Rotberg: A Talk on the Borrowing Side

by Ellen Tillier

The Bank's World interviewed Eugene H. Rotberg, Vice President and Treasurer, on the Bank's new borrowing techniques and the reasons for implementing them.

Q Mr. Rotberg, why is the Bank using new borrowing instruments, particularly short-term borrowings or floating rate notes?

A. First, given the size of the Bank's lending program, we need to tap markets that are less restricted in size or access than the fixed rate bond markets. Second, we want to diversify the maturity structure of our debt.

Third, the Bank, unlike most institutions, has an interest rate mismatch between its short-term assets (its liquidity) and its long-term liabilities which, until recently, were all at fixed rates. The rate of return on the Bank's short-term assets, however, can be quite volatile due to their short maturity—typically three to six months—which inevitably results in unpredictable returns within a given year. The introduction of a modest amount of rate-sensitive liabilities offsets that volatility somewhat.

Fourth, we are reluctant to lock in high cost borrowings, such as in U.S. dollars, whose costs are borne by developing countries. On the other hand, we don't think it prudent to borrow only Deutsche mark, yen and Swiss francs given the potential exchange risk. A shorter maturity dollar instrument would therefore provide the flexibility to raise resources in dollars without locking in the costs to our borrowers for long periods.

But the bottom line is that the size of the Bank's projected borrowing and lending programs makes it imprudent to plan to borrow only in fixed rate markets to finance an expanding lending program. It gets down to a question of judgment and prudence. While the Bank can rely on fixed rate bond markets for substantial amounts, there is a limit, perhaps, say, $8 billion to $9 billion a year, beyond which wisdom would dictate either slowing down the lending program or diversifying our borrowing instruments. Given the needs of our borrowers, we think the latter is the appropriate choice for a development institution. The risks of relying solely on the fixed rate market are simply too great and are potentially very costly.

Q. What are the risks that cause you to doubt the size of and access to the fixed rate markets?

A. First, experience has taught us that we don't have guaranteed access to medium- and long-term markets—in any currency. Countries can have balance-of-payment difficulties. Their savings rates can decline. In response to inflationary pressures or to weakness of the exchange rate, savings can shift out of fixed rate markets into shorter term instruments. Also, governments often find they must restrict access to their markets only to themselves or to domestic borrowers as a result of large government deficits or competing domestic priorities. And markets can become saturated with the obligations of one issuer, particularly if the market is not growing.

Over the past 10 years, there has been minimal, if any, growth in corporate and foreign borrowings in the U.S. fixed rate bond market. The World Bank's first bond issue in 1947 in the United States was about the same size as its most recent issues.

The facts are that inflation—or the expectation of inflation—the fear of loss of capital and a preference for liquidity cause individuals and institutions to place resources in the many money market instruments now available—bank deposits, savings and loan association deposits, and floating rate notes—which give high rates of return, liquidity and no capital risk. With a Bank borrowing and lending program 10 times larger than 10 to 15 years ago, it just isn't wise to plan on financing that program solely in the fixed rate markets—whose size remains virtually unchanged for corporate and foreign borrowers.

Q. Are there any other reasons for using short-term instruments?

A. Yes. Size. The shorter term markets are now about $700 billion in the United States. As you may know, when the economic environment is difficult, shorter term markets expand and it is the medium- and long-term markets that become uncertain and vulnerable. Finally, short-term instruments are often, if not usually, much less costly.

It comes down to a rather simple principle. The Bank can support an expansion of its lending program by borrowing *modest* amounts through instruments such as floating rate notes, the Central Bank Facility, discount notes and similar instruments which attract a broader base of funds, are more reliable, less readily saturated and provide a diversified maturity structure.

Q. Can you put the whole program into context?

A. At year-end FY84, we will have

COVER: Pam Severski, Loan Department, takes the wheel while "Blue Marble" passengers relax and enjoy the ride home to Springfield.
Photo by Michele Iannacci/Art by Bill Fraser

about $46 billion in debt outstanding, of which only about $3 billion will be in short-term obligations, that is, with a maturity of less than one year. Longer dated obligations carrying floating rates reset periodically during the year will account for another $500 million at most. This means that less than 8% of the Bank's debt includes instruments whose costs can change within a given year. I do not think this is an imprudently large proportion of variable rate or short-term debt.

Q. Can you describe these new instruments more specifically?

A. The short-term obligations are called discount notes. They are obligations with a maturity that can range from a few days to almost a year, similar to a U.S. Treasury bill. They are sold, like U.S. Treasury bills, at a discount from par which represents the return on the instrument. Discount notes appeal to corporations, money market funds, commercial banks, savings and loan associations and institutions whose cash management objectives require highly liquid funds with minimal risk of capital loss in the short term.

A floating rate note has a longer maturity—five, 10 to 15 years. The interest rate is reset every three to six months and is priced at a spread over the prime rate, LIBOR (London Inter-Bank Offered Rate), or the three-month U.S. Treasury bill. We could tap this market—which is more costly than discount notes—for substantial amounts. Our program, here too, is rather modest, but it would permit, along with the other new instruments, an expansion of Bank lending.

Finally, we offered a new one-year facility to central banks in January 1984. We reset the interest rate every month based on the yield of new one-year U.S. Treasury bills as a pricing benchmark. We offer the central banks the right to receive back their investment before a year expires, at par, on two days' notice. It is an attractive and fair instrument which we think will command the attention and support of a broad base of central banks.

Another useful instrument—more a methodology than a borrowing instrument—is the swap transaction. It has provided a way of obtaining Swiss francs, Deutsche mark or guilders without entering the market in those currencies. A swap is simply a transaction where we might issue, say, U.S. dollar obligations, and the other party issues—or has already issued—say, a Swiss franc obligation. Both parties remain obligated to the respective buyers of their bonds. We sign separate agreements—called forward contracts—stipulating that we will supply the Swiss francs to the other party as its obligations to its bondholders come due and it, in turn, will supply us the dollars as our obligations to our bondholders come due. Each of the parties may have a comparative advantage as a lower cost borrower in one market rather than the other, or we both may wish to avoid market saturation—and thereby avoid jeopardizing our standing in a particular market.

Swap transactions create a forward exchange market for five to 10 years, a favorable development that facilitates trade since it provides a method for hedging long-term currency or interest rate risk through the execution of long dated forward contracts. So far, the Bank has done $3 billion in currency swaps. It has had a particularly favorable effect in substantially lowering the Bank's cost of borrowing and therefore its lending rate to the developing countries.

Q. Why didn't the Bank use these instruments before?

A. First, because we didn't need to. Our borrowing program wasn't all that large. Second, it was thought imprudent to finance ourselves, even in small amounts, with liabilities sensitive to interest rates because our

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'Swap transactions create a forward exchange market for five to 10 years.'

Photos by Michele Iannacci

Eugene Rotberg in the Bank's trading room.

loans were at fixed rates—even though we had sizable and volatile short-term assets on our books.

In any event, following a change in 1982, the charges the Bank levies on its borrowers are reset every six months based on the average cost of a pool of outstanding debt. The pool is quite stable because (a) it contains many currencies, (b) it includes a wide range of maturities, (c) it reflects the Bank's borrowing costs over a long period of time, and (d) it is quite large. Costs of marginal borrowings, whether fixed or floating, are therefore diluted and volatility minimized.

Once a borrowing is made, however, it stays in the pool until repaid. That is one of the reasons why we are reluctant to rely exclusively on fixed rate medium- and long-term borrowings—particularly if they carry high nominal costs.

Let me also mention that the changing cost of the pool from new borrowings has been less volatile than would have been the case in the private sector or under the old IBRD interest rate system.

To recap, the new instruments have given us—and through us, the developing countries—increased flexibility. It has provided less costly loans and, more important, a more assured access to funding for the present and projected lending program.

Q. Are there limits on these borrowing techniques?

A. We can never be sure where the limits are. All we know is that if we reach the limit—in any market, *fixed* or *otherwise*, we have gone too far. The market will perceive that we have overextended ourselves. That is why it is so crucial to diversify into a wide variety of different instruments. It's too late to diversify *after* a market has been overtaxed.

Market participants are sophisticated. They do not take well to issuers who seek their support in time of need—particularly through new instruments unveiled, for the first time, during a difficult period. New instruments and market support must be developed *before* they are needed or required—when they are recognized as an option, a choice, a part of a program of diversification—not as a last resort.

Q. How does the idea of the "Bank's bank" come into the picture?

A. If you agree that we will have to finance new lending through instruments of the sort we have been talking about, a question arises as to the most appropriate vehicle for the financing. Some believe it should be done within the Bank proper. Others think it would be more efficient and effective to do it through an affiliate institution.

Those who support the latter approach make two points: First, since most of the borrowing to finance a lending program greater than current levels will have to be in the short-term or variable rate markets, it doesn't make sense for governments to provide a one-for-one capital guarantee to providers of those funds. Commercial banks obtain that kind of money in volumes 20 or 30 times their capital.

Second, a lending institution that seeks to attract increased participation from the private sector, and to encourage joint operations as a means of increasing lending to developing countries, is better placed to perform that function if it finances itself with a financial structure similar to that of institutions with whom it expects to do joint operations.

The opposite view holds that, first, we should simply give a full one-to-one guarantee under the Bank's traditional capital structure to the providers of the short-term or variable rate resources. Then, we should go out and borrow the resources in the short-term or variable rate market to finance the lending permitted under the new authority. After all, the argument goes, it doesn't really cost the member governments anything because guarantees aren't "real" money. Second, we don't need an affiliate to attract the private sector into co-financing arrangements. The Bank has gained a great deal of experience in this area and is presently conducting a pilot program to identify ways in which our co-financing program can be further enhanced.

Q. How does a capital increase fit into the picture?

A. An increase in the Bank's capital, of course, doesn't address the issues. Nagging questions remain: What kind of financing will be nec-

essary to fund increased lending and what is the appropriate institutional vehicle to tap those markets? I just don't believe the fixed rate bond market can be prudently relied on to provide the answer. And I believe that we should not and need not provide a one-to-one guarantee for short-term or variable rate funds. And, if not, it behooves us to debate and then decide how and where we will finance an expanded lending program and through what kind of institution—leveraged or not leveraged.

Q. Are the new instruments sufficient to permit an expansion of Bank lending?

A. Yes, I think any reasonable increase in lending expansion can be accommodated by the techniques already implemented. Indeed, I think any reasonable increase in lending can be accommodated by keeping these new instruments at a fairly *low* percentage of outstanding debt. No great innovations are needed beyond those already implemented.

Q. Let me go back to the basic question: Is there any possibility that the fixed rate markets could finance a substantially expanded lending program?

A. Sure. It's possible that global inflationary expectations will disappear; that the U.S. will have stable growth financed through increased fixed term savings; that governments will spend only within their means; that the funding techniques of the world's commercial banks will change as savings move into the long-term fixed rate markets; that liquidity will command no premiums; that fear of capital loss will no longer address the attention of investors; and that balance-of-payments, exchange rates and flight of capital will no longer be concerns of public policy makers.

In that environment, one might envision a growing and vibrant long-term fixed rate bond market to which The World Bank would have unfettered access.