# The World Bank: A Financial Appraisal

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# Introduction

The World Bank, formally known as the International Bank for Reconstruction and Development, is an international organization, owned and controlled by governments that constitute its membership/ shareholders. Its function is to finance economic growth and productivity in developing member countries.*

The World Bank finances its lending operations primarily through the sale of debt obligations to private investors, financial institutions, and governments. The Bank's capital, which is subscribed by member countries, its retained earnings, and the flow of repayments on its loans also contribute to the Bank's resources.

From time to time, financial commentators have asked whether there is a conflict between the Bank's role as a development institution and its responsibilities to its creditors and to its shareholders. The point of my remarks is straightforward: Although the Bank has several "constituencies," there is no conflict between its development efforts and the interests of either its shareholders or bondholders.

The fact is that creditors and shareholders insist on prudent financial policies as a condition for the development efforts of the Bank. Sound projects, attention to country creditworthiness, assessment of risk, and adequate levels of liquidity and reserves are required by the management of the Bank and by its creditors and stockholders. Not one of these requirements is inconsistent with the needs or aspirations of the developing world. Thus, underlying the Bank's development activities is a market-based institution that attracts funds from governments and capital markets for projects and programs that make sense in developing member countries. In order to do its job, the Bank maintains financial and lending policies and practices that satisfy the demands of the marketplace.

The World Bank has two major financial assets: Its outstanding loans and its liquidity. Its liabilities consist of its outstanding debt and its capital and reserves. I shall consider each of these elements with a view to explaining how the Bank functions as a profitable and sound financial institution, paying careful attention to the creditworthiness of the countries to which it lends and the development returns on the projects it finances in those countries.

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* This paper contains a summary of informal remarks made in seminars and information meetings concerning the financial operations of the International Bank for Reconstruction and Development—the World Bank. It does not deal with the Bank's affiliates, the International Development Association (IDA) or the International Finance Corporation (IFC), unless specifically noted.

## Section One: *Lending Policies*

It may be useful to set forth, in some detail, the lending policies of the Bank. The success of the Bank as a development institution derives basically from the quality of its loan portfolio; the uses to which its loans are put ultimately will determine whether the Bank will continue to serve as an expanding development institution deserving of market support. The text that follows is intended to summarize what the great majority of the Bank staff—economists, financial analysts, engineers, and hundreds of technical specialists—research, analyze, and resolve before recommending making a loan.*

It is worth stressing, first, that the structure and substance of the Bank's lending operations are different from those of commercial banks. The Bank's loans are tied to specific projects or economic programs that are evaluated on the basis of their financial and economic soundness. The projects must produce acceptable rates of return and must be of high priority in a country's overall economic development program.

A broad spectrum of projects is financed by the Bank. The projects are in sectors such as agriculture and rural development, industry, power, telecommunications, transportation, education, urban development, water supply and sewerage, and so forth. The Bank does not lend in support of military or political objectives, or for the purpose of facilitating exports of any particular industrialized country.

Of the $61.1 billion equivalent in loans committed by the World Bank over the last three and a half decades, about $11.3 billion has been repaid. Disbursed and outstanding loans held by the Bank on September 30, 1980 amounted to over $27.2 billion and a further $24.8 billion of committed loans had not yet been disbursed. These commitments will be disbursed, over time, as the appropriate documentation for financed goods and services is received and audited. It typically takes six or seven years to disburse fully a loan after commitment.

The breakdown, by sector, of the Bank's total loans approved through September 30, 1980 is:

* A fuller description of the World Bank's lending policies is contained in an article, "The Project Cycle," by Warren C. Baum, which is summarized in this section.



**Breakdown, by Sector, of World Bank Loans**
(as of September 30, 1980)

| Purpose | | Amount committed (in US$ millions) | % of total |
|---|---|---|---|
| Agriculture and rural development | | $12,552.0 | 21 |
| Education | | 2,143.4 | 3 |
| Energy | | 728.5 | 1 |
| Industrial development and finance | | 4,420.4 | 11 |
| Industry | | 5,074.5 | 8 |
| Nonproject | | 2,716.1 | 4 |
| Population and nutrition | | 226.8 | — |
| Power | | 11,969.8 | 20 |
| Technical assistance | | 41.6 | — |
| Telecommunications | | 1,263.8 | 2 |
| Tourism | | 363.6 | 1 |
| Transportation | | 13,093.5 | 21 |
| Urban development | | 1,158.4 | 2 |
| Water supply and sewerage | | 2,783.2 | 5 |
| Loans to IFC | | 550.0 | 1 |
| Total original loans committed | | 61,085.6 | 100 |
| Net adjustment for cancelled loans, loan sales to third parties, and exchange rate adjustments | | 2,264.1 | |
| | | 63,349.7 | |
| Of which not yet disbursed: | | | |
| Effective loans | 19,418.3 | | |
| Noneffective loans | 5,380.8 | 24,799.1 | |
| Of which repaid: | | 11,314.2 | |
| Total disbursed and outstanding loans | | 27,236.4 | |

### *Project Identification and Preparation*

The projects financed by the Bank must make financial and economic sense. The project cycle is a unique activity by which the Bank assists beneficiaries of its loans to prepare and implement projects within the context of agreed development objectives. It is the framework within which a long-term working relationship develops between the Bank and the borrower, and by which the Bank controls the progress of its projects and the quality of its outstanding loan portfolio. An understanding of that process is fundamental to an evaluation of the Bank's credit.

The first stage of the cycle identifies high-priority projects that appear suitable for Bank financing and that are compatible with the borrowing country's development policy. Project identification is accomplished through economic and sectoral reviews that establish overall priorities and through cooperation with government and parastatal agencies, as well as with cooperatives, private business and organizations, and other domestic groups targeted for support. The project must support activities recognized by the government as being of high priority. Once projects are identified, they are incorporated in the Bank's tentative five-year lending program for the country, thus constituting the project pipeline for that country. The Bank typically finances, on the average, 30 percent of the project costs. The balance is financed by the country's own internal resources or other means of external finance.

When a project is in the pipeline, the prospective borrower and the Bank enter into a phase of close cooperation. Preparatory work is usually undertaken within the country by the government or its executing agency; in most cases, however, the Bank will assist in the preparation process, identify the main issues, and set the timetable for further project development. Preparatory work covers the whole spectrum of technical, economic, financial, and institutional aspects of the project design and its objectives. It may be a lengthy process; however, the time devoted is justified in that it constitutes a crucial screening process and establishes the soundness of the venture.

### *Appraisal and Negotiation*

The next step is carried out directly by the technical and economic staff of the Bank. Appraisal falls completely within the Bank's responsibility and deals with four main aspects of the project—technical, institutional, economic, and financial. The Bank is responsible for sound project design and engineering. Alternative solutions are examined to achieve the most favorable results at the lowest possible cost. It is the appraisal stage at which the project is formally presented to the Bank's management for final decisions on its structure, technical features, and operational issues. The Bank's policy on project formulation strives to obtain a cost-benefit relationship compatible with the efficient use of scarce resources and with prices reflecting real economic values.

It is at this stage that the Bank and borrower meet to resolve outstanding project and policy issues. The agreements reached between the Bank and the borrower are reflected in legal documents with covenants and responsibilities covering all aspects of project execution. Once negotiations are completed, the appraisal report is completed; its contents are summarized in a President's report that, along with



loan documents, is presented to the Bank's Executive Directors for approval. The entire process from project identification to final approval usually takes about 18 months.

### *Supervision, Procurement, and Disbursement*

The Bank staff supervise and monitor current operations to ensure their sound execution. First, projects are fully supervised on site at least once a year, although Bank staff will review specific aspects of project operations in the field on the average of two to three times a year, depending on the complexity of the operation and the economic environment. Usually Bank staff will advise on technical and managerial matters to facilitate construction or other types of operations. Equipment purchased under a Bank-financed loan is examined and the borrowers' records and accounts are reviewed. The Bank seeks to maintain a continuing discussion aimed at the early identification and resolution of problems. The borrower is required to submit periodic reports on the progress of the project.

The Bank controls disbursements on its loans. The proceeds of loans are not simply conveyed to a borrower at the time of loan signing. This, too, distinguishes lending procedures of the Bank from those of conventional commercial institutions. Applications to disburse loan proceeds are carefully scrutinized and monitored to ensure that the goods and services procured are quantitatively and qualitatively acceptable and conform to the schedule of project operations covered in the legal agreements. Bidding on contracts is pursuant to international competitive bidding under procedures supervised by the Bank.

A typical Bank loan takes six to seven years to disburse. Since the Bank does not pay out the loan immediately, but credits it to a loan account, loan proceeds are disbursed either against an application for reimbursement accompanied by documentation provided to the Bank proving payment for items and/or services, or are made directly by the Bank to suppliers of equipment or services based on an application supported by contracts, purchase orders, or other evidence corresponding to authorized purchases specified under the loan agreement. The Bank's staff is specifically charged with reviewing applications for disbursement of loans and authorizing disbursement on loans.

### *Program and Structural Adjustment Lending*

The Bank has had a long policy of making nonproject loans. These loans, representing less than 4 percent of total Bank lending in fiscal year 1980, consist of program and import loans in support of specific national development aims and sectoral development objectives.

Structural adjustment lending is considered in those situations in which a serious deterioration in a member country's balance of payments has occurred or can be anticipated, and when the deterioration is due principally to factors that are not likely to be reversed easily or quickly. Obviously, countries may experience balance of payments difficulties for many reasons that cannot, in practice, always be separated with any degree of accuracy. A precondition to structural adjustment lending is the willingness of the government to formulate a suitable economic program. Such a program may involve changes in the balance between import substitution and export promotion as, for instance, an expanded effort to develop domestic energy resources and improve the efficiency of their use; it may involve changes in policies or institutions, e.g., stricter guidelines on the profitability of investment and improved capacity to evaluate projects; or it may involve changes in the composition of investments to emphasize more effective utilization of existing capacity and quick-yielding investments.

The purpose of lending for structural adjustment is to support those programs that seek to reorient production and investment allocations in the light of changed economic circumstances and thus, over the longer term, to help reduce current account deficits to sustainable levels. Support for structural adjustment programs should also help to catalyse other sources of external capital.

The major safeguard for the Bank in such lending is that satisfactory policy performance under an agreed program of action is a precondition for subsequent structural adjustment lending. If conditions warrant, and the Bank's analysis demonstrates that the appropriate safeguards can be maintained, structural adjustment lending could come to constitute about 10 percent of the Bank's outstanding portfolio. The focus and objectives of such lending are to complement and render more effective the framework for traditional project loans, rather than to substitute for the project approach.

### *Creditworthiness*

Quite understandably, even after recognition of the attention to the quality of project appraisal and implementation, potential lenders sometimes raise questions about the creditworthiness of the governments to which the Bank lends. After all, the Bank lends only to governments (or under government guarantees), and, ultimately, it is



those governments that must have the foreign exchange to meet their debt-service obligations. I will not pretend that the Bank can predict with certainty which borrowers 10, 15, or 20 years from now will be creditworthy. What I can do here, briefly, is describe what the Bank's several hundred economists and financial analysts look at in evaluating the creditworthiness of a potential borrower.

The process assesses the appropriateness and soundness of country management, sectoral and macro-economic policies, factors bearing on social development, financial policies, monetary stability, fiscal base, levels of technology, export performance, balance of payments position, external debt, foreign exchange earnings, import dependence, the structure of resource allocation, prospects for external aid from other sources, and the budget process and expenditure control system.

Thus, the Bank examines a country's reliance on trade and whether it can feasibly curtail imports in order to conserve scarce foreign exchange for other higher-priority requirements and service debt obligations. The Bank also reviews the country's relative commitment of resources to productive and service-oriented projects. The Bank insists on, and has the right to obtain, this information. In fact, the depth of the Bank's country evaluations is rarely equalled by commercial lending institutions.

A significant portion of the World Bank's staff is committed to determining whether a country will be able to service its debt. Much time, effort, energy, and intelligent thought goes into making appropriate decisions as to the extent of eligibility for a Bank loan at market rates. And, if sufficient doubt exists, the country does not, and will not, receive a loan from the Bank. The country may be eligible for assistance from IDA, a source of concessional funds, or, in appropriate cases, it may be possible to "blend" World Bank and IDA resources. But in no case will countries whose debt-servicing capacity and prospects are insufficient receive a Bank loan. The Bank, unlike IDA, as described later, relies, for the most part, on market borrowings to finance its lending; and it cannot, and does not, make loans under circumstances that, even at the margin, involve an inappropriate or imprudent risk.

### *Loans as an Earning Asset*

Although most Bank loans are disbursed over six to seven years, the interest rate applicable to those loans is set at the time the loan is approved by the Bank's Executive Directors and remains unchanged over the life of the loan. The rate is based on a spread of 50 basis points over the marginal cost of the Bank's borrowed resources—specifically, the previous six months' and projected next six months' average cost of borrowings. At the time the Bank makes a loan, neither the Bank nor its borrowers knows what currency or currencies will actually be disbursed. The Bank, as a practical matter during the disbursement period, uses a number of currencies that are available to it, either from its liquidity or the funds that it is then borrowing.

Although the interest rate on World Bank loans is fixed for the entire life of the loan, it is the Bank's practice to review the interest rates on new loans—to be made over the succeeding six months—and to set a new interest rate on such loans, if appropriate, according to the formula set forth earlier in this text. This procedure permits the Bank to adjust the rate on new loans in a way that is consistent with changes in the marketplace. And, while there is a lag between the time of setting the interest rate for a particular loan and the cost of borrowing funds at the time of disbursement, the large base of fixed loans already in the portfolio, together with the Bank's substantial equity, permits it to manage its income over a period of time so as to maintain or increase its reserves and retain market support.

A typical World Bank loan consists of a four-year grace period on the principal and repayments of principal over a period of 17 years. Interest is paid semi-annually by the borrower on the disbursed balance of the loan in each currency outstanding. Since the Bank may not take any currency risks with respect to its borrowings, the loss or gain of currency appreciation or depreciation is borne by the borrowers. In addition, the Bank charges a commitment fee of 0.75 of 1 percent on the undisbursed balance of the loan. A further description of these matters is set forth in Section Five on "Profitability."

### *Loan Portfolio Experience*

What has been the financial experience of the Bank with respect to its loan portfolio? The Bank has not had *any* losses on loans. The Bank has never had a write-off of a loan. The Bank has never had a nonaccruing loan. The Bank has a firm policy against rescheduling its outstanding loans: The Bank does not change the terms of loans or stretch out principal payments or "refinance" a maturity. The project/program concept described previously does not permit such action. The Bank, in short, does not write blank checks, either for development, or to permit countries to service their debt.

Borrowers meet their obligations to the Bank in a timely fashion.



At September 30, 1980, of the $27.2 billion in loans disbursed and outstanding, only $900,000 in interest charges—no principal—was over 60 days late. And all that amount was paid up by December 31, 1980. Over $2.9 billion in interest charges, commitment fees, and principal payments were received during the Bank's fiscal year that ended June 30, 1980. And while the Bank's financial statements include a "general reserve," that item constitutes, in fact, its accumulated retained earnings. The Bank has no actuarial basis for "reserves" simply because the Bank has never had to write-off a loan. That is not to say that we never will have a "bad" loan. But borrowers have, in fact, seen fit to maintain impeccable financial relationships with the World Bank.

There are substantial pragmatic reasons why borrowers do not default on World Bank loans. In the event of a default, no further disbursement would be made on that loan or any other loan outstanding but not yet disbursed to the country. And, no new loans would be committed until the default had been made up. Borrowers know our policies in this regard, and given the substantial amount of the Bank's undisbursed loans, they would be extremely reluctant to take steps to jeopardize the transfer of future resources.

A default to the Bank also carries serious consequences that would affect the international credit of the country involved, both with other countries and with commercial suppliers of resources. If, for example, principal or interest payments on loans are even 30 days late, the Executive Directors of the Bank, representing all 139 member governments, are formally notified of this delinquency.

As noted, the Bank, after 34 years of lending, has yet to experience a write-off on a loan. We have seen numerous changes of governments in countries, including changes by armed revolution, coup, and assassination. Without exception, however, the successor governments have honored their predecessors' obligations to the Bank. This attitude, I suggest, is engendered not only by the sanctions inherent in a default to the Bank, but also by the Bank's nonpolitical approach to the granting of loans and by the fact that Bank loans contribute materially to a country's economic stability and growth.

I think it is also fair to say that borrowers trust the World Bank. They trust its objectivity and its commitment simply to do the right thing. Borrowers want to maintain a relationship with an institution that does not attach political strings to loans and that has a competent body of professionals whose role is to make decisions strictly on economic and financial grounds. I have no doubt that, for some borrowers, it is that pool of intelligence and the objectivity of the Bank's technical advice that are as important as the actual transfer of monetary resources. Borrowers know that those resources will no longer be available to them should their relationship with the Bank become less than impeccable.

## Section Two: *Borrowing Operations*

The World Bank's borrowing operations constitute the major source for financing its lending program. The Bank borrows about 70 percent of what it lends. The aggregate of the Bank's borrowings in the six fiscal years 1975-80 was about $30 billion, compared with $8.6 billion in the preceding six years. Its outstanding debt rose from $12.3 billion in 1975 to $29.7 billion at September 30, 1980. The higher rate of borrowing in the capital markets supported the World Bank's financial requirements that resulted from the expansion in its lending operations during the period.

### *Borrowing Policies*

The Bank's basic borrowing policy is to diversify the markets for its obligations in order to avoid undue dependence on one particular market. The Bank's obligations are held by investors in more than 100 countries in Africa, Asia and the Pacific, Europe, the Middle East, and North and South America. The Bank is the largest nonresident borrower in virtually all countries where its issues are held.

When the Bank first borrowed in 1947, the only major market open to it was the United States. It was there that most borrowed funds were raised through the 1950s. Beginning in 1950, the Bank started to develop markets for its securities in other countries and, in that decade, it raised funds in Belgium, Canada, the Federal Republic of Germany, the Netherlands, Switzerland, and the United Kingdom. As world trade and finance recovered from the effects of World War II, the Bank pressed, in the late 1960s and the 1970s, to establish a substantial and widespread market for its securities outside the United States—both with the traditional private institutional markets and with governments and their agencies that had funds to invest.

The shifting pattern of savings and foreign exchange since the mid-1960s was thus reflected in corresponding shifts in the major



sources of funds for the Bank. The Federal Republic of Germany was the principal source in the late 1960s, Japan in the early 1970s, certain members of the Organization of Petroleum-exporting Countries (OPEC) in 1974, and the United States in 1977. In fiscal years 1976 and 1977, the Bank raised the majority of its funds in the United States, Germany, and Switzerland. In fiscal years 1978, 1979, and 1980, substantial borrowings were executed in Swiss francs, Deutsche mark, and Japanese yen, reflecting the demand of nonresident investors. The Bank has developed the flexibility to select the markets and currencies that will allow most favorable borrowing conditions and has lessened its dependence on any particular market.

The Bank's securities are today denominated in 17 different currencies. As shown in the accompanying table, while the US dollar historically has been the currency of choice for World Bank borrowings, in recent years, the Deutsche mark, Swiss franc, and Japanese yen have financed most of the Bank's increasing requirements. The cost of the Bank's outstanding debt essentially has remained unchanged since 1975—the implications of which are described later.

The diversity of the Bank's borrowings is unique. Since 1970, the Bank has borrowed, through public issues or private placements, in Austria, Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, Lebanon, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, Yugoslavia, and in the Eurobond market, as well as in OPEC countries. In many, if not most, of these countries, the Bank has access to markets beyond that accorded other nonresident borrowers.

### *Borrowing Program*

Given the diverse mix of the Bank's borrowings by country and currency, it may be useful to examine what the Bank looks at in deciding where, when, what, and how much to borrow. The Bank does not borrow at random. Given the life of its outstanding loans, it aims to have an average life at fixed interest rates of eight to ten years for its debt. It seeks to achieve this goal after taking into account direct placements (which use no financial intermediaries) of two- to six-and-one-half-year bonds or notes with central banks. These direct placements are continually refinanced, but because of their rather short-term nominal maturity, the Bank offsets these borrowings with 10-year to 15-year or even 20-year resources.

The Bank is prepared to give long-term call protection with respect to public issues. It will adjust sinking funds and amortization to meet

## Outstanding Borrowings, by Currency of Borrowing
(in millions of US$ equivalents)

| Currency | 1975* | 1976* | 1977* | 1978* | 1979* | 1980* | As of September 30, 1980 |
|---|---|---|---|---|---|---|---|
| United States dollars | $ 5,692.5 | $ 7,151.1 | $ 9,172.9 | $ 9,847.8 | $ 9,733.0 | $ 9,819.4 | $ 9,396.1 |
| Austrian schillings | — | — | — | — | — | 80.0 | 78.0 |
| Belgian francs | 80.8 | 70.9 | 75.4 | 80.0 | 85.3 | 80.7 | 78.2 |
| Canadian dollars | 145.3 | 153.8 | 129.4 | 110.2 | 93.9 | 59.9 | 58.7 |
| Deutsche mark | 2,858.7 | 3,198.8 | 4,493.5 | 5,687.8 | 7,061.1 | 8,809.7 | 9,118.8 |
| French francs | 37.1 | 30.6 | 28.8 | 28.5 | 29.5 | 29.3 | 26.5 |
| Italian lire | 95.2 | 71.4 | 50.9 | 52.6 | 51.6 | 47.4 | 41.8 |
| Japanese yen | 1,500.9 | 1,495.0 | 1,652.9 | 2,919.1 | 3,515.7 | 4,133.7 | 4,268.8 |
| Kuwaiti dinars | 422.7 | 390.6 | 373.2 | 352.6 | 310.5 | 278.9 | 271.8 |
| Lebanese pounds | 33.7 | 30.5 | 24.4 | — | — | — | — |
| Libyan dinars | 135.1 | 101.3 | 101.3 | 101.3 | 101.3 | 101.3 | 101.3 |
| Netherlands guilders | 195.9 | 313.3 | 335.2 | 403.1 | 426.0 | 426.7 | 417.7 |
| Pounds sterling | 34.9 | 27.6 | 8.9 | 9.0 | 9.8 | 9.9 | 10.0 |
| Saudi Arabian riyals | 143.3 | 141.6 | 141.6 | 145.1 | 148.2 | 150.2 | 150.6 |
| Swedish kronor | 38.1 | 33.7 | 33.5 | 31.7 | 31.5 | 30.1 | 30.0 |
| Swiss francs | 673.1 | 1,237.0 | 1,655.1 | 2,635.2 | 4,485.3 | 5,427.9 | 5,501.1 |
| United Arab Emirates dirhams | 76.0 | 76.0 | 77.0 | 77.4 | 79.0 | 72.9 | 73.2 |
| Venezuelan bolivares | 123.7 | 123.5 | 123.5 | 121.1 | 118.8 | 109.5 | 101.3 |
| Totals | $12,287.0 | $14,646.7 | $18,477.5 | $22,602.5 | $26,280.5 | $29,667.5 | $29,779.1 |
| Weighted average effective interest rates** | 7.14% | 7.41% | 7.40% | 7.24% | 7.06% | 7.23% | 7.27% |

*As of June 30.
**These rates reflect the cost of borrowings established at the date of issues.



fully the requirements of the buyers of its securities. It is also prepared to accept delayed delivery of funds for as long as one or possibly two years.

The Bank does not favor public issues over private placements. For example, of approximately 30 to 50 different issues a year, fewer than 10 are listed or traded in public markets. The remainder are placed with governments or central banks or through private placements with the investment banking community.

The Bank does not take a currency risk on its borrowings: Pending disbursement, the Bank holds, as part of its liquidity, the currencies it has borrowed. As noted in the previous section, when it disburses these funds, the Bank disburses to its borrowers the currencies borrowed and borrowers repay their loans, and pay interest thereon, in the same currencies as those originally disbursed by the Bank. Borrowers are lent a variety of different currencies over the six- or seven-year disbursement period.

The Bank, however, acts as if it took the currency risk. That is, it calculates the implicit revaluation potential of a currency borrowed against the interest rate differential of other major currencies. Thus, if the cost of a Swiss franc borrowing is 5 percent for 10 years and the cost of a US dollar issue is 12 percent for a similar maturity, a rather simple formula tells us that the implicit revaluation of the Swiss franc over 10 years, which would offset the favorable nominal interest rate differential, is 91 percent. Thus, if we think that the dollar will not devalue more than 91 percent over the succeeding 10 years, we borrow Swiss francs. If, on the contrary, we believe that the dollar is likely to devalue by more than 91 percent, we will borrow US dollars. It is not a random choice.

One of the principal reasons why the Bank borrowed almost exclusively in Deutsche mark, yen, and Swiss francs in recent years is that it was our belief that the dollar, given the interest rate differentials vis-a-vis these currencies, was undervalued. This does not mean that we believed that the dollar would not devalue at all. Rather, we did not believe the dollar would devalue by as much as the interest rate differential implied. For the Bank's borrowers, the gain from this policy has been considerable—in the hundreds of millions of dollars in recent years—since the Bank's borrowers have had the advantage of both a low nominal interest rate and a revaluation gain in terms of dollars. Clearly, however, we do not know whether future movements of the US dollar vis-a-vis these other currencies will be

**Classification of Bank Debt, by Category of Holders**
(as of June 30, in US$ millions)

| | US dollars | % of total | Other currencies | % of total | Total | % of total |
|---|---|---|---|---|---|---|
| **1980** | | | | | | |
| Central banks or government accounts | $3,371.5 | 34.3 | $ 4,525.8 | 22.8 | $ 7,897.3 | 26.6 |
| Other holders | 6,447.9 | 65.7 | 15,322.3 | 77.2 | 21,770.2 | 73.4 |
| Total outstanding debt | $9,819.4 | 100.0 | $19,848.1 | 100.0 | $29,667.5 | 100.0 |
| **1979** | | | | | | |
| Central banks or government accounts | $3,678.0 | 37.8 | $ 4,077.6 | 24.6 | $ 7,755.6 | 29.5 |
| Other holders | 6,055.1 | 62.2 | 12,469.9 | 75.4 | 18,525.0 | 70.5 |
| Total outstanding debt | $9,733.1 | 100.0 | $16,547.5 | 100.0 | $26,280.6 | 100.0 |
| **1978** | | | | | | |
| Central banks or government accounts | $3,676.1 | 37.3 | $ 3,678.2 | 28.8 | $ 7,354.3 | 32.5 |
| Other holders | 6,171.7 | 62.7 | 9,076.5 | 71.2 | 15,248.2 | 67.5 |
| Total outstanding debt | $9,847.8 | 100.0 | $12,754.7 | 100.0 | $22,602.5 | 100.0 |
| **1977** | | | | | | |
| Central banks or government accounts | $3,659.0 | 39.9 | $ 2,784.5 | 29.9 | $ 6,443.5 | 34.9 |
| Other holders | 5,513.9 | 60.1 | 6,520.2 | 70.1 | 12,034.1 | 65.1 |
| Total outstanding debt | $9,172.9 | 100.0 | $ 9,304.7 | 100.0 | $18,477.6 | 100.0 |



in a direction that will offset the lower nominal interest rate advantage afforded by such other currencies.

### *Markets of Borrowings*

The World Bank sells its securities in two main categories of markets: First, it places its bonds and notes directly with its member governments, their agencies, or central banks. Second, it offers its issues to investors in the private investment markets through the medium of investment banking firms, merchant banks, or commercial banks. During the five fiscal years 1976 to 1980, the World Bank borrowed from governmental sources in some 95 of its member countries and has sold its securities through underwriters in markets of five countries. A breakdown of the Bank debtholders among governments (or central banks) and private holders—mainly institutional holders—during fiscal years 1977 to 1980 is shown in the accompanying table on page 16.

The widespread holdings of the Bank's obligations by member countries and their central banks, which represented about 27 percent of its total outstanding debt at the end of fiscal year 1980, reflect their support for the Bank's development activities and their assessment of its credit. The diversification through direct placement with governments or central banks has given the Bank increased flexibility in its borrowing program by providing a stable and permanent source of resources at market-based terms.

A breakdown of outstanding Bank obligations held by investors (as distinguished from currencies) indicates that a large amount of the Bank's debt is concentrated in five sources: the United States, the Federal Republic of Germany, Japan, Switzerland, and OPEC.

### *Borrowing Costs and Debt Structure*

The Bank's obligations carry a "Triple A" rating or equivalent at the principal bond rating services in the United States. Outside the United States, governments typically prefer that sales of World Bank issues be set at yield levels that are comparable to those obtainable on government-backed issues of similar maturity.

As noted before, the Bank's borrowing costs have remained relatively stable despite the continued increase in the volume of its borrowings, reflecting the Bank's ability to attract funds in many international markets and currencies—and because the flexibility provided by its liquidity permits the Bank to avoid capital markets during periods of instability or excessively high rates. The average

## Classification of Outstanding Debt, by Source of Borrowing

(as of June 30; in US$ billions)

| | Total (%) 1977 | 1978 | 1979 | 1980 | Total 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|
| United States | 27.92 | 25.72 | 21.68 | 18.01 | $ 5.2 | $ 5.8 | $ 5.7 | $ 5.4 |
| Germany | 23.51 | 24.33 | 25.41 | 27.72 | 4.3 | 5.5 | 6.7 | 8.2 |
| Switzerland* | 7.99 | 10.60 | 15.53 | 15.94 | 1.5 | 2.4 | 4.1 | 4.7 |
| Japan | 9.06 | 13.03 | 13.49 | 14.07 | 1.7 | 2.9 | 3.6 | 4.2 |
| OPEC** | 19.74 | 16.65 | 15.38 | 14.17 | 3.6 | 3.8 | 4.0 | 4.2 |
| Other | 11.78 | 9.67 | 8.51 | 10.09 | 2.2 | 2.2 | 2.2 | 3.0 |
| | 100.00 | 100.00 | 100.00 | 100.00 | $18.5 | $22.6 | $26.6 | $29.7 |

*Switzerland is not a member country of the Bank.
**Of which:

| | Total (%) 1977 | 1978 | 1979 | 1980 | Total 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|---|---|---|
| Saudi Arabia | 7.56 | 6.39 | 5.81 | 5.58 | $ 1.4 | $ 1.4 | $ 1.5 | $ 1.7 |
| Kuwait | 3.11 | 2.50 | 2.04 | 1.88 | 0.6 | 0.6 | 0.5 | 0.6 |
| Libya | 1.15 | 1.30 | 2.06 | 1.70 | 0.2 | 0.3 | 0.5 | 0.5 |
| Venezuela | 2.98 | 2.41 | 2.05 | 1.67 | 0.5 | 0.5 | 0.5 | 0.5 |



## Historical Borrowing Costs

| | 1975* | 1976* | 1977* | 1978* | 1979* | 1980* | As of Sept. 30, 1980 |
|---|---|---|---|---|---|---|---|
| | % | | | | | | |
| Average cost of: | | | | | | | |
| Borrowings executed in period | 8.16 | 8.17 | 7.46 | 6.73 | 6.22 | 8.24 | 8.20 |
| All borrowings outstanding during period** | 7.06 | 7.32 | 7.53 | 7.45 | 7.21 | 7.28 | 7.35 |
| Total borrowings and other funds (equity) available during period | 4.96 | 5.43 | 5.96 | 6.09 | 5.98 | 6.00 | 6.05 |

*Fiscal years ended June 30.
**Cost of borrowings as a percentage of average borrowings outstanding during fiscal period.

## Maturity Structure of Outstanding Borrowings

(in US$ billions)

| | 1975* | Total (%) | 1976* | Total (%) | 1977* | Total (%) | 1978* | Total (%) | 1979* | Total (%) | 1980* | Total (%) | As of Sept. 30, 1980 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 year | $ 1.3 | 10.6 | $ 1.4 | 9.5 | $ 1.4 | 7.6 | $ 1.7 | 7.5 | $ 2.5 | 9.5 | $ 2.7 | 9.1 | $ 2.4 | 8.1 |
| 2-5 years | 4.0 | 32.5 | 5.2 | 35.4 | 6.8 | 36.7 | 9.3 | 41.2 | 10.2 | 38.8 | 12.4 | 41.8 | 12.7 | 42.8 |
| 6-10 years | 4.2 | 34.1 | 5.5 | 37.4 | 7.3 | 39.5 | 7.8 | 34.5 | 9.3 | 35.4 | 9.1 | 30.6 | 8.8 | 29.6 |
| 11 or more years | 2.8 | 22.8 | 2.6 | 17.7 | 3.0 | 16.2 | 3.8 | 16.8 | 4.3 | 16.3 | 5.5 | 18.5 | 5.8 | 19.5 |
| Total | $12.3 | 100.0 | $14.7 | 100.0 | $18.5 | 100.0 | $22.6 | 100.0 | $26.3 | 100.0 | $29.7 | 100.0 | $29.7 | 100.0 |

Note: Most of debt maturing in less than six years held by central banks has virtually always been refinanced.
*As of June 30.

cost of all the Bank's outstanding borrowings, totaling $29.7 billion as of September 30, 1980, was 7.35 percent. It should be noted, however, that because of its large equity base, the cost of its total resources —borrowings *plus* paid-in capital and reserves—was only 6.05 percent. The table at the top of page 19 sets forth the Bank's borrowing costs and its costs of total funds.

As noted in the previous section, the cost of the Bank's new borrowings is directly reflected in the charges the Bank levies on the new loans it makes. The interest rate to be charged on loans submitted to the Bank's Executive Directors after January 12, 1981 was set at 9.60 percent. At least once a year, and more often if necessary, the Bank's lending rate is adjusted so as to achieve a spread of approximately 0.5 of 1 percent a year above its marginal cost of borrowing for the most recent and prospective six-month period.

The average life of the Bank's outstanding debt as of September 30, 1980 was 6.24 years. The average life of its outstanding public debt, however, was 7.23 years. The nonpublic borrowings from governments and central banks are carried at an average maturity of 3.49 years. These are not, however, "short-term" borrowings. If experience over the last 23 years is a fair guide, it is reasonable to expect that these placements with central banks, including particularly the two- to six-and-one-half-year issues (the Deutsche Bundesbank, The Bank of Japan, the World Bank's US dollar Central Bank Issues and its Swiss franc Central Bank Issues) will be refinanced at maturity. These issues have been consistently refinanced at interest rates prevailing for government obligations. It is expected that the Bank's placements with "official" institutions amount to permanent debt with the interest rate for particular issues fixed periodically.

The maturity structure of the Bank's debt may be compared with the average life of its outstanding loans receivable—9.12 years at September 30, 1980. Thus, the Bank is a relatively long-term lender and borrower at fixed interest rates. That lending is also financed by paid-in capital and retained earnings, aggregating $7.7 billion, that provides "infinite maturity" resources. If intermediate or longer maturities were not available for an extended period at rates compatible with our lending rate, the Bank would draw down its liquidity until the market stabilized. And, if the markets for fixed-rate obligations remained unstable for a prolonged period of time—say, several years—the Bank would use the further option of reducing its lending program, and, thereby, its future cash requirements. Alternatively, the



Bank would either raise the interest rates on new loans to the point that it could prudently borrow intermediate- and longer-term resources at higher costs or borrow at floating or variable rates and, to the extent necessary, pass those costs on to its borrowers.

## Section Three: *Capital Structure*

The capitalization of the World Bank is not complex; nonetheless, it is frequently misunderstood.

The World Bank's capital structure is composed of subscribed capital and net accumulated earnings (reserves). Subscribed capital, the largest portion of the Bank's equity base, in turn, is divided into two parts—"paid-in capital" and "callable capital."

### *Capital Structure Characteristics*

Two features of the Bank's capitalization are of central importance to its strength as a financial institution.

The first is the limit it imposes on the Bank's lending. Under the Bank's Articles of Agreement, the Bank's *outstanding and disbursed loans* must not exceed its subscribed capital and reserves—i.e., a ratio of "one-to-one." Risk assets of commercial institutions, on the other hand, often exceed 15 to 20 times their equity base. A binding ceiling, therefore, is placed on the level of outstanding Bank loans—its risk assets. The Bank's lending operations, therefore, are limited by the size of its capital base. Even if the Bank were to borrow unlimited amounts, it could not, under its Articles of Agreement, disburse those funds on loans since the founders of the Bank made a conscious decision to restrict the Bank's lending operations not to how much it could borrow but, rather, in relation to its capital and reserves—and, in an extraordinarily conservative way, by restricting those loans to its equity base. Currently, the Bank has $27.2 billion of loans outstanding against subscribed capital and reserves of $44.3 billion—a ratio of 0.61 to 1.

The second feature of the Bank's capital is the distinction and role of "paid-in capital" and "callable capital."

**Paid-in capital** is that portion of the subscribed capital that is actually paid to the World Bank by its members and is available for use in its general operations. It represents only 10 percent of the World Bank's subscribed capital and, in essence, is the paid-in equity interest of its member governments, thereby constituting a permanent capital contribution. At September 30, 1980, total paid-in capital amounted to approximately $4.1 billion.

No dividends have been paid to the Bank's stockholders. The paid-in capital contributes materially to the net profits of the Bank. Since 1948, the Bank has made a profit in every single year. By September 1980, it had retained earnings of about $3.6 billion, which were added to its resources. This was a net amount, *after* approximately $1.5 billion had been transferred in grants from the Bank's net income to its affiliate, the International Development Association (IDA).

The sum of the Bank's paid-in capital and accumulated net profits —after grants to IDA—is about $7.7 billion. Since the cost of the funds the Bank *borrowed* as of September 30, 1980 was 7.35 percent, the cost to the Bank of *all* funds (borrowed funds plus paid-in equity) at September 30, 1980 was reduced to 6.05 percent, reflecting a ratio of approximately $7.7 billion of paid-in equity to $29.7 billion of debt—a debt-equity ratio of about 3.9 to 1. These cost-free funds (the paid-in capital and accumulated earnings) provide considerable leverage. The profit produces reserves. The Bank pays strict attention to these reserves—retained earnings, if you will—to provide protection for its bondholders.

**Callable capital** constitutes the remaining 90 percent of the World Bank's subscribed capital. The World Bank's "callable" capital, unlike the paid-in portion, may not be used in its operations for disbursements, or for administrative expenses. It is solely for the protection of its bondholders and can *only* be used for that purpose. The Bank's Articles of Agreement require that it call, to the extent necessary, "callable capital," if it is unable to meet its debt obligations in full out of its other assets. In the event of a call on capital, all members must meet it up to the full amount of the members' subscription. Failure by one or more members to honor the obligation to pay does not relieve any other member from its obligation to meet a call. Moreover, if the amount received on a call is insufficient to meet the Bank's obligations, then it must issue further calls until it has the necessary amount to satisfy the obligations. With the addition of $36.7 billion in callable capital, which is solely available to protect the holders of World Bank obligations, the effective equity base (inclusive of callable capital) behind the Bank's risk assets rises to $44.3 billion. Whichever capital base is used—in the case of the



Bank, both are appropriate—the ratio of debt or risk assets to equity is extraordinarily low.

I must confess that the Bank has been unable to envision a chain of events that would trigger a call on the "callable capital." First, management, on recognizing the prospect of a cash requirement extending beyond the time frame of its liquidity position—currently over $9 billion—would most certainly reduce new lending and, thereby, reduce future calls on its liquidity. Further, given its liquidity position, the long maturity of much of the Bank's debt, the large and stable cash inflows to the Bank from interest and principal payments, and its large equity base, the amount of a call on capital would be but a fraction of total callable capital.

Since, however, the only risk that can prompt any call, albeit small, is a failure to maintain market support, we can see why member stockholders who have "callable capital" at risk: (a) have given the Bank access to markets; and (b) have insisted that the Bank conduct its affairs in such a way that it will remain a prime credit in the marketplace. Voting power in the Bank is determined by the capital contribution (paid-in and callable) of its member countries.

A final, rather technical point about the callable capital deserves comment. Payments of calls may be made, at the member's option, either in gold or in US dollars, *or* in the currency or currencies needed to discharge the obligations for which the call was issued. The fact that the Bank's indebtedness is denominated in 17 currencies means that in the case of a country where the Bank has issued its obligations in that country's currency, a call on capital may not require a payment in foreign exchange to meet those obligations.

Despite these financial safeguards, the fact is that the Bank is operated "as if" the guarantee of callable capital for the benefit of bondholders did not exist. The Bank's shareholders insist on it. These shareholders guide the Bank's financial policies with a full understanding that their callable capital is at risk. That means that the Bank's *operating* policies concerning liquidity, diversification of sources of borrowing, the maturity of its debt, accumulation of reserves and income-generating capacity, and lending policies, including creditworthiness and project quality—all matters of proper concern to bondholders—are designed to ensure that the callable capital need never be called. That is what I mean when I speak of the existence of an identity of interest between stockholders and bondholders.

## Capitalization Review, 1975-80
(in US$ millions)

| | 1975* | | 1976* | | 1977* | | 1978* | | 1979* | | 1980* | | As of September 30, 1980 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Amount | Total capital-ization (%) | Amount | Total capital-ization (%) | Amount | Total capital-ization (%) | Amount | Total capital-ization (%) | Amount | Total capital-ization (%) | Amount | Total capital-ization (%) | Amount | Total capital-ization (%) |
| Debt outstanding | 12,287 | 27.13 | 14,647 | 30.74 | 18,478 | 35.82 | 22,602 | 38.88 | 26,280 | 39.45 | 29,668 | 40.58 | 29,724 | 40.13 |
| Equity | | | | | | | | | | | | | | |
| Reserves (retained earnings) | 2,177 | 4.81 | 2,136 | 4.48 | 2,235 | 4.33 | 2,483 | 4.27 | 2,905 | 4.36 | 3,481 | 4.76 | 3,587 | 4.84 |
| Paid-in capital | 3,082 | 6.81 | 3,086 | 6.48 | 3,087 | 5.99 | 3,305 | 5.69 | 3,743 | 5.62 | 3,996 | 5.47 | 4,075 | 5.50 |
| Total equity | 5,259 | 11.61 | 5,222 | 10.96 | 5,322 | 10.32 | 5,788 | 9.96 | 6,648 | 9.98 | 7,477 | 10.23 | 7,662 | 10.34 |
| Total debt and equity | 17,546 | 38.75 | 19,869 | 41.70 | 23,800 | 46.14 | 28,390 | 48.84 | 32,928 | 49.43 | 37,145 | 50.81 | 37,386 | 50.48 |
| Callable capital | 27,739 | 61.25 | 27,775 | 58.30 | 27,782 | 53.86 | 29,741 | 51.16 | 33,686 | 50.57 | 35,963 | 49.19 | 36,678 | 49.52 |
| Total capitalization | 45,285 | 100.00 | 47,644 | 100.00 | 51,582 | 100.00 | 58,131 | 100.00 | 66,614 | 100.00 | 73,108 | 100.00 | 74,064 | 100.00 |

*As of June 30.



The Bank's member governments, we must assume, will support policies that are consistent with their interest in promoting economic development and, indeed, their own self-interest. These are not inconsistent considerations. Ultimately, the strength of an institution such as the World Bank must rest on the support given to it by its shareholders. Given the performance of the Bank and the very real financial commitments its members have made to the institution—in the form of callable capital, paid-in resources, and the investment of their societies in the obligations of the Bank—there is every incentive for members both to support the Bank and to insist on prudent financial policies. The direct economic and political gains from a productive world are also consistent with that support.

### *Capital Increases*

As noted earlier, the Bank's ratio of equity to outstanding loans is currently 0.61 to 1, as reflected by outstanding loans of $27.2 billion and capital and reserves of $44.3 billion. Further increases in capital are contemplated. The recent history of capital increases is described in the next two paragraphs.

In May 1976, formal agreement was reached for a selective capital increase of $8.5 billion, most of which has already been subscribed.

The selective capital increase, when fully subscribed, would raise the Bank's subscribed capital to $40.75 billion. Member governments, however, have concluded that the World Bank's lending should continue to expand in real terms, for which a further increase in capital would be required. In January 1980, therefore, the World Bank's Board of Governors approved a general capital increase aimed at doubling its capital to approximately $80 billion. Of the approximately $40 billion to be subscribed under the general capital increase beginning October 1, 1981, 7.5 percent, or about $3 billion, would be paid in and the remainder of $37 billion applied towards "callable capital." Proforma, this additional capital will raise paid-in capital to about $7 billion and callable capital to about $73 billion. This additional capital should significantly enhance the protection afforded to holders of World Bank securities and, of course, will increase the Bank's lending capacity under its Articles of Agreement.

### *Future Capital Increases*

Suggestions have been made for another major capital increase to permit funds for lending beyond the levels noted in the previous paragraphs. It is too early to predict exactly the size of a further capital increase, or whether the Bank's present 1:1 ratio should be changed to, say, 2:1, by amendment of the Bank's Articles to permit it to lend, say, proforma, over $160 billion against more than $80 billion of paid-in and callable capital and reserves. Or, whether a separate affiliate might be formed with a different capital structure to accommodate increased lending beyond that permitted by the general capital increase. The precise format will surely develop over time and be fully consistent with prudent financial standards and the requirements of the marketplace. What is clear, however, is that it may be fairly said that still, after years of a substantial acceleration in lending, the Bank is an "underleveraged" institution and indeed, if anything, offers to bondholders a diverse system of protections not available elsewhere.

## Section Four: *Liquidity Policy*

No discussion about the World Bank would be meaningful without an evaluation of its liquidity. At June 30, 1980, the World Bank's short-term liquid assets—its liquid "cash" position—aggregated about $10.0 billion. That was equal to about one-third of its outstanding debt. The reason for a sizable liquid position is that the Bank wishes to maintain short-term liquid assets at a level that can adequately meet all its disbursements and debt-servicing requirements without the need to borrow new funds for a period of time, thus making it relatively independent of adverse conditions in credit markets. The policy gives the Bank, within limits, of course—possibly for as long as a year—the flexibility to decide where to borrow, how much, at what cost, and on what terms.

The Bank's liquidity is fully invested, liquid, and marketable. These investments are limited to obligations of governments (or certain government agencies) and to time deposits and other unconditional obligations of banks and financial institutions. The resources are readily available to meet financial requirements, both to service debt and disbursements on loans, which together comprise the principal demand on the Bank's cash resources.

The Bank systematically has built up its liquidity position by borrowing in excess of its current net requirements at times when resources were obtainable at what the Bank considered reasonable costs and terms to maturity. Thus, although the Bank borrows in anticipation of future requirements, it does not "fully fund" its loan commitments given the rather long disbursement period. The World



Bank's borrowing program is currently designed to maintain its liquid assets at 40 percent of its net cash requirements for the succeeding three years. The Bank's net cash requirements, in turn, are largely a function of its past and projected lending program (which is reflected in its disbursements) and the amortization of loans and debt.

The ratio of liquid assets to total debt of the Bank, a broad measure of liquidity strength, has averaged 39.4 percent during the last five years. During periods of high interest rates, the Bank draws down on its liquidity. Conversely, it is built up during periods of relatively low nominal rates by accelerating its borrowing program beyond immediate requirements.

Questions have been raised concerning the costs of this policy and the reasons for it. The advantage is simply that if the Bank does not wish to borrow resources because of the high level of interest rates or the maturities available, the Bank would draw down its liquidity to meet requirements until market conditions stabilized. In short, the Bank's liquidity position gives it the flexibility to decide where, how much, at what cost, and on what terms to maturity it will borrow, rather than have its cash requirements leave it no alternative but to borrow. The cost of carrying liquidity represents the spread between the return on these investments and the Bank's marginal borrowing costs. Suffice it to note here that the Bank's liquid investments are managed with a view to maximizing the overall financial return on its assets. Historically, that policy has resulted in a minimal cost to the Bank. Indeed, over the last five years, it has been a source of considerable profit to the Bank.

If it appeared that because of an expectation of prolonged instability in world capital markets, the Bank's liquidity might decline to an unacceptable level, the Bank could reduce its lending program. So far, no such measures have been required, nor do we expect that they will be needed. Our first line of prudence, however, is to have more liquid resources than we currently need, which can be drawn down when market conditions are unstable. If instability were to continue for long periods, the Bank would use the option of reducing its commitments, that is, its lending program.

### *Liquidity Management*

The Bank's liquid resources are actively managed. It has traded up to $120 billion a year. Since the liquidity is designed to offer flexibility, it is managed (even where there is a positive yield curve) so that the short-term investments will produce a return higher than the

**Statement of Income**
(in US$ 0,000)

| | 1976* | 1977* | 1978* | 1979* | 1980* |
|---|---|---|---|---|---|
| Income | | | | | |
| Income from loans: | | | | | |
| Interest | $ 825,191 | $ 985,271 | $1,218,443 | $1,543,471 | $1,800,996 |
| Commitment charges | 71,336 | 87,458 | 106,149 | 125,371 | 143,787 |
| Income from investments | 424,892 | 536,054 | 613,560 | 743,940 | 834,498 |
| Other income | 8,228 | 8,593 | 8,414 | 11,788 | 20,249 |
| Total income | $1,329,647 | $1,617,376 | $1,946,566 | $2,424,570 | $2,799,530 |
| Expenses | | | | | |
| Interest on borrowings | $ 977,298 | $1,251,922 | $1,541,529 | $1,817,395 | $1,975,469 |
| Administrative expenses | 122,282 | 140,802 | 148,126 | 172,027 | 197,967 |
| Bond issuance and other financial expenses | 9,950 | 14,508 | 18,726 | 28,606 | 38,193 |
| Discount on sales of loans | 264 | 694 | 74 | — | — |
| Total expenses | $1,109,794 | $1,407,926 | $1,708,455 | $2,018,028 | $2,211,629 |
| Net income | $ 219,853 | $ 209,450 | $ 238,111 | $ 406,542 | $ 587,901 |

*Fiscal years ending June 30.



marginal cost of borrowing long-term funds. We do not want holding liquidity to be costly. The rules are straightforward:

1. A security, once purchased, is always available for sale.
2. The portfolio is managed with a view toward obtaining the highest potential future financial rate of return.
3. The staff is to pay no attention to the book cost of a security after it is purchased in determining whether or not to sell it. Book cost is a past event; it tells us nothing about whether we should hold a security or sell it.
4. We ask ourselves only one question: Is the potential future rate of return greater if we hold a particular security to some specific date in the future, or is it better that we sell the security and use the proceeds for an alternative, potentially better investment?
5. We predict interest rates for five different maturities and for six different instruments, ranging from one day out to five years. We do so at probabilities of 1 in 2, 1 in 4, and 1 in 10. We seek to hold that security which has the highest probability of giving us the highest rate of return with the least amount of risk/uncertainty. Conversely, we sell those investments that have, in our view, the lowest potential return and highest risk.
6. Everything we own, we would purchase if we did not already own it. We will move the portfolio from an average life of four years down to an average life of two weeks if we think that rates are likely to rise—subject to liquidity constraints in the secondary market.
7. We measure ourselves against perfection: What would have been the rate of return if we had moved the portfolio, weekly, in hindsight, to maximize return and minimize loss?

One final point. The staff is trained to admit to error and to admit to making mistakes. We measure ourselves in terms of opportunities lost, not what our books show. In short, we admit to error and measure ourselves, in hindsight, against what would have happened if we had made the best possible decisions.

## Section Five: *Profitability*

The World Bank's profit of $588 million for the fiscal year ended June 30, 1980 was the highest in its history. It represented an increase of 44 percent over the profits of $407 million for fiscal year 1979 and substantially higher than profits in the three prior fiscal years.

The table that follows shows the primary source of the Bank's earnings and costs (as described in earlier sections of this paper) as projected for June 30, 1981.

| | Assets[1] | |
|---|---|---|
| | Amount (in US$ billions) | Return (%) |
| Cash and investments | 10.0 | 9.0 |
| Receivable from disbursed loans* | 30.1 | 8.0 |
| Total assets | 40.1* | 8.2 |

| | Liabilities[1] | |
|---|---|---|
| | Amount (in US$ billions) | Cost (%) |
| Debt outstanding | 32.6 | 7.5 |
| Reserves | 4.0 | — |
| Paid-in capital | 4.0 | — |
| Total debt, reserves, and paid-in capital | 40.6 | 6.0 |

*Including commitment fees on undisbursed loans.
[1] Other assets and liabilities constitute approximately $1.6 billion and $1.2 billion, respectively.

The next table shows the evolution of the Bank's profitability as measured by its return on capital and the spread of the cost of funds against interest on outstanding loans.

**Profitability and Debt-service Review**

| | 1976* | 1977* | 1978* | 1979* | 1980* |
|---|---|---|---|---|---|
| Net income (US$ millions) | 220 | 209 | 238 | 407 | 588 |
| Change in net income (%) | (20.0) | (5.0) | 13.9 | 71.0 | 44.5 |
| Return on average paid-in capital (%) | 7.1 | 6.8 | 7.2 | 10.9 | 14.7 |
| Cost of outstanding debt (%) | 7.3 | 7.5 | 7.5 | 7.2 | 7.3 |
| Average cost of total funds (%) | 5.4 | 6.0 | 6.1 | 6.0 | 6.0 |
| Average interest rate on disbursed and outstanding loans** (%) | 6.7 | 6.9 | 7.1 | 7.3 | 7.4 |

*As of June 30.
**Excludes 0.75% commitment fee on undisbursed loans.



Basically, the Bank's earnings are determined by its ability to adjust the charges that it makes on its new loans to conditions in the credit markets. During a period of secular rising or declining interest rates, such adjustments may have to be made rather frequently so as to avoid a condition in which the loans on its books are at levels not consistent with the cost of funding. In this connection, the return on the Bank's liquidity, over the short-run, tends to even out disparities that otherwise might occur.

Finally, and most importantly, a substantial amount of paid-in equity (paid-in capital and retained earnings), which now constitutes about $7.7 billion and on which no dividends have been paid, provides a resource that permits the Bank to earn substantial overall net profit and, just as important, maintain a charge to developing countries lower than that which, without such an equity base, might otherwise be required. Fundamentally, therefore, the spread between the 6 percent cost of funds and the 8.2 percent return on assets on a rather large base of fixed costs and assets permits the Bank both to maintain profitability and, within limits, predict how marginal changes in the cost of borrowing or its lending rate will affect future changes in its profitability.

## Section Six: *The Role of IDA*

There often is confusion about the difference between the World Bank and its affiliate, the International Development Association (IDA). IDA was established in 1960. Its purpose is to assist in financing economic development in those developing countries whose ability usefully to employ and absorb externally borrowed funds exceeds their ability to service such debt on conventional terms, including the terms of World Bank loans.

Membership in IDA is open to all members of the World Bank; 125 countries have elected to join. IDA's terms to its borrowers are concessional—50 years to final maturity and a service charge of only 0.75 of 1 percent a year. Eligible recipients of IDA credits are those poorer developing countries that have an annual per capita gross national product of $680 or less. The funds employed by IDA in its credit operations come primarily from grants from industrialized and economically developed members. In addition, an aggregate of $1.5 billion has been provided by the World Bank to IDA in the form of grants. These grants have been made from the Bank's net income in each of the fiscal years 1964-80 after prudent allocation of Bank net income to reserves. And only that portion of net income is available to IDA that otherwise might have been appropriate for dividend payments. The Bank's yearly grants to IDA account, at present, for about 3 percent of IDA's annual resources.

While IDA's terms to its borrowers are concessional, there is nothing "soft" about the credits themselves. The same rigorous standards of country and project evaluations applied to Bank loans are used in examining IDA credits. Although the borrower may not be deemed creditworthy for a Bank loan, the projects financed by IDA must have the same rate of return as a Bank project. These are not "free" loans to a society. There is no subsidy to the consumers on IDA credits and the same charges, say, for electric power or water, that must be levied on consumers in a Bank-financed project must also be levied on consumers benefiting from an IDA-financed electric power or water supply project. It is just that, irrespective of cash flow from the project, the *country* may not be able to generate sufficient foreign exchange resources necessary to service conventional debt while simultaneously pursuing valid developmental goals. Essentially, after all, countries are obliged to meet their obligations, and if they are not able to do so because of inadequate foreign exchange reserves, the domestic cash flow from, say, a power project, will be of rather limited value to external creditors who provide the finances for its construction. That is why country creditworthiness studies are basic to the operations of the World Bank.

IDA's funds, as mentioned earlier, come, for the most part, from the financially stronger governments that, on a three-year cycle, agree to replenish IDA's resources. Bondholders do not supply its resources directly or indirectly. It is important to note that if funds become unavailable for IDA operations from direct government contributions or replenishments, the World Bank would not lower its creditworthiness standards to make up for the shortfall.

The same management and staff are responsible for maintaining the operations and portfolio of the World Bank and operating the IDA program. Nonetheless, it is important to understand that the two institutions are legally and financially separate entities. This includes separation in respect of assets, liabilities, and capitalization. The Bank's operations and credit standing are not involved with IDA. IDA cannot borrow from the Bank. IDA credits provide the source of financing that the Bank cannot and should not make at market terms. IDA, in a very real sense, therefore, permits the World Bank to service



the needs of very poor countries without jeopardizing its creditworthiness standards and evaluation process. It provides a means of supplying high-priority lending of high quality for valid development purposes without imposing an inappropriate credit risk on suppliers of Bank funds.

## Section Seven: *Conclusion*

It may be appropriate to conclude these remarks with some reference to the environment in which we live as it affects the investment climate, generally, and the attitude of investors toward the World Bank. Despite the financial strength of the Bank and its commitment to prudent financial policies, I would be less than frank, and indeed quite naive, if I assumed that it was universally recognized by the investment community in, say, the United States, as the only premier credit in the marketplace. Few people understand the Bank (it is often confused with IDA); fewer still have any conception of its financial structure, liquidity, profitability, guarantees, the repayment record of its borrowers, or the quality of its lending operations. Admittedly, it is a fairly complicated institution and portfolio managers, given a bewildering variety of potential alternatives, sometimes feel more comfortable with an investment that they can clearly categorize as "government," or "foreign," or "utility," or "industrial." Few are aware of the meticulous country and project appraisal work that goes into making a World Bank loan.

Further, the reaction of the financial community to often-inaccurate public commentary about the problems faced by developing countries certainly does not contribute to a dispassionate evaluation of our credit. We, therefore, conduct our operations and maintain financial policies that recognize that the Bank's financial structure and strength may not be fully understood; that questions are sometimes raised about our lending policies that are based on inaccurate knowledge of the operations of the Bank; and, indeed, that there may be some hostility toward the very role of the Bank itself. Despite our success in coping with these sometimes subliminal, sometimes expressed, concerns, we will continue to conduct ourselves as if the perception of investors will not always be rational and fully informed. Our financial policies, in short, will be designed to permit the Bank to operate successfully in difficult environments.

That is why we have built the overwhelming financial strength described here, and that is why we intend to keep it that way and maintain our standing as one of the strongest financial institutions in the world. We are not a social welfare agency committed to making transfer payments to solve the problems of misery or poverty. We are a development bank using the most sophisticated techniques available to facilitate development, while providing unmatched protection and strength for creditors and shareholders.



## Selected Financial Data

(dollar amounts expressed in millions of US$)

| | 1978* | 1979* | 1980* |
|---|---|---|---|
| Balance sheet data — end of period: | | | |
| Cash and liquid investments (net of commitments for settlement) | $ 8,857 | $ 9,750 | $ 9,966 |
| Effective loans: | | | |
| Disbursed and outstanding | 19,359 | 22,874 | 26,675 |
| Undisbursed | 13,706 | 16,264 | 18,095 |
| Borrowings outstanding | 22,602 | 26,280 | 29,668 |
| Capital and reserves: | | | |
| Paid-in capital, reserves, and accumulated net income | 5,788 | 6,648 | 7,477 |
| Callable capital | 29,741 | 33,686 | 35,963 |
| Net income | 238 | 407 | 588 |
| Borrowings outstanding — end of period: | | | |
| Placed with official sources | 7,354 | 7,755 | 7,897 |
| Placed with others | 15,248 | 18,525 | 21,771 |
| Cash and liquid investments as a percentage of borrowings outstanding — end of period | 39.19 | 37.10 | 33.59 |
| Average cost of: | | | |
| Borrowings drawn down in period | 6.73% | 6.22% | 8.24% |
| Borrowings outstanding during period | 7.45% | 7.21% | 7.28% |
| Total borrowings and other funds available during period | 6.09% | 5.98% | 6.00% |
| Average interest rate on: | | | |
| Loans approved in period | 7.57% | 7.54% | 8.14% |
| Disbursed and outstanding loans—end of period | 7.10% | 7.27% | 7.41% |
| Commitment charge on undisbursed loans | 0.75% | 0.75% | 0.75% |
| Return on: | | | |
| Average liquid investments | 6.99% | 7.55% | 8.76% |
| Average earning assets | 7.41% | 7.71% | 8.17% |
| Average life of borrowings outstanding—end of period (years): | | | |
| Placed with official sources | 3.84 | 3.61 | 3.40 |
| Placed with others | 7.29 | 6.90 | 7.02 |
| Total outstanding | 6.17 | 5.93 | 6.05 |
| Average life of loans committed—end of period (years) | 10.23 | 9.68 | 9.22 |
| Disbursed and outstanding loans as a percentage of subscribed capital and reserves—end of period (Articles limit percentage to 100) | 54.49 | 56.71 | 61.41 |

*Fiscal years ended June 30.

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