoint, namely whether the incentive to withdraw from the loan account would be sufficient, it would seem that what matters is the principle of a commitment fee rather than its level. Finally, end use supervision procedures should make it possible to detect abuses and stop undue delays.

36. The objections raised relate exclusively to the effectiveness of a fixed (and low) commitment fee. The

higher the fee, it is said, the less the chance that borrowers will either neglect their own interest or the interest of the Bank. Delays have occurred for periods longer than had been reasonably anticipated. There have even been cases where the borrower was able to find short-term financing which, added to the 3/4% fee, remained lower than the Bank loan rates. True, they were remedied in time but at the expense of an added burden for end use supervisors. In such cases even 3/4% may not be high enough.

37. The suggestion of a sliding scale is an attempt to reconcile these two points of view. Insofar as earnings are concerned, its effect would be approximately the same as ~~xx~~ that of a simple reduction of the rate, perhaps a little smaller in the second suggestion listed in para.34 (rates growing year ~~after~~ by year), perhaps a little bigger if the starting rate were only nominal as indicated in the third suggestion listed in para.34, where only delays beyond original estimate are penalized.

38. The advantage to the borrowers would be about the same too. The purpose of the sliding scale idea is of course to provide an incentive to the borrower to withdraw and

a careful borrower should respond to it. There is, however, a difference between the two systems of sliding scale. In one of them, the fee increases from year to year, even if from the outset it could be foreseen that disbursements would extend over several years. It is difficult to imagine that the borrower could hasten deliveries which have from the beginning been staged over a period. The other more elaborate scheme takes account of this circumstance and provides a penalty only if delays are longer than originally anticipated. The incentive element is therefore much stronger in the more complicated scheme. Its <u>disadvantage</u> might be precisely that it is complicated: the precise timing of a program of deliveries is difficult to estimate in advance and controversies may well arise between the Bank and the borrowing country if the latter finds that delays are not due to its own negligence but, for instance, to the manufacturers.

<u>Chapter IV - Discrimination among IBRD Borrowers</u>

39. A number of factors have emerged in the recent past which have an important bearing on the borrowing policy of member countries. One of them is the fact that some

countries which would float public issues find it more difficult today both because the European markets are too narrow to satisfy their capital needs and because the New York market is not at present in a position to satisfy foreign borrowers. These countries which include the industrialized countries of Europe, Australia and Japan, turn to the World Bank for assistance. The question arises whether the Bank should not charge them higher rates than it charges the developing countries which have no access to the market. Another factor is the realization that in a number of developing countries the foreign debt service has reached sizeable proportions or that external payment difficulties may be foreseen for the future, or both. The question arises whether, in special cases, the Bank should not charge them lower rates than its current rates in order to alleviate the burden of the new debt.

40. Both these suggestions tend to create a discrimination among the borrowers. It will be recalled that in 1946 the principle of no discrimination had been adopted. The issue at the time was, however, quite a different one, namely whether the countries which were the most likely to experience

payment difficulties should not pay higher rates than countries which apparently presented less risk. Discrimination had been discarded on the grounds that appraising comparative risks at 10 or 20 years distance could be most misleading, that the prewar market practice of charging high rates to reputedly weaker debtors had simply compounded their payment difficulties, and finally that the Bank was a cooperative institution which could not treat its individual members differently from one another. Today the problem is reversed and deserves reexamination. This discussion will bear first on the suggestion that borrowers which used to have access to the market be charged more, than on the proposal that some developing member countries should receive a more favored tratment will be considered.

i) Charging more to Countries which used to have access to the market:

41. The arguments in favor of this procedure run as follows. The countries in question are precluded from floating bond issues by exceptional and temporary circumstances. They feel that they are justified in calling on foreign capital. If the Bank shares that feeling, it cannot refuse to assist them. But since the call on the

Bank is due to the fact that the market is temporarily closed to them they should and can pay the same charges which they would have paid for a public issue. Granting them the somewhat lower rates which the Bank offers normally would constitute an undesirable encouragement for them to reduce their efforts to get free access to the market or to avoid the trouble of distributing their borrowing among several markets. This would tend to limit the amounts of lendable funds which the Bank could place at the disposal of less advanced countries. Furthermore, if the worst comes to worst, the Bank itself may find the market for its own bonds temporarily restricted. It would be unfortunate if advanced countries should preempt the Bank's capacity to lend. Finally, it is essential that the market should never have the impression that the Bank is competing with it. The best way of avoiding this is to charge borrowers whose credit is normally good enough to allow them to call on the market terms similar to those which the market would have accepted. Similarly, the higher the rate charged, the better the chance that sales out of the portfolio can be handled without loss to the Bank.

42. <u>Against</u> this suggestion, however, it can be said that

the real question is whether lending is justified or not. This is particularly difficult to ascertain for advanced countries which sometimes, and quite reasonably, tend to borrow abroad rather than internally because the interest differential between their internal rates and prevailing rates on foreign markets makes it attractive. But once the Bank is convinced that for lack of internal savings and for lack of access to international markets vital investment needs would remain in abeyance, it is one of the Bank's functions to satisfy these needs. This places the country in the same position as any other member. It does not justify a discrimination against it. As a cooperative institution the Bank must treat all its members alike.

43. A variant (1) of this suggestion would envisage the purchase by the Bank of a bond issue of the borrower at a price corresponding to the real cost which this issue would entail if it were floated in the market. To take account of the fact that the borrower is by definition an advanced country and that market issues do not usually link borrowing with specific projects or imports, the loans could be for general purposes and be spent in local currency. Selling arrangements would be the same as in ordinary IBRD loans, i.e. consultation

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(1) Mr. R. Cope's internal memorandum of November 18, 1963

with the borrower would be necessary before a sale is effected. This proposal will not be discussed here (at this stage.)

ii) Charging less to a developing country:

44. In its simplest form (1) the proposal is to distinguish between IDA Part I and Part II members. Part I countries would continue to pay interest computed as at present (this does not preclude an even higher rate as in the suggestion discussed in paras.41 and 42). Part II countries would uniformly have the benefit of a reduction of interest from say 5 1/2% to say 4 1/2% or 4%. It is assumed here that the proposal would affect past as well as future loans.

45. The arguments in favor are the same as those in favor of an across the board reduction charges (para.29). In addition, however, it may be said that the sacrifice of the Bank in terms of earnings would be less than if the reduction in charges applied to all borrowers. Furthermore, a comparison with market rates is not possible for Part II countries. Finally, the Bank would not find itself

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(1) Mr. Moussa's memorandum dated September 19, 1963.

obliged to discriminate on the basis of criteria which may be misinterpreted since the member countries themselves have accepted to be divided into Part I and Part II members.

46. The main argument <u>against</u> the proposal relates to discrimination in general. The "cooperative" basis of the institution has always been respected. Is it likely that Part I countries would themselves propose that a distinction be made between them and Part II? In addition, of course, as mentioned in para.30, the reaction of the market to what may be called "low rate" might be unfavorable.

47. On various occasions, suggestions similar to the one described under para.44 have been presented. They do not, however, imply one single rate for all Part II countries but adjusting the rates to individual cases. Countries for which severe transfer difficulties must be foreseen would benefit by a greater reduction than those with better prospects. The argument is that the role of the Bank is to assist the developing countries and that uniformity does not take account of varying circumstances. On the other hand, these proposals meet with the same objections

as the preceding one. In addition, the task of differentiating among developing countries would be extremely difficult and would involve the Bank in most delicate negotiatio ns with each and all of its members. This last argument may, however, not be as strong as it seems since today already the Bank agrees to blending IBRD loans and IDA credits in varying proportions.

Chapter V - Special Conditions for Loans made out of Special Funds

48. In a number of suggestions made recently the basic assumption is that the present earnings of the Bank should remain unaffected. Their allocation would, however, be different from what it has been in the past. Out of its own earnings the Bank would set aside certain amounts for specific lending purposes. It has already been suggested that new income be set aside in a "surplus account". One possible use of this account could be assistance to IDA or IFC. Another suggestion is that a substantial fraction of the incóme be set aside in a "general development assistance grant and loan account" (1) or "Special Fund". Allocations to this Fund would be in

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(1) Dr. Lieftinck, July 30, 1963 (FPC/63-11)
Dr. Donner, August 1, 1963 (FPC/63-12)

substantial amounts and the Fund would grow fairly quickly over the years. Out of this fund financing of operations related to the Bank's activities but not normal for it, grants for expanded technical assistance and loans on easier terms in specific fields (such as agriculture or education) could be made . Both ~~long~~ longer terms and lower interest rates than usual in IBRD normal operations could be granted by the Fund (1).

49. One of the advantages of this sbheme is that it leaves the present earning capacity of the Bank untouched. From the operational standpoint, one of the advantages is that it allows for assistance on special terms to certain individual countries. Another is that instead of applying differential rates to different borrowers, the discrimination would be made on the basis of the type of project.

50. One of the difficulties which such a scheme could encounter is that the number of acceptable projects in the fields mentioned - agriculture, education, etc. - might grow fairly quickly and that as soon as they would exceed the amount available in the Fund, it would become necessary to choose, i.e. to discriminate among borrowers. Another

(1) Mr. Tazi, on November 26, made a similar proposal, except that he included infrastructure among the types of projects suitable for financing out of reserve funds.

difficulty might be in administering still a third source of funds in addition to IBRD proper and IDA. This, however, may not be insuperable. If - as will be discussed below - IDA were eventually to discriminate among borrowers there would probably be no objection to transferring the Special Fund to that organization and merging their operations.

Chapter VI - Proposed amendments to IDA Procedures

51. On several occasions it has been suggested that IDA could be more flexible in its terms. Until now one rate of "service charge" - 3/4 of 1% - and one term of repayment - 50 years with lo years grace and 10 years low amortization - have been applied to all credits. Would there not be a point in adapting terms more closely to the project or the prospects of the borrowing country? For instance: a higher interest rate and shorter periods of grace and redemption could be imposed on borrowers with fair prospects or for projects which promise to yield quick financial or economic returns. Figures like 2% interest and 30 or 40 year periods of redemption have been cited. Another suggestion is that some credits should contain a clause providing for a review at given intervals, say every 10 years, at which time if the country's position so warrants, the credit could be converted into an IBRD

loan on conventional terms (1).

52. Both these schemes imply some discrimination among countries. But there is always a strong element of discrimination in the very concept of IDA. It is meant to assist those member countries which do not offer favorable prospects for IBRD financing. Moreover, blending IDA and Bank financing is a recognition that discrimination is possible and helpful. The schemes outlined under para.51 merely offer a new field for discrimination. They would still allow for very lenient terms when the circumstances justify it but in a number of intermediate cases these terms are not really necessary. There is no reason to assume that the developing countries which today are in a weak external position will not find their prospects improved after a period. Development if successful is supposed to bring about improvement in savings and balance of payments. One advantage from the financial policy point of view would be that some turnover in the capital of IDA would become possible. In the second scheme (allowing for conversion into a conventional loan) one

(1) It has also been suggested (Mr. Machado) that a commitment fee be charged on IDA credits just as in the case of IBRD loans. This will not be discussed here.

could even envisage that the Bank would actually finance the conversion and thus replenish IDA funds to an extent.

53. The objection would be of a somewhat practical character. The discrimination implied in present practices is not as elaborate as the one proposed. It would imply classifying each country considered as deserving IDA aid by comparison with the others and a periodic review of this comparison. The tests could only be hypothetical and tenuous. It would probably also bring about a trend towards higher rates at the very time (and this is a matter of tactics) when the U.S. Government is fighting congressional committees to keep the rates of AID loan assistance at a level comparable to that of IDA. The call for low cost development capital would be weakened if IDA should have a substantial income and if its capital could be turned over even in part.

54. With regard in particular to the second suggestion (review of credit terms at intervals), very serious difficulties might be encountered at the time of the review. The prospects of the country might well be interpreted differently by IDA and by the debtor country, which would

make for delicate negotiations. It might well be found at the time that new investments would be required to push the country's development further and that an increased debt service makes its external financing more difficult. Finally, a review clause might work as an incentive to the country to overburden itself with debt from other than IBRD/IDA sources in anticipation of a review.

Chapter VII - Subsidization by third parties of rates payable to the Bank (or IDA)

55. Two suggestions have been made which would tend to subsidize the borrowers from outside sources. They are based on following assumptions:

a) that the Bank can easily float new bond issues in the private market and therefore fully satisfy growing needs for Bank/IDA financing;

b) that the lending rates (including commission) of the Bank cannot be reduced;

c) but that it is imperative for underdeveloped countries to pay lower rates than Bank rates;

d) that Part I governments will find it less expensive and will prefer to finance interest differentials rather than provide capital contributions to IDA or make bilateral credits.

i.) <u>The Swiss Scheme</u>

56. Under this proposal (1), a number of countries - presumably Part I plus Switzerland - would agree to form a pool to pay interest or part of the interest on IBRD loans. The pool could, for instance, pay 3 1/2% out of the 5 1/2% owed by the borrower, and thus reduce the latter's burden to only 2%.

57. The <u>advantages</u> to the countries participating in the pool are that they could assist development by way of a modest contribution only, although repeated yearly. The developing countries would see their service burden lightened and could therefore borrow more for the same cost. As to the Bank, its income would be better assured since part of the interest charges would be borne by Part I countries. Finally, it would tend to develop multilateral assistance as against bilateral loans. Having contributed to the pool, the donor countries would be less inclined to assume direct financing.

58. The <u>objections</u> to the scheme would be partly psycho-

(1) See Mr. Karasz' memorandum to Files of March 18, 1963, Mr. Knapp's memorandum of March 28, 1963 and Mr. Karasz' memo to Mr. Miller of Sept.18, 1963.

logical, partly practical. The scheme assumes that the interest charges of the Bank are detrimental to development. This has not been demonstrated and is largely a matter of opinion. The Bank's rates are not considered excessive by financial circles, as has been pointed out in para.30. They remain below the rate of return of investment in the recipient countries and normal external borrowing rates. The question may also be raised in the market whether the Bank is not assuming unduly high risks since it has to rely on sources other than the debtors to meet service charges. This might be detrimental to the Bank's borrowings. From a practical point of view, it is not clear whether the benefits of the pool would be available to all Part II countries indiscriminately. It would seem perhaps unnecessary, and some of the debtor countries may well prefer to establish their own credit without recourse to a pool. Alternatively, the Bank itself may wish to induce some countries to shoulder fully their own obligations. This would raise again the problem of discrimination discussed before. Another question relates to the relationship with the pool. An increase in multilateral as compared with bilateral financing would be welcome. But could one safeguard the Bank against undue pressure on the part of the members of the pool in favor of certain projects rather than others? Finally, the scheme assumes that the Bank would in effect increase its lending since it would substitute for some bilateral operations. It can be doubted whether it would be easier for the Bank to issue more bonds than it would be for the Part I countries to issue their own.

ii.) Mr. Horowitz' Scheme (1)

59. This plan is based on identically the same premises as the previous one, but assumes that development assistance at low rate will be given through IDA rather than the Bank. Two alternatives are suggested. In the first, the Bank would borrow on the market and lend the proceeds to IDA at cost (say 5 1/2%). IDA in turn would relend the money on lenient terms (say 1%). The difference would be covered by an "Interest Equalization Fund" contributed by Part I countries. Assuming that $3,000 m. are lent in this way in 5 years, the "Fund" should provide $135 m. per annum after 5 years. If the present contributions to IDA were kept invested in Part I countries instead of

(1) His statement at Board of Governors, Oct.2, 1963, (Press Release Nr.55) - His note to Mr. Black, dated Sept.25, 1962 - Mr. Black's reply dated Dec.4, 1963 and Mr. Horowitz' letter to Mr. Woods, dated Oct.25, 1963.

being lent out, this could constitute a guarantee Fund of roughly \$1,000 m. and bring in an income of say \$30 m., thus reducing the yearly payments by the Equalization Fund to say \$105 m. per annum. One could even consider, if necessary, that IDA obligations to the Bank be guaranteed by the members contributing to the Fund, or that the bonds issued by the Bank to finance IDA carry a special guarantee from the same countries (presumably substituting for the 80% - now 90% - guarantee capital).

60. The other alternative proposed is that IDA itself should issue bonds. The interest differential would be covered by the Equalization Fund and the IDA bonds would be guaranteed by the Part I nations, plus the subscription still available to IDA, or say \$1,000 m.

61. The advantages would be the same for both alternative plans. If successful, they would allow for more IDA lending than its capital subscriptions would permit. Mr. Horowitz assumes \$3,000 m. instead of the \$1,000 m. now available. At the same time it would reduce the need for cash outlays of Part I countries in support of IDA. Moreover, all the points made in para.57 concerning the

Swiss scheme would also be relevant here.

62. The objections which the plan would encouter are the following. Some have already been mentioned in para.58 concerning the Swiss scheme. Even more difficult to overcome would be the terms of Article VI, Section 6, of IDA which specifically provides that "the Association shall not borrow from or lend to the Bank". The purpose of this provision was to ensure a complete separation between Bank and IDA funds and credits so as not to "prejudice the Bank's credit standing in the community" (1). This would seem to rule out the first alternative. Considering the second one, the main practical problem would be to create a market for IDA bonds. This assumes not only that Part I governments undertake to contribute to the Equalization Fund for a long period and to guarantee IDA bonds but also that it will be possible to convince bondholders to purchase obligations of an institution "whose avowed purpose is to lend long to borrowers who would by definition be uncreditworthy for normal lending" (1). Even assuming that these legal and market obstacles could be overcome, the question as to whether considerable amounts of bonds can be floated

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(1) Mr. Black's letter to Mr. Horowitz of Dec.4, 1962.

in international markets is a moot one. Except for the New York market, the others are relatively narrow and they are not likely to absorb amounts which might reach well over $1,000 m. a year if IBRD needs and increased IDA needs are to be satisfied, ie. if the scheme is to succeed. Hence, the suggestion (1) that it would be easier for Part I countries to borrow in their own names for relending on soft terms to IDA or for giving it additional capital on grant terms.

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(1) Mr. Black's letter to Mr. Horowitz, Dec.4, 1962.

ANNEX 1

SCHEDULE OF I.B.R.D. LOAN INTEREST RATES
(Including 1% Loan Commission)

Years to Final Maturity	May 1947	March 1948	July 1948 to March 1949	March 1949 to April 1950	April 1950 to April 1951	April to June 1951	June to Aug. 1951	Aug. to Oct. 1951	Oct. 1951 to Feb. 1952	Feb. to Dec. 1952
1								4%	4-1/8%	4-1/8%
2				3%				"	"	"
3								"	"	"
4								"	"	"
5								"	"	"
6								"	"	4-1/4%
7		3-3/4%		3-1/2%	3-1/2%		4%	"	"	"
8								"	"	4-3/8%
9								"	4-3/8%	4-1/2%
10			3-9/16%			3-7/8%	4-1/8%	4-1/4%	"	"
11								"	"	"
12							4-3/8%	"	"	"
13								"	"	"
14								"	"	"
15				4%	3-3/4%			4-3/8%	4-1/2%	4-5/8%
16								"	"	"
17								"	"	"
18					3-7/8%			"	"	"
19								"	"	"
20		4-1/2%	4-1/2%	4-1/4%	4%			4-1/2%	"	4-3/4%
25	4-1/4%				4-1/4%			"	"	"

Note: Until 1951 the loan interest rate was established for each loan as it was made. Thereafter, schedules of rates were announced from time to time within the Bank as general guides. However, a rate only becomes final on any particular loan when approved by the Board.

SCHEDULES OF I.B.R.D. LOAN INTEREST RATES

(Including 1% Loan Commission)

Years to Final Maturity	Dec. 1952 to July 1953	July 1953	Aug. 1953 to Feb. 1954	Feb. to April 1954	April 1954 to Dec. 1955	Dec. 1955 to June 1956	June 1956 to Dec. 1956	Dec. 1956 to Feb. 1957	Feb. 1957 to May 1957
1	4-1/8%	4-1/2%	4-1/2%	4-1/4%	4%	4-1/4%	4-3/4%	5%	5-1/2%
2	"	"	"	"	"	"	"	"	"
3	"	"	"	"	"	"	"	"	"
4	"	"	"	"	"	"	"	"	"
5	"	"	"	"	"	"	"	"	"
6	"	4-5/8%	4-5/8%	4-1/2%	4-1/4%	4-1/2%	"	"	"
7	4-1/4%	"	"	"	"	"	"	"	"
8	"	"	"	"	"	"	"	"	"
9	4-3/8%	"	"	"	"	"	"	"	"
10	4-1/2%	"	4-3/4%	4-5/8%	4-1/2%	"	"	"	"
11	"	4-7/8%	"	"	"	4-3/4%	"	"	"
12	"	"	"	"	"	"	"	"	"
13	4-5/8%	"	4-7/8%	4-3/4%	4-5/8%	"	"	"	"
14	"	"	"	"	"	"	"	"	"
15	4-3/4%	"	"	"	"	"	"	"	"
16	"	5%	5%	4-7/8%	4-3/4%	"	5%	"	"
17	"	"	"	"	"	"	"	"	"
18	"	"	"	"	"	"	"	"	"
19	"	"	"	"	"	"	"	"	"
20	4-7/8%	"	"	"	"	"	"	"	"
25	"	"	"	"	"	"	"	"	"

SCHEDULES OF I.B.R.D. LOAN INTEREST RATES

(Including 1% Loan Commission)

Years to Final Maturity	May 1957 to July 1957	July 1957 to Oct. 1957	Oct. 1957 to Nov. 1957	Dec. 1957 to Dec. 1957	Jan. 1958 to Jan. 1958	Feb. 1958 to Apr. 1958	May 1958 to Aug. 1958	Sept. 1958 to April 1959
1	5-5/8%	5-3/4%	6%	5-3/4%	5-5/8%	5-1/2%	5-3/8%	5-3/4%
2	"	"	"	"	"	"	"	"
3	"	"	"	"	"	"	"	"
4	"	"	"	"	"	"	"	"
5	"	"	"	"	"	"	"	"
6	"	"	"	"	"	"	"	"
7	"	"	"	"	"	"	"	"
8	"	"	"	"	"	"	"	"
9	"	"	"	"	"	"	"	"
10	"	"	"	"	"	"	"	"
11	"	"	"	"	"	"	"	"
12	"	"	"	"	"	"	"	"
13	"	"	"	"	"	"	"	"
14	"	"	"	"	"	"	"	"
15	"	"	"	"	"	"	"	"
16	"	"	"	"	"	"	"	"
17	"	"	"	"	"	"	"	"
18	"	"	"	"	"	"	"	"
19	"	"	"	"	"	"	"	"
20	"	"	"	"	"	"	"	"
25	"	"	"	"	"	"	"	"

SCHEDULES OF I.B.R.D. LOAN INTEREST RATES

(Including 1% Loan Commission)

Years to Final Maturity	May 1959 to Jan. 1960	Feb. 1960 to March 1960	March 1960 to June 1960	July 1960 to Aug. 1962	Sept. 1962 to
1	6%	6-1/4%	6%	5-3/4%	5-1/2%
2	"	"	"	"	"
3	"	"	"	"	"
4	"	"	"	"	"
5	"	"	"	"	"
6	"	"	"	"	"
7	"	"	"	"	"
8	"	"	"	"	"
9	"	"	"	"	"
10	"	"	"	"	"
11	"	"	"	"	"
12	"	"	"	"	"
13	"	"	"	"	"
14	"	"	"	"	"
15	"	"	"	"	"
16	"	"	"	"	"
17	"	"	"	"	"
18	"	"	"	"	"
19	"	"	"	"	"
20	"	"	"	"	"
25	"	"	"	"	"

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Statistics for the Fiscal Years 1948, 1953, 1958 and 1963

	Fiscal Year Ended June 30			
	1948	1953	1958	1963
Gross Earnings				
Loan earnings -				
Interest	$ 9,917,304	$ 29,983,062	$ 71,471,126	$ 133,613,153
Commissions *	3,051,478	9,551,822	20,160,705	31,295,385
Commitment charges	2,136,027	3,366,376	5,162,573	9,678,887
Service charges	-	99,879	158,739	28,055
Interest on investments	3,593,623	9,345,538	21,047,408	59,498,841
Other income	5,546	144,352	817,033	1,072,274
Total	$ 18,703,978	$ 52,391,029	$ 118,817,584	$ 235,186,595
Expenses				
Interest on bonds	$ 6,232,963	$ 16,208,117	$ 47,311,896	$ 101,821,187
Bond issuance and other financial expenses	111,873**	340,592**	1,005,832	1,866,385
Discount on sale of loans	-	-	-	1,142,050
Administrative expenses	4,048,882	5,724,270	8,259,383	16,406,273
Total	$ 10,393,718	$ 22,272,979	$ 56,577,111	$ 121,235,895
General Position at end of Fiscal Year				
Reserves -				
Special Reserve	$ 3,084,930	$ 37,236,477	$ 113,893,359	$ 254,943,361
Supplemental Reserve	4,255,780**	82,192,499**	236,381,149	558,115,003
Bank Indebtedness -				
Due in 5 years	$ 1,512,507	$ 61,947,271	$ 538,859,706	$ 933,565,371
Due after 5 years	252,443,281	494,426,731	1,119,580,430	1,585,636,557
Total	$ 253,955,788	$ 556,374,002	$ 1,658,440,136	$ 2,519,201,928
Bank Loans -				
Committed (net of refunds and cancellations)	$ 513,000,000	$ 1,560,018,378	$ 3,728,672,734	$ 6,983,238,409
Outstanding - Effective and non-effective	$ 486,055,751	$ 1,475,693,077	$ 3,087,834,962	$ 4,718,265,671

* Commissions are credited to the "Special Reserve". The excess of the remainder of income over expenses is credited to the "Supplemental Reserve".

** Reflects retroactive adjustment of bond issuance costs made in 1957.

Treasurer's Department
Finance Division
November 29, 1963

Relevant Documents

FPC/63-5-Cavanaugh

(not for public use)

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

DECLASSIFIED

Date: 11/15/2010 BFW

CONFIDENTIAL

FPC63-5

FROM: The Secretary

January 31, 1963

Attached is a staff paper which discusses, in the light of the Bank's present and projected future earnings, various courses which the Bank might follow regarding reserves, loan charges and dividends.

This paper will be discussed by the Bank's Financial Policy Committee on Tuesday, February 12, 1963 immediately following the regular meeting of the Executive Directors of the Bank scheduled to begin that day at 10:00 a.m.

Distribution:

Members of the Financial Policy Committee
President
Vice Presidents
Department Heads

THE BANK'S FINANCIAL POLICY

A. RESERVES

I. Relevant Provisions of the Articles of Agreement

Several sections of the Bank's Articles refer to reserves. In most instances, these references are general, indicating an expectation that reserves will be established but not requiring any particular action. Article IV, Section 4(a), however, directs that a commission be charged during the first ten years of the Bank's operations (i.e., 1946-56), at a rate between 1% and 1-1/2% per annum, on loans made out of borrowed funds and on guarantees. It authorizes an increase or a reduction in this rate of commission after ten years. Article IV, Section 6, provides that the commission shall be allocated to a Special Reserve to be held in liquid form and to be used only for the purpose of meeting liabilities of the Bank on its borrowings and guarantees.

II. Reserves Established by the Bank

The Bank has established two reserves on its books: (a) the Special Reserve called for by the Articles and (b) a Supplemental Reserve, established by the Executive Directors and the Board of Governors in 1950. The Special Reserve has been built up out of allocations of commission receipts, whereas the Supplemental Reserve has been built up out of (a) an initial allocation of the excess of income over expenditure which existed at the time of its creation and (b) subsequent allocations of net income currently earned. The development of these two reserves and their status as of December 31, 1962, are shown in Annex Table 1.

III. Functions of Reserves

The Bank's reserves (that is, the statutory loan commission and accumulated earnings, whether allocated to the Special Reserve or the Supplemental Reserve) serve the normal function of reserves: they protect against an impairment of capital in the event of losses. In addition, they strengthen the Bank's credit, facilitate its financing operations in the market and add annually to its cost-free but interest-earning assets.

The assets which develop the Special Reserve, on the one hand, and the Supplemental Reserve, on the other, are not treated and may not be used in an identical manner. The latter are not required by the Articles to be, and are not in fact, segregated or restricted to any particular use. They broaden the Bank's capital base and add to the resources available for lending, thus reducing the over-all cost to the Bank of funds used in lending operations. In contrast, the assets which develop the Special Reserve are segregated and must, as noted above, be kept in liquid form. They may not be used for lending operations; their use is restricted to meeting the Bank's obligations arising out of its borrowings or guarantees. Accordingly, it is a further function of the Special Reserve to assure the Bank's ability to meet the claims of creditors.

In considering what should be the Bank's policy with respect to reserves, the problem of the level of reserves should not be confused with concern for a satisfactory degree of liquidity. The maintenance of general reserves is not necessarily an assurance of liquidity. Apart from the Special Reserve, the Bank could have large reserves and no liquid assets, or no reserves and a high degree of liquidity. In fact, whereas the Special Reserve as of

December 31, 1962, amounted to $239 million, as of that date the Bank's other liquid assets (not including loans) amounted to $1,619 million. It is the proportion of total assets, whatever their origin, which is held in liquid form which determines the Bank's liquidity at any given time.

IV. Availability of Capital

Only 1% of the Bank's capital has been paid in and is freely available for any purpose. The 9% paid in in the currency of the member can be loaned only with the member's consent and can be used to meet contractual payments of interest or amortization on the Bank's own borrowings only after the Bank's subscribed capital has been entirely called.1/ The unpaid 90% of the Bank's capital is no doubt the most important single element of protection to the Bank's bondholders. However, the only prudent assumption for the Bank to make is that a call on the 90% portion might make it very difficult for the Bank to continue operations. Accordingly, the existence of this uncalled capital should not influence a decision concerning the level of reserves.

V. Risks

The Articles of Agreement authorize loans to be made only if private lenders are unwilling to risk their capital on reasonable terms. Thus Bank loans can be assumed to involve more risk than those which the private market is willing to undertake.

1/ In 1959 the Bank's authorized capital stock was increased from $10 billion to $21 billion and members were given the opportunity to double their subscriptions. Under a resolution of the Board of Governors, the 2% and 18% portions of subscriptions on account of the increase, as well as the 80% portion, were left subject to call. Accordingly, since the increase in capital stock, the situation has been that 1% of total subscriptions has been paid in in gold or dollars and 9% in members' own currencies; the 90% balance of subscriptions remains subject to call.

A default by one of the Bank's borrowers will not necessarily result in complete loss of a loan. The cases in which a loan can be considered entirely uncollectible are likely to be exceptional. Instances might be outright repudiation by the debtor country or, in the case of the disappearance of the borrowing or guaranteeing state as a political entity, by the successor state. An example is the repudiation of Czarist Russia's debt by the Revolutionary Government after the first World War. In addition, there may be instances (e.g., Cuba, for the moment at least) in which, although there is no formal repudiation, payments are suspended as a result of political changes in circumstances which cast doubt on the ultimate collectibility of a loan.

The widespread defaults which resulted from the world depression of the 'thirties and from the war have to a large extent been the subject of settlements. But there were considerable variations from country to country in the period during which the defaults persisted and in the terms of the final settlements. Substantial losses were incurred by the creditors. Whatever the judgment as to the likelihood of a world depression or a world war, the possibility of widespread defaults and substantial loss to the Bank arising as a result of either cannot be completely ruled out.

The more likely risks, however, are of an essentially different order: defaults which are the consequence of serious balance of payments crises or political disturbances--internal or external--affecting individual countries. Such troubles have beset many countries from time to time, although their duration has generally been temporary. They have sometimes resulted in a suspension of payments, a renegotiation of the terms of loans or an adjustment of the amount due.

The duration and extent of the default would depend upon a number of factors. For example, if there were a drastic decline in the export price of a particular commodity or an inexpensive substitute for it were developed, this might well give rise not only to serious balance of payments difficulties for an individual country but also to difficulties for a group of countries all dependent on that commodity. Here the risk of default, while being less than world-wide, would not be limited to a single debtor.

It must be concluded, therefore, that in the normal course of Bank operations, even short of a world depression or a world war, there may be periods during which the Bank would be faced with service suspensions on a substantial scale, without any assurance as to the terms on which, or the time after which, debt service might be resumed.

History affords little guidance to an appraisal of these risks. It seems clear that it should not be the objective, assuming it were feasible to do so, to build reserves to a level which would enable the Bank to meet its obligations and cover all losses even in the event of a prolonged calamity, which would in any case cause at least a suspension of Bank operations. On the other hand, the Bank cannot ignore the possibility that one or another of its large borrowers, whose number is increasing, may run into payments crises, or that several borrowers may simultaneously find themselves in such difficulties. The very urgency and intensification of the development effort would tend, in the absence of an adequate volume of assistance on lenient terms, to increase rather than decrease this possibility.

VI. Level of Reserves

Neither the experience of the Bank nor that of other lenders, nor, for that matter, an appraisal of risks which may in the future confront the Bank, affords any basis for devising a formula to determine the "proper" level of the Bank's reserves. The most important consideration appears to be the preservation of the Bank's borrowing ability. The accumulation of reserves

serves an important function in giving assurance to the private market. But since this is a psychological matter, it cannot readily be given precise quantitative expression. The precise level of reserves is of less importance than the fact of their continued accumulation at what may be considered a satisfactory rate in the light of the volume, character and scope of the Bank's activities.

VII. Future Reserve Policy

In determining future reserve policy, the Bank has essentially two courses open to it. It may continue to put all net income to reserves, or it may put to reserves only that portion of net earnings necessary to maintain approximately the existing relationships between reserves and loans outstanding and between reserves and borrowings outstanding, using the balance for some other purpose.

The arguments in favor of continuing to accumulate reserves at the fastest possible rate are the following:

(a) In view of the uncertainty of the risks which may confront the Bank, even apart from the risk of a prolonged calamity, prudent financial policy calls for the building up of the strongest possible reserves.

(b) A high level of reserves assists in keeping the Bank's loan charges down. The support given to the Bank's credit standing by large reserves enables the Bank to borrow at favorable rates; if the Bank had to pay more for its borrowed funds, its own loan charges would have to rise. Moreover, should the cost of borrowing rise for other reasons, a high level of reserves provides the Bank with a source of cost-free money which can be "mixed" with borrowed funds in the Bank's lending operations, thus enabling loan charges to be lower than would be the case if only borrowed funds were put out on loan.

(c) The accumulation of reserves at the fastest possible rate would enable the Bank to expand its operations and to consider modifications of its lending terms, e.g., adopting longer grace periods or extending amortization periods.

The argument in favor of stabilizing reserves at roughly their present relationship to loans and borrowings outstanding is the following:

Reserves are projected to reach 24% of loans outstanding and 31.7% of borrowings outstanding, as of June 30, 1963.[2/] This ratio of reserves to loans and borrowings would not be adequate in the event of a prolonged calamity. But a calamity, as indicated above, would in any event cause a suspension of the Bank's operations. The present ratio does seem adequate to cover the other and more likely risks discussed above, and it seems probable that investors would regard as prudent and sound a policy of adding to reserves at a rate which would maintain approximately this relationship. This conclusion would of course be valid only so long as there were no seriously adverse changes in the economic or political climate; no substantial change in the nature of the Bank's activity or in the risks implicit in the size, character or terms of its loans; and, in particular, no substantial losses on loans or guarantees.

2/ See Annex Table 2.

B. LOAN CHARGES

I. Relevant Provisions of the Articles of Agreement

Article IV, Section 4(a) provides that the "terms and conditions of interest" on loans "shall be determined by the Bank." The section also leaves to the determination of the Bank "the rate and any other terms and conditions of commission" to be charged in connection with loans. However, as noted in Part A of this paper, the Articles themselves prescribed the permissible range of the commission on loans made out of borrowed funds during the first ten years of operations; only thereafter could the Bank charge a commission outside the specified range. The commission might exceed the 1-1/2% limit "if experience indicates that an increase is advisable," but only in respect of future loans. It might be less than 1%, and the reduction might be applicable to outstanding portions of existing loans as well, if the Bank considered the reserves accumulated out of commissions received and "other earnings" to be "sufficient to justify a reduction."

Article III, Section 4, lists the conditions on which the Bank may guarantee or make loans. It requires (paragraph ii) that the Bank be satisfied that in the prevailing market conditions the borrower would be unable otherwise to obtain the loan under "conditions which in the opinion of the Bank are reasonable for the borrower," and (paragraph iv) that in the Bank's opinion "the rate of interest and other charges [on loans made by it] are reasonable and such rate [and] charges *** are appropriate to the project."

II. Evolution of the Policy Concerning Loan Charges

The Bank's policy on loan charges was established in 1947 and has remained substantially unchanged. Its main features are:

(i) Loan charges are related to the Bank's own borrowing cost.

(ii) Loan charges are not related to the source of funds or to the credit standing of the borrower.

(iii) Loan charges include a 1% annual commission and a small margin over the Bank's borrowing cost to cover expenses.

Initially, the Bank's loan agreements distinguished between interest and commission. The rate of interest was set at 1/4% over the Bank's actual or estimated cost of borrowing at the time the loan was made. It was, and has continued to be, uniform as among borrowers.[3/] The commission rate was fixed at 1%, likewise without distinction as among borrowers.

In 1949, the Bank changed its practice with respect to loan charges although its basic policy remained unchanged. From that time on, loan agreements have provided for a single interest charge, based on the Bank's own borrowing costs plus 1-1/4%. The resolutions of the Executive Directors authorizing the loans provide that, of the interest received, 1% shall be considered as commission, to be set aside in the Special Reserve.

The rate of interest (including commission) on long-term loans has varied over the years from 4% to 6-1/4% in consonance with variations in the Bank's own borrowing costs. The effective loan charges to borrowers have in fact been lower in many cases, because of savings of interest resulting from sales by the Bank of portions of loans at yields to the purchasers below the "gross" interest rate.

3/ The rate has varied with the term of the loan during periods when differentials existed in the major markets between long-term and medium-term rates for the Bank's own bonds. This interest differential disappeared some six years ago. If it should recur it would presumably again be taken into account in setting loan charges.

In mid-1955, the Executive Directors considered whether to reduce the 1% commission at the end of the first ten years of operations, that is, in June 1956. The management recommended and the Executive Directors agreed that the rate of commission should not be changed at that time. In December 1956 a change in loan charges was again considered, together with the question of declaring a dividend. In the view of the management, total reserves had then reached the point at which the Bank could, without undue risk, both reduce the commission and pay a dividend. The Executive Directors considered proposals for a reduction of the commission from 1% to 3/4%, coupled with a dividend of 2% on the 18% portion of subscriptions outstanding on loans, plus 2% on that portion of subscriptions paid in in gold or dollars. After extensive discussion, it was agreed to defer action on these proposals. The question of a reduction in loan charges was re-examined in June 1957 and in March 1960 but again no action was taken.

Discussion of a reduction of loan charges has always focused on the 1% commission. It therefore seems useful to comment on the significance of the commission as part of the loan charges. Under the initial practice of separating the charge for interest and the commission, the result of the Bank's policy of a uniform total loan charge was that the commission was charged not only on loans made out of borrowed funds (as to which a commission of not less than 1% was then mandatory under the Articles), but also on loans made out of the Bank's own resources. When the Bank changed its practice and adopted a "gross" interest charge, it could have decided to allocate 1% of interest receipts, as commission, out of only that portion of interest receipts which related to borrowed funds out on loan. This action would have had no consequence for loan charges. It would merely have meant a reduction in the amounts allocated to the Special Reserve and a corresponding increase in the net income allocated to the Supplemental Reserve. By the same token, a reduction in the rate of commission could be adopted without necessarily affecting loan charges.

It may also be noted that during the December 1956 discussions of a possible reduction in the rate of commission, the question was raised whether the Articles required that any reduction be made applicable both to outstanding loans and to future loans. In an opinion (R57-4) dated January 8, 1957, the General Counsel concluded that if the Bank should reduce the rate of commission charged on new loans "it would not be mandatory under /Article IV,7 Section 4(a) for the Bank to apply the reduced rate to outstanding portions of existing loans."

III. Future Policy on Loan Charges

The case for a reduction in loan charges rests on the argument (a) that the Bank, as a cooperative institution, should make development assistance available at the lowest cost to its borrowers consistent with prudent financial policy and (b) that the Bank's present financial position and its prospects would permit a reduction without prejudice to its financial soundness.

A reduction of loan charges would reduce the Bank's income and, accordingly, the amounts available for additions to reserves, for transfer to IDA or for payment of a dividend. It is relevant, therefore, in considering whether to reduce charges, to take account of the financial implications of such action. As of December 31, 1962, disbursed loans outstanding held by the Bank amounted to $3,153 million. Thus the Bank's receipts on these loans would be reduced by just under $8 million per annum for each 1/4% reduction of loan charges.[4/]

The arguments against reducing loan charges fall into two categories.

(a) One category relates to the direct financial implications: any reduction, however small, would reduce the Bank's net income. But while it is clear that a substantial reduction could seriously endanger the Bank's financial condition, it is equally clear that a small reduction would by itself not have this effect. Therefore in any appraisal of the financial consequences of a decision to reduce charges, it would be material whether that decision was to be taken in isolation or in association with a decision to devote substantial amounts of available income to another use.

The second category of arguments against a reduction rests on broader considerations.

(b) By any of a number of criteria, the Bank's loan charges are low. They are low in comparison to the interest rates which the Bank's most creditworthy members must pay to borrow at long term in the principal capital markets of the world, including, in many cases, their own markets. The Bank's charges are low in relation to the yield to the economy of the countries in which Bank-financed projects are located. They are low in comparison to the interest rates which prevail in most member countries. Thus they fully meet the test of reasonableness imposed by the Articles.

(c) The Articles direct the Bank to abstain from lending in competition with the private market when funds are available in the market on reasonable conditions. In accordance with this injunction, the Bank has from time to

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4/ Whether, if it were decided to reduce loan charges, the reduction would be at the expense of allocations to the Special Reserve or to the Supplemental Reserve would depend upon whether the reduction took the form of a reduction in the rate of commission, or perhaps elimination of the commission. A decision on the latter question would depend upon the Bank's judgment of the relative significance of the functions of these reserves, as discussed in the preceding Part of this paper.

time referred some of its strongest borrowers to the private market, even though the cost of borrowing there was somewhat higher than the cost of borrowing from the Bank. This policy has not always been well received by the particular borrowers. The situation would become more difficult to the extent that the gap between the Bank's loan charges and the cost of borrowing in the market were to be further widened. Moreover, to increase the disparity between Bank and market rates might weaken the incentive of the less developed countries to accept the disciplines and adopt the policies which would help to build their economies to the point at which they might be able to have direct recourse to the private market.

(d) Any substantial reduction of loan charges would adversely affect the Bank's market image as an institution run along sound business lines. This might make the Bank's bonds less acceptable.

(e) Any substantial reduction could result in a yield below the level demanded by the market, with a consequent impairment of the Bank's ability to sell portions of loans to private investors. This would increase the Bank's need to borrow funds for its lending operations, which in turn might in the long run mean a rise in borrowing costs. It would also reduce the Bank's ability, through the sales of loans, to mobilize private capital for investment in development. A falling off of sales of portions of loans would, moreover, hamper the Bank in achieving the objective of establishing the credit of its borrowers in the private market.

(f) Insofar as concerns the possible application of any reduction of loan charges to outstanding loans, a substantial portion of the income which the Bank would thus forego would be "saved" by countries which are Part I members of IDA. Of the total disbursed loans outstanding held by the Bank on

December 31, 1962, in the amount of $3,153 million, 32% was repayable by Part I countries. And as applied to future loans, a reduction would be of no, or of relatively slight, immediate advantage to those Bank members which lack or have relatively little capacity to borrow on Bank terms; yet it is the membership of this group which has been growing and which includes most of the Bank's newest members.

(g) In view of the inevitable uncertainties surrounding the Bank's operations, no action should be taken which would irrevocably reduce the Bank's income for any future period. Since a reduction of loan charges would affect net income over the full term of the loans to which the new level of charges would apply, even a small reduction in charges might be unwise.

(h) Since the Bank's net income is derived primarily from the local currency portions of subscriptions which members have made available,[5] those members which have contributed these funds are entitled to compensation at least to the extent of the 2% preferential dividend specified in the Articles[6] before loan charges are reduced.

The suggestion has been made that these last two arguments may be countered in part at least if, in years when the Bank's financial condition and prospects permitted, the Bank were to pay a 2% dividend on the local currency portion of subscriptions out on loan, coupled with a rebate to borrowers of a portion of loan charges paid to the Bank during the year in question, with the aggregate amount of the rebate bearing some relation to the amount of the dividend and with due regard to the needs of reserves. However, while this proposal would meet some of the objections advanced to a reduction of loan charges, it would not overcome others.

5/ See Annex Table 3.

6/ See Part D.

C. DIRECT TRANSFER OF BANK EARNINGS TO IDA

I. Relevant Provisions of the Articles of Agreement

There is no provision of the Articles of Agreement of either the Bank or IDA which explicitly deals with a transfer by the Bank of a portion of its earnings to IDA. In the current discussion of Bank financial policy, reference has been made to Article VI, Section 6 of the IDA Articles, which provides that IDA shall not borrow from or lend to the Bank.

II. Policy Concerning Transfer

The arguments in favor of a direct transfer of some portion of Bank earnings to IDA are the following:

(a) A transfer would be the most effective and tidy way of assuring that some part of the Bank's income, over amounts required for reserves, will continue to be used for the promotion of economic development on the kind of terms for which there is great need.

(b) If the Bank declared a dividend, it would presumably be hoped that member countries would devote the amount received to development purposes, whether in the form of a contribution to IDA or otherwise. But once a dividend became part of general revenues, requiring an appropriation out again to become available to IDA or to be otherwise used in development, some portion of the dividend would be likely to remain in the local treasury or to be devoted to other uses. Moreover, if Part II countries are not to be invited to participate in second-round IDA subscriptions, their portion of a Bank dividend would not find its way back to IDA, in any event. A direct transfer would preclude this possibility of "leakage" both in Part I and Part II countries.

(c) A direct transfer, unlike a dividend, would not invite the criticism that the Bank was withdrawing funds from the development field and turning over to its wealthier members the bulk of the funds withdrawn.

The principal arguments against a direct transfer of a portion of Bank earnings to IDA are the following:

(a) Although the Articles of Agreement of the Bank and of IDA do not expressly prohibit the Bank from giving funds to IDA or IDA from receiving them, it is the implication of the prohibition which they do contain (i.e., that IDA shall not borrow from the Bank), that Bank funds will not be used to finance IDA and that there will be no financial connection between the two institutions. A transfer of earnings would therefore violate the spirit, even though not the letter, of the Articles.

(b) A direct transfer would run counter to the representations made to the market at the time IDA was established and in its early days. The market might regard this as a breach of faith, with a consequent adverse effect upon the Bank's credit standing. Apart from any question of good faith, the transfer might appear objectionable to the market, as an indication that the Bank intended to engage in "giveaways."

(c) Some members of the Bank are not members of IDA. To the extent the Bank has earnings in excess of amounts required for reserves, these earnings belong to all the members of the Bank. It would be unfair to transfer any portion of these earnings to an institution, even an affiliated institution, to which some Bank members do not belong.

(d) On their face, the Bank's Articles suggest that if net earnings exceed the amount thought necessary for accumulation of reserves, the Bank should consider reducing loan charges or declaring a dividend. Nothing in the Articles contemplates the possibility of an outright transfer of sizeable amounts of earnings to another institution, even an affiliate. If the Bank's members wish to dispose of profits in a way not contemplated (even if not actually prohibited) by the Articles, the Articles themselves should be amended to authorize that action, and the action should not be taken in the absence of an amendment.

(e) To adopt the technique of augmenting IDA resources by a transfer of Bank earnings is likely to encourage pressure by the capital-exporting countries for unduly large transfers to IDA (either directly or by the dividend route).

D. DIVIDENDS

I. Relevant Provisions of the Articles of Agreement

Article V, Section 14(a) of the Bank's Articles provides that the Board of Governors shall determine annually what part of the Bank's net income, after making provision for reserves, shall be allocated to surplus and what part, if any, shall be distributed.

Article V, Section 14(b) prescribes the basis on which any distribution of net income is to be made. It provides that "up to two percent non-cumulative shall be paid, as a first charge against the distribution for any year, to each member on the basis of the average amount of the loans outstanding during the year made under Article IV, Section 1(a) (i) out of currency corresponding to its subscription. If two percent is paid as a first charge, any balance remaining to be distributed shall be paid to all members in proportion to their shares."

In the current discussions by the Executive Directors concerning the Bank's financial policy, three figures have been mentioned as a possible aggregate dividend. One is a dividend of $27 million. This would represent the two percent non-cumulative dividend referred to in the preceding paragraph, calculated on the average amount of the local currency portion of subscriptions actually out on loan. This would be distributed almost entirely to Bank members which are Part I members of IDA. A second aggregate mentioned is a dividend of $50 million. After distribution of the two percent preferential dividend, there would be a balance of $23 million to be distributed on the basis of shareholdings. Countries in the Part I group would receive, in addition to the bulk of the two percent dividend, most of the $23 million balance. Part II members of IDA would receive in all some $7 million. The third figure mentioned is a dividend of $60 million. If a dividend of that magnitude were declared, about $50 million in all would be received by Part I countries and some $10 million by Part II countries.[7/]

II. Future Dividend Policy

The principal arguments in support of a dividend are the following:

(a) The fact that the Bank's Articles prescribe the basis on which a dividend distribution is to be made may be taken to indicate an expectation,

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7/ These calculations are shown in Annex Table 4.

at the time the Articles were drafted, that a dividend would be paid if circumstances permitted. At an early stage of the Bank's growth, when earnings were relatively small, any dividend which could prudently have been paid, after the addition of a satisfactory amount to reserves and without jeopardizing the Bank's efforts to build and preserve a reputation for financial soundness, would have been too small to be of much value. The Bank's earnings have now reached a level permitting payment of a significant dividend after putting a reasonable amount to reserves.

(b) Projections of the Bank's net income over 1963-73 indicate that on certain assumptions (including the assumptions that the Bank will suffer no losses over the next ten years and that there will be no change either in the Bank's loan charges or in the present level of interest rates in the market during that period), a $50 million dividend paid annually over the period would leave substantially unaffected the present relationship between reserves and loans outstanding, on the one hand, and reserves and borrowings outstanding, on the other.[8/] The projections indicate that there would be a slight decline in the ratio in the next few years, but that by the end of the fiscal year 1973 the ratio of reserves to loans outstanding would have risen from the 24% projected for June 30, 1963, to 26.9%, and the ratio of reserves to borrowings outstanding would have risen from 31.7% to 36%. Obviously a change in any of the assumptions on which the projections are based could change the outlook substantially. If adverse changes occurred, that circumstance would presumably be taken into

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8/ See Annex Table 2.

account in determining the amount of any dividend to be paid in future years. Similarly, if the Bank's earnings rose substantially with no offsetting adverse change in relevant conditions, that situation would presumably also be taken into account.

(c) The payment of a significant dividend would enhance the Bank's standing in the business and financial communities of the world, and would be taken as further evidence that development assistance can be carried out on a business-like basis. In the long run this might result in more development assistance being made available than would otherwise be the case. It would in any event provide a strong argument in support of increasing participation in well-organized multilateral assistance programs.

(d) The argument that those members which have released usable local currencies, from which the Bank's profits principally derive, should be compensated, at least to the extent of receiving the 2% preferential dividend, was mentioned in the discussion of loan charges.

(e) Finally, besides the arguments advanced in the context of Bank operations, there is the argument that distribution of a dividend would facilitate additional subscriptions for IDA. The governments of the industrialized countries can be expected to take account of the decision to pay a dividend in determining the amounts of their second-round subscriptions to IDA. Should the less developed countries be invited to participate in the increase, the amounts which these countries would receive by way of a Bank dividend would presumably make it easier for them to subscribe additional funds to IDA.[9]

9/ In its application to the less developed countries, this argument assumes a dividend in excess of the 2% dividend on loans outstanding made out of local currency subscriptions.

The principal arguments against declaring a dividend are the following:

(a) The Bank's Articles do not make the declaration of a dividend mandatory. The Bank, as a development agency, should not dispose of its income in a manner which, by reason of the dividend distribution formula prescribed by the Articles, would be of primary benefit to the wealthier, capital-exporting countries among the Bank's membership. As indicated above, those countries which comprise the Part I group of IDA members would receive 86% of a $50 million dividend. This objection may be countered by the comment that in present circumstances a large part of the benefits accruing initially to the Part I countries will in fact be passed on to the poorer Part II countries in the form of expanded contributions to development assistance.10/ However, the envisaged benefit is not only problematical but would be deferred. Since a dividend is not mandatory, income not put to reserves should be devoted to purposes directly and immediately helpful to the less developed countries, as by reducing loan charges.

(b) Once the Bank declares a dividend, it would be hard to pass a dividend or even to pay a lower dividend in succeeding years without creating an unfortunate impression in financial circles. In fact, if earnings rose, the Bank could expect to be under pressure to increase the amount of dividend. It is even conceivable that the pressure could lead to reserve allocations of somewhat lower amounts than would be desirable by conservative financial standards.

(c) Finally, because most of the immediate benefits of any dividend

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10/ The argument that a dividend would facilitate additional subscriptions to IDA has already been mentioned.

would accrue to the industrialized countries, the Bank would be subject to considerable criticism, particularly in the less developed countries but also in some quarters of the industrialized countries, if it paid a dividend. This would be seen as evidence that the Bank, although designed to help the less developed countries, has in fact been operated as a commercial institution making substantial profits for the industrialized countries out of loan charges paid by the less developed countries. However much such criticism might misrepresent the true situation, it would nevertheless be widely heard and might well have an adverse effect upon the standing and reputation of the Bank and consequently upon the Bank's ability effectively to discharge its functions.

Other Dividend Possibilities

Some of the objections raised to a dividend might be avoided by declaring a dividend under conditions designed to assure that all or a large part of the amount distributed would be devoted to increasing the resources of IDA. For example, a dividend might be authorized as part of, or might be conditioned upon, an agreement by all Part I members to turn over to IDA the amounts received as a dividend. Alternatively, a dividend might be authorized without any strings, but accompanied by declarations by the Bank's principal shareholders that, subject to legislative approval, they intended to turn over to IDA as a supplementary contribution any dividend payments they received.[11/] It need not be an essential element of this scheme that declarations be made

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11/ The possibility of "leakage" of some part of dividend receipts is discussed in Part C. This possibility might be avoided or minimized to the extent that legislatures were prepared to authorize that the Bank be instructed to pay over to IDA directly, as a supplementary contribution by the country concerned, the amount of any dividend it would otherwise have received. The technique might, in some countries, avoid the necessity of yearly legislative appropriations.

by all of the countries which are Part I members of IDA. Provision might also be made for declarations by Part II countries.

The declaration of a dividend under these circumstances would assure that at least a substantial portion of the aggregate amount of any dividend would become available, through IDA, for urgent development purposes, without creating any direct financial relationship between the Bank and IDA and, in the case of the dividend accompanied by a declaration of intent, would separate the Bank's action from governmental decisions concerning disposition of the dividend. At the same time, both arrangements might be thought to create an undesirable interconnection between dividend payments and the IDA replenishment, although, under the declaration of intent technique, the connection would be more remote.

ANNEX TABLE 1

RESERVE BALANCES

(in millions of dollars)

	Special Reserve	Supplemental Reserve	Totals
June 30, 1947	--	(-) 1	(-) 1
June 30, 1948	3	4	7
June 30, 1949	8	15	23
June 30, 1950	14	28	42
June 30, 1951	20	44	64
June 30, 1952	28	62	90
June 30, 1953	37	82	119
June 30, 1954	49	105	154
June 30, 1955	62	130	192
June 30, 1956	77	159	236
June 30, 1957	94	195	289
June 30, 1958	114	236	350
June 30, 1959	138	282	420
June 30, 1960	165	341	506
June 30, 1961	194	408	602
June 30, 1962	223	476	699
Dec. 31, 1962	239	516	755

Treasurer's Department
January 22, 1963

ANNEX TABLE 2

CONFIDENTIAL

R62-110

FROM: The Secretary

December 28, 1962

PROJECTION OF ACTIVITIES

1. In accordance with your request there are attached two schedules indicating how the activities of the Bank might evolve during the eleven-year period beginning July 1, 1962 and ending June 30, 1973. Schedule A assumes no dividends are paid. Schedule B assumes dividends of $50 million per annum with the first payment being made in fiscal 1963-64 out of 1962-63 earnings.

2. These projections are based on many assumptions and estimates, a change in any one of which could change the picture very substantially. While these assumptions and estimates are considered to be reasonable, the projections are put forward with considerable diffidence and should be used with great caution.

3. Many of the assumptions used in preparing the projections are evident from the figures themselves. Others are as follows:

a) New loans are assumed to be amortized from the third to the twenty-fifth year with an average life of about thirteen years.

b) Loans sold are assumed to be from maturities in the second through the eighth year after sale with a percentage spread in these years of 10%, 15%, 25%, 20%, 15%, 10% and 5%.

c) No losses.

d) $1,450 million of 18% funds and $205 million of 2% funds disbursed and outstanding on loans.

Distribution:

Executive Directors and Alternates
President
Vice Presidents
Department Heads

e) Net income is estimated on the assumption that there will be no change in loan charge policies or in the present level of interest rates in the market; that grants and administrative expenses, including \$10 million for educational purposes, will approximate \$25 million per annum; and that the costs of borrowing and the income from the use of borrowed funds (exclusive of the 1% loan commission) will continue to be approximately equal.

f) The figures in the column "Borrowings Maturing" are based on presently outstanding bonds and the assumption that no new short-term issues will be sold except for the annual roll-over of \$100 million of the central Bank issues now outstanding: amortization of other new issues is assumed to be from fifth year after placement to the twenty-fifth year with an average life of about twelve years.

SCHEDULE A

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Projection of Activities - Without Dividends

(Expressed in Millions of U.S. Dollars)

Fiscal Years Ending June 30	Loans Made	Loans Repaid to Bank	Loans Sold	Loans Disbursed	Net Income	Loan Commissions	Lendable Cash Balance	Undisbursed Balance of Loans	Loans Disbursed Held by Bank	Net New Funds	Borrowings Maturing	New Borrowings	Borrowings Outstanding	Cumulative Reserves		
														Supplemental	Special	Total
1963	700	110	200	700	75	32	1390	1700	3355	11	110	121 *	2540	550	256	806
1964	700	110	200	700	75	35	1045	1700	3745	(30)	130	100	2510	625	291	916
1965	700	135	200	700	80	39	1000	1700	4110	240	345	585	2750	705	330	1035
1966	700	140	200	700	85	43	1000	1700	4470	275	205	480	3025	790	373	1163
1967	700	170	200	700	90	46	1000	1700	4800	240	203	443	3265	880	419	1299
1968	700	180	200	700	95	49	1000	1700	5120	225	363	588	3490	975	468	1443
1969	700	200	200	700	100	53	1000	1700	5420	200	303	503	3690	1075	521	1596
1970	700	240	200	700	105	55	1000	1700	5680	155	248	403	3845	1180	576	1756
1971	700	270	200	700	110	58	1000	1700	5910	120	298	418	3965	1290	634	1924
1972	700	300	200	700	115	60	1000	1700	6110	85	388	473	4050	1405	694	2099
1973	700	320	200	700	120	62	1000	1700	6290	60	448	508	4110	1525	756	2281

Percentages

Fiscal Years Ending June 30	Total Reserves to Loans Outstanding	Total Reserves to Borrowings Outstanding	Special Reserve to Borrowings Outstanding
1963	24.0 %	31.7 %	10.1 %
1964	24.5	36.5	11.6
1965	25.2	37.6	12.0
1966	26.0	38.4	12.3
1967	27.1	39.8	12.8
1968	28.2	41.3	13.4
1969	29.4	43.3	14.1
1970	30.9	45.7	15.0
1971	32.6	48.5	16.0
1972	34.4	51.2	17.1
1973	36.3	55.5	18.4

* Actual borrowings this fiscal year to date

December 26, 1962

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

SCHEDULE B

Projection of Activities - After Dividends

(Expressed in Millions of U.S. Dollars)

Fiscal Years Ending June 30	Loans Made	Loans Repaid to Bank	Loans Sold	Loans Disbursed	Net Income	Loan Commissions	Lendable Cash Balance	Undisbursed Balance of Loans	Loans Disbursed Held by Bank	Net New Funds	Borrowings Maturing	New Borrowings	Borrowings Outstanding	Cumulative Reserves		
														Supplemental	Special	Total
1963	700	110	200	700	75	32	1390	1700	3355	11	110	121 *	2540	550	256	806
1964	700	110	200	700	25	35	1000	1700	3745	(25)	130	105	2515	575	291	866
1965	700	135	200	700	28	39	1000	1700	4110	337	345	682	2852	603	330	933
1966	700	140	200	700	31	43	1000	1700	4470	329	205	534	3181	634	373	1007
1967	700	170	200	700	34	46	1000	1700	4800	296	203	499	3477	668	419	1087
1968	700	180	200	700	37	49	1000	1700	5120	283	363	646	3760	705	468	1173
1969	700	200	200	700	40	53	1000	1700	5420	260	303	563	4020	745	521	1266
1970	700	240	200	700	43	55	1000	1700	5680	217	258	475	4237	788	576	1364
1971	700	270	200	700	46	58	1000	1700	5910	184	313	497	4421	834	634	1468
1972	700	300	200	700	49	60	1000	1700	6110	151	408	559	4572	883	694	1577
1973	700	320	200	700	52	62	1000	1700	6290	128	474	602	4700	935	756	1691

Percentages

Fiscal Years Ending June 30	Total Reserves to Loans Outstanding	Total Reserves to Borrowings Outstanding	Special Reserve to Borrowings Outstanding
1963	24.0 %	31.7 %	10.1 %
1964	23.1	34.4	11.6
1965	22.7	32.7	11.6
1966	22.5	31.7	11.7
1967	22.6	31.3	12.1
1968	22.9	31.2	12.4
1969	23.4	31.5	13.0
1970	24.0	32.2	13.6
1971	24.8	33.2	14.3
1972	25.8	34.5	15.2
1973	26.9	36.0	16.1

* Actual borrowings this fiscal year to date

December 26, 1962

NET INCOME

(in millions of dollars)

	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61	1961-62
A. Paid-in capital + reinvested profits	950	1,150	1,300	1,500	1,800	1,950	2,030
B. Average interest on disbursed loans held by the Bank	3.45%	3.47%	3.56%	3.70%	3.87%	4.02%	4.16%
C. Item B times Item A	33	40	46	56	70	78	84
D. Item C less administrative expenses	26	32	38	46	60	66	71
E. Net income	29	36	42	46	60	63	70

Treasurer's Department
January 22, 1963

TENTATIVE
CALCULATION OF A DIVIDEND TO IBRD MEMBER COUNTRIES

ANNEX TABLE 4

As of June 30, 1962

IBRD Member	Average 18% 1/ on Loan (Millions)	Number of Shares	2% Dividend on average 18% on Loan	$ 50 Million Dividend: Balance Pro-rated by Shareholdings	$ 50 Million Dividend: Total Dividend	$ 60 Million Dividend: Balance Pro-rated by Shareholdings	$ 60 Million Dividend: Total Dividend
Part I Countries							
Australia	$ 32.70	5,330	$ 654,000	$ 589,077	$ 1,243,077	$ 849,270	$ 1,503,270
Austria	9.00	1,000	180,000	110,521	290,521	159,338	339,338
Belgium	40.50	4,500	810,000	497,345	1,307,345	717,020	1,527,020
Canada	67.50	7,500	1,350,000	828,908	2,178,908	1,195,032	2,545,032
Denmark	11.40	1,733	228,000	191,533	419,533	276,132	504,132
Finland	3.90	760	78,000	83,996	161,996	121,097	199,097
France	66.65	10,500	1,333,000	1,160,470	2,493,470	1,673,045	3,006,045
Germany	75.00	10,500	1,500,000	1,160,470	2,660,470	1,673,045	3,173,045
Italy	32.40	3,600	648,000	397,875	1,045,875	573,616	1,221,616
Japan	59.90	6,660	1,198,000	736,070	1,934,070	1,061,189	2,259,189
Luxembourg	1.80	200	36,000	22,104	58,104	31,868	67,868
Netherlands	45.95	5,500	919,000	607,865	1,526,865	876,357	1,795,357
Norway	9.30	1,333	186,000	147,324	333,324	212,397	398,397
South Africa	17.15	2,000	343,000	221,042	564,042	318,675	661,675
Sweden	18.00	2,000	360,000	221,042	581,042	318,675	678,675
United Kingdom	234.00	26,000	4,680,000	2,873,546	7,553,546	4,142,779	8,822,779
United States	571.50	63,500	11,430,000	7,018,082	18,448,082	10,117,941	21,547,941
Total - Part I Countries	$ 1,296.65	152,616	$ 25,933,000	$ 16,867,270	$ 42,800,270	$ 24,317,476	$ 50,250,476
Part II Countries							
Afghanistan	$ —	300	$ —	$ 33,156	$ 33,156	$ 47,801	$ 47,801
Argentina	0.50	3,733	10,000	412,575	422,575	594,808	604,808
Bolivia	—	210	—	23,210	23,210	33,461	33,461
Brazil	—	3,733	—	412,575	412,575	594,808	594,808
Burma	0.95	400	19,000	44,209	63,209	63,735	82,735
Ceylon	0.50	600	10,000	66,313	76,313	95,603	105,603
Chile	—	933	—	103,116	103,116	148,662	148,662
China	—	7,500	—	828,908	828,908	1,195,032	1,195,032
Colombia	0.42	933	8,400	103,116	111,516	148,662	157,062
Costa Rica	0.36	80	7,200	8,842	16,042	12,747	19,947
Cyprus	—	150	—	16,578	16,578	23,901	23,901
Dominican Republic	—	80	—	8,842	8,842	12,747	12,747
Ecuador	1.15	128	23,000	14,147	37,147	20,395	43,395
El Salvador	0.18	60	3,600	6,631	10,231	9,560	13,160
Ethiopia	0.50	100	10,000	11,052	21,052	15,934	25,934
Ghana	1.40	467	28,000	51,613	79,613	74,411	102,411
Greece	—	500	—	55,260	55,260	79,669	79,669
Guatemala	0.30	80	6,000	8,842	14,842	12,747	18,747
Haiti	—	150	—	16,578	16,578	23,901	23,901
Honduras	0.35	60	7,000	6,631	13,631	9,560	16,560
Iceland	0.13	150	2,600	16,578	19,178	23,901	26,501
India	21.60	8,000	432,000	884,168	1,316,168	1,274,701	1,706,701
Indonesia	—	2,200	—	243,146	243,146	350,541	350,541
Iran	5.85	900	117,000	99,469	216,469	143,404	260,404
Iraq	0.95	150	19,000	16,578	35,578	23,901	42,901
Ireland	3.15	600	63,000	66,313	129,313	95,603	158,603
Israel	1.95	333	39,000	36,803	75,803	53,059	92,059
Jordan	—	150	—	16,578	16,578	23,901	23,901
Korea	—	250	—	27,630	27,630	39,834	39,834
Laos	—	100	—	11,052	11,052	15,934	15,934
Lebanon	0.80	90	16,000	9,947	25,947	14,340	30,340
Liberia	—	150	—	16,578	16,578	23,901	23,901
Libya	—	200	—	22,104	22,104	31,868	31,868
Malaya	3.15	500	63,000	55,260	118,260	79,669	142,669
Mexico	15.20	1,733	304,000	191,533	495,533	276,132	580,132
Morocco	—	700	—	77,365	77,365	111,536	111,536
Nepal	—	100	—	11,052	11,052	15,934	15,934
New Zealand	—	1,667	—	184,238	184,238	265,616	265,616
Nicaragua	—	60	—	6,631	6,631	9,560	9,560
Nigeria	—	667	—	73,717	73,717	106,278	106,278
Pakistan	0.20	2,000	4,000	221,042	225,042	318,675	322,675
Panama	0.04	4	800	442	1,242	637	1,437
Paraguay	—	60	—	6,631	6,631	9,560	9,560
Peru	2.37	350	47,400	38,682	86,082	55,768	103,168
Philippines	1.90	1,000	38,000	110,521	148,521	159,338	197,338
Portugal	—	800	—	88,417	88,417	127,470	127,470

- Continued -

ANNEX TABLE 4 (continued)

TENTATIVE

CALCULATION OF A DIVIDEND TO IBRD MEMBER COUNTRIES - (CONTINUED)

As of June 30, 1962

IBRD Member	Average 18% 1/ on Loan (Millions)	Number of Shares	2% Dividend on average 18% on Loan	$ 50 Million Dividend: Balance Pro-rated by Shareholdings	$ 50 Million Dividend: Total Dividend	$ 60 Million Dividend: Balance Pro-rated by Shareholdings	$ 60 Million Dividend: Total Dividend
Part II Countries (continued)							
Saudi Arabia	---	733	$ ---	$ 81,012	$ 81,012	$ 116,795	$ 116,795
Spain	---	2,000	---	221,042	221,042	318,675	318,675
Sudan	1.80	200	36,000	22,104	58,104	31,868	67,868
Syrian Arab Republic	---	200	---	22,104	22,104	31,868	31,868
Thailand	2.05	600	41,000	66,313	107,313	95,603	136,603
Tunisia	---	300	---	33,156	33,156	47,801	47,801
Turkey	---	1,150	---	127,099	127,099	183,238	183,238
United Arab Republic	---	1,066	---	117,815	117,815	169,854	169,854
Uruguay	---	105	---	11,605	11,605	16,730	16,730
Venezuela	1.90	1,400	38,000	154,729	192,729	223,073	261,073
Viet-Nam	---	300	---	33,156	33,156	47,801	47,801
Yugoslavia	1.70	1,067	34,000	117,926	151,926	170,013	204,013
Total - Part II Countries	$ 71.35	52,232	$ 1,427,000	$ 5,772,730	$ 7,199,730	$ 8,322,524	$ 9,749,524
GRAND TOTAL	$ 1,368.00	204,848	$ 27,360,000	$ 22,640,000	$ 50,000,000	$ 32,640,000	$ 60,000,000

1/ Basis:
Average of 18% on Loan as at:

June 30, 1961	$ 1,341.90
June 30, 1962	1,394.00
	$ 2,735.90
Average	$ 1,367.95

Knapp - 3/28/1963

COPY

OFFICE MEMORANDUM

TO: Messrs. Cope, Demuth, Cavanaugh

DATE: March 28, 1963

FROM: J. Burke Knapp

SUBJECT: Funds for Economic Development

You will be interested to see the attached memorandum from Arthur Karasz which I discussed with him and Johnnie Miller while I was in Paris.

I poured cold water on the idea, which has a family relationship to those of Governor Horowitz.

As far as the application of the idea to the Bank was concerned, I emphasized that we did not consider the Bank interest rates unduly burdensome and that I thought the market reaction would be very bad to the subsidization of Bank interest rates.

Attachment

JBKnapp/pd

COPY

OFFICE MEMORANDUM

TO: Files DATE: March 18, 1963

FROM: Arthur Karasz

SUBJECT: Funds for Economic Development. A Swiss Proposal.

1. Mr. Montandon is a member of the Swiss Delegation to OECD, Paris. In the company of Mr. Guetta, IMF, Paris, he paid me a visit on March 14.

2. His purpose: explain an idea on how to reduce the interest burden on IBRD loans. According to Montandon the idea was the subject of long and detailed discussions in Bern and he was instructed by the ministries of finance and foreign affairs to explain it to IBRD.

3. The interest burden could be reduced if a number of nations agreed to form a pool and used the pool's resources to pay interest, or part of the interest, on the loans of IBRD. To use an example: if the interest were, say 5½ per cent and the pool agreed to pay 3½, the debtor would only have to pay 2 per cent to IBRD from his own resources.

4. Advantages:

a) The cost of borrowing would become less of an obstacle to economic development.

b) IBRD could borrow more easily, even on an expensive market.

c) The cost of economic development would be reduced for the donors: instead of having to put up the capital they would just have to maintain the pool for the payment of interest.

5. The cost of IBRD loans is quite high. We hear constant and bitter complaints - as I did during my recent stay in the Far East.

Thus, the Swiss proposal would help to solve in an ingenious way one of the obstacles to economic development. However, as it generally happens in such cases, there will be some difficult questions of detail to be answered, such as:

a) Will all of the new IBRD loans be cheapened through the new pool or only those which could not carry the normal burden? If only part of the loans were accepted by the pool, where would the dividing line run, and who would be entitled to draw it?

b) The contributing members of the pool would have to assume a long-term obligation of payment. In other words, if a 20-year loan were cheapened from 5½ to 2 per cent IBRD would need the assurance that the difference of 3½ per cent will be paid to the pool, and through the pool to IBRD during the entire period of twenty years.

6. In short, the pool would be a sort of SUNFED, but limited to interest payments for development capital. Its advantages could be summarised as follows: it would

a) reduce the cost of borrowing for the developing countries;

b) make it easier for IBRD to borrow on the market;

c) finally, it would open up projects which, until now, because of the high cost, could not be considered as self-liquidating;

d) as compared to IDA, have the advantage of not making us depend on capital grants; thus, it would perhaps be relatively easier to find subscriptions to the pool. In addition, the ties of IBRD to the money market would continue to be maintained.

7. During the meeting Montandon emphasized several times that he was speaking in an official capacity. He was instructed by his Government to discuss the matter with IBRD and report on our first reactions.

It might be that Bern chose this way just to try us out. In case of some interest on the part of IBRD they would make a proposal in a more formal way.

I promised to report to Management and let him know.

Karasz - 9/18/1963

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

INTERNATIONAL FINANCE CORPORATION

COPY

Mr. Wilson:

This is something on which we should have a position if it gets to the stage of being discussed in OECD. It is essentially Horowitz' idea of last year.

J.D. Miller

COPY

OFFICE MEMORANDUM

TO: Mr. John Duncan Miller Date: September 18, 1963

FROM: Arthur Karasz

SUBJECT: Swiss Proposal to Reduce Cost of Borrowing from IBRD

1. In my memo dated March 18, 1963 I reported my conversations with Mr. Montandon, a member of the Swiss delegation to OECD. Montandon, on instruction from his government, approached us with a proposal concerning the reduction of the interest certain underdeveloped countries would have to pay for IBRD loans.

2. The original of my above memo was submitted to Mr. Knapp during our trip to Brussels in March 1963. Mr. Knapp did not agree with the conclusions of the Swiss; he was of the opinion that acceptance of the Swiss proposal might have unfavorable repercussions on IBRD relations with bondholders in the private capital market. Nevertheless, while instructing us to explain this to Montandon, he authorized us to continue conversations with the Swiss and see whether some new formula could be found.

3. Montandon reported to Bern and we had several meetings but only to clarify some details. Later, during a visit to Paris by Mr. Demuth (July 1963), we again discussed the Swiss proposal, without finding any new helpful element.

4. On September 17, Montandon told me the following:

His government, "in spite of the negative attitude shown by IBRD", continues to be interested in the idea of reducing the interest rate on development loans. The Swiss government is convinced that development loans should be provided from private sources and not by governments. However, the price of private capital being high, ways have to be found to assist the underdeveloped countries in the payment of the interest.

What sort of projects would have to be financed in the Swiss scheme? They are thinking of projects which cannot pay our current rates but still do not need the facilities offered by IDA. Thus projects "between IBRD and IDA".

It is interesting to note that the Swiss government would be ready to request parliament for the appropriation of a global sum, sufficient to cover expenses for a long period of time, well beyond the current budget.

5. The Swiss delegation to OECD was instructed to discuss the proposal with the other members of OECD. They will start with France, Germany, UK, US and the Scandinavian countries.

Montandon will keep us informed.

R-97 & Revision

Statutory Commission

1948

CONFIDENTIAL

R-97 (Second Revision)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

February 6, 1948

FROM: The Secretary

MEMORANDUM ON LOAN POLICY

Following the discussion at the Regular Meeting of the Executive Directors on January 28, 1948, the Memorandum on Loan Policy has been revised, (Paragraph 15(a) (ii)), and is attached for information.

Distribution:

Executive Directors and Alternates
President
Vice President
Department Heads

EMW:gm
Sec: 2-116

CONFIDENTIAL

DECLASSIFIED

Date:

R-97 (Second Revision)

Dated April 16, 1947
Revised January 28, 1948
January 29, 1948

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

MEMORANDUM ON LOAN POLICY

as revised on January 29, 1948

1. The primary purpose of the Bank is to "assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peace-time needs and the encouragement of the development of productive facilities and resources in less developed countries".

2. In carrying out that purpose the Bank is to "promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources".

3. The Bank is further enjoined to "promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members", to arrange "the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first"; and to "conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a war-time to a peace-time economy".

4. Furthermore, in making or guaranteeing any loan the Bank is required to "pay due regard to the prospects that the borrower, and, if the borrower is not a member, that the guarantor, will be in a position to meet its obligations under the loan"; and to "act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole".

5. The Bank is, therefore, a cooperative financial institution designed to promote mutual assistance among its members in the reconstruction and development of their territories and the promotion of the long-ranged balanced growth of international trade and the maintenance of equilibrium in balances of payments.

6. With due regard to the purposes of the Bank as set forth in the Articles of Agreement; to the magnitude of its task of assisting in the economic and financial recovery of the world; to the responsibilities of the Bank towards its members as stockholders and potential borrowers, and towards the investors who must supply the major portion of its loanable funds - these are adopted as principles governing its loan policy: -

A. The Need to take Calculated Risks

7. It is essential for the Bank to take calculated risks that private capital is not now willing to assume, especially risks arising from general economic and political uncertainties, and from the magnitude of the amounts required.

B. The Need to insist on Constructive Lending

8. In accepting these general risks, it is necessary for the Bank to insist that the purposes for which its funds are used are constructive, practical and essential to the economic rehabilitation or development of the borrowing countries, and beneficial to the world economy.

C. The Distribution of Loanable Funds

9. Since the Bank's resources are limited in relation to the demands to be made upon it, it is not enough to consider individual applications on their merits. First consideration shall be given to the most urgent needs whether for reconstruction or development; these can be defined broadly as the elimination of bottlenecks and the restoration and expansion of productive facilities that will contribute most effectively to the healthy revival of the world economy.

D. The Principle of Successive Advances

10. The Principle of successive advances arises from two reasons:

(a) First, the Bank's purpose is not fulfilled by the mere granting of loans. It has a continuing responsibility regarding the utilisation of its loans. This responsibility can best be discharged by meeting the needs of borrowing countries with successive advances in the light of their own performance, and by the maintenance of close collaboration between the Bank and borrowing countries.

(b) Secondly, the present limited resources of the Bank preclude it from providing finance for a long period ahead for all the qualifying applications. The Bank can lend no faster than it can borrow. Its current policy must, therefore, be one of making successive advances to individual borrowing countries to meet their most important needs as they arise.

E. The Primary Responsibility of the Borrower for the Major Contribution to its Recovery

11. The Bank shall proceed on the basis that, important though its financial contributions can be, the major effort must be made by the borrowing

countries. The future of every country must depend primarily on its willingness and ability to utilise to the fullest and for productive purposes its own resources.

F. The Fulfilment of Contracts

12. In view of the fact that the realisation of the purpose of the Bank - to assist in economic recovery and development, both by direct or guaranteed loans, and by the encouragement of private lending - depends on its ability to work towards the opening up of all sources of finance, it has an inescapable interest in the fulfilment of obligations in good faith. Therefore, it has responsibility for appraising fairly all factors affecting confidence in international loans and of encouraging all steps which tend to promote such confidence.

G. The Use of the Proceeds of Loans

13. The Articles of Agreement provide that arrangements shall be made to ensure that the proceeds of loans are used efficiently for the specified purposes. Such arrangements shall ensure that:

(a) Disbursements are for expenditure on goods and services acquired in accordance with the terms of the loan agreement; and

(b) The goods and services so purchased are employed for the purposes stated in the loan agreement.

H. Technical Advice

14. The efficient utilisation of loans depends, in large measure, on the quality of the engineering and other technical skills employed, not only in the preparation of projects submitted, but also in their execution. Accordingly,

the Bank will scrutinise carefully the engineering and technical skills used in the preparation of projects and proposed to be used in their execution. The Bank will be prepared to consult with an advise applicants concerning the provision of requisite engineering and other technical services.

I. Interest on Loans, Commissions and Conditions of Redemption

15. Subject to modification in the light of changing conditions:

(a) The Rate of Interest on Loans

(i) The rate of interest on loans made by the Bank shall be stated separately from the rate of commission to be charged on such loans.

(ii) Such rate of interest shall be approximately one-quarter of one per cent per annum higher than the rate of interest which the Bank estimates to be the rate of interest that it would have to pay for money for a term similar to that of the loan.

(iii) A commitment fee at the rate of $1\frac{1}{2}\%$ shall be charged on undisbursed amounts of the loan from the date on which the Bank undertakes a firm commitment to make a loan and for a period of six months thereafter,

(iv) During the period of six months after a firm commitment to make a loan has been undertaken, interest shall begin on the date of disbursement and is to be charged only on the amount disbursed; after six months, interest shall be charged on the whole amount of the loan for which the Bank has undertaken a firm commitment.

(v) Where the above procedure is followed, the principle shall be adopted of refunding to the borrower the interest earned by the Bank on liquid assets held against undisbursed commitments on which the borrower pays full interest. This shall be effected by the borrower receiving, on the amount undisbursed, an interest credit equal to the interest rate determined by the average of the bids on 3 months Treasury bills of the United States Government on the First Treasury issue after the first of January, April, July and October of each year, credit interest to be computed every 3 months after the period has elapsed. In order, however, that the net charge to the borrower shall not be less than the commitment fee chargeable on undisbursed amounts during the initial period of six months, the interest credit shall be limited to a rate not greater than the difference between the rate of the commitment fee and the rate of interest on the loan.

(b) Commission on Loans

The rate of commission to be charged by the Bank on loans made by it shall be one per cent per annum on the amount of the loan outstanding and such commission shall be charged on all loans made by the Bank whether made out of capital or out of borrowed funds.

(c) Provisions for the Redemption of Loans prior to Maturity at Option of the Borrower

(i) Loans made by the Bank shall be subject to redemption at any time prior to maturity at the option of the borrower.

(ii) Upon optional redemption of all or any part of the loan prior to maturity the borrower shall be required to pay a premium at a rate approximately equal to the rate of premium which the Bank shall reasonably expect to have to pay on the optional redemption of securities issued by it having substantially the same maturity.

(iii) The Bank at its option may waive the payment of all or part of such redemption premium on the optional redemption prior to maturity of loans made by it when the Bank is satisfied that it can use the amounts of the loan so repaid to retire its own securities without loss of interest or otherwise use such amount in its operations.

J. The Protection of the Bank's Loans

16. The Bank is required to protect the integrity of its loans. Since such loans will be repayable in foreign exchange, the Bank must provide suitable protection against the borrower impairing its ability to provide the necessary foreign exchange either by pledging its foreign exchange resources as security for other external debt or by improvidently incurring an excessive amount of external debt. To that end the borrower should agree not to pledge its sources of foreign exchange so as to give other external debt priority over the Bank's

loans without the consent of the Bank. In appropriate cases an exception to this principle may be made in order to permit short-term self-liquidating transactions. The borrower should also agree not to incur additional external debt without first consulting with the Bank.

K. The Relations between the Bank and Borrowing Countries

17. In order to accomplish its purposes, the relations between the Bank and its members must be based on confidence and a spirit of mutual co-operation. The relations of the Bank with its borrowers must be broader and closer than the ordinary relations between a creditor and a debtor. There must be the fullest exchange of information with regard to all matters of mutual interest and full opportunity to consult and advise with each other on all such matters. That must be true not only at the inception of the loans but throughout the life of the loans.

18. Since the financial assistance rendered by the Bank will provide only a part of the resources which the borrower will require for the accomplishment of the particular project or program for which the loan is made, and since in the end the accomplishment of such project or program must depend on the constructive efforts and savings of the government and people of the nation to which the loan is made, both the Bank and the borrower must be assured that those efforts and savings can and will be mobilised.

19. The Bank, therefore, has an interest in:

(a) Internal economic and financial measures taken by the borrowers to implement their reconstruction or development programs;

(b) Continuing developments relating to the economic and financial progress of the borrower.

L. The Recognition of Principles in Contracts

20. The contracts of the Bank with its borrowers should contain appropriate recognition of the principles here enunciated and appropriate provisions to implement such principles. Such principles are necessarily subject to modification from time to time in the light of changing conditions.

R-97 (First Revision)

CONFIDENTIAL

Dated April 16, 1947
Revised January 28, 1948

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

DECLASSIFIED
Date: 11/15/2010 BAW

MEMORANDUM ON LOAN POLICY

as revised on January 28, 1948

1. The primary purpose of the Bank is to "assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peace-time needs and the encouragement of the development of productive facilities and resources in less developed countries".

2. In carrying out that purpose the Bank is to "promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources".

3. The Bank is further enjoined to "promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members", to arrange "the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first"; and to "conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a war-time to a peace-time economy".

EMW:gm
Sec:2-96

4. Furthermore, in making or guaranteeing any loan the Bank is required to "pay due regard to the prospects that the borrower, and, if the borrower is not a member, that the guarantor, will be in a position to meet its obligations under the loan"; and to "act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole".

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(v) Where the above procedure is followed, the principle shall be adopted of refunding to the borrower the interest earned by the Bank on liquid assets held against undisbursed commitments on which the borrower pays full interest. This shall be effected by the borrower receiving, on the amount undisbursed, an interest credit equal to the interest rate determined by the average of the bids on 3 months Treasury bills of the United States Government on the First Treasury issue after the first of January, April, July and October of each year, credit interest to be computed every 3 months after the period has elapsed. In order, however, that the net charge to the borrower shall not be less than the commitment fee chargeable on undisbursed amounts during the initial period of six months, the interest credit shall be limited to a rate not greater than the difference between the rate of the commitment fee and the rate of interest on the loan.

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loans without the consent of the Bank. In appropriate cases an exception to this principle may be made in order to permit short-term self-liquidating transactions. The borrower should also agree not to incur additional external debt without first consulting with the Bank.

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18. Since the financial assistance rendered by the Bank will provide only a part of the resources which the borrower will require for the accomplishment of the particular project or program for which the loan is made, and since in the end the accomplishment of such project or program must depend on the constructive efforts and savings of the government and people of the nation to which the loan is made, both the Bank and the borrower must be assured that those efforts and savings can and will be mobilised.

19. The Bank, therefore, has an interest in:

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20. The contracts of the Bank with its borrowers should contain appropriate recognition of the principles here enunciated and appropriate provisions to implement such principles. Such principles are necessarily subject to modification from time to time in the light of changing conditions.

Sec: 2-96

R-44 - Nov.7, 1946

R - 44

(To be submitted to the Executive Directors on November 15 for approval)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

November 7, 1946

COMMITTEE ON FINANCIAL POLICY

REPORT ON RATES OF INTEREST

The attached Report on the subject of interest rates and commissions to be charged in connection with direct loans, will be presented to the Executive Directors on November 15, 1946 for approval.

M M Mendels

M. M. Mendels
Secretary

Distribution:

Executive Directors and Alternates
President (4)
Vice President
Treasurer
General Counsel (10)
Loan Director
Research Director
Chief of Communications
Secretary

Sec-78

R-44

(To be submitted to the Executive Directors on November 15 for approval.)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

November 7, 1946.

COMMITTEE ON FINANCIAL POLICY

REPORT ON RATES OF INTEREST

I. The Committee on Financial Policy met on October 9, 23 and 30 and November 6 and considered the policy aspects of interest rates and commissions to be charged in connection with direct loans.

II. The Committee was of the opinion that the questions to be answered are:

1. Should there be differentiation in interest rates as between debtors?
2. Should there be differentiation in rates of commission as between debtors?
3. Should there be differentiation in interest rates as between loans of different terms of maturity?
4. Should there be a fixed relation between the interest charged on loans given by the Bank and the interest paid by the Bank on its debentures of the same term of maturity as such loans?
5. Should there be differentiation in interest rates as between loans in different currencies?
6. Should the costs of control and supervision be borne by the debtor or by the Bank or shared by both and should there be a general rule as to the charge of costs or can there be differentiation as between types of loans and between debtors?

Sec-78

III. The consensus of the Committee in answering these questions of policy is set forth below:

Questions 1 and 2 - Interest and Commission Rates

Differentiation in interest rates and levels of commission could only be based on an appraisal of the risk differential.

As regards the rate of commission, Article IV, Section 4(a) appears to exclude such differentiation. The commission was clearly meant to be a uniform contribution from all borrowers to a special reserve fund, as provided in Article IV, Section 6.

As regards interest rates, the Articles give no such indication of uniformity. The Committee agreed, however, that, for the time being at least, no differentiation of interest rates based on an appraisal of the risk differential should be attempted. The appraisal of a risk differential between countries poses almost unanswerable questions. The combination of rumours, assumptions and expectations on which the market bases its appraisal could never guide the Bank in fixing its interest rates. Apart from that, it is clear that the charging of very high interest rates would defeat the object of the Bank and would be in conflict with Article III, Section 1(b). Insofar as such high charges have been imposed in the past by private investment agencies in concluding international loans, they have proved to be a heavy burden to the debtors without in reality covering the risk of the lenders. If the Bank would want to differentiate in interest rates, this differentiation would have to be kept within relatively narrow limits. Although that would mean that those debtors on whom the higher charges would be imposed would not be necessarily heavily burdened, the effect of the higher charge would nevertheless be politically painful.

The Committee therefore agreed that there should be no differentiation in either interest or commission charges as between debtors. This of course does not mean that all loan contracts will contain the same interest rates at all times (See under 3, 4 and 5).

Question 3 - Rates on Differing Maturities.

It seems obvious that there should be varying rates of interest on loans of different terms of maturity.

Question 4 - Borrowing and Lending Rates.

There is no good reason to link the interest charged on loans to the overall interest actually paid by the Bank on its own debentures. The Bank is not forced to have the maturities of its own debentures in absolute concurrence with the maturities of the loans given. But it is logical that there should be a relation between the interest charged on loans of a given maturity and the rate at which the Bank could issue debentures of the same maturity. The rate of interest charged on a loan concluded at a given moment should therefore be related to the interest rate prevailing in the market at that moment. But it is impossible to establish a fixed rule as to an eventual spread between the two rates.

Question 5 - Different Currencies.

In consequence of what is said under 4 it is obvious that there may be differentiation in interest rates as between loans in different currencies.

Question 6 - Costs of Supervision.

The answer to this question should be deferred until the report of the Staff on the subject of control and supervision has been received.

IV. In view of the loan applications presently pending, a statement of policy in regard to interest rates is desirable and cannot for long be avoided. The recommendations of this report are, therefore, provisional and are not intended to lay down a rigid policy, incapable of revision in the future when the Bank shall have commenced operations and factors affecting the Bank's determination of interest rates may have come to light. Nor does this report intend to preclude differentiation as between loans of different character (specific projects versus general purpose loans) although it does not recommend any such differentiation at the moment. Differentiation in connection with collateral attached to a loan should be considered in case such collateral would materially reduce the risk of the loan. All such appraisals can only be made in connection with specific loan applications, and the Committee recommends that the Bank staff on the Loan Committees should analyze the various elements entering into the loans, in an attempt to arrive at a practical judgment of the risk differential. Such analysis will serve as a guide to future policy in determining rates of interest.

(Sgd) J. W. Beyen

J. W. Beyen, Chairman
Committee on Financial Policy

Members: Leon Baranski
R. B. Bryce
Emilio G. Collado
Sir James Grigg
Luis Machado

Sec-78

Difference between lending rates of different currencies

Special Commission

Committee on Financial Policy
Document No. 5.

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

November 7, 1946.

COMMITTEE ON FINANCIAL POLICY

Re: Memorandum of the Acting Treasurer on Financial Policy

(Committee on Financial Policy
Document No. 3.)

Resume of discussion at the meeting of
the Committee on November 6, 1946.

1. Discussion was focussed especially on paragraph A. 4 of the memorandum.

2. It was the general view of all present that if the policy put forward in said paragraph were to be followed for a long time, it would bar a rapid development of a great volume of credits, as credits, particularly those destined for the financing of capital goods, will in their initial period be taken up slowly, resulting in an accumulation of unused commitments which, according to the thesis of paragraph 4, should not much exceed the Bank's liquid assets, especially as long as the Bank is still in its infancy.

3. In the discussions, various ideas were brought forward to enable the Bank to extend its loaning activities to a larger volume than that anticipated in the appendix of the memorandum.

4. It was stated that once an issue was made of the Bank's bonds, the Bank could make commitments above its liquid assets. Although it would not be certain at which rates the Bank could borrow, it would, apart from exceptional circumstances, always be able to borrow at some rate. A clause stating that such circumstances would permit the Bank to withdraw from loan contracts could be inserted

therein, thereby protecting the Bank.

5. The Committee, however, realized that it could not be denied that the Bank would in this way run the risk of a rising rate of interest to be paid on its bonds, which might result in losses, especially so if the market, realizing that the Bank was badly in need of money, were to take advantage of such a situation.

6. To eliminate this risk of losses on interest, various methods were discussed. Taking for granted that the Bank functions in the interest of the borrowers and in view of the fact that the Bank acts as a sort of cooperative credit association, it might fit well into that picture to charge the borrowers a rate not fixed in advance but always related to the rate the Bank would have to pay, plus a margin.

7. This flexible rate would eliminate the Bank's losses on interest but would, on the other hand, leave the borrower in the air as to the cost of a loan, thereby preventing a country from calculating the cost of the projects to be financed. It seemed that this circumstance would make countries reluctant to sign a loan contract on such a basis, even if the country had the right to rescind the contract. Once part of a project were underway, it would be difficult for a country to stop half-way regardless of how high interest rates might rise. Furthermore, interest might go up further after a project had been completed.

8. On the other hand it was noted that if the method of a flexible rate were to be followed, it might be possible to eliminate the charging of a commitment commission.

9. In view of the disadvantages of a flexible interest rate, it

was generally thought that methods should be studied to limit the amount of unused commitments as far as possible.

10. It was stated that as long as the contracts for the materials needed for the projects were not signed, it seemed unnecessary for the Bank to enter into firm loan commitments. In the circumstances borrowers could first enter into a preliminary contract with the Bank, by which the Bank would be only engaged to make a loan at a later date, certain conditions to be mutually agreed upon later. In this way the project and most of the conditions of the loan could be agreed upon with a few exceptions such as rate of interest.

11. It was realized, however, that this solution would only partly meet the difficulties as orders for projects are generally not placed at one and the same time and that once one order is placed, the borrowing member has to be sure to be able to finance the rest, thereby necessitating a firm commitment from the Bank.

D. Crena de Iongh
Acting Treasurer

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R/57-4 - 1/8/57