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L.B. Rist: memorandum on Loan Charges and relevant Documentation

1963 (B)

R-367 - 8/11/1950

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

CONFIDENTIAL

R-367

(For consideration by the Executive Directors on August 15, 1950.)

TO: Executive Directors

August 11, 1950

FROM: The President

COMMITMENT CHARGE POLICY

The Staff Loan Committee at its meeting on July 20, 1950, considered the attached memorandum of a Working Party composed of various members of the Bank's staff which had been organized to study and recommend a formula for the computation of the commitment charge.

It was the conclusion of the Staff Loan Committee that the present scale of commitment charges could be substantially reduced without endangering the net income target set out in the memorandum.

It was also concluded that a flat commitment charge from the effective date to the date of disbursement of 3/4 of 1% could be adopted, applicable to prospective loans and the undisbursed portions of existing loans. It should be clearly understood that this rate is predicated upon the source of funds and the scale of revenue and expenditures estimated in the memorandum, and that any material modification of these factors may necessitate a reappraisal of the Bank's commitment charge policy.

I recommend that the Board agree to the conclusions stated above, possibly after consideration by the Financial Policy Committee, if the Board so desires. Upon approval by the Board, the change in the commitment charge could become effective at an early date.

CONFIDENTIAL

Commitment Charge Policy

1. The Staff Loan Committee at its meeting of June 7, agreed that a working party should be organized to study and recommend a formula for the computation of the commitment charge, after which the Committee should give further consideration to the Bank's liquidity and commitment charge policy.

2. The following staff members were appointed to constitute such working party:

S. Aldewereld, Treasurer's Department
E. G. Burland, Loan Department
R. W. Cavanaugh, Treasurer's Department
A. F. Luxford, Legal Department
M. M. Rosen, Economic Department

3. In accordance with its terms of reference, the Working Party based its considerations on the understanding that the desire of the Bank is to obtain a net income approximating annually 2% on capital made freely available which now amounts to $750,000,000, and therefore the desired net income on such total is to be in the neighborhood of $15,000,000. It was assumed that there would be no material reduction in the amount of 18% capital available to the Bank for lending. It was also assumed that further issuance of the Bank's own bonds or sales of bonds out of its portfolio would not be of such magnitude as materially to affect the computations set forth in this paper.

4. The Working Party, in making its analysis, concluded that it should utilize the latest actual financial data bearing on the subject as a basis for a forecast of the revenues and expenditures for the fiscal year 1950/51.

5. Accordingly, investment income, loan interest and loan service charges which actually accrued to the Bank during the month of June 1950 were used as a base and these figures were projected on an annual basis. The following five hypotheses as to new loans and loan disbursements during 1950/51 were used to estimate gross profit for such year, exclusive of income from commitment charges:

1) no new loans and no further disbursements
2) $150,000,000 new loans and no further disbursements
3) $150,000,000 new loans and disbursement of $60,000,000
4) $150,000,000 new loans and disbursements of $90,000,000
5) $150,000,000 new loans and disbursements of $120,000,000

From each such estimate of gross income there was deducted the amount of administrative expenses as presently budgeted for the next fiscal year and one year's bond interest charges on the Bank's present borrowings.

6. It was arbitrarily assumed by the Working Party that new loans during the next fiscal year would approximate $150,000,000. It was further assumed, based on actual disbursements during the last fiscal year approximating $90,000,000, that disbursements during 1950/51 would be the same. For purposes of illustration, other disbursement figures were also examined.

7. There were therefore obtained the net income figures, exclusive of commitment charges, which would result under the above five assumptions.

8. There were then computed the amounts which would accrue to the Bank as commitment charge income, under each of the above situations, on the basis of commitment charge rates of 1/2 of 1%, 3/4 of 1% and 1%, respectively.

9. The estimated net income thus resulting at these various levels of commitment charges would be as follows:

Estimated Income for Fiscal 1950/51*
On Various Assumptions

(in thousands)

Commitment Charge Rate	I Assuming No New Loans or Disbursements	II Assuming $150,000,000 New Loans & No Disbursements	III Assuming $150,000,000 New Loans & $60,000,000 Disbursements	IV Assuming $150,000,000 New Loans & $90,000,000 Disbursements	V Assuming $150,000,000 New Loans & $120,000,000 Disbursements
1/2%	13,684	14,059	14,509	14,736	14,960
3/4%	14,145	14,708	15,083	15,272	15,460
1%	14,607	15,357	15,657	15,809	15,959

10. The Committee further projected for the fiscal year 1951/52 assumption IV, viz. $150,000,000 new loans and $90,000,000 disbursements annually, and this calculation resulted in an estimated net income of:

$16,800,000 at a commitment charge of 1/2 of 1%
$17,500,000 at a commitment charge of 3/4 of 1%
$18,200,000 at a commitment charge of 1%

11. Over and above the projected income, the Bank will, of course, receive the 1% statutory commission on amounts disbursed. The balance, as of June 30, 1950, amounted to $13,737,205. On the assumption for $150,000,000 loans and $90,000,000 disbursements annually the amounts accruing would be $6,590,000 during 1950/51 and $7,490,000 during 1951/52.

12. Since the latest draft of Loan Regulations 3 and 4 envisage a change in approach in respect to the Bank's procedure on firm commitments, i.e., that the terms of such arrangements should be settled by agreement between the parties, and since the total earnings from this source during the last fiscal year were negligible, it was felt that no action was required on this subject at this time.

* For details of calculation see Annex A

ANNEX "A"

Estimated Income for Fiscal 1950-1951 on Various Assumptions
(in thousands)

	I		II		III		IV		V	
	Assuming No New Loans or Disbursements		Assuming $150,000,000 New Loans and No Disbursements		Assuming $150,000,000 New Loans & Disbursements of $60,000,000		Assuming $150,000,000 New Loans & Disbursements of $90,000,000 1/		Assuming $150,000,000 New Loans & Disbursements of $120,000,000	
Investment Income 2/	5,400		5,400		5,100		4,950		4,800	
Loan Interest 3/	18,948		18,948		19,848		20,300		20,748	
Loan Service Charge	104	24,452	104	24,452	104	25,052	104	25,354	104	25,652
Administrative Exp.	4,926		4,926		4,926		4,926		4,926	
Bond Interest	6,765	11,691	6,765	11,691	6,765	11,691	6,765	11,691	6,765	11,691
Net		12,761		12,761		13,361		13,663		13,961
Commitment Charge										
1/2%	923	13,684	1,298	14,059	1,148	14,509	1,073	14,736	999	14,960
3/4%	1,384	14,145	1,947	14,708	1,722	15,083	1,609	15,272	1,499	15,460
1%	1,846	14,607	2,596	15,357	2,296	15,657	2,146	15,809	1,998	15,959

1/ Loan Disbursements in fiscal 49-50 = $90,000,000

2/ Assuming 1% investment income loss on additional disbursements

3/ Assuming 3% loan interest on additional disbursements

Treasurer's Department
7-12-50

R-71 -Jan.17.1947

R - 71
(To be submitted to the Executive Directors on January 21, 1947 for approval)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

January 17, 1947

COMMITTEE ON FINANCIAL POLICY

R 71

Report on Financial Policy

The Committee on Financial Policy after further discussion of the issues enumerated in Committee on Financial Policy Document No. 13, dated December 19, 1946, submits the following recommendations to the Executive Directors.

I. THE BANK'S POLICY OF HOLDING LIQUID ASSETS.

1. The Committee has come to the conclusion that the decision whether the Bank should at all times keep liquid assets covering the total of its commitments under loan-contracts cannot usefully be taken at the present moment. It is only from practical experience that the Bank can learn how large its holdings of liquid assets - in relation to all its commitments including other commitments than those to borrowers - will have to be. In all likelihood the Bank will be overcovered during the greater part of 1947 as it may well go to the market in the first half of 1947 before the total amount of its commitments exceeds its available capital.

2. It may be advisable in the first years to keep relatively larger liquid holdings than later when the Bank's standing in the market has been established. The cost of such greater

liquidity may even be counterbalanced in so far as it would help to improve that standing and thereby reduce the cost of borrowing. It is clear, therefore, that the Bank, in deciding about its system of charging interest to its borrowers, should follow a policy that does not prejudice the liquidity policy which the Bank will adopt in the future.

II. THE DATE FROM WHICH INTEREST SHOULD BE CHARGED.

3. Such freedom is assured if the Bank charges interest to the borrower on the full amount of the loan (in so far as firmly committed) from the moment the loan is granted - in other words from the date of commitment. Charging interest from the date of disbursement would involve the Bank in a loss should it decide at any date to adopt the 100% liquidity policy.

4. The question should be asked, on the other hand, whether it would be unfair to the borrower to charge interest from the date of commitment whilst following a partial liquidity policy. The Committee feels that it would not be unfair for the following reasons:

(a) Calculated over the whole period of the loan, the total charge to the borrower is not substantially heavier if he is charged interest also over the relatively short period between commitment and disbursement than if, over that latter period, he is only charged a commitment fee of, say, one per cent on the undisbursed commitment.

(b) Charging interest from the date of disbursement would make it difficult for the Bank to fix, at the date of the granting of the loan, a rate of interest, not to be changed during the currency of the loan. Therefore, the rate would have to be fixed as disbursements take place. It is needless to say that such a system would be complicated and it was generally felt that the borrower would prefer to know where he stands from the date the loan is granted.

5. One member of the Committee, though in general agreement with this reasoning, made the reservation that the answer to the question whether such a system would be fair to the borrower was dependent on what rate of interest was charged and notably on whether the Bank would charge an interest rate higher than or equal to the interest rate it would have to pay on its own borrowings of the same maturity. The other members feel that as long as the margin between interest charged and interest paid remains within limits justified by the necessity for the Bank to build up reserves and eventually pay a small dividend, the system of charging interest from the date of commitment could not be considered unfair to the borrower.

6. One member of the Committee felt that exceptions might have to be considered in cases of development loans, since experience would indicate that it is not unusual for two or more years to elapse between the commitment and the disbursement of monies loaned for development purposes; in such cases, the system of charging interest from the date of commitment might result in too heavy a charge on the borrowers.

7. The Committee has generally considered it advisable that the contractual rate of interest should be fixed at a definite figure. If, in the long run, the Bank would appear to amass large surpluses, not considered fully necessary for the covering of risks, it should be up to the Bank to decide whether a dividend should be paid or a rebate should be given to the borrowers.

III. DATE FROM WHICH STATUTORY COMMISSION SHOULD BE CHARGED.

8. The Committee is of opinion that the statutory commission should be charged from the date of disbursement. In case an irrevocable credit is opened (either by the Bank itself or for its account by another bank) the date of the opening of such credit should be considered to be the date of disbursement; the Bank from such date has a definite obligation to a third person to disburse the amount for which the credit has been opened and such amount thereby becomes part of the outstanding portion of the loan (see Article IV, Section 4).

IV. REFUNDING TO THE BORROWER OF THE INTEREST EARNED BY THE BANK ON LIQUID ASSETS HELD AGAINST UNDISBURSED COMMITMENTS.

9. The Committee is of the general opinion that refunding of such interest to the borrower should not take place. Such refunding would deprive the Bank of a source of revenue and therefore inevitably result in the necessity of charging the borrowers a higher rate of interest. The calculation of the refund would be complicated and such complication does not seem justified in view of the fact that ultimately the benefit to the borrower would be negligible.

V. WHAT MARGIN, IF ANY, SHOULD THERE BE BETWEEN INTEREST CHARGED AND INTEREST PAID AND WHAT SHOULD BE THE STATUTORY COMMISSION?

10. The Bank's income consists of the difference between interest charged on the one hand and interest paid, plus expenses on the other. If the system of charging interest from the date of commitment is followed, the Bank will earn interest on its loans, whether disbursed or not, together with interest on its short term investments, and will have to pay interest on its borrowings. The difference is available for

a. expenses.

b. building up a surplus or paying a dividend.

11. The Committee has generally recognized the necessity to build up a surplus. The payment of a dividend, though desirable in the more distant future, is not in the interest of the Bank for several years to come. The building up of a surplus is necessary to enable the Bank to meet all manner of risks. The main risk is certainly that of default. This risk is supposed to be covered by the special reserve, to be formed out of the statutory commission of not less than one and not more than one and one half per cent per annum.

12. The Committee, in its large majority, is against charging more than one per cent per annum. The Loan Director was of the opinion, however, that the maximum statutory commission of one and one half per cent should be charged, or at least one and one fourth per cent in the event, as recommended by the Committee, that the interest earned by the Bank on liquid assets held against undisbursed commitments be not refunded to the borrower. (Vide his comments contained in Committee on Financial Policy, Document No. 20).

13. But as the risk of default cannot be measured, it is felt that the decision to limit the statutory commission to one per cent per annum enhances the necessity to build up a surplus. This surplus will be built up from the following sources:

a. interest on capital and surplus invested in loans and liquid assets.

b. margin of interest between the rate charged on loans and the rate paid on borrowings.

c. interest earned on liquid assets financed out of borrowed funds.

14. Under the system of charging interest from the date of commitment there need not be a net loss of interest on b, even if the liquid holdings against commitments would be financed out of borrowed funds.

15. The income earned under c will depend on the amount of undisbursed commitments covered by liquid assets. In case the liquid holdings are smaller than the amount of undisbursed commitments the income under c will be less, but this will be largely compensated for by the fact that there is a reduction pro tanto in the borrowings of the Bank. In case the Bank reaches the limit of the expansion of its business, the income under c will gradually disappear since there will be no undisbursed commitments. It should be noted however that in that case the one per cent statutory commission will be paid on the full amount of the loans.

16. Although the unpaid capital provides ample security for the creditors of the Bank, the policy of the Bank should be to

accumulate such surplus and keep such liquidity as to enable it to carry on its business and meet its obligations without recourse to the unpaid capital even if it has to suffer postponements or defaults on its loans. The unpaid capital should be considered as "a last resort". On the other hand, the Bank need not base its charges on the principle that it should never resort to calling up capital even in case of a prolonged crisis of a world wide nature.

17. Attached is a Memorandum by the Treasurer (Committee on Financial Policy, Document No. 19) sketching the situation of the Bank at certain dates. The calculations are based on assumptions regarding the rate of expansion of the Bank's operations, the liquidity policy to be followed and the expenses to be paid and on two different assumptions regarding charges of interest and commission.

18. No provision is made in the calculations for current defaults in amortization payments.

On the other hand, the following items of income are neglected:

a. return from investment of the surplus,

b. return from investment of the special reserve,

c. any advantage the Bank may obtain from borrowing at shorter maturities than its lending maturities,

d. utilization of the 18% in non-dollar currencies for lending operations,

e. the favourable influence devolving from the admission of new members.

19. Any diminution in the Bank's expansion or failure to reach the lending limit would unfavourably affect the building up of

surplus and reserve but would on the other hand reduce the rate of accumulation and level of the outstanding obligations. Their coverage by the unpaid capital would of course be relatively larger.

20. The synoptic table gives no picture of the assumed liquidity policy as it does not give the figures of the special reserve and surplus. They can be found in the pro forma balance sheets attached to the memorandum. In the first three balance sheets it is assumed that the debtor be charged no more than the theoretical cost of borrowing by the Bank, which should of course include not only interest but also all other borrowing costs. There would be no margin between the cost to the Bank and the cost to the borrower except the 1% statutory commission. In the other three balance sheets it is assumed that there is a margin of ¼% between interest charged and interest paid.

21. On the assumptions taken as basis for the calculation the difference in total cash would be as follows:

December 31, 1948 total cash without interest margin -		$ 882.4 million
	with interest margin -	889.2 million
	difference -	6.8 million
December 31, 1951 total cash without interest margin -		$ 801.1 million
	with interest margin -	840.9 million
	difference -	39.8 million
December 31, 1956 total cash without interest margin -		$1.044.9 million
	with interest margin -	1.181.9 million
	difference -	137.0 million

22. With the exception of one member, the Committee felt that it would be wise to charge interest at a rate ½% higher than the theoretical interest paid. Not only should the earnings of the Bank provide suitable coverage against defaults but should be such as to permit the payment of a dividend after a number of years under favorable circumstances. Without a margin of at least ¼% such would hardly be feasible even after 10 years.

VI. LOAN CONTRACTS

23. As the first loan contracts are likely to be signed before the first debenture issue of the Bank, the interest and amortization of such loans will have to be based on an estimate of what the market will require with respect to the Bank's debentures.

24. The Committee is of the opinion that loan contracts should fix the rate of interest at a definite figure. The relation between such rate of interest and the prevailing market rate is a matter of policy but should not form part of the contract.

25. While the Committee agreed that the Bank's debtors could not be denied the right to accelerate amortization of loans, it has no recommendations to make at present as to whether such repayment should be at a premium or as to the rate of any premium.

VII. SUMMARY OF RECOMMENDATIONS

The Committee recommends that:

1. The Bank adopt a system of charging interest to its

borrowers which does not prejudice the future determination of the liquidity to be followed.

2. Interest should be charged to the borrower on the full amount of the loan committed from the date of commitment.

3. The statutory commission should be charged on disbursements from the date of disbursement.

4. The contractual rate of interest should remain the same over the whole period of the loan.

5. The rate of the statutory commission should be limited to one per cent per annum. (N.B. Contrary opinion of the Loan Director outlined in Part V, para. 12, above.)

6. The rate of interest charged on Bank loans should be equal to the theoretical interst paid on Bank borrowings of the same maturity,

   (a) plus a margin of ¼% (majority recommendation)

   (b) with no margin added or only a fractional one (minority recommendation).

7. Refund should not be made to the borrower of interest earned by the Bank on liquid assets held against undisbursed commitments.

J. W. Beyen, Chairman
Committee on Financial Policy

Distribution:

Executive Directors and Alternates
President
Vice President
Treasurer
General Counsel
Loan Director
Research Director
Public Information Director
Chief of Communications
Secretary

L. Baranski
R. B. Bryce
E. G. Collado
Sir James Grigg
L. Machado

Sec-290

CONFIDENTIAL

Committee on Financial Policy
Document No. 19

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

January 6, 1947

COMMITTEE ON FINANCIAL POLICY

Memorandum on Financial Policy:

Supplementing my memorandum of December 27, 1946, I have the honor to submit to you an additional memorandum on Financial Policy.

D. Crena de Iongh
Treasurer

Distribution:

Members of the Committee on Financial Policy
President
Vice President
Treasurer
General Counsel
Loan Director
Research Director
Chief of Communications
Secretary

Committee on Financial Policy
Document No. 19

SECOND SUPPLEMENTARY MEMORANDUM ON COMMITTEE ON FINANCIAL POLICY DOCUMENT NO. 14 OF DECEMBER 27, 1946

1. At the further suggestion of Mr. Collado, an additional schedule of hypothetical operations of the Bank has been prepared covering the period 1947 through 1956. No further elaboration on various financial policies appears necessary in this memorandum as the questions have been fully discussed in previous memos. The figures in the attached schedule are similar to those in Document No. 14, except that rate of development of lending operations has been assumed to be slightly smaller in the present schedule and the period under consideration has been extended to ten years.

2. The method of preparing the attached schedule differs very slightly from that employed for the preparation of Document No. 14 as follows:

   (a) In the first place, the origin of paid-in dollar capital has been treated in more detail as shown in columns 1-4.

   (b) Secondly, interest paid on debentures and interest received from loans has been given in gross figures rather than net balance figures as was the case in Document No. 14. This was, of course, necessary as columns have been added to show, first, interest received assuming interest was charged from the date of commitment, and, also, interest at 3½% charged from the date of disbursement and charged from the date of commitment.

   (c) Thirdly, the figures in column 9, representing funds raised in the market, are based through 1948 on estimates of the actual amounts of funds which will be taken up in the market and the date at which these funds will be raised, as was the case in Document No. 14. After 1948, however, the amount of funds raised in the market, in the present schedule, has been assumed to be sufficient, together with the

Bank's own funds, to cover commitments by 75% to 50% through 1949 and by 50% in subsequent years.

(d) Fourthly, in this schedule, the income going to the special reserve as a result of the 1% commission charge is shown on the basis of 1% on commitments as well as 1% on disbursements.

3. Two sets of Pro Forma Earnings Statements and Pro Forma Balance Sheets for the years 1948, 1951 and 1956 are attached hereto, marked A and B. Set A assumes that interest will be received on loans at the rate of 3% per annum, that the Bank's debentures will be issued with an interest rate of 3% per annum, that interest will be charged on loans from the date of the loan commitment, and that a 1% commission for the special reserve will be charged from the date of loan disbursement. Set B assumes that interest will be received on loans at the rate of 3¼% per annum, that the Bank's debentures will be issued with an interest rate of 3% per annum, that interest will be charged on loans from the date of the loan commitment, and that a 1% commission for the special reserve will be charged from the date of loan disbursement.

4. Additional factors which have <u>not</u> been taken into consideration and which would have a favorable effect upon the financial position at the end of the 10-year period are:

(a) Increase in capital by possible admission of new members.

(b) Return through the reinvestment of surplus.

(c) Return through the reinvestment of the special reserve.

(d) Utilization of the 18% in non-dollar currencies for lending operations.

(e) From the schedule it is not apparent that repayment by borrowers on principal and, consequently, amortization on debentures by the Bank will be fully offset by new Bank loans and issuance of new debentures. It is evident, therefore, that the picture given in the schedule does not reflect the true status of the Bank regarding the liquidity of operations. The amount of loans outstanding at the end of the 10-year period may not include the full amount of the loans made by the Bank in the beginning of the 10-year period.

Assuming repayment of principal by borrowers at the rate of 5% per annum, after five years of grace, this would amount to:

	(In Millions)
1952	35
1953	100
1954	160
1955	220
1956	280

5. I fully realize that there are, apart from the factors mentioned in paragraph No. 4, several variables which will affect the figures in the schedule. Inasmuch as the purpose of the schedule is to give the general expected trend of the operations, it was not considered expedient to calculate the effect of all variables, because it would not change the general trend materially.

6. In conclusion, I would like to remark that several additional Pro Forma Earnings Statements and Balance Sheets could be prepared from this schedule illustrating various financial methods. However, this has not been undertaken as the schedule has been prepared for the purpose of using it as a basis for oral discussion.

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
	Capital subscriptions (1) (13)	Capital subscribed not called (1)	Paid-in non-dollar capital (1)	Paid-in dollar capital (1)	Amount of loans committed (1) (4)	Disbursed to borrowers on loans (1) (4)	Undisbursed commitments (1) (4)	Cash and investments on hand (1)	Funds raised in the market (1)	Borrowed funds invested in short term securities at .80% p.a. (1)	Interest earned on borrowed funds (16)	Ratio of cash and investments to undisbursed commitments	Paid-in dollar capital used in lending operations (1)	(Interest on loans at 3% p.a.) Interest charged from date of commitment (2)	Interest charged from date of disbursement (2)	(Interest on loans at 3½% p.a.) Interest charged from date of commitment (2)	Interest charged from date of disbursement (2)	Interest paid on borrowed funds at 3% p.a. (16)	Paid-in dollar capital funds in cash (1)	Paid-in dollar capital funds invested on short term securities at .80% p.a. (1)	Interest Earned on own funds invested in short term securities (2)	(Commission of 1% Special Rese Charged on commitments (2)
1947, 1st quarter	7,790,500,000	6,621,925,000	600,015,000	561,186,500 (11) (8)	400,000,000	50,000,000	350,000,000	511,000,000	—	—	—	146%	50,000,000	1,500,000	187,000	1,625,000	203,000	—	386,000,000	125,000,000	250,000 (15)	500,000
2nd quarter	8,024,500,000 (7)	6,419,600,000	872,910,000	727,075,000 (12) (9)	750,000,000	100,000,000	650,000,000	827,000,000	200,000,000 (5)	200,000,000	400,000	127%	100,000,000	4,312,000	562,000	4,672,000	609,000	1,500,000	502,000,000	125,000,000	250,000	1,437,000
3rd quarter	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	1,100,000,000	300,000,000	800,000,000	927,000,000	500,000,000 (6)	500,000,000	400,000	116%	300,000,000	6,937,000	1,500,000	7,516,000	1,625,000	1,500,000	302,000,000	125,000,000	250,000	2,312,000
4th quarter	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	1,400,000,000	500,000,000	900,000,000	727,000,000	500,000,000	500,000,000	1,000,000	81%	500,000,000	9,375,000	3,000,000	10,156,000	3,250,000	3,750,000	102,000,000	125,000,000	250,000	3,125,000
1948, 1st quarter	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	1,700,000,000	750,000,000	950,000,000	777,000,000	800,000,000 (17)	777,000,000	1,600,000	82%	727,000,000	11,625,000	4,687,000	12,594,000	5,078,000	6,000,000	—	—	—	3,875,000
2nd quarter	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	2,000,000,000	1,000,000,000	1,000,000,000	827,000,000	1,100,000,000 (18)	827,000,000	1,904,000	83%	727,000,000	13,875,000	6,562,000	15,031,000	7,109,000	8,250,000	—	—	—	4,625,000
3rd quarter	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	2,300,000,000	1,250,000,000	1,050,000,000	827,000,000	1,350,000,000 (19)	827,000,000	1,904,000	79%	727,000,000	16,125,000	8,437,000	17,469,000	9,141,000	10,125,000	—	—	—	5,375,000
4th quarter	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	2,600,000,000	1,500,000,000	1,100,000,000	827,000,000	1,600,000,000 (20)	827,000,000	1,904,000	75%	727,000,000	18,375,000	10,312,000	19,906,000	11,172,000	12,000,000	—	—	—	6,125,000
1949,	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	3,800,000,000	2,750,000,000	1,050,000,000	527,000,000	2,550,000,000 (21)	527,000,000	5,416,000	50%	727,000,000	96,000,000	63,750,000	104,000,000	69,062,000	62,250,000	—	—	—	32,000,000
1950,	8,024,500,000	6,419,600,000	872,910,000	727,075,000 (12)	5,000,000,000	4,000,000,000	1,000,000,000	527,000,000	3,800,000,000 (22)	527,000,000	4,216,000	53%	727,000,000	132,000,000	101,250,000	143,000,000	109,687,000	95,250,000	—	—	—	44,000,000
1951,	8,024,500,000	6,419,600,000	872,910,000	731,990,000 (10)	6,200,000,000	5,200,000,000	1,000,000,000	532,000,000	5,000,000,000 (23)	532,000,000	4,256,000	53%	732,000,000	168,000,000	138,000,000	182,000,000	149,500,000	132,000,000	—	—	—	56,000,000
1952,	8,024,500,000	6,419,600,000	872,910,000	731,990,000	7,400,000,000	6,400,000,000	1,000,000,000	532,000,000	6,200,000,000 (24)	532,000,000	4,256,000	53%	732,000,000	204,000,000	174,000,000	221,000,000	188,500,000	168,000,000	—	—	—	68,000,000
1953,	8,024,500,000	6,419,600,000	872,910,000	731,990,000	8,100,000,000	7,000,000,000	1,100,000,000	557,000,000	6,825,000,000 (25)	557,000,000	4,356,000	51%	732,000,000	232,500,000	201,000,000	251,875,000	217,750,000	195,375,000	—	—	—	77,500,000
1954,	8,024,500,000	6,419,600,000	872,910,000	731,990,000	8,100,000,000	7,600,000,000	500,000,000	257,000,000	7,125,000,000 (26)	257,000,000	3,256,000	51%	732,000,000	243,000,000	219,000,000	263,250,000	237,250,000	209,250,000	—	—	—	81,000,000
1955,	8,024,500,000	6,419,600,000	872,910,000	731,900,000	8,100,000,000	7,600,000,000	500,000,000	257,000,000	7,125,000,000	257,000,000	2,056,000	51%	732,000,000	243,000,000	228,000,000	263,250,000	247,000,000	213,750,000	—	—	—	81,000,000
1956,	8,024,500,000	6,419,600,000	872,910,000	731,900,000	8,100,000,000	7,600,000,000	500,000,000	257,000,000	7,125,000,000	257,000,000	2,056,000	51%	732,000,000	243,000,000	228,000,000	263,250,000	247,000,000	213,750,000	—	—	—	81,000,000
											$ 38,980,000			$ 1,643,624,000	$1,388,247,000	$ 1,780,594,000	$ 1,503,936,000	$1,332,750,000			$ 1,000,000	$ 547,424,000

Committee on Financial Policy
Document No. 19.

SCHEDULE NOTES

(1) Outstanding at end of period
(2) Interest or commission on average amount outstanding during period
(3)
(4) It is assumed that repayment of loans will be offset by new loans
(5) $200,000,000 borrowed 4/1/47
(6) $300,000,000 borrowed 9/30/47
(7) $234,000,000 subscription of Lebanon, Turkey, Italy and Syria on 4/15/47
(8) Does not include deferment for ½% on China, Czechoslovakia, Denmark, Greece, Poland and Yugoslavia due 6/25/51, nor pending deferment of 1½% on Czechoslovakia and Yugoslavia
(9) Increase due to assumed payment by Czechoslovakia and Yugoslavia of 1½% on 5/1/47 and 2% from Italy, Syria, Turkey, Lebanon on 4/15/47
(10) Deferment ½% (see note 8) paid 6/25/51
(11) Because it does not include deferments of $2,458,500 and $4,915,000, columns #2, 3 and 4 do not equal # 1.
(12) Not including deferment of $4,915,000 so columns #2, 3 and 4 do not equal # 1
(13) Does not include 6 additional shares which may be sold to Paraguay. Subscriptions may be higher when other countries join the Bank. These are not included here. While column #5 shows $8,100,000,000 committed, a figure in excess of capital subscribed, additional members, and reserves, must be considered in this connection.
(14) Including estimated deficit 12/31/46 of $625,000 (approximately)
(15) $125,000,000 actually invested 12/31/46 (approximately)
(16) Actual interest paid on or earned on borrowed funds
(17) $300,000,000 borrowed about 1/1/48
(18) $300,000,000 borrowed 4/1/48
(19) $250,000,000 borrowed 7/1/48
(20) $250,000,000 borrowed 10/1/48
(21) $950,000,000 borrowed about 6/30/49
(22) $1,250,000,000 borrowed about 6/30/50
(23) $1,200,000,000 borrowed about 6/30/51
(24) $1,200,000,000 borrowed about 6/30/52
(25) $625,000,000 borrowed about 6/30/53
(26) $300,000,000 borrowed about 6/30/54

A

PRO FORMA BALANCE SHEET
DECEMBER 31, 1948
IN MILLIONS OF DOLLARS

Assuming:
1. 3% interest received; 3% interest paid
2. interest charged from date of commitment
3. commission of 1% for special reserve charged from date of disbursement

ASSETS		LIABILITIES	
CASH AND INVESTMENTS ON HAND		CAPITAL SUBSCRIBED	$ 8,024.5
CASH	$ 43.5		
INVESTMENTS	827.1	SURPLUS	43.5
CASH SET ASIDE FOR SPECIAL RESERVE	11.8	SPECIAL RESERVE	11.8
	$ 882.4		$ 8,079.8
HOLDINGS IN OTHER CURRENCIES THAN U.S. DOLLARS	872.9	DEBENTURES OUTSTANDING	1,600.-
LOANS DISBURSED	1,500.-	UNDISBURSED LOAN COMMITMENTS	1,100.-
LOANS UNDISBURSED	1,100.-		
UNCALLED SUBSCRIPTIONS	6,419.6		
DUE FROM MEMBERS	4.9		
	$10,779.8		$10,779.8

PRO FORMA STATEMENT OF INCOME AND EXPENDITURES
1948

Assuming:
1. 3% interest received; 3% interest paid
2. interest charged from date of commitment

INTEREST ON LOANS AT 3%	$ 82,124,000
LESS INTEREST ON DEBENTURES AT 3%	43,125,000
	$ 38,999,000
INTEREST ON INVESTMENTS-BORROWED FUNDS	9,112,000
INTEREST ON INVESTMENTS-OWN FUNDS	1,000,000
	$ 49,111,000
LESS OPERATING EXPENSES	5,625,000
INCOME TO SURPLUS	$ 43,486,000

PRO FORMA STATEMENT OF SPECIAL RESERVE 1948

COMMISSION OF 1% OF LOAN DISBURSEMENTS	$ 11,747,000

A

PRO FORMA BALANCE SHEET
DECEMBER 31, 1951
IN MILLIONS OF DOLLARS

Assuming;
1. 3% interest received; 3% interest paid
2. interest charged from date of commitment
3. commission 1% for special reserve charged from date of disbursement

ASSETS		LIABILITIES	
CASH AND INVESTMENTS ON HAND		CAPITAL SUBSCRIBED	$ 8,024.5
CASH	$ 156.4		
INVESTMENTS	532.-	SURPLUS	156.4
CASH SET ASIDE FOR SPECIAL RESERVE	112.7	SPECIAL RESERVE	112.7
	$ 801.1		$ 8,293.6
HOLDINGS IN OTHER CURRENCIES THAN U.S. DOLLARS	872.9	DEBENTURES OUTSTANDING	5,000.-
LOANS DISBURSED	5,200.-	UNDISBURSED LOAN COMMITMENTS	1,000.-
LOANS UNDISBURSED	1,000.-		
UNCALLED SUBSCRIPTIONS	6,419.6		
	$14,293.6		$14,293.6

PRO FORMA STATEMENT OF INCOME AND EXPENDITURES
1951

Assuming;
1. 3% interest received; 3% interest paid
2. interest charged from date of commitment

INTEREST ON LOANS AT 3%	$ 478,124,000
LESS INTEREST ON DEBENTURES AT 3%	332,625,000
	$ 145,499,000
INTEREST ON INVESTMENTS-BORROWED FUNDS	23,000,000
INTEREST ON INVESTMENTS-OWN FUNDS	1,000,000
	$ 169,499,000
LESS OPERATING EXPENSES	13,125,000
INCOME TO SURPLUS	$ 156,374,000

PRO FORMA STATEMENT OF SPECIAL RESERVE 1951

COMMISSION OF 1% OF LOAN DISBURSEMENTS $ 112,747,000

A

PRO FORMA BALANCE SHEET
DECEMBER 31, 1956
IN MILLIONS OF DOLLARS

Assuming:
1. 3% interest received; 3% interest paid
2. interest charged from date of commitment
3. commission of 1% for special reserve charged from date of disbursement

ASSETS		LIABILITIES	
CASH AND INVESTMENTS ON HAND		CAPITAL SUBSCRIBED	$ 8,024.5
CASH	$ 325.2		
INVESTMENTS	257.-	SURPLUS	325.2
CASH SET ASIDE FOR SPECIAL RESERVE	462.7	SPECIAL RESERVE	462.7
	$ 1,044.9		$ 8,812.4
HOLDINGS IN OTHER CURRENCIES THAN U.S. DOLLARS	872.9	DEBENTURES OUTSTANDING	7,125.-
LOANS DISBURSED	7,600.-	UNDISBURSED LOAN COMMITMENTS	500.-
LOANS UNDISBURSED	500.-		
UNCALLED SUBSCRIPTIONS	6,419.6		
	$16,437.4		$16,437.4

PRO FORMA STATEMENT OF INCOME AND EXPENDITURES
1956

Assuming:
1. 3% interest received; 3% interest paid
2. interest charged from the date of commitment

INTEREST ON LOANS AT 3%	$ 1,643,624,000
LESS INTEREST ON DEBENTURES AT 3%	1,332,750,000
	$ 310,874,000
INTEREST ON INVESTMENTS-BORROWED FUNDS	38,980,000
INTEREST ON INVESTMENTS-OWN FUNDS	1,000,000
	$ 350,854,000
LESS OPERATING EXPENSES	25,625,000
INCOME TO SURPLUS	$ 325,229,000

PRO FORMA STATEMENT OF SPECIAL RESERVE 1956

COMMISSION OF 1% OF LOAN DISBURSEMENTS $462,747,000

B

PRO FORMA BALANCE SHEET
DECEMBER 31, 1948
IN MILLIONS OF DOLLARS

Assuming;

1. 3¼% interest received; 3% interest paid
2. interest charged from date of commitment
3. commission of 1% for special reserve charged from date of disbursement

ASSETS		LIABILITIES	
CASH AND INVESTMENTS ON HAND		CAPITAL SUBSCRIBED	$ 8,024.5
CASH	$ 50.3		
INVESTMENTS	827.1	SURPLUS	50.3
CASH SET ASIDE FOR SPECIAL RESERVE	11.8	SPECIAL RESERVE	11.8
	$ 889.2		$ 8,086.6
HOLDINGS IN OTHER CURRENCIES THAN U.S. DOLLARS	872.9	DEBENTURES OUTSTANDING	1,600.-
LOANS DISBURSED	1,500.-	UNDISBURSED LOAN COMMITMENTS	1,100.-
LOANS UNDISBURSED	1,100.-		
UNCALLED SUBSCRIPTIONS	6,419.6		
DUE FROM MEMBERS	4.9		
	$10,786.6		$10,786.6

PRO FORMA STATEMENT OF INCOME AND EXPENDITURES
1948

Assuming;

1. 3¼% interest received; 3% interest paid
2. interest charged from the date of commitment

INTEREST ON LOANS AT 3¼%	$ 88,969,000
LESS INTEREST ON DEBENTURES AT 3%	43,125,000
	$ 45,844,000
INTEREST ON INVESTMENTS-BORROWED FUNDS	9,112,000
INTEREST ON INVESTMENTS-OWN FUNDS	1,000,000
	$ 55,956,000
LESS OPERATING EXPENSES	5,625,000
INCOME TO SURPLUS	$ 50,331,000

B

PRO FORMA BALANCE SHEET
DECEMBER 31, 1951
IN MILLIONS OF DOLLARS

Assuming:
1. 3¼% interest received; 3% interest paid
2. interest charged from date of commitment
3. commission of 1% for special reserve charged from date of disbursement

ASSETS		LIABILITIES	
CASH AND INVESTMENTS ON HAND		CAPITAL SUBSCRIBED	$ 8,024.5
CASH	$ 196.2		
INVESTMENTS	532.-	SURPLUS	196.2
CASH SET ASIDE FOR SPECIAL RESERVE	112.7	SPECIAL RESERVE	112.7
	$ 840.9		$ 8,333.4
HOLDINGS IN OTHER CURRENCIES THAN U.S. DOLLARS	872.9	DEBENTURES OUTSTANDING	5,000.-
LOANS DISBURSED	5,200.-	UNDISBURSED LOAN COMMITMENTS	1,000.-
LOANS UNDISBURSED	1,000.0		
UNCALLED SUBSCRIPTIONS	6,419.6		
	$14,333.4		$14,333.4

PRO FORMA STATEMENT OF INCOME AND EXPENDITURES
1951

Assuming:
1. 3¼% interest received; 3% interest paid
2. Interest charged from date of commitment

INTEREST ON LOANS AT 3¼%	$ 517,969,000
LESS INTEREST ON DEBENTURES AT 3%	332,625,000
	$ 185,344,000
INTEREST ON INVESTMENTS-BORROWED FUNDS	23,000,000
INTEREST ON INVESTMENTS-OWN FUNDS	1,000,000
	$ 209,344,000
LESS OPERATING EXPENSES	13,125,000
INCOME TO SURPLUS	$ 196,219,000

B

PRO FORMA BALANCE SHEET
DECEMBER 31, 1956
IN MILLIONS OF DOLLARS

Assuming:
1. $3\frac{1}{4}\%$ interest received; 3% interest paid
2. interest charged from date of commitment
3. commission of 1% for special reserve charged from date of disbursement

ASSETS		LIABILITIES	
CASH AND INVESTMENTS ON HAND		CAPITAL SUBSCRIBED	$ 8,024.5
CASH	$ 462.2		
INVESTMENTS	257.-	SURPLUS	462.2
CASH SET ASIDE FOR SPECIAL RESERVE	462.7	SPECIAL RESERVE	462.7
	$ 1,181.9		$ 8,949.4
HOLDINGS IN OTHER CURRENCIES THAN U.S. DOLLARS	872.9	DEBENTURES OUTSTANDING	7,125.-
LOANS DISBURSED	7,600.-	UNDISBURSED LOAN COMMITMENTS	500.-
LOANS UNDISBURSED	500.-		
UNCALLED SUBSCRIPTIONS	6,419.6		
	$16,574.4		$16,574.4

PRO FORMA STATEMENT OF INCOME AND EXPENDITURES
1956

Assuming:
1. $3\frac{1}{4}\%$ interest received; 3% interest paid
2. interest charged from the date of commitment

INTEREST ON LOANS AT $3\frac{1}{4}\%$	$ 1,780,594,000
LESS INTEREST ON DEBENTURES AT 3%	1,332,750,000
	$ 447,844,000
INTEREST ON INVESTMENTS-BORROWED FUNDS	38,980,000
INTEREST ON INVESTMENTS-OWN FUNDS	1,000,000
	$ 487,824,000
LESS OPERATING EXPENSES	25,625,000
INCOME TO SURPLUS	$ 462,199,000

(not for public use)

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PLEASE RETURN TO
SECRETARIAT
M. POLLOCK

CONFIDENTIAL

SecM57-16

FROM: The President

January 24, 1957

WORLD BANK RESERVES

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

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

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

Attachment

Distribution

Executive Directors and Alternates
President
Vice Presidents
Department Heads

Sec. 57-37

The World Bank's Reserves

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

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

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

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

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

- - - - - - - - -

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

While there is no basis for disagreement with any of the above assumptions, it does seem that, in considering the adequacy of the Bank's reserves, it would be unrealistic to assume that, just because there have been no defaults in the past

ten years and the Bank continues to exercise every possible caution in the granting and investment of loans, a decision affecting the Bank's future reserves should be based on the hope that something beyond the Bank's control will never happen. In this respect the Bank is like an insurance company that has been collecting premiums in a community that has never had a fire but where any house might burn to the ground overnight.

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

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

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

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

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

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

On the other hand, a default by a single country is, however, a possibility that the Bank must foresee and should provide for. Which borrowing countries are likely to default, however, is again something that no one

can forecast. The financial history of the world is full of surprises in this field. Small, weak, poor countries are often better credit risks than large, rich and potentially stronger countries. The Bank can no more imagine which member country is likely to default in the future than a life insurance company can predict which policyholder is likely to die first.

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

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

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

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

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

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

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

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

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

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

However, the serious responsibility of keeping the World Bank sound and functioning cannot be satisfied merely by the ability to meet a default by the largest single borrower. In fact, it is doubtful if the Bank will ever be faced with the unpleasant but rather simple question of a default by just

one country. If the Bank is ever faced with default, it will more likely be a default by a number of countries, perhaps by a whole economic area, rather than a default by one country alone. A member country will default on its Bank obligations only as a matter of last resort; but a country may find itself, along with other countries, in an economic depression affecting the income of a whole area, and making it impossible for a number of countries to meet their obligations to the Bank.

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

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

A vivid example of the type of possible economic crisis to be kept in mind in discussing the Bank's reserves is the crisis the world is going

through at this moment due to the closing of the Suez Canal. On the one hand, a number of countries producing oil in the Middle East area are seeing their exports substantially reduced and their costs considerably increased; and, on the other hand, whole continents of consumers are not only faced with expanding costs, but with the need to draw on scarce foreign exchange reserves to meet the unavoidable needs of rationed essential services.

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

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

If such criteria were adopted as a basis for building the Bank's reserves, then the conclusion is that, since the Bank's largest investments in any one geographical area on December 31, 1956 stood at US$1,084,921,464,

the Bank should have not less than $300 million and not more than $500 million in its reserves in order to continue to operate in the future, insured against possible defaults and faithful to the basic cardinal principles described before:

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

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

LUIS MACHADO

January 24, 1957

Mr Rist

(not for public use)

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

CONFIDENTIAL

FOR EXECUTIVE DIRECTORS' MEETING

DECLASSIFIED
Date: 11/15/2010 RAW

R 57-39

(For consideration at a date to be announced)

FROM: The Secretary

June 4, 1957

PRINCIPAL CONSIDERATIONS AFFECTING CONCLUSIONS AS TO APPROPRIATE LEVELS OF BANK RESERVES

I. Scope of memorandum

This memorandum has been prepared by the staff in response to suggestions made by several Executive Directors at the January 15 meeting of the Financial Policy Committee. It makes no attempt to suggest a formula for determining the level of reserves. Indeed, the view of the staff is that such a determination cannot be made on the basis of a formula; it calls for a continuing re-examination of all relevant factors by the Executive Directors and the Board of Governors. The Articles of Agreement [Article V, Section 14(a)] provide an opportunity for such a re-examination annually. The principal factors which the staff considers relevant are set out in this memorandum.

Unless otherwise stated, the word "reserves", as used in this memorandum, refers to statutory loan commissions and to accumulated earnings, whether allocated to the special reserve or the supplemental reserve or held as surplus.

Distribution:

Executive Directors and Alternates
President
Vice Presidents
Department Heads

Sec. 57-177

II. Preliminary points

Three preliminary points must be made:

(a) Ordinary business and banking rules and standards cannot be applied automatically to the reserve policy of the Bank. The Bank differs from other banking institutions in many important ways, including the following:

(i) It follows from the general objectives of the Bank and the nature of its operations that the Bank's loans are assumed to be more risky than those which the private market is willing to undertake. Indeed, the Articles of Agreement authorize loans to be made only if private lenders are unwilling to risk their capital on reasonable terms.

(ii) The Bank's Articles of Agreement impose certain limitations on the use of some of its funds not customarily found in the capital structure of other financial institutions. The 18% portion of members' capital subscriptions is available for lending only with the consent of the member concerned. Unloaned 18% capital and principal repayments on loans out of capital are not immediately available to meet the Bank's obligations arising out of its own borrowings or

guarantees (Article II, Section 5 and Article IV, Section 7). Funds held in the special reserve, on the other hand, may be used for no other purpose than to meet the Bank's liabilities; and probably, though this question of interpretation has never been decided, it may be used only "in cases of default on loans" (Article IV, Sections 6 and 7).

(b) For the purposes of this memorandum, the 80% liability of members should not be regarded as a source of protection to the Bank as a going institution, even though that liability is perhaps the most important single element of the Bank's credit. The 80% should rather be looked upon as a last resource to be availed of for the ultimate protection of the Bank's bondholders. The only prudent assumption for the Bank to make is that a call on the 80% might make it very difficult for the Bank's operations to continue. Accordingly, the 80% liability should be disregarded in arriving at a policy with respect to reserves.

(c) A determination of the desired level of Bank reserves does not decide the appropriate level of loan charges. It is certainly a consideration in fixing loan charges but it is not the only consideration or even the decisive one. Even if reserves should reach what is considered to be a satisfactory level, the Executive Directors might decide not to reduce loan charges either

(i) in order to avoid a level of rates lower than must be paid by those Bank members who can borrow in the private market; (ii) in order to facilitate participations and portfolio sales; or (iii) in order to assure a margin of earnings for distribution as dividends.

III. The problem of liquidity

The problem of fixing the level of Bank reserves should not be confused with the problem of maintaining a satisfactory degree of liquidity in the Bank's assets. The Bank needs liquid assets to meet its immediate operating requirements, to service its own obligations and to disburse under approved loan commitments. The distinction between level of reserves and degree of liquidity is admittedly somewhat blurred in the Bank's capital structure by the requirement of Article IV, Section 6, that the special reserve is to be held in liquid form. Since there is no such statutory requirement with respect to the supplemental reserve, the latter contributes directly to the Bank's liquidity position only to the extent that amounts appropriated to this reserve are in fact at any given time held in liquid form. It is the proportion of total assets, whatever their origin, held by the Bank in liquid form, which determines liquidity.

IV. Nature of risks inherent in the Bank's lending operations

A default by one of the Bank's borrowers will not neces-

sarily, and probably rarely would, result in complete loss of a loan. In all likelihood the cases in which a loan can be considered entirely uncollectible will be exceptional. Instances might be outright repudiation by the debtor country or, in the case of disappearance of the borrowing or guaranteeing state as a political entity, by the successor state. Even when such extreme situations arose in the past, the expectation that some payment would ultimately be made never completely disappeared.

The widespread defaults which resulted from the world depression of the thirties and from the war have to a large extent been the subject of settlements. But the period during which the defaults persisted and the terms of the final settlements varied considerably from country to country. Substantial losses were incurred by the creditors. Whatever the judgment as to the likelihood of a world depression or a world war, the possibility of widespread defaults and substantial loss to the Bank arising as a result of either cannot be completely ruled out.

The more likely risks, however, are of an essentially different order: defaults which are the consequence of balance of payments difficulties or political developments - internal or external - affecting individual countries.* Such troubles have beset many countries from time to time, although their duration has generally been temporary. They have sometimes resulted in a suspension of payments, a renego-

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* For the purposes of this paper, losses due to currency depreciation need not be taken into account. There is no risk of such losses on loans made out of borrowed funds or out of 18% capital. Loans out of borrowed funds are repayable in the currency borrowed; and Article II, Section 9, has been interpreted by the Executive Directors to require the value of loaned 18% capital to be maintained by the member whose currency is loaned. It is true that loans out of 2% capital and out of earnings are subject to the exchange risk, but this risk is not of present significance for the purposes of this paper because the great preponderance of such loans would be repayable in dollars.

tiation of the terms of the loan or an adjustment of the amount due.

The duration and extent of the default would depend upon a number of factors, some of which it may not be within the power of the borrower to influence. These factors would include a marked decline in the price of, or in the demand for, an important export commodity; activities of other governments; the availability of facilities for obtaining new credits and the disposition to make new investments; and the willingness of creditors to refinance or accept delays.

A fall in the export price of a particular commodity or the development of an inexpensive substitute for it may well give rise to balance of payments difficulties not only for an individual country but also for a group of countries all dependent on that commodity. Here the risk of default, while being less than world-wide, would not be limited to a single debtor.

It must be concluded, therefore, that in the normal course of Bank operations, even short of a world depression or a world war, there may be periods during which the Bank would be faced with service suspensions, without any assurance as to the terms on which, or the time after which, debt service may be resumed.

History affords little guidance to an appraisal of these risks. A brief review of the historical record of sterling bonds

prior to the depression of the thirties and of dollar bonds during the thirties is set forth in Annex A*.

It is in any event clear that to cover the risk of defaults by reason of a world depression or a world war would require an amount of reserves far in excess of the amount which the Bank could hope to accumulate under its present rate policies and with continued expansion of its operations.

What have been referred to as the more likely risks - defaults of a temporary character by individual debtors or groups of debtors - should, however, be fully covered by reserves, in time. In several countries Bank commitments already exceed $200 million and may be expected to become even larger. The Bank cannot ignore the possibility that one or another of its large borrowers, whose number is increasing, may run into payments difficulties, or that even several borrowers may simultaneously find themselves in such difficulties.

The decade of the Bank's existence has been a period of prosperity and expansion, and debt service charges incumbent upon the borrowers have been on the whole moderate in relation to the state of their economies. The Bank must, however, take account of the possibility that exchange stringencies, even though geographically restricted, may set in, or that some of its members may assume too heavy a debt burden.

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*Annex A - Part I relates to defaults on sterling bonds of governments and political subdivisions. Part II relates to dollar bonds of governments, political subdivisions and corporations. Corporations were included in the sources upon which Part II is based. However, it appears that omission of the data relating to corporate bonds would not substantially change the percentage of defaults shown.

V. Functions of reserves

The reserves serve a number of purposes.

(1) They protect the Bank against an impairment of capital in the event of losses on loans and guarantees by providing a fund against which such losses can be written off. This does not mean that the Bank would automatically write off a loan whenever there is a delay in payment. On the contrary, it may be assumed that normally loans would not be written off. As indicated in the preceding section, in many, if not most, default situations the Bank would be justified in looking forward to resumption of debt service.

(2) The reserves add to the resources available to the Bank for its lending operations. Their use is not limited by any statutory provision, except insofar as the special reserve is concerned. At the same time they reduce the over-all cost to the Bank of money used in lending operations. In this respect they help to keep loan charges low.

(3) The reserves have another function: they strengthen the Bank's credit and facilitate its financing operations in the market. The Bank's ability to service its obligations, to disburse fully under existing commitments, and last but not

least to expand its commitments, depends ultimately upon its ability to borrow in the market.

Reserves strengthen the Bank's credit in two ways. First, by providing more extensive earnings coverage for service of the Bank's bonds, they assist the Bank's marketing operations. Secondly, and this is more important, the market regards the reserves as evidence of the Bank's financial soundness and of its ability to ride out periods of payments difficulties or even default on the part of its borrowers. To the extent that the market is reassured by a high level of reserves and borrowing by the Bank is thus facilitated, the reserve level affects the Bank's ability to meet its obligations and to expand its operations. In this connection the psychological importance of maintaining an appropriate level of reserves can hardly be overstated.

VI. Reserve policies of other institutions

As already stated, the Bank cannot be compared with ordinary banking institutions. There are, however, other medium- and long-term financing institutions which are similarly confronted with the problem of determining the proper level of reserves to cover either international or domestic long-term risks or both. Annex B attempts to draw some comparisons between the capital structures, reserves and dividends of a selected number of these institutions and of the Bank. It is interesting to note that in most of the cases reviewed it has been considered proper policy to accumulate reserves for the protection of both creditors and capital. Although in one of the cases mentioned, losses have been too heavy to permit the setting aside of a reserve fund, it was the explicit intention of the founders of all the institutions reviewed that reserves should be set up.

VII. Conclusions

Neither the risks confronting the Bank nor the practices of the most comparable institutions afford any basis for devising a formula to determine the "proper" level of reserves for the Bank.

The most important consideration appears to be the preservation and strengthening of the Bank's borrowing ability.

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VII. Conclusions

Neither the risks confronting the Bank nor the practices of the most comparable institutions afford any basis for devising a formula to determine the "proper" level of reserves for the Bank.

The most important consideration appears to be the preservation and strengthening of the Bank's borrowing ability.

It appears clear that the accumulation of reserves serves an important function in giving assurance to the private market, but since this is a psychological matter, it cannot readily be given precise quantitative expression. The level of reserves is of less importance than the fact of their continued accumulation, and accumulation at what may be considered a satisfactory rate.

There are two reasons why it may be unwise, just at this time, to freeze reserves on a fixed level, however determined. The Bank cannot now predict what the reaction of the market will be when the Bank's bond issues begin to approach the limit of the United States 80% liability. Neither can it foresee what proportion of its new loans will be made out of its 18% capital (from the returns on which reserves can be built up quickly) and what proportion will be made out of borrowed funds (which permit only a slow accumulation of reserves).

Annex C, which consists of two charts, is an attempt to show the development of reserves to 1962 on the assumption that the Bank will lend $400 million per annum, that in two years disbursements will rise to the same level, that all contractual payments will be made, that $50 million of loans will be sold annually, and that the pattern of repayment of future loans will correspond generally to that prevailing for loans outstanding today.

ANNEX A

Historical Summary of Defaulted Foreign Bonds

1825 - 1945

To illustrate the extent, incidence and geographic distribution of defaults since the early part of the nineteenth century an historical summary has been prepared. The summary is divided into two parts: Part I deals with the hundred year period from 1825 to 1930, while Part II covers the more recent period from 1920 to 1945.

PART I

Defaults on Sterling Bonds of Governments and Political Subdivisions from 1825 to 1930.

The attached Table I lists defaulted sterling bonds issued by foreign governments and political subdivisions during the hundred years ending in 1930. Although this table provides a good illustration of the defaults which occurred it does not cover all the defaults in this period. Defaults also occurred on government bonds issued in other currencies, e.g. francs, marks and dollars. The London market has been chosen both because the number of foreign issues floated in London was greater than in any other market and because more information is available about the sterling issues than about other bonds. The table is in two parts. The figures for the period from 1825 to 1870 are not entirely comparable with the figures shown for the period from 1871 to 1930. For the earlier period the amounts shown are the total principal amounts of the bonds on which defaults occurred, while the later figures represent the outstanding principal amounts actually in default.

The defaults shown were not all total losses. There were many readjustments which reduced the apparent losses to the investing countries. In this

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connection, it would be interesting to know the total amounts outstanding on all foreign government sterling bonds in order to determine the proportion of defaulted bonds as related to the total outstanding. The information necessary for such a study is not available but some guidance can be found in a report made in 1875 by a Select Committee of the House of Commons on Loans to Foreign States. It recorded that about 54% of all foreign government issues were in default in the early 1870's. The percentage of defaults must have been even higher in the late 1870's with the addition of the Turkish defaults. The best estimates available are that the ratio of defaulted bonds to the total was about 15% in the 1820's, that it rose to the high point already mentioned in the 1870's, and that it went down to about 1% in 1910.

The largest single default was that of Turkey in the late 1870's, while the second largest default was the repudiation of Czarist Russia's debt by the Revolutionary Government after the first world war. Leaving aside these two conspicuous cases which arose under rather special circumstances, the movement of defaults over the hundred years under review may be divided into four periods.

The first period coincides with the second quarter of the last century. Defaults rose from £ 15 million in 1825 to a peak of £ 45 million in the late thirties and declined to £ 8 million by 1845. This temporary rise in defaults was due entirely to the insolvency of Spain.

The second period covers a little under fifty years from 1846 to 1893 and includes the depression of the seventies. The total of defaults rose from £ 8 million to £ 88 million which was the highest peak attained during the hundred years' period. About £ 30 million of the increase occurred before the depression and was attributable mainly to the Mexican defaults which started in the late

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forties. During the depression of the seventies the number of defaulting countries rose from four to thirteen and new defaults amounted to £ 50 million of which about two-thirds was due to the default of Peru. Both Mexico and Peru resumed the service on their debts in the early nineties with the result that the total of defaults dropped to about £ 9 million by the end of the period.

During the third period of twenty years from 1896 to 1915, and during the last period of fifteen years from 1916 to 1930, total defaults rose to £ 46 million and £ 63 million respectively. The increase in the amount of suspended payments was due to the Argentine default in the third period and to a new Mexican default in the fourth period.

Thus, excluding Turkey and Russia, four major defaults occurred during the hundred years under review.

	Defaulted amount maximum £ million	Approximate duration of maximum default
Spain	33.3	1837-41
Peru	32.9	1876-88
Argentine	36.3	1893-96
Mexico	55.0	1917-21

The immediate causes for the defaults are manifold. The hundred year period was characterized by far-reaching political changes in South America and the Balkans. Political instability, recurrent revolutions and wars, poor administration, over-borrowing and sudden interruptions in the inflow of foreign capital were primarily responsible for most of the payments difficulties. Although the largest wave of defaults coincided with the depression of the 1870's, it is difficult to establish any clear causal relationship between depressed conditions in the world markets and the defaults by individual countries. It seems that the fall in the price of a leading export commodity, which almost suggests itself as a likely cause for default, was generally only a contributing

and aggravating factor after internal conditions had already deteriorated. The only significant exception where the default can be directly related to a major economic change is perhaps Peru whose default in the 1870's followed the exhaustion of its best guano deposits.

PART II

Defaults on U.S. Dollar Bonds of Governments, Political Subdivisions and Corporations from 1920 to 1945.

After World War I the United States became the leading source of new foreign capital. Since its foreign lending record is more readily available than the records of other countries this part of the review is limited to foreign bonds issued in the United States.

The nineteen twenties were particularly propitious for a great outflow of American capital. Prosperity brought a high national income and a large volume of savings seeking profitable investment. The largest foreign borrowers in the United States during the period were European, with North American, Latin American and Far Eastern borrowers following in that order.

Table II shows the estimated total amounts of foreign dollar bonds, both government and corporate, outstanding at the end of each year from 1920 to 1945 with estimates of the amounts and percentages of the issues in default. The defaults during the 1920's were relatively small. In the year 1920, bond issues of Mexico, Russia and Ecuador were in default, the total amount of the defaulted bonds being about $388 million. Of this amount $302 million represented Mexican bonds, some of which remained in default until 1942 and others until 1946, and $11 million were Ecuadorian bonds which were not settled until 1955. There were also some $75 million of Russian bonds on which the Foreign Claims Settlement Commission of the United States is now considering making small payments out of

frozen Czarist Russian assets. China started to default in 1921 when $5.5 million of bonds were in arrears. Starting in 1924 and 1925, two small issues of Brazilian states went into default as to sinking fund requirements only. These Brazilian defaults were settled, together with other arrears, in 1944.

The year 1931 marked the beginning of a new period of defaults, which reached serious proportions. Defaults rose to a maximum of $3 billion in 1933 when issues in default represented 37% of the total outstanding. During the following years, up to 1945, the amount in default was reduced by about one-quarter, and repayments, repatriation and settlements reduced the total outstanding even more rapidly (from $8.2 billion in 1933 to $4.9 billion in 1945). As a result, the ratio of defaults to the total outstanding continued to rise to about 50% in the last five years of the period.

By 1935 when defaults were still close to the peak reached two years before, the major areas of defaults were, first, Latin America with 85% of the par value of outstanding bonds in default, and then Europe with 51% in default. Latin American countries where defaults existed, in some cases for short periods only, included Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, El Salvador, Guatemala, Mexico, Panama, Peru and Uruguay. Germany is mainly responsible for the high percentage of defaults in Europe prior to World War II.

Of the outstanding dollar bonds of Canada and Newfoundland only 3% were in default in 1935. None of these was a Dominion government or a Dominion guaranteed issue. The record of the Far East was even better, with no new default during the depression. It is striking that a few big borrowers, namely four countries which had issued bonds in the United States totalling $1.7 billion, accounted for the great bulk of the defaulted bonds. They were Brazil, Chile, Colombia and Germany.

During the 30's the relationship between defaults and economic stress was quite clear. The raw material producing countries were hard hit by the great depression and therefore among the first to default; their difficulties were aggravated by the almost abrupt cessation of foreign lending in 1931. In other words, the quality of the loans made in the 1920's deteriorated.

In the latter part of the 1930's the new defaults were not directly related to the economic crisis. In 1938 and 1939 Czechoslovakia and Austria suspended payments as a result of the German occupation. World War II brought the defaults of Italy and Japan, while certain occupied countries like Belgium and Denmark could only make partial payments.

Table III compares the issues in default with total outstanding foreign bonds at three test dates, namely the end of 1929, before the depression, the end of 1935 when the defaults caused by the economic crisis were about at their peak, and the end of 1945 when most of these defaults and all of those caused by the war were still unsettled.

Economic Staff
May 15, 1957.

TABLE I

STERLING BONDS OF FOREIGN GOVERNMENTS AND POLITICAL SUBDIVISIONS IN DEFAULT

1825 to 1930

(£ million)

Year	Europe			Ottoman Empire	Russia	Africa	Latin America																United States	Total
	Greece	Portugal	Spain			Liberia	Argentina	Bolivia	Brazil	Chile	Colombia	Costa Rica	Dominican Republic	Ecuador	Guatemala	Honduras	Mexico	Nicaragua	Paraguay	Peru	Uruguay	Venezuela		
Figures shown from 1825 to 1870 represent total principal amounts at time of issue																								
1825-1830	2.8	-	-	-	-	-	1.0	-	-	1.0	3.4	-	-	-	0.1	-	6.4	-	-	-	-	-	-	14.7
1831-1835	2.8	-	-	-	-	-	1.0	-	-	1.0	3.4	-	-	-	0.1	-	6.4	-	-	-	-	-	-	14.7
1836-1840	2.8	-	33.3	-	-	-	1.0	-	-	1.0	-	-	-	-	0.1	-	6.4	-	-	-	-	-	-	44.6
1841-1845	2.8	-	33.3	-	-	-	1.0	-	-	1.0	-	-	-	-	0.1	-	-	-	-	-	-	-	*	38.2
1846-1850	2.8	-	-	-	-	-	1.0	-	-	-	-	-	-	-	0.1	-	0.4	-	-	-	-	3.8	*	8.1
1851-1855	2.8	4.5	-	-	-	-	1.0	-	-	-	-	-	-	-	0.1	-	10.6	-	-	-	-	3.8	*	22.8
1856-1860	2.8	4.5	-	-	-	-	1.0	-	-	-	-	-	-	-	-	-	10.6	-	-	-	-	3.8	*	22.7
1861-1865	2.8	4.5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	23.0	-	-	-	-	5.4	*	35.7
1866-1870	2.8	-	-	-	-	-	-	-	-	-	-	-	-	1.8	-	-	27.9	-	-	-	-	6.9	*	39.4
Figures shown from 1871 to 1930 represent total principal amounts actually in default																								
1871-1875	2.8	-	-	-	-	0.1	-	1.7	-	-	-	3.3	0.7	-	0.5	3.5	27.9	-	1.5	-	-	6.9	*	48.9
1876-1880	2.4	-	-	197.4	-	0.1	-	1.7	-	-	-	3.3	0.7	1.8	0.5	5.4	27.9	-	1.5	32.9	3.2	6.6	*	285.4
1881-1885	-	-	-	190.9	-	0.1	-	-	-	-	-	2.4	0.7	1.8	0.5	5.4	27.9	-	1.5	32.9	-	-	*	264.1
1886-1890	-	-	-	-	-	0.1	-	-	-	-	1.9	2.7	0.7	1.8	0.5	5.4	29.4	-	1.5	31.8	-	-	*	75.8
1891-1895	-	-	-	-	-	0.1	36.3	-	-	-	1.9	-	-	1.8	-	5.4	-	-	-	-	-	-	*	45.5
1896-1900	-	-	-	-	-	0.1	36.3	-	-	-	1.9	2.0	-	0.7	-	5.4	-	-	-	-	-	-	*	46.4
1901-1905	-	-	-	-	-	-	17.8	-	-	-	2.7	-	3.9	-	1.5	5.4	-	-	-	-	-	-	*	31.3
1906-1910	-	-	-	-	-	-	-	-	-	-	-	2.0	-	-	1.5	5.4	-	-	-	-	-	-	*	8.9
1911-1915	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1.5	5.4	-	-	-	-	-	-	*	6.9
1916-1920	-	-	-	-	-	-	-	-	-	-	-	-	-	2.3	-	5.4	35.5	-	-	-	-	-	*	43.2
1921-1925	-	-	-	-	148.3	-	0.3	-	-	-	-	-	-	2.3	-	5.4	55.0	-	-	-	-	-	*	211.3
1926-1930	-	-	-	-	148.3	-	0.3	-	5.9	-	-	-	-	2.3	-	5.4	4.1	-	-	-	-	-	*	166.3

Source: Annual Reports of theCorporation of Foreign Bondholders, London.

* The Corporation of Foreign Bondholders has not been able to obtain reliable information on the defaulted bonds of certain Southern States. Some of these bonds were repudiated by individual states and others (confederate bonds) were cancelled by the Fourteenth Amendment to the Constitution of the United States.

IBRD - Economic Staff
May 7, 1957

TABLE II

ESTIMATED TOTALS OUTSTANDING OF U.S. DOLLAR BONDS OF FOREIGN GOVERNMENTS, POLITICAL SUBDIVISIONS AND CORPORATIONS

1920 - 1945
($ million)

End of year	Estimated total of issues outstanding	Estimated issues in default	
		Amount	% of total issues outstanding
1920	2,700	388	14.4
1921	3,400	393	11.6
1922	4,000	393	9.8
1923	4,300	393	9.1
1924	5,300	395	7.5
1925	6,100	400	6.6
1926	6,800	400	5.9
1927	7,800	400	5.1
1928	8,500	400	4.7
1929	8,700	400	4.6
1930	9,200	400	4.3
1931	9,100	938	10.3
1932	9,000	1,758	19.5
1933	8,193	3,030	37.0
1934	7,800	2,950	37.8
1935	7,490	2,886	38.5
1936	7,062	2,884	40.8
1937	6,565	2,746	41.8
1938	6,309	2,526	40.0
1939	6,092	2,346	38.5
1940	5,958	2,499	41.9
1941	5,658	2,468	43.6
1942	5,572	2,782	49.9
1943	5,341	2,746	51.4
1944	5,119	2,551	49.8
1945	4,863	2,394	49.2

For the earlier years the figures shown are not exact but are the best estimates available. Beginning in 1933, the figures were taken from studies made by the Institute of International Finance of New York University and may be considered close estimates.

IBRD - Economic Staff
May 9, 1957

TABLE III

STATUS OF OUTSTANDING UNITED STATES DOLLAR BONDS OF FOREIGN GOVERNMENTS, POLITICAL SUBDIVISIONS AND CORPORATIONS IN 1929, 1935 AND 1945

(In millions of dollars)

Item	December 31, 1929			December 31, 1935			December 31, 1945		
	Total amount outstanding	Total amount in default	% in default	Total amount outstanding	Total amount in default	% in default	Total amount outstanding	Total amount in default	% in default
TOTAL, ALL AREAS	8,700.0	389.2	4.5	7,490.0	2,885.6	38.5	4,863.6	2,394.5	49.2
NORTH AMERICA	1,858.4	-	-	2,618.5	81.2	3.1	1,589.3	80.2	5.0
Canada	1,858.4	-		2,613.3	81.2		1,584.4	80.2	
Newfoundland				5.2	-		4.9	-	
SOUTH AMERICA	1,728.0	308.7	17.9	1,866.3	1,576.4	84.5	1,337.1	750.5	56.1
Argentina	358.7	-		351.2	95.9		183.8	0.8	
Bolivia	58.1	-		59.4	59.4		59.4	59.4	
Brazil	314.8	6.7		349.2	349.2		217.4	69.8	
Chile	236.3	-		308.0	308.0		170.2	150.6	
Colombia	164.9	-		156.1	156.1		148.7	105.8	
Costa Rica	9.4	-		8.8	8.8		8.1	8.1	
Cuba	94.8	-		123.8	103.2		97.1	9.4	
Dominican Republic	19.1	-		16.3	16.3		12.1	4.3	
El Salvador	5.6	-		12.6	12.6		8.8	8.5	
Guatemala	0.4	-		2.2	2.2		-	-	
Haiti	14.5	-		9.8	-		6.7	6.7	
Honduras	1.3	-							
Mexico	302.0	302.0		295.6	295.6		273.6	238.6	
Panama	17.3	-		18.6	14.4		15.8	1.1	
Peru	76.6	-		91.3	91.3		85.7	85.7	
Uruguay	44.2	-		63.4	63.4		49.7	1.7	
Venezuela	10.0	-							
EUROPE	3,025.5	75.0	2.5	2,376.1	1,222.5	51.4	1,419.9	1,275.0	89.8
Austria	72.3	-		64.2	-		36.9	36.9	
Belgium	210.6	-		153.5	-		29.6	9.5	
Bulgaria	13.4	-		16.9	16.9		16.6	16.6	
Czechoslovakia	31.4	-		26.8	1.1		9.6	9.6	

TABLE III

STATUS OF OUTSTANDING UNITED STATES DOLLAR BONDS OF FOREIGN GOVERNMENTS, POLITICAL SUBDIVISIONS AND CORPORATIONS IN 1929, 1935 AND 1945 (CONT.)

(In millions of dollars)

Item	December 31, 1929			December 31, 1935			December 31, 1945		
	Total amount outstanding	Total amount in default	% in default	Total amount outstanding	Total amount in default	% in default	Total amount outstanding	Total amount in default	% in default
EUROPE (CONT.)									
Danzig, Free City	3.0	-		3.9	-		3.4	3.4	
Denmark	164.6	-		148.8	1.0		121.9	92.9	
Estonia	3.8	-		3.6	-		3.3	3.3	
Finland	63.2	-		40.9	-		9.0	-	
France	334.6	-		135.7	-		15.5	-	
Germany	964.4	-		886.9	883.6		668.0	668.0	
Greece	25.8	-		26.9	26.9		26.9	26.9	
Hungary	59.9	-		56.9	56.9		53.2	53.2	
Irish Free State	5.1	-		1.3	-		0.6	-	
Italy	315.0	-		218.0	-		150.7	150.7	
Lithuania	1.8	-							
Luxembourg	7.1	-		8.0	-		-	-	
Netherlands	6.0	-		70.2	-		-	-	
Norway	180.7	-		158.2	-		83.2	12.5	
Poland	131.7	-		99.2	-		39.7	39.7	
Romania	9.7	-		10.9	10.9		10.9	10.9	
Russia	75.0	75.0		75.0	75.0		75.0	75.0	
Sweden	104.7	-		86.7	86.7		-	-	
Switzerland	48.7	-							
United Kingdom	143.0	-		20.1	-		-	-	
Yugoslavia	50.0	-		63.5	63.5		65.9	65.9	
AUSTRALASIA AND FAR EAST	859.1	5.5	0.6	629.1	5.5	0.9	517.3	288.8	55.8
Australia	240.6	-		255.1	-		227.5	-	
China	16.7	5.5		5.5	5.5		6.5	5.5	
Japan	327.2	-		368.5	-		283.3	283.3	

TABLE III

STATUS OF OUTSTANDING UNITED STATES DOLLAR BONDS OF FOREIGN GOVERNMENTS, POLITICAL SUBDIVISIONS AND CORPORATIONS IN 1929, 1935 AND 1945 (CONT.)

(In millions of dollars

Item	December 31, 1929			December 31, 1935			December 31, 1945		
	Total amount outstanding	Total amount in default	% in default	Total amount outstanding	Total amount in default	% in default	Total amount outstanding	Total amount in default	% in default
AUSTRALASIA AND FAR EAST (CONT.)									
Dutch East Indies	174.4	-							
Philippine Islands	100.2	-							
Liberia	2.2	-							
Held outside U.S.A.	1,226.8	*							

Sources: Institute of International Finance of New York University.
Department of Commerce.

* Included in amounts in default listed above.

IBRD - Economic Staff
May 9, 1957

ANNEX B

Capital structure, reserves and dividends of various medium- and long-term finance institutions.

Two world wars and the great depression of the thirties have led to the establishment of a large number of medium- and long-term finance institutions which had no parallel in the past.

However, the Bank together with its recently established affiliate - the International Finance Corporation - are the only institutions of a genuinely international character. The Bank's capital stock is held by a large number of governments, its bond issues have access to all the major capital markets and its loans are world wide in scope. These three characteristics are not to be found in the statutes or operations of any other institution, except - in a more limited sense - the European Investment Bank to be established under the Common Market Treaty. Most of the existing medium- and long-term finance institutions draw their funds primarily from domestic sources and restrict their operations either to their national economies or, as in the case of France and the United Kingdom, to the economies of their respective commonwealth areas. The Export-Import Bank makes loans on a world-wide basis like the Bank; however, it does not depend for the continuation of its operations on recourse to the market.

Thus, at present there is no lending institution fully comparable with the Bank. Nevertheless, all the other institutions do accumulate reserves against losses to protect their creditors and to maintain their capital intact.

The attached tables show the position of a selected number of institutions classified into three categories. Table 1 covers the category of international institutions operating on an international scale; it lists four such institutions, namely the IBRD, the IFC, the proposed European Investment Bank and the Coal and Steel Community. Table 2 comprises four national institutions operating on an international scale; these are the Export-Import Bank, the Commonwealth Development Finance Company, the Colonial Development Corporation and the Caisse Centrale de la France d'Outre-Mer. Table 3 shows the position of some of the national institutions operating on a national scale.

As for the first category, the capital of the European Investment Bank, like that of the IBRD and the IFC, would consist of government participations, whereas the Coal and Steel Community has no subscribed capital. Both of these institutions have power to raise additional funds in the market or to borrow from other sources.

At the end of March 1957, the IBRD maintained reserves representing about 15% of loans outstanding and 28% of bonds outstanding. The Coal and Steel Community has so far restricted its borrowing and lending operations to the approximate level of the guarantee fund established by its member governments. The European Investment Bank would be under the obligation to accumulate reserves equal to 10% of its subscribed capital; this formula, if applied to IBRD, would call for reserves of $926 million as compared to $266 million as of March 31st.

In the second category, the Export-Import Bank is by far the largest institution. Its reserves amount to 16% of loans outstanding and 36% of

funds borrowed from the Treasury. In 1951 when reserves reached a level equal to 10% of loans outstanding, the Export-Import Bank began to pay a dividend of 2% which was raised to $2\frac{1}{4}$% in 1953 and has been maintained at this level since.

As for the Caisse Centrale de la France d'Outre-Mer, its lending operations consist, for three-quarters, of advances to overseas territories and for one-quarter, of advances controlled by a French government investment fund (FIDES). Although it has statutory power to borrow in the market, it has so far obtained all its funds from the French Government. After covering administrative expenses and providing for interest payments to the government, there seems to be no net earnings left for accumulating reserves. In fact the Caisse Centrale carries only a very small reserve which has remained unchanged during the last five years.

The capital stock of the Commonwealth Development Finance Company is held partly by the Bank of England and partly by private corporations; additional funds are borrowed from private sources. The Company seems to have reached the stage where it will be possible to begin the accumulation of reserves.

The Colonial Development Corporation has no share capital; it obtains all its funds from the government. The Corporation has suffered substantial losses which are being gradually written off out of current earnings.

The third category consists of a large number of medium- and long-term finance institutions, including the various development institutions established after the second world war. The institutions listed in Table III have been so selected as to illustrate the major characteristics of this

category.

Capital structure, reserves and dividends in this category vary a great deal from institution to institution. The capital stock is usually divided among the government, the central bank and other shareholders, including private or public banking institutions. Additional funds are raised by issuing bonds or by borrowing, in various forms, from the government or other domestic sources, and in some cases also from external sources such as the IBRD.

Except for the Herstelbank, and the Reconstruction Finance Corporation which is a special case, reserves are rather low in relation either to the amount of commitments or to the amount of borrowed funds. This is due in part to the fact that, in some cases, there is included in the amount of commitments a large volume of operations either guaranteed by the government or carried out on behalf of the government. Moreover, there is less need for reserves to the extent that borrowers are required to provide adequate commercial security such as bank guarantees, mortgages or collateral deposits. Another factor tending to reduce the level of reserves is the distribution of dividends, in some cases comparatively high.

The above analysis leads to the conclusion that the accumulation of reserves is a common characteristic of all the institutions listed in the three tables. However, the extent to which reserves have actually been set aside depends on the particular nature of the operations of the individual institution.

TABLE 1

INTERNATIONAL INSTITUTIONS OPERATING ON AN INTERNATIONAL SCALE

Institution	Million U.S. dollars						Percentages Reserves to	
	Subscribed capital	Capital paid in	Reserves	Borrowed funds	Loans and guarantees outstanding	Dividend	Loans and guarantees outstanding	Borrowed funds
I.B.R.D. (March 1957)	9,265	1,111	266	948	1,741	-	15.3	28.1
I.F.C. (April 29, 1957)	92	92	-	-	-	-	-	-
Proposed European Investment Bank	1,000	250	100	-	-	-	-	-
European Coal and Steel Community (April 30, 1956)	none	-	100	113	101	-	99.-	88.5

General notes

Reserves include unallocated profits and special reserves.

Loans - The term is used to mean loans disbursed and outstanding.

Specific notes

I.B.R.D.

Paid-in capital excludes the amount shown on the balance sheet as "receivable on account of subscribed capital".

Loans include $23 million of loans sold with the Bank's guarantee.

European Investment Bank

Reserves are to attain a minimum of 10% of the subscribed capital.

European Coal and Steel Community

Reserves represent the guarantee fund which recently reached the statutory minimum of $100 million.

Borrowed funds include $100 million from Ex-im bank.

TABLE 2

NATIONAL INSTITUTIONS OPERATING ON AN INTERNATIONAL SCALE

Institution	In national currencies as indicated										Percentages		
	Subscribed capital	Capital paid in			Reserves	Borrowed funds			Loans 2/	Dividend	Reserves to		Dividend to
		Government 1/	Private	Total		Government 1/	Private	Total			Loans 2/	Borrowed funds	Capital paid in
Export-Import Bank - U.S.A. ($000.000-Dec. 1956)	1,000	1,000	-	1,000	435	1,197	-	1,197	2,636	22.5	16.5	36.3	2.25
Commonwealth Development Finance Co. Ltd. - U.K. (£000-March, 1956)	15,000	2,025	825	2,850	17	-	5,985	5,985	8,728	-	0.2	0.3	-
Colonial Development Corporation-U.K. (£000-Dec.1955)	none	-	-	-	-	47,494	1,483	48,977	37,845	-	-	-	-
Caisse Centrale de la France d' Outre-Mer-France (Ffr.000.000-Dec. 1955)	2,500	2,500	-	2,500	500	186,306	-	186,306	178,689	-	0.3	0.3	-

1/ Including government institutions.

2/ Including participations and guarantees - amounts outstanding.

Notes to Table 2

General notes

Reserves include unallocated profits and special reserves.
Loans - The term is used to mean loans disbursed and outstanding.

Specific notes

Export-Import Bank
"Loans, participations and guarantees" exceed the total of capital, reserves and borrowed funds because the latter are exclusive of "liabilities on loans disbursed by commercial banks".

Commonwealth Development Finance Co.Ltd.
Reserves - The low level of reserves is due to the fact that profits earned since the beginning of operations in 1953 have been used to write off initial expenses.

Colonial Development Corp.Ltd.
Capital - The corporation has no share capital; it obtains all its funds from the government.
Losses - The corporation has sustained substantial losses; the amount still to be written off amounted to £10 million at the end of 1955.

Caisse Centrale de la France d'Outre-Mer
Capital - The "Caisse" has no share capital; the amount shown as capital has been appropriated from the budget.
Loans include operations on behalf of the government or guaranteed by the government.(Operations of the issue department are small and have been disregarded).

TABLE 3

NATIONAL INSTITUTIONS OPERATING ON A NATIONAL SCALE

Institution	In national currencies as indicated											Percentages		
	Subscribed capital	Capital paid in			Reserves	Borrowed funds				Loans 2/	Dividend	Reserves to		Dividend to
		Government 1/	Private	Total		Government 1/	Private	Foreign	Total			Loans 2/	Borrowed funds	Capital paid in
Reconstruction Finance Corp. U.S.A. ($000.000-June 1953)	100	100	-	100	317	287	-	-	287	662	-	47.9	110.5	-
Finance Corp. for Industry Ltd. - U.K. (£000-March 1956)	25,000	166	334	500	921	-	41,152	-	41,152	41,239	17	2.2	2.2	3.4
Industrial and Commercial Finance Corp.Ltd. U.K.(£000 - March 1956)	15,000	-	7,500	7,500	2,650	-	22,000	-	22,000	32,193	216	8.2	12.0	2.9
Crédit National - France (Ffr.000.000-Dec.1955)	2,100	-	-	2,100	6,655	279,502	59,842	-	339,344	356,581	173	1.9	2.0	8.2
Herstelbank-Netherlands (fl.000.000 - Dec. 1955)	300	151	149	300	49	67	81	16	164	433	8	11.3	29.9	2.7

1/ Including government institutions.

2/ Including participations and guarantees - amounts outstanding.

TABLE 3 CONTINUED.

Institution	In national currencies as indicated											Percentages		
	Subscribed capital	Capital paid in			Reserves	Borrowed funds				Loans 2/	Dividend	Reserves to		Dividend to Capital paid in
		Government 1/	Private	Total		Government 1/	Private	Foreign	Total			Loans 2/	Borrowed funds	
Société Nationale de Crédit à l'Industrie - Belgique (Bfr.000.000- Dec. 1956)	410	41	175	216	220	2,546	20,019	-	22,565	19,697	25	1.1	1.0	11.6
Kreditanstallt für Wiederaufbau - Germany (DM000.000 - Dec. 1955)	1	1	-	1	210	3,956	889	-	4,845	5,291	-	4.0	4.3	-
Istituto Mobiliare Italiano-Italy (lire 000.000- March 1955)	5,511	-	-	1,653	16,134	-	218,892	21,236	240,128	266,588	133	6.1	6.7	8.0
Mediobanca - Italy(lire 000.000-June 1955)	3,000	-	3,000	3,000	706	-	52,172	-	52,172	38,018	210	1.9	1.4	7.0
Nacional Financiera, S.A.- Mexico (Pesos 000.000- Dec. 1955)	200	-	-	200	78	-	-	-	2,186	2,449	12	3.2	3.6	6.-

1/ Including government institutions.

2/ Including participations and guarantees - amounts outstanding.

TABLE 3 CONTINUED

Institution	In national currencies as indicated											Percentages		
	Subscribed capital	Capital paid in			Reserves	Borrowed funds				Loans 2/	Dividend	Reserves to		Dividend to Capital paid in
		Government 1/	Private	Total		Government 1/	Private	Foreign	Total			Loans 2/	Borrowed funds	
Banco de Desenvolvimento Economico-Brazil (Cruzeiros 000,000-Dec. 1954)	20	20	-	20	72	2,333	-	540	2,873	2,032	-	3.5	2.5	-
Corporacion de Fomento de la Produccion - Chile (Pesos 000.000-Dec. 1954)	none	14,854	-	14,854	1,255	1,735	-	6,216	7,951	18,565	-	6.8	15.8	-

1/ Including government institutions.

2/ Including participations and guarantees - amounts outstanding.

Notes to Table 3

General notes

Reserves include unallocated profits and special reserves; the existence of hidden reserves, in some cases, is possible and even probable.

Loans, participations and quarantees - Owing to the inclusion of guararantees, the amount shown under this heading is, in some cases, larger than the combined total of capital, reserves and borrowed funds. In the case of three institutions, namely the Credit National, the Société Nationale de Crédit a' l'Industrie and the Herstelbank, the balance sheets include operations guaranteed by the government or carried out on behalf of the government; they also include advances made in order to prefinance payments due by the government on account of war damages.

Specific notes

Reconstruction Finance Corporation

Status - The corporation entered into liquidation in 1954.

Reserves - The high level of reserves as compared to the other magnitudes is due mainly to the fact that no dividends have been paid until reserves reached $250 million.

Finance Corp. for Industry

Capital - The amount shown under "Government or government institutions" has been subscribed by the Bank of England.

Dividend - Net of income tax.

Industrial and Commercial Finance Corp.

Capital - A small proportion has been subscribed by the Bank of England.

Crédit National

Capital is held mainly by nationalized banks.

Loans, participations and guarantees - Short-term acceptance credits to finance government expenditures have been excluded. (This branch of operations will not continue).

Société Nationale de Crédit à l'Industrie

Borrowed funds - amount shown under "Government or government institutions" consists of E.R.P. counterpart funds and advances from the Treasury. Bond issues are guaranteed by the government.

Kreditanstallt für Wiederaufbau

Reserves - include DM 129 million from E.R.P. counterpart funds.

Borrowed funds - amount shown under "Government or government institutions" consist mainly of E.R.P. counterpart funds.

Istituto Mobiliare Italiano

Capital - many semi-public institutions are among the shareholders.

Mediobanca

Capital - held by the three big commercial banks.

Reserves - a large amount of hidden reserves appears probable.

Borrowed funds consist exclusively of time deposits. Therefore, a high degree of liquidity is maintained and this explains the large excess of "Borrowed funds" over "Loans, participations and guarantees".

Notes to Table 3 Continued

Nacional Financiera

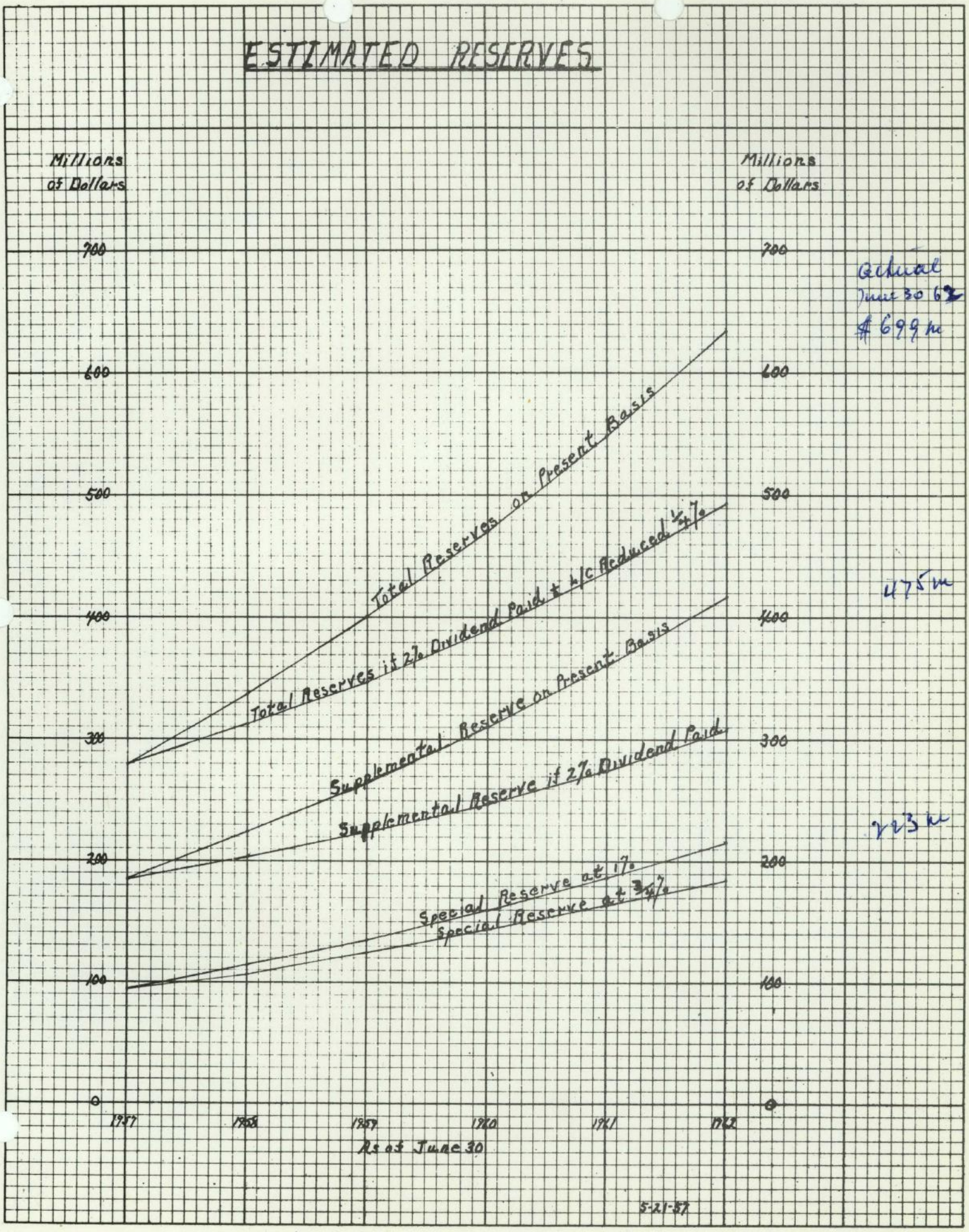
Capital - The government holds a small majority; the rest being held by financial and investment institutions.
Borrowed funds include an unspecified amount of foreign loans.

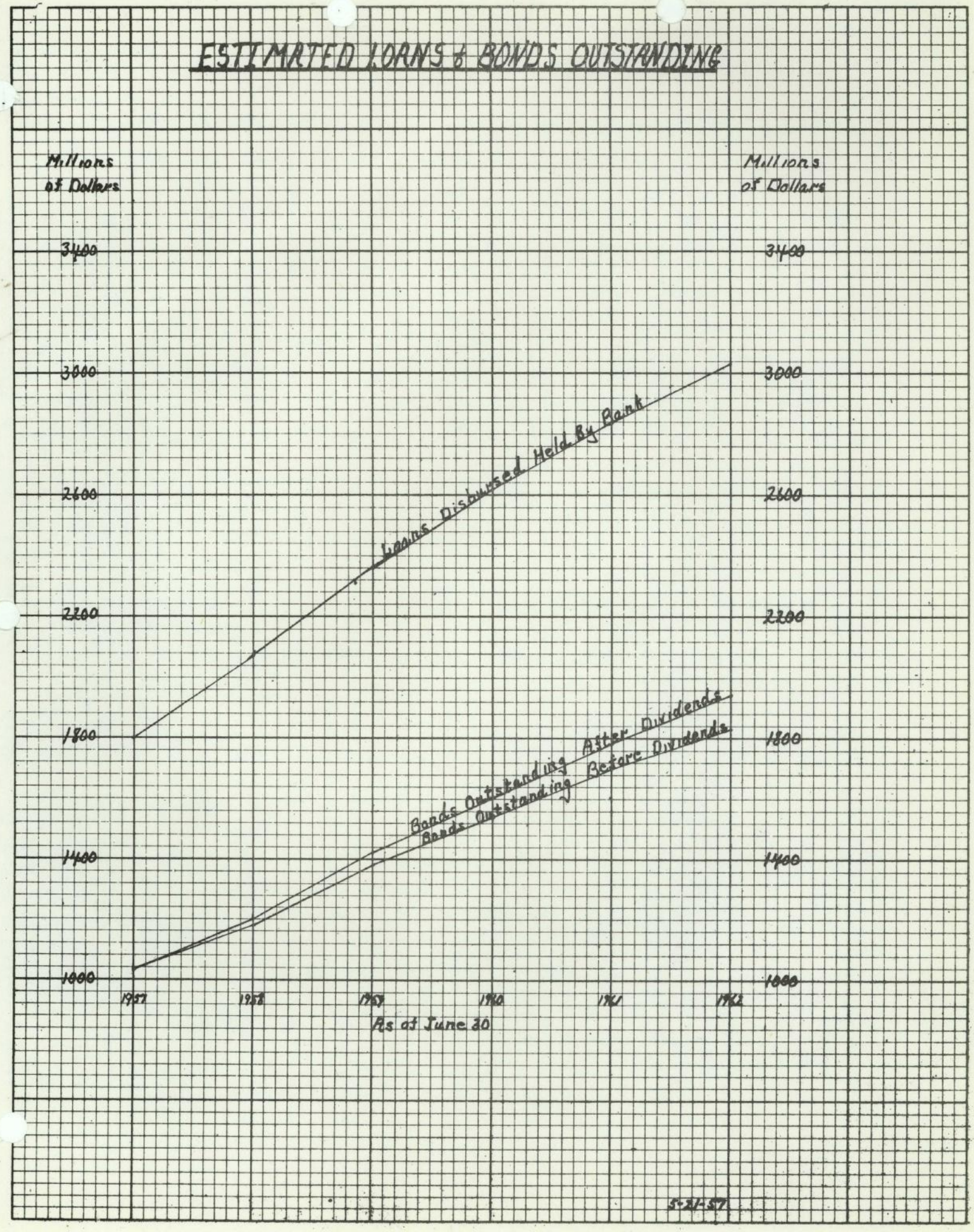
Banco de Desenvolvimento Economico

Capital - is provided by the government.
Borrowed funds - include funds still to be received by the corporation from the Treasury.

Corporacion de Fomento

Capital - is currently accumulating from government appropriations.


ESTIMATED RESERVES
Millions of Dollars
Millions of Dollars
700
600
500
400
300
200
100
0
Total Reserves on Present Basis
Total Reserves if 2% Dividend Paid & L/C Reduced ½%
Supplemental Reserve on Present Basis
Supplemental Reserve if 2% Dividend Paid
Special Reserve at 1%
Special Reserve at 3/4%
1957
1958
1959
1960
1961
1962
Rs as of June 30
Actual June 30 62 $699 m
475 m
223 m
5-21-57


ESTIMATED LOANS & BONDS OUTSTANDING
Millions of Dollars
Millions of Dollars
3400
3000
2600
2200
1800
1400
1000
Loans Disbursed Held By Bank
Bonds Outstanding After Dividends
Bonds Outstanding Before Dividends
1957
1958
1959
1960
1961
1962
As of June 30
5-21-57

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

CONFIDENTIAL

FPC 63-19

December 4, 1963

*Memorandum of Meeting of Bank Financial Policy Committee on "BANK FINANCIAL POLICY" (Reports FPC63-8, FPC63-16 and FPC63-17), Tuesday, November 26, 1963, at 10:30 a.m.

1. There were present:

Chairman

George D. Woods, President

Executive Directors and Alternates acting as Executive Directors

Alice Brun
Reignson C. Chen
John M. Garba
L. Denis Hudon (Alternate)
Ali Akbar Khosropur (Alternate)
Rene Larre
Luis Machado
K.S.S. Rajan
Sergio Siglienti (Alternate)
Andre van Campenhout
John C. Bullitt
Otto Donner
John M. Garland
Fernando Illanes
M. Kumashiro (Alternate)
Pieter Lieftinck
Jorge Mejia-Palacio
Sir Eric Roll
Abderrahman Tazi

Alternates not acting as Executive Directors

Helmut Abramowski
A. Bogoev
Lempira E. Bonilla
Jose Camacho
Erle Cocke, Jr.
Jennifer Forsyth (Temporary)
A. K. Ghosh
Mohamed Nassim Kochman
F. Oellerer
Eino Suomela
A.J.J. van Vuuren
J. Waitzenegger

Officers and Staff Participating

Geoffrey M. Wilson
M. M. Mendels
A. Broches
Richard H. Demuth
Mrs. Shirley Boskey
Lyell Doucet

*This memorandum consists of staff notes of the discussion in the Committee and is not an approved record.

Distribution:

Members of the Financial Policy Committee
President
Vice Presidents
Department Heads

2. The Chairman said that two particular aspects of the Bank's financial policy were before the Committee for discussion: proposed Bank/IDA policy in the field of education (FPC/63-16), and policy concerning the term of Bank loans (FPC/63-17). Papers on proposed policy in the field of agriculture and on maintenance import loans would be given to the Directors in the not too distant future. It would not be easy to reach conclusions or to fix policies in these areas. If it should not be possible to agree on the recommended policies concerning education in the course of the day's discussion, another meeting would be scheduled.

3. Mr. Tazi said he would like to comment on the Financial Policy Paper of July 18 (FPC/63-8). The countries he represented agreed with the proposals set forth in the Chairman's Annual Meeting address. They hoped that the new policies, particularly those respecting industry and agriculture and expanded technical assistance activities, would be implemented soon.

4. Mr. Tazi thought all developing countries would welcome the proposal to allocate future net income to a new "Earned Surplus" account, rather than continuing to allocate it in its entirety to the Special Reserve. Keeping in mind the importance of retaining the capital market's confidence in the Bank, he suggested that it might be sufficient to allocate, say, 20 percent of net income to the Special Reserve, with the balance going to the "Earned Surplus" account. Perhaps there might be a retroactive allocation to the "Earned Surplus" account, from the time (June 30, 1963) the Special Reserve had reached the level of $476 million, as the Financial Policy Paper had proposed. If the Bank were to adopt such a policy, which he thought fairly conservative, it could feel free to use the funds in the "Earned Surplus" account with greater flexibility and without jeopardizing its standing in the financial market. Consideration might be given to the possibility of using a substantial part of the "Earned Surplus" account for industrialization and infrastructure loans at rates of interest lower than the Bank's normal rate.

5. Mr. Tazi added that he had development finance companies (development banks) in mind as recipients of such "industrialization" loans. If the Bank lent to them at a rate below its normal one, these companies could relend the proceeds at rates of interest more conducive to accelerated industrial growth than the rates which they now charged. When they borrowed at 5½ percent, they had to relend at 8 percent or more; some finance companies charged more than 10 percent. It missed the point to say that such rates were justified because they were lower than those charged by other local sources of finance. The less developed countries could not industrialize and become competitive if their entrepreneurs had to pay a higher rate of interest than was paid by entrepreneurs in the developed countries. One object of foreign capital inflows was, by increasing the supply of funds, to help reduce the discrepancy between interest rates among countries. Mr. Tazi thought that the concept of "pioneer industries" developed in the Financial Policy Paper would be easier to apply if the interest rate were substantially less than 8 to 10 percent. The development finance companies

could afford to charge only 6 percent if they themselves had been able to borrow at 3 to 4 percent.

6. As for the infrastructure loans he had mentioned, Mr. Tazi said that infrastructure projects yielded economic returns over fairly long periods. Moreover, their economic benefits were indirect and could not be captured in the form of an adequate financial return for the government. Yet in many countries such projects were a prerequisite for further industrialization and the modernization of agriculture. He therefore suggested that consideration be given to using a part of the "Earned Surplus" account for making long-term, low-interest (say 3 percent) loans for infrastructure projects in countries where these projects were of primary importance for further economic growth.

7. Mr. Tazi also proposed that a study of the Bank's interest rate policy be undertaken. Direct loans to established private industries, at 6½ to 8 percent, without government guarantee, would be a welcome addition. But the number of such loans would necessarily be limited. Moreover, the beneficiaries were likely to be concentrated in countries in which there was already a capital market. He therefore thought that direct non-guaranteed loans should be made out of the Bank's "normal resources" rather than out of the "Earned Surplus" account, reserving the latter for the requirements of infant industries and infrastructure in countries most in need of them.

8. Mr. Tazi proposed that the practice of normally meeting only the foreign exchange component of the cost of projects be relaxed whenever justified. Exceptions should become more common.

9. Mr. Tazi noted that the Chairman's Annual Meeting address had referred to delays in project preparation and execution. He agreed that that was a serious problem, and welcomed the announced intention to investigate the causes of delay. The countries he represented were aware that their own procedures might be a contributing factor, but they also believed that delays occurred in the course of the Bank's project appraisal. He suggested that any study undertaken include consideration of the Bank's own appraisal procedures.

10. Concerning education, Mr. Tazi said that he fully agreed with the general lines of the paper before the Committee. However, he had one comment on the role envisaged for the Bank. The lack of expert knowledge in the planning and financing of educational facilities often led to considerable waste. Here the Bank's intervention could be very useful, quite apart from the provision of capital. In his view, the Bank was better equipped than any other agency to improve the efficiency of educational investment programs. UNESCO and other agencies could be of great help in identifying and formulating projects. Project appraisal and supervision, however, should remain the primary responsibility of the Bank. The Bank should also have primary responsibility for helping countries to determine the over-all level of expenditures on education and the kind of skills to be developed.

11. With respect to the "Term of Loans" paper, Mr. Tazi inquired whether it was to be understood that when there was a conflict between the repayment terms appropriate to the economic life of the project and those appropriate to the economic situation of the borrowing country, the latter would always prevail. If not, he wondered under what conditions the project's circumstances would prevail when there was a conflict. He also had a question concerning the kind of conditions in the borrowing country which would be considered to justify a longer repayment and grace period. Paragraph 17 of the paper seemed to indicate that countries which had poor export prospects or an unfavorable debt position over the medium term would be beneficiaries of such loans. He agreed, but he wondered whether these were the only categories. He appreciated that clear-cut categorization might not be advisable. But if the answer to both questions was "yes," he wondered if that could not be spelled out more clearly in the conclusions. Perhaps the paper might be shortened and simplified so that governments could understand it more easily.

12. The Chairman said that he would like to reserve until the next meeting of the Committee the answers to the two questions Mr. Tazi had raised, particularly those relating to the paper on the term of loans. His first reaction was to agree with Mr. Tazi's view that it would not be desirable to be too precise on which would be controlling, the over-all situation of the country or factors related to the project.

13. Sir Eric Roll said he strongly supported the Chairman's initiative. He also shared the Chairman's view that nothing done in the way of modifying or in extending the activities of the Bank should affect the Bank's financial standing. But he wanted to point out that while it was important for the sake of the status of the Bank and its affiliates to push out the frontiers of the Bank's activities, it seemed unlikely, given the proviso on the financial standing of the Bank itself, that in the reasonably near future any such extension of activity could be the complete answer to the basic financial problem--the continuing accumulation of net income. Sooner or later the problem of the accumulation of funds, even assuming that the Bank's activities were extended as contemplated, would need to be tackled. This might well call for consideration of a problem which Sir Eric did not propose to touch on in any detail at present: the possibility of transferring excess funds to the Bank's affiliates, in particular to IDA.

14. In regard to the paper on education, Sir Eric said that education was of fundamental importance for economic development. He did not regard it as simply a social investment. Very often in the less developed countries industrial and agricultural development had been held back by lack of suitably trained and educated people to run development schemes. Aid for education was not only of the utmost importance but was likely in itself to make more fruitful the Bank's other activities in the development field. At the same time, the provision of increased facilities for mass education, which could be extremely expensive, was not an activity for which the Bank or its affiliates were equipped or designed to carry out. Moreover, the direct economic importance of education projects was less easily measured

and quantified than that of other kinds of projects. These considerations might well lead to the preliminary conclusion that as a rule educational projects were more likely to fall within the sphere of IDA than of the Bank. Sir Eric was not proposing a categorical distinction or an absolute rule, but he thought this might well be found to be so in practice, because of the economic position of the countries most likely to be concerned, as well as the nature of the projects themselves.

15. As for the detailed considerations in the paper, Sir Eric said he was not clear about the precise position of university education. Paragraph 5 of the paper referred to vocational and technical education and training at various levels and to general secondary education. He hoped that this was not intended to exclude university education. University education might be just as important for economic development: universities had a vital function to carry out in training the administrative and professional manpower required by the developing countries. Mr. Demuth replied that it was intended to include university education in the technical field, for example, agricultural universities. The paper did not intend to include general university education. The reason was primarily that university education received a good deal of financial support through foundations and bilateral programs, so that it seemed less important for the Bank to enter that field.

16. Sir Eric said that the only other point he wished to touch upon at present was the question of the relationship to UNESCO. He agreed that it was essential for the Bank to be aware of the existence of institutions like UNESCO and FAO. It would be both wrong and unwise to go ahead in the educational and agricultural fields as if those institutions did not exist and did not have a very important role to play. The precise relationship had to be worked out in detail. To the extent the language of paragraph 9 of the paper was to be taken as the basis for that relationship, he had no quarrel with it: the Bank should normally regard UNESCO as in effect its technical arm in the education sector. Both from the point of view of the Bank's relationship with institutions of that kind, as well as from the point of view of efficient and economic management of its own resources, it would clearly be wrong, Sir Eric thought, to duplicate technical facilities already available. It was not the intention, he was sure, in any way to diminish or limit the responsibility of the Bank/IDA for deciding upon the policy issues involved and upon the financing of particular projects. The Chairman confirmed Sir Eric's impression. Before any loan was recommended to the Directors, he and his colleagues would have come to a judgment about it. Mr. Maheu, the Director General of UNESCO, had been given a copy of the paper and asked for his comments. He had just replied by cable as follows: "Have studied very carefully paper you forwarded with letter of 31 October on Bank/IDA policies in education field and welcome wholeheartedly your proposals as a basis for expanded cooperation. You will receive my detailed reply Tuesday afternoon the 26 of November." The Chairman added that when the possibility of expanding activity in the field of education was first broached, the principal reaction on the part

of Executive Directors was concern lest a whole new set of experts be added to the Bank's staff. Outside the Bank, he had sensed that the Bank was not regarded as having an especially close relationship with the United Nations and the other specialized agencies. In the light of these considerations, he had felt it especially important to assure that the Bank made maximum use of such talents as were available in UNESCO--and in FAO as well. He had an open mind as to how effective the proposed relationship could be. It would take at least a year to find out whether UNESCO could organize itself to be of assistance. In any case, it would be the Bank which would decide whether a particular loan would or would not be made.

17. Sir Eric said that assuming broad agreement on the proposals in the paper, subject to the working out of details, there remained the question of the possible range or scope of the Bank's increased activity in the education field. For example, he wondered whether the Chairman was thinking in terms of, say, six or a dozen projects over a 12-month period, costing from one to five million, or rather of 20 or 30 projects costing between five and twenty million. He was not asking for an answer at present; that was not practicable. But he thought that at some point it would be desirable to have an idea of the order of magnitude envisaged. The Chairman replied that he would prefer to say that the Bank would feel its way. He also noted that whenever he had referred to the proposed new areas of activity he had expressly stated that he expected the bulk of the Bank's business to continue to be the kinds of project financed in the past.

18. Concerning the Term of Loans paper, Sir Eric said that it was couched in such restrained and modest terms that he had no fear of what was proposed. Provided that each case was looked at on its merits in regard to both the life of the project and the economic position of the country concerned, there was no reason to shrink from the possibility of a lengthening of maturities. Extension of the grace period was perhaps a slightly more contentious subject, but this could be looked at as projects came along. He added that since the paper was somewhat vague--quite naturally so--something a little more specific would probably be desirable at a later time. The Chairman agreed that the paper was vague; it was intended to provide a historical background. He had thought it well to acquaint the Directors with his own feeling that there might be instances where the Bank's current maximum term of 25 years was not necessarily desirable--where, in the view of the Area and the Technical Operations Departments the life of the project should not necessarily be controlling. If no Director was greatly shocked by the proposal, he envisaged that every now and then in the next five years a loan would be made with a period of grace longer than the historical maximum and with a term of more than 25 years. The exceptions so far as maturity was concerned were likely to be few and far between; the exceptions with respect to period of grace might be more frequent. The purpose of the paper was to elicit a reaction rather than to request approval of a general principle.

19. The Chairman said he welcomed Sir Eric's comment that some consideration should be given to the question whether the accumulating and accumulated surpluses might not be used in the operations of the Bank's affiliates. He was beginning to be persuaded by his colleagues and by some of the Governors that it might be difficult to amend the Bank's Articles to authorize non-guaranteed loans to private industry, and that to do so might conceivably be misunderstood in financial circles. Another way to achieve the desired objective would be for the Bank to extend a credit to IFC for the purposes of making such loans. Before the next Annual Meeting, hopefully in the first quarter or first half of next year, some proposal respecting both IDA and IFC would be put to the Executive Directors, for consideration well in advance of the Annual Meeting. He had the question of the use of some of the Bank's earnings by its affiliates very much in mind.

20. Mr. Illanes associated himself with Sir Eric's comments concerning the importance of education for economic progress. In 1960 Latin American governments had invested the equivalent of $1.5 billion in education and must now, because 40 percent of the population was under 15 years of age, invest at the rate of almost $3 billion annually. It was therefore extremely important that resources, monetary and human, be well invested and that the planning be adequate. Mr. Illanes said he agreed completely with the education paper. He thought UNESCO could be very useful as a center of planning and survey, but at the same time it was important to assure that its role did not interfere with the relationship between the Bank on the one hand and member governments on the other. It would also be important for the Bank to fix priorities in the education sector as it did in other fields.

21. Mr. Bullitt said that with respect to the paper on Term of Loans, he saw no problem in following the course suggested. His own inclination would be to give weight to the exchange situation of the borrowing country. As for the education paper, he associated himself with much of what Sir Eric said. He too would be interested in having some impression of the magnitude of what was contemplated, although he understood the problems in that connection. He wondered whether the Chairman thought the proposal likely to entail an increase in the Bank's over-all lending--whether the limitations on the level of lending had been imposed by the foreign exchange situation of member countries or by availability of the types of projects which the Bank had hitherto been willing to finance. It was probably not possible to make a clear-cut distinction between these factors. He strongly supported the Chairman's initiative in the education field. The Bank could make not only an important but a totally new contribution to development if it entered the field as proposed by the paper. At the same time, he thought it important to proceed on a case-by-case basis, and that the Bank should be particularly cautious with respect to the burden put on UNESCO. The scheme outlined in paragraph 9 of the paper for the Bank/UNESCO relationship seemed sensible. He welcomed the Chairman's intention to proceed slowly at first so that not too much would be expected of the UNESCO staff too soon. The idea of having UNESCO as a technical arm of the Bank in this field should enable the Bank to work out a satisfactory relationship.

It was important that, as intended, the Bank should review independently whatever projects UNESCO suggested. He understood that some education projects were in preparation in the Bank, and he hoped that the Committee discussion would not unduly delay the bringing forward of those projects, or that they would be changed or canceled because of efforts to work out arrangements with UNESCO. The Chairman replied that there was no intention to backtrack on projects well underway--in Tanganyika, the Philippines and Pakistan--and to ask UNESCO to review them. On the other hand, he did not intend to try to hurry through projects which were at present in more or less an embryonic stage. Instead, he would prefer to delay them to see if arrangements could not first be worked out with UNESCO; the projects might serve as an incentive. As for Mr. Bullitt's inquiry whether increased lending could be expected, the Chairman thought it could be, not immediately but in perhaps two or three years. Many of the Bank's newer members had very real problems in the education sector. On the question whether the Bank should attempt to build up a staff of its own or use UNESCO to the maximum, his own preference was to encourage UNESCO to build a staff; UNESCO had a closer relationship with education ministries than the Bank could have. Given that either UNESCO or the Bank had to create or strengthen facilities or capacities, he thought it was more appropriate for UNESCO to do so.

22. Mr. Bullitt said he was also interested in the general scope of the education financing contemplated. Would the emphasis be on general secondary education and on a broad scale, endeavoring to cover a large part of the needs of a given country, or would it be on pilot projects or particularly adapted to local resources and needs? The Chairman replied that the Bank would have to feel its way. He doubted that it would often provide substantially all the financing needed for a given program in a given country. The Bank did not have sufficient funds and he was not sure, if it did, that it would be well for it to preempt the field. In the beginning the Bank would be doing a pilot operation, breaking the ground and initiating desirable procedures, with the hope that these, or essentially these, would be followed by others.

23. Mr. Mejia said he had been enthusiastic about the proposed financial policy from the beginning. He was sorry to hear that the Chairman did not intend to press for a modification of the Articles of Agreement. His impression of the comments made by other Directors was that there was a general retreat from the original broad concept. He regretted this. The paper on education was important, because it introduced the concept of Bank financing of education. But then the paper proposed to restrict financing to vocational and technical training at various levels and general secondary education, and even in those fields it would be limited to physical facilities, being available for operating expenditures only in exceptional circumstances. There were many important areas other than secondary education and vocational education. Primary education was very important especially in some countries. There was an institute in Colombia which made loans to students for technical training in Colombia and abroad; it had

financed over 20,800 students. If the Bank could lend to that kind of institute it would be of great assistance both to education and to the country's balance of payments. Such loans would be analagous to loans to development banks for the assistance of industry. There were other possible vehicles, created under the Alliance for Progress program, to channel private and public funds into the education sector. Then there were institutions which trained skilled personnel for industries. The Chairman inquired whether there were more qualified students than could be accommodated with available funds. What Mr. Mejia was proposing was outside the area dealt with in the paper. It was the Chairman's impression that, thanks to the activities of various foundations and government grants, it was very rare for a qualified student to be unable to find financial assistance. He would like to discuss the matter further with Mr. Mejia. His present view was that that was not an appropriate area for either the Bank or IDA and should be left to private philanthropy and individual governments. As for the proposal for Bank activity in the education field, it had always been related to possible Bank financing in other sectors. The Chairman did not believe that he or his colleagues or the Directors who had already spoken were very far away from the starting point on education. The earlier reference to an amendment of the Articles in any case had nothing to do with education; it related to the government guarantee requirement. As he had said, there might be an easier way to accomplish the objective there.

24. As for the "Term of Loans" paper, Mr. Mejia endorsed the conclusion that an extension of the period of grace and amortization would be justified. However, he felt it inadvisable to put first, in the summary of conclusions, the paragraph which referred to past policy. It would be preferable to begin with sub-paragraph (b) on page 8, which emphasized the economic situation of the borrowing country. The Chairman replied that sub-paragraph (b) had no less significance than sub-paragraph (a). He did not propose to recommend to the Directors that in any specific case the maturity of a loan be longer than 25 years, the historic precedent, unless there was a reason to do so. That reason, as the paper indicated, would be the economic situation of the borrowing country. Where that situation created a problem, the Bank would have to consider whether to extend the period of grace, giving only short-term assistance to the government, or the amortization period, which would give the government a longer time to repay. But the Bank would always look at the specific situation. Mr. Cope commented that the paragraph of conclusions began with reference to a fairly well-established policy, and moved on into less familiar ground. It concluded with the positive statement in sub-paragraph (d) that "There is room for making Bank loans at somewhat longer terms and with longer grace periods." The Chairman said that he had wanted to determine whether it would in principle be acceptable to the Directors, if it seemed desirable in a specific case, to extend the term of a loan beyond 25 years or to extend the grace period. His impression of the discussion so far was that this would be acceptable. Unless in the balance of the discussion he sensed a different atmosphere, indicating that the great preponderance of Directors were opposed, it was likely that

within the next few months there would be occasion to recommend a loan with longer maturity.

25. Mr. Lieftinck said he considered it the task of the Bank and IDA to try to make well-balanced efforts to assist member countries in their development problems, and to consider carefully the proper place of various activities in various fields. The financing of physical structures for development, which had heretofore been the Bank's main concern, should remain the center of its activities. He regarded Bank and IDA financing of education as a supplementary activity, intended to increase the effectiveness of these institutions' main activity. That called for a balanced and selective approach in the education field. He was not saying that general education was not of primary importance. However, not everything of importance fell within the scope of Bank and IDA activity. The Bank and IDA, in his view, would not be justified in going very far even in the fields of technical education and vocational training, highly important though these were to developing countries. He agreed with the statement in paragraph 5 of the education paper that the Bank and IDA should be prepared to consider financing as a necessary step in producing trained manpower of the kind and in the numbers needed to forward economic development. But that, in his opinion, was permissive only. He would prefer that the Bank/IDA concentrate for the time being on financing vocational education and technical education to the extent required to make the Bank's principal activities more productive and more efficient. This did not preclude being prepared to assist countries to plan and finance education projects more efficiently. That was a kind of technical assistance which the Bank could very well provide. As a next step the Bank could help to establish private schools in special fields of technical education. It should gain more experience before going beyond that to assist in the provision of specialized and priority educational facilities--schools, equipment and teachers--directly needed for or closely related to the efficient implementation of Bank projects. He was not yet prepared to agree that the Bank should enter the field of general secondary education. Sir Eric had said that he doubted that there would be much which the Bank, as distinct from IDA, could do in the education field. Mr. Lieftinck agreed; it was likely to be principally IDA which would become more active. There might be exceptional cases where Bank financing would be justified, closely related to Bank-financed projects. He had in mind particularly the financing of extension services.

26. With respect to cooperation between the Bank/IDA and UNESCO, Mr. Lieftinck thought there were two extreme positions; probably neither would be favored. Paragraph 12 of the paper seemed to contemplate the possibility that the Bank/IDA might finance UNESCO activities directly. He would not favor that. Perhaps it was intended to suggest the possibility of financing not UNESCO, but UNESCO experts. The Chairman said the latter was the intention. The other extreme, which Mr. Lieftinck would not favor either, would be for the Bank to try to build up a completely self-sufficient staff to handle education projects. He did think the Bank should not rely entirely on outside staff. Cooperation with UNESCO would not be a substitute

for the building up of a small, well-trained staff to advise on the application and implementation of educational policies and to assist in project preparation. His concept of cooperation with UNESCO was therefore different from that described in paragraph 9 of the education paper, which proposed that UNESCO be considered as the Bank's technical arm, in connection not only with project identification but also with preparation, appraisal and end-use supervision. That contemplated more delegation of responsibility to UNESCO than he would favor.

27. With regard to the paper on Term of Bank Loans, Mr. Lieftinck referred to paragraph 9 on page 2, which mentioned three considerations: the Bank's financial position, the economic situation and prospects of the borrowing country and the circumstances of the project. His preliminary view was that under the Articles of Agreement it would be difficult to give weight to the situation of the borrowing country. The Articles provided that the schedule of principal repayments should be "appropriate to the project." The paper distinguished between conditions and terms appropriate to the project and those appropriate to the borrowing country; Mr. Lieftinck thought this distinction should be observed. Moreover, if the Bank were to take the country's economic situation into account in fixing the term of a loan, Bank policy would go too far in the direction of IDA policy, under which the terms of financing were not to burden unduly the balance of payments position of the country concerned.

28. Mr. Lieftinck referred to paragraph 27 of the Term of Loans paper, which mentioned the physical life or earnings of the project and the earnings of the enterprise as a whole. The criterion of physical life had to be applied cautiously, in view of the rapid technological advances being made. He had an open mind with respect to giving consideration to the earnings of the enterprise as a whole; to adjust the term of a loan to the prospective earnings of an enterprise as a whole was very risky and difficult to calculate. He was, in general, inclined to favor only a marginal extension of the term of repayment. By that he meant perhaps an additional five years, beyond the normal 25-year maximum, for long-term projects. The term for other kinds of projects might be adjusted correspondingly. So there was a certain flexibility in the field; he was confident the Bank would be cautious.

29. The Chairman said he did not differ with Mr. Lieftinck's general approach and his view that activities in the field of education were supplemental to primary Bank operations. Perhaps the paper might have made that somewhat clearer. However, as a practical matter, in the course of operations it would be clear that the technical education proposed for financing would be related to anticipated Bank business. As for secondary schools, which were essential to supply candidates for technical education, the Chairman expected that over the course of the next three years some projects for such financing would come to the Directors. They would be tied in to the principal objectives of the Bank. Thus far in the discussions, the Executive Directors did not seem troubled by the possibility of financing

secondary schools in certain selected areas; the Chairman thought it essential that the Bank be willing to consider such financing. He would not venture a guess as to the probable number of secondary school projects.

30. The Chairman agreed with Sir Eric and Mr. Lieftinck that most likely the countries with high priority in the education field, whether for secondary schools or technical and vocational education, would be IDA countries.

31. The Chairman said he was troubled by Mr. Lieftinck's approach to the matter of Bank cooperation with UNESCO. As long as the Bank was part of the United Nations family, he thought it would be unwise for it to enlarge its staff of experts in the field of education, until and unless it was persuaded on the basis of experience that UNESCO could not or would not do the job well. His view was the same with respect to FAO in agriculture, although because of the nature of agricultural projects, where economic returns could more readily be evaluated, the Bank might play a greater role.

32. Mr. Lieftinck remarked that UNESCO dealt with ministries of education, while the Bank dealt primarily with ministries of finance. He thought that it was appropriate for the Bank to assist ministries of finance more than ministries of education in the pursuit of sound educational policies. The Chairman agreed. That was, in part, why he believed that UNESCO, which did have an established relationship with ministries of education, was the entity upon which the Bank should rely with respect to the soundness of an educational program and educational concepts, and the need for given physical facilities. When these had been established, Bank staff would consult with the ministry of finance. The Chairman appreciated that Mr. Lieftinck did not agree. He himself believed that it would be a tactical error to try to build the kind of staff on educational matters that the Bank had in, say, the power or transport field, and that the proper course was to give UNESCO a reasonable period to work out a satisfactory cooperative relationship. Perhaps a year was not long enough. In proposing that UNESCO be regarded as in effect the Bank's technical arm in the education sector unless and until it became evident that it could not perform that function, the Chairman did not mean to imply that the existing staff group working on education would be disbanded. Perhaps the group would have to be enlarged, but the one or two additions would not be operators or technicians. They would have the competence to evaluate the findings and recommendations of the UNESCO experts. If the arrangement proved unsatisfactory and the Bank nevertheless wished to operate in the educational field, then the proposal in paragraph 9 of the paper would have to be reviewed. The Chairman would welcome an expression of other Directors' views on the question whether the Bank should build up an education staff of its own or--as he would recommend--cooperate with UNESCO, until it had been demonstrated that UNESCO could not or would not discharge the responsibility.

33. Responding to the Chairman's request that he comment on Mr. Lieftinck's interpretation of the provision of the Articles concerning terms of lending "appropriate to the project," Mr. Broches said that the words occurred in

Article III, Section 4, which prescribed general conditions for Bank lending. Sub-paragraph (iv) of that section specified that in the opinion of the Bank the rate of interest and other charges should be reasonable and that such rate, charges and the schedule for repayment of principal should be "appropriate to the project." He had not heard those words interpreted as Mr. Lieftinck had read them. His own recollection was that the provision had been intended more as a warning against unrealistic repayment schedules, financing on too short a term. The same was true for the rate of interest and other charges. It was drafted to achieve what was spelled out in the next sub-paragraph--that the Bank would pay due regard to the prospects that the borrower would be able to repay and hence that the Bank should not charge too much. A very low interest rate could be unreasonable, too; so could an extremely long repayment schedule. In the cases, which might be relatively few, where it was clearly difficult to reconcile the project considerations and the balance of payments considerations, the paper suggested in effect breaking the transaction into two parts--lending to the government and relending to the borrower. He thought in that situation it might be possible to consider that these were in fact two projects, one narrow and one broad. The ultimate borrower would then be called upon to repay within a "normal" period, and the country would have a somewhat longer repayment period. In any case, he thought the language was not intended to be read as Mr. Lieftinck had read it.

34. Mr. Machado said that there were those who considered the Bank's only function to be the financing of economic development projects. There were also those who felt that without reducing the kind of lending which had earned the Bank its reputation, the Bank might explore other avenues of service, particularly since in a number of countries the large investment projects--roads, railroads, etc.--might soon all be financed. Education was only one of the possible new fields. He believed that the Bank could also do a great deal in the field of health. He was glad, however, to hear some of his colleagues declare that education was not only a social but an economic problem in the underdeveloped countries. One of the bottlenecks was a shortage of personnel qualified not only to plan a project but to run it successfully on a business basis. Anything that the Bank could do to assist countries to overcome that handicap would not only help the country but facilitate the financing and execution of Bank projects. On the matter of the proposed Bank/UNESCO relationship, Mr. Machado felt that cooperation between the two institutions was essential in the beginning; UNESCO had the know-how and experience that the Bank lacked in the education field.

35. At 1:16 p.m., the meeting was adjourned, to resume the following day.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

CONFIDENTIAL

FPC 63-19/1

FROM: The Secretary

December 5, 1963

Memorandum of Meeting of Bank Financial Policy Committee
FPC 63-19 of December 4, 1963

The following corrections are to be made in the above memorandum:

Page 10, Para. 25, lines 23-28 (incl.) of such paragraph, substitute the following for the two sentences beginning "As a next ....." and ending "..... implementation of Bank projects."

"Next, the Bank/IDA could help to establish pilot schools and research centers in special fields of technical education. He could also support Bank/IDA assistance in the provision of specialized and high-priority educational facilities--schools, equipment and expatriate teachers--directly needed for or closely related to the efficient implementation of Bank projects. More experience should be gained before going beyond that."

Page 11, Para. 28, for line two of such paragraph substitute the following:

"which mentioned the physical life of the project, the earnings of the project and the earn-"

Page 11, Para. 28, line six, substitute "project" for the words "enterprise as a whole;"

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