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Meeting: Reserves Adequacy
Review of Policy

Tuesday, December 3, 1996
3:00 - 4:00 p.m.
E1227 (Conference Room)

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A. CLASSIFICATION

- ☒ Meeting Material
- ☐ Trips
- ☐ Speeches

- ☐ Annual Meetings
- ☐ Corporate Management
- ☐ Communications with Staff

- ☐ Phone Logs
- ☐ Calendar
- ☐ Press Clippings/Photos

- ☐ JDW Transcripts
- ☐ Social Events
- ☐ Other

B. SUBJECT: MEETING: RESERVES ADEQUACY - REVIEW OF POLICY (N)
(B) - Tuesday, December 3, 1996
VENUE: E 1227 (CONF. ROOM)
CONTACT: JANE @ 87307
IN ATTENDANCE: JDW, EINHORN, WILSON, TWO OTHERS TO BE ADVISED, HANY
(B) PREPARE BY WILSON // DUE WED., NOV 27
EXC: HANY //LFG (11/8/96 10:54a)

DATE: 12/17/96

C. VPU

Corporate

- ☐ CTR
- ☐ EXT
- ☐ LEG
- ☐ MPS
- ☐ OED
- ☐ SEC/Board
- ☐ TRE

Regional

- ☐ AFR
- ☐ EAP
- ☐ ECA
- ☐ LAC
- ☐ MNA
- ☐ SAS

Central

- ☐ CFS
- ☐ DEC
- ☐ ESD
- ☐ FPD
- ☒ FPR
- ☐ HRO

Affiliates

- ☐ GEF
- ☐ ICSID
- ☐ IFC
- ☐ Inspection Panel
- ☐ Kennedy Center
- ☐ MIGA

D. EXTERNAL PARTNER

- ☐ IMF
- ☐ UN
- ☐ MDB/Other IO
- ☐ NGO
- ☐ Private Sector

- ☐ Part I
- ☐ Part II
- ☐ Other

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U.S.A.

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December 2, 1996

Mr. Wolfensohn

Jim -

Briefing papers for meeting on Reserves Adequacy
Tuesday, 12/3, 3:00 - 4:00 p.m.

Attached are two papers:

- A New Approach to Portfolio Concentration Management (draft Board paper).
- The Adequacy of IBRD's Equity Capital (for information).

We have also provided a short summary of the Concentration paper, which you may find helpful. Jessica Einhorn has seen previous drafts of the two papers and they have been approved by the ALCo (Asset and Liability Committee). However, Jessica has not read the final draft of the Concentration paper.

Regards,



Attachments

SHORT SUMMARY

A NEW APPROACH TO PORTFOLIO CONCENTRATION MANAGEMENT

Summary

1. This paper proposes an alternative approach to portfolio concentration management for IBRD. The current 10% guideline restricts lending to large, creditworthy countries for reasons unrelated to their performance, or debt servicing capacity, at a time when Bank resources could permit higher lending.
2. The new approach unbundles the risk management from the equitable access objective and allows lending to large creditworthy borrowers to expand to a well-defined point. Under the new approach, loans to the largest borrowers would be subject to a dollar limit that is set relative to an agreed measure of equitable access to total IBRD resources or to IBRD's ability to bear the risk of concentration, whichever is lower. The paper recommends defining the "equitable access" limit as 10% of IBRD's Statutory Lending Limit¹, and the "concentration risk limit" according to IBRD's current Board-approved financial policies. The new approach has several other important operational advantages. First, it delinks country lending ceilings from total debt outstanding and disbursed (DOD), thereby allowing CAS lending targets to be set independently from developments in other countries. Second, it allows IBRD to proactively manage the exposure that it is willing to take to its largest borrower in the context of its capital base. Third, it clarifies what is considered to be an equitable share of IBRD's total resources.

The Current Portfolio Concentration Guideline

3. The current 10% guideline is used to define an upper limit for the Bank's lending plans to individual borrowers. An individual borrower's projected debt outstanding and disbursed (DOD) is limited to 10% of total projected DOD for all borrowers. This guideline was adopted in 1985 to meet two objectives simultaneously: equitable access and concentration risk. The first objective is to ensure that borrowers have "fair" access to IBRD's financial resources. The second objective, as decided by the Board², is to protect IBRD against its largest borrower going into nonaccrual.
4. As IBRD has a highly concentrated portfolio and a limited ability to quickly restructure its assets or liabilities, it carries sufficient equity capital³ to protect itself against the risk of its largest borrower going into non-accrual. In addition, IBRD also seeks to ensure that after this loss, it can still generate sufficient income to rebuild its equity base and continue to intermediate on behalf of its other borrowers. This assessment is done within the context of a simulation model that projects the balance

¹ The Statutory Lending Limit is defined as subscribed capital plus reserves plus the portion of the surplus account held for deferred decisions. See Annex 2 of the draft Board paper for details.

² See Review of the Adequacy of Loan Loss Provisions and Reserves, R93-73, April 22, 1993.

³ Defined as usable paid-in capital, reserves, and unallocated surplus.

sheet, income statement and cash flows. If the simulation indicates that IBRD's equity capital needs to be increased, then a recommendation is made to the Board to increase reserves at the time the annual net income allocation paper is presented. As paid-in capital is viewed as likely to remain constant, reserves is the component of equity capital that is adjusted.

5. Looking ahead, current commitments indicate that IBRD's exposure to its largest borrower is projected to rise substantially in absolute terms and in relation to the overall portfolio. Under the existing portfolio concentration policy, either future lending commitments to some large borrowers would have to be curtailed (sharply in some cases), in order to comply with the 10% guideline, or the Bank would need to allow these countries to exceed the guideline. If the latter course is followed, reserves would have to be increased correspondingly. This would, however, occur *ex post* and would result in large lumpy claims on net income in particular years. This could present the Board with difficult choices between maintaining financial standards and meeting other priority development objectives.

6. Among the major drawbacks of the current guideline are:

- As long as total DOD is below IBRD's Statutory Lending Limit, a dollar lent to a large borrower is not a dollar taken away from any other borrower.
- IBRD lending and its relationship with one country should not depend on events in another country.
- The current guideline does have negative "feedback effects", causing lending to large borrowers to be cut back due to lower-than-expected lending levels in other countries.
- Given the volatility at the global, regional, and country levels, it is difficult to project overall portfolio growth. This creates uncertainties for the Bank and its clients in formulating lending and financing plans.
- Given the long lead time between commitment and disbursement, once the guideline is breached, the IBRD cannot adjust its lending and financial policies fast enough to rectify the situation in the short -to- medium term.

A New Approach to Portfolio Concentration Management

7. The proposed approach would meet both the risk management and equitable access objectives underlying the current guideline. Loans to the largest borrowers would be constrained by a dollar limit set independently of overall portfolio growth. This limit would be determined by either the concentration risk limit or the equitable access limit, whichever is lower. The concentration risk limit would be determined *ex ante* by the adequacy of IBRD's capital to withstand the shock of the largest borrower going into arrears-- thereby ensuring that IBRD's financial standing is maintained. The equitable access limit would be based on a Board-endorsed definition of an "equitable share" of Bank resources. As under the current guideline, the Board may wish to retain some flexibility in the application of these limits.

8. With respect to the concentration risk limit, we propose to continue to use the current, Board-approved method of portfolio concentration management. However, instead of the current approach (whereby reserves are adjusted *ex post* to reflect actual exposure), the new approach would involve an *ex ante* decision which clearly links risk management to IBRD's equity capital. Thus, at the time of the annual net income paper, FPI would review the adequacy of the Bank's equity capital relative to its exposure to its largest borrower within the context of a five-year projection period. This approach would allow lending to large, creditworthy borrowers to expand to a well-defined point that reflects the income allocation choice of the Board. It also creates a framework that would enable IBRD to obtain the benefits of forward planning, while maintaining the flexibility to make adjustments on an annual basis to meet other possible unexpected demands on net income.

9. Concerning the equitable access limit, while a number of criteria could be used to define this limit, our analysis shows that the most appropriate criterion would be either the IMF quota or IBRD capital subscription. Both of these measures would suggest that an individual borrower's share of total IBRD resources (defined as the Statutory Lending Limit) should be targeted at about 10%. There are also other good reasons to adopt 10% as the maximum share of the Bank's resources.

10. By adopting the new approach, the constraint on Bank lending to some of IBRD's large borrowers (China, Indonesia, India, Mexico) would be lifted, creating the potential of increased lending and income. Whether this will occur depends on creditworthiness and other considerations, but at least portfolio concentration will no longer be a supply constraint. Under reasonable and conservative assumptions, lending commitments to these countries could increase by at least \$20 billion (25%) over and above the current lending plans in the first five years which would generate a substantial increase in income.

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A NEW APPROACH TO PORTFOLIO CONCENTRATION MANAGEMENT

A. Introduction

1. This paper proposes an alternative approach to portfolio concentration management for IBRD. As explained in the paper, the current 10% guideline restricts lending to large, creditworthy countries for reasons unrelated to their performance, or debt servicing capacity, at a time when Bank resources could permit higher lending. The negative effects of the current guideline are particularly binding when IBRD lending ceases to grow, as has occurred since 1989.
2. The paper recommends the adoption of a new guideline composed of two limits. Under this approach, loans to the largest borrowers would be subject to a dollar limit that is set relative to an agreed measure of equitable access to total IBRD resources, or to IBRD's ability to bear the risk of concentration, whichever is lower. The paper also recommends an approach to defining these limits. In brief, "equitable access" is defined as 10% of IBRD's Statutory Lending Limit¹, while the "concentration risk limit" is defined according to IBRD's current Board-approved financial policies. Under these policies, the Board has decided that IBRD should maintain sufficient equity to protect itself against its largest borrower going into non-accrual. Adoption of the new approach would make this an *ex ante* management decision rather than an *ex post* response, as under the current guideline. In addition, the definition of either of these two limits could be revised without affecting the decision to replace the current guideline by the new approach.
3. The new approach unbundles the risk management from the equitable access objective and allows lending to large creditworthy borrowers to expand to a well-defined point. The Bank's risk bearing capacity would be fully protected in line with its income generating capacity, while equitable access among Bank members is respected. The new approach has several other important operational advantages. First, it delinks country lending ceilings from total debt outstanding and disbursed (DOD), thereby allowing CAS lending targets to be set independently from developments in other countries. Second, it allows IBRD to proactively manage the exposure that it is willing to take to its largest borrower in the context of its capital base. Third, it clarifies what is considered to be an equitable share of IBRD's total resources.
4. The following section of the paper, section B, explains how the current 10% guideline is applied, discusses the objectives underlying the guideline, and outlines how the resulting concentration risk is managed. Section C analyzes the drawbacks of the current guideline and discusses the options available to address these drawbacks. Section D presents the new approach and explains its implications. The attached five annexes provide a detailed analysis of the issues

¹ The Statutory Lending Limit is defined as subscribed capital plus reserves plus the portion of the surplus account held for deferred decisions. See Annex 2 for details.

discussed in this paper. Annex 1 describes recent trends in IBRD lending and explains how the current guideline has contributed to the flat growth and declining quality of IBRD's portfolio. Annex 2 explains the link between portfolio concentration and IBRD's current financial policy and provides the definition of the concentration risk limit. It also discusses alternative approaches to managing concentration risk. Annex 3 explores alternative definitions of equitable access and the rationale for defining this limit as 10% of the Statutory Lending Limit. Annex 4 provides an illustration of the proposed approach and its lending implications. Annex 5 discusses particular issues related to China.

B. IBRD's Current Approach To Concentration Management

5. **What Is the Guideline?** IBRD has had a concentration guideline since the 1970s, with the current 10% guideline being endorsed by the Board in 1985.² This guideline is used to define an upper limit for the Bank's multi-year lending plans (presented in the CAS) for individual borrowers. First, an estimate of an individual borrower's projected debt outstanding and disbursed (DOD) to IBRD is derived, based on the current pipeline of undisbursed debt and the Region's projected lending program. Second, the DOD for all borrowers is estimated using the same approach. Third, the DOD of an individual borrower is compared to total DOD to determine if the individual borrower's share is likely to significantly exceed 10%. If this is the case, the guideline comes into play as a constraint on lending plans. Given the lag between commitments and disbursements, the guideline can be a constraint even when an individual borrower's share of the IBRD portfolio is currently below 10%.³

6. The 10% guideline is one of three types of exposure guidelines currently used by the Bank for risk management. As previously reported to the Board,⁴ the other two are the share of exports guideline and the debt service guidelines. Taken together, the exposure guidelines help the Bank manage exposure risk. They focus attention on those countries where lending may need to be constrained or where the links between exposure and policy reforms need to be strengthened. For most of IBRD's small and medium-sized borrowers, these creditworthiness factors constrain lending well before the concentration guideline becomes effective.

7. **Objectives of the Current Guideline.** The current 10% guideline was adopted to meet two objectives simultaneously: equitable access and concentration risk. Equitable access refers to the objective of ensuring that borrowers have "fair" access to IBRD's financial resources, taking into account their needs and capacity to repay. In practice, this translates into a cap on the potential amount IBRD is prepared to lend to a single member. As explained above, the current guideline attempts to achieve this objective by limiting commitments to an individual borrower so that its projected debt outstanding and disbursed (DOD) does not significantly exceed 10% of projected total DOD.

² See "10% Exposure Guideline", SecM85-850, July 17, 1985.

³ This is the case of China at the present time.

⁴ Review of IBRD Policy on Exposure Guidelines, JAC93-27, June 8, 1993.

8. With regard to concentration risk, portfolio theory identifies two kinds of risks: non-systemic risks that affect individual asset returns, and systemic risks that could affect the whole portfolio. Diversifying the portfolio reduces the first kind of risk; broadly speaking, the less diversified the portfolio, the higher the risk. Under current practices, IBRD attempts to diversify its portfolio by applying the same 10% of DOD rule that is used to achieve the equitable access objective. However, IBRD's actual exposure to its largest borrower also triggers an important *ex post* financial decision that is required to manage the resulting concentration risk. This relates to the need to protect IBRD's financial standing and to ensure that it has the capacity to operate for the benefit of all its members.

9. **Management of Concentration Risk.** Given IBRD's highly concentrated portfolio and its limited ability to quickly restructure its assets or liabilities, the Board⁵ decided that IBRD should protect itself against its largest borrower going into nonaccrual. This position has been adopted for a number of sound financial reasons, including the need to ensure that IBRD and its members are fully protected against the possible default of any one borrower. As is the case in all banks, IBRD achieves this objective by ensuring that it carries sufficient equity capital (which includes usable paid-in capital, reserves, and unallocated surplus) to protect itself against this low probability risk. Thus, IBRD ensures that it can absorb the loss of income from its largest borrower going into non-accrual for an extended period of time, and that, after this loss, it can still generate sufficient income to rebuild its equity base and continue to intermediate on behalf of its other borrowers. This assessment is done within the context of a simulation model that projects the balance sheet, income statement and cash flows over a 10-year horizon. If the simulation indicates that IBRD's equity capital needs to be increased, then a recommendation is made to the Board to increase reserves at the time the annual net income allocation paper is presented. As paid-in capital is viewed as likely to remain constant, reserves is the component of equity capital that is adjusted. Thus, any adjustment in reserves occurs *ex post* in reaction to the actual exposure that IBRD has to its largest borrower. For example, in 1994, recognizing the increase in IBRD's exposure to its largest borrower, reserves were adjusted to accommodate the 12% of DOD that was accounted for by Mexico.

10. Looking ahead, current commitments indicate that IBRD's exposure to its largest borrower is projected to rise substantially in absolute terms and in relation to the overall portfolio. Under current policy, either future lending commitments to some large borrowers would have to be curtailed (sharply in some cases), in order to comply with the 10% guideline, or the Bank would need to allow these countries to exceed the guideline. If the latter course is followed, reserves would have to be increased correspondingly. This would however, occur *ex post* and would result in large lumpy claims on net income in particular years. This could present the Board with difficult choices between maintaining financial standards and meeting other priority development objectives.

⁵ See Review of the Adequacy of Loan Loss Provisions and Reserves, R93-73, April 22, 1993.

C. Drawbacks of the Current Guideline

11. Many of the drawbacks of the current guideline emanate from the fact that it attempts to achieve two distinct objectives through one measure, i.e. total DOD. While this approach has the merit of simplicity and may have served its purpose when total DOD was expanding, its drawbacks become apparent when the portfolio does not grow. As a review of recent trends in the loan book shows (Annex 1), IBRD's portfolio has stagnated since 1989 and portfolio risk has risen. Ironically, the guideline itself has contributed to these trends. This is because, although the guideline has been implemented flexibly, the slowdown in total IBRD loan growth (the denominator) has led to restrictions in the lending programs of IBRD's largest borrowers, some of which have strong economic and policy performance.

12. Among the major drawbacks of the current guideline are:

- First, the most obvious shortcoming relates to equitable access. As long as total DOD is below IBRD's Statutory Lending Limit, IBRD can make additional commitments to any borrower without reducing its capacity to lend to another borrower - i.e. a dollar lent to a large borrower is not a dollar taken away from any other borrower. When loan growth is flat, the current guideline restricts lending to large borrowers even though IBRD has sufficient head room to increase lending to any borrower.
- A closely related second point is that, as a matter of principle, loans to any borrower should not be cut back because lending to other borrowers has declined below expectations. IBRD lending and its relationship with one country should not depend on events in another country.
- Third, the current guideline can create perverse effects via potentially negative "feedback effects". A reduction in lending to one large country, such as Indonesia, leads to a drop in total Bank lending. If the guideline is applied, lending to other large countries, such as China, Mexico or Russia, would need to be reduced. In turn, this could cause Indonesia's loan program to decline further. These feedback effects were not important at the time the guideline was adopted due to growth in the overall portfolio.
- Fourth, given the volatility at the global, regional, and country levels, it is difficult to project overall portfolio growth. This creates uncertainties for the Bank and its clients in formulating lending and financing plans.
- Fifth, given the long lead time between commitment and disbursement, once the guideline is breached, the IBRD cannot adjust its lending and financial policies fast enough to rectify the situation in the short -to- medium term.

13. IBRD could address the issue of lending to large borrowers in a number of ways. First, it could keep the current guideline and hope the problems discussed above will be resolved through rapid growth of the overall portfolio. This would, however, require an increase in lending

commitments from the current level of about US\$15 billion to US\$26 billion next year. While Bank-wide changes, including new products, may result in increased lending, it is extremely unlikely that a change of this magnitude will occur at this pace. Second, it could keep the current guideline and raise the limit from 10 percent to 12 percent in line with the actual portfolio concentration. This would postpone the problem, but would not address the fundamental drawbacks identified above. Finally, the Bank could replace the current guideline with one that limits exposure to any individual borrower on the basis of the IBRD's financial capacity and some measure of equitable access.

D. A New Approach To Portfolio Concentration

14. The proposed approach would meet both the risk management and equitable access objectives underlying the current guideline. Loans to the largest borrowers would be constrained by a dollar limit set independently of overall portfolio growth. This limit would be determined by either the concentration risk limit or the equitable access limit, whichever is lower. The concentration risk limit would be determined *ex ante* by the adequacy of IBRD's capital to withstand the shock of the largest borrower going into arrears (see Annex 2 for a detailed discussion of the Bank's policy in this area) -- thereby ensuring that IBRD's financial standing is maintained. The equitable access limit would be based on a Board-endorsed definition of an "equitable share" of Bank resources (see Annex 3 for a full discussion of alternative measures of fairness). If these recommendations are adopted, the binding limit (which would be a stock figure) would be converted into country specific commitment levels (flow figures) via the FPICR disbursement model and given to Operations. This approach provides large borrowers and Operations staff an easy to understand limit (in loan commitments), set independently from overall portfolio growth.

15. With respect to the concentration risk limit, we propose to continue to use the current, Board-approved method of portfolio concentration management, as discussed in paragraph 9. However, instead of the current approach (whereby reserves are adjusted *ex post* to reflect actual exposure), the new approach would involve an *ex ante* decision which clearly links risk management to IBRD's equity capital. Thus, at the time of the annual net income paper, FPI would review the adequacy of the Bank's equity capital relative to its exposure to its largest borrower within the context of a five-year projection period. This approach would allow lending to large, creditworthy borrowers to expand to a well-defined point that reflects the income allocation choice of the Board. It also creates a framework that would enable IBRD to obtain the benefits of forward planning, while maintaining the flexibility to make adjustments on an annual basis to meet other possible unexpected demands on net income.

16. Concerning the equitable access limit, while a number of criteria could be used to define this limit, the analysis in Annex 3 shows that the most appropriate criterion would be either the IMF quota or IBRD capital subscription. Both of these measures would suggest that an individual borrower's share of total IBRD resources (defined as the Statutory Lending Limit) should be targeted at about 10%. There are other good reasons to adopt 10% as the maximum share of the Bank's resources. First, the current 10% guideline has been agreed by shareholders as an

equitable limit⁶. Second, of the eligible IBRD countries (excluding Part I, IBRD graduates and IDA-only countries), the largest three members each holds exactly 10% of capital subscriptions, but IBRD exposure in any of these three countries is still far below this limit. Third, there is a precedent in that an individual borrower's share of the Statutory Lending Limit did reach just over 9% in 1987 with Board approval.

17. As under the current guideline, the Board may wish to retain some flexibility in the application of these limits. For example, the Board may decide to allow an individual borrower to temporarily exceed the agreed concentration limits as long as suitable steps are taken to moderate the impact on other members and protect the financial standing of IBRD. One approach would be for the borrower to cover the increase in exposure above the guideline by a corresponding allocation of its foreign exchange reserves.

18. **Implications of the New Approach.** Due to the large "headroom" that currently exists (total DOD is currently about \$111 billion compared to a potential of US\$200 billion), it is anticipated that the "concentration risk limit", rather than the "equitable access limit", will be the binding constraint over the next ten years or more. This is true under almost any relevant definition of equitable access. Thus, the operationally relevant decision relates to the adequacy of IBRD's equity capital. As discussed in paragraph 9 above, IBRD has a framework through which it determines the adequacy of equity capital relative to the actual exposure to its largest borrower (also see Annex 2). Under the new approach, this assessment becomes an *ex ante* basis for determining the concentration risk limit in the context of a forward-looking five-year horizon. Thus, when the decision on the allocation of net income is made, the Board will also decide the maximum level of exposure IBRD can take to its largest borrower over the next five years. Annex 3 provides a numerical illustration of this approach, assuming that IBRD's current financial policies are maintained and the equitable access objective is defined in terms of the Statutory Lending Limit. As noted earlier, one of the strengths of the new approach is that it would permit management and the Board to revise either of the two concentration limits without revisiting the decision to adopt the new guideline.

19. Finally it should be noted that by adopting the new approach, the constraint on Bank lending to some of IBRD's large borrowers (China, Indonesia, India, Mexico) would be lifted, creating the potential of increased lending and income. Whether this will occur depends on creditworthiness and other considerations, but at least portfolio concentration will no longer be a supply constraint. Annex 4 shows that under reasonable assumptions, lending commitments to these countries could increase by at least \$20 billion (25%) over and above the current lending plans in the first five years which would generate a corresponding increase in income. Even this figure may be conservative because lending commitments could be higher if creditworthiness and other considerations are met.

⁶ See Board document SecM85-850, July 17, 1985

E. Recommendations

In summary, Management recommends that:

- The current 10% guideline be replaced by a dollar limit set relative to an agreed measure of equitable access to total IBRD resources or to IBRD's ability to bear the risk of concentration, whichever is lower.
- The "equitable access" limit be defined as 10% of IBRD's Statutory Lending Limit⁷, about \$20 billion.
- The "concentration risk limit" be determined at the time of the net income paper, in conjunction with the Board's decisions on reserves and other components of equity capital. At that time, the Board would review the adequacy of the Bank's equity capital relative to its exposure to its largest borrower within the context of a five-year forward looking framework. The binding limit (which would be a stock figure) would be converted into country specific commitment levels (flow figures) via the FPICR disbursement model and given to Operations.

FPICR

December 2, 1996

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⁷ The Statutory Lending Limit is defined as subscribed capital plus reserves plus the portion of the surplus account held for deferred decisions.

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ANNEX 1

Page 1 of 3

THE 10% GUIDELINE AND TRENDS IN BANK LENDING TO LARGE COUNTRIES

- The 10% Guideline.** The Bank has had a concentration guideline since the 1970s. This guideline was originally expressed as a limit on the share of the largest four borrowers, 33% of the portfolio. This limit was reduced to 30% in 1982 and supplemented with a country-specific guideline of 6-8%, with higher risk countries held at 6%. In practice, however, a 33% guideline was still used for the four largest borrowers. In 1985, the 33% guideline was abandoned, and the limit was reformulated as 10% of loans outstanding.¹
- In the 1980s, Brazil was the only country that breached the guideline. For five consecutive years 1984-1988, Brazil's share in IBRD portfolio exceeded 10%. Beginning in 1990, portfolio shares of Mexico and Indonesia have also exceeded 10%. Looking ahead, China will almost certainly breach the guideline. And if the Russia lending program continues at the level of 1993-95, it too will breach the guideline by 2009.
- Overall Bank Lending.** Total Bank lending in terms of commitments has followed two distinct phases since 1980. Between 1980 and 1988, commitments rose from about \$7.5 billion to almost \$15 billion a year, due primarily to the build-up in lending to China and the rapid expansion of programs in India and several large Latin American countries. Average annual growth of commitments was 7.9% during this period (Table 1A). In the second phase, since 1989, total commitments have stagnated, averaging about \$15.6 billion annually 1989-96. In real terms, commitments have declined since 1989. According to Regional lending plans, this trend is expected to continue in the next three years.

Table 1A: Average Annual Growth In Bank Lending 1980-2013

	1980-88	1989-1996	Projections 1997-2013
Commitments	7.9	0.0	1.6
Debt Outstanding & Disbursed	17.9	5.9	0.0

Source: FPICR

¹ See "10% Exposure Guideline", SecM85-850, July 17, 1985.

4. Debt outstanding and disbursed (DOD) has followed the same trend as commitments, albeit with a lag (Table 1A). DOD is affected by exchange rate movements thereby making the connection between commitments and DOD more complex. Growth in DOD averaged 17.9% a year (14% in real terms) in 1980-1988 and 5.9% in 1989-96. Based on data from the Regions, total debt outstanding is projected to remain flat in the future.

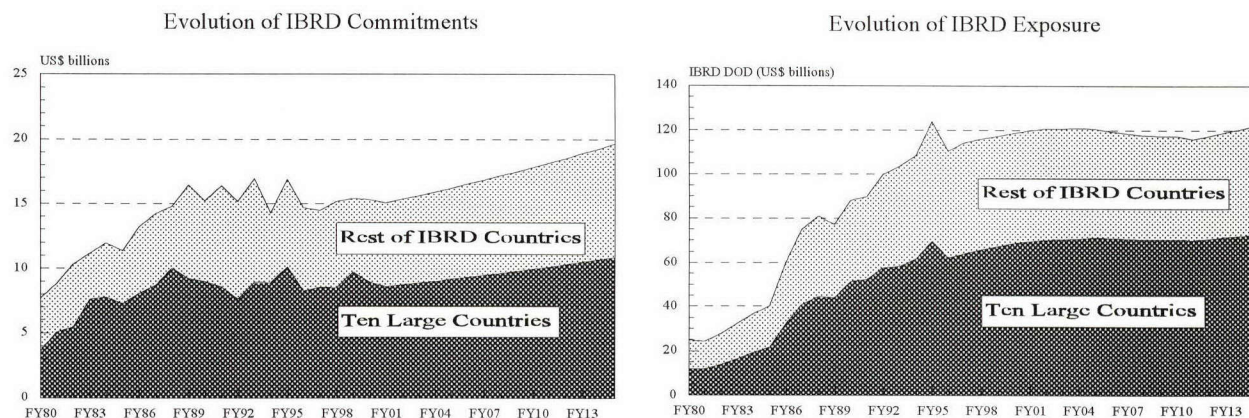
5. **Lending to Large Countries.** Of the seventy eight currently eligible Bank members, ten large countries account for more than half of commitments and debt outstanding and disbursed (Table 2 and Figure 1A). A large borrower is defined in this paper as any country that has accounted (or is expected to account) for more than 5% of the total portfolio in any year between 1980 and 2013. The ten large borrowers accounted for 58.2% of portfolio growth in 1980-88 and 60.7% in 1989-96..

Table 1B: Ten Large IBRD Countries

	Commitment		Portfolio Share	Contribution to Growth in Exposure	
	Av.FY80-82	Av.FY94-96		FY80-88	FY89-96
	(US\$ Millions)		FY96	FY80-88	FY89-96
			%	%	%
Brazil	753.7	855.0	5.2	10.7	-5.6
China	33.3	2335.0	6.7	2.5	16.4
India	606.6	663.0	8.7	6.7	11.7
Indonesia	726.4	1300.0	10.7	11.0	12.5
Korea	468.0	218.0	1.8	4.2	-3.8
Mexico	679.4	1481.0	12.1	7.8	19.4
Philippines	466.0	318.0	4.4	4.4	5.1
Russia	0.0	1692.0	1.5		5.1
Turkey	656.6	303.0	4.2	8.5	-2.8
Yugoslavia	308.2	N/A	N/A	2.3	-3.4
Total 10 Large Countries	4698.2	9165.0	56.3	58.2	60.7
Bank Total	8927.6	15251.0	100.0	100.0	100.0
Share of Bank Total	52.6	59.6			

Source: FPICR

Figure 1A



Source: FPICR

6. **Reasons for the Slowdown in Lending.** Both demand and supply factors played a role in the slowdown in lending. In 1989-96, the demand for Bank lending by some large borrowers--India, Mexico (before December 1994), and the Philippines (FY95-96) -- fell because of the ready availability of large private capital flows, the reduced role of the State (which has led to less government borrowing), and perhaps, more cumbersome requirements by the Bank relative to other creditors. On the supply side, lending has also been reduced by deteriorating policy performance in some countries -- Brazil, Turkey, Yugoslavia. For other countries, lending has been restricted by the portfolio concentration guideline -- China, Indonesia, and Mexico.

7. **How Does the 10% Guideline Restrict Lending to Large Countries?** Mexico and Indonesia are good cases in point. In 1992, the portfolio shares of Mexico and Indonesia were projected to reach 10.4% and 10.1%, respectively, for FY94, based on an anticipated growth rate of the overall Bank portfolio of 5% a year. However, the Bank's overall portfolio grew by only 2%, resulting in the shares of Mexico and Indonesia rising to 12% and 11.1% respectively, even though lending programs in both countries did not increase. Lending programs to these countries were then cut back to comply with the 10% guideline. This had a ripple effect on lending to other large countries, increasing their share of a lower-than-expected total.

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ANNEX 2

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IBRD's FINANCIAL POLICY IN MANAGING PORTFOLIO CONCENTRATION RISK AND ALTERNATIVE FORMULATIONS OF THE 10% GUIDELINE

IBRD's Current Financial Policy For Managing Portfolio Concentration Risk

1. The most significant risk faced by the Bank is the country credit risk in its loan portfolio. Other risks, principally market risk (i.e. interest rate risk, exchange rate risk and commercial credit risk) and institutional risk are relatively small. The Bank protects itself from country credit risk in two main ways. Expected losses in the Bank's loan portfolio resulting from high probability collectibility risks are covered by loan loss provisions. Unexpected losses due to low probability risks, including a large borrower going into nonaccrual are covered by the Bank's equity, which includes paid-in capital, reserves and surplus.
2. Many well-managed financial institutions have diversified loan portfolios and, at a minimum, establish protection against their largest exposure. As a prudently managed institution, the Bank has established similar standards. However, in contrast with commercial banks, IBRD's portfolio has a highly concentrated structure. This is because it has a finite client base (currently there are about 78 eligible borrowers) and because it ultimately is exposed to sovereign risk, not a diversified set of individual project risks. Consequently, the entire loan portfolio of a country is placed in non-accrual status if the debt service payment on any one loan in the portfolio is overdue by more than six months².
3. With respect to portfolio concentration risk, the Bank's current financial policy, as approved by the Board,³ is designed to meet two inter-related objectives. First, it seeks to ensure that the Bank can absorb the loss of income from an unexpected risk event such as a large borrower going into nonaccrual for an extended period of time. Second, it seeks to ensure that after this loss, the Bank can generate sufficient income to rebuild its equity and continue to intermediate on behalf of other borrowers.
4. The IBRD's risk bearing capacity is assessed through the use of a multi-currency, dynamic simulation model that projects the balance sheet, income statement and cash flows over a 10-year horizon. This model can thus be used to measure IBRD's capacity to recover from any number of risk events, including either a market or country credit risk event, or a combination of the two. The capacity to remain a viable financial institution in the event that the largest single borrower fails to service its debt is one of the most important "stress tests" that are run through the model. If this analysis indicates that IBRD's equity capital needs to be adjusted, this occurs at the time the Board considers the net income allocation paper through an

² See Operational Directive 13.45, February 1991, para. 3.

³ See Review of the Adequacy of Loan Loss Provisions and Reserves, R93-73, April 22, 1993.

adjustment in reserves. This is because, in the context of IBRD, the other components of equity capital are viewed as constant.

5. It has been suggested that IBRD could adopt the original "BIS" regulations, issued in 1988, which recommended that Banks assign risk weights for credit risk as a first step toward linking risk to capital adequacy.⁴ The Bank did not adopt the original BIS guidelines for a number of reasons: (i) the recommended capital ratios are minimums, not targets, and the Bank's objective in establishing its targets is not just to remain solvent, as a commercial institution does, but to maintain its financial standing including its AAA rating, to fulfill its development mandate; (ii) the minimum ratios are appropriate for the best credits of commercial banks, while the Bank's clients, by definition, are riskier than the best customers of commercial banks; (iii) by its nature, the Bank's portfolio is more concentrated because we have a fixed number of clients; (iv) the Bank cannot raise additional capital quickly the same way commercial banks do; and (v) Bank examiners also need to evaluate the need for capital to absorb other risks, such as potential for losses from interest and exchange rate movements.

6. Moreover, the 1988 Accord was always viewed as a first step rather than a full-blown approach to capital adequacy analysis. Since then, considerable work has been done by banking regulators toward: (i) improved empirical approaches toward finding risk weights; and (ii) ways to include types of risk other than just credit risk, as well as risk covariances, in a capital adequacy analysis. Improvements have been made toward performing such assessments in a dynamic rather than static framework. The industry also has moved forward in its own practices. On May 21, 1996, the Basle Committee on Banking Supervision reported on further progress by allowing banks to use their own simulation models to stress test for multiple risks in a dynamic setting; by suggesting an exposure limit for a single borrower be set at 25% of total bank capital; and by suggesting that interest rate risk be managed through the use of sophisticated measurement systems. Thus, IBRD's current dynamic stress testing approach is more in line with the more recent Basle recommendations on capital adequacy.

7. Due to the unique character of IBRD's portfolio, concentration risk will always need to be assessed in determining capital adequacy. In the US, regulatory authorities have prescribed even higher standards than the Basle Accord -- i.e., largest borrower exposure to be in the range of 10-15% of total capital.⁵ The largest Bank borrower now accounts for about 57% of IBRD's

⁴ This Accord emphasizes the role of capital in protecting a financial institution against insolvency, liquidation and unexpected losses. Under this framework, a bank's assets are grouped into different risk categories carrying different risk weights. Total risk assets are calculated by summing the risk-weighted assets across all risk categories. Off-balance sheet items are explicitly taken into account. The risk assets are required to be supported by capital, with a recommended minimum level of capital equal to 8% of total risk assets.

⁵ In the United States, the Federal Reserve Act specifies that national banks shall at no time provide loans and extension of credit to a single borrower (not fully secured by collateral having equal market value) in excess of 10% of the unimpaired capital and unimpaired surplus of that bank⁵, and in the case of fully secured, 15% of the

capital, that is, excluding callable capital. If callable capital were included, the proportion would be 6.6% of the Bank's total capital. The fact that the Bank has callable capital in case of need, even though this capital is unlikely to be available to meet the arrears caused by a single borrower, is also a distinct feature of IBRD when compared to commercial banks.

8. There are several reasons why the risk bearing capacity of the Bank is assessed in terms of equity capital and not in terms of total capital (which includes callable capital). First, in the unexpected event that the largest borrower goes into nonaccrual for an extended period, equity capital would act as a cushion to protect the Bank's capital base. In principle, a call on capital could be made to buttress this cushion. In practice, however, it would take time to obtain this capital, exposing IBRD to a possible liquidity shortfall. In these circumstances it is unlikely that IBRD would be able to retain its AAA rating which may cause the cost of borrowing to rise sharply for all other members. Second, in the current environment of severe budget constraints, many member governments may not agree to an increase in paid-in capital, especially on account of the largest borrower going into nonaccrual. Third, without sufficient equity capital, the Bank could be forced into defensive lending as it is held hostage to the largest borrower. This may prompt other countries to follow, resulting in lower portfolio quality.

9. It should also be noted that other multilateral development banks, with portfolio's that are similar to that of IBRD, manage their portfolio concentration in a similar way. Portfolio concentration and reserves-to-loans ratios of MDBs are shown in Table 2A and Figure 2A below.

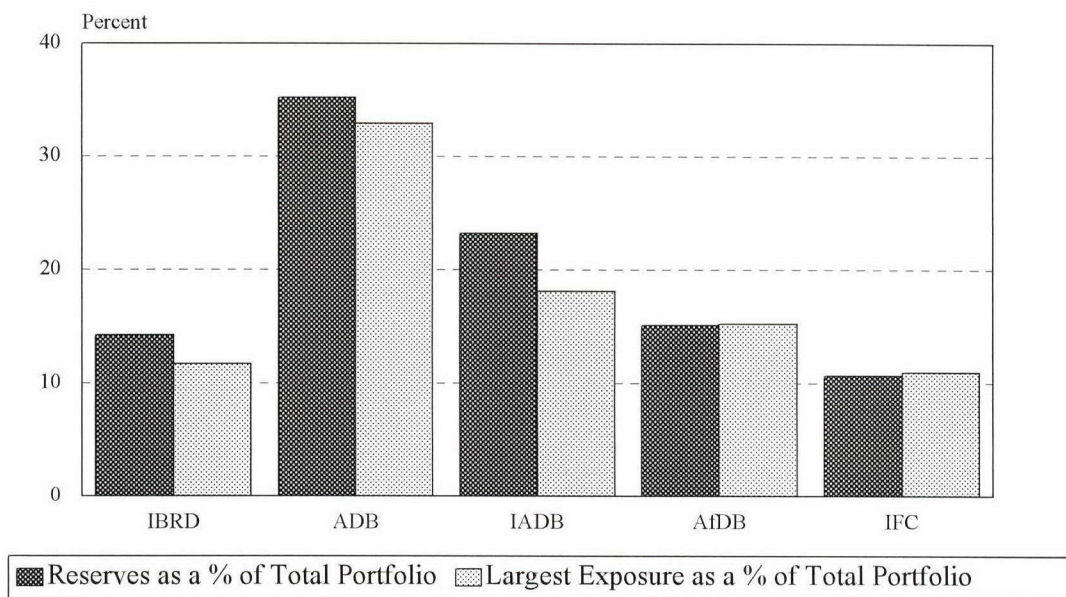
Table 2A: MDBSs: R/L And Exposure To The Largest Borrower ^{a/}
(%)

	R/L	EXPOSURE	LARGEST BORROWER
IBRD	14.3	11.7	Mexico
ADB	35.2	32.9	Indonesia
IADB	23.2	18.1	Mexico
AfDB	15.2	15.2	Morocco
IFC	10.7	11.0	Argentina
<u>a/</u> As of December 30, 1995			

Source: FPIFP

unimpaired capital and unimpaired surplus. Exceptions include obligations secured by a like amount of bonds, notes, or Treasury bills of the United States, where no limit applies. In the case of consumer paper with full resource endorsement or unconditional guarantee, a 25% limit applies.

Figure 2A: Portfolio Concentration and Reserves Ratios in MDBs, 1995

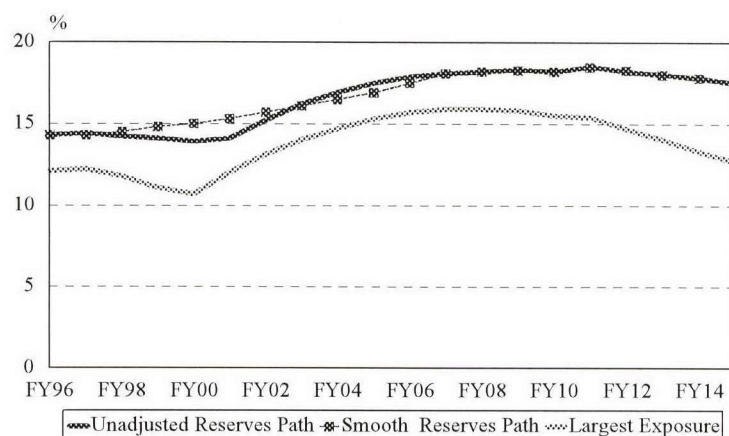


Source: FPICR

10. Looking ahead, current commitments indicate that IBRD's exposure to its largest borrower is projected to rise substantially in absolute terms and in relation to the overall portfolio. Under current policy, either future lending commitments to some large borrowers would have to be curtailed (sharply in some cases), in order to comply with the 10% guideline, or the Bank would need to allow these countries to exceed the guideline. If the latter course is followed, reserves would have to be increased correspondingly. This would however, occur *ex post* and would result in large lumpy claims on net income in particular years. This could present the Board with difficult choices between maintaining financial standards and meeting other priority development objectives.

11. For example, IBRD's exposure to its largest borrower is projected to increase from 12% of its DOD in 2001 to 13.1 % in 2002. Under current financial policies, this would result in a \$1.3 billion claim on net income in that year to increase reserves. Of course, the need to adjust reserves could be forecast and smoothed out over a number of years. However, this would, in effect, mean that the current guideline (defined as 10% of DOD) has been replaced by a new guideline which is similar to the one suggested in this paper. Both the unadjusted and smooth paths of reserves are shown in Figure 2B, along with the projected exposure to the largest borrower.

Figure 2B: Current Financial Policy and Portfolio Concentration



Source: FPICR

Alternative Formulations Of The Current Guideline

12. **Raising the Limit.** Raising the guideline limit from 10% to 12% to match the reserves already accumulated would relieve the exposure constraint, allow more lending to some large countries and formalize actual portfolio concentration. However, this approach simply postpones solving the problem. It is still subject to fluctuations in loan growth. It still restricts Bank lending when there is no issue with equitable access nor with risk management, assuming the Bank's capital adequacy is maintained. It still has feedback effects and makes lending program in one country depend on events in another country. More importantly, it cannot address many exposure issues related to current lending plans to some large borrowers.

13. **Risk-Adjusted Guidelines.** An alternative formulation is to establish a risk-adjusted limit. It has been suggested that this formulation would allow the concentration guideline to be relaxed without having to build up reserves. This approach assumes that if the Bank increased its share of loans only to the most creditworthy borrowers, the improvement in the average credit quality of the portfolio could reduce risks enough to offset the increase in nonsystematic risks arising from increased concentration. A variation on this theme is that the Bank could increase the concentration limit for the most creditworthy borrowers -- say, to 15% of the portfolio -- without having to increase reserves. The argument is that the risk to the Bank of lending 10% of the portfolio to a medium-to-high-risk country is comparable to lending 15% of the portfolio to a low-risk country.

14. This approach confuses portfolio concentration risk with overall portfolio risk and misses the diversification objective of the guideline. As approved by the Board, the current financial policy ensures that reserves are adequate to protect against the risk of extended arrears by a

single large borrower⁶. This should remain the objective, even if the increase in portfolio concentration were limited to the Bank's most creditworthy borrowers. Furthermore, even if there were trade-offs between risks due to average creditworthiness and those due to diversification, in practice, there is a limit to the extent to which the Bank can freely minimize these risks, given its mandate as a development institution and a lender of last resort.

15. More importantly, experience has shown that while it takes a long time for country risk to improve, risk downgrading can happen overnight. Given the "tanker phenomenon" discussed in the report, Bank lending decisions cannot adjust quick enough to make the risk adjusted guideline operational.

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⁶ It should be noted that we do not maintain sufficient reserves to absorb the losses from any two of the largest borrowers going into extended arrears at the same time. This is because it is assumed that these large borrowers (in the medium- to low-risk category) do not share common risk factors (covariance risk). In the Board's judgment, the Bank's current risk bearing capacity is sufficient.

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ANNEX 3

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ESTABLISHING A MEASURE OF EQUITABLE ACCESS TO TOTAL BANK RESOURCES

1. Given that the Bank is a multilateral institution, it is important to ensure that eligible member countries have equitable access to IBRD's resources. In this paper, IBRD-eligible countries are defined as those officially listed in Operations Directives and World Bank Annual Report as "countries eligible for IBRD funds" as well as those "eligible for a blend of IBRD and IDA funds"⁷. Part I countries, "IBRD graduates" and IDA-only countries are not included.
2. The broadest measure of IBRD resources is the Statutory Lending Limit defined by IBRD's Articles of Agreement. As explained in the text, it is only when this limit is reached that the issue of equitable access among member countries arises, because then a dollar lent to a member is a dollar taken from another member. This limit is defined as the sum of capital subscription, reserves, and that portion of the surplus account held for deferred decisions⁸. At the present time, this limit amounts to \$195.9 billion.
3. In establishing a measure of equitable access, we looked at a number of possible criteria including: i) population; ii) number of poor people; iii) IMF quota, or size of the country in the world; and iv) IBRD capital subscription.
4. **Population.** One possible measure of equitable access is population size. Table 3A shows the top 10 IBRD-eligible countries, their population, and percentage share in total population of eligible borrowers. One obvious difficulty with this approach is that countries vary tremendously in size. Moreover, of 78 eligible member countries, only three have shares higher than 5%. For example, if resources were to be distributed according to population, Tunisia, an IBRD member with an excellent borrowing record, would see its exposure reduced from the current \$1.6 billion to \$400 million (0.2% of the Statutory Lending Limit). Vanuatu with less than 200 thousand people, would not have any access. On the other hand, China alone would take up to 31% of total resources, and together with India, would account for 55% of the total, a share that is difficult to justify on the basis of equitable access.

⁷ See, for example, the 1996 Annual Report, page 233 or OD 3.10, Annex D, June 1996.

⁸ According to the Articles of Agreement, this limit includes "unimpaired capital, reserves and surplus". This is interpreted as subscribed capital plus reserves plus the portion of the surplus account held for deferred decisions. For example, as of August, 1996, subscribed capital amounted to \$180.6 billion, and reserves and the portion of surplus held for deferred decisions amounted to about \$15.3 billion. See Table 1, page 2 and page 18 of Annex IV, Allocation of FY96 Net Income Paper.

Table 3A: IBRD Top Ten Countries by Population Size

Country	Population (in millions, mid-1994)	% Share*
China	1190.9	31.1
India	913.6	23.9
Indonesia	190.4	5.0
Brazil	159.1	4.2
Russia	148.3	3.9
Pakistan	126.3	3.3
Nigeria	108.0	2.8
Mexico	88.5	2.3
Philippines	67.0	1.8
Iran	62.5	1.6

*/ Adjusted for eligible IBRD countries only.

Source: World Development Report 1996.

5. **Number of Poor People.** An alternative approach to measuring equitable access could be to use the number of poor people. However, this raises a number of problems. First, poverty comparison across countries is subject to immense measurement difficulties. How should the poor be defined? Should the poor in urban Sao Paulo be subject to the same poverty line (the headcount index approach) as the poor in rural India? Second, from a practical viewpoint, data are neither reliable nor available on a timely basis to guide Bank lending decisions. Third, there is a moral hazard issue associated with this approach since countries that advance most rapidly in poverty reduction will see their share of Bank resources reduced the most. Fourth, the varying number of the poor across countries makes it difficult to use this criterion to distribute resources because some countries are bound to have a huge claim while others may have virtually none. For instance, using the headcount index approach (the number of people below the poverty line, defined as \$370 per person per year, constant 1985 Purchasing Power Parity prices), the 1990 World Development Report identified South Asia as the region where the largest number of the poor (nearly half of the world's poor) reside. Indeed, India alone accounts for 38% of the poor in developing countries (45% if Africa, where IBRD access is marginal, is excluded). Table 3B below, taken from that report, shows the top four countries in terms of number of the poor and their representative share of the poor of developing countries. As with the case of population, India and China alone would account for 55% of Bank resources if this approach were taken.

Table 3B: Top Four Countries by Number of Poor

Country	Number of Poor (millions)	% Share in All Dev. Countries
India	420.0	37.6
China	210.0	18.8
Brazil	33.2	3.0
Indonesia	30.0	2.7
Total Developing Countries	1116.0	100.0

Source: WDR 1990, p. 29-47, Tables 2.1 and 3.3

6. **Country Size in the World Economy.** A third alternative would be to measure equitable access using IMF quotas. A country's IMF quota is the basis of that country's financial relations with the IMF⁹. It takes into account macroeconomic measures of the country's economic strength and its role in the world economy¹⁰. Until 1963, IMF quotas were determined by the Bretton Woods formula that includes basic variables, such as average annual import and export flows, gold holdings and dollar balance, and national income (which takes into account population size). Since 1963, the formula has been revised twice to include GDP (instead of national income), reserves, and current receipts and payments. Table 3C below shows the largest 10 IBRD countries in terms of IMF quotas and their shares in quotas of all eligible members.

Table 3C: Top Ten IBRD Countries, by IMF Quotas

Country	IMF Quotas (millions DRs)	% Share *
Russia	4313.3	10.6
China	3385.2	8.3
India	3055.5	7.5
Brazil	2170.8	5.3
Venezuela	1951.3	4.8
Mexico	1753.3	4.3
Argentina	1537.1	3.8
Indonesia	1497.6	3.7
South Africa	1365.4	3.4
Nigeria	1281.6	3.2

*/ Share in total quotas of IBRD eligible countries.

Source: IMF Survey, September 1996.

⁹ See IMF Survey, IMF, September 1996.

¹⁰ The Bank's capital subscriptions indeed parallel the Fund's quotas in this regard for the original 44 members of the Bank.

7. **IBRD Capital Subscription.** Finally, equitable access could be measured relative to a borrower's capital subscription. A member's share of IBRD's resources is proportional to the portion it pays, i.e., in terms of capital subscription. It also corresponds to the use of the Statutory Lending Limit as a measure of total Bank resources because subscribed capital is, by far, the most important component of this limit. Table 3D below shows the top IBRD eligible borrowers, their number of shares and the share in total subscription of eligible countries¹¹.

Table 3D: Top Ten IBRD Countries by Capital Subscription

Country	Number of Shares	% Share*
China	44,799	10.0
India	44,795	10.0
Russia	44,795	10.0
Brazil	24,946	5.5
Iran	23,686	5.3
Mexico	18,804	4.2
Argentina	17,911	4.0
Indonesia	14,981	3.3
South Africa	13,462	3.0
Nigeria	12,655	2.8
*/Adjusted for eligible IBRD countries only		

Source: World Bank Annual Report, 1996.

8. The largest four countries defined using this measure are the same as those defined using the IMF approach. Moreover, 10% is the largest share defined either way. There are at least three additional reasons why a 10% maximum share of the Bank's resources is reasonable. First, the current 10% guideline has been agreed by shareholders as an equitable limit (see Board document SecM85-850, July 17, 1985). Second, of the eligible IBRD countries, i.e., excluding Part I, IDA and nonaccrual countries, currently the largest three members each holds exactly 10% of capital subscriptions, yet IBRD exposure in any of these three countries is far below this limit. Third, historically, the largest share of the Statutory Lending Limit was 9%, reached in 1987.

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¹¹ To account for the fact that some countries may graduate from IDA -only group to IBRD-eligible, capital subscription for the latter group could be allowed to increase by 20% of subscription of the former group. In that case, the share of the largest countries would marginally decrease from 10% to 9.7%. Also, there will be some countries going from IBRD eligible to IDA-only, thus offsetting this trend.

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AN ILLUSTRATION OF THE PROPOSED GUIDELINE

A. DEFINITION

1. **Equitable Access Limit.** The Statutory Lending Limit is projected to average about \$197 billion for FY97-02¹. Assuming the share of the largest borrower is kept as a fixed percentage of this limit, the maximum exposure can be expressed as an absolute dollar amount. For example, if the proportion were 10%, the limit for our largest borrowers would be about \$20 billion. If the proportion were 12%, the limit would be \$24 billion. This proportion is an important judgment to be made by the Bank's shareholders. Annex 3 discusses the criteria which could be used in making this judgment and recommends adoption of 10% of IBRD's Statutory Lending Limit. Hence, the illustration below uses \$20 billion on the average as an equitable access limit. This limit could be adjusted if there were a capital increase. In addition, countries could be allowed to temporarily exceed this limit if it is clear that current and future lending programs will bring them into compliance with the guideline in an acceptable timeframe.

2. **Concentration Risk Limit.** The concentration risk limit would be determined by the Bank's ability to withstand the shock of the largest borrower going into arrears. The Bank's overall risk bearing capacity has to cover this risk as well as other types of risks. As discussed in Annex 2, the Bank's current reserves policy seeks to ensure that the Bank can absorb the loss of income from its largest borrower going into non-accrual for an extended period of time and continue to generate sufficient income to rebuild its equity and intermediate on behalf of other borrowers². While this approach is not the only way to evaluate the Bank's risk bearing capacity, it is clear that *no matter how capital adequacy is assessed³, portfolio concentration risk is the most important source of credit risk faced by the Bank (although not the only risk), and therefore would need to be taken explicitly into account in the analysis.*

¹ The Statutory Lending Limit is defined as subscribed capital plus reserves plus the portion of the surplus account held for deferred decisions. For example, as of August, 1996, subscribed capital amounted to \$180.6 billion, and reserves and the portion of surplus held for deferred decisions amounted to about \$15.3 billion. See Table 1, page 2 and page 18 of Annex IV, Allocation of FY96 Net Income Paper.

² The current FPI methodology uses a simulation model to examine the impact of the shock on the Bank's capital (including usable paid-in capital and reserves) and future income-generating capacity. Because most of the Bank's capital is relatively fixed over time, reserves are the key variable in this respect. This model can be used to "stress test" IBRD's capacity to respond to other shocks as well.

³ The issue of reserves adequacy is intimately linked to the broader framework of IBRD capital and risk-based assets. A task force has been set up to review the pertinent issues of this framework and its recommendations could have an important bearing on the assessment of reserves adequacy in the future.

B. ILLUSTRATION

3. Based upon the current lending programs provided by the Regions, IBRD's projected exposure to its largest borrower over the next 10 years is projected to increase from \$13.3 billion in FY96 (for Mexico) to \$18.7 billion in FY07 (for China). If the equitable access limit is defined as above (i.e. about \$20 billion), IBRD's headroom will not be a constraint on lending. However, under current financial standards this level of exposure will require a corresponding increase in IBRD's equity capital (i.e. paid-in capital, reserves and unallocated surplus). Hence, the concentration limit is the operationally relevant component of the new guideline.

4. At the present time, IBRD's equity capital is about \$23.3 billion, comprised of \$8 billion of usable paid-in capital, and \$15.3 billion of reserves and unallocated surplus. Given an actual exposure of \$13.3 billion to Mexico, the simulation model indicates that IBRD requires \$10 billion to cover other risks and to be able to generate sufficient income to rebuild its equity and intermediate on behalf of its other borrowers if the largest borrower goes into nonaccrual. For purposes of illustration, we will assume that the amount of equity capital that IBRD needs to maintain over and above its exposure to its largest borrower remains constant and that the amount of paid-in capital is not increased. Consequently, the increase in exposure to its largest borrower will need to be matched by a corresponding adjustment in reserves plus surplus.

5. It is important to note that the assumptions underlying this illustration can be changed without undermining the case for adopting the new two-part guideline. For example, the "other risks" confronting IBRD could change significantly as a result of a significant shift in overall portfolio risks or if IBRD were to undertake operations (on either the funding or lending side) that have different risk characteristics. This would necessitate an adjustment in the amount of equity capital that IBRD needs to hold to cover these risks. Alternatively, it could be determined that IBRD needs a different amount of equity capital to recover from its largest borrower going into nonaccrual or that a different "stress test" is more relevant, e.g., the possibility that a number of borrowers may go into nonaccrual simultaneously (covariance risk). However, these type of decisions are, and should continue, to be made in the context of the Net Income Allocation paper which is considered by the Executive Directors on an annual basis. Thus, the adoption of the new two-part guideline does not commit IBRD to a pre-determined path of reserves - it simply makes the decision concerning the trade-off between lending and managing concentration risk more transparent than is currently the case.

6. Given the assumptions outlined above, i.e., that the Bank's current financial policies are maintained and paid-in capital is constant, the concentration risk limit is

derived by comparing IBRD's projected exposure to its largest borrower with the path of reserves⁴ over the next five years. For example, Table 4A shows the trend in key variables for FY96-05. Based on the Regions' lending plans, IBRD's exposure to its largest borrower stays fairly flat for four years (\$13.3 billion on average), but then jumps to \$14.3 billion in FY01 and continues to increase to \$18.7 billion by FY06. In order to smooth the allocation of net income, the illustration shows that this path of exposure could be accommodated by an annual allocation from net income of about \$300 million between FY96-01 and about \$550 million between FY01 and FY06. This is consistent with maintaining the reserves to loan ratio at the current level of about 14.3% for the next 3 years and then allowing it to slowly increase up to about 17.1% by FY06. As explained above, the actual level of reserves will be determined annually in the context of a full assessment of the risks facing IBRD and its projected income capacity at that time. In addition, one must note that all of the ratios in Table 4A reflect current lending plans which, by their nature, become less reliable in the outer years. As noted in this paper, the introduction of new, more competitive products, particularly the Single Currency Loans, as well as the change in the concentration guideline itself (see below), may have a significant positive effect on the level of lending. This will, in turn, result in a lower reserves-to-loan ratio.

Table 4A: An Illustration Of Possible IBRD Equitable Access And Concentration Risk Limits
(US\$ billions, unless otherwise indicated)

COUNTRY	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03-13 Average
In Absolute Value (\$billion)								
Statutory lending limit a/	195.9	196.2	196.5	196.8	197.1	197.4	198.0	201.1
DOD b/	110.5	114.3	115.9	117.1	118.6	119.7	120.5	118.6
Equity Capital	23.3	23.6	23.9	24.2	24.5	24.8	25.4	28.5
Reserves c/	15.3	15.6	15.9	16.2	16.5	16.8	17.4	20.5
Exposure to the largest borr. b/	13.3	14.0	13.7	13.1	12.6	14.3	15.7	18.0
Equitable access limit	19.6	19.6	19.7	19.7	19.7	19.7	19.8	20.1
Concentration limit	13.3	13.6	13.9	14.2	14.5	14.8	15.4	18.5
In Percentage of DOD (%)								
Exposure of the largest borr.	12.1%	12.2%	11.8%	11.1%	10.7%	12.0%	13.1%	14.7%
R/L ratio d/	14.3%	14.1%	14.1%	14.3%	14.3%	14.5%	14.9%	17.8%

a/ Subscribed capital plus reserves and unallocated surplus .

⁴ Because actual exposure of the largest borrower varies from year to year, the concentration risk limit must be based on an average value (during the following five years) of exposure and/or of the portion of equity capital devoted to portfolio concentration.

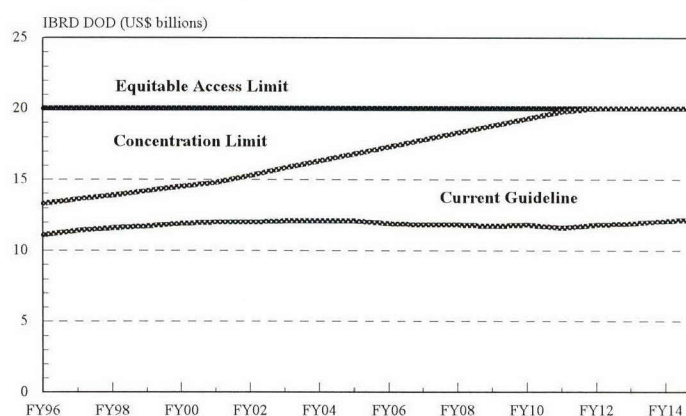
b/ Under the current Bank-wide lending plans, which are based on the FY97-99 Lending Allocation Review.

c/ Usable paid-in capital plus reserves and unallocated surplus.

d/ Reserves divided by DOD net of loan loss provisions.

Source: FPICR

Figure 4A: Current and New Limits



Source: FPICR

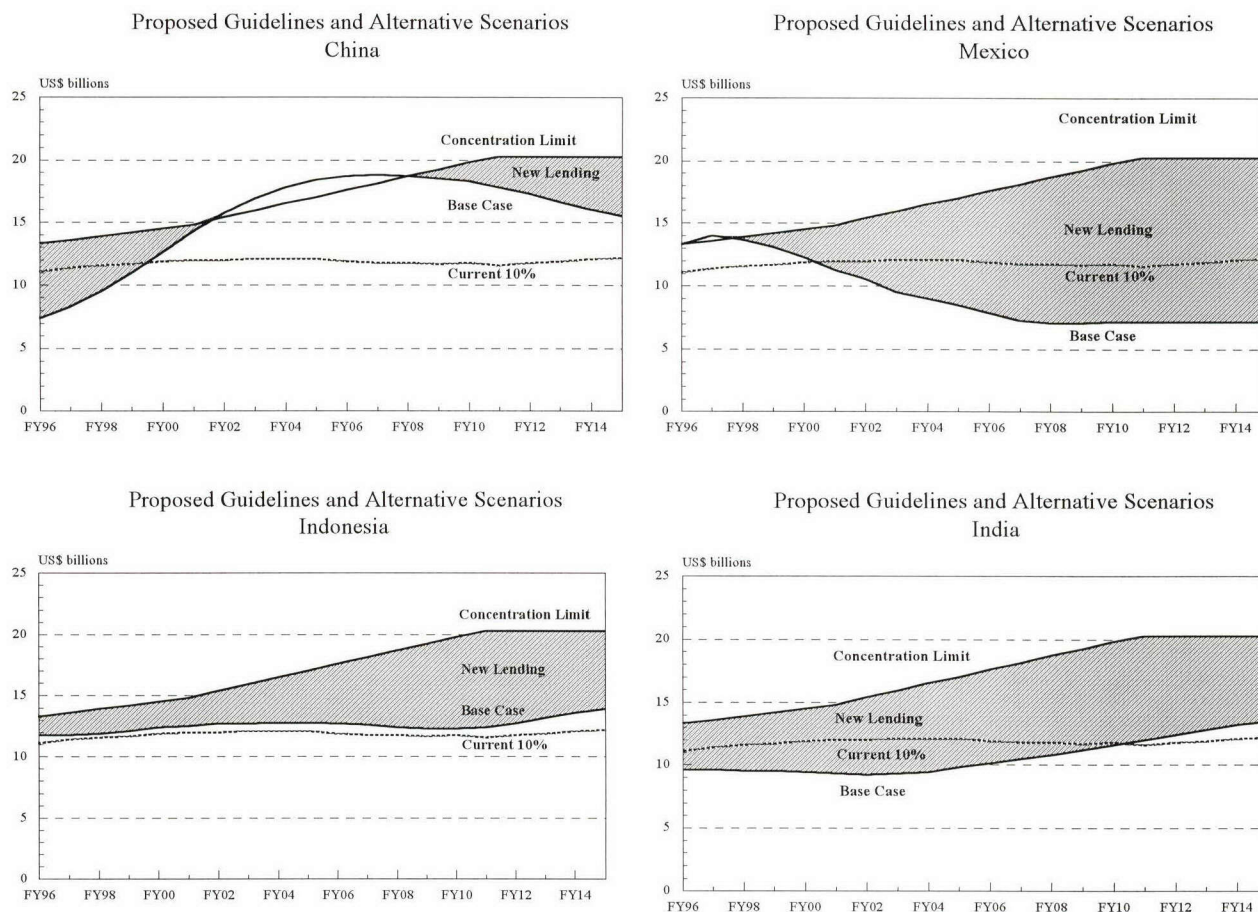
7. However, while it is likely that actual lending will differ from planned lending, it is important to note that disbursements over the next 5 years (and hence actual DOD and exposure), are primarily determined by the existing pipeline of committed loans - not new loans. This is the so-called “tanker effect”, which reflects the disbursement profiles that are associated with IBRD projects. Consequently, the accuracy of the projected level of exposure to our largest borrower and total DOD is inversely correlated with time. Thus, it will be necessary for the Board to decide what is an appropriate timeframe over which to base its decision on reserve adequacy. One of the major benefits of the new approach is that it permits the Board to make this decision in a pro-active forward looking context as opposed to the more reactive process that results under the current guideline. An analysis of disbursement performance would indicate that a 5 year timeframe is appropriate. This strikes a suitable balance between planning ahead and thus avoiding the necessity to increase reserves dramatically in one or two years but allowing the flexibility to respond to unforeseen changes in circumstances.

C. IMPLICATIONS OF THE PROPOSED APPROACH FOR LARGE BORROWERS.

8. By adopting the new guideline, the constraint on Bank lending to some of IBRD’s large traditional borrowers (China, Indonesia, India, Mexico) will be lifted. Whether this will result in higher Bank lending depends on creditworthiness and other considerations, but, under the new guideline, the portfolio concentration guideline itself will no longer be a supply constraint. For illustration, assume that the limits given in Table 4A were adopted and all other conditions were met. Our simulation indicates that lending

commitments to these countries could increase by at least \$20 billion (25%) over and above the current lending plans in the first five years. Figure 4B below shows the range of possible lending to large countries. The actual lending program to an individual country, of course, depends on creditworthiness and other considerations.

Figure 4B: Implications of the Proposed Approach



Source: FPICR

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ANNEX 5

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WBG ARCHIVES

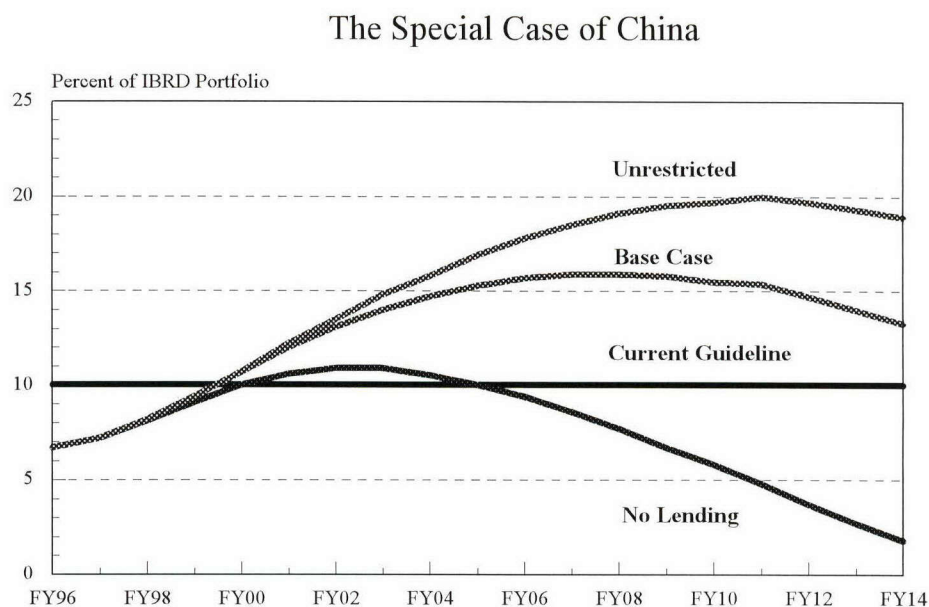
THE OVERSHOOTING PROBLEM: CHINA EXPOSURE

1. **The Special Case of China.** China presents a particular set of issues for several reasons. It includes a large proportion of the world's poor and has a corresponding large demand for IBRD projects. It has a demonstrated track record of being able to implement Bank projects well (above the average for countries of similar income levels), and has the capacity to efficiently and effectively absorb IBRD support. Being a relatively new member, China's amortization stream is low; and it has had a large lending program, compressed into a short period (1991-96).⁵ Almost all loans were project loans. Thus, there is a huge stock of pipeline debt, estimated at \$8.9 billion by the end of FY97, the year for which lending has been approved by the Board. Thus, the current lending pipeline and expectations regarding future commitments have created a situation which is difficult to manage under any approach to portfolio concentration.

2. The dilemma facing the Bank in lending to China is acute (Figure 5A). Even if lending were to drop to zero in FY98, China's exposure would still exceed the current 10% guideline: exposure would reach a peak of \$12.8 billion or 10.9% of DOD in 2002, before declining below 10% in 2006. If lending were to be maintained at the current \$2.5 billion a year, exposure would rise to a peak of 20% of portfolio in 2011. This scenario is depicted as the "Unrestricted Case" in Figure 5A. Under the current Bank-wide lending plans, which are based on the FY97-99 Lending Allocation Review approved by Management, it is assumed that lending will drop gradually to \$1.5 billion in 2001 and will remain at that level. Even then, exposure would stay significantly above 10%, reaching a peak of \$18.8 billion or 15.9% of DOD by 2007. This is the "Base Case" in Figure 5A. Note that under the Bank's existing financial policy, *ceteris paribus*, reserves would need to increase by a corresponding amount.

⁵ Bank lending only took off in 1990s. Annual commitments averaged about \$490 million between 1980-91 and rose to \$2.1 billion in 1992-96.

Figure 5A: The Special Case of China



Source: FPICR

3. Because China is projected to contribute more to portfolio growth than any other country in the next decade, a cutback in projected lending would sharply reduce total lending. This would, if the current guideline was adhered to, have feedback effects on other large borrowers and thereby cause second run cuts in the lending program of China itself. Looking at this from the opposite side, DOD to all other borrowers would have to grow by about 6% per year for China to be in compliance with the current guideline⁶. Because of the lag between commitments and DOD (it takes an average 7 years for an IBRD investment project to disburse), this implies that lending commitments would need to jump to about \$26 billion a year, compared to the \$15 billion p.a. projected for the next three years.⁷

⁶ This would still require an increase in dollar reserves, but not in the reserves to loan ratio.

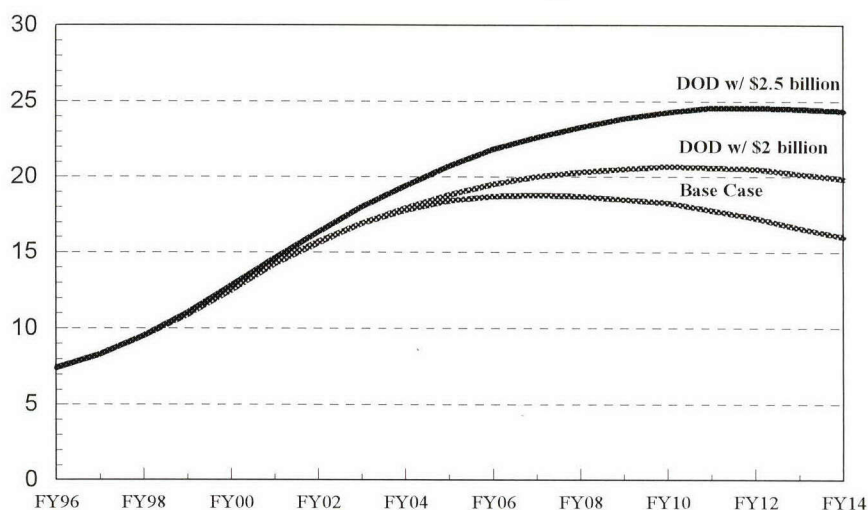
⁷⁷ The relationship between commitments and disbursed debt is also complicated by the composition of lending and the maturity of the Bank-country lending relationship that affects the amortization profile. Thus, as argued earlier, using the Bank-wide debt stock for lending decisions is not reliable.

4. **The Proposed Approach and China Exposure.** The proposed approach can help resolve the dilemma facing the Bank in lending to China. By unbundling the portfolio concentration management decision into two distinct limits, it provides Management and the Board with greater flexibility. First, China's lending program would no longer be constrained by lending decisions in other countries. Second, if the equitable access limit is defined as recommended in this paper, lending to China will not be constrained by this limit until 2008. Third, a much higher level of lending is compatible with the concentration limit than under the current 10% of DOD guideline. As explained above, the extent to which lending can be increased depends on Management's readiness to add to reserves. The illustration provided in Annex 4 shows that the concentration risk to China can be managed beyond the year FY05 if between \$300 to \$550 million is added to reserves each year.

5. Moreover, by clearly defining the constraint (i.e., concentration risk and not headroom) the new approach may allow Management to pursue alternative mechanisms through which to manage this risk. For example, given China's high level of foreign exchange reserves (about \$100 billion, or 7 months of imports) it may be mutually beneficial to pursue the option of having China deposit a small part of these reserves in a special account which could be used in the event that China were to go into arrears. This type of approach may provide a useful mechanism by which IBRD could manage China's exposure for a temporary period until the portfolio matures and net flows are correspondingly reduced.

Figure 5B

China: Alternative Lending Scenarios



Source: FPICR

FPICR

December 2, 1996

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THE ADEQUACY OF IBRD'S EQUITY CAPITAL

1. This note describes the current methodology for assessing the adequacy of IBRD's equity capital. By virtue of the underlying earnings strength it provides, the IBRD's equity capital is the principal determinant of its risk bearing capacity. The note starts by describing the role of the Bank's equity base in achieving its strategic objectives. It then presents the principal tools available to the Bank to strengthen its equity base. Next, it describes the current approach for assessing the adequacy of IBRD's equity capital and explains why possible alternative approaches are inappropriate in the Bank's context. Finally, it briefly describes the current practices of other multilateral development banks (MDBs).

The Role of Equity

2. The Bank's equity base is comprised of usable paid-in capital and retained earnings (reserves, surplus and unallocated income). As of June 30, 1996, the Bank had outstanding usable paid-in capital in the amount of about \$8 billion, General and Special Reserves of about \$15 billion, surplus of \$710 million and unallocated income of about \$1.2 billion, for a total equity base of approximately \$25 billion (see Table 1).

Table 1:
IBRD's Equity Capital as of June 30, 1996
(\$ million)

Usable Paid-in Capital 1/	8,024
General Reserve	14,964
Surplus	710
Special Reserve	293
Unallocated Income	1,187
Total Equity	<u>25,178</u>

1/ The usable paid-in capital represents about 73% of total paid-in capital. The remainder, the non-usable paid-in portion is made up largely of non-interest-bearing demand notes. The Articles of Agreement provide for maintenance of value. If currencies of member countries depreciate relative to the standard of value, the members owe the Bank the decline in value of their contribution. On the other hand, if the currencies appreciate, the Bank is required to reimburse the members.

3. The Bank's equity policies play a significant role in meeting the institution's strategic financial objectives. As a development institution, the IBRD's mission is to promote economic development in its borrowing members. A principal financial objective, therefore, is to maintain a strong AAA credit standing which permits the Bank to intermediate on behalf of its borrowers the finest lending terms from the capital markets. A premier credit standing also signals to the Bank's stakeholders (borrowers, donor countries, other members and investors in Bank debt obligations) the strong expectation that the negative effects of all plausible risks on Bank income can be met through the Bank's own cash resources. A strong equity base also permits the Bank to take managed risks. In line with its development purpose, the most significant risk taken by the Bank is lending to its member countries to promote their economic development. Maintaining a strong equity base allows the Bank to lend to its borrowers at low intermediation spreads above the cost of its own borrowing. Finally, IBRD's policies on income allocation are closely linked to maintaining an equity base that would assure self-sustainability of the Bank.

Avenues for Increasing Equity Capital

4. Because equity consists of usable paid-in capital plus retained income, the Bank has basically two avenues available to it for strengthening its equity base: (i) obtain an increase from the shareholders in the amount of outstanding paid-in capital (either through an increase in subscribed capital with a portion of the increase being paid in, or through an increase in the paid-in portion of the current subscribed capital); and/or (ii) retain earnings in reserves. The paid-in portion of the Bank's equity base is generally determined by shareholders at each periodic General Capital Increase and is often governed by non-financial (as well as financial) considerations. Moreover, in the current environment of severe fiscal constraints, many member governments are now likely to be extremely reluctant to agree to an increase in the Bank's paid-in capital. The focus of annual income allocation decisions, therefore, is whether changes are needed in the reserves portion of total equity to maintain a risk bearing capacity that is consistent with the Bank's purpose and strategic objectives.

Assessing the Adequacy of Equity Capital

5. The Bank's equity capital is the principal element of its risk-bearing capacity. Equity capital can be regarded as adequate if it provides a sufficient earnings base to permit the Bank to absorb and recover from potential interruptions in loan service by borrowers, losses on loans and other plausible adverse events. Adequate equity capital assures the various stakeholders with regard to the Bank's ability to meet its financial obligations out of its own resources in the face of plausible risks and to rebuild reserves to support future growth in order to remain a viable financial institution.

6. Risks faced by the Bank. Risk is defined as unexpected loss. In line with its development mandate, the most significant risk faced by the Bank is the country credit risk in its loan portfolio. Policies have limited the institution's exposure to other risks commonly accepted by financial intermediaries viz. market risks (i.e. interest rate risk, exchange rate risk and commercial credit risk) and institutional risk.

7. Measuring the Adequacy of Equity Capital. The Bank protects itself from potential losses in two main ways. Expected or probable losses in the Bank's loan portfolio resulting from high-probability collectibility risks, either from default or extended nonaccrual, are covered by loan loss provisions. Unexpected losses due to low-probability risks, such as those resulting from the largest borrower (or a group of small borrowers) going into nonaccrual,¹ as well as other risks, are covered by the Bank's equity capital.

8. Equity capital is an important element of the Bank's capacity to cope with risks by virtue of the income generating capacity it provides. Although there are other options available to the Bank to cope with risks so that its own obligations are met fully and on time, none of these, in practical terms, is a feasible option. These options are as follows:

- (i) Discontinuance of waivers of loan charges. This can be achieved readily in reaction to a large risk event but only up to the amount of the annual waiver in place at that time;
- (ii) Imposition of extraordinary charges on loans. However, any amounts that can be raised through extraordinary charges are unlikely to be large enough to cope with a sizable risk;
- (iii) Call on subscribed capital. The Bank has the authority under its Articles of Agreement to call subscribed capital from its members when required to meet its obligations. A call, however, is likely to have serious consequences. It would impose an unexpected financial cost on the members responding to the call, may cause the Bank to lose its AAA rating, increase the cost of borrowing for the Bank, raise lending rates to the borrowers, and cause losses in market value to investors in the Bank's obligations.

9. Hence, the Bank must hold sufficient equity capital to provide assurance that it has the risk-bearing capacity to absorb the effects of a large unexpected risk event and continue to intermediate on behalf of its other borrowers. The test of equity capital adequacy is that the Bank have the ability to absorb the loss of income from such a shock,

¹ Many well-managed financial institutions have diversified loan portfolios and, at a minimum, establish protection against their largest exposure. As a prudently managed institution, the Bank has established similar standards to protect itself against unexpected losses from low-probability risks by developing the risk-bearing capacity to withstand a large unexpected risk event such as a large borrower going into nonaccrual for an extended period of time.

generate residual income after this loss sufficient to absorb some additional risk, and still add to reserves at a rate slightly above that of projected loan growth so that it can have the capacity to rebuild its equity and continue its operations. Moreover, the ICR² also should recover sufficiently after the shock to assure the markets of the Bank's ability to continue to honor its financial obligations in a timely fashion out of its own resources. These policies have been discussed in Board documents³, most recently in the context of the allocation of FY96 net income.⁴

10. The Bank's risk-bearing capacity is assessed through the use of a multi-currency, dynamic simulation model that projects the balance sheet, income statement and cash flows over a 10-year horizon. This model can be used to measure IBRD's capacity to recover from any one, or a number of risk events, including either a market or country credit risk event, or a combination of the two. The capacity to remain a viable financial institution in the event that the largest single borrower fails to service its debt is also tested. If the analysis indicates that IBRD's usable equity needs to be adjusted, this occurs through an adjustment to reserves at the time of the annual net income allocation decisions. Other components of equity are assumed to remain constant.

11. Alternative Approaches. It has been argued that IBRD should adopt the original BIS regulations, issued in 1988, which recommended that banks assign weights for credit risk as a first step toward linking risk to capital adequacy.⁵ In the context of the Bank, a strict application of the BIS guidelines to the Bank's balance sheet is not appropriate for several reasons: (i) the recommended capital ratios are minimums, not targets, and the Bank's objective in establishing its targets is not just to remain solvent, as a commercial institution does, but to maintain its financial standing including its AAA rating, to fulfill its development mandate; (ii) the minimum ratios are appropriate for the best credits of commercial banks, while the Bank's clients, by definition, are riskier than the best customers of commercial banks; (iii) by its nature, the Bank's portfolio tends to be concentrated because the Bank has a relatively small number of clients; (iv) the Bank cannot raise additional capital quickly the way commercial banks do; and (v) there is also a need to evaluate the capital requirement for absorbing other risks, such as potential for losses from interest and exchange rate movements.

² The ICR (interest coverage ratio) is the ratio of the sum of the Bank's interest expense and net income to its interest expense. It is a measure of the Bank's ability to honor its debt service obligations out of its own cash resources.

³ See Review of the Adequacy of Loan Loss Provisions and Reserves, R93-73, April 22, 1993.

⁴ See Allocation of FY96 Net Income, R96-160, July 17, 1996.

⁵ This Accord emphasizes the role of capital in protecting a financial institution against insolvency, liquidation and unexpected losses. Under this framework, banks' assets are grouped into different risk categories carrying different risk weights. Total risk assets are calculated by summing the risk-weighted assets across all risk categories. Off-balance sheet items are explicitly taken into account. The risk assets are required to be supported by capital, with a recommended minimum level of capital equal to 8% of risk assets.

12. Moreover, the 1988 Accord was a first step rather than a full-fledged approach to capital adequacy analysis. Since then, considerable work has been done by banking regulators toward: (i) improved empirical approaches toward finding risk weights; (ii) ways to include types of risk other than just credit risk, as well as risk covariances, in a capital adequacy analysis. Improvements have been made toward performing such assessments in a dynamic rather than a static framework. The industry has also moved forward in its own practices. On May 21, 1996, the Basle Committee on Banking Supervision reported on further progress by allowing banks to use their own simulation models to stress test for multiple risks in a dynamic setting; by suggesting an exposure limit for a single borrower be set at 25% of total bank capital; and by suggesting that interest rate risk be managed through the use of sophisticated measurement systems. Thus, IBRD's current stress testing approach is more in line with the more recent Basle recommendations of capital adequacy.

13. Due to the unique character of IBRD's portfolio, portfolio concentration risk will always need to be assessed in determining capital adequacy. In the US, regulatory authorities have prescribed even higher standards than the Basle Accord -- i.e. largest borrower exposure to be in the range of 10-15% of total capital.⁶ In comparison, the largest borrower exposure of the Bank now accounts for about 57% of IBRD's equity capital.

Current Practices of Other MDBs

14. Other multilateral development banks (which also lend to developing countries in support of economic development) have loan portfolios that are similar to that of IBRD in many ways. In general, the most significant risk faced by the MDBs, like IBRD, is the country credit risk in their loan portfolios. Although these banks have varying levels of portfolio concentration, they manage their loan portfolio risks in a similar way as the IBRD, by holding reserves and capital commensurate with the degree of portfolio concentration. The levels of portfolio concentration and the reserves-to-loans ratios of the MDBs are shown in Table 2 and Chart 1 below.

⁶ In the United States, the Federal Reserve Act specifies that national banks shall at no time provide loans and extension of credit to a single borrower (not fully secured by collateral having equal market value) in excess of 10% of the unimpaired capital and unimpaired surplus of that bank, and in the case of fully secured loans and credit, 15% of the unimpaired capital and unimpaired surplus. Exceptions include obligations secured by a like amount of bonds, notes, Treasury bills of the United States, where no limit applies. In the case of consumer paper with full resource endorsement or unconditional guarantee, a 25% limit applies.

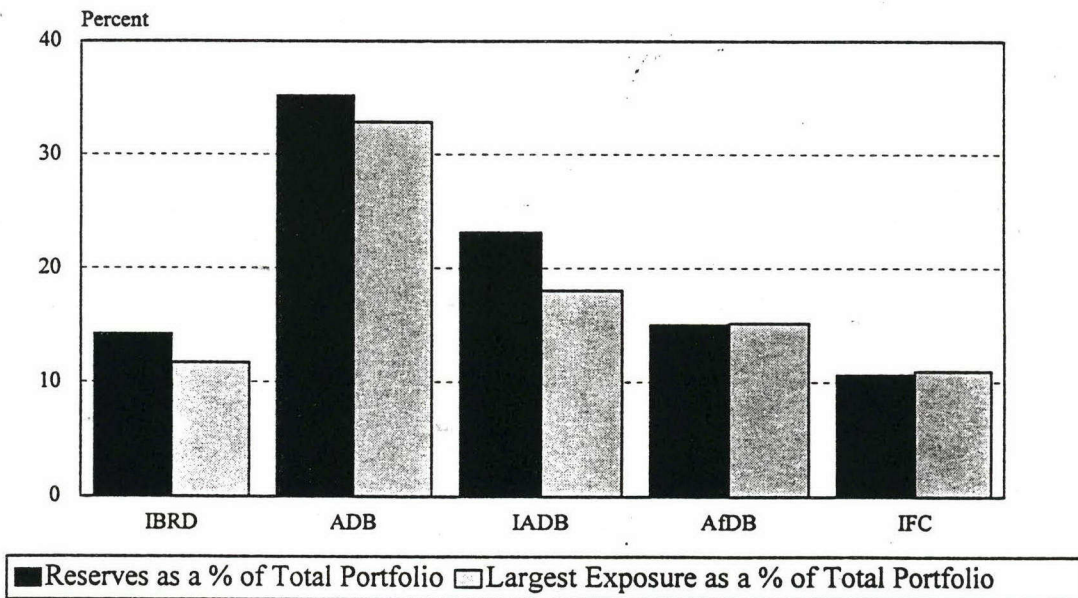
Table 2:
MDBs: R/L And Exposure To The Largest Borrower ^{a/}
(%)

	R/L	EXPOSURE	LARGEST BORROWER
IBRD	14.3	11.7	Mexico
ADB	35.2	32.9	Indonesia
IADB	23.2	18.1	Mexico
AfDB	15.2	15.2	Morocco
IFC	10.7	11.0	Argentina

^{a/} As of December 30, 1995

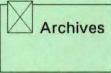
Source: FPIFP

Chart 1:
Portfolio Concentration and Reserves Ratios in MDBs, 1995



Source: FPICR

E. COMMENTS: This brief includes the following:
-Briefing Note Short Summary
-A New Approach to Portfolio Concentration Management
-The Adequacy of IBRD's Equity Capital

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