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The subject is financial stress, our response to it and liability management.

It may be useful to start with a story:

- A saintly pious man was visited by an angel of heaven.

  What are you doing here? I sent three boats...

I. What are the floods that have visited the world's financial system over the last decade or two?

   a. Volatile exchange rates. ¥360, ¥170, ¥320, ¥150.

   b. Volatile interest rates. 7%; 16%; 7%.

   c. Uncertain access to funding.

   d. Changes in world patterns and volumes of financial savings: OPEC; Japan; the Euro dollar market.

   e. Increased government borrowings.

   f. Restrictions on the flow of capital.

g. Capital flight.

h. Recession; inflation.

i. Increased competition amongst intermediaries for funds (banks, investment banks, non-banks).

j. Deregulation - across borders.

k. Huge BOP shifts (oil price changes).

l. An LDC debt crisis.

m. Increased communication links.

n. Very high material rewards or compensation for getting it right.

II. Given that environment, the code words are innovate, leverage, globalization. But the human psyche, and certainly the bureaucratic setting has not changed. There always remains how do we cope with financial uncertainty in a competitive world.

a. We respond to peer pressure. Develop and then sell that magic zero coupon bond with a perpetual maturity so a borrower needs pay neither interest or

b. Capture rewards quickly and visibly.

c. Share blame or responsibility. Do not be identified as the provider of unwisdom.

d. An accounting system is used in the full knowledge that opportunities lost are not measured. Only visible mistakes are punished. ¥ borrowed at 300 revalues to 150 to the US$ - a mistake, if borrowed. Yen not borrowed devalues from 170 to 300 - no mistake.

e. Another sympathetic accounting convention. You need not show losses until you sell.

f. A financial community which considers as acceptable present pleasure for future pain. Warrants are permissible if one looks good now.

III. Now, given the financial stress and the bureaucratic setting, and the desire to look good, the financial community invents and expands the use of warrants, futures, options, ruffs, niffs, extendables, retractables, rate caps, insurance; all of which are designed either to -

a. protect or hedge against risk,

b. leverage risk,

c. hide risk,

d. provide certainty of funding.

Unfortunately, sometimes the objective shifts after the fact to justify a particular action.

IV. What is the reaction to innovate?

From Managers and Supervisors and CFOs and Chairmen -

a. Fear - we don't understand it, too complex. Uncertainty, they understand and accept. However, the idea of <u>coping</u> with uncertainty is a bit too much.

b. Resentment. Who are you to cope with the future.

c. You are too young, too smart, too visible, too highly paid.

From Governments, there is also concern:

a. Credit risk shifts from banks (whom they control and regulate) to non-banks.

b. Off balance sheet risk makes control, regulation difficult. The banks become opaque, and government senses a loss of power.

c. It all complicates the monitoring of money supply.

d. Exchange rate controls will be difficult to re-establish. Too many participants. Too many diverse interests. Too many loopholes.

e. Too many players. Too much leverage.

f. The domino syndrome. Too many intermediaries of unknown credit quality between buyers and sellers, investors and borrowers.

g. There is also the concern that banks, who hold public deposits, in an effort to maintain profitability, will find themselves, as a competitive matter engaging in complex operations, with uncertain managerial control. Banks historically train staff to lend; it is not clear to regulators that senior managers can cope with risk taking related to interest rates and exchange rates - the core of most innovation.

h. There is also concern with the twin dilemna of banks have to cope with shrinking returns on assets as better credits move to the securities markets. They must either innovate or put more risky assets on their books to maintain profitability.

i. There is concern about how the leveraged instruments will increase volatility.

j. And concern about how the non-cash instruments in the private sector - options and futures, will make currency intervention even more difficult.

V. This is the environment we (and you) operate in. Let me share with you, our philosophy on financial debt management.

a. We cannot predict either interest rates or exchange rates, 6 months, 1 year, 5 years from now at a 75% degree of certainty.

b. There is just as much risk in borrowing as in not borrowing.

c. It is of the greatest importance to have maximum <u>choice</u> as to when to borrow, where to borrow, what currency, how, fixed or floating, long or short.

d. Mistakes will always be made - many times in executing a program.

e. External forces, outside ones control, will limit access to reasonable terms in any particular currency. Oil prices, recession, high interest rates, BOP difficulties, protectionism, politics. These variables apply to IBM, China, Brazil, Exxon, and the World Bank.

These principles have resulted in the following financial debt structure at the World Bank:

- Outstanding debt $75 Billion
- 18 currencies - by choice
- 95% fixed rate; 2% short; 3% floating
- No LIBOR. Too volatile

- 20% placed officially
- 1 day to perpetual maturity
- 125 times a year - $12 billion a year

Conclusion:

- Diversify across currencies sources, countries, maturity, technique, silently and publicly.

I suggest borrowers ignore concepts such as Euro, Asian, Yankee markets, etc. Ask where are the buyers. The domicile of the bond issue only reflects legal, tax, and regulatory considerations - usually of intermediaries. It has nothing to do with the location of the market - which is where the customers are, not the Bankers. -

- Build liquidity. Borrow now, not later. Manage the resulting cash.
- Accelerate when you think rates are low. Borrow long.
- Don't innovate under stress. It is too late then.
- Borrow when you do not have to.
- Don't surprise markets. Don't pick off customers by excessively tight pricing.
- Bankers are not adversaries.
- Avoid market saturation. Use swaps extensively. Most important, plan and act as if the world is a hostile place.
- Pay all debts on time.

VI. Now - given (1) unpredictability of rates, (2) the propensity of bureaucracies and staff to look good and sometimes be good, (3) the development

of new hedging and leveraging instruments, (4) rather flexible accounting conventions for reporting mistakes, (5) highly motivated investment bankers, what will my successors and you likely find:

The answer is deceptively simple to state. Liability Management. But of a scope and complexity not easy to assess, as yet.

a. It will be just quite similar to asset management.

b. We all know assets are traded to increase their rate of return. Buy low, sell high - stocks, bonds, warrants, futures, options.

c. But if portfolio managers can manage the instruments issued by corporations and sovereign governments, why not also the issuer, the CFO, the Treasurer, the government borrower. They are learning quickly. After all, it is the same instrument.

d. But, one says, you can't always repay the DM; Y; SwF, once issued. But you can. You can swap it, for as long as 15 years.

e. Liabilities will constantly be restructured. Options will permit borrowers to borrow now and set the rate later, or set the rate now and borrow later.

f. Currency options will permit issuers to hedge their positions - buy long term insurance, or alternatively leverage their views even more.

g. Borrowings, once entered into will be reversed through non-cash instruments either because they were profitable and, therefore, to be captured, or unwise and one wishes to cut future losses, or show existing ones in a particular year.

h. In short, CFOs and Corporate Treasurers and government debt managers will acquire new skills, new visibility, and there will be new accountability. That will involve a new potential to be measured. Already, my debt managers are building a trading table to manage $70 Billion of debt, just like our cash managers trade our short term liquid assets.

i. No longer will financial officers issue debt - then wait and see.

j. There will be great pressures on the liability side to use the new instruments, to move from fixed rate to floating rate and back again. To move into and out of and back into DM and Y on the liability side of the balance sheet.

k. There will be pressures to take gains to shore up lagging performance elsewhere. If you can't sell cars, at least be in a position to take the gains on borrowing wisely.

l. There will also be pressures to hedge, protect, insure and stick to selling cars or textiles rather than taking unmatched, uninsured exchange rate exposures.

m. And pressure to do the opposite, to leverage, create <u>a profit center</u> in the management of the debt structure.

I cannot tell whether these developments will be used to look good or be good, or to protect or hedge or leverage. It is too early in the process. Perhaps, the constraints will come from governments or corporations not pre-

pared to compensate liability managers for managing the same instruments as their asset manager counterparts!

But the potential is there to think about and measure opportunities lost and for managing the whole balance sheet. In short, I suspect world debt will be traded and securitized by debt managers, just as effectively and quickly as portfolio asset managers.

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