Folder Title: Leonard B. Rist - Memorandum on Loan Charges and Relevant Documentation - Correspondence - Volume 1 - 1963

Folder ID: 1849858

Dates: 12/31/1963 - 12/31/1963

Fonds: Records of Individual Staff Members

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

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L.B. Rist: memorandum on Loan Charges and relevent documentation 1963

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MEMORADUM on LOAN CHARGES

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RELEVANT DOCUMENTATION

(Documents filed according their order of quotation in the memorandum)

LOAN CHARGES

Committee on Loan Charges
Leonard B. Rist, Chairman
Robert W. Cavanaugh
S. Raymond Cope

December 31, 1963

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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 over time, and the discussions which 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 attempts to set forth the arguments for and against. It is not the purpose of this paper to make recommendations.

PART I - PRESENT SITUATION

Chapter 1. IBRD - Definition and history of loan charges

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

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 made a specific charge for the preparation of the loans or for end-use supervision. There was some discussion at the very outset (1946) as to whether some special compensation should be paid for these services, and

the question was left open. This matter, however, has not been referred to since, 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. As regards the <u>interest rate</u>, the Articles of Agreement offer no precise guidance. Article I(ii) says that one of the purposes of the

Bank is "to supplement private investment by providing, on suitable conditions, finance for productive purposes...", and Article III Section 4 says that "the Bank may...make loans...subject to the following conditions...(iv) In the opinion of the Bank the rate of interest and other charges are reasonable and such rate, charges and the schedule for repayment of principal are appropriate to the project." The interest rate is therefore a matter of policy to be determined by the 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/ The margin of 1/4% was originally intended to assist the Bank in covering administrative expenses. It has not always been applied rigorously and the 1/4% has in fact also 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 estimated 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.

1/ R-97, April 1947 and revision of February 1948

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. Article IV Section 4(a) provides that in the case of loans made out of borrowed funds a commission will be charged during the first ten years (and after that at the Bank's discretion) of no less than one per cent and no more than one and one half per cent. Section 6 provides that this <u>special commission</u> shall be set aside in liquid form "as a special reserve" for meeting obligations of the Bank. The commission has been charged at the rate of 1% on all loans -- including those made out of the Bank's own funds -- and when the ten year period lapsed on June 26, 1956, the same policy was continued by decision of the Executive Directors.

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, and represents payment for the service rendered by the Bank in holding money available for withdrawal. Full interest is

charged only as of the date when actual disbursement takes place. The rate of the commitment fee 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%. This rate 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 into 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 impracticable to charge different rates according to whether the Bank

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1/ In current practice, it comes into effect 60 days after the signing of the loan contract.

was using its own funds or borrowed money to finance the borrower. It would have involved decisions as to which funds should be allocated to which borrower, and such decisions could only have been highly arbitrary. Treating all borrowers alike in this respect was the only practical solution. Similarly -- as was pointed out in para.7 -- the special commission was levied on all loans, 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 answer1/ 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 and in favor of a uniform rate were two. First, it is practically impossible to appraise the risk differential, this being a matter of judgment rather than computation. Second, the pre-war practice of the private market had been to charge more for higher risks, but this had not really compensated the bondholders for the defaults which had occurred.

c) Differentiation as between maturities:

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

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

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 which currency 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 cases where a currency other than the U.S. dollar is made available for lending, 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 close to the average rate on U.S. dollar bonds.

14. Similarly, the <u>special 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 out of borrowed funds? As indicated in para. 7, both categories of loans were treated on the same basis.

b) if the commission were modified or eliminated, should these changes be retroactive? The Articles of Agreement on this point are not mandatory1/ and no decision has been necessary since the commission has not been modified, but past discussions by the Executive Directors seem to suggest that several Directors were inclined to make any change 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 problem has arisen when an obligation was sold out of the portfolio.

15. With regard to the commitment charge, the Bank has modified its policy on several occasions, as related in para. 8. The principle of a commitment fee has, however, never been disputed. It rests not only on traditional banking practice, and on the idea that in keeping the money available for withdrawal the Bank performs a service for which it should be compensated, but also on the wish to induce borrowers to withdraw funds from the loan account at the earliest possible date.

1/ See Memorandum of the General Counsel, R-57-4 of January 8, 1957.

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" since slow disbursements were inevitable, 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 lowered 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 level and their impact on the Bank's borrowers on the one hand, and on the Bank's earnings and reserves on the other. These two aspects of the problem will be treated separately.

a) 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 domestic income and savings (and in the case of a government

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1/ R-367 of August 11, 1950.

loan, part of the national revenue). It is good policy for a borrowing country to try to reduce these payments.[1] 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%. If the interest is assumed to be 4-1/2% instead of 5-1/2% as in FPC 63-13, the total charge decreases substantially. Using the same examples as in the memorandum quoted, the figures work out as follows:

Type Loans of 1000 units	Term of Loan Years	Grace period after full disbursement	Interest Rate	Present Value in units	Difference	Peak Annual Service in units	Difference
A IBRD loan	20	none	5-1/2% 4-1/2%	617 561	- 9.8%	96 89	- 7.3%
B IBRD loan, interest payable from date of disbursement	40	6 years	5-1/2% 4-1/2%	519 421	- 18.8%	69 62	- 10.1%
C IBRD loan, interest capitalized over grace period	40	6 years	5-1/2% 4-1/2%	396 293	- 26%	109 90	- 17.4%

18. The average return on newly invested capital is generally higher than the interest (including commission) charged by the Bank and this

[1] Unless, of course, a lowering of the rates would involve the danger of limiting the amount of foreign capital available.

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 average cost of capital and average return on capital, the greater the service rendered to the borrower. The borrowing countries, like any other borrower, obviously benefit by lower charges on loans.

19. Conversely, it is equally to the interest of the borrowing member countries of the Bank that continuity 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 to the advantage of all its borrowing members. This implies a reasonable level of earnings and reserves, and the charges are the main source of earnings.

b) Earnings and reserves policy:

20. The determination of an appropriate level of earnings and reserves has been a constant preoccupation of the Bank. This is the direct consequence of the fact that the Bank must borrow, that the bondholders rely largely on the 80% (now 90%) guarantee capital of the Bank, but that for the protection of the shareholders as well as of the bondholders, reserves should be accumulated. The greater this accumulation in relation to borrowed funds and to loans outstanding, the less the risk that the 80% (now 90%) guarantee capital will be called upon to meet the Bank's obligations.

21. As early as 1946 the need to earn a satisfactory income and to

accumulate reserves had been recognized. In 1947 the Committee on Financial Policy mentioned the desirability of building up 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.2/ 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. 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."3/ Various formulas were tentatively examined. One of them4/ 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.5/ Admittedly such formulas could only be indicative. They could not be considered either rigid or permanent. The conclusion of this debate was that "the level of reserves is of less importance than the fact of their continued accumulation...at what may be considered a satisfactory rate."3/

1/ R-71 of January 17, 1947.

2/ In fiscal year 1963 the figure was 3.3%, if the special commission is excluded from net earnings. Net earnings (including the special commission) amounted to over 5% of the Bank's own funds available for lending (excluding the special reserve).

3/ R-57-39, June 4, 1957.

4/ Mr. Machado's memorandum (Sec.Memo.57-16).

5/ On the basis of the figures as of June 1963, Bank reserves (total $813 million) represented 125% of the obligations of India, its biggest debtor, and 59% of the obligations of Asia as a whole (excluding Japan) if it were considered as one economic area.

22. It is interesting to note that in this discussion little distinction was drawn between the supplemental reserve which is available both for Bank operations and for the protection of bondholders and shareholders, and the special reserve which is not available for operations and can only serve to protect the bondholders. In other words, the absolute level of all reserves was considered more important than the equity debt ratio; i.e., the relation between the Bank's own funds available for lending and the Bank's borrowings. On the other hand, in keeping with the normal practice of market analysts and with the requirements of a number of States where Bank bonds were being sold, the question of the net earnings available for the service of Bank bonds was considered directly relevant. At present the net earnings coverage of 1.5 times required by some States compares with an actual coverage of Bank fixed charges of over 2 times in 1962/63.

23. In addition, something new had emerged in 1957. The market for foreign bonds had experienced a revival. Both in order to save on its resources and to abide by the principle of no competition implied by the Charter, 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 direct 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 satisfactory earnings coverage, b) accumulating reserves, c) staying in step with the market. Factors other than loan charges have a direct influence on net earnings and reserves. Such are the Bank's administrative expenses, or the outlays for services to member countries, which are under the control of the Bank. Another one is the liquidity policy; the greater the amount of quick assets held by the Bank, the lower the available funds remunerated 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.

Chapter III. The International Development Association

25. 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. The U.S. and 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 the organization is to provide "finance to meet the important developmental requirements [of the less developed areas included within its membership] on terms which are more flexible 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 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 "<u>service charge</u>" 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 for this purpose and it was agreed that its level would be reviewed from time to time in the light of experience.

1/ February 1961.

28. In the three years of its operations, administrative expenses allocated to IDA have actually been far in excess of the income arising from the service charge. For a satisfactory coverage of IDA expenses the service charge should have been around 2-1/2% p.a. in 1962/63. Income from liquid funds is, however, large enough to allow IDA to operate at a profit. On the other hand, if all effective credits had been fully disbursed and had therefore earned the service charge, 1/2% p.a. would have been enough to cover expenses. There has not been any suggestion that the level of the service charge should be reviewed at this stage.

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 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 expected from 18% (now 9%) capital, since it 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 at $700 million a year. It is, therefore, just as important as in the past to convince the potential subscribers to the Bank's bonds that its earnings coverage is satisfactory, even though the 80% (now 90%) guarantee capital will always be the major consideration in the bondholders' minds. Nevertheless, the accounts of the Bank as of now are in such a shape that they can only inspire confidence.

31. In the last six years the changes have indeed been 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 m. Second, the market is aware of the fact that a number of other countries have improved their credit to a point which would undoubtedly allow them to share the guarantee obligation with the U.S. As a result of these two factors, the funded debt, although it 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, free reserves have risen from $185 m. (not including $94 m.

special reserve) to \$578 m. (not including \$235 m. special reserve). Thus the Bank's own funds available for lending have nearly doubled. Fifth, since administrative expenses -- even including technical assistance to member countries -- have not risen any more quickly, 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 projections prepared in December 1962 -- which assume no change in the present financial policies of the Bank, continued lending at the rate of \$700 million per annum and portfolio sales of \$200 million per annum -- total reserves could rise by some \$140 m. in 1967/68 and by some \$180 m. 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, still assuming the Bank maintains its present policies, total reserves would pass the \$1,000 m. mark by 1965 and the \$2,000 m. mark by 1972. As shown in Annex IV, this 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 equal to total indebtedness, thus maintaining the present 1 to 1 equity debt ratio. They would also still represent about one-half of total loans outstanding. The present situation thus seems to open up an opportunity to reexamine both the rate of reserve accumulation and the level of earnings.

1/ i.e. including the special reserve which is, however, not available for lending.

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. Over the recent months or years a number of suggestions have come to the attention of the Bank which would result in modifying the pattern of loan charges as described in Part I. They fall into several categories. A first set of proposals would affect the interest rate (including commission) charged by the Bank, either by an across the board lowering of the rate, 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 set of proposals 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, it is to the interest of the borrowing countries. Second, the Bank could afford it. The first point has been discussed in paras. 17 and 18. The intention of the founders of the institution was to allow all members to benefit by the credit of the most prosperous ones, and the 80% (now 90%) guarantee capital was created for that very purpose. Since then, by organizing IDA and "blending" IDA credits with Bank loans, the Bank has recognized the importance of reducing debt burdens. Should not the Bank also contribute to this aim in its own operations if it can afford it? On that second point, it can be noted that in 1962/63 Bank expenses, including services to member countries, represented roughly 1/2% of total loans outstanding and disbursed. Compared to this, the "margin of 1/4%" mentioned in para. 5 would appear insufficient to cover expenses, but only assuming that the Bank has no resources besides borrowed funds. At present, however, the Bank's own funds represent about one-half of total resources available for lending (see para. 31). Their cost to the institution is nil, and they have all along been counted on as an important source of revenue. The margin of 1/4% had never been conceived as the main source of coverage for Bank expenses, but only as one additional element. The margin of 1% to 1-1/4% which the Bank now charges over the assumed cost of borrowings is thus more than ample. In 1962/63, reducing the rate by one point on all loans would have meant a decline in earnings of around $40 million and -- assuming this had been by way of eliminating the

special commission -- it would still have left a little over $70 million net earnings available for reserves. On the same basis, net earnings coverage of fixed charges would have declined from over 2 to around 1.7 times; still a satisfactory level according to market standards.

36. The arguments against a reduction in rates relate first to the market reaction. In the view of the market, present lending rates can hardly be called excessive. They are generally considered below the average rate of return on capital in the borrowing countries. They are certainly below the rate at which underdeveloped countries could borrow abroad. More important even, they are below the rate which the governments of many advanced countries must pay in their own markets. It would be unfortunate if the Bank could be accused of indulging in "soft lending". In spite of the overriding importance of the 80% (now 90%) guarantee capital in the minds of the subscribers, sales of bonds might be made harder if such an impression were to prevail. The other arguments relate to more technical points. It is true that a one point reduction in the rate today would still leave substantial net earnings available. But this balance is available for reserves only on the assumption that it is not otherwise allocated. Moreover, the impact of a lowering of rates tends to grow with time. Projections show that the one point reduction in rate mentioned in the preceding paragraph could mean a reduction in earnings of about $62 million by 1973, leaving a balance of net earnings of about $120 million (instead of around $180 million). It would also mean that in 1973 the coverage of fixed charges by net earnings could be reduced to between 1.6 and 1.5 times -- still an

acceptable figure according to legal requirements, but distinctly lower than today. Perhaps more important is the fact that sales out of portfolio would be seriously impeded since the borrowers' obligations are less attractive to private investors if the lending rate is low. This in turn implies that the borrowing needs of the Bank would increase correspondingly. Finally, if a reduction were applied to all outstanding loans, this would tend to benefit all present debtors on the basis of their past borrowings, rather than on the basis of their present 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% as assumed earlier. Even allowing for the danger that the market might interpret this as a first step leading to a further decline, the words "soft loans" would hardly be applicable, and the impact on earnings and reserves would be much less. Similarly, a reduction in rates could be allowed on new loans only, leaving past loans unchanged. While over the years the effect on earnings would become progressively heavier, in the first year the impact would be negligible — roughly $7 million for a one point reduction and $3-4 million for a 1/2 point reduction, on the basis of 1962/63 figures. Again, the impact on earnings and on the market would be reduced if certain borrowers only were allowed the benefit of a reduction. This brings up the problem of discrimination, which is discussed in the next chapter.

Chapter II. Proposals involving discrimination among Bank 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 find it impossible today 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, or 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. In the second place, 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. Following one or both of these suggestions would mean discriminating among borrowers and abandoning the uniform rate policy. It will be recalled that in 1946 the principle of no discrimination had been adopted. As related in para. 11, 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. Today the problem is exactly reversed. Nevertheless some, though not all, of the arguments brought forth in the earlier days are again relevant. For instance, it was 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 countries) accepted the thought that they would 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 Executive Directors 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 are and should remain clearly separate. The Bank can cooperate with private lenders or governmental organizations which have different terms of lending. Cooperation with IDA should be on the same basis, and should imply no identification of one institution with the other. Moreover, the uniform rate policy has the advantage that the market knows precisely what our lending terms are. Abandoning that principle may give the market the impression that Bank terms are variable and unpredictable. The proposals discussed below assume that these

arguments are not considered compelling, and that discrimination as such could be accepted Bank policy.

a) <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 recourse to 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 bond issue. Granting them the somewhat lower rates which the Bank normally offers may 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 borrowers in question are precisely those whom the market would normally be interested in financing, and 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 to 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. <u>Against</u> 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 an advanced country which understandably tends to borrow abroad rather than internally when 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 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. Marketing decisions could be made 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.

b) Charging less to a developing country:

45. In its simplest form[2] 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, 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. The example quoted was from, say, 5-1/2% to 4-1/2%, or even 4%.

1/ Mr. S.R. Cope's internal memorandum of November 18, 1963.

2/ Mr. P. Moussa's memorandum dated September 19, 1963.

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 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 prospective debt position of the borrowers. This could logically, but not necessarily, 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 would entail a smaller absolute decline in the earning capacity of the Bank.

48. The arguments <u>in favor</u> 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 of 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 usually not possible for Part II countries.

49. The main arguments <u>against</u> the proposal relate of course to discrimination (see para. 39 and following) and to a reduction in rates (see para. 36), including the danger of creating an unfavorable effect in the market. But there are also some practical difficulties. Would it not be necessary to create sub-categories among Part II countries? Some of them may be considered fairly close to market operations (e.g. Mexico, Nigeria, the Philippines). Would it be logical to grant them most-favored-country treatment? Still another difficulty might arise from the fact that a few Bank members are not members of IDA. There is a danger, therefore, that each country might have to be treated on an individual basis. While this is not insuperable, the complications would certainly be considerable.

<u>Chapter III. Varying the charges on Bank loans according to the type of project</u>

50. Certain projects financed by the Bank are either not self-liquidating in financial terms, or are very slow yielding. Roads (other than main roads), education, a number of agricultural projects, may fall into that category. A number of bilateral aid agencies make loans for such projects at interest rates which are distinctly more favorable than would be the case in their usual lending operations.

51. The question thus arises whether the Bank would be <u>justified</u> in following the same practice. It would allow some projects to come closer to financial viability, and if the government is the borrowing agent, it would reduce the financial burden of that government when it borrows externally for such projects.

52. The main argument <u>against</u> this suggestion is that the Bank finances countries through projects. It makes capital inflows possible, thus increasing the general level of investment by facilitating investments of a productive character. Economic yields 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 matter most. Furthermore, the Bank finances only part of the investment undertaken year by year in any given country. It does not limit its financing to self-liquidating projects, but also includes non-self-liquidating projects because of their potential contribution to the aggregate economic yield of all investments. Thus there seems to be no particular reason to distinguish among projects. An additional consideration may be adduced here. A policy which would result in reducing loan charges on low-yielding projects would induce member countries to call more and more on the Bank for that type of financing. They may tend to disregard real priority investments for the purpose of borrowing cheaply for low priority projects.

53. The proposal could be reversed. One could suggest, for instance, that high-yielding self-liquidating projects could be charged a higher interest rate than low-yielding ones. The same <u>objections</u> could, however, still be offered in this case, <u>mutatis</u> <u>mutandis</u>. It is 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 is 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 ceased to be 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 level of 10%, instead of increasing by roughly 0.5% p.a. as is forecast if no change is 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, earnings are affected only if and to the extent that the aggregate interest charge is reduced below its present level of 5-1/2%. In addition, the special reserve cannot increase beyond its present amount. But 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).1/ Moreover, if a reduction in interest were adopted and appeared at a later date to have been unwarranted, it would probably be easier to increase the general rate of interest than to reinstate part or all of the special commission. A merger of the commission into the interest rate thus seems to be simpler and to 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 be refunded to the borrowers as, when and if contractual service payments are regularly met.2/ Several points remain obscure. The proposal is probably not meant to involve paying back the commission after a loan has been fully repaid. This would mean distributing a reserve which has been accumulated for the protection of the Bank's creditors, and would meet with legal obstacles. More likely what is

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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.

at stake is refunding year by year the amount received as 1% commission the year before. Provided the income from the commission were kept in a suspense account in the course of the fiscal year, this would raise no legal problem. The cost of the operation would of course differ considerably according to whether the proposal would apply to all loans outstanding or only to new loans.

59. The advantage of such a method is of course that nominally the Bank's charges do not appear to be changed, while in effect the borrower is given an important discount on service charges. Furthermore, since the commission is meant to provide a liquidity reserve against losses, it seems attractive to allow a compensation to the contributors when the risk of loss -- or part of the risk -- is past.

60. Apart from the problem of avoiding withdrawals from an existing reserve, which is mentioned in para. 58, the proposal seems to raise other objections. It would lead to an interruption in the building up of the special reserve. As pointed out in para. 57, the Bank could, without harm to its financial position or status, cease to increase this reserve. But it would be simpler to take a clear cut decision to do so, rather than to let this happen as a result of other policies. More important is a point of principle. The special 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 not take account of the fact that, in the future, defaults are still possible.

Chapter V. Possible changes in the commitment charge

61. Several suggestions were made recently with regard to the commitment fee. The first[1] is to reduce it by one-half (from 3/4 of 1% to 3/8 of 1%). A second one is to the effect that a sliding scale be introduced instead of a single rate; the rate would increase from time to time to a level higher than the present 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 great advantage of the first proposal is its simplicity. It does not imply any change in present Bank procedures. 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 hardly hurt 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 commitment fee is perhaps more important than its level. The view is widely held that disbursement and end use

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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.

supervision procedures make it possible to detect abuses and prevent 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 expected. 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. In so far as earnings are concerned, its effect would not be very different from that of a straight lowering of the rate; perhaps smaller in the second suggestion listed in para. 61 (rates growing year by year), perhaps a little bigger in the third one. To the extent that the borrowers would have to pay less, this could be an advantage to them.

65. To the extent that the borrower is actually in a position to influence the rate of withdrawal, a sliding scale should be effective. It is, however, difficult to imagine that the borrower could speed up deliveries which, from the beginning, were expected to extend over a period. The more elaborate scheme takes account of this circumstance, and provides a penalty only if delays are longer than originally expected. 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 feels 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 not be reduced. 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 the automatic allocations to supplemental reserves, and to consider what allocation should be made of net earnings at the end of the fiscal year. 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" or "Special Fund".[1] Allocations to this "Fund" would be in substantial amounts, and it would grow fairly quickly over the years. Out of this fund financing of operations related to the Bank's activities but not normal to it, grants for expanded technical assistance and loans on easier terms to specific countries or specific projects (such as agriculture or education) could be made. Both longer terms and lower

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

interest rates than usual in IBRD normal operations could be granted by the Fund.[1]

67. From the operational standpoint, one of the advantages 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 special Fund from the Bank's own operations, which would continue on conventional and presumably uniform terms.

68. One of the difficulties 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 easier.

Chapter VII. Proposed amendments to IDA lending terms

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.

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

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1/ Mr. Tazi, 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.

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. It would encounter serious objections. Distinguishing among countries, however, would meet with no theoretical objections, especially if the Bank itself should feel inclined to discriminate 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. 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.

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. 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 increasing debt service makes its external financing more difficult. Again, a review clause might work as a positive disincentive to a country to improve its position, or as an incentive to incur excessive debt from other than IBRD/IDA sources in anticipation of a review. Finally, one may question the likelihood of a responsible government's accepting, at the time of the credit, what in effect would be an unlimited liability.1/

1/ Under exceptional circumstances this may, however, be conceivable. For instance, a country at present non-eligible for IDA may be struck by a disaster (flood, earthquake) and require an undetermined period to recover its normal balance. Its government may find it possible to enter into an undertaking which would appear like an act of faith.

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 the 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 will not 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 provide capital contributions to IDA or make bilateral credits.

i) The Swiss Scheme:

76. Under this proposal,1/ a number of OECD 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 advantages to the countries participating in the pool are that they could assist development by way of a modest yearly contribution

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1/ Mr. Karasz' memorandum to Files of March 18, 1963
Mr. Knapp's memorandum of March 28, 1963
Mr. Karasz' memorandum to Mr. Miller of September 18, 1963.

only, although this would admittedly imply a long-term commitment on their part. The Bank's income would be better assured since part of the interest charges would be borne by Part I countries. Finally, multilateral assistance would be encouraged, 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 are mostly of a practical character. If it were to be really successful, and if Part I countries counted on the Bank to substitute for some of their bilateral aid, Bank borrowings would have to expand quite substantially. This might not be as easy as the authors of the scheme seem to imagine. Even assuming that this issue did not arise, the scheme presupposes not only complicated agreement between Bank, borrower, and the interest equalization Fund (or rather its members), but also legislation by each of the contributors to the fund, committing them over a period of years. Another question would be whether some of the debtor countries might not prefer to establish their own credit without recourse to a pool, or whether the Bank might not wish to induce some countries to shoulder fully their own obligations. Alternatively, the pool itself might wish to devote its resources to a limited number of countries.1/ The problem of discrimination would therefore arise. Finally, is there not a danger that the countries contributing to the pool might at some stage put pressure on the Bank in favor of certain countries or certain projects rather than others?

1/ for instance, countries for which a consortium or consultative group has been formed, or countries undergoing a broad foreign debt reorganization.

ii) Mr. Horowitz' Scheme 1/

79. 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. This is probably due to the desire not to involve the Bank in soft lending or discrimination. 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. The author assumes that the very high figure of, say, \$3,000 million could be lent in this way by the Bank to IDA in 5 years. This would entail a contribution by the Equalization Fund to IDA of \$135 million per annum after 5 years. 2/

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 million instead

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1/ His statement at Board of Governors Meeting, October 2, 1963 (Press Release No. 55). His note to Mr. Black, dated September 25, 1962. Mr. Black's reply dated December 4, 1962. Mr. Horowitz' letter to Mr. Woods, dated October 25, 1963

2/ The scheme assumes that the present contributions to IDA are kept invested in Part I countries instead of being lent out, and that this constitutes a guarantee fund of roughly \$1,000 million and brings an income of say \$30 million, thus reducing the yearly payments by the Equalization Fund to say \$105 million per annum.

of the $1,000 million 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 legal obstacle arises 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". As to the second alternative, it raises the problem of creating a market for IDA bonds. One may well wonder first whether allowing IDA to go into debt might not distort its character. One of its great strengths is that it has no debt, and that the contributions to it have been offered without expectation of repayment. IDA can actually risk its capital. It would probably not be able to risk funds owed to its creditors. One may also wonder whether a market could be found for the obligations of an institution "whose avowed purpose is to lend long to borrowers who would by definition be uncreditworthy for normal lending".1/ Finally, the magnitude of the borrowing operations assumed in the scheme is quite considerable. The market for obligations of international organizations' bonds is certainly limited. For the Bank and IDA together to sell $1,000 million net per annum would be a major achievement. The highest net amount borrowed by the Bank in any single year was $627 million in 1957/58,

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1/ Mr. Black's letter to Mr. Horowitz of December 4, 1962.

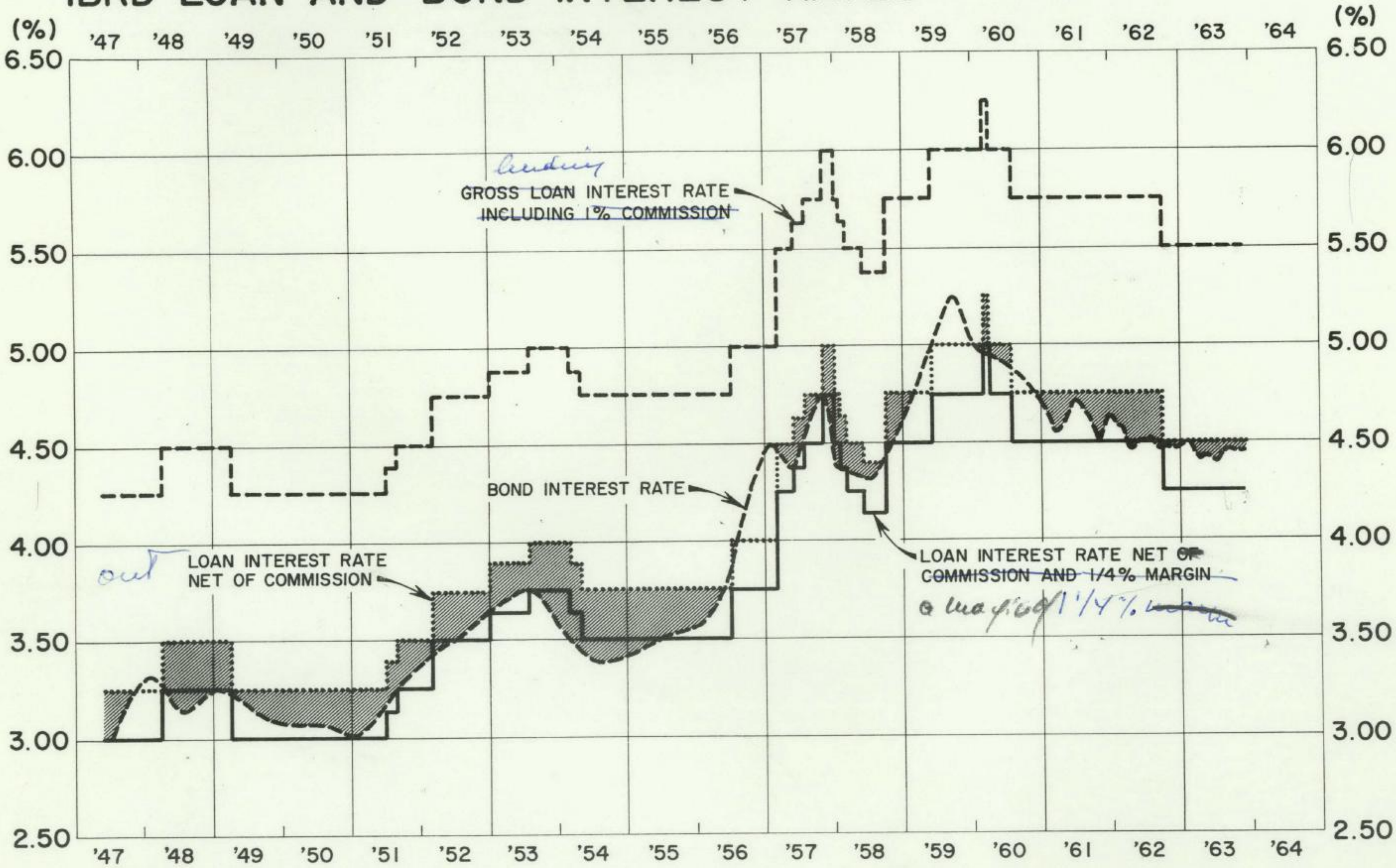
and the highest five-year average was $315 million for the period 1956/57 to 1960/61. Even if the markets could absorb amounts as large as those mentioned by Mr. Horowitz, there is no assurance that the financial authorities would look with favor upon extensive borrowings in their countries for capital exporting purposes particularly if, as should be assumed, the credits would be untied.

CHARGE ON "UNQUALIFIED AGREEMENT TO REIMBURSE"

(see para. 4)

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 1-1/2%) plus a special unqualified commitment 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 1/2%, 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.

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take new issues, and include short term :

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

(Including 1% Loan Commission)

ANNEX III

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	"	"	"	"	"

ANNEX IV

COMPARISON OF SOME IMPORTANT BALANCE SHEET ITEMS
(in millions of dollars)

Fiscal year ending June	Bank's Own Funds: Capital available for lending	Bank's Own Funds: Reserves: Special	Bank's Own Funds: Reserves: Total (including b.)	Bank's Own Funds: Total	Borrowings outstanding	Own Funds plus borrowings d. + e.	Loans: Outstanding held by Bank including undisbursed	Loans: Undis-bursed fraction of loans
	a.	b.	c.	d.	e.	f.	g.	h.
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 change in present policy.
** 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.