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Folder Title:	Representation of the Financial Community, New York, NY. February 25,1982
Folder ID:	1775988
Series:	Speeches
Dates:	02/01/1982 - 03/03/1982
Subfonds:	Records of President A. W. Clausen
Fonds:	Records of the Office of the President
ISAD Reference Code:	WB IBRD/IDA EXC-09-3962S
Digitized:	03/01/2023

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Representatives of the Financial Community - New York - February 25, 1982

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A1995-266 Other #: 1 209436B

Representation of the Financial Community, New York, NY. February 25,1982

THE WORLD BANK: A FINANCIAL APPRAISAL

Remarks

By

A. W. Clausen, President

The World Bank

before

Representatives of the Financial Community

New York

February 25, 1982

Good Afternoon, Ladies and Gentlemen,

I am particularly pleased to have the opportunity to meet with you today to discuss the financial policies and operations of the World Bank. The reason I'm pleased is that it is through the efforts of people like you--who help us access private capital--that the Bank is able to carry out its function. That function, quite simply, is to provide financial and technical assistance to stimulate growth and productivity in our developing member countries.

In fulfilling that function, the Bank performs a unique and critically important international role--a role of financial intermediary that serves the interests of the industrial as well as the developing countries. We are carrying out that role at a time of growing difficulty and complexity in the global economy. After 31 years as a commercial banker, I accepted the presidency of the World Bank because I believe that the development of the emerging world and the attendant improvement in the standard of living of those people--is one of the most challenging tasks confronting us in the final decades of the Twentieth Century. I believe the World Bank's role in helping to meet this challenge is more important than ever.

Today I would like to discuss briefly the unique nature of this role and how it serves the interests of developed and developing countries alike.

The Bank is unique in its security and strength. It is also unique in its purpose and program.

To begin with, the Bank is, as the name implies, a Bank. It's a very sound and prudent bank. But it is more than, and different from, the kind of bank we are usually accustomed to. It is an international development institution, with most of the world's governments as its shareholders--the United States being the largest.

Even though the Bank is wholly owned by governments, its philosophy is grounded in the interdependence of the public and private sectors. This concept is reflected fully in our founding charter and remains the touchstone of our operations. Indeed, the private sector--in terms of the investor community throughout the world--is the primary source of the World Bank's lending to developing countries. We borrow from the private capital markets all over the world and lend to the developing countries on the basis of sound economic criteria for productive purposes that enhance the prospects for further private investment and effort--both local and international.

Having been a commercial banker for so many years, it will not surprise you that one of the first things I did was to look carefully at the way the World Bank operates on traditional financial terms. At the outset, let me say, I have been impressed with the record established: a loan portfolio that has not suffered one penny of loss in the Bank's entire 35 years of operations; a firm policy against any participation in debt reschedulings; callable capital of $35 billion from the world's governments--to be increased to $72 billion--that serves exclusively as a guarantee for the protection of the Bank's bondholders; high-quality liquid assets amounting to more than $8 billion; and annual net profits--currently running at the level of about $600 million a year--realized every year since 1948, of which more than $3 billion have been ploughed back into the institution to strengthen its equity base. The fact is, it is an overwhelmingly strong institution as measured in purely traditional financial terms.

The Bank essentially has two financial assets: its outstanding loans and its liquidity. On the liability side, it has outstanding debt and a unique capital structure. I want to touch on each of these items briefly in an effort to explain how the Bank functions as a unique profitable and sound financial institution.

Since it began operations in 1946, the Bank has loaned about $71 billion. Of this amount, approximately $13 billion has already been repaid or sold to other parties, leaving about $58 billion of committed loans. However, $29 billion of that balance still remains undisbursed--to be drawn down by borrowers over the next six to seven years. Therefore, the World Bank's accounts receivable, currently disbursed and outstanding, is about $29 billion. It is expected to rise to about $32 billion by June 30, 1982. That represents the Bank's risk assets. It is our loan portfolio. What has been the financial experience with that portfolio?

In the first place, the Bank has never had a default on any of its loans...It has never had a non-accruing loan...It has never suffered a loss on a loan...We have seen numerous changes of governments in countries but without exception the successor governments have honored their predecessors' obligations to the Bank.

The Bank has a firm policy against debt rescheduling and does not participate in such exercises. It does not change the interest, the principal or the terms of a loan after it has been approved. Nor does the Bank refinance loans to permit its borrowers to service their debt. It is a project lender for the most part and does not provide a cash flow to its borrowers. In exceptional circumstances, non-project lending may be considered but the conditionality is stringent and furthermore, this type of lending in any one year has never exceeded 10 percent of total annual commitments.

It takes, on average, more than 2 years to help a country develop and then to appraise a project before it is presented to the Bank's Board of Directors for loan approval. The Bank's investigation covers all aspects of the project: economic, technical, financial, organizational, managerial, and operational. The project must be of high priority to the economic growth of the country. If it is not, the Bank will not finance it.

Now, what are the results, in financial terms, of all of this thorough analysis? Well, one set of figures should suffice to make the point:

Of $4 billion in interest and principal and other charges due to the Bank from its loans for the fiscal year which ended on June 30, 1981, only approximately $160,000 of interest was more than 60 days past due on that date, and only $1.6 million in principal was similarly late. By October 22, the date of our first prospectus in the United States after June 30, 1981, all of even these trivial amounts had been paid.

The second major asset of the World Bank is its liquidity. The Bank's liquid cash balances are currently about $8 billion and at the end of this fiscal year, June 30, 1982, will stand at about $10 billion. That liquidity is equal to about one-third of all our outstanding debt.

Why do we keep such a high level of liquidity? First, it has been a consistent profit center of the Bank invested at higher returns than the cost of borrowing. Second, it gives us flexibility on when, where, and how much to borrow. We simply draw it down...when rates are high or capital markets are unstable and build it up (by borrowing more than we have to) when we have access to stable capital markets at low costs. Quite simply, we do not wish to be captive to unstable markets. Therefore, we hold liquidity.

One final point on our liquidity. We never take a currency risk on our liquidity. We do not speculate among the different currencies. Our job, however, is to predict interest rates in the 20 different currencies which make up our liquidity--to decide whether to be long or short--and to manage the liquidity so it produces the highest financial rate of return. That, in turn, permits us to keep our lending rate at a minimum without jeopardizing the Bank's profitability.

Let me turn now to some specifics about the liability side of the balance sheet. We expect our outstanding debt to be about $34 billion at June 30, 1982. The main characteristics of that indebtedness are quite different from those of a commercial bank.

First, it is in 16 different currencies and the Bank does not take a currency risk on its borrowings.

Second, the average life of the Bank's debt is 7 years; all at fixed interest rates. For the World Bank to obtain funds for its lending, it must meet the rather vigorous tests of the medium- and long-term capital markets--the demands of the insurance companies, pension funds, and other institutional investors. Because of the success of our borrowing program, we have not found it necessary to have a "discount note" or CD base of funds or to issue other forms of variable rate paper.

About 30 percent of our debt is held by central banks or governments who have bought our paper, mostly through direct private placements, and who hold our obligations as part of their foreign exchange reserves.

The balance of our debt comes from private financial marketplaces all over the world. We are the largest non-resident borrower in the world in every capital exporting country.

. We are a triple-A borrower everywhere.

. The maturities of our debt range from 2 years to 25 years.

. We estimate that only $6-7 billion of our debt is held by U.S. investors. As much paper has been placed by the Swiss, the Germans, and the Japanese, each, as by the U.S. investment banking community. This is not to say that the United States market does not figure prominently in our plans. It does indeed. We have just recently returned to the American market after an absence of several years, but it is our intention to be a regular participant in this market from here on out.

. OPEC has supplied 15-20 percent of our outstanding debt--mostly by means of 5-12 year fixed rate direct private placements in half a dozen currencies.

My main point here is straightforward. Diversity. We have adopted a policy of diversifying our indebtedness by currency, by country, by source, by maturity, by technique of borrowing. We do 50-60 different public issues, private placements, and fixed rate syndicated loans a year. We never rely on one method, source or market. We will not be hostage to one environment. You may ask: What has this policy produced? Again, some rather straightforward facts are illuminating:

In 1975, the cost of our then $12 billion of outstanding debt was 7.2 percent. We project that as of June 30, 1982, after years of inflation and the erosion of the fixed rate markets, we will have oustanding debt of $33 billion--almost a 300 percent increase. We project the cost will be about 8.2 percent!

In one sense, we are very much like a commercial bank, but instead of matching short term and volatile funding with similarly variable rate loans, we seek to make medium- and long-term fixed rate loans and fund them with medium- and long-term fixed rate borrowings. When the time comes that fixed rate resources are insufficient to meet the size of our lending program, we will simply consider variable rate borrowing and, of course, variable rate lending in some form or another.

Permit me now to say a word or two about the unique features of the Bank's capital structure.

The Bank's equity as of June 30, 1982, is projected to be about $9 billion. That equity is divided into two roughly equal parts: retained earnings and paid-in capital. We have never paid dividends on equity, not because we couldn't but because we chose not to do so.

As you can see, we have a debt/equity ratio of about 4 to 1, as compared to a commercial bank's 25 to 1. Not bad--particularly for an institution which has never suffered a loss on a loan and does not participate in rescheduling or refinancings and has almost $10 billion in cash.

As I mentioned earlier, the outstanding projected debt of $33 billion is expected to cost about 8.2 percent as of June 30, 1982. Thus, the cost of total funds (debt plus equity) will be about 6.5 percent as of June 30, 1982. Our current lending rate is 11.6 percent.

Another unique feature about the Bank is its subscribed capital. The $4 billion of paid-in capital represents only 10 percent of the Bank's total subscribed capital. It is the portion that is actually paid to the World Bank by its member governments and is available for use in our general lending operations. But it is just the tip of the iceberg. There is, in addition, another $36 billion of callable capital. There are several points to consider with respect to the Bank's callable capital.

First, it can never be used to run the Bank. It can never be used for disbursements to developing countries. It is solely for the protection of the Bank's bondholders or other creditors. The only time it can be used is to meet obligations to bondholders or creditors if we need to call on it. We never have had to call on it, and we never expect to. Not with the quality of our loan portfolio, our cash position, profits, sources of funds and our loan experience. Nonetheless, the larger the amount of callable capital, the greater the protection for the bondholder. It is the icing on a very palatable "financial cake."

The Bank operates, however, as if that "guarantee" fund does not exist. It operates with prudent and meticulous financial policies.

The Bank's shareholders insist on it. They guide the Bank's financial policies with a full understanding that their callable capital is at risk in that it is a guarantee to bondholders.

We are now in the process of receiving over the next 4 to 5 years another $40 billion in capital which member countries have agreed to subscribe. Three billion dollars will be paid in and $37 billion will be added to our callable capital. Pro forma, that will give us about $72 billion of callable capital--guarantee capital if you will--in the mid to late 1980's, plus over $7 billion of paid-in capital, plus about the same amount--$7 or $8 billion--of retained earnings. That tallies up to an aggregate equity base of more than $85 billion.

Now a final word about profits. Bank profits have risen dramatically. In the early 1970's, they were $170 million. They went up to the $250 million level, then escalated rapidly to $400 million in the late 70's--then to $600 million in 1981--in part because of our equity base compared to debt, in part because of the composition of that debt, and in part because of returns on liquidity. We are rather satisfied with that picture considering we lend long term at fixed interest rates. Our forecasts indicate that profits will remain at or about current levels for the next few years. We intend to remain a profitmaking institution.

Before concluding, allow me to say a word about a point I mentioned earlier--the uniqueness of the World Bank as an effective financial intermediary serving the best interests of the developing and developed nations alike...the smallest and the largest...the poorest and the richest. Let's take a specific example of the smallest and the largest and how they each benefit...the Comoros islands and the United States.

The Comoros are a group of islands in the Indian ocean that joined the Bank in 1976. This country has a voting power of less than one percent. It is one of the poorest countries in the world with a GNP per capita of about $100 per annum. Apart from growing coconuts, the Comoros' main productive activities include the growing of ylang-ylang, which sounds like one of the pandas in the Washington zoo, but which actually is a valuable essence used in the manufacture of expensive perfumes. The World Bank is working closely with the Government of the Comoros and engages it in a broad array of policy dialogues. Among other things, in 1980 we approved a credit of $5 million to help improve the growing of coconuts and the production of copra, the major export crop, which is the lifeline for those islands. We are advising the government on marketing and pricing policies, and even on the elimination of rodents, which is a major problem. The people of the Comoros are benefiting from our interaction.

The United States, on the other hand, is a founding member of the World Bank, holds the largest share of voting power--a little more than 20 percent--and benefits in many different ways. I note only one here. Since the World Bank was established, its operations, including those of the International Development Association, have resulted in a net positive impact on the United States balance of payments of more than $5 billion.

This pattern of mutual benefit is duplicated broadly. In summary, ladies and gentlemen, the World Bank has proved to be a good deal.

* * *

Thirty-five years ago, my predecessors came to New York to sell the first issues of a new institution called the International Bank for Reconstruction and Development -- now called the World Bank. It was a gigantic undertaking. They got in touch with 2,650 security dealers and more than 1,700 participated in the sale of the Bank's two issues of July 15, 1947. These were $100 million in 2.25 percent, 10-year bonds, and $150 million in 3 percent, 25-year bonds. Both were offered to agents at 100 on July 11. And both issues were heavily oversubscribed!

Well, we are not likely to see those rates again soon. But one thing hasn't changed and remains as vital and alive today as it was then.

And that is the unshakable commitment of those early founders and managers of the World Bank to a fundamental concept--the concept of promoting sound economic development through the mobilization of private capital and deploying that capital for productive activities in creditworthy developing countries.

The men with that vision were not dreamers; they were hard-headed realists from this very same financial community here in New York. They were people like yourselves.

It is certainly our intention to carry on in that great tradition and with your support the World Bank will continue to play the unique role that it has for the last four decades. This is the way we can best help meet the challenges of the 1980s.

Thank you once again for your interest in our institution. And now I'd be happy to respond to your questions.