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A.W. Clausen Briefing - Briefings 05

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C. COMPLEMENTARITY WITH THE PRIVATE SECTOR

1. With the recent change in administration in the United States, increased attention is now being focussed on the issue of whether the Bank is engaged in activities which could be done as well, or better, by the private sector. As applied to the choice of projects or sectors for Bank lending, this issue is essentially an operational one. But there are also financial aspects:

- Complementarity in project finance. Questions have been raised as to whether the IBRD is doing all it reasonably can to use private loan funds in substitution for its own resources whenever that is feasible.
- Marketing the IBRD portfolio. Much of the IBRD's loan portfolio carries interest rates and maturities which would be unattractive to private investor unless sold at a substantial discount. Nevertheless, some part could be marketed without a discount, either with or without an IBRD guarantee. The question is whether the IBRD should seek to make more effective use of its limited lending capacity through more aggressive marketing of the relatively attractive portions of its loan portfolio.
- "Graduation". This refers to the phase out of lending which takes place when a country is able to finance itself on reasonable terms without IBRD lending. It is

mostly an operational problem, but it can have implications for the quality of the IBRD loan portfolio.

Complementarity in Project Finance

2. Notwithstanding the recent growth in private cofinancing (see table below), many commercial bankers have expressed reservations about the Bank's cross-default clauses and have asserted that the cofinancing program could be even more successful if these clauses were strengthened. This issue was addressed in a recent staff report prepared for the Task Force on Non-Concessional Flows (copy attached in reference documents). The report concluded that it would be difficult to significantly improve the protection offered to co-lenders, without imposing on the Bank a mandatory acceleration of loan repayments in the event of default. This is opposed for several reasons. Firstly, mandatory acceleration would impair the Bank's operational flexibility. Secondly, it would act as a strong deterrent for borrowers and would in that way directly conflict with the stated objective of additionality.

World Bank Cofinancing with Commercial Lenders

<u>Fiscal Year</u>	<u>Cofinancing</u>	
	<u>Number of Projects</u>	<u>Amounts(\$ m)</u>
1974	2	84.7
1975	1	55.0
1976	5	272.5
1977	9	549.9
1978	7	129.9
1979	13	513.9
1980	21	1,775.4
1981 Est.	21	2,074.9

3. Another possibility discussed in the same report was the initiation of a new type of cofinancing program along the lines of the IFC and IDB. The method employed would involve sales of participations in loans that are made as supplements to the Bank's normal loans. These supplemental loans would include terms and conditions (particularly "floating" interest rates) that are acceptable in the private capital markets. The underlying assumption is that such a dual loan structure would prove attractive to lenders who lack the "muscle" to engage in direct lending to developing countries, but at the same time are unwilling to participate in traditional cofinancing. The Bank has taken the position that it has no objection to complementary financing if borrowers and lenders want it, but there are at present no plans for the Bank taking any initiative in this regard.

Marketing the IBRD Portfolio

4. Sales from the portfolio of existing IBRD loans have been relatively insignificant in recent years. Rapidly rising interest rates and investor aversion to medium and long-term fixed rate paper have combined to make most of the IBRD portfolio unattractive as a commercial proposition. Exceptions arise mainly when investors seek maturities in hard currencies such as Swiss francs. The Bank has had a negative posture on such sales because, when viewed as an alternative to direct IBRD bond or rate issues, they are a relatively expensive way of raising funds.

5. The possibility of portfolio sales has come up again in recent months, however, in a different context. The idea is to use them to "free up" a part of the IBRD's legally limited lending capacity, thereby permitting a higher level of new lending with a given capital base. The staff report to the Task Force cited earlier examined three alternatives: (a) unguaranteed sales; (b) partially guaranteed sales of individual loan amounts; and (c) partially guaranteed sales of "pools" of loans. (A parallel may be drawn with mortgage pass-through certificates). The Task Force has recommended to the Development Committee that the Bank be invited to take these ideas a step further through consultations with investment bankers. The subject is on the agenda for the Gabon meeting. No decision has been taken internally on how to respond to this request.

Graduation

6 The Bank is a lender of last resort. The Bank's Articles provide that it may guarantee, participate in, or make loans when it is satisfied that in the prevailing market conditions the borrower would be unable otherwise to obtain the loan on reasonable terms.

7. Over the years, higher-income borrowers have gradually been phased out of Bank lending as they have become capable of meeting their needs for external capital on their own. Annex 1 lists the countries which have been phased out after FY58, showing the year of the last Bank loan to each country and the country's per capita income (in US \$ at 1978 prices) in that year.

8. There are three principal issues in this area:

- (i) Criteria: [Discussed in the briefing materials on operations]
- (ii) Graduation Process: [Discussed in the briefing materials on operations]
- (iii) Effect on the Bank's Portfolio: The implementation of a graduation policy will have an obvious impact on the quality of the Bank loan portfolio. As lending to the now high income, low risk countries is reduced or

phased out, increased lending will go to the presently lower income, higher risk countries (e.g. India, China, Indonesia, Egypt and Nigeria), thus increasing the latter's share of the portfolio and possibly impairing its quality. In the past, as countries were phased out, new borrowing members entered the Bank, thus ensuring portfolio diversification. This pattern can no longer be expected and portfolio concentration is likely to result; for example, in 1980 the portfolio share of the 10 largest borrowers was just over 51%, and by 1990 it is expected to rise to about 62% even without taking lending to China into account. (See also Section B.2 above).

- (iv) Graduation from IDA: The prospects for graduating individual countries from IDA to IBRD lending have been discussed in the Operations Book. From the point of view of planning for IBRD/IDA lending, the issue is that the identified needs of the poorest countries are likely to be significantly higher than available IDA resources for the foreseeable future.

Reference Documents

- C.1.01 Proposals for IBRD Cooperation with Commercial Banks
(Staff report to the Task Force on Non-Concessional Flows)
C.1.02 Report of Task Force on Non-Concessional Flows

GNP Per Capita of Phased-Out Countries

(In US \$ at 1978 Prices)

<u>Country</u>	<u>Date of Last Loan</u>	<u>GNP per Capita 1/</u>
Australia	FY62	5,470
Austria	FY62	3,995
Denmark	FY64	6,980
Norway	FY64	5,595
Italy	FY65	2,757
Japan	FY67	4,140
New Zealand	FY72	5,138
Iceland	FY74	4,742
Finland	FY75	6,577
Israel	FY75	2,783
Ireland	FY76	3,391
Spain	FY77	3,818
Singapore	FY78	3,336
Greece	FY79	3,479

1/ GNP estimates refer to the year the last loan was made to the country by the Bank. Calculations are based on 1978 exchange rates.

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C.1.01

Report prepared by Bank staff for the Development Committee's
Task Force on Non-Concessional Flows.



JOINT MINISTERIAL COMMITTEE
OF THE
BOARDS OF GOVERNORS OF THE BANK AND THE FUND
ON THE
TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES
(Development Committee)



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February 23, 1981

Task Force on Non-concessional Flows

PROPOSALS FOR IBRD COOPERATION WITH COMMERCIAL BANKS

Attached is a paper on Proposals for IBRD Cooperation with Commercial Banks, prepared in response to a request from the Task Force on Non-concessional Flows. The paper examines a number of mechanisms by which the IBRD might facilitate the movement of a larger volume of capital on non-concessional terms to developing countries.

At this stage the report represents a staff effort to translate general ideas, which have been put forward from time to time, into concrete and potentially actionable proposals. The proposals are not recommendations of the Bank and, except where explicitly noted, have not been considered by the Executive Board.

Attachment

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REPORT TO THE TASK FORCE ON NON-CONCESSIONAL FLOWS

PROPOSALS FOR IBRD COOPERATION WITH COMMERCIAL BANKS

C O N T E N T S:

1. REPORT TO THE TASK FORCE.

- Section 1: Introduction
- Section 2: Measures to Expand Cofinancing
- Section 3: Complementary Financing
- Section 4: The Use of IBRD Guarantees
- Section 5: Summary of the Proposals

2. ANNEX I: IBRD Cofinancing operations 1973 through 1980

3. ANNEX II: Memorandum to Executive Directors on World Bank Cofinancing

4. ANNEX III: Complementary Financing: Detailed Features

5. ANNEX IV: Memorandum to Executive Directors on the Use of IBRD Guarantees

6. ANNEX V: Loan Pass-Through Certificates: Detailed Features

REPORT TO THE TASK FORCE ON NON-CONCESSIONAL FLOWS:
PROPOSALS FOR IBRD CO-OPERATION WITH COMMERCIAL BANKS

Section 1: Introduction

1. This paper has been prepared in response to a request from the Task Force on Non-Concessional Flows. It examines a number of mechanisms by which the IBRD might facilitate the movement of a larger volume of capital on non-concessional terms to developing countries. Measures with a similar objective which could be adopted by other International Financial Institutions or by national export credit agencies fall outside the scope of this report.

2. The analysis seeks to clarify the main implications of several proposals and, to this end, states these proposals in rather specific terms. The purpose of this approach is to uncover issues which might not emerge from a more general discussion and to facilitate prompt action in the event one or more of the proposals commands general support. It should be emphasized, however, that at this stage the report represents a staff effort to translate general ideas, which have been put forward from time to time, into concrete and potentially actionable proposals. The proposals are not recommendations of the Bank and, except where explicitly noted, have not been considered by the Executive Board.

3. Section 2 examines proposals for strengthening the cofinancing operations of the Bank. While cofinancing with commercial lenders has expanded rapidly in recent years, it has been suggested that even more could be done if:

- (i) the present form of the cross-default clause were modified to give private lenders greater assurance that the Bank would take effective remedial action in the event of a payment default on the cofinanciers' loan;
- (ii) the Bank's operating procedures were modified to give stronger incentives to both staff and borrowers to make use of cofinancing whenever it is appropriate.

Each of these suggestions is examined in turn.

4. Section 3 considers an alternative form of joint operation with commercial lenders. This form - called Complementary Financing - involves the sale of participations in IBRD loans that have been structured to accommodate the interests of commercial lenders. Programs of this general type are already being operated by the Inter-American Development Bank (IDB) and by the International Finance Corporation (IFC). The approach adopted here differs from these other programs in several respects.

5. Section 4 considers ways in which the guarantee powers of IBRD might be employed productively. The question of full and partial guarantees for individual loans - a subject which the Development Committee and the IBRD Executive Board have discussed in the past - is reviewed very briefly. The larger part of this section is concerned with another potential use of the guarantee power which has not yet been considered in any depth; namely, its use in connection with the sale of claims on specially constructed "pools" of IBRD loans.

6. The concluding Section 5 summarises the main points made in the earlier Sections and suggests some of the issues which members of the Task Force may wish to consider in their report to the Development Committee.

Section 2: Measures to Expand Cofinancing

7. Cofinancing in the sense of joint action between the IBRD and other lenders in a single project has been a prominent feature of Bank operations for many years. The greater part of cofinancing has been with other official lenders, but joint operations with commercial lenders have grown rapidly in the past few years. ^{1/} The number of such operations has risen from one or two a year in FY74-75 to 13 in FY79 and 21 in FY80. The volume of funds committed by commercial lenders has also expanded over the years. In FY80, when there were a few very large project financings, it exceeded \$1.75 billion.

Strengthened Cross-Default Clause

8. Notwithstanding the growth in private cofinancing, many commercial bankers have expressed reservations about the Bank's cross-default clause and have asserted that the cofinancing program could even be more successful if the clause were strengthened so as to provide automatic action on IBRD's part in the event of a payment default on a cofinancing partner's loan. The present cross-default clause gives both the IBRD and the colender(s) the option to:

- (i) suspend disbursement on its loan in the event the loan from the other party is suspended, cancelled or accelerated, or to
- (ii) accelerate its own loan in the event the other party has accelerated its own pursuant to the borrower's default.

In either case, action by the party which has experienced a default is a

1/ A summary of World Bank Co-financing operations for the years FY73 through FY80 is attached as Annex 1.

necessary precondition for the implementation of cross-default provisions by the other party.

9. Some commercial banks have expressed reservations about the optional character of the cross-default clause. Their concern seems to be that the IBRD's interest in maintaining good relations with borrowing countries and in avoiding debt-servicing problems in its own loan portfolio would make it reluctant to take action, even if the borrower's performance on the colenders' loan were unsatisfactory. The bankers' proposal is that the cross-default clause be made mandatory. This could be done in a variety of ways. One approach would be through a written undertaking from the IBRD to colenders that it would not request Board approval for additional IBRD lending to borrowers who have had defaults of substance (as distinct from later payments) on a cofinanced loan and who have failed to make reasonable efforts to remedy that situation.

10. The World Bank has opposed making the cross-default mandatory for two main reasons:

(i) First, mandatory cross-default clauses would be unacceptable to many borrowing countries. Bank insistence on such clauses could therefore impede operations and have the (presumably unintended) effect of actually reducing the volume of cofinancing.

(ii) Secondly, even if such clauses were accepted by some borrowers, they would make it more difficult for the Bank to exercise its judgement as to whether the circumstances surrounding the payment default should justify suspension of new loan operations.

11. An alternative approach would be to modify the current cross-default clause so as to mandate certain specific Bank actions in the event of a default. These actions could include steps such as the following:

(i) Notification by the IBRD to its Executive Board of significant defaults or delays in payment on the colenders' loan;

(ii) Agreement by the IBRD that, in the event of payment defaults on colenders' loans, it would consult with colenders and participate in the effort to negotiate remedies with the borrower concerned.

12. The first of these steps - notification of significant defaults or late payments - could be implemented fairly easily. While it would probably add a certain degree of "moral suasion" to the incentives felt by borrowers to maintain timely service of this form of debt, notification would be unlikely to influence significantly the colenders' risk perceptions, and hence would probably not substantively alter the volume or terms of funds the colenders are willing to supply to developing country borrowers.

13. The second step would go further in reassuring potential colenders that the Bank would not stand aside in the event of payment disputes, in order to avoid become entangled itself. It would also give the Bank and its borrowers adequate assurance that each particular problem could be dealt with on its merits. This option, along with others, has recently been discussed on an informal basis by Bank staff with representatives of several international banks. There is no doubt that mandating World Bank action in the event of defaults on colenders' loans would be welcomed by the banks and would somewhat enhance the attractiveness of cofinancing to them. The impact in terms of additionality - that is, the willingness of commercial lenders to accept a higher exposure in individual developing countries because of the cofinancing option - is less clear. It is likely that such cofinancing would substitute, at least in part, for other forms of commercial lending.

Operational Incentives for Cofinancing

14. The attractiveness of cofinancing to borrowers depends upon it being arranged in such a way as to reassure borrowers that the total volume of IBRD finance is not being reduced because of cofinancing. This requires advance planning and structuring the IBRD lending program so that cofinancing supplements the planned volume of IBRD loans in appropriate projects. While advance planning along these lines is accepted in general terms in current Bank operations - indeed the pipeline of projects thought likely to be of interest to potential colenders is distributed widely, well in advance of Board approval of these projects - it is also recognized that certain practical difficulties hamper the effectiveness of cofinancing programs in varying degrees. First, colenders find it difficult to commit themselves months or even years in advance when the details of the prospective projects are not known, and other financing opportunities in the country concerned could prove equally attractive. Borrowers have similar difficulties. Secondly, the desirability of cofinancing from the borrowers' point of view will very much depend on the precise terms of the commercial loan, and these terms obviously cannot be established in advance. Several important developing countries see cofinancing as a relatively cumbersome way of mobilizing commercial bank finance, and are prepared to adopt this approach only if it offers demonstrable advantage such as longer maturities or lower borrowing costs. Colenders have been reluctant to concede the principle that cofinanced loans should generally command improved terms.

15. One way of dealing with these difficulties is through advance discussion with individual borrowing countries in which the potential advantages and drawbacks of cofinancing are candidly examined and an agreed framework for future cofinancing activities established. This already happens for some countries; the proposal is simply to pursue such discussions more systematically. The benefits of cofinancing - such as the establishment of links with banks not already active in the borrowing country, or the creation of financing opportunities that are more attractive to banks than general purpose loans to the government - vary from country to country. The point of systematic discussion with prospective borrowers would be to clarify the circumstances in which cofinancing

should be pursued and when it would not be in the borrowers' best interest to do so. Mutually agreed cofinancing objectives for individual countries would then provide the basis for subsequent monitoring of results.

16. The benefits which might be derived from such changes in operational procedures are difficult to estimate, partly because there is no very reliable way of estimating the practical importance of the alleged operational disincentives. In some countries, particularly those that have hitherto not really thought through their position on cofinancing, there could be some increase in the future volume of cofinancing. In others, the reluctance to use cofinancing might be reaffirmed, but even in such cases, there may be some advantage in clarifying why cofinancing is not considered a useful technique. This could, for example, point the way to alternative approaches. It could also temper the uncritical assumption that is frequently made that cofinancing is always a good thing, irrespective of country circumstances.

Section 3: Complementary Financing

17. Whereas cofinancing involves a direct loan agreement between the borrower and the colender(s), the purchase of a participation in an IBRD loan involves no separate loan agreement. To-date participation sales have been of two major types:

(i) Participations as such, negotiated between IBRD and private lenders after the terms of the loan have been determined but before disbursement to the borrower has commenced.

(ii) Portfolio sales from existing IBRD loans, after completing of loan disbursement to the borrower. This practice was discontinued in 1977.

In either case the sale is made on a "no recourse" basis and is negotiated for standard fixed-rate IBRD loans.

A New Framework for Participation Sales

18. Complementary Financing refers to the framework for an extended participation program. It is designed to take account of the characteristics of international financial markets, as sources of floating rate funds. The possibility of expanded participation sales along these lines has been considered in general terms by the Executive Board of the Bank,^{1/} but to-date no specific proposal has either been presented or approved. The elements of a specific proposal are presented in some detail in Annex III.

19. A dual loan structure: The essence of the proposal is that IBRD would restructure its participation sales to private lenders in a manner

^{1/} Annex II, "World Bank Cofinancing", p.9, section 4.14.

designed to attract a larger volume of commercial funds. It is addressed to new loans, as distinct from portfolio sales. When Complementary Financing is resorted to, the extension of credit by IBRD would involve a dual loan structure, with two loans, respectively designated as "A" and "B". The "A" loan would be funded solely by IBRD and be structured in accordance with its current practice. The "B" loan would also be negotiated between IBRD and the borrower but would include the participants' contributions. It would be structured to meet the requirements of commercial lenders i.e., be at floating rates and have maturities acceptable to them. The implications of the dual loan structure, as well as options pertaining to incorporating the "A" and "B" loans under a single or under separate Loan Agreements, are examined in sections 6 and 7 of Annex III.

20. For projects suitable for Complementary Financing, IBRD would seek the borrower's authorization to solicit bids for the "B" loan. IBRD would evaluate such offers and transmit them to the borrower with appropriate recommendations. Assuming borrower approval, the terms of the "B" loan would be finalized. Where appropriate, participants could organize as a syndicate and appoint a lead-bank to liaise with IBRD on loan documentation, disbursements etc. Participations in the "B" loan would be sold by IBRD to commercial banks on a "best efforts" basis, i.e. without any underwriting commitment on its part. Funds obtained in this fashion would only be made available to a borrower as, if and when received by IBRD from the participants. If private lenders' participations were to fall short of the targeted amount of the "B" loan, this shortfall would have to be met by the borrower, either from domestic or international sources.

21. An important issue in the design of a Complementary Financing program is whether or not the Bank would retain a portion of the "B" loan for its own account. If it does not retain any of the loan, then the protections offered to commercial lenders would differ only slightly from traditional cofinancing. While the "B" loan would technically be a Bank loan, in substance it would be held entirely by commercial lenders whose claims on the borrowers would be without recourse to the Bank. Whether in such circumstances the borrower would treat the "B" loan obligation in a manner different from a traditional cofinancing is a matter for conjecture. If there is some perceived advantage to the commercial lender in the "B" loan arrangement, it would have to be set off against the fact that all remedies and relations with the borrower would have to be handled through the Bank.

22. If, on the other hand, the Bank were to retain a portion of the "B" loan for its own account, the situation would be very different. First, since the "B" loan would be a floating rate facility, IBRD participations therein would be a departure from its traditional policy on lending only at fixed rates. Secondly, and more wide-ranging in its potential implications, any rescheduling of a "B" loan would involve the IBRD directly. From the participants' viewpoint the perceived security of such loans - hence their attractiveness - would be substantially increased.

23. If the Bank were to extend to "B" loans its current firm policy against participation in rescheduling, the preferred creditor position - which can be justified for the IBRD because of its dependence on long-term capital markets - would be extended to commercial lenders. This would undoubtedly prove attractive to lenders but would evidently be detrimental to the borrowers' interests. The other possibility; namely for the IBRD to depart from its current policy with respect to rescheduling on its own share of "B" loans would constitute a fundamental policy change on its part. Even if confined to the realm of "B" loans, rescheduling could affect the Bank's credit-rating with its own lenders and bondholders. In view of these implications the latter option would almost certainly not be acceptable to the Bank.

24. Implications of Complementary Financing: The proposal for a dual loan structure is based on the premise that it would create an instrument which is attractive to commercial lenders who are not likely to engage in traditional cofinancing on a substantial scale. If IBRD did not retain any portion of the "B" loan for its own account, this category of lenders might include smaller banks that lack the resources to establish direct contacts with developing country borrowers and their governments and that would thus welcome the opportunity of having IBRD represent them in negotiating the loan and ensuring that the terms of the loan contract are faithfully executed. If, on the other hand, the Bank were to retain a portion of the "B" loan and were thereby to extend to lenders the benefits of non-rescheduling, this would probably prove attractive to most commercial banks, including those that are currently withholding from cofinancing in view of the alleged weakness of the cross-default clauses.

25. The implications of Complementary Financing for additionality in resource transfers would obviously depend on the policy adopted by the Bank with regard to the potential rescheduling of "B" loans. If a no-rescheduling policy is adopted, Complementary Financing could probably attract substantial funds. In fact, restraint on this type of privileged financing would be more likely to come from the borrowers and IBRD. Both the borrowers and the Bank will be concerned to restrict the proportion of debt service which is owed to creditors who can refuse to participate in rescheduling. Indeed, debt rescheduling can be an indispensable step in crisis situations. If the share of preferred creditors (i.e. those who would be immune from rescheduling) in a country's external debt becomes too large the debtor could be deprived of the benefit of this option and therefore be unable to cope satisfactorily in the event serious debt management problems should arise. This situation might also raise legitimate objections from other commercial lenders to a country which is affected in this way.

Sales from IBRD Portfolio

26. A further approach to mobilizing commercial funds for developing countries would be for the Bank to resume sales from its existing loan portfolio. As mentioned, regular portfolio sales were discontinued in 1977. This policy decision was based on the perception that portfolio

sales would always be a more expensive form of funding than direct borrowings, since such sales would need to be offered at a yield above an equivalent direct IBRD borrowing. This yield differential would compensate the purchaser for the higher credit risk presented by a participation. Furthermore, if - because the currency in which a participation was denominated proved particularly attractive to the purchaser - a sale could be made at a yield below the original interest rate stipulated in the loan agreement, the interest differential would - as a matter of Bank policy - be rebated to the borrower.

27. In addition to these facts the advantages which might tend to offset such higher costs were not regarded as being very compelling. Sales of loans which had already been disbursed were not thought likely to be an effective way of introducing new lenders to borrowing countries. While the sale of a loan would in theory free up some of the IBRD's lending capacity and make possible additional lending, the amounts involved were considered too small to make a material difference, especially since the maturities likely to be sold were those falling due within the next few years. Because of the Bank's practice of limiting commitments to an amount which can be sustained indefinitely, increases which reduce the size of the loan portfolio in the next few years do not relieve the capital constraint.

28. The resumption of portfolio sales by IBRD would therefore need to be based on changes in certain Bank policies or practices; namely:

- (i) that the policy of reimbursing interest rate differentials to borrowing countries be discontinued and that such differentials should accrue instead to the IBRD;
- (ii) that portfolio sales be marketed not mainly on the basis of the attractiveness of particular currencies, but rather on the attractiveness of selected borrowers' credit position, thereby serving as a means of familiarizing commercial lenders with particular IBRD borrowers, and helping to pave the way for their future direct market access to fixed rate lenders.
- (iii) that portfolio sales be built into a regular program operating on a significant scale - say, at least \$300 million per annum - and that future sales be deducted from the projection of disbursed loans used to determine the permissible level of "steady state" lending.

29. Implications of resumed portfolio sales: Whereas the contribution of cofinancing and Complementary Financing to additionality in resource flows would be direct - even if difficult to forecast accurately at this stage - portfolio sales are likely to be a source of indirect

additionality. If participations purchased from IBRD are supplemental to the commercial banks' aggregate lending to developing countries this increment will, in the first instance, accrue to IBRD. Strict addition to the resource flows will only occur when these funds are on-lent by IBRD to developing countries. As regards the commercial lenders likely to be attracted by resumed portfolio sales, one can assume that this formula would appeal to smaller banks and other fixed rate lenders that would see this instrument as somewhat less risky than the purchase of a participation in a syndicated commercial bank loan. The attraction of acquiring a fixed rate instrument in a strong currency would no doubt continue to be an important feature as well. From a marketing viewpoint portfolio sales should thus be regarded as parallel to Complementary Financing, the principal distinction being that the former concerns existing loans and the latter new financings by IBRD.

Section 4: The Use of IBRD Guarantees

32. The possible use of IBRD's guarantee authority has been reviewed on several occasions in recent years, most recently in July 1980. (A copy of Memorandum R80-200 of July 15, 1980 to the Executive Directors is attached under Annex IV). These reviews have consistently concluded that full IBRD guarantees of commercial loans to developing countries are unattractive for several reasons:

- (i) Fully-guaranteed loans are unlikely to be an effective means of familiarizing commercial lenders with the borrower concerned since the underlying country-risk would not need to be investigated.
- (ii) Fully-guaranteed loans raised by a country might create a precedent and jeopardize the success of future unguaranteed borrowings by the same country.
- (iii) There are no obvious cost advantages for the borrowers since IBRD's guarantee fee would absorb the larger part of whatever reduction in interest rate results from the guarantee.
- (iv) Any guarantee extended by IBRD reduces its own lending authority by the full amount of the guarantee from the moment it is committed (i.e. regardless of actual draw-down on the guaranteed loans).

These factors also imply that the use of full guarantees does not induce long-run additionality in resource flows.

31. Partial guarantees on the contrary can be used on a selected basis to stimulate private lending to developing countries, provided specific goals are pursued. These goals are: first, additionality; secondly, the promotion of borrowers whose creditworthiness is not fully

appreciated by market sources; thirdly, the stimulation of developing country lending by non-traditional sources such as institutional lenders or second-tier or regional banks.

32. Partial guarantees can be designed in various ways; could cover only the outer years of a loan, or be restricted to principal or interest only. So far, partial guarantees have not been provided by the IBRD, possibly because conditions in international capital markets in recent years have favored borrowers. In the international financial climate of the 1980s there may be greater demand for such partial guarantees. The IBRD remains open to specific proposals that may be put forward for individual operations. In addition, consideration may be given to a form of guarantee which applies not to individual loans, but rather to groups of loans. This option is taken up in the next section.

Loan Pass-Through Certificates

33. A detailed procedural and operational outline for a Loan Pass-Through Program is presented in Annex V. It should be made clear at the outset that this proposal has not yet been analyzed and should be regarded as a basis for discussion, not as something ripe for decision.

34. The key feature of the proposal is that IBRD would issue "pass-through" Loan Certificates, based on a pool comprising a cross-section of disbursed loans. The Certificates would be partially guaranteed by IBRD, up to a fixed amount, to provide an uninterrupted income stream for certificate holders, irrespective of possible payments by the borrowers whose loans have been pooled.

35. The structure of the pass-through arrangement does not require coincidence in time between principal and interest payments on pooled loans, and similar payments on the Certificates. IBRD would act as collecting and paying agent on behalf of the certificate holders. All payments received on pooled loans would transit through a Certificate Account from which disbursements would be made to the certificate holders at certain pre-agreed dates.

36. Implications of Loan Pass-Through Certificates: Loan pass-through would satisfy the criterion of additionality if funds raised by IBRD through the placement of Certificates are subsequently used for further program and project loans. It would principally benefit borrowers whose market access is constrained by the commercial lenders' internal exposure limits, since the pass-through certificates would presumably not count against those country-specific limits.

37. Loan pass-through arrangements would result in the creation of a new type of negotiable international financial asset. If supported by an effective secondary market for Loan Certificates, there could be a clear distinction between these instruments and normal bank loans. Such certificates could therefore prove particularly attractive to a category of

private investors - as distinct from commercial banks - who have hitherto been unable to partake in existing forms of development country finance. This formula may also appeal to smaller or regional commercial banks whose lending policies do not normally include developing country risks and whose risk perceptions could be swayed by the negotiability of the proposed instruments. If these expectations were to materialize, a tangible degree of indirect additionality would be attained, since the certificate holders' contributions would increase IBRD's subsequent lending potential. Furthermore, the market's aggregate lending ceilings for developing country risks would also be increased.

38. Finally, loan pass-through arrangements would provide a framework to leverage the IBRD guarantee power since the funds forthcoming from certificate holders would be a multiple of IBRD's direct guarantee commitment.

Section 5: Summary and Appraisal of the Proposals

39. The principal question addressed by the proposals is that of the continued and increased availability of non-concessional funds to developing countries. Concern over the developing countries' access to international capital markets is amplified by the fact that, in the first three quarters of 1980, the volume of developing country borrowings has contracted in relative terms, at a time when their needs were increasing. Furthermore, increased international competition for funds and the deteriorating risk perception by major lenders has affected - and will continue to affect - these countries' access to funds and the cost and terms of non-concessional finance.

40. Against this macro-economic background the principal objective of the proposals analyzed above is to achieve additionality. The proposals are based on the premise that additionality hinges on the lenders' risk perceptions and that new initiatives from IBRD should aim to improve this risk perception. It is assumed that measures which result in improved risk perception by a commercial bank may ultimately result in increased lending ceilings. Furthermore, by attracting new lenders to the field of developing country finance, the international capital markets' aggregate ceilings could also be raised.

41. There are also several instances where initiatives which would be welcomed by commercial banks could raise objections or reservations from the borrowers and would therefore, ultimately, prove counter-productive. Mandatory cross-default clauses for cofinancing and the possibility of a modified Bank policy on rescheduling of "B" loans in Complementary Financing are cases in point. The Task Force may wish to consider these points when formulating its own report to the Development Committee.

42. Each set of proposals aims to either improve existing practices (e.g. cofinancing, participation sales) or to create new methods of financial intermediation (Complementary Financing, partially-guaranteed Loan Pass-Through Certificates) by the World Bank. The proposals are therefore complementary to one another rather than mutually exclusive. This complementarity is reinforced by the fact that, even though international financial markets cannot be strictly compartmentalized, each set of proposals is aimed at a particular category of commercial lenders.

(i) Cofinancing will primarily appeal to major international banks that wish to anchor their future loans to developing countries on a more solid base. Strengthened cross-default clauses, the more systematic treatment of cofinancing flows and the setting of country-specific objectives aim to fulfil this goal.

(ii) Complementary Financing as well as resumed participation sales are aimed to attract banks whose traditional lending policies have been less explicitly oriented towards developing countries. It is expected that the technical and administrative assistance provided by participating in IBRD loans will enable them to accommodate a larger proportion of developing country risks in their loan portfolios.

(iii) Partially-guaranteed Loan Pass-Through Certificates are specifically aimed at commercial banks whose involvement in this type of lending has hitherto been minimal. It also endeavours to break new ground by providing a financial vehicle which would enable non-bank lenders and private investors to diversify their portfolios to include loans to developing countries. If the latter segment of the international financial community responds positively to this initiative it could become a new source for the supply of funds to selected countries.

43. As regards the issue of direct versus indirect additionality, cofinancing and Complementary Financing fall in the former category, participation sales and Loan Pass-Through Certificates in the latter. Measures which aim to promote direct additionality seem more attractive because they operate directly on the volume of non-concessional flows. However to the extent that there are legal or other constraints on the IBRD's lending capacity, the mobilization of its loan assets could become important.

Financial Studies Division
Financial Policy & Analysis Dept.
February 12, 1981.

International Bank for Reconstruction and Development

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ANNEX I

SecM80-774

FROM: Vice President and Secretary

October 14, 1980

CO-FINANCING

The attached tables provide data on World Bank co-financing operations for fiscal year 1980, and update information distributed with SecM79-665 of September 7, 1979.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
President's Council
Vice Presidents, IFC
Directors and Department Heads, Bank and IFC

TABLE 1. WORLD BANK CO-FINANCING OPERATIONS, FISCAL YEARS 1973-80

(Amounts in US\$ million)

Fiscal Year	Projects with Co-financing		Official		Export Credit		Private		Bank Group Contribution		Total Project Costs
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	IBRD	IDA	
1973	37	496.2	30	313.0	10	183.2	-	-	478.9	308.0	2,813.1
1974	48	1,463.0	44	788.8	11	589.5	2	84.7	1,092.6	184.3	5,446.0
1975	53	1,940.3	48	923.3	10	962.0	1	55.0	1,033.6	346.1	8,817.4
1976	73	2,255.1	61	1,079.7	16	902.9	5	272.5	1,583.3	403.1	9,620.3
1977	81	2,289.1	72	1,547.9	9	191.3	9	549.9	1,866.2	698.0	9,916.5
1978	87	2,426.4	77	1,757.2	15	539.3	7	129.9	1,827.5	798.8	11,730.0
1979	109	3,149.4	88	1,976.3	16	659.2	13	513.9	2,993.3	1,146.2	14,004.8
1980	93	6,516.3	68	2,458.6	23	2,282.3	21	1,775.4	3,192.9	1,605.2	21,535.5

Notes: (1) Information provided on private co-financing is tentative since private loan arrangements are usually completed when funds are required, which may be as long as one to two years after approval of a project by the Board of Executive Directors. Data on private co-financing also include all external private loans which assist in financing World Bank operations, whether or not formal co-financing arrangements are concluded.

(2) Since these tables reflect adjustments in co-financing data for FY73-79, the statistics for those years differ from tables published earlier.

10/6/80

TABLE 2. WORLD BANK CO-FINANCING OPERATIONS BY REGION, FISCAL YEAR 1980

(Amounts in US\$ million)

Region	Projects with Co-financing		Sources of Co-financing						Bank Group Contribution		Total Project Costs
	No.	Amount	Official		Export Credit		Private		IBRD	IDA	
			No.	Amount	No.	Amount	No.	Amount			
Eastern Africa	14	433.2	14	427.4	1	5.8	-	-	90.0	435.5	1,216.7
Western Africa	19	630.4	19	610.4	1	20.0	-	-	252.9	229.1	1,556.2
East Asia & Pacific	13	917.5	8	319.8	7	449.3	6	148.4	991.5	21.4	3,453.0
South Asia	13	375.3	13	368.1	1	7.2	-	-	-	708.5	2,422.1
EMENA	18	1,508.2	7	262.4	6	651.6	7	594.2	897.0	167.7	6,393.9
LAC	16	2,651.7	7	470.5	7	1,148.4	8	1,032.8	961.5	43.0	6,491.6
TOTAL	93	6,516.3	68	2,458.6	23	2,282.3	21	1,775.4	3,192.9	1,605.2	21,535.5

10/6/80

TABLE 3: WORLD BANK CO-FINANCING OPERATIONS - DISTRIBUTION BY OFFICIAL SOURCES, FISCAL YEARS 1973-80

(Amounts in US\$ million)

Fiscal Year	Multilateral (except OPEC)			OPEC (Bilateral & Multilateral)			Other Bilateral		
	% of Total Co-financing	No. Projects	Amount	% of Total Co-financing	No. Projects	Amount	% of Total Co-financing	No. Projects	Amount
1973	33	10	101.8	8	3	26.1	59	21	185.1
1974	43	22	337.7	14	4	107.8	43	30	343.3
1975	17	17	156.3	56	17	518.2	27	24	248.8
1976	26	29	275.3	41	28	445.8	33	28	358.6
1977	31	34	486.2	30	23	464.1	39	43	597.6
1978	29	39	503.6	30	31	527.7	41	40	725.9
1979	32	60	625.6	14	16	285.1	54	46	1,065.6
1980	46	41	1,123.7	19	17	465.8	35	37	869.1

Multilateral Agencies

African Development Bank (AFDB)
 African Development Fund (ADF)
 Asian Development Bank (ADB)
 Caribbean Development Bank (CDB)
 Central American Bank for Economic Integration (CABRI)
 Council of Europe
 Fondo Financiero Para el Desarrollo de la Cuenca del Plata (FOFIN-CUENCA)
 European Communities, Non-Associated Country Program
 European Communities, Special Action Account
 European Development Fund (EDF)
 European Investment Bank (EIB)
 East African Development Bank
 Inter-American Development Bank (IDB)
 International Fund for Agricultural Development (IFAD)
 International Livestock Center for Africa (ILCA)
 Nordic Investment Bank (NIB)
 UN Agencies (UNDP, UNFPA, UNICEF, UNCDF)
 World Food Program

Organization of Petroleum Exporting Countries (OPEC)

Abu Dhabi Fund
 Arab Bank for Economic Development in Africa (BADEA)
 Arab Fund for Economic and Social Development
 Iran
 Iraqi Fund
 Islamic Development Bank
 Kuwait Fund for Arab Economic Development
 Libya: Libyan Arab Foreign Bank (LAFB)
 OPEC Fund
 Qatar
 Saudi Fund for Development
 Venezuela Investment Fund (VIF)

Bilateral Agencies and Governments

Australia: Australian Development Assistance Bureau (ADAB)
 Belgium: Belgian Administration for Development Cooperation (ACCD)
 Canada: Canadian International Development Agency (CIDA)
 China
 Denmark: Danish International Development Association (DANIDA)
 Finland: FINIDA
 France: FAC, CCCE
 Germany: KIV
 German Development Company (DEC)
 German Technical Assistance (GTZ)
 Italy
 Japan: Overseas Economic Cooperation Fund (OECF)
 Netherlands: Netherlands Minister for Development Cooperation (MDC)
 New Zealand
 Norway: NORAD & Norwegian Government
 Sweden: Swedish International Development Authority (SIDA)
 Switzerland: Swiss Development Cooperation (SDC)
 UK: ODA (formerly ODI)
 Commonwealth Development Corporation (CDC)
 USA: USAID

THE WORLD BANK
Washington, D.C. 20433
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Office of the President

February 19, 1980

MEMORANDUM TO THE EXECUTIVE DIRECTORSSUBJECT: World Bank CofinancingI. Introduction

1.1 The World Bank has been playing an increasing role in coordinating and stimulating external capital flows to its borrowers. It has done so through a range of activities of different degrees of intensity and formality. Cofinancing is the most formal type of role played by the Bank, in which World Bank funds are directly associated with funds provided by other sources in financing specific projects or programs in developing countries.^{1/} The number of IBRD/IDA cofinancing operations rose from about 10 per year in the late 1960s to 34 in FY73 and 107 in FY79, and is expected to reach about 130 in FY80. The volume of cofinancing, i.e., the amount of funds provided by the colenders, rose from \$448 million in FY73 to \$3,205 million in FY79, and may reach \$7,000 million in FY80.^{2/} In FY79, 43% of the projects approved by the Board involved some cofinancing, and the funds provided by colenders were equivalent to 32% of total Bank lending. Though these amounts should be seen in the context of overall capital flows to developing countries, which are many times larger and have also grown rapidly, they are nevertheless substantial. Developing countries again face sharply increased resource requirements. Within the range of World Bank activities aimed at helping them surmount this problem, cofinancing can play a useful and perhaps increasingly important role. This is especially true with respect to the Bank's cooperation with private capital sources.

1.2 This memorandum reviews the Bank's recent experience with cofinancing operations and analyzes the main ways in which their volume and development impact might be enhanced. In general, the memorandum concludes that there are several practical ways in which the Bank can proceed with its efforts to expand its cofinancing role. It is worth noting at the outset, however, that the overall thrust of the proposals is to strengthen this activity in the near term and not to make radical changes in World Bank operations. This memorandum discusses past experience and new proposals separately for each of the three main categories of cofinancing partners, namely: official aid agencies, export credit institutions, and private lenders.

1/ Annex A contains definitions and terminology relating to cofinancing.

2/ Attachment 1 shows the breakdown of cofinancing by source for the period FY73-79. In the first four months of FY80, actual cofinancing was about \$2,300 million.

1.3 One factor common to all cofinancing operations is the set of services the Bank offers to cofinanciers in sharing with them the benefits of its project preparation, appraisal and supervision procedures. These services are not cost free. The Bank incurs the cost of the additional staff time spent on cofinanced projects and rarely receives similar services in return. It is not yet possible to calculate these additional costs accurately, but it has been estimated that cofinancing increases a project's appraisal costs by 5% to 10% and supervision costs by about 20%. Naturally when the Bank funds released by cofinancing are used for other projects, the new projects also add to the Bank's overall administrative costs. Some other services rendered to specific cofinanciers such as acting as billing agent, also entail costs. These costs are modest in comparison with the benefits of cofinancing, which accrue to Bank borrowers as a group, both those which receive cofinancing directly, and those which receive the Bank resources released by it. It is therefore appropriate that these additional costs should be borne by the borrowers collectively, that is by the Bank itself.

II. Cofinancing with Official Agencies

2.1 Throughout the period FY73-79 official agencies provided around 60% of the total cofinanced funds, and participated in 70% of cofinancing operations. Until 1975, these were almost exclusively DAC agencies. Following the oil price rise in 1973-74, official aid from OPEC sources rose dramatically. The Bank then had an opportunity to assist both the oil-importing developing countries and relatively new OPEC development institutions, which wished to accelerate the commitment of their funds through cofinancing, and thereby benefit from the World Bank's project preparation, appraisal and supervision experience. OPEC sources accounted for over half of the Bank's cofinancing with official sources in FY75 and FY76.^{1/}

2.2 These efforts may have secured some increases in aid pledges. The main benefit from the Bank's cofinancing, however, was to increase the effectiveness of their aid and hasten its commitment to specific projects. Because of earlier commitment, disbursements were also advanced, even if the disbursement process itself may not always have been accelerated. In subsequent years, the share and even the absolute amount of cofinancing with OPEC sources fell, as these agencies built up their own staffs and procedures.

2.3 In some cases, the Bank has also helped to accelerate the utilization of aid from DAC members. However, most cofinancing with DAC aid agencies has been motivated by a mutual will for coordinated approaches and by a desire to spread aid activities over many countries and sectors.

^{1/} Including national government agencies and multilateral institutions deriving their resources wholly or largely from OPEC members.

Such spreading of aid activities may by itself entail a cost, particularly for small borrowers, in confronting their small administrations with an array of external agencies. However, given the political and other motives for spreading aid to several countries and sectors, cofinancing reduces the administrative burden on the borrower. Furthermore, cofinancing activities can benefit from the considerable country experience and large technical assistance resources of some bilateral aid agencies.

2.4 Cofinancing with the World Bank can also reduce or eliminate the procurement disadvantages of tied aid financing. This is done in a particularly effective way when several aid agencies participate, and tied aid does not have to finance supplies for which the aid agency's country is an inefficient supplier. The Bank facilitates this by combining cofinancing from many appropriate sources. Thus in FY78, the Madagascar Power Project was financed by IDA and six aid agencies. The complementary credit for Tarbela in Pakistan, also in FY78, brought together IDA and seven aid agencies.

2.5 On the whole, cofinancing with official aid agencies has worked well. It has helped to channel aid funds to high priority uses and it has been an increasingly active instrument of aid coordination. The qualitative impact of such coordination cannot be rigorously measured, but it is generally agreed that it has increased the developmental impact of aid by avoiding fragmentation and by saving scarce managerial time in the borrowing countries.

2.6 The renewed crisis faced by developing countries as a direct and indirect result of the latest oil price increase will again require extraordinary efforts by the international community, especially in meeting the needs of the poorest countries for sharply increased concessional assistance. There will be renewed needs and opportunities for the Bank to make a vigorous effort to reactivate and develop cofinancing arrangements with the aid agencies of oil-exporting countries. The pressures on developing countries will also intensify the need for efficiency and coordination of aid, and the Bank can continue to expand its joint activities with bilateral and multilateral aid programs originating in DAC member countries.

III. Cofinancing with Export Credit Institutions

3.1 In export financing, the Bank's partners are specialized agencies (like the US Export-Import Bank) and also ordinary commercial banks extending buyers' credits.^{1/} Official insurance or guarantee agencies (like ECGD

^{1/} In this paper no distinction is made between buyers' credits and suppliers' credits unless otherwise noted. Commercial banks also make direct "sovereign risk" loans, unguaranteed in the capital exporting country. These are discussed in Section IV on page 5.

and COFACE) are important indirect participants, as are monetary authorities which refinance export credits on specially favorable terms. Cofinancing allows these agencies to participate in deals which they could not conclude alone, either because the loans would be too big or because their country's suppliers would be clearly unsuitable for substantial parts of the projects.

3.2 Cofinancing with export credits grew from \$71 million in FY73 to \$514 million in FY74 but has shown no clear trend since. At \$652 million in FY79, cofinanced export credits were a little lower than in FY74 in real terms. During the same period, net disbursements of all export credits to developing countries rose from about \$3.3 billion in 1973 to \$13.2 billion in 1978.^{1/}

3.3 Cofinancing with export credits can take the form of organized joint financing. In this, the Bank plays the central role in organizing and supervising the financing process, by arranging for export credit agencies to participate up to agreed amounts and on appropriate terms in the financing of a common list of goods to be procured under international competitive bidding. This procedure ensures competitive suppliers, but borrowers sometimes feel that it results in adverse financial terms. In recent years, unorganized parallel financing has been a more usual practice. The Bank and the borrower agree on dividing the project into separate packages. The borrower assumes full responsibility for negotiating export credits, and takes into account their availability and terms in awarding the contract. Under this procedure, it is sometimes difficult to ensure that only the most competitive suppliers are selected. Yet cofinancing with export credits, when successful, has several advantages for borrowers: it ensures that this resource is applied to high priority projects and programs, it helps to reduce and even cancel the cost advantage of procurement tying, and the overall financial terms of export credits are often quite favorable.^{2/}

3.4 In recent years, most export credits have been extended by commercial banks, insured by specialized agencies in the exporting countries and given access to specialized refinance facilities. In practice, commercial banks have generally found it easier to work without World Bank involvement, often complementing export credit facilities with straight financial credits for down-payments, local currency costs, or procurement in third countries. This is in part because it has been difficult to reconcile the Bank's procurement rules with those governing access to specialized insurance and refinancing facilities in the exporting country. These difficulties have also hampered efforts by the Bank and the borrowers to arrange coordinated financial packages for projects.

^{1/} Source: DAC. The commitments, of course, were much higher.

^{2/} Attachment 2 shows the terms of export credit cofinancing arrangements obtained for selected recent projects.

3.5 There is no easy solution to this problem. One possible approach might be to establish general lines of credit for individual borrowing countries to cover procurement on a range of projects, rather than arranging financing on a project by project basis only. With the prior authorization of export credit insurance agencies and monetary authorities, commercial and specialized banks would agree in advance to finance a certain proportion (possibly up to 100%) of procurement placed in that country on the basis of international competitive bidding. Once established, such arrangements would have administrative simplicity as well as the advantages of continued full adherence to efficient procurement practices, and might well enhance the volume and development impact of resource flows to developing countries. Provided such an agreement covers a high proportion of potential suppliers, it should be beneficial to all involved. Because of the many countries and types of agencies involved, considerable negotiating effort will be required. The Bank has started to consult with export credit agencies and commercial lenders as to their interest in such "umbrella type" arrangements, and proposes to pursue these efforts.

IV. Cofinancing with Private Sources

4.1 Perhaps the most dramatic change in development finance in the 1970s was the expansion of lending to developing countries by commercial banks. In terms of net annual disbursements, these grew from an average of \$4 billion in 1970-72 to \$10 billion in 1974, \$20 billion in 1978 and an estimated \$23 billion in 1979.^{1/} In 1974 and 1975, recycling of OPEC surpluses constituted the main source of these funds. In the following years, very liquid conditions dominated the international banking system, because of a combination of easy monetary policy in the US and weak credit demand throughout the OECD area. This allowed commercial bank lending to continue expanding after OPEC surpluses fell, and actually to reach its greatest growth rate in 1978 when the OPEC countries were overall net users rather than sources of commercial bank funds. This state of high liquidity of the banking system also created intense competition among banks, which in turn resulted in a narrowing of "spreads" charged over the basic cost of funds (the London Interbank offered rate, LIBOR, for six-month funds is the most widely used point of reference), lengthened maturities of loans, and greatly reduced differentials in the terms applied to developing countries and other borrowers.

4.2 In this environment of highly liquid markets, easily available loans and little discrimination between borrowers, neither borrowers nor lenders saw much benefit in cofinancing with the World Bank. The rate of growth in the volume and number of cofinancing operations has nevertheless been significant. There were three operations accounting for \$136

^{1/} Source: OECD. Amounts exclude guaranteed export credits.

million in private cofinancing in fiscal years 74 and 75, and a total of 26 cofinancing operations accounting for \$929 million in private funds over the following three fiscal years. In calendar year 1979, there were 18 cofinancing operations with commercial banks supplying \$1353 million to 13 countries. However, these amounts are modest in comparison with the estimated \$23 billion net lending to developing countries by commercial banks in 1979. Banks were so eager to lend to developing countries in the past few years that there is no indication that past cofinancing has added significantly to the flow of funds to the beneficiaries, or eased the terms on which such funds were available. The benefits of the Bank's cofinancing with private sources must be seen in their contribution to laying the groundwork for assisting developing countries secure continued access to international capital markets in the long run. As noted in paragraph 4.10 below, developing countries will need to continue and, in fact, increase their borrowing from commercial banks in the next few years. Yet Broad economic and institutional factors will both make for much tighter credit conditions and create specific constraints on developing country borrowings from these sources. These new circumstances could make for a sharp further increase in cofinancing with the World Bank; more importantly they should enhance the value of such cofinancing in securing additional capital on reasonable terms. In formulating policies for maximising the Bank's usefulness in this new situation, it may be useful to review the Bank's procedures and experience to date.

Procedures and Experience

4.3 In contacts with commercial banks, regular operating staff are assisted by the Senior Adviser, Cofinancing, whose office was established in October 1975, and in the Latin America and Caribbean Region, by an adviser in the Regional Vice President's Office. The specialized cofinancing staff which is now reinforced by a special cofinancing unit in the Legal Department, initiates contacts with commercial banks and is a major focal point for continuing relationships with them. They inform lenders about the Bank's and borrowers' general policies and concerns, but for project-specific information, they refer them to the Regional Offices and to the borrowers. The specialized staff is also the Bank's original source of information and advice on the best sources of commercial financing for particular projects. In general, they actively promote cofinancing both with commercial banks and with borrowers.

4.4 Lenders may seek general information or be interested in a specific project listed in the "Monthly Operational Summary." The Bank then gives them broad, non-confidential information about cofinancing needs and possibilities, and facilitates contacts with the proper agency of the borrower. When mutual interest develops, potential cofinanciers can be given confidential documents, with the borrower's permission. Normally, the organization of the cofinancing arrangement will be quite advanced, and a lead bank will have been selected, before confidential materials, such as appraisal reports, are released to commercial banks.

4.5 When commercial banks extended untied financial loans as part of cofinancing with the Bank, the Bank generally includes a cross-default clause in its loan agreements. Cross-default clauses, a standard feature of commercial banks' international loans, link the loans of several lenders in such a way that a default on any associated loan is a default on all associated loans. The Bank has accepted optional cross-default provisions which give it the right, at its option, to exercise its remedies in the event that the cofinancier suspends or accelerates its loan as the result of a default under its loan agreement. Some private cofinanciers feel that this clause gives them additional security in that the Bank has the right to apply its remedies if default occurs on these loans. They often press for a removal or reduction of the optional character of the clause so as to increase its deterrent effect and its value to them. The Bank has refused to commit itself in advance to exercise its remedies in the case of a suspension or acceleration by the commercial banks on their loans. It has made it clear that it reserves the right to decide whether and in what way to take action in such a case. As for borrowers, they have shown some distaste even for optional cross-default provisions.

4.6 Past cofinancing operations of the Bank have not substantially increased the volume or improved the terms of commercial bank loans. In the prevailing easy market conditions, this was usually neither feasible nor particularly useful. However, the Bank has increased the market's base by introducing new lenders. This will help to protect the market against the emergence of problems affecting particular lenders, such as portfolio limits on lending to specific countries, insufficiency of the capital base, or limitations arising out of national monetary and balance of payments policies. This impact may be achieved even if after introduction of one or a few operations, subsequent loans are concluded without reference to the Bank. This has indeed happened occasionally.

4.7 Measured by this standard of diversification and given the limited interest for cofinancing due to market conditions, the Bank's role has been helpful. In particular, the Bank has had success in introducing new lenders to the market. In early years, US banks dominated private cofinancing sources. From about 50% in 1975 and 1976, their share dropped to 17% in 1978 and 32% in 1979, while the share of European banks increased from 18% to 27% over the same period.^{1/} The share of Japanese banks increased from 5% in 1975 to 35% in 1979. It is noteworthy that while overall Japanese commercial bank lending to developing countries contracted sharply between 1978 and 1979, cofinancing did not.

^{1/} These figures relate to calendar years.

4.8 In 1975, 14 commercial banks signed loans pertaining to cofinancing arrangements with the World Bank; in 1976, 20 did so, (of which only 6 were "repeaters" and 14 were new to this type of operation); in 1977, 58 (of which 46 new and 12 repeaters); in 1978, 19 (of which 8 new and 11 repeaters); and in 1979, 50 (of which 18 new and 32 repeaters). Thus 100 commercial banks have already made loans for cofinancing operations, many of them several times. "Repeater" banks' cofinancing loans have tended to increase over time. Relatively recent newcomers include both large banks e.g., Credit Agricole, and second-tier banks, whose involvement in international lending operations can give such markets greater depth and stability.

4.9 Most of the commercial banks cofinancing well-established international borrowers like Brazil and Argentina had already lent to those countries in recent years. In several other cases, however, most participants were making their first loan to the borrowers. For example, none of the six commercial banks which cofinanced the Pattani Hydroelectric Loan to Thailand, none of the six involved in the Second Livestock Loan to Romania, and only four out of the 19 participants in the Eighth Power Loan to Malaysia had previous relations with the country. Thereafter, five of the participants in the Thailand project, and five of the new participants in the Malaysia project undertook direct eurocurrency lending to those same countries.

Present Opportunities for Expanded Cofinancing

4.10 Developing countries now face a deteriorating economic environment. To mitigate the slowdown in their economic growth and facilitate their adjustment to the new economic environment, they need to incur and finance sharply increased balance of payments deficits. These cannot be financed without large private lending to them, in particular continued active lending by commercial banks. The effective recycling of the surpluses generated by the new oil price rise is also dependent upon such lending. Yet commercial bank lending will be constrained by a variety of broad economic factors, including competition from developed countries on capital markets, and the generally more restrictive monetary policies likely to prevail. More specific institutional factors will also constrain commercial bank lending to oil-importing developing countries. They include the increased share of such loans in the banks' portfolios, the relationship of these assets to the banks' capital, and the banks' risk-bearing capacity. Many of these factors are, in the ultimate analysis, related to uncertainties concerning the creditworthiness of developing countries and the soundness of their development. Cofinancing with the World Bank takes up an important new role in this context. Cofinanced loans are used for sound development projects and programs. By thus ensuring the soundness of the final assets, cofinancing can effectively contribute to bolstering the banking system and expanding its lending on a sustainable basis. It can also help to introduce assets best suited to the needs of specific types of banks and other investors.

4.11 There are three main opportunities for the Bank to play an expanded role in cofinancing with private sources. The first lies in the creative use of lending to finance structural adjustments; the second involves additional flexibility in terms and conditions of Bank loans; and the third is to assist borrowers in gaining access to private sources of long-term finance.

4.12 Structural Adjustment Loans. Such lending may form an increasingly important part of the Bank's efforts to help developing member countries adjust to structural problems. Cofinancing by commercial banks can increase the volume and development impact of such assistance. The very existence of structural adjustment problems would sometimes deter commercial bank lending. A structural adjustment loan signals that effective development policies are being followed, and co-financing with such a loan may be a particularly appropriate way to introduce or reintroduce commercial banks to that country.

4.13 Terms and Conditions of Lending. The Bank's present loan portfolio offers limited resale possibilities because it is made up of fixed-rate instruments. Given a choice between an IBRD bond and an unguaranteed World Bank loan to a developing country, lenders will normally prefer the bond unless the loan were priced to yield substantially more. The Bank can enhance prospects for sales of participations to the private sector by deliberately designing particular loans to include a portion for resale on terms other than those used for financing by the Bank itself, i.e., on floating rate terms. Both the Inter-American Development Bank and the International Finance Corporation do this regularly. While the volume of their operations is much smaller than the Bank's (IDB has arranged 14 such private cofinanced loans, for a total of \$378 million, in the past four years), their experience indicates that this technique could offer a useful additional tool to be used by the Bank in selected cases.

4.14 In future, the Bank will actively explore the desirability of making part of its loans for selected projects in the form of floating rate medium-term loans, with the deliberate intention of reselling to private investors the instruments pertaining to these loans. Such resales would be arranged before, or at the time of disbursement, so that the Bank's lending authority will remain exclusively committed to long-term, fixed interest loans. The Bank could thus supplement its own resources by tapping the very large potential offered by short-term private capital funds. The number, variety and interest of cofinanciers should be increased by the loans having "passed through" the books of the Bank. All loan sales would be made without Bank guarantees or any other type of recourse to the Bank, and would leave unimpaired the Bank's further lending authority out if its own resources. This will be usually preferable to the use of other methods, such as firm "buy-back" agreements, which would involve some impairment of the Bank's future lending authority.

4.15 We think these and similar new arrangements could be attractive to some commercial banks and provide more assurance to colenders than the Bank's current cofinancing practices. We see no need to take the further step of making the exercise of the Bank's remedies mandatory in the event of defaults on colenders' loans, in connection with these or more traditional cofinancing operations.

4.16 Assistance with Long-Term Finance. In the 1950s and 1960s, several higher-income borrowers arranged for bond issues--both public and private placements--to complement World Bank loans in financing specific projects. Similar arrangements might be used to assist present borrowers in improving access to private sources of long-term finance. In 1978, World Bank borrowers issued over \$4 billion worth of international bonds. Association with a World Bank project through cofinancing could add to the attractiveness of developing country bonds to certain investors. We plan to identify a limited number of projects suitable for such cofinancing, beginning with large projects related to sectors which relevant institutional investors are already financing in countries most likely to be successful in securing such private finance, and we shall consult with borrowers as to how the Bank might assist them. Such projects could then be simultaneously discussed with large insurance companies and pension funds operating on national markets (with respect to private placement), and with underwriters operating in international markets (with respect to public issues of international bonds).

V. Conclusion

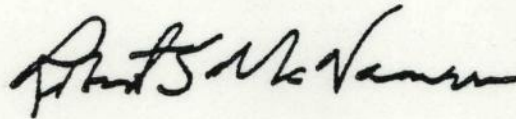
5.1 Cofinancing has grown rapidly in recent years. Through cofinancing arrangements with official aid agencies, export credits and commercial banks, the Bank has improved the development impact of external capital and increased the effectiveness with which tied funds are used.

5.2 The Bank has achieved some success in introducing new lenders to developing countries. However, while cofinancing with private sources increased substantially in recent years, this increase was only a fraction of the total increase in commercial bank lending to developing countries that took place over the same period. It is unlikely that much cofinancing with private banks was additional to capital flows which would have otherwise taken place, or that it materially affected the terms and conditions of such flows.

5.3 Over the next few years, competition for external capital is going to be more acute, in particular by developed countries. Monetary policies are likely to continue the restrictive, anti-inflationary stance they recently assumed, and thus reduce the liquidity of the world banking system and increase the cost of funds. Past borrowing, which has increased the share of developing country loans in the portfolios of commercial banks,

will also make further lending to such countries increasingly difficult, particularly in view of the deteriorating capital structure of many banks. In these circumstances, cofinancing with the World Bank may play a much more important role. By ensuring the sound use of external capital and the overall effectiveness of development and structural adjustment programs, it can serve as the catalyst needed in critical cases for private capital inflows to occur, on reasonable terms.

5.4 Implementing the approaches suggested in this paper will introduce new complications into the Bank's operations, it will somewhat increase administrative costs, and it will entail greater bank responsibility to private cofinanciers. We believe that the benefits to the developing countries will outweigh these costs, which are expected to be modest in any case. Both the quantity and quality of capital flows to the developing countries can be improved. This is crucial as we look to the great capital needs of developing countries and difficult capital markets expected in the 1980s.



Attachments

COFINANCING DEFINITIONS AND TERMINOLOGY 1/

1. As currently used in the Bank,^{2/} the term "cofinancing" refers in general to any arrangement under which funds from the Bank are associated with funds provided by other sources outside the borrowing country in the financing of a particular project. In some cases, funds from other sources may support parts of an entity's or agency's overall program in the sector to which the Bank project relates; such other financing is regarded as cofinancing if it is required to complete the financing plan for the Bank-supported project or if the Bank has played an active role in inducing the investment of funds by the other sources.

Types of Cofinancing

2. Joint Financing - the term "joint financing" refers to a cofinancing operation for which there is a common list of goods and services and where the financing of a disbursement for all or certain items is shared between the Bank and the colender in agreed proportions. Orders for all goods and services must be placed in accordance with procurement procedures acceptable to the Bank, normally the Bank's standard international competitive bidding rules.

3. Parallel Financing - the term "parallel financing" refers to a cofinancing operation in which the Bank and the colender finance different goods and services or parts of a project. Parallel financing is preferred by some colenders, either because they wish their financing to be identified with particular parts of a project for public relations purposes or because their procurement procedures are not compatible with the Bank's requirements for international competitive bidding. Under parallel financing arrangements, the Bank and the colender agree in advance on the parts of the project to be financed by each. The Bank then administers procurement related to its part of the project and the colender does likewise. Often, however, arrangements are made for regular exchange of information and joint supervision of the implementation of the project. Parallel financing permits greater flexibility in arranging for finance.

4. Participations - under some circumstances, the sale of participations in a Bank loan may be regarded as a type of cofinancing. This is particularly true where arrangements for the sale of participation are worked out prior to the making of the Bank loan in order to complete the required financing plan. In such cases, the Bank will administer the loan on behalf of the participant, who enters into a participation agreement with the Bank. Sales from the Bank's portfolio of portions of old loans, while releasing Bank funds for other purposes, are generally not regarded as cofinancing as the term is employed in the Bank.

^{1/} This Annex is derived from Operational Manual Statement 1.24.

^{2/} As used in this paper, "Bank" means Bank and IDA and "loan" means loan and credit.

Sources of Cofinancing

5. Official - official sources of cofinancing include governments, their agencies and multilateral financing institutions. This source is sometimes referred to as "donor" financing and the terms of such financing are often concessional in some degree.

6. Export Credits - as used generally in the Bank, export credits refer to financing which is linked to the procurement of certain goods or services from a particular country. The source of funds may be governmental or commercial or a mixture of both, and the actual financing may take the form of "buyer's credits" where loans are made by banks in the exporter's country directly to the importer (the borrower) or "suppliers' credits" where loans are made by the exporter to the importer in the recipient country. Export credits are often guaranteed or insured in a significant portion by an agency of the supplying country.

7. Private Institutions - financing by private institutions includes direct financing provided by commercial banks, insurance companies or other institutions or persons in the private capital markets outside the country of the borrower.

3. Parallel Financing - the term "parallel financing" refers to a cofinancing operation in which the Bank and the cofinancing institution provide goods and services or parts of a project. Parallel financing is preferred by some cofinanciers, either because they wish their financing to be identified with particular parts of a project for public relations purposes or because their procurement procedures are not compatible with the Bank's requirements for international competitive bidding. Under parallel financing arrangements, the Bank and the cofinancier agree in advance on the parts of the project to be financed by each. The Bank then administers procurement related to its part of the project and the cofinancier does likewise. Other, however, arrangements are made for regular exchange of information and joint supervision of the implementation of the project. Parallel financing permits greater flexibility in arranging for finance.

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1/ This Annex is derived from Operational Manual Statement 1.24.
2/ As used in this paper, "bank" means Bank and IDA and "loan" means loan and credit.

COFINANCING WITH WORLD BANK PROJECTS: FY73-79

	FY73		FY74		FY75		FY76		FY77		FY78		FY79	
	US\$m	No. of Projects	US\$m	No. of Projects	US\$m	No. of Projects	US\$m	No. of Projects	US\$m	No. of Projects	US\$m	No. of Projects	US\$m	No. of Projects
Official Sources														
DAC - Bilateral	257.5	24	422.8	28	306.4	30	458.5	26	452.0	39	841.9	38	1,126.3	46
- Multilateral	28.6	2	9.4	2	25.1	2	104.5	3	-	-	1.2	1	257.2	27
OPEC - Bilateral	26.1	3	18.5	2	476.2	14	354.8	16	172.2	18	313.9	15	224.0	11
- Multilateral	-	-	-	-	41.5	3	171.9	14	232.1	16	139.1	15	59.1	10
Other	65.1	9	280.4	18	297.8	17	204.5	23	409.0	22	521.3	30	337.0	39
Total Official	377.3	38	731.1	50	1,147.0	66	1,296.2	82	1,265.3	85	1,817.4	99	2,003.6	133
Export Credits	71.1	3	514.2	10	711.6	7	663.6	10	333.3	10	375.0	11	651.5	15
Private Funds	-	-	60.0	1	76.3	2	286.0	5	423.7	10	219.2	11	549.8	16
Total Cofinancing	448.4	36	1,305.4	40	1,934.9	55	2,245.8	65	2,022.3	71	2,411.6	78	3,204.9	107
Of Which: Foreign Cost	407.7		1,290.8		1,876.6		2,157.7		1,917.5		2,187.5		2,625.8	
Local Cost	40.7		14.6		58.3		88.1		104.8		224.1		379.1	
Financing By World Bank	751.1		1,268.2		1,349.4		1,871.6		2,199.7		2,446.0		4,085.0	
Of Which: IBRD	445.9		1,102.6		1,018.3		1,485.6		1,805.2		1,811.7		2,952.8	
IDA	305.2		165.6		331.1		386.0		394.5		634.3		1,132.2	
Total Project Cost	2,783.2		5,197.4		8,746.2		8,927.2		8,333.4		11,242.3		13,633.6	
Percentage Shares														
Official Sources	84.1		56.0		59.3		57.7		62.7		75.4		62.5	
Export Credits	15.9		39.4		36.8		29.5		16.5		15.5		20.3	
Private Funds	-		4.6		3.9		12.7		21.0		9.1		17.2	

Note: Breakdown of the number of cofinanced projects by source may exceed total, as several Agencies participate in cofinancing a given project.

Source: Senior Adviser Cofinancing/PAB.

COLENDER TERMS FY79

Country	Board Approval Date	Export Credits			Private		
		Amount (Sm)	Mat. Grace --(Yrs.)--	Interest (%)	Amount (Sm)	Mat. Grace --(Yrs.)--	Interest L=LIBOR
Portugal	1/ 4/79	31.0	-	-	28.8	10 4	L+7/8
Romania	11/28/78	12.9	8	2.5	-	-	-
	1/ 9/79	11.0	8	3	-	-	-
	3/20/79	-	-	-	100.0	10 4	L+5/8 \$70m. L+3/4 \$30m.
Yugoslavia	3/10/78	-	-	-	20.0	12 5	L+7/8
Brazil	3/ 6/79	-	-	-	90.0	10 4	L+1-1/2
	6/ 7/79	-	-	-	60.0	10 5	12
Colombia	11/14/78	-	-	-	22.9	10 5	L+3/4 L+7/8 after 3 yrs.
Dominican Republic	6/12/79	30.1	12	4	-	-	-
	5/17/79	-	-	-	10.0	10 4	L+1-1/4 L+1-3/8 after 4 yrs.
Paraguay	6/21/79	-	-	-	7.0	12 6	L+7/8 L+1 after 6 yrs.
Uruguay	4/17/79	-	-	-	5.0	10 3.5	L+7/8

DETAILED PROPOSALS FOR IBRD COMPLEMENTARY FINANCINGI. The purpose and general principles of Complementary FinancingA. An Alternative to Traditional Cofinancing

1. Complementary Financing is designed as a program that would associate private lenders with new IBRD Project and Structural Adjustment loans in a manner designed to give the colenders greater implicit protection than in traditional cofinancing.

2. As a trade-off for this increased implicit protection, participating banks would be expected to relinquish a large part of their autonomy and initiative in conducting negotiations with the borrower(s). All such negotiations would be conducted through the intermediary of IBRD. Similarly, loan administration and the exercise of remedies against defaulting borrowers would remain vested with IBRD, subject to proposed rules set out in paragraphs 20 and 21 below.

3. Complementary Financing is therefore aimed at attracting banks whose size and international exposure have so far precluded active involvement in the field of developing country finance. In doing so, Complementary Financing would contribute to broadening the sources of non-concessional finance for developing country borrowers.

B. Legal Structure

4. The proposed structure of Complementary Financing involves a dual loan structure with two loans, respectively designated as "A" and "B". The "A" loan would be entirely funded by IBRD and be in the standard IBRD format. The "B" loan would be primarily - though not exclusively (see paragraph 15 below) - funded by participating commercial lenders. Its terms and conditions would be substantively different from those of the "A" loan.

5. As regards loan agreements, Complementary Financing could either involve a single loan agreement, covering both "A" and "B" loans, or separate loan agreements for each loan. In the former case separate schedules to the master agreement would set out the covenants, terms and conditions that are specific to each loan rather than common features of both.

6. In the event two separate loan agreements are resorted to, IBRD would be a co-signatory of the "B" loan. This feature would provide the legal basis for the greater protection afforded to participants.

ANNEX III

7. "A" loans would be at fixed rates and for maturities stipulated by IBRD for that borrower. "B" loans would be structured to accommodate commercial banking practices and therefore usually carry floating rates and shorter overall and average maturities.

II. The selection of cases suitable for Complementary Financing.

8. The task of selecting projects and programs suitable for Complementary Financing would be left to IBRD, in consultation with its prospective borrowers. The criteria for selecting such loans would be similar to those adopted in the case of traditional cofinancing. In all instances, the overriding consideration would be the extent to which Complementary Finance results in additional financing on reasonable terms for the borrowing country.

9. Borrower benefit would be demonstrated if the conditions below are satisfied:

(i) Commercial funds provided under the "B" loan are at more advantageous terms (e.g. lower cost or longer maturities) than those obtained from direct market borrowings.

(ii) New lenders who have had no prior business relations with the borrower agree to participate in the "B" loan.

10. Operational incentives to support a Complementary Financing program would be similar to those proposed in the Report to the Task Force on Non-concessional Flows (paragraphs 14 to 16) of which this proposal is part.

11. For projects suitable for Complementary Financing, IBRD would seek the borrower's authorization to solicit bids for the "B" loan. IBRD would evaluate such offers and transmit them to the borrower with appropriate recommendations. Assuming borrower approval, the terms of the "B" loan would be finalized. Where appropriate, participants could organize as a syndicate and appoint a lead-bank to liaise with IBRD on loan documentation, disbursements etc. Participations in the "B" loan would be sold by IBRD to commercial banks on a "best efforts" basis, i.e. without any underwriting commitment on its part.

III. Disbursement Procedures and Show-down by the Borrower.

12. IBRD criteria and procedures for disbursement of loan funds to a borrower would apply equally to the "A" and "B" loans.

13. Allowance would be made for differential timing in the disbursement of "A" and "B" funds. This would, for instance, be the case when the "B" loan has been negotiated after the "A" loan or when the commercial lenders' reluctance to enter into lengthy advance commitments has to be accommodated. In the former case "B" funds would be disbursed last, in the latter case, first.

14. Consistent with the principle of "best efforts", the IBRD would only make "B" loan funds available to the borrower to the extent such funds have been provided by the participating commercial banks. If private lenders' participations were to fall short of the targeted amount of the "B" loan, this shortfall would have to be met by the borrower either from domestic or international sources.

15. The above notwithstanding, IBRD might decide to retain a portion of the "B" loan for its own account. Such retention could be justified if it provided commercial banks with a strong incentive to enter into Complementary Financing for certain borrowers (see main Report paras 21-23 for discussion of the policy issues surrounding this decision). Similarly, if a substantial shortfall of colender funds in the "B" loan threatened to jeopardize the completion of a project or program, IBRD could fund all or part of this shortfall, while reserving the right to sell its share thereof at a later stage.

IV. Loan Administration under Complementary Financing.

16. Loan administration in the broad sense covers:

(i) negotiating the terms and conditions of a loan with the borrower;

(ii) preparing and executing the loan documents;

(iii) controlling disbursements and collecting principal, interest and premiums (if any) from the borrower, when due;

(iv) monitoring borrower performance under the terms of the loan covenants and notification to the borrower of default thereunder, as and when it occurs;

(v) exercising remedies against events of default as justified by the circumstances.

17. Except as specified for the exercise of remedies, (paragraphs 20 and 21 below) loan administration on the "A" and "B" loans will be provided by IBRD, acting both for itself and on behalf of its colenders. This feature of Complementary Financing would accommodate the lack of familiarity with developing country finance of most participating banks.

V. Events of Default and the Exercise of Remedies.

18. As a result of the legal structure proposed for Complementary Financing, the "B" loan would be regarded de jure as a loan extended by IBRD. This would apply de jure and de facto when IBRD has retained a share of a "B" loan for its own account.

19. From the above, it follows that, from the borrower's viewpoint, any default on the "B" loan would amount to a default against IBRD. Also consistent with the above, would be an arrangement whereby partial payments of interest or principal by the borrower would be apportioned between the "A" and "B" loans, pro rata to their size. As a result, to the extent both loans are concurrent in time, any such default would affect both. However, if one assumes that "B" loans would normally carry shorter maturities than standard IBRD loans, any default occurring after the final repayment of "B" would not affect the commercial lenders.

20. As regards the differential exercise of certain remedies such as acceleration (i.e., accelerate the "B" loan in cases where IBRD has decided not to take such action on the "A" loan) it is proposed that IBRD would, in all cases, have to approve the participants' request. In deciding on the most appropriate course of action, IBRD would be guided by the borrower's interest and by what would, in its opinion, be the most salutary method of avoiding protracted debt management problems.

21. Where the principle of the differential exercise of remedies has been accepted IBRD would act solely as agent, acting on behalf of the commercial lenders, rather than in its own name. In instances where IBRD has retained a share of the "B" loan for its own account, the differential exercise of remedies would have to be ruled out.

VII. Loan Rescheduling.

22. The IBRD's firm policy is not to agree to requests for loan rescheduling by its borrowers. The delicate question raised by Complementary Financing where IBRD is a co-signatory of the "B" loan - whether by means of a separate loan agreement or of a schedule to a master agreement - is whether the case for preferred creditor status can be extended to the commercial co-lenders.

23. The simplest case is where the "B" loan is covered by a separate loan agreement and where IBRD has not retained a share of the "B" loan. In that instance, there is no obvious justification for extending the preferred creditor status to colenders.

24. In cases where IBRD has retained a share of the "B" loan two options arise in the event the borrower requests debt rescheduling:

- (i) Consistent application of IBRD's no-rescheduling policy to both "A" and "B" loans.

- (ii) Restriction of the no-rescheduling policy to the borrower's obligations under the terms of the "A" loan only.

25. From a legal perspective a differential attitude in respect of two loans to the same borrower, where IBRD is itself a lender in its own right, would be difficult to justify. It would also be contrary to the principle set forth in paragraph 21 above.

VII. Colenders' Access to Information on the Borrower.

26. All documents prepared by IBRD in connection with the project/program to be financed and the evaluation thereof, all background- and economic reports on the borrower as well as all data and information supplied by the borrower to IBRD, would have to be made available for full disclosure to any of the colenders participating in the "B" loan. Such disclosure would be subject to explicit approval by the borrower, it being understood that withholding such approval would preclude Complementary Financing and therefore cause a commensurate reduction in the total financing for a given project/program.

27. Colenders for their part would make a formal undertaking to treat the information so obtained as confidential. This applies particularly to instances where prospective colenders have obtained information to facilitate their credit evaluation and have subsequently decided not to participate in the "B" loan.

VIII. Summary and Conclusion.

28. Complementary Financing should be seen as a means of attracting non-traditional lenders to the field of developing country finance. Its aim is to supplement flows of non-concessional resources through methods that differ from traditional cofinancing techniques and thereby to provide further additionality in financial flows to developing countries.

29. The principal technical features of Complementary Financing are:

- (i) a dual loan structure;
- (ii) the legal designation of the "B" loan as an IBRD loan, by virtue of its signature thereof;
- (iii) loan negotiation and administration by IBRD on the colenders behalf;
- (iv) the option of a differential exercise of remedies in the event of borrower default;
- (v) in cases where IBRD retains a portion of the "B" loan for itself, the potential extension to commercial lenders of the Bank's preferred creditor status.

30. With regard to additionality, from the lenders' viewpoint, a degree of additionality could only be achieved if Complementary Financing substantially improves their perceived credit risk and if loan administration services provided by IBRD offeres an effective incentive to smaller, less-internationalized banks. In other words, additionality could reasonably be expected if Complementary Financing is considered as qualitatively distinct from and technically safer than cofinancing.

31. From the borrowers' perspective, the precondition for additionality through Complementary Financing lies in the perceived advantages of conducting negotiations with private lenders through the intermediary of IBRD and in the absence of potential constraints arising from this form of borrowing.

32. The latter considerations point to the crucial importance of the question of potential loan rescheduling. An extension of the Bank's preferred creditor status to commercial lenders would probably prove unacceptable to most developing countries and therefore hamper the future viability of Complementary Financing. This issue will have to be borne in mind if and when the proposal is considered for implementation.

Financial Studies Division
Financial Policy & Analysis Dept.
February 12, 1981.

VIII. Summary and Conclusion

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THE WORLD BANK
Washington, D.C. 20433
U.S.A.

Office of the President

July 15, 1980

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Brandt Commission's Recommendation Concerning
the Use of the World Bank's Guarantee to Improve
Access of Developing Countries to Capital Markets

Recommendation: "The World Bank and other international financial institutions should provide guarantees and play their part in ensuring a continued flow of commercial funds." ^{1/}

1. The Commission feels that the economic environment in the coming years will be one in which the international capital markets might not, in the absence of intermediation by some public institutions, finance an adequate proportion of the very large capital requirements of the developing countries. The use of the World Bank's guarantee authority is seen as one form that such intermediation could take. This paper discusses, within the framework of the Bank's Articles of Agreement, the feasibility of using the guarantee authority, and the likely effects on the borrowing countries and on the World Bank.

Legal Authority

2. There are no legal barriers to the use of the Bank's guarantee authority; in fact, the Bank's Articles of Agreement treat guarantees as the primary form of development assistance and direct lending as an alternative to it (Article I). This is because, when the Bank was established, its European members required both capital for reconstruction and assistance in re-entering the capital markets. The Bank's guarantee was seen as a source of support facilitating the re-entry.

3. The Bank's Articles of Agreement treat guarantees as being similar to loans in their financial and other implications. In particular, the Articles stipulate that the sum of loans and guarantees by the Bank cannot exceed its capital plus retained earnings (Article III, Section 3). The Bank

^{1/} Willy Brandt and others, North-South: A Program for Survival, London: Pan Books, 1980, p. 275.

must meet the same conditions when it guarantees a developing country's obligations as it must when it extends a direct loan. The eligibility criteria for loans and Bank guarantees are almost the same (Article III, Section 4). These criteria are: (a) loans and guarantees can be issued only to member governments or with their guarantee; (b) both loans and guarantees have to be for a specific project, except in special circumstances (Article III, Section 4(vii)); (c) in both cases the appraisal and supervision of the project and the assessment of the borrower's creditworthiness are required (Article III, Section 4(iii)); and (d) for both loans and guarantees, the Bank must ensure that the amounts borrowed will be used only for the purposes for which the loan was granted (Article III, Section 5).

4. There are only some minor differences between the Articles' requirements for guarantees and loans. These are: (a) the Bank is required to control the disbursements only for direct loans and not for a loan it guarantees (Article III, Section 5); (b) the restrictions on loans extended for local currency expenditures (Article III, Section 3) are applicable only to direct loans and not to guarantees; (c) the Bank can guarantee loans only with the approval of the member countries in whose markets loans are raised and in whose currency they are denominated, and only if those members agree to the unrestricted conversion of the funds involved into the currency of any other member country (Article IV, Section 1); whereas these conditions have already been met in case of the Bank's resources available for direct lending.

5. The Articles do not impose any limit on the scope of the guarantee. This means the Bank can give either a full or a partial guarantee ^{1/} as long as all other terms and conditions (which are the same for a full or a partial guarantee) of the Articles are met. The amount of reduction in the Bank's commitment authority would depend upon what elements of the loan were guaranteed. If the Bank were to guarantee only the principal of a loan, the commitment authority would be reduced by that amount. If the Bank were to guarantee principal and interest only, Article IV, Section 5(c) would be relevant:

"Guarantees by the Bank shall provide that the Bank may terminate its liability with respect to interest if, upon default by the borrower and by the guarantor, if any, the Bank offers to purchase, at par and interest accrued to a date designated in the offer, the bonds or other obligations guaranteed."

^{1/} See below.

- 3 -

The Bank's maximum liability under such a provision in its guarantee would be the principal amount plus the amount of interest that would accrue between the date of the last interest payment and the date the Bank purchased the obligations involved.

6. The Articles also specify that: "In guaranteeing a loan made by other investors, the Bank receives suitable compensation for its risk" (Article III, Section 4(vi)). "In guaranteeing a loan, the Bank shall charge a guarantee commission payable periodically on the amount of the loan outstanding at a rate determined by the Bank" (Article IV, Section 5(a)).

Historical Experience

7. The Bank has not directly used its guarantee authority, because it was felt that direct lending was more appropriate to the needs of its members. This was so even when the Bank's major borrowers were the more developed countries, and even when the statutory limits on Bank lending were so remote as to be disregarded in practice. Borrowers have preferred direct loans from the Bank to Bank-guaranteed loans from some other source, because the latter would be provided on harder terms, and in addition, the borrowers would have had to pay a guarantee commission.

8. The Bank has, however, used its guarantee authority indirectly, that is, by first making a direct loan and then selling that loan or a part of it to private investors with a guarantee (see Annex). This first occurred in 1948 when the Bank, with its guarantee, placed a part of its shipping loan to the Netherlands with a group of banks in the United States. The last sale of a loan with the Bank's guarantee was made in 1956 (the total amount between 1948 and 1956 of such sales was \$69 million). The guaranteed loan sales were abandoned because they did not add much to a borrowing country's creditworthiness nor provide a cost-effective means of raising funds for them, as compared with direct borrowing from the Bank. Nor did they add to the overall resources that could be mobilized by the Bank, as the guaranteed principal amounts remained a charge against the Bank's overall lending authority until their repayment, in exactly the same way as if they had not been sold.

Effects on Borrowers

9. A borrower would find it advantageous to borrow under a World Bank guarantee if this:

- increased the inflow of funds over and above that which could be achieved by direct borrowing from the Bank;

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- improved the borrower's market standing;
- reduced the cost of funds; or
- improved his cash flow position by lengthening the maturity of his borrowing.

These effects are examined below. The discussion is at first limited to the use of full guarantees.

(i) Additionality

10. All financial institutions must take into account contingent liabilities born out of guarantees. In the case of the Bank, as noted above, the Articles of Agreement specify that, from the point of view of its relations to total capital, guarantees should be treated in a way identical to the treatment of loans. This relationship would presumably prevail even if the rules governing the relationship of loans to capital were themselves changed. Therefore, whatever the Bank's lending authority, no additional capital inflows would result directly from the substitution of full guarantees to direct lending. In fact, the use of guarantees might even cause the Bank's lending authority to be used up more quickly, because the limitations established by the Articles of Agreement apply to disbursements when the Bank lends directly, but to commitments when the Bank offers guarantees.

11. Additionality may also result if, somehow, the sale of fully guaranteed loans gradually helped borrowers to establish a certain 'market standing', and to introduce unguaranteed borrowings into the same markets. This possibility is examined in the following section.

(ii) Market Standing

12. It is sometimes argued that borrowing private funds under World Bank guarantees would help certain countries to improve their standing in international capital markets, so that they could issue their own unguaranteed obligations in the future.

13. It is difficult to find evidence of situations where a third party guarantee permanently enhanced the market standing of the recipient. The Bank's own (admittedly limited) experience with resales of loans with guarantees gives no indication that issuing full IBRD guarantees for a borrower's private market obligations materially assisted in improving the borrower's credit rating. This was an important factor in the decision to discontinue

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the practice of guaranteed loan sales. Conversely, there is considerable evidence that the best way to establish a credit rating and to obtain improved access to more desirable sources of finance is by first borrowing from relatively hard sources and maintaining an impeccable debt service record. Thus, guaranteed export credits have often precluded syndicated Eurocredit borrowings; and such loans, in turn, have helped to introduce developing countries to the floating rate note and bond markets.

14. If the Bank were to offer guarantees, the creditors are likely to scrutinize mostly the creditworthiness of the guarantor (i.e., the Bank), rather than that of the issuer, because this would save them the cost and trouble of detailed long-term country economic analyses of a large number of widely varying and complex economies. Thus the process of exposing the borrower directly to the investor and promoting familiarization through successive in-depth creditworthiness evaluations, ultimately making it possible to issue unguaranteed obligations, is not likely to be much advanced.

(iii) Cost of Funds

15. Private bank loans are provided at higher interest cost and shorter terms than World Bank loans. This would still be the case if a guarantee improved the terms of such loans, to the point of making them comparable to those obtained by prime industrial country borrowers. This does not mean that the terms of the guaranteed loan would not be better than those of an unguaranteed loan; however, even this gain would be small under present market conditions for a wide array of borrowers, as the differentiation between high- and low-ranked borrowers (through spreads over LIBOR and management fees) has tended to be small. IBRD guaranteed bond issues would have to carry terms and offer yields more onerous than those of the Bank's own bond issues. This has been invariably the case even for the Government-guaranteed issues of such integral emanations of national states as the FHA in the US, or the SNCF in France. Moreover, even if a developing country did obtain the same maturity as the IBRD does on its borrowing, it would not be as well off as if it borrowed directly from the Bank, because the World Bank performs term intermediation, i.e., it lends longer than it borrows.

16. Finally, the IBRD is obligated (see supra, para 3) to subject guarantees to the same appraisal and supervision processes as direct loans. The costs of these would have to be recovered through the guarantee commission, to be charged in accordance with the Bank's Articles. One cannot yet precisely estimate the costs involved or the commission to be charged; but there are strong a priori reasons for such a commission to be not less than the .5% per annum spread between the Bank's borrowing and lending

rates paid by the Bank's direct borrowers. These guarantee commissions would further augment the difference between the cost of direct loans and the cost of loans guaranteed by the Bank.

Partial Guarantees

17. The foregoing discussion indicates that the use of full guarantees is not likely to provide much significant benefit to borrowers in terms of additional capital flows, cost of funds, length of maturities, or market standing. However, it is possible that in some cases the use of partial guarantees might be appropriate. ^{1/} A partial or limited guarantee means one of the following: (a) a guarantee of interest payments only; (b) a guarantee of principal only; or (c) a guarantee of principal or interest or of both only for some years out of the total maturity of a loan.

18. A partial guarantee can be put into effect in a number of ways. The most important could be the guaranteeing of a fixed amount of the principal. For the borrower and the lender this would have the advantage that, as the principal was increasingly paid off, a growing proportion of the outstanding principal amount would be covered by the guarantee. This would help alleviate some of the lender's concern, because later maturities are generally viewed as being riskier than earlier ones. The same effect could be obtained by guaranteeing the principal repayments of the last X years of the loan.

19. The impact of such guarantees on the Bank's finances should be compared with a loan with a correspondingly long grace period. The Bank does not normally make loans with very extended grace periods. If it were nevertheless found feasible to guarantee such later maturities, the corresponding guarantee commission would have to be higher than earlier indicated (para. 16). Such partial guarantees may be particularly useful to countries seeking to establish themselves on bond markets. A partial guarantee, covering, say, the outer maturities of a bond issue, may have a multiplier effect and enable the borrower to secure a larger total amount under acceptable conditions. There is no evidence yet as to how significant the multiplier effect of a partial Bank guarantee would be; the value of the guarantee tool could only be established and measured if it were put to use on a significant scale.

^{1/} Article IV, Section 1 "(a) The Bank may make or facilitate loans which satisfy the general conditions of Article II in any of the following ways:(iii) By guaranteeing in whole or in part loans made by private investors through the usual investment channels."

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Alternatives to Bank Guarantees

20. From time to time, the Bank has considered the advantages of accepting closely binding cross-default clauses, as a means of mobilizing additional cofinancing for its borrowers. These would not involve financial obligations by the Bank, but would obligate it to apply specific remedies in case specified events of default affected the borrower's obligations to the co-lender. It is the Bank's policy not to accept such binding cross-default clauses, because it does not want to give up its freedom of decision concerning the application of its remedies in the event of actual or alleged default by a borrower. If the Bank were to extend guarantees to loans by third party lenders, its freedom of decision would be even more severely curtailed. It is therefore desirable to examine the possibility of using alternative means for facilitating the entry of selected borrowers into capital markets, and for helping them to mobilize a multiple of the resources committed by the Bank.

21. The resale of loans specifically designed for that purpose may achieve the resource-mobilizing impact of partial guarantees, without limiting the Bank's freedom of action in case of a subsequent dispute between the lender and the borrower. A partial guarantee such as the one described in the preceding section, i.e., limited to the later maturities of a private loan, would be very similar to a direct Bank loan, of which the early maturities are resold without the Bank's guarantee. Such a technique may be even more helpful to establishing the borrower's creditworthiness and introducing it to private lenders, because the Bank would normally locate such lenders directly, and could also perform certain regular services: for instance, the Bank has usually acted as billing agent on behalf of the purchasers of its loans. Of course, in the case of guaranteed loans, the financial and other terms and conditions of the direct loan agreement itself are closely adapted to the requirements of the lender, which may be quite different from those of the Bank. For a loan to be saleable, it may be desirable to design its terms and conditions at the outset in ways likely to be attractive to other lenders.

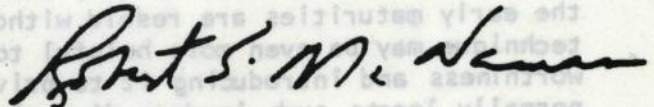
22. The Bank has made minimal use of loan sales in the past. They exceeded \$100 million only in FY70 (\$195 million), in FY77 (\$165 million) and in FY78 (\$162 million). This was because the cost to the Bank of funds obtained through such sales is normally higher than the cost of direct borrowing by the Bank. That is likely to remain the case in future. However, if a borrower must develop its access to funds other than the Bank, and limit the use it makes of the Bank's overall lending authority, the combination of direct financing of some maturities with the resale of others may be as advantageous to the borrower as the extension of partial guarantees by the Bank.

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Conclusion

23. Guarantees affect the Bank's lending authority in the same way as loans disbursed and outstanding. Under foreseeable circumstances, there would be little benefit to the Bank or to its borrowers if the Bank were to fully guarantee loans by third parties. There is more justification for the use of partial guarantees, which might sometimes help borrowers to mobilize funds larger than the guarantee extended by the Bank or to introduce them to new lenders or preferred loan instruments. However, the use of the technique also involves risks for the Bank, by reducing its freedom of action. The possibility of achieving the same aims by using other techniques, in particular loan sales without guarantee, and cofinancing, should be carefully considered in each case.

24. If the use of such techniques is found to be not feasible or not beneficial, and if borrowers so request, the Bank is prepared to extend partial or full guarantees to certain loans. ^{1/} This would be done on the understanding that such guarantees would substitute for the same amount of direct lending to the borrower.



1/ The issue of guarantees was earlier considered in a staff memorandum, dated July 29, 1976 on "Use of the IBRD's Guarantee Authority", (Development Committee DC/WG/CM/76-7 dated August 4, 1976.) Subsequently, the Development Committee's Working Group on Access to Capital Markets noted (DC/WG/CM/77-4 dated August 1, 1977), that "The World Bank, in the light of the Committee's discussion in April, is now prepared to consider requests from member countries for partial guarantees of their bond issues. The initiative would now, therefore, seem to lie with individual "threshold" countries." No such request has yet been received by the Bank from any member country.

ANNEX

Sales of IBRD Loans with Guarantee

<u>Borrower</u>	<u>Loan No.</u>	<u>Years when sold</u>	<u>Amount (\$m)</u>
Belgium	14	1949	16.1
Brazil	11	1954-55	0.8
Chile	5	1955	0.1
	6	1951-53	1.7
	49	1954-56	0.6
Colombia	18	1952-53	2.0
	38	1953	0.1
	39	1952-53	0.2
	43	1952-53	0.8
	54	1953	0.1
El Salvador	22	1953	1.0
Finland	16	1952	0.7
France	1	1952	5.0
India	17	1952-53	4.8
	19	1952-53	2.6
	23	1956	1.0
Luxembourg	4	1955	0.2
Mexico	12	1952-56	2.2
	24	1952-53	0.6
	56	1953-56	1.3
	103	1956	1.6
Netherlands	2	1952-54	5.8
	7	1948	12.0
	15	1952	0.2
Nicaragua	44	1953	a/
	45	1953	a/
	52	1953	a/
Paraguay	55	1953	0.1
Pakistan	60	1952-53	0.7
Peru	57	1953-55	0.6
	67	1953-55	0.4
	98	1954-55	0.1
South Africa	41	1953-56	2.5
Thailand	35	1953	0.2
	36	1956	0.8
Turkey	27	1953	0.1
Uruguay	30	1953-56	2.0
		TOTAL	69.0

a/ Less than \$50,000.

DETAILED PROPOSAL FOR AN IBRD LOAN PASS-THROUGH PROGRAMI. The Loan PoolA. Composition and Structure of the Pool

1. The governing principle of the pass-through program, will be risk diversification through the multiplicity of loans and borrowers included in it. A loan pool representing a cross-section of IBRD's borrowings would constitute the basis of the program. Pass-through certificates would be issued on the strength of each loan pool.

2. Depending on market reaction and on preferences expressed by particular investor/lender groups, it is conceivable that IBRD would adopt a multi-tier marketing strategy and constitute separate loan pools to cover particular market segments. In this case, each separate pool would have a specific risk-weighting, depending on the prospective investors it is aimed at.

3. The principle of risk diversification notwithstanding, it could be the case that greater homogeneity in the risk composition of individual loan pools should be resorted to. This would prevent any deleterious impact on the market-rating of certain country borrowers (e.g., as a result of higher interest rates arising from the blending of credit risks in broadly-based loan pools). Regionally-based (e.g., Latin America, South-East Asia) or activity-based (e.g., energy, mining) pools could be considered.

4. In all instances, and subject to the availability of "poolable" loan maturities, the various categories of credit-risks included in a given pool would be distributed as evenly as possible over its entire duration.

B. Currencies of Loan Pools

5. At the outset all loan pools (and the attendant pass-through certificates) will be denominated in single currencies. The currency of a given pool will be determined in the light of market preferences at the time each pool is set up and subject to the dual constraint of (i) availability in IBRD's portfolio of sufficient loans or loan maturities in that currency; and (ii) IBRD's earned yield on loans in that currency.

6. In all cases, only loans or loan maturities disbursed and repayable in the chosen currency would be pooled. This would avoid the creation of additional exchange risks for the borrowers concerned.

7. Given the current rate structures of the principal currencies and the constraints on the yield offered to pool participants, it is expected that loan pools will initially be denominated in hard currencies, particularly the Swiss franc or Japanese Yen.

8. These principles notwithstanding, if and when loans structured on the basis of IBRD's 'Currency Pooling System' (CPS) are included in a loan pass-through program, it will have to be decided--in the light of market circumstances--whether such loans should be "unpooled" with respect to CPS (with the borrower's agreement) or offered to investors as a multiple-currency asset.

C. Interest Rate

9. In all cases, interest offered to investors will be limited to that earned by IBRD on the pooled loans. Yields in excess of IBRD's own (average) Lending Rate for any given loan would be ruled out.

10. Guarantee fees, selling commissions and other expenses incurred by IBRD in connection with the establishment of a pool and the placement of certificates will be deducted from the Lending Rate in order to determine the Maximum Interest Rate to be offered to pool investors.

11. The offered interest rate for any given loan pool will be determined in the light of:

- (i) market conditions at the time;
- (ii) the currency in which the pool is to be denominated;
and
- (iii) the market segment for which that pool is earmarked.

12. If market conditions permit the offered interest rate on a loan pool to be below the Maximum Interest Rate, this differential will accrue to IBRD. Borrowers will not be eligible for pro rata refunds of such differentials.

13. Where private non-bank investors are concerned, loan pools will usually, but not necessarily, carry fixed interest rates.

14. Where commercial banks are concerned, allowance will be made for their traditional propensity to favor floating rate assets. To accommodate this preference, any loan pool earmarked for priority placement with banks could carry floating rates at an appropriate margin over LIBOR for the currency concerned.

15. In determining the permissible range of floating, attention will have to be paid to the Maximum Interest Rate. Allowing for the fact that money-market movements could push LIBOR for the reference currency over the Maximum Interest Rate, the latter will be set as a ceiling on the interest to be earned on floating rate loan pools.

16. Given the potential interest rate risk for investors (particularly banks) that are thus constrained by a ceiling, a number of compensatory formulas are recommended, as a trade-off for this risk. They include:

(i) A ratchet effect such that, as soon as a floating rate reaches the Maximum Interest Rate, it would be frozen at that level until the final maturity of the pool.

(ii) A floor on permissible interest rate variations to trade-off downside and upside risks.

(iii) A possible drop-lock feature, turning a floating rate pool into a fixed-rate one at a predetermined floor.

The ratchet will undoubtedly provide the most effective compensation.

D. Duration and Amortization of a Loan Pool

17. The final maturity of a loan pool will be determined in the light of market conditions at the time and of the duration of poolable loan maturities. It will never exceed that of the last maturity of a pooled loan, or portion of loan.

18. If, as seems likely, initial investor preferences will be for medium-term assets, only specific maturities of each eligible loan will be pooled.

19. Loan pools will be amortized progressively so that their average life is substantially shorter than the final maturity. Grace periods will be determined in the light of market conditions, subject to the constraint of the amortization profile of pooled loans.

20. Even amortization schedules (say, equal semi-annual) are recommended, on grounds that they are most compatible with usual market practice.

E. Notification to Borrowers

21. Notwithstanding the fact that all IBRD loan agreements provide for the sale of participations or for the assignment of IBRD's rights under such loan agreements, each borrower whose loan(s) has (have) been included in a pool will formally be notified of this fact.

22. In order to allow for the wish of certain investors--particularly banks--to use the purchase of IBRD loan pass-through certificates as a stepping stone to establish direct financial relations with certain of the borrowers, a list of certificate holders could be provided to the borrowers included in a given pool. The feasibility of such disclosure will, evidently, depend on whether bearer or registered certificates are issued. Full disclosure of the identity of all certificate holders can only be considered in the latter case.

II. Participation Certificates

A. Loan Pass-through Certificates

23. The model of the Loan Pass-through Certificates will be derived from that of "mortgage pass-through certificates", as used in private capital markets in the US.

24. Each Loan Certificate will represent a fractional undivided interest in a given pool and therefore represent a similar fractional undivided interest in each of the loans contained in that pool.

B. Unit Denomination

25. In order to maximise the appeal and participation range of loan pools--particularly those aimed at non-bank investors--Pass-through Certificates will be issued in small unit denominations (say, US\$50,000). Certificates will be available in such unit denominations or in multiples thereof.

C. Trustees

26. It is not envisaged that IBRD would resort to the use of trustees in connection with the issue and sale of Pass-through Certificates. IBRD will however be committed to use due care and attention in the management of loans that are included in a pool and in the collection of monies forthcoming from such loans.

27. All interest- and principal payments by borrowers on pooled loans will be received by IBRD on the certificate holders' behalf and placed in the Certificate Accounts described below.

III. Pools and Loan Servicing

A. Fiscal Agents

28. Since private placements will initially be resorted to, IBRD will act as collecting and paying agent on the certificate holders' behalf.

29. If necessary, fiscal agents will be appointed if and when public issues of certificates are resorted to, in order to handle the greater volume of interest and principal repayments on such public issues.

B. Certificate Accounts

30. In respect of each loan pool IBRD will establish and maintain with itself an interest-bearing Certificate Account into which all of the following payments will be deposited:

- (i) all principal payments on any of the loans concerned, including pre-payments and the resultant premiums, if any;
- (ii) all interest payments in respect of the same; and
- (iii) all interest earned by IBRD from depositing Certificate Account balance in domestic or international money markets, it being understood that such balances would be deposited between the date of their receipt by IBRD and that of contractual payments by IBRD to certificate holders.

The need for Certificate Accounts arises from the fact that there will probably be no coincidence in time between principal and interest receipts on IBRD loans, and the corresponding disbursements to certificate holders.

31. Except as provided by the terms of the guarantee, only monies received from the principal debtors and interest earned thereon will be available for disbursement to the certificate holders.

32. IBRD will be entitled to withdraw from each Certificate Account any difference between the interest earned on pooled loans and that offered to certificate holders. Such withdrawals will include IBRD's guarantee fees, the selling agents' fees and monies needed to cover other expenses incurred in connection with the formation of a pool and the placement of Loan Certificates.

IV. IBRD Guarantees and the Exercise of Remedies

A. The General Principles

33. The administration and enforcement of all pooled loans, including all matters provided for or contemplated by any of the Loan Documents, any bonds or notes issued thereunder, security instruments (if any) and other related documents, will be handled solely by IBRD.

34. In such administration and enforcement, IBRD specifically reserves the right, at its discretion and without notice to the certificate holders, to exercise, refrain from exercising or waive any rights under the Loan Documents, under bonds or notes issued thereunder and held by IBRD, under any security for the pooled loans, the bonds or notes, or any other agreement with the borrower(s) or the guarantor(s) (if any) or to modify any provisions thereof.

35. The above notwithstanding, IBRD will not, without the prior written consent of all or of qualified majority of certificate holders or their authorized representatives, give any waiver, or consent to any modification, which would vary the obligations of the borrower(s) or the guarantor(s) (if any) to pay, in the specified currency and on the specified dates, the principal amount (including premium if any) of the loan(s) included in the pool and the interest thereon at a rate per annum not less than that stipulated on the certificates.

36. IBRD will exercise the same care in the administration and enforcement of the loan(s) as it exercises with respect to loans or parts thereof which are for its own account.

B. Partial IBRD Guarantees

37. In order to maximise the investor appeal of Loan Certificates, a partial guarantee will be issued by IBRD in connection with each pool. IBRD's liability under such guarantees will be limited to a certain percentage (say 10%) of the original principal amount of each pool, and therefore represent an equal percentage of the par value of each Loan Certificate.

38. The amount of IBRD's guarantee liability on each loan pool will be reduced in line with the amortization thereof. The percentage of the par value of Pass-through Certificates outstanding for each loan pool, covered by such guarantee will however remain unaltered until the final redemption of that pool.

C. The Legal Structure of IBRD's Guarantee

39. Although defined as a percentage of the original principal amount of each loan pool, IBRD's protection will cover any default or late payment of principal or interest thereon and premium if any, up to the amount of the guarantee as defined at any moment in time.

40. Furthermore, if and when funds that had formerly been disbursed by IBRD under the terms of its guarantee are received from the borrower(s) concerned, the amount of the guarantee commitment will be restored accordingly.

41. Following from these operating principles, the guarantee will provide certificate holders the safeguard of an uninterrupted income stream on their investment, irrespective of (possible) late payments by the borrowers whose loans have been pooled.

D. The Exercise of Remedies by Certificate Holders

42. Except as provided under the terms of the guarantee, certificate holders will have no recourse against IBRD. Their rights against the borrowers and the exercise of such rights are to be interpreted in accordance with the General Principles set out in section 33 to 36.

43. From the above, it follows that:

(i) the exercise of remedies by certificate holders against defaulting borrowers (for interest overdue and unguaranteed principal amounts) should be conducted solely through the intermediary of IBRD;

(ii) although the certificate holders would not be in a position to dictate a particular course of action IBRD or to exercise remedies directly against the borrower, they would have the right to seek legal redress and compensation from IBRD if IBRD fails to meet its obligations set out in para. 36 above.

V. The Placement of Loan Pass-through Certificates

A. The Use of Investment Banks in Selling Certificates

44. As Pass-through Certificates will potentially be of small unit denominations and be placed with a relatively large number of individual investors, investment banks or other financial intermediaries will be used as selling agents.

B. A Placement Memorandum

45. To ensure that certificate purchasers are fully informed of the composition of the pool to which their Pass-through Certificates relate each placement will be supported by a detailed Memorandum providing information on IBRD, its activities and record, and on the borrowers whose loans are included in the pool. The certificate holders' rights and obligations will also be set out in the Placement Memorandum.

C. Securities Laws and Central Bank Approvals

46. Securities laws in the market(s) where placements of Pass-through certificates are envisaged will always be complied with. It is recognized that under the terms of such securities laws the dividing line between "private placements" and "public offerings" is often quite tenuous, especially where large operations with substantial numbers of investors/participants are concerned. As and where necessary, the legal formalities required for public offerings will be complied with, particularly with regard to publicity and investor information.

47. In accordance with usual practice, approval will be sought from the relevant authorities of the countries in whose markets Loan Pass-through Certificates would be offered for placement or in whose currencies the Certificates would be dominated.

D. A Secondary Market in Certificates

48. Bearing in mind investors' preferences for liquid financial assets, a secondary market for Loan Pass-through Certificates would have to be organized in co-operation with the investment bank(s) acting as selling agent in the placement of such Certificates.

VII. Subsidiary Questions

A. Guarantee Fees

49. IBRD guarantee fees will be charged at the usual level (0.5% per annum). This cost will be taken into account when calculating the interest rate of fixed-rate certificates or the spread of floating-rate Certificates and thus be borne by the investors.

B. Selling Commissions

50. Selling commissions at a level commensurate with normal market conventions will be paid to the investment bank(s) acting as selling agents on IBRD's behalf. Such commissions shall be deducted from the proceeds of certificate sales, it being understood that allowance will have been made for them in calculating the interest rate or spread of Certificates.

VIII. Summary and Conclusion

51. Loan pooling and the issue of partially-guaranteed Loan Pass-through Certificates should be seen as a means of attracting non-traditional lenders to the field of developing country finance. Its aim is to supplement IBRD's resources and thereby to provide additionality in financial flows to NODCs. This additionality will be achieved if:

(i) Loan pooling succeeds in attracting commercial lenders and certain non-bank sources of funds whose size or past market orientation has prevented their direct lending to such countries (e.g., through loan syndications or bond investments) or their participation in IBRD cofinancing.

(ii) Funds obtained by IBRD from such sources are used for additional project and/or program lending.

(iii) Certificate purchases by the lenders concerned do not result in a partial or commensurate reduction of their purchases (if any) of IBRD bonds.

52. The principal features of the proposed Loan Pass-through Certificates are:

- (i) risk diversification;
- (ii) partial guarantee coverage by IBRD;
- (iii) availability in small unit denomination;
- (iv) complete agency service by IBRD; and
- (v) yields commensurate with the perceived credit risk, and therefore higher than on IBRD bonds, but lower than for any direct obligations of the borrowers included in the pool.

53. Furthermore by reducing the perceived risk attached to such operations, it is plausible to expect that loan pooling could enhance the future direct market access of the borrowers whose loans have been pooled.

Financial Studies Division
Financial Policy and Analysis Department
February 12, 1981

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C.1.02

Report of the Development Committee's Task Force on
Non-Concessional Force.



JOINT MINISTERIAL COMMITTEE
 OF THE
 BOARDS OF GOVERNORS OF THE BANK AND THE FUND
 ON THE
 TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES
 (Development Committee)



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March 24, 1981

Task Force on Non-concessional Flows

REPORT ON SELECTED ISSUES

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Introduction

1. The Task Force on Non-Concessional Flows has held a number of meetings to consider prospects for non-concessional financial flows, and particularly the economic context of future commercial bank lending to developing countries. In the course of this work it has also consulted representatives of international commercial banks.

2. The Task Force considers that a degree of additionality in non-concessional flows could be achieved by Multilateral Development Institution actions to broaden the range of financial techniques and improve the attractiveness of financial instruments available for lending to developing countries. Such actions are reviewed in Part I of this Report.

3. The Task Force has also discussed the main issues relating to the external indebtedness of developing countries, and held a preliminary discussion of proposals designed to increase the lending ability of MDIs. These topics are discussed in Parts II and III respectively of this Report.

4. The Task Force looks for guidance from ministers on the course of action to be adopted on the proposals set out in this Report.

Part I: COOPERATION BETWEEN MULTILATERAL DEVELOPMENT
INSTITUTIONS AND FINANCIAL INSTITUTIONS

Section 1: Scope and Range of the Proposals

5. In discussing cooperation between MDIs and financial institutions the Task Force had before it a paper, prepared by the World Bank staff, which analyzed various initiatives towards these ends. The Task Force commends the innovativeness of these proposals and bases its recommendations on the contents of the staff study. The staff report dealt only with the procedures and practices of the World Bank. The Task Force, however, considers that in appropriate cases the analysis could be extended to other MDIs.

6. The detailed recommendations of the Task Force are set out below and cover the following issues:

- (i) The widening of cofinancing arrangements between MDIs and commercial lenders;
- (ii) The sale of portfolio and loan participations by MDIs;
- (iii) The use of MDI guarantees;
- (iv) The issue and placement of Pass-Through Loan Certificates by MDIs.

7. Each set of proposals in the World Bank staff paper aims either to improve existing practices (Cofinancing, Participation Sales) or to create new methods of financial intermediation (Complementary Financing, partially-guaranteed Loan Pass-Through Certificates) by the World Bank and other MDIs. The proposals are therefore complementary to one another rather than mutually exclusive. It is noted that the proposals set out below may involve changes in the lending programs and priorities of MDIs.

8. While individual financial institutions may wish to participate in more than one scheme, each of the proposals is principally aimed at a particular category of lenders:

- (i) A widening of cofinancing arrangements will appeal to major financial institutions that may wish to extend their future lending to developing countries. Improved cross-default clauses, the more systematic treatment of cofinancing flows, and the setting of country-specific objectives are aimed at this goal.
- (ii) Complementary Financing and resumed participation sales are designed to attract banks whose traditional lending

policies have been less explicitly oriented towards developing countries. The technical and administrative assistance that they would receive by participating in MDI loans could encourage them to accept a larger proportion of developing country risks in their loan portfolios.

(iii) Partially-guaranteed Loan Pass-Through Certificates are particularly designed to be attractive to commercial banks whose involvement in developing country lending has hitherto been minimal. This proposal also endeavors to break new ground by providing a financial vehicle that would enable non-bank lenders and private investors to diversify their portfolios to include loans to developing countries.

9. The Task Force recommends to the Development Committee that the IBRD and other MDIs discuss, as speedily as possible, the proposals included in this report with banks and other financial institutions in major financial centers. These discussions would assess the reactions of financial institutions to these proposals, and thus provide an estimate of their potential in facilitating the flow of non-concessional resources to developing countries.

10. The benefits of the proposals, in terms of additional flows of resources to developing countries, or of improved terms for commercial loans available to them, are difficult to quantify. Some increase in flows or improvement in terms of loans may be achieved; it is also possible that they will serve to maintain the existing level of flows which could otherwise be impaired by a deterioration, whether actual or perceived, of the creditworthiness of developing countries.

11. The Task Force concluded that the proposals discussed here could be seen as complementary to other measures, such as an increase in the lending authority of these MDIs, and indeed might partly overlap with them.

12. Several commercial lenders have emphasized their preference for early direct contacts with developing country borrowers. Nevertheless, a number of these proposals provide for MDI assistance in loan negotiations since they aim to attract the interest of potential lenders and borrowers who have not hitherto engaged in this type of financing. This assistance could help to stimulate more direct contacts between lenders and borrowers in the future.

Section 2: Cofinancing

13. The Task Force believes that a significant increase in cofinancing by the MDIs and financial institutions is desirable if it leads to additional transfers of non-concessional resources. This additionality could take the form of an increased volume of loans, of a widening of the circle of developing countries with access to commercial

loans or of increasing the number of market sources willing to lend to them. An increase in cofinancing that was merely a substitute for other capital flows would not be considered satisfactory.

14. The Task Force accordingly consulted a group of commercial bankers to discover what changes in present MDI cofinancing practices would make cofinancing more attractive to them. The bankers suggested the following:

- (i) a greater participation for the banks in the discussions with the potential borrower;
- (ii) a streamlining of procedures;
- (iii) more "commercial" terms and conditions of loans;
- (iv) improving cross-default clauses.

15. The Task Force agrees that there is some merit in (i) and (ii) above and recommends that MDIs be requested to explore ways with financial institutions and borrowers to implement them. Some members of the Task Force also believe that (iii) would be an acceptable price to pay, if significant additionality can be secured.

16. The Task Force discussed various ways of improving cross-default clauses. In principle, such improvements could range from a relatively modest change in the present optional arrangement to a far-reaching modification, making the acceleration of loan repayments mandatory. The more modest changes might consist of (i) notification to the Executive Board of the MDI concerned of significant defaults or delays in payment on the colenders' loan; or, if that failed to restore normal banking relations, (ii) agreement by the MDI that it would consult with colenders and participate in the effort to negotiate remedies with the borrower concerned. The strongest form of cross-default clause (a "mandatory" clause) would require, (iii) the MDI to seek accelerated repayment of its loans if the colenders decided to do likewise; it might be possible to incorporate some safeguards for borrowers in such a clause to ensure that it would be implemented only as a last resort when other attempts to find a solution satisfactory to colenders and the borrowers had failed.

17. The Task Force agrees that such changes to cross-default clauses could only be justified if they promise worthwhile additionality and that the amount of modification to be introduced should be the minimum needed to achieve that end. It also agrees that there is no accurate way of estimating in advance how much additionality might be expected from each of the three steps discussed above. Some members of the Task Force therefore favor some modification of cross-default clauses, perhaps in an exploratory way, starting with minimum changes in order to test their acceptability to both colenders and borrowers.

18. However, such changes, particularly "mandatory" cross-default clauses, raise some fundamental issues. In the view of other members of the Task Force, these are sufficiently serious to make the introduction of mandatory clauses by MDIs unacceptable, regardless of the expected amount of additionality.

19. These fundamental issues include the following:

- (i) mandatory loan acceleration would make it more difficult or impossible for an MDI to exercise its judgement whether a suspension of new loan operations would be justified;
- (ii) by threatening the excellent service record of MDI loans, such a clause could impair the credit standing of the MDIs and so increase the cost of their financing. This would increase the cost of their lending to all borrowers and thus be detrimental to their interests.
- (iii) mandatory cross-default clauses could undermine the interests of borrowing countries, as lenders might require such clauses as a minimum requirement in all future loans.

20. The Task Force recognized the seriousness of these issues but was unable to agree to what extent the promise of additionality would justify subordinating them in the interests of enlarged capital flows. It therefore urges MDIs to seek an acceptable balance between risk and protection in their future discussions with potential colenders and borrowers.

21. The Task Force recognizes that the attractiveness of cofinancing to borrowers depends upon its being arranged in such a way as to reassure borrowers that the total volume of MDI finance is not being reduced because of cofinancing. The Task Force considers that this will require a measure of advance planning of cofinancing programs and perhaps earlier consultations with potential cofinanciers, so that MDI lending can be structured in a way which ensures that the planned volume of MDI lending is supplemented by cofinancing, for appropriate projects.

Section 3: Complementary Financing and Sales from Loan Portfolios

22. Whereas cofinancing involves a direct loan agreement between the borrower and the colender(s), the purchase of a participation in an MDI loan involves no separate loan agreement. Participation sales by MDIs have been of two main types:

- (i) Participations as such, negotiated between an MDI and private lenders after the terms of the loan have been determined but before disbursement to the borrower has commenced.

- (ii) Portfolio sales from existing loans, after completion of loan disbursement to the borrower. The World Bank discontinued this practice in 1977.

In either case, the sale is made on a "no recourse" basis and is negotiated for standard fixed-rate loans. The Task Force notes that such sales could be assimilated to "ex post" cofinancing.

(i) A new framework for commercial lender participations in MDI loans

23. The Task Force recommends that, where applicable, MDIs should consider increasing their loan participation programs by adopting a framework that would take account of international financial markets as sources of medium-term floating rate funds.

24. This new framework is designated "Complementary Financing".^{1/} It differs from existing practices chiefly by adopting a dual loan structure. When Complementary Financing is resorted to, the extension of credit by an MDI would involve two loans, designated as "A" and "B". The "A" loan would be funded solely by an MDI and be structured in accordance with its current practice. The "B" loan would also be negotiated between that MDI and the borrower, in consultation with the commercial lenders. As distinct from the "A" loan, the "B" loan would include the participants' contributions. It would be structured to meet the requirements of commercial lenders, i.e. be at floating rates and have maturities acceptable to them. The precise terms and conditions of "B" loans would evolve in line with market practices.

25. It can be expected that income-generating industrial projects will be favored by financial institutions attracted by Complementary Financing. For such projects, each MDI would seek the borrower's authorization to solicit bids for the "B" loan. The MDI would evaluate such offers and transmit them to the borrower with appropriate recommendations. Assuming borrower approval, the terms of the "B" loan would be finalized. These terms might include some of the features recommended in the context of traditional cofinancing.

26. Where appropriate, participants could organize as a syndicate and appoint a lead-bank to deal with the MDI on loan documentation, disbursements, etc. Participations in the "B" loan would be sold by that MDI to financial institutions on a "best efforts" basis, i.e. without any underwriting commitment on its part. Funds obtained in this fashion would be made available to a borrower as, if, and when received by the MDI from the participants. If private lenders' participations were to fall short of the targeted amount of the "B" loan, this shortfall would have to be met by the borrower, either from domestic or international sources.

^{1/} The IDB and IFC already have a program of Complementary Financing, broadly similar to that set out here.

27. The Task Force noted that sales on a "best effort" basis could entail certain risks for borrowers, insofar as a shortfall of funds could affect the completion of projects financed in this manner. The Task Force also noted that MDIs might become involved in loan syndication in connection with "B" loans and raised the question whether this might entail certain underwriting commitments on their part.

28. The Task Force considers that the principal issue raised by this proposal is whether MDIs should retain a portion of the "B" loan for their own account. In the absence of such retention, this formula would offer lenders roughly the same protection as cofinancing, albeit in a framework where MDIs could possibly attract substantial commercial funds. Conversely, where retention of a portion of a "B" loan is adopted by an MDI, its preferred creditor status would be extended to commercial participants in that loan. However, giving a preferred creditor status to participating commercial lenders could adversely affect the borrowers, by reducing their flexibility in dealing with serious debt management problems. It might also raise objections from other -- non-preferred -- commercial lenders to a country which was affected by these difficulties.

29. A further implication of MDI participation in a "B" loan is that the MDI concerned would become engaged in floating rate lending.

30. The Task Force recommends that MDIs review the proposals outlined above and consider the advantages and disadvantages of adopting such a framework. The issue of MDI participation in "B" loans should be scrutinized with particular care and legal advice sought on this point.

(ii) Increased sales by MDIs from their existing loan portfolios

31. The Task Force believes that MDIs could mobilize additional commercial funds for developing countries by promoting sales from their existing loan portfolios.

32. In order to ensure that portfolio sales do not become a costly alternative to direct borrowings by MDIs, and to safeguard the objective of additionality in non-concessional flows, the Task Force recommends that portfolio sales be based on the following principles:

(i) Interest rate differentials not be reimbursed to borrowing countries, but accrue instead to the MDI concerned;

(ii) Portfolio sales be marketed not merely on the attractiveness of particular currencies, but rather on the attractiveness of selected borrowers' credit positions. This would help familiarize commercial lenders with particular country borrowers, and pave the way for their future direct market access;

(iii) Portfolio sales be built into a regular program, commensurate with the operating scale of each MDI, and that future

sales be deducted from the projection of disbursed loans used to determine the permissible level of "steady state" lending.

33. The Task Force wishes to emphasize that whereas the contribution of cofinancing and Complementary Financing to increasing resource flows would be direct -- even if difficult to forecast accurately -- that of portfolio sales is likely to be indirect. If participations purchased from an MDI are added to the financial markets' aggregate lending to developing countries, such funds will, in the first instance, accrue to that MDI. Strictly speaking, non-concessional resource flows will only increase when these funds are on-lent by the MDI to developing countries.

34. The Task Force believes that portfolio sales could appeal to smaller banks and other fixed rate lenders that might see this instrument as somewhat less risky than the purchase of a participation in a syndicated commercial bank loan. From a marketing viewpoint, portfolio sales should thus be regarded as parallel to Complementary Financing, the principal distinction being that the former concerns existing loans and the latter new financings.

Section 4: The Use of MDI Guarantees

35. The Task Force noted that two separate issues should be considered under this heading, namely the use of MDI guarantees, on the one hand, and the development of new multilateral guarantee frameworks, on the other.

36. As regards the latter, the Task Force has received proposals from the Dutch, French and Mexican delegations, each of which sets out a tentative institutional framework for multilateral guarantee schemes. These proposals will be discussed in detail by the Task Force at its next meeting.

37. With regard to MDI guarantees, the Task Force considers that full MDI guarantees of commercial loans to developing countries are unattractive for several reasons:

- (i) Fully-guaranteed loans are unlikely to be an effective means of familiarizing commercial lenders with the borrower concerned since the underlying country-risk would not need to be investigated.
- (ii) Fully-guaranteed loans raised by a country might create a precedent and jeopardize the success of future unguaranteed borrowings by the same country.
- (iii) There are no obvious cost advantages for the borrowers since the MDI guarantee fee would absorb the larger part of any interest rate reduction resulting from the guarantee.

38. Partial guarantees, on the contrary, lend themselves to selective use (e.g. they could cover later maturities of a given loan, or be restricted to principal or to interest payments) which makes them a possible tool to stimulate non-concessional resource flows. Furthermore, insofar as the guarantee fee would be restricted to that portion of a loan which is covered by such partial guarantees, the cost impact on borrowers would be limited.

39. So far, partial guarantees have not been provided by the IBRD or other MDIs, possibly because conditions in international capital markets in recent years have favored borrowers. The Task Force considers that the international financial climate of the 1980s may elicit a greater demand for partial guarantees and recommends that MDIs introduce the necessary procedures to offer such partial guarantees to financial institutions.

40. The Task Force noted that one operational drawback arising from the use of guarantees is that they reduce an MDI's lending authority in the same way as loans disbursed and outstanding. In other words, the lending authority is diminished from the moment guarantees are issued, i.e. regardless of the actual drawdown of guaranteed loan facilities.

41. The Task Force therefore recommends that MDIs be asked to examine procedures necessary to ensure that guarantees be treated pari passu with loans and that they impair their lending authority only after guaranteed loans have been disbursed.

42. The Task Force also recommends that MDIs and their member governments should examine the implications of direct "guarantee leverage", i.e. of procedures whereby the lending authority is curtailed by less than the amount of the guarantee. This recommendation is based on the hypothesis that only a small proportion of guarantees is ever likely to be effectively called upon by guaranteed lenders. The introduction of such measures would be tantamount to increasing any MDI's combined loan and guarantee ceiling beyond current gearing limits.

43. The Task Force noted that, to introduce the changes in guarantee procedures recommended for examination, the statutes and/or Articles of Agreement of MDIs may have to be modified.

Section 5: Loan Pass-Through Certificates

44. The Task Force proposes that MDIs should examine the possibility of issuing partially-guaranteed "pass-through" Loan Certificates, based on a pool comprising a cross-section of disbursed loans. The Certificates would be partially guaranteed by the MDI concerned up to a fixed amount, to provide an uninterrupted income stream for certificate holders, irrespective of possible payments by the borrowers whose loans have been pooled. Each loan certificate would represent a fractional undivided interest in each of the loans contained in that pool.

45. The governing principle of the pass-through program would be risk diversification through the multiplicity of loans and borrowers included in each "pool" of loans. The partial guarantee would be structured so as to apply equally to defaults on or late payments of interest and/or principal of certificates outstanding.

46. At the outset, all loan pools (and the attendant pass-through certificates) would be denominated in single currencies. The currency of a given pool would be determined in the light of market preferences at the time each pool was set up and subject to the dual constraint of (i) availability in an MDI's portfolio of sufficient loans or loan maturities in that currency; and (ii) the MDI's earned yield on loans in that currency.

47. Bearing in mind investors' preferences for liquid financial assets, the Task Force considers that a secondary market for Loan Pass-through Certificates would have to be organized by each MDI in cooperation with the investment bank(s) acting as selling agent in the placement of such Certificates. In this connection, the Task Force wishes to stress the potential financial implications for MDIs of organizing a secondary market.

48. Furthermore, the implementation of a loan pass-through program would entail certain additional tasks for MDIs, such as collecting- and paying agency services on the certificate holders' behalf. The Task Force recommended that the legal and cost implications of such services be examined.

49. The principal attraction of the proposed loan pass-through program is that it would result in the creation of a new type of negotiable international financial asset, distinct from traditional loan or portfolio participations. Such certificates might prove particularly attractive to a category of private investors -- as distinct from commercial banks -- who have hitherto been unable to partake in existing forms of developing country finance. The Task Force also believes that this formula could appeal to smaller or regional commercial banks whose lending policies do not normally include developing country risks and whose risk perceptions could be influenced by the negotiability of the proposed instruments. If this belief is correct, a degree of indirect additionality would be attained, since the certificate holders' contributions would increase each MDI's subsequent lending potential.

50. The Task Force therefore concluded that, provided the interest rate structure of international money and capital markets becomes favorable and can accommodate the yield ceilings mentioned in paragraph 46 (ii) above, loan pass-through programs could satisfy the objective of additionality in a manner similar to portfolio sales. Furthermore, by attracting new lenders, such programs could raise the financial markets' aggregate lending ceilings for developing country borrowers.

part II: External Indebtedness of Developing Countries

51. The Task Force has discussed some of the main issues relating to the external indebtedness of developing countries. For this purpose, it had before it a comprehensive set of papers prepared by the Fund staff describing and analyzing the principal aspects of this question. These papers were discussed on January 26, 1981 by the Executive Directors of the Fund who approved the staff proposals regarding the Fund's role in debt rescheduling, including in the context of the newly adopted UNCTAD Resolution on debt and development problems of developing countries (Resolution 222-XXI). The Task Force commends the Fund staff for these papers and welcomes the decision of the Executive Board to publish them.

52. The Task Force emphasizes that developments regarding external debt must be viewed in the broader context of the world economic situation. It recognizes the serious debt situations facing a number of developing countries. It notes that several factors, both domestic and exogenous, have brought the debt issue to the forefront of problems facing these countries, including the rapid rise of external debt in the recent past, changes in its composition, the consequent hardening in the average terms of debt, and the rise in the level of debt service burden resulting from these developments. The Task Force believes that both short- and longer-term aspects of the debt question must be kept under constant vigilance.

53. The Task Force has examined the implications of these factors for the economic development of developing countries. A large number of developing countries rely to a considerable extent on external sources of finance to supplement domestic savings. The external debt difficulties facing many countries could have a negative impact on continued inflow of external resources. The Task Force stresses the importance of sound debt management, including borrowing on appropriate terms, in order to avoid debt servicing problems and thus help sustain inflows. At the same time, the Task Force continues to believe that a sustained large capital inflow will be necessary.

54. The Task Force has discussed the question of the debt indicators frequently employed in analyses of debt situations of developing countries. It notes the importance of bearing in mind the purpose for which debt indicators are used and the particular qualities of various indicators; great care must be exercised when utilizing debt indicators. The Task Force emphasizes that debt indicators, taken on their own, are not a substitute for comprehensive reviews of the economic situation and prospects of the countries involved.

55. The Task Force has also discussed the impact of inflation on external debt, including the proposition that anticipated inflation leads to a more rapid amortization of a given loan since actual interest payments include a component reflecting the erosion of future amortization payments. This question is of increasing importance because private commercial loans extended at variable interest rates, which incorporate inflationary expectations, are becoming the dominant form of finance for

many countries. The Task Force is concerned that failure by creditors to take this factor into account in their assessments of economic conditions in borrowing countries may have a negative impact on financial flows. It is particularly important to avoid situations where, by cutting back on new lending, banks may add to balance of payments instability. The Task Force encourages further study of this subject.

56. The Task Force notes that debt servicing problems have emerged in several countries and that an increasing number of them have sought debt rescheduling. It notes that these problems evolved over a period of years and reflected the accumulated effects of external and internal imbalances attributable to a variety of factors. The Task Force emphasizes that an important objective of debt rescheduling should be to re-establish the creditworthiness of the debtor country, allowing it to honor its commitments, and to promote the restoration of financial flows interrupted by debt problems. Debt rescheduling should be viewed as part of a comprehensive effort to help the debtor countries implement the necessary adjustment policies.

57. The Task Force recognizes the importance of a multilateral framework which brings together the interested parties to discuss debt matters. It considers that the existing multilateral arrangements for the renegotiation of official debt constitute an effective forum for the rescheduling of public and publicly guaranteed debt. It notes that the Fund and the Bank intend to cooperate in a very informal manner with UNCTAD on debt matters.

58. The Task Force has discussed the restructuring of debts to commercial banks. In view of the increasing proportion of debt owed to these banks, the Task Force recognizes the contribution that restructuring operations by these institutions can make, if required, in the overall context of the flow of resources to developing countries. It acknowledges, however, that the approach of private banks to debt restructuring is governed by considerations different from those of official institutions. It also recognizes that governments and inter-governmental institutions cannot determine the conditions for private debt restructuring. Nevertheless, the Task Force encourages banks to take a constructive approach to debt restructuring, and to examine ways in which they can be of further assistance in assuring stable and sustained financial relations with developing countries. It is important that private debt restructuring should be viewed as part of a comprehensive effort to assist the debtor country concerned. The IMF, the World Bank, and the regional development banks might be able to provide good offices in facilitating these matters.

59. In regard to the long-term aspects of the debt problem, the Task Force felt that questions regarding the relationship between different sources of finance for developing countries, especially taking into account the magnitude and nature of their financing requirements, must be kept under review.

Part III: Increase in Lending Capacity of Multilateral
Development Institutions (MDIs)

60. The Task force will be examining several proposals, such as a change in the gearing ratio of MDIs, the establishment of affiliates in the MDIs, including an energy affiliate of the World Bank, and other ways of increasing flows of funds from the MDIs. For these discussions the Task Force has suggested that a paper be made available by the World Bank for consideration by the Task Force no later than July.

61. The Task Force, at its meeting of October 1980 in Puerto Marquez, Mexico, asked representatives of financial institutions to comment on the issues mentioned in the foregoing paragraph. There was a discussion of the possibility of modifying the "gearing ratio" of the World Bank., i.e. relaxing the statutory lending limit, in order to help to increase the flow of resources to developing countries. There was general agreement among the representatives of financial institutions that the international capital markets had the capacity to absorb somewhat larger borrowing programs by MDIs, although they disagreed whether modifying the gearing ratio would affect the quality of the bonds issued or the borrowing standing of these institutions. Many current holders of World Bank bonds are believed to look upon the soundness of the institution, rather than the gearing ratio or the guarantee provided by the callable capital, for the purchase of bonds. This would suggest that there would not be a problem in modifying the gearing ratio. Nevertheless, other creditors may attach considerable importance to the existing ratio which constitutes a 100% backing of bonds by the capital of the World Bank. It is thus possible that the impact of a change would vary from one group of creditors to another. One possibility is that the ratio might be removed from the Articles entirely and replaced, for example, by a by-law. It was suggested, however, that even if the ratio were relaxed, the World Bank would need to proceed cautiously in any consequent expansion of its lending program.

62. The Task Force has considered the possibility that the flow of non-concessional capital to developing countries could also be increased through the creation of new institutions, or affiliates of existing institutions, that would finance activities of high priority. The Task Force questioned representatives of financial institutions on three specific proposals.

63. (i) The creation by an MDI of an institution, similar to a commercial bank, that would take deposits and lend to LDCs at market rates: The representatives of the financial institutions indicated that this proposal had limited possibilities, and they doubted whether it would generate additional resources for developing countries;

(ii) A facility for financing the purchases of capital goods by LDCs: Most participants from the financial community felt that this facility would not necessarily lead to additional flows, but agreed that,

in order to have a more clearly defined opinion, more studies should be prepared;

(iii) An affiliate of the World Bank to finance energy projects in LDCs: Most representatives of the financial community present at the Puerto Marquez meeting expressed support for this idea and supported its further examination.

64. The Task Force understands that the expansion of the World Bank's lending program and ancillary issues will be discussed by the Development Committee.