Folder Title: Leonard B. Rist - Loan Policy, Reserves - Correspondence - Volume 2

Folder ID: 1849855

Dates: 6/30/1956 - 1/24/1957

Fonds: Records of Individual Staff Members

ISAD(G) Reference Code: WB IBRD/IDA-09

Digitized: 9/21/2015

PUBLIC DISCLOSURE AUTHORIZED

L.B. Rist: Loan Policy, Reserves

(2)

DECLASSIFIED
WITH RESTRICTIONS
WBG Archives

Mr Rist

(not for public use)

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

CONFIDENTIAL

DECLASSIFIED

Date: 11/15/2010 STB

SecM57-16

FROM: The President

January 24, 1957

WORLD BANK RESERVES

During the discussion among the Executive Directors at the meeting of the Financial Policy Committee on Tuesday, January 15, the suggestion was made that a paper should be prepared by the staff setting forth the principal considerations that the Bank should take into account in reaching conclusions about appropriate levels for the Bank's reserves.

Dr. Machado has prepared a memorandum on the subject, which is circulated herewith at his request.

A paper is also being prepared by the staff and will be circulated in due course.

Attachment

Distribution

Executive Directors and Alternates
President
Vice Presidents
Department Heads

Sec. 57-37

The World Bank's Reserves

A Memorandum prepared by Dr. Luis Machado, Executive Director for Mexico, Cuba, Peru, Venezuela, Costa Rica, Guatemala, El Salvador, Honduras, Nicaragua and Panama.

The question of what should be considered as proper and adequate reserves for the World Bank has been puzzling the Executive Directors for some time. The subject has come to the front recently with the expiration of the ten-year period mentioned in Section 5, Article IV of the Articles of Agreement of the Bank. The need for its study has been emphasised by the Governors of several member countries at the last two meetings of the Board of Governors, when they expressed the view that the statutory commission might now be reduced, in view of the fact that during the past ten-year period, there have been no defaults, and that, as a result of the conservative policies followed by the Bank, substantial reserves of US$253,729,146 had accumulated by December 31, 1956. Of these reserves, the 1% statutory commission accounts for US$85,080,362 and the remaining US$168,648,784 are the undistributed operational profits of the Bank.

Since most of the funds now constituting the almost $254 million of total reserves have been accumulated by the Bank as a result of the free release of the 18% of their subscriptions by certain member countries, the Directors are also faced at this time with the proposal that, as a matter of equity, any reduction in the 1% statutory commission should be accompanied by the payment of a dividend, as provided for under Section 14(a) of Article V of the Articles.

Sec. No. 57-37

Since the payment of a dividend simultaneously with a reduction in the 1% statutory commission would naturally affect the future accumulation of reserves (especially if the reduction in the statutory commission should be applied retroactively to all existing loans made so far by the Bank) the question of what should be a proper and adequate amount of reserves for the World Bank becomes a basic and fundamental question that has to be answered before the Executive Directors can take any action in these matters.

This is not an easy question to answer. There are no precedents to be guided by, because there has not been in existence before us any institution comparable to the World Bank. The present paper does not pretend to have found the answer. It merely sets out a few thoughts in the hope that they may in turn arouse better ideas from others and enable us to find the best possible answers to these serious questions with which the Bank is now faced.

- - - - - - - - -

The first question is : Why should the World Bank have any reserves at all?

The Bank is a stock corporation, all of whose stockholders are Governments. A Government guarantee is generally considered the best, safest and soundest form of obligation that can be obtained from any given country. The membership of the Bank has guaranteed full payment of the Bank's bonds up to the face value of members' respective stock subscriptions. Theoretically, therefore, the World Bank merely on the strength of the supporting guarantees of member governments, could operate without reserves.

Since the volume of loans made by the Bank and the amount of its total outstanding bond issues represent only a small fraction of its total subscribed capital, it is evident - even if some governments might not, upon call, pay the full amount of stock subscribed by them - that the capital obligations of all other member governments would be sufficient theoretically to permit the Bank to operate without reserves.

Sections 4 and 5 of Article IV of the Articles of Agreement of the Bank, however, provide that a commission ranging from 1% to 1-1/2% per annum shall be paid on all outstanding loans. The Executive Directors, at the time of organizing the Bank, fixed the statutory commission at 1%.

The statutory commission was a wise provision by the founders of the Bank at the Bretton Woods Monetary Conference; because 80% of the member governments' obligation to pay for their stock was deferred by Section 5(ii) of Article II of the Bretton Woods Agreement until needed to meet the Bank's own obligations. It was hoped at Bretton Woods (and the events of the past ten years proved that the assumption was correct) that the yearly payment by borrowers of a statutory commission on all outstanding loans would eventually create a reserve that might take care of any defaults and preclude, or postpone for a long time, the necessity of calling upon member countries for the unpaid 80% balance of their stock subscriptions.

On the other hand, it cannot be questioned that the existence of sizeable reserves, ready to be used in an emergency, without having to call on member governments for additional payments on their stock subscriptions, is an inducement for the purchase of World Bank bonds by the public, and that it has had a beneficial effect in opening access of the Bank to the capital markets of the world, enabling the Bank to raise funds at interest rates lower than the rates generally paid by other institutions.

The Executive Directors and the Management of the Bank are charged with a triple responsibility:

a) To make funds available to member countries for reconstruction or development at the lowest possible rates;

b) Regardless of the interest rates to be paid by borrowers, to have funds in sufficient amounts always available to member countries for the financing of their projects; and

c) To conduct its affairs so that there shall be no need to call on member governments to contribute the 80% deferred portion of their stock subscriptions.

The Executive Directors, in discharging their responsibility as Trustees of an international organization, must subordinate the questions of reduction in the statutory commission and payment of dividends to the maintenance of the above three cardinal principles.

In a paper circulated to the Executive Directors on January 11, 1957 (FPC-57-40) prior to a meeting of the Financial Policy Committee to consider these questions, estimates were made of what would be the effects on the Bank's reserves over the next five years by a reduction of 1/4% in the statutory commission and by payment of a 2% dividend. In preparing these estimates the staff naturally had to assume that:

a) There would be no defaults on loans in the next five-year period;

b) Additional amounts of the 18% portion of capital subscriptions would continue to be made freely available to the Bank at a rate of $50 million a year; and

c) Outside participations in Bank's loans and portfolio sales would continue at an average rate of $50 million a year.

While there is no basis for disagreement with any of the above assumptions, it does seem that, in considering the adequacy of the Bank's reserves, it would be unrealistic to assume that, just because there have been no defaults in the past ten years and the Bank continues to exercise every possible caution in the granting and investment of loans, a decision affecting the Bank's future reserves should be based on the hope that something beyond the Bank's control will never happen. In this respect the Bank is like an insurance company that has been collecting premiums in a community that has never had a fire but where any house might burn to the ground overnight.

The Executive Directors would be more comfortable if, having foreseen the possibility of defaults, they could still feel that the Bank's reserves were adequate, not only to meet the Bank's outstanding obligations to bondholders without impairing its capital and without calling on member governments for additional payments, but strong enough to retain, even with defaults, its good credit and open access to world capital markets.

It is far more important to know that, regardless of possible defaults, the Bank will continue to be able to raise money in the future for the financing of its member countries' projects at current prevailing rates or better, than to make at this time a small reduction in the rates that borrowers are paying on past loans. And it might be penny-wise and pound-foolish to embark now on a yearly dividend policy, if in so doing the Bank lowered its reserves to the point where, in the event of a default, it might have to call on member countries for a payment on their 80% deferred subscriptions, and thus seriously impair for the future its good standing and credit in the few available money markets of the world.

Therefore, in order to determine the proper and adequate amount of reserves of the World Bank, consistent with the three basic principles above outlined, possible defaults should be considered in their effect not only on reserves but also on the Bank's general credit position.

In the above mentioned paper, it was estimated that at the end of the next five years (without defaults) the Bank's reserves would amount to about 29% of its outstanding bonds and to about 19% of its disbursed loans if no change is made in the statutory commission and no dividends are paid; and to 22% and 15%, respectively, if such change in policy is now adopted.

In trying to determine the adequate amount of reserves, it must be kept in mind that while reserves are accumulated for the purpose of promptly discharging the Bank's obligations to outsiders, regardless of defaults by members, their amount has to be determined primarily by the amount of outstanding loans, because it is only in outstanding loans that defaults can occur.

It is important to consider the types of default that the Bank may face in the years to come. First, it is reasonable to rule out a general, universal, simultaneous default by all borrowers. While theoretically possible, a catastrophe of this type cannot be anticipated by any conceivable action by the Bank now. The Bank's situation would be similar to the situation of a life insurance company, all of whose policyholders died at the same time. No reserves can possibly be accumulated to meet such an extreme situation. In that event, the Bank would simply have to be liquidated and bondholders would have to be content to receive in payment of their bonds the 29% or 19%, (whatever proportion our reserves might bear at that time to outstanding bonds) plus whatever might be salvaged from the paid-in capital of the Bank. ? 80%

On the other hand, a default by a single country is, however, a possibility that the Bank must foresee and should provide for. Which borrowing countries are likely to default, however, is again something that no one can forecast. The financial history of the world is full of surprises in this field. Small, weak, poor countries are often better credit risks than large, rich and potentially stronger countries. The Bank can no more imagine which member country is likely to default in the future than a life insurance company can predict which policyholder is likely to die first.

The Bank would, however, be acting on the safe side, if in considering the possibility of default by countries, it made provision to take care of a default by the country having borrowed the largest amount of money from the Bank; not because there is any direct relation between the aggregate size of loans and the likelihood of default, but because in making provision for a default by the largest borrower the Bank would automatically be making provision for a default by any smaller borrower.

Now - what would be an adequate reserve to meet a default by a single borrower? Should it be 100% of the outstanding loans? Would it be prudent to accept a lesser percentage? If so, how much?

There are two types of default. One is the complete and total repudiation by a borrowing member of its obligations to the Bank. While history records cases of repudiation in the past and its repetition may occur in the future, it is not probable that the Bank would encounter such repudiations by member countries. A member country deliberately repudiating its obligations to the Bank would be practically committing economic suicide, for it would foreclose all possibility of future financial assistance from the outside world. Also, since the projects for which Bank loans are made are mostly sound, self-liquidating projects, in which member governments in most cases merely act as guarantors, the political reasons on which repudiations are generally based or excused either do not exist or are, at least, considerably minimized in Bank loans.

A default by a member country is more likely to reflect a temporary situation, caused by a serious economic depression or an emergency, such as war or internal strife, beyond the debtor's control, creating a grave disequilibrium in its balance of payments. While from a banker's point of view, a default is a default, and when one occurs the loans in default must be considered in suspense, the fact remains that the Bank would be justified, instead of assuming a 100% loss of a loan from the very moment the default takes place, in accepting a smaller percentage of loss, since sooner or later a solution would be found to the problem and the loan would be renegotiated or adjusted. Seldom would the Bank's loss amount to the full 100% of a defaulted loan.

If this reasoning is correct, then what would be an adequate percentage of reserves to provide for possible default of a loan--75%, 50%, 25%, 10%?

The percentage might be determined by the following formula: viz., adding the average yearly interest paid by the Bank on its outstanding bonds to the average yearly percentage of amortization of its bonds and multiplying such total by the number of years that it may prudently be assumed it might take to restore a defaulting member to financial health.

This formula may be explained in detail as follows. The Bank now pays an average interest of nearly 3-1/3% on its outstanding bonds. It amortizes its bonds over an average of 15 years, i.e., at the rate of 6-2/3% yearly. This amounts to practically a fixed financial charge of 10% per year on its outstanding bonds held by the public. Although the average interest rates paid by the Bank on its bonds will increase in the future, the Bank will probably be able to borrow for longer maturities, and thus diminish the yearly percentage of amortization. If its average interest rate should go as high as 4-1/2%, it could, by trying to average 20-year maturities, still have a of what

total financial charge not exceeding 10% to service its bonds at all times. The figure of 10% per annum may, therefore, safely be taken as a conservative basis for building reserves.

Now the next question is, how many years might it take a country that has been forced to default on its obligations to the Bank to restore its financial health to the point where it can resume service on its defaulted obligations? Here, again, any estimate is purely a speculative guess. Experience has shown that once a country has defaulted it takes some time to find out what its troubles are, to devise the proper solutions, and to apply the corrective measures. It might safely be assumed that not less than three years nor more than five years could be the rule of thumb to apply for the time being to this matter. Therefore, by applying the suggested formula (interest, plus amortization multiplied by years) in this case (3-1/3% plus 6-2/3% x 3 or 5) the Bank would end up with an empirical formula of 30% minimum and 50% maximum as the amount of reserves that the Bank for the time being might consider adequate and should attempt to accumulate to provide for the possible default on a loan by a single member country.

At present (January 1957) the largest borrower owes the Bank US$317,730,000 - 30% of that sum would amount to practically US$100 million, and 50% to practically US$150 million. Since the Bank's reserves on December 31, 1956 amounted to US$253,729,146, it might properly be said that present reserves are adequate to take care of a possible default by any single borrowing member of the Bank.

However, the serious responsibility of keeping the World Bank sound and functioning cannot be satisfied merely by the ability to meet a default by the largest single borrower. In fact, it is doubtful if the Bank will ever be faced with the unpleasant but rather simple question of a default by just one country. If the Bank is ever faced with default, it will more likely be a default by a number of countries, perhaps by a whole economic area, rather than a default by one country alone. A member country will default on its Bank obligations only as a matter of last resort; but a country may find itself, along with other countries, in an economic depression affecting the income of a whole area, and making it impossible for a number of countries to meet their obligations to the Bank.

Let us use, for example, a hypothetical case in Latin America. Fourteen out of 20 Latin American member countries of the Bank are coffee exporters. Coffee is the lifeblood, the economic backbone, of more than half the people inhabiting Latin America. If tomorrow some genius were to discover an inexpensive substitute for coffee and thus remove the main source of livelihood of the Latin American Republics, an economic depression of such magnitude would develop in the area that not one but practically all the Latin American Republics would overnight be unable to meet their most urgent financial obligations. Even countries where no coffee is grown or where coffee is a minor export would be drawn into the crisis, because the economies of countries are today so closely interwoven that depression in Argentina or Chile affects Uruguay, Paraguay and Bolivia, just as an economic crisis in the United Kingdom affects every country in the sterling area.

Let us hope that no one will invent a cheap substitute for coffee. But let us keep in mind that in the economic field such events have happened, as any Chilean exporter of nitrate can testify, when the production of nitrate out of the free air put Chile out of business at the end of the first World War.

A vivid example of the type of possible economic crisis to be kept in mind in discussing the Bank's reserves is the crisis the world is going through at this moment due to the closing of the Suez Canal. On the one hand, a number of countries producing oil in the Middle East area are seeing their exports substantially reduced and their costs considerably increased; and, on the other hand, whole continents of consumers are not only faced with expanding costs, but with the need to draw on scarce foreign exchange reserves to meet the unavoidable needs of rationed essential services.

For these reasons, in determining what should be adequate reserves for the Bank, the Bank should not stop at setting merely the amount required to take care of the default of a single member country. Without any guiding past experience or precedent, the Bank should broaden its horizon and attempt to apply some formula; perhaps the empirical formula suggested above, or some better formula, not just to a country, but to an economic area, perhaps to a continent; and in so doing the Bank would automatically also be providing adequate reserves against default by any single borrowing country.

What economic area or continent in this case should the Directors select to set the Bank's reserves? The less developed? The less politically stable? The one most often affected by recurring economic crisis? Here again, it is impossible to discriminate, and it might be suggested that the economic area or continent where the largest part of the Bank's loans has been invested would probably be the best and most logical decision, for the larger would automatically take care of the smaller, regardless of the economic or political stability of the areas concerned.

If such criteria were adopted as a basis for building the Bank's reserves, then the conclusion is that, since the Bank's largest investments in any one geographical area on December 31, 1956 stood at US$1,084,921,464, the Bank should have not less than $300 million and not more than $500 million in its reserves in order to continue to operate in the future, insured against possible defaults and faithful to the basic cardinal principles described before:

(a) Funds always available to member countries for financing projects at the lowest possible rates;

(b) No calls on member countries for payments on their 80% deferred stock subscriptions.

LUIS MACHADO

January 24, 1957

Sec. 57-37

Leonard B. RIST January 22, 1957

RESERVES

could

Chapter I - What kind of losses can the Bank sustain.

Chapter II - Other dangers that the Bank may run into (Liquidity).

Chapter III - Proper level of reserves.

INTRODUCTION

For the purpose of this discussion, all reserves are considered on the same footing, irrespective of whether they arise from statutory commission (special reserve) or from regular earnings. The argument developped here is in substance that building up reserves against losses is always useful from a balance sheet point of view, but that the possible losses of the Bank cannot be guessed at or measured in advance, While other dangers confront the Bank - largely but not necessarily related to losses for which a reserve coverage is needed. Implications are drawn from these remarks both as to the liquidity policy of the Bank and as to the proper level total reserves should reach.

I - LOSSES

As the thinking of the Bank has evolved since its organization, there seems to be general consensus in the management and in the Board that recourse to the 80% guarantee would in fact close the market to further bond issues. It is implicitly assumed, therefore, that the 80% capital should only be called upon ~~xx~~ as a last recourse if the state of the world is so bad that further borrowing operations in the foreseeable future seem either unnecessary or impossible. Calling on the 80% guarantee for small amounts is assumed to carry the same connotation as calling on it for larger amounts. As long as the Bank wants to remain in the lending and therefore in the borrowing ~~x~~ field, and does not contemplate liquidation or temporarily closing down for new business, the use of the 80% guarantee is precluded. The 80% capital is therefore reserved for the case where a world or continent-wide transfer crisis would occur - a hypothesis which can hardly be visualized expept in the event of a world war or of a world depression.

This means that all other emergencies would have to be met without recourse to the 80% capital. What are they ?

a) Possible repudiations; or quasi repudiation.

A ~~total~~ final, irrecoverable loss would only be incurred in the case of repudiation. ~~While~~ In the past one country only has repudiated its foreign debt outright (USSR), but one cannot exclude the possibility that this ~~can~~ may happen again in other areas. ~~The causes may be varied;~~ ~~could~~ a new government may refuse to recognize contracts signed by its predecessor. It must be granted that even in Latin America where government changes have occurred by violent means, the tradition is well established that a government cannot refuse to recognize the signature of its predecessor, but precedents are not a full guarantee that it will not happen in the future. All in all this is a rather unlikely occurrence.

Another case would be that of a country which ~~goes~~ would ~~over to ideologies which~~ take a strong anti-Western attitude after having borrowed from the West. It may not repudiate outright but suspend payments as Poland and Czechoslovakia have done, leaving no room for negotiation ~~fxx~~ with the creditor. For all intents and purposes, from the point of view of the creditor this amounts, financially if not morally, to the same as if ~~itx~~ his claim had been repudiated. ~~The first hypothesis is only ~~mxly~~ ~~xxxxly~~ likely to happen in the case of small Latin American debtors.~~ The hypothetical case second may involve debtors in Eastern Europe or Asia. Among our present debtoss, this may involve: Yugoslavia, Lebanon, Iran, Siam. In the case of a very strong advance of the Eastern bloc, one might also put in the same category: Finland, Turkey, Pakistan India. Among our potential ~~xxxxxxxxx~~ debtors, the whole of the Middle East and Indonesia.

total loans - [illegible] total

It becomes immediately apparent that the repudiation on the part of a small, isolated debtor - a most unlikely occurrence - would have, by definition, only a small effect on our balance sheet, but possibly would come as a shock to the market. Most likely, this should be a temporary shock.

On the contrary, quasi repudiation, or likely durable defaults, due to political reasons might involve some of our large debtors. T he effect on the balance sheet may only be registered as annual payments come due but undoubtedly ~~thx~~ in the judgment of the market our losses would be appraised in terms of total principal amount ~~mf~~ owed to us. These are quite substantial amounts and will be building up rather quickly, but even under these circumstances it is not likely that for a long time to come ~~such~~ the risk of quasi repudiations could exceed the amount of our capital and surplus. The actual service of our bonds would not be endangered, assuming the other debtors continue to pay as due, and there would be no cause for calling on the 80%. The great trouble to the Bank would be the difficulty it would encounter in placing new obligations; in other words, the future operations of the Bank would be severely jeopardized. Even if we did not call on the 80% the effect on the market would be the same as if we had.

b) Repudiations or quasi repudiations of a generalized character seem to be unlikely contingencies. Defaults on one or more installements is, on the other hand, the main threat to the Bank. It cannot be overlooked that by invoking the escape clause, the British will have called to the minds of other debtor countries the text of Article IV Sect 4 of the Bretton Woods Agreement. Requests for postponement or unilateral decision to postpone on the part of our borrowers, would hardly be considered as precedent breaking after the British incident.

Under what circumstances could this occur? Temporary balance of payment difficulties is the only one. If this occurred for a small debtor and if strong determination to pick up service as soon as possible were expressed by the debtor at the time when the default occurs, the Bank would be perfectly justified in considering the missing installment not as a loss but as a frozen claim. While this may save the apperances on balance sheet, it would hardly satisfy the market. It is probable that the effect on the market would very much depend not only on the amount of the defaulted installment or ~~of~~ on the amount of the total indebtedness to the Bank for that particular debtor, but rather on ~~its~~ the debtor's general credit standing. The bankers in this country ~~always surprised~~ have always expressed surprise when ~~it is~~ we confirmed to them that we have never suffered a default; they would probably not be shaken in their appraisal of the Bank's credit if some of our smaller debtors should ask for renegotiation or postponement. But this is where the real danger lies: if several smaller debtors or one, ~~xx~~ tow or three of the bigger ones should run into trouble at the same time, then market operations should become extremely difficult for the Bank. In other words, a default by Guatemala or Salvador would hardly affect our credit, but a coffee crisis bringing about defaults or threats of defaults from all our coffee growing members, may have a disastrous effect on our operations. The copper producing countries - or at some future time, the oil producing countries - if they were to borrow - might bring about the same kind of reappraisal. It is hardly likely that similar circumstances would prevail among our European debtors, unless there was a general war or depression - a case previously covered.

Thomas
3614

Reserve for liquidity purposes not needed for any other use on the basis or market for loans

Rist

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

DECLASSIFIED

Date: 11/15/2010
STB

CONFIDENTIAL

FPC 57-40

FROM: The Secretary

January 11, 1957

FINANCIAL POLICY COMMITTEE
January 15, 1957

The attached memorandum has been prepared as background for the meeting of the Committee on Financial Policy to be held at 10:00 a. m., Tuesday, January 15, 1957, in the Board Room.

Attachment

Distribution:

Executive Directors and Alternates
President
Vice Presidents
Department Heads

Sec. 57-27

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

FPC 57-40

January 11, 1957

In connection with the discussion of a reduction of 1/4% in the statutory loan commission and of a distribution of 2% on the 18% currencies outstanding in the loans and the 2% capital of members, an estimate has been made of the results of Bank operations for each of the fiscal years 1956-57 through 1960-61.

In making these estimates the following general assumptions have been made:

1. New loans will be at an average annual rate of $400 million a year. (It would make comparatively little difference in the total accumulation of reserves over a 5-year period whether the rate of new loans might be $400 million a year or $500 million a year since the increased volume of lending would have to be financed entirely out of borrowed money on which we just about break even and the rate of disbursement on loans would not be sufficiently rapid to effect materially the accumulation in the Special Reserve.)

2. There will be no losses on loans during the 5-year period.

3. Participations and portfolio sales will average about $50 million a year.

4. Disbursements on loans for the current fiscal year will amount to $325 million and will rise to $400 million for the fiscal year ending June 30, 1961.

5. Additional 18% funds used by the Bank will increase at an average rate of not less than $50 million a year.

6. Repayments to the Bank by borrowers will be about $22 million for the current fiscal year and will rise to about $75 million for the fiscal year ending June 30, 1961.

Total reserves of the Bank were $228 million on June 30, 1956. On the basis of the assumptions indicated above, and if no change is made in the present statutory loan commission of 1% and no dividends are paid, estimated additions to the reserves by fiscal years and the balances as of the end of each fiscal year would be as follows:

Sec. 57-27

(In Millions of U. S. Dollars)

Fiscal Year Ending	Estimated Additions			Estimated Total Reserves		
	Special Reserve	Supplemental Reserve	Total	Special Reserve	Supplemental Reserve	Total
June 30,1957	$ 17	$ 32	$ 49	$ 94	$183	$277
June 30,1958	19	34	53	113	217	330
June 30,1959	21	37	58	134	254	388
June 30,1960	24	41	65	158	295	453
June 30,1961	26	45	71	184	340	524
Total Additions	$107	$189	$296			

It is further estimated that disbursed loans held by the Bank on June 30, 1961 would be about $2.7 billion and the estimated reserves of $524 million would amount to about 19% of loans compared with the reserves amounting to 15% of disbursed loans held by the Bank at June 30, 1956. Estimated bonds outstanding would be about $1.8 billion and estimated reserves would amount to about 29% of this liability compared with reserves amounting to about 27% of bonds outstanding at June 30, 1956.

If it is decided to reduce the statutory loan commission by 1/4% as of January 1, 1957 on both loans outstanding and new loans made after that date and if it is also decided to make the distribution of 2% previously discussed, the estimated annual charges and the estimated total reserves as of the end of each fiscal year after these charges would be as follows:

(In Millions of U. S. Dollars)

Fiscal Year Ending	Estimated Annual Charges			Estimated Reserves After Charges		
	Reduction in Statutory Commissions	Dividends	Total	Special Reserve	Supplemental Reserve	Total
June 30,1957	$ 2	$ 19	$ 21	$ 92	$164	$256
June 30, 1958	5	20	25	106	178	284
June 30,1959	5	21	26	122	194	316
June 30,1960	6	22	28	140	213	353
June 30,1961	7	23	30	159	235	394
Totals	$25	$105	$130			

The effect of these charges would be that the estimated total reserves at June 30, 1961 would be about 25% less than they would have been without the reduction in the commission and the payment of the 2% distribution.

The resulting estimated reserves of $394 million at June 30, 1961 would then be 15% of estimated loans outstanding held by the Bank and about 22% of estimated bonds outstanding.

Record Removal Notice

File Title Leonard B. Rist - Loan Policy, Reserves - Correspondence - Volume 2	**Barcode No.** 1849855
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)
Attorney-Client Privilege

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	31-Oct-14

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

FROM: The President June 27, 1955

FINANCIAL POLICY COMMITTEE - NOTICE OF MEETING

The Financial Policy Committee will meet on Thursday, June 30 at 10:00 a.m. in the Board Room to consider the attached memorandum relating to the Loan and Guarantee Commission and Reserves.

Our situation with respect to potential risks of loss on loans is such that it is not possible to determine what may be considered to be reasonably adequate reserves. Consequently, it would be undesirable to reduce the allocations to reserves, at least until our experience with loan repayments covers a much longer period of time than that during which we have been operating.

Another aspect of our operations is also, in my opinion, directly affected by the rate of the commission. Buyers of our bonds attach a considerable importance to our present practice of charging the 1% commission. If we were to reduce the commission I believe that there would be an unfavorable reaction in the market.

Under the various circumstances mentioned I recommend that we continue to charge the 1% commission.

Attachment.

THE LOAN AND GUARANTEE COMMISSION
AND
RESERVES

1. The Articles of Agreement provide that at the end of a ten year period of operations (June 24, 1956) the rate of commission charged by the Bank on loans and guarantees may be increased on such loan and guarantee operations entered into after that date if experience indicates that an increase is desirable, or may be decreased on both then outstanding and future loans and guarantees if the Special Reserve and other reserves are considered sufficient to justify a reduction.

2. There is no precedent which can usefully be relied upon in determining the appropriate size of Bank reserves. Both the risks assumed by the Bank, on the one hand, and the safeguards inherent in its capital structure on the other are different in character from those of other, more conventional financial institutions. Many more years of experience will be necessary before it can be determined whether our operations may result in a proportionally greater or smaller loss than the previous losses in this field. Consequently, there is obviously room for a difference of opinion as to what the amount of reserves should be and therefore as to the most appropriate rate of commission.

3. Among the many factors affecting the risk of loss inherent in Bank operations are the following:

a. Our lending is in the international field where, certainly under present circumstances, the risks are inherently greater than in domestic lending in the industrialized countries.

b. The Bank can make loans only to borrowers who cannot otherwise raise funds on reasonable terms.

c. Our loans are comparatively few in number with relatively large amounts loaned to each borrower, whereas the risks assumed by other lending institutions are far more diversified. It must also be remembered that our operations so far have been in a period of general prosperity and improvement in the economy of our borrowers, with a resulting excellent loan service record. No one can predict what our losses might be under less happy circumstances.

4. In general, reserves against losses on loans are provided for two purposes; (a) to protect creditors; and (b) to protect stockholders. The Bank's creditors may rely on full protection from the uncalled 80% of stock subscriptions in case our reserves are not adequate to absorb losses and provide funds with which to pay our obligations. However, the Bank is intended to be a continuing institution and its financial policies should therefore be designed so as to avoid, if at all possible, a call on the 80%, with its resultant impairment of capital. If a call on the 80% should have to be made, the position of the Bank with regard to the sale of its obligations would be greatly weakened and its lending would therefore have to be sharply curtailed.

5. At present our total reserves are about 9% of loans made and held by the Bank. However, the funds representing our Supplemental Reserve, which is about 6% of loans, are part of our operating funds and are intermingled with other funds in our loans. If excessive losses had to be absorbed, the Supplemental Reserve could not be a source of immediate funds. The Special Reserve, which has been built up from the

1% commission, is only about 3% of loans. The funds representing this reserve are fully segregated and represent our only reserve funds readily available to meet our obligations.

6. There is obviously a direct relationship between the volume of our loans and the appropriate size of our reserves. However, since it is impossible to forecast accurately the future activities of the Bank, three different assumptions as to the volume of our loans have been made in order to indicate the possible future financial position of the Bank. These are:

a. That new loans of $300 million will be made in the fiscal year beginning July 1, 1955, and each year thereafter;
b. That new loans of $400 million will be made annually;
c. That new loans of $500 million will be made annually.

7. Other assumptions made in the projections under paragraph 6 a, b, and c, are for the period from July 1, 1955, to June 30, 1966, as follows:

a. No losses will be incurred.
b. Loan repayment schedules on future loans will be similar to those on present loans.
c. $100 million of one to five year maturities will be sold annually under assumptions 6 a and 6 b, and $150 million under 6 c.
d. Gross loan disbursements will level off in 1957 at $300 million, $400 million and $500 million, respectively, per annum.
e. Additional 18% capital will become available at the rate of $25 million a year.
f. Net income will increase by an amount each year which is $1 million more than the preceding year.

8. To illustrate the variations in the reserve position of the Bank on the basis of the assumptions indicated, projections have been made to June 30, 1966, with the following results:

(a) If we assume that new loans will be $300 million a year the following situations are indicated:

Loans made, held by Bank — $3,468 Million

	Special Reserve		Supplemental Reserve	
	(Amounts in Millions)			
	Amount	Percent	Amount	Percent
Reserves;				
With 1% Commission	$300	8.7	$450	13.0
" 3/4% "	243	7.0	450	13.0

(b) If we assume that new loans will be $400 million a year the following situations are indicated:

Loans made, held by Bank — $4,444 Million

	Special Reserve		Supplemental Reserve	
	(Amounts in Millions)			
	Amount	Percent	Amount	Percent
Reserves;				
With 1% Commission	$335	7.5	$450	10.1
" 3/4% "	270	6.1	450	10.1

(c) If we assume that new loans will be $500 million a year the following situations are indicated:

Loans made, held by Bank — $5,237 Million

	Special Reserve		Supplemental Reserve	
	(Amounts in Millions)			
	Amount	Percent	Amount	Percent
Reserves;				
With 1% Commission	$358	6.8	$450	8.6
" 3/4% "	287	5.5	450	8.6

We, of course, cannot overlook the possibility that there may be a decision to pay dividends. If a dividend of 2% on the 18% currencies used is paid for each of the fiscal years in the period beginning July 1, 1956, and ending June 30, 1966, total dividends during the ten years, on the basis of the assumptions stated, would amount to $179 million. The Supplemental Reserve of June 30, 1966, would then be $271 million rather than $450 million.

STAFF LOAN COMMITTEE

SLC/O/778

Memorandum from the Treasurer

THE LOAN AND GUARANTEE COMMISSION AND RESERVES

General

The articles of Agreement provide that the Bank shall charge a commission on loans involving the use of borrowed funds and on guarantees at a rate of not less than one percent per annum and not greater than one and one-half percent per annum during the first ten years of the Bank's operations. In practice a rate of one percent has been charged on all loan and guarantee operations. The Articles also provide that at the end of the ten year period (June 24, 1956) the rate of commission may be increased on such loan and guarantee operations entered into after that date if experience indicates that an increase is desirable; or may be decreased on both then outstanding and future loans and guarantees if the Special Reserve and other reserves are considered sufficient to justify a reduction.

Factors to be Considered

In attempting to determine the sufficiency of reserves we are faced with the fact that there is no adequate experience to serve as a basis for an informed judgment. There is no precedent in the field of international lending where the policies and practices are comparable to those being followed by the Bank, or, presumeably, where as effective safeguards exist. Many more years of experience will be necessary before it can be determined whether our operations may result in a proportionally greater or smaller loss than the previous losses in this field. Consequently, there is obviously room for a difference of opinion as to what the amount of all reserves should be and as to whether the one percent commission should be continued, decreased or increased.

In considering the question of reserves we must keep in mind that the Bank can only make loans to borrowers who cannot otherwise raise funds on reasonable terms and thus that our potential risks ~~of loss~~ are greater than those of most lending institutions. An even greater risk results from the fact that our loans are comparatively few in number with relatively large amounts for individual borrowers, whereas other lending institutions have a vastly increased number of loans in proportion to the amount loaned. We already have several members whose loans are as much as 10% of total loans ~~and in time these concentrations may become even greater~~. This heavy concentration of risks would indicate that our reserves should be comparatively larger than those of other lending institutions.

We must also consider the loan commission in relation to the burden that it, together with other loan charges, places on the economy of our borrowing members. However, we must not forget our obligation to avoid competition with private lenders. Theoretically, the relationship of our loan charges to those of private lenders would not enter into a decision as to whether a member could raise money outside the Bank on reasonable terms. However, if our total loan charges were say three percent and private lenders charged four percent the practical effect would be that many would certainly accuse us of unfair competition with private lenders.

Moreover, we are at the point, or almost so, where some of our members can raise funds in the private market at rates comparable with our present total loan charges. If we reduce our total charges below the rate at which such members can borrow from others we would be treating these members unfairly if they find that, after having suffered the privations necessary to establish a credit rating, they must pay more for funds raised elsewhere than other members pay the Bank.

Another important factor in this picture is that the 80% portion of the Bank's capital is reserved to protect our creditors. However, should it be necessary to call any part of this, we could expect considerable difficulty in marketing additional bonds and thus we should certainly not count on such 80% as the normal means of absorbing losses. Further, sound business policy would require the accumulation of reserves adequate to absorb losses without their being charged to stockholders, which would result in an impairment to capital.

Present and Future Reserves of the Bank

At present the Special Reserve and Supplemental Reserve equal about 9% of loans held by the Bank (i.e. loans made less cancellations, sales and repayments).

It is, of course, impossible to forecast accurately the future activities of the Bank. Numerous assumptions can be made about the many factors that enter into a calculation of future reserves. One basic element in such a forecast is the amount of loans that may be made each year. We know that there are so many uncertainties entering into finally making a loan that we cannot estimate with any reasonable degree of accuracy the loans that will be made even within a three months period. However, our annual volume of new loans, since the period of development loans, has increased each year until we will exceed $400 million during the current year. On the basis of this trend and the fact that many of our members are either just beginning, or are substantially expanding, their development programs we might be justified in forecasting a continuing substantial increase in the volume of loans over the next few years compared with our present volume.

On the other hand, it might be reasonable to assume that after the next two years, the level of lending is more likely to decrease than increase as our borrowers have increasing direct access to private capital markets and catch up somewhat on the backlog of projects they need and for which they can be expected to find the local and foreign currency without undue internal pressure.

Since there is no basis for making a realistic forecast of loan volume, two different assumptions have been made in order to indicate the possible future financial position of the Bank. These are:

(1) That new loans of $450 million will be made in each of the fiscal years 1955-56 and 1956-57, and that thereafter they will level off at $400 million per annum; and

(2) That new loans of $400 million will be made in each of the fiscal years 1955-56 and 1956-57, and that thereafter they will level off at $300 million per annum.

Other Assumptions made in the projections under (1) and (2) above are as follows:

1) There will be no losses incurred

2) Loan repayments on future loans will be prorated on the same annual percentages as exists on all present loans

3) $100 million of one to five year maturities will be sold annually

4) Loan disbursements will soon level off at $400 and $300 million respectively per annum.

5) Additional 18% capital will become available at the rate of $25 million a year

6) Net income will increase by an amount each year which is $1 million more than the preceding year.

To illustrate the variations in the reserve position of the Bank there is attached a summary of forecasts on the basis of assumptions indicated. It is interesting to point out particularly, however, the Bank's position as of June 30, 1966 under varying assumptions.

If we assume that new loans will amount to \$450 million in each of the fiscal years 1955-56 and 1956-57, and \$400 million each year thereafter, the following situations are indicated:

Loans made, held by Bank	\$4,565 million	
If no dividends are paid:	Amount (In Millions)	Percent
Total reserves, with 1% commission	\$795	17.4
" 3/4% "	727	15.8
" 1/2% "	660	14.4
If a dividend of 2% on 18% currencies used is paid for fiscal years beginning July 1, 1956:		
Total reserves, with 1% commission	635	13.8
" 3/4% "	567	12.3
" 1/2% "	500	10.9

On the above assumption as to volume of loans, bonds outstanding at June 30, 1966 would be about \$2.4 to \$2.6 billion.

If we assume that new loans will amount to \$400 million in each of the fiscal years 1955-56 and 1956-57 and \$300 million each year thereafter, the following situations are indicated:

Loans made, held by Bank	\$3,610 million	
If no dividends are paid:	Amount (In Millions)	Percent
Total reserves, with 1% commission	\$765	21.2
" 3/4% "	705	19.5
" 1/2% "	645	17.9
If a dividend of 2% on 18% currencies used is paid for fiscal year beginning July 1, 1956:		
Total reserves, with 1% commission	605	16.8
" 3/4% "	545	15.1
" 1/2% "	485	13.5

On the above assumptions as to volume of loans, bonds outstanding at June 30, 1966 would be about \$1.6 to \$1.8 billion.

The estimates about possible outstanding bonds under each of the two assumptions as to loan volume are given only as a matter of interest. Although reserves are accumulated for the protection of creditors their adequacy must be determined by the risks involved in loans. If the reserves were represented by fully segregated and unquestionably sound assets creditors would be fully protected if reserves equalled or exceeded indebtedness, and there would then be no need to consider the relation between reserves and loans in determining the adequacy of reserves for the protection of creditors.

Summary

1. Typical lending institutions have large numbers of loans, negligible concentrations in single loans, and a very wide diversification of risks.

2. The Bank has a heavy concentration of risks with a limited number of borrowers, with certain borrowers having a substantial proportion of the Bank's total loans.

3. In view of the uncalled 80%, potential creditors may be considered to be fully protected on the basis of likely maximum borrowing requirements of the Bank. However, the Bank would probably not be able to borrow further funds if a call has to be made on the 80% and would consequently have to discontinue, or sharply curtail, further lending.

4. Inadequate reserves, which might not cover losses, could result in an impairment of capital and an unjustified loss to stockholders.

5. It would be sound policy to continue the 1% commission and pay no dividends until the Bank has had additional years of experience in collecting its loans and there is a more accurate forecast possible as to the future volume of lending.

Henry W. Riley
Treasurer

HWR:RWC/gm
June 21, 1955

		June 30, 1956		June 30, 1961		June 30, 1966	
Assume: Loans of $450 million fiscal years 1955-56 and 1956-57, and $400 million each year thereafter.							
Loans made, held by Bank		$2.3 billion		$3.6 billion		$4.6 billion	
Reserves, if no dividends are paid and commission is:		Amount	Percent	Amount	Percent	Amount	Percent
				(Amounts in Millions)			
1%	Special	$ 74		$181		$345	
	Supplemental	145		285		450	
	Total	$219	9.5	$466	13.0	$795	17.4
3/4%	Special	$ 74		$155		$277	
	Supplemental	145		285		450	
	Total	$219	9.5	$440	12.2	$727	15.8
1/2%	Special	$ 74		$128		$210	
	Supplemental	145		285		450	
	Total	$219	9.5	$413	11.5	$660	14.4
Reserves, if a 2% dividend is paid annually on currencies used beginning in fiscal year 1956-57 and commission is:							
1%	Special	$ 74		$181		$345	
	Supplemental	145		211		290	
	Total	$219	9.5	$392	10.9	$635	13.8
3/4%	Special	$ 74		$155		$277	
	Supplemental	145		211		290	
	Total	$219	9.5	$366	10.2	$567	12.3
1/2%	Special	$ 74		$128		$210	
	Supplemental	145		211		290	
	Total	$219	9.5	$339	9.4	$500	10.9

Assume: Loans of $400 million in fiscal years 1955-56 and 1956-57, and $300 million each year thereafter.

		June 30, 1956		June 30, 1961		June 30, 1966	
Loans made, held by Bank		$2.2 billion		$3.1 billion		$3.6 billion	
Reserves, if no dividends are paid and commission is:		Amount	Percent	Amount (Amounts in Millions)	Percent	Amount	Percent
1%	Special	$ 74		$177		$315	
	Supplemental	145		285		450	
	Total	$219	9.9	$462	15.0	$765	21.2
3/4%	Special	$ 74		$150		$255	
	Supplemental	145		285		450	
	Total	$219	9.9	$435	14.0	$705	19.6
1/2%	Special	$ 74		$125		$195	
	Supplemental	145		285		450	
	Total	$219	9.9	$410	13.2	$645	17.9
Reserves, if a 2% dividend is paid annually on currencies used beginning in fiscal years 1956-57, and commission is:							
1%	Special	$ 74		$177		$315	
	Supplemental	145		211		290	
	Total	$219	9.9	$388	12.5	$605	16.8
3/4%	Special	$ 74		$150		$255	
	Supplemental	145		211		290	
	Total	$219	9.9	$361	11.6	$545	15.1
1/2%	Special	$ 74		$125		$195	
	Supplemental	145		211		290	
	Total	$219	9.9	$336	10.8	$485	13.5

(R-357) already in R. Files (21)
(For consideration by the Executive Directors on July 27, 1950.)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

To : The Executive Directors July 25, 1950.

From : The President

Establishment of Reserve Against Losses on Loans and Guarantees File

In the course of discussions by the Ad Hoc Committee on the Withdrawal of Poland about the settlement of accounts with Poland on its withdrawal from membership in the Bank, the question was raised as to the desirability of the Bank's establishing a reserve against losses on loans made or guaranteed by it.

The Bank's loan charges have been calculated to yield a modest income over and above operating expenses. In explaining its policy in this regard the Bank has stated that during the early years of its operations it needs to accumulate reasonable reserves in addition to the amount accumulated in the special reserve.

The Board of Governors to date has not distributed any of the net income of the Bank to members as a dividend. The Bank is in the stage of its development where all its net income must be retained for the purposes of the Bank.

By its very nature the Bank's business involves substantial risks. In my opinion and that of the Treasurer, arrived at after consultation with the Bank's independent accountants, the present level of the special reserve is not an adequate reserve against losses in the light of the nature of the Bank's business. The Articles

Sec: 4-255

of Agreement expressly envisage the establishment of other reserves against losses in addition to the special reserve (see, Article IV, Sections 5(a) and 7; Article V, Section 14(a)).

For these reasons I am of the opinion that for the future the net income of the Bank, instead of being allocated to surplus as in the past, should be allocated to a reserve against losses on loans or guarantees made by the Bank until such time as the Executive Directors or the Board of Governors determine that the reserves of the Bank are adequate. If this view is accepted, then, to be consistent, the amounts previously allocated to surplus by action of the Board of Governors should be transferred to the same reserve.

In short, it is, in my opinion, desirable to establish on the books of the Bank a reserve against losses on loans and guarantees and to allocate to such reserve

(a) the entire existing surplus of the Bank (less the amount thereof payable to Poland on repurchase of its shares),

(b) the net income of the Bank for the fiscal year ended June 30, 1950 (less the amount thereof payable to Poland on repurchase of its shares),

(c) the net income of the Bank accruing thereafter until further action by the Executive Directors or the Board of Governors.

If such action is taken, in addition to meeting the needs of the Bank for adequate reserves, it would also solve an anomalous situation that has arisen in connection with the provisions of the Articles of Agreement relating to settlement with withdrawing members.

Sec: 4-255

Under Article VI, Section 4 of the Articles of Agreement, the repurchase price of the shares of a withdrawing member is determined on the basis of the book value of its shares on the date of withdrawal and, consequently, a withdrawing member would be entitled to its proportionate share in the surplus and net income of the Bank.* A withdrawing member, therefore, takes from the Bank's surplus a portion of the Bank's earnings which the Board of Governors specifically determined should be retained and devoted to the Bank's purposes. The withdrawing member likewise takes a share from the Bank's current net income which presumably, on the basis of the Board of Governors' past action, would also be retained and devoted to the Bank's purposes.

Another anomalous aspect of the situation arises from the fact that a withdrawing member receives part of the Bank's net income to which it would not have been entitled if that part had been paid out as a dividend. Under the Articles of Agreement, members whose 18% currencies are used by the Bank have a first claim on any dividends which may be paid by the Bank. When a withdrawing member, whose 18% currency has not been used is paid a share in the surplus and current net income of the Bank, in effect such payment is tantamount to a dividend to that member which it could not have received by remaining a member.

If a reserve were established in accordance with my recommendation above, these anomalies would be avoided. It is the opinion of the General Counsel that the amount of such a reserve existing at the date of the withdrawal of a member would be deducted in determining the book value of

---

* A withdrawing member would be entitled to share in surplus and current net income, even though it remains contingently liable to the Bank for losses on loans and guarantees.

Sec: 4-255

the shares of such member, so long as the amount of the reserve was not unreasonable in relation to the total amount of the loans and guarantees made by the Bank, a contingency which is not likely to present any problem for some time to come. Since no such reserve existed at the date of Poland's withdrawal, the establishment of the reserve at this time would have no effect on the repurchase price of Poland's shares.

Sec: 4-255

The action necessary to establish such a reserve can be taken in part by the Executive Directors and in part by the Board of Governors. The Articles of Agreement make a clear distinction between the allocation of income to reserves and the distribution of income to members (see, Article V, Section 2 (b) (vii) and Section 14). The General Counsel is of the opinion that the power to allocate income to reserves is one of the powers which can be and have been delegated by the Board of Governors to the Executive Directors under the Articles of Agreement, whereas the power to distribute income to members can be exercised only by the Board of Governors.

The Executive Directors, therefore, can, without further action by the Board of Governors, allocate to reserves the current net income of the Bank for the fiscal year ended June 30, 1950, and net income accumulating thereafter. Since the Board of Governors could decide to make a distribution to members as dividends (modifying the action taken by the Executive Directors to the extent required to make such distribution), it would be desirable for the Executive Directors to bring their action to the attention of the Board of Governors and to request the Board to approve the policy of the Executive Directors in that respect. Insofar as the existing surplus is concerned, since the Board of Governors itself established such surplus, the Board of Governors, rather than the Executive Directors, should take the action necessary to transfer the surplus to the reserve.

I recommend, therefore, that the Executive Directors take the following action:

(a) Adopt a resolution establishing a reserve against losses on loans and guarantees made by the Bank and placing in such reserve the net income of the Bank for the fiscal year ended June 30, 1950 (less the amount thereof payable to Poland) and the net income accruing thereafter until further action by the Executive Directors or the Board of Governors. A draft of such resolution is attached hereto as Appendix A.

(b) Recommend that the Board of Governors transfer the existing surplus of the Bank (less the amount thereof payable to Poland) to such reserve and note with approval the policy of the Executive Directors with respect to the establishment of such reserve. A draft of a report to the Board of Governors making such recommendation, together with a resolution to that effect, is attached hereto as Appendix B.

APPENDIX A

[DRAFT]

RESOLVED, that the net income of the Bank for the fiscal year ended June 30, 1950, after making provision for any amount that shall be payable in respect thereof on account of the repurchase by the Bank of the shares of Poland, and the net income of the Bank accruing thereafter and until further action by the Executive Directors or the Board of Governors shall be allocated to a reserve against losses on loans or guarantees made by the Bank. Such reserve shall be established on the books of account of the Bank and shall be separate from the special reserve established under Section 6 of Article IV of the Articles of Agreement.

APPENDIX B

[DRAFT]

REPORT OF THE EXECUTIVE DIRECTORS

Transfer of Surplus to Reserve Against Losses on Loans and Guarantees Made by the Bank; Action Taken by the Executive Directors Establishing Such Reserve

1. As appears from the Financial Statements of the Bank for the fiscal year ended June 30, 1950, which are set forth in Appendices ___ to the Fifth Annual Report, the net income of the Bank for that year was $13,698,398. In addition, $5,663,064 have been set aside during the past fiscal year in the special reserve created under Section 6 of Article IV of the Articles of Agreement of the Bank. As of June 30, 1950, the special reserve totalled $13,737,205.

2. Previous Boards of Governors of the Bank, after the fiscal year ended June 30, 1948, and the fiscal year ended June 30, 1949, have allocated the entire net income of the Bank for each such year to surplus, and have made no distribution of income to members as dividends. During the period from December 27, 1945, when the Articles of Agreement of the Bank entered into force, to June 30, 1946, the Bank operated at a deficit. As of June 30, 1950, the surplus of the Bank totalled $13,641,094.

3. The purpose of not making a distribution of net income to members as dividends was to enable the Bank to retain the net income for the purposes of the Bank and thus, in effect,

to enable the Bank to accumulate reserves in addition to the amount accumulated in the special reserve. The Executive Directors believe that the Bank is in the stage of its development where this has been, and continues to be, necessary to a sound financial policy.

4. It is the opinion of the Executive Directors that the present level of the special reserve is not an adequate reserve against losses in the light of the nature of the Bank's business. The Articles of Agreement expressly envisage the establishment of other reserves against losses in addition to the special reserve (see, Article IV, Section 5 (a) and 7; Article V, Section 14 (a)). For these reasons the Executive Directors believe that (1) the net income of the Bank, instead of being allocated to surplus as in the past, should properly be allocated to a reserve against losses on loans or guarantees made by the Bank until such time as the Executive Directors or the Board of Governors determine that the reserves of the Bank are adequate and (2) in order to be consistent with this view, the amounts previously allocated to surplus by the Board of Governors should be transferred to such reserve.

5. Accordingly, on , 1950, the Executive Directors have, pursuant to the powers which have been delegated by the Board of Governors to the Executive Directors under the provisions of Article V, Section 2 (b) (vii) of the Articles of Agreement of the Bank, established a reserve

against losses on loans or guarantees made by the Bank and have allocated to such reserve

(a) the net income of the Bank for the fiscal year ended June 30, 1950 (after making provision for any amount payable therefrom on the repurchase by the Bank of the shares of Poland);* and

(b) the net income of the Bank accruing thereafter until further action by the Executive Directors or the Board of Governors.

6. In addition, the Executive Directors recommend that the Board of Governors

(a) transfer the entire existing surplus of the Bank amounting to $13,641,094 (after making provision for any amount payable therefrom on the repurchase by the Bank of the shares of Poland),* to such a reserve, and

(b) note with approval the policy of the Executive Directors in establishing such reserve as set forth in paragraph 5 above.

7. The attached resolution is recommended for adoption.

---

* Poland withdrew from membership in the Bank on March 14, 1950, prior to the establishment of such reserve.

DRAFT

RESOLUTION OF THE BOARD OF GOVERNORS

Transfer of Surplus to Reserve Against Losses on Loans and Guarantees Made by the Bank; Action Taken by Executive Directors Establishing Such Reserve

RESOLVED:

1. That the Report dated August , 1950 on the Transfer of Surplus to Reserve Against Losses on Loans and Guarantees Made by the Bank and Action Taken by Executive Directors Establishing Such Reserve and the recommendations therein contained be, and they hereby are, approved;

2. That the Board of Governors hereby determines that the surplus of the Bank amounting to $13,641,094 as of June 30, 1950 (after making provision for any amount that shall be payable in respect thereof on account of the repurchase by the Bank of the shares of Poland) be transferred to the reserve against losses on loans and guarantees made by the Bank; and

3. That the Board of Governors hereby notes with approval the policy of the Executive Directors in establishing such reserve.

Sec: 4-255

THE RESERVE POLICY OF THE EXPORT-IMPORT BANK

1. The Eximbank has been continuously striving to improve its reserve position. It reserves in relation to total outstanding loans amounted to 4.80% in June 1948; they reached 10.3% in December 1950 and have since progressed further to 16.5% in December 1956.

2. The amounts of outstanding loans have been derived from the balance sheet and correspond also with the amounts indicated in the "Monthly Statements." The amount of outstanding loans includes all disbursements minus repayments; they are inclusive of all loans advanced through agent banks for which Eximbank bears the responsibility; they exclude the contingent liabilities related to the unused balances of guaranteed letters of credit and the amount of unused authorizations.

3. The Export-Import Bank Act of 1945 as amended, states, that "net earnings of the Bank after reasonable provision for possible losses shall be used for payment of dividends on capital stock."1/ In conformity with this paragraph the Bank "has refrained in prior years from the payment of dividends on its capital stock pending the accumulation of a reasonable reserve against possible future losses."2/ In fiscal 1951, the reserve ratio reached the 10% level, as a result the Board of Directors felt that "the earned surplus heretofore reserved in its entirety against possible future losses has now reached a point where part of the net

1/ Section 2a.

2/ Export-Import Bank of Washington, 12th Semi-Annual Report to Congress, January-June 1951, p. 20-21.

~~future~~ earnings for the fiscal year ending June 30, 1951, may properly be paid as a dividend on the capital stock of the Bank."[3/] Accordingly the Board declared a dividend of 2% or \$20 million on the \$1 billion outstanding stock of the Bank held by the U.S. Treasury. Since fiscal 1953, the dividend has been raised to 2¼% of the outstanding stock.

4. In addition to these reserves, the Bank has charged off during its twenty-two year history slightly over \$500,000 for defaulted loans, a loss ratio of approximately one one-hundred of one per cent of loans disbursed.

5. The Eximbank's reserve policy has probably been influenced by the following factors:

- reasonable reserves have to be put aside because the Bank is, in general, directly and primarily responsible for the losses on its loans;

- the Bank's profit expectations are good. This is due to the fact that there is a substantial difference between interest rates charged and interest rates on its own borrowings. This difference was a minimum of \$1.10 in 1953 and has been as high as \$1.50 in fiscal 1948 and 1951;

- reserves have not to be built up to attract capital in the market. The Bank can borrow all its resources from the Treasury at reasonable rates. Before 1947 the interest rate on its borrowings from the Treasury amounted to only one per cent; since then they have fluctuated in accordance with the market and reached a maximum of 3 1/8% in May 1956. The

---

3/ Op. cit., p.21.

average rate charged by the Treasury for fiscal 1956 amounted to 2.85%;

- the payment of dividends still left the greater part of net profits available for addition to reserves. As a result, the reserve ratio has shown a steady improvement.

EXPORT-IMPORT BANK

End of month and 6 months ending		(million U.S. dollars) Loans outstanding 1/	Net profits 2/	Undivided profits	Reserves for default	Reserves for contingencies	Dividends	(Percentages) Net Profit / outst. loans	Reserves & undiv. profits / Outst. loans
1948	June	2,229.4	44.9 3/		0.3	107.0		2.01	4.80
	December	2,138.5	23.7		0.3	130.6		1.11	6.11
1949	June	2,164.7	24.1		0.3	154.6		1.11	7.14
	December	2,179.6	24.2		0.3	178.6		1.11	8.19
1950	June	2,226.3	24.9		0.2	203.1		1.12	9.12
	December	2,219.5	25.6		0.2	228.6		1.15	10.30
1951	June	2,314.6	26.1		0.2	234.8	20.0	1.13	10.14
	December	2,289.0	27.2	27.2	0.2	234.8		1.19	11.45
1952	June	2,388.9	24.6		0.2	266.6	20.0	1.03	11.16
	December	2,496.1	26.0	26.0	0.2	266.3		1.04	11.71
1953	June	2,547.0	25.7		0.2	295.6	22.5	1.01	11.61
	December	2,833.3	28.4	28.4	0.2	295.6		1.00	11.44
1954	June	2,761.8	28.9		0.2	330.5	22.5	1.05	11.97
	December	2,768.3	29.6	29.6	0.2	330.5		1.07	13.01
1955	June	2,737.3	29.4		0.2	367.1	22.5	1.07	13.41
	December	2,668.9	30.3	30.3	0.2	367.1		1.14	14.89
1956	June	2,648.3	29.9			404.9	22.5	1.13	15.29
	December	2,636.0	30.2			435.1		1.15	16.51

1/ Include loans made with Eximbank funds and loans advanced through agent banks; exclude guaranteed letters of credit.

2/ After deduction of interest paid to the Treasury.

3/ For the 12 months ending June 30, 1948.

EXPORT-IMPORT BANK

End of month - 6 months ending		Total loans outstanding	Interest received	Treasury notes	Interest paid to Treasury	Int. received outst. loans	Int. paid Treasury notes
		(in million U.S. dollars)				(Percentages)	
1948	June	2,229.4	54.41 1/	970.6	8.74 1/	2.44 1/	0.90 1/
	December	2,138.5	30.21	907.8	6.09	1.41	0.67
1949	June	2,164.7	30.67	913.9	6.11	1.42	0.67
	December	2,179.6	30.81	917.0	6.19	1.41	0.68
1950	June	2,226.3	31.72	964.5	6.38	1.42	0.66
	December	2,219.5	32.70	942.1	6.68	1.47	0.71
1951	June	2,314.6	33.49	1,039.6	6.97	1.45	0.67
	December	2,289.0	35.10	1,005.0	7.41	1.53	0.74
1952	June	2,388.9	34.99	1,088.1	9.85	1.46	0.91
	December	2,496.1	38.33	1,194.2	11.77	1.54	0.99
1953	June	2,547.0	37.47	1,227.1	11.21	1.47	0.91
	December	2,833.3	43.05	1,501.9	14.05	1.52	0.94
1954	June	2,761.8	43.56	1,347.0	14.09	1.58	1.05
	December	2,768.3	43.21	1,311.5	13.03	1.56	0.99
1955	June	2,737.3	42.56	1,271.0	12.49	1.55	0.98
	December	2,668.9	43.19	1,231.9	12.20	1.62	0.99
1956	June	2,648.3	42.33	1,206.5	11.70	1.60	0.97
	December	2,636.0	42.78	1,197.1	11.70	1.62	0.98

1/ For the 12 months ending June 30, 1948.

COMPARATIVE STATEMENT OF CONDITION

ASSETS	December 31, 1956		June 30, 1956	
Cash		$ 5,802,711		$ 1,023,725
Loans receivable		2,636,022,530		2,649,107,478
Borrower's liability under guaranteed letters of credit		54,616,196		23,119,081
Accrued interest on loans		23,584,835		22,662,196
Other assets		97,977		88,945
Total Assets		2,720,124,249		2,696,001,425
LIABILITIES				
Investment of the U. S. Government:				
Notes payable to U. S. Treasury	$1,197,100,000		$1,206,500,000	
Capital stock held by U. S. Treasury	1,000,000,000		1,000,000,000	
Dividend payable	-		22,500,000	
Earned surplus: Reserve	435,095,993		404,853,241	
		2,632,195,993		2,633,853,241
Accounts payable		129,814		76,410
Special deposits by borrowers		408,624		283,723
Guaranteed letters of credit outstanding		54,616,196		23,119,081
Liability on loans disbursed by commercial banks		30,883,332		37,327,813
Deferred credits		1,678,182		1,142,024
Reserve for employees accrued annual leave		212,108		199,133
Total Liabilities		$2,720,124,249		$2,696,001,425
Undisbursed credit authorizations		$1,552,969,952		$ 739,239,635

COMPARATIVE STATEMENT OF

INCOME AND EXPENSES

	6 months ended Dec. 31, 1956	6 months ended June 30, 1956
Income:		
Interest on loans	$42,781,495	$42,326,862
Other	13,182	87
Total income	$42,794,677	$42,326,949
Less: Operating Expenses:		
Interest paid to U. S. Treasury	11,696,905	11,695,473
Other	855,020	756,789
Total operating expenses	$12,551,925	$12,452,262
Net profit	$30,242,752	$29,874,687

OPERATIONS - EXPORT-IMPORT BANK

1934 - 1956

Total profits earned	$555,689,267
Total interest paid to Treasury	166,264,538
Total dividends paid	150,905,178
Total amount added to surplus	404,726,561
Total amount reserved for losses	525,554
Total losses	395,374
Balance of reserve for losses	130,180