1985 ?

IBRD'S FINANCIAL STRUCTURE AND FINANCIAL OPERATING PROGRAMS

Presented by Eugene Rotberg, Vice President and Treasurer

Informal Remarks (no prepared text)

MR. ROTBERG: Thank you Moeen.

The Treasurer's complex has, essentially, only a reflected responsibility.

Joe Wood, who is sitting here, tells us what we should do. Abraham Shihata, the Vice President and General Counsel, tells us what we are legally allowed to do. Hans Hittmair tells us, after we do it, how we must report what we have done and, finally, the financial marketplace tells us what it will accept. Our responsibility essentially, is to manage and execute the Bank's borrowing and investment program consistent with their views!

The constituency of the financial marketplace, as you all know, is not represented at this table or in the World Bank buildings. As a result, over the years there has developed a relationship, if you will, between the Bank's financial management and the private marketplace which is based on some basic underpinnings. Let me share them with you.

First, the private marketplace understands that we will advise them openly and in a timely fashion "what is going on in the Bank". We disclose how we operate, the way we conduct business, what our policies are, what our financial statements mean: we treat the financial market with the respect that it deserves because, among other things, that marketplace provides the finance for the Bank's lending program.

Second, we try to be fair to investors and to the investment community. And by "fair", I mean not to take advantage of them, not to be too cute, and not to treat them as adversaries merely because we are the borrowers and they are the lenders.

Third, there has developed, if you will, an ethical/legal contract which, in some cases, is rather precise - a prospectus; in other areas a matter of a more subjective nature: how we will conduct our operations -- that we will go about doing our business in a professional way; we will not write blank checks, function as a commercial bank, reschedule loans, we will remain essentially a non-political institution and not take steps which would jeopardize our preferred creditor status; that we will lend and charge for loans at a rate higher than our cost of borrowing, etc.

And, finally, perhaps most important, our "contract" with the private market implies that we will encourage confidence in the quality of our lending operations, with attention to appraisal, to supervision, to insuring a

meaningful policy dialogue, with concern to the creditworthiness of our borrowers, the productivity of the projects and the quality of the development dialogue.

These matters are important to us, and basically are at the heart of the support which the marketplace has provided to the Bank.

What I would like to do now is describe to you the financial statement which we have presented to the marketplace.

I have had distributed a one-page sheet, which I think most of you now have in front of you. Essentially, it is the Bank's balance sheet and profit and loss statement; indeed it is before each of you virtually every week of the year as an annex -- I think it's called "Annex V" -- to the document which is distributed on the occasion of each borrowing operation of the Bank.

It's a projected balance sheet and, therefore, it's slightly different than the figures that most of you would be familiar with because it includes projections for results estimated as of June 30th, 1985.

Let me first address the opening line, "Cash and liquid investments;" the figure is $16.7 billion at a projected return of 11 percent for 1985.

That liquidity is managed within the Treasurer's complex by a Department Director -- his name is Hani Findakly.

Where does the $16.7 billion come from? Essentially, it comes from the cash flow derived, for the most part, from the Bank's borrowings. It is actively managed. It trades in excess of $2 trillion a year. It is all in fixed interest obligations. It has a maturity for some of the instruments, as short as one day and for others, as long as five years and three months.

It is in either government bonds or government guaranteed bonds, or in the direct obligations of commercial banks. It is in 25 different currencies.

The Board has established a set of guidelines -- indeed, strict guidelines -- on the nature and quality of the instruments which can be purchased. All of the investments are liquid, that is, they can all be sold in the market; they all have a market value.

There is no currency risk whatsoever ever taken with respect to the Bank's liquidity; that is, we do not speculate across currencies. The liquidity is used to service our debt, both interest and principal, and is used, generally, to meet the Bank's disbursement requirements - now estimated at about $10 billion a year.

The liquidity is derived mainly from borrowings which represent the partial funding of the World Bank's loan commitments. That is to say one of the key elements of the Bank's cash flow (which results in liquidity being at $16 billion) is the loan commitment level at the World Bank which, after a lag results in disbursements - often over a five to seven year period after commitments are made. The liquidity represents partial funding of these commitments pending their disbursement.

Indeed, that is one of the crucial differences between the World Bank and a commercial bank. In commercial banks when funds are lent, they are disbursed almost immediately, within a matter of several weeks. At the World Bank when funds are committed, relatively small amounts are disbursed within the first months, or even within the first six months or year of commitment. The average life of the disbursement pattern after commitment is usually such that most disbursements are made between the third and fourth year after a commitment.

Thus, the liquidity reflects the borrowings that are currently made to fund commitments which later will be disbursed. We are now borrowing to finance disbursements, the commitments for which were made several years ago.

The liquidity has been, almost consistently over the last decade, a major profit center for the Bank. Moreover, the Bank's liquidity permits the Bank to have some flexibility perhaps for a period of several months, as to how much, when, what markets and in what maturity the Bank would borrow.

On the other hand, if the Bank did not borrow for a period of, let us say, one year, the liquidity would drop by approximately $10 billion.

Another way of putting it is simply to say that the Bank has a negative cash flow from operations of approximately $10 billion. In other words, if one were to add up the Bank's net income, plus the flow of repayments on loan amortizations from borrowers, and subtract from that amount, the disbursements and repayments due on the Bank's outstanding bank debt, one would end up with minus $10 billion.

The point I want to emphasize, however, is that the liquidity is not -- I repeat, is not "extra" money. It is simply that portion of a partial funding of loans already on our books but not yet disbursed.

I might also mention that the projected rate of return of about 11 percent for FY85 is likely to be higher this year.

The next figure on the balance sheet is the disbursed and outstanding loans. Moeen has referred to that figure of approximately $42 billion.

It is particularly relevant to understand, again, this concept of the "undisbursed" loans. The Bank, at the present time, has made -- I think as of this month -- $105 billion of loans, i.e., that's how much the Board has approved in the history of the Bank.

Of that amount, something on the order of $24 or $25 billion has been repaid. That leaves a total of <u>both</u> disbursed and undisbursed loans of close to $80 billion.

$42 billion is now disbursed and outstanding. That is the debt servicing obligation of LDCs to the IBRD.

The balance of some $38 billion you will not see on a balance sheet; it is the undisbursed portion of commitments already made and will be disbursed over a time The undisbursed portion will grow as new commitments are made.

The liquidity is a partial funding of that $38 billion, plus some amount needed for the <u>projected</u> commitments to be made each year.

Let me also direct your attention to the 9.26 percent return on loans. The 9.26 percent represents the cost to our borrowers if we calculated (a) the lending rate applicable to that $42 billion of disbursed loans, (b) the commitment fee and (c) the front-end fees as a percentage of the disbursed and outstanding loans. If one looked at just the <u>interest rate</u> on the Bank's outstanding loans, one would see a figure of 8.5 percent. But since the Bank has a front-end fee and a commitment fee, it moves that 8.5 percent interest rate up to 9.26 percent.

I mentioned a few moments ago that we had $38 billion of undisbursed loans. Those undisbursed loans carry an interest rate of about 9.7 percent. So we have a <u>current</u> interest rate of 8.5; a total return, including fees of 9.6; and <u>future</u> interest rates on what are now undisbursed loans of approximately 9.7.

Now, if you add the liquidity and the loans you see a balance sheet of about $60 billion, with a rate of return on our two assets (loans and liquidity) of about 9.53 percent.

Let me now direct your attention to the liability side of the balance sheet.

The few accounting friends that I have left in the world tell me that if I come up with $60 billion on the asset side, I've got to come up with $60 billion on the liability side. First, you can see projected outstanding indebtedness of $50.9 billion.

The first thing you might notice is that it is very substantially medium and long-term indebtedness: $47.2 billion. Of that amount less than $500 million is at floating interest rates. The rest, $46.7 billion, is all at fixed interest rates. In short, our medium and long-term debt is almost exclusively at fixed interest rates.

We have short-term paper outstanding - i.e., indebtedness with an original maturity of less than one year of $3.7 billion.

And, as you can observe our short term debt consists of two parts: discount notes -- a month, two, three months in maturity -- and the Central Bank facility which has exactly a one-year maturity. The $3.7 billion for those two short term instruments might be compared to the Bank's total indebtedness of $50.9 billion.

The $47.2 billion is in 18 different currencies. Our prospectus describes the various currencies which make up that $47.2 billion. It is substantially in Swiss franc, deutsche marks, yen, guilders and U.S. dollars.

I want to emphasize, however, that one should not -- I repeat, should not -- assume when one sees, for example, U.S. dollars as part of the Bank's outstanding indebtedness that the funds were borrowed in the United States. In fact, something like $7 or $8 billion is all that is now outstanding from borrowings in the United States.

The rest of the dollar denominated debt is from central banks, from OPEC and from the Eurodollar market.

Similarly, when one sees deutsche marks, do not assume that the deutsche marks all came from German savings. They substantially did, but there are substantial amounts supplied by nonresidents who have purchased our deutsche mark bonds. And similarly, with respect to Canadian dollars or sterling it is simply the currency of debt not the source of the funds.

Nonetheless, as all of you know, the Bank must obtain the approval of the government whose currency is being borrowed, as well as the marketplace in which it is being borrowed.

So if we borrow dollars in, say, the Swiss market, we obtain approval of both Switzerland and the United States. And, similarly, if we borrow yen in London, we will need approval of both the Japanese Government, as well as that country whose managers are used to place the yen.

The maturity of the 47 billion of debt is as short as one year and as long as 99 years -- our latest issue.

We are, as you have heard from Moeen, executing a borrowing program of about $12 billion this fiscal year. That means that we will do a borrow-

ing, somewhere in the world, every two days, each working day of the year. We do approximately 130 bond issues or private placements a year.

We borrow from central banks; indeed, central banks constitute approximately 20 percent of our outstanding indebtedness. That $10 billion is in a variety of currencies: yen, deutsche marks, Swiss francs and dollars, etc. We have very large placements, for example, with the Saudi Arabian Monetary Authority, with the Bank of Japan and with the Bundesbank.

We also have programs where all central banks are offered from time to time -- twice a year -- to subscribe to Swiss franc and dollar bond issues.

Generally, our public issues are liquid, marketable, and listed. The Bank has, as a matter of policy -- or management has, as a matter of policy, an aversion -- so far -- to LIBOR-based instruments. We do not like borrowing at LIBOR, because we do not feel comfortable borrowing at a rate which is the rate that commercial banks charge to each other.

We believe that we are a better credit risk than commercial banks and, therefore, should not price even our few floating-rate notes, based on the rates commercial banks charge to each other.

As a result, the floating rate paper that I referred to -- we've done three issues with floating rates, almost $500 million are all based on the Treasury Bill rate as a benchmark, in U.S. dollars -- or in the most recent case, in Canadian dollars.

What else can I say about the borrowings? Over the next five years, we will have to borrow over $70 billion. We are currently borrowing about $12 billion a year.

Approximately 80 percent of whatever the World Bank lends must be borrowed. We do not have, as you know, taxing power. We cannot print money. We essentially, therefore, must go to the private marketplace.

Let me interject also that when I say, "the private marketplace," even our borrowings from central banks are at the market; that is, they are not subsidized, they are not at concessional rates. We bring our issues to central banks, and price them at rates which are equivalent to what they would invest their foreign exchange reserves at in a market operation. We do not ask them to subscribe as support for development, though, of course, the resources are used for that purpose. In short, we are offering them what we think is a financially fair rate.

One cannot talk about the borrowing program of the Bank without mentioning its effect on the lending rate. The lending rate of the Bank -- and you will hear more from Joe Wood and from David Bock about this -- is related to the cost of borrowing. As you will hear in more detail, the Bank has a

pooled cost of borrowings based upon all of our borrowings done since 1982; we add a half of a percent to that cost, so that when the Bank borrows deutsche marks, yen, Swiss franc, dollars, sterling, guilders, Belgian francs, ECUs, etc., we average the nominal interest rate cost, calculate the costs for a six-month period, put them into the pool of borrowings which commenced in 1982 and add half a percent. That represents the new interest charge paid to the Bank by its borrowers over the next six months; it is changed after six months reflecting the new pooled cost.

So there is a direct flow-through of the interest costs of our borrowing right through the Bank to charges to LDCs.

In addition, there is a second pool called the "currency pool", which also pools for all borrowers the mix of currencies which we disburse on loans. Essentially, the currencies we disburse on loans are the currencies which we borrow and do not hold as part of our liquidity. Those are disbursed into a pool and all borrowers pro rata also owe those funds to the Bank.

This meeting is not the time to go into the complexities of the currency pool. It is extremely important, though, and has an enormous effect on the effective costs of loans charged to LDCs since they take the currency risks or benefits.

I am sure that Hans, or Joe or David would be delighted to talk to you in detail about how that currency pool functions. I would urge you, however, to read a document which is distributed every six months to the Board which sets forth the effective cost of World Bank charges to its borrowers and which includes the effect of the borrowings and disbursement of the major non-dollar currencies: the deutsche mark, the yen and the Swiss franc. That document also sets out what the cost would have been in U.S. dollars, in nominal terms, what it has been in nominal terms in deutsche mark, yen and Swiss francs and most important what the effective cost is, calculating the exchange rate changes in deutsche mark, yen and Swiss francs from the dates of disbursement to our borrowers as compared to the current rates.

Let me mention at this point that just as the borrowings costs are passed on through the six-monthly change in the interest rate, so, too, the currency risk is passed on to borrowers: the deutsche mark, the yen, the dollars, the Swiss francs, whatever the advantages and disadvantages may be, over time, are passed on to IBRD borrowers.

The Bank is not legally permitted to borrow deutsche marks, convert them for our own account into dollars, and lend dollars. We borrow deutsche marks; we invest deutsche marks; we lend deutsche marks. We borrow yen, we temporarily invest yen, disburse yen. The overall balance sheet must always be in balance. We are repaid in those same currencies, interest and principal so that we in turn can service our debt in those same currencies.

There are four major initiatives which have been instituted in recent years with respect to the borrowing activities of the Bank.

First, the Swap program. The Swap program -- I think we have supplied you a document which you may wish to read, permits us to take on liabilities in Swiss francs or deutsche marks, or more recently, yen, without borrowing them, by simply borrowing dollars, sterling or Canadian dollars and swapping those currencies into lower nominal cost currencies. The Swap program is substantial - close to $5 billion equivalent in swaps has been done already.

The second initiative is the central bank facility -- a new way of attracting central bank funds with a one-year maturity, giving central banks the possibility, should they need it, of having immediate liquidity at par.

The third new instrument is the Discount Note Program which is the only quite short-term borrowing of the Bank; we expect to have 2.5 billion outstanding by the end of the fiscal year.

The fourth new facility is the Floating Rate Note program - currently about $476 million outstanding.

The Swap program, as you can appreciate, has very substantially resulted in lowering costs of Bank borrowing and, therefore, the charges on its loans because the lending rate is affected by post-swap -- that is after-swap costs of the Bank. For example, if we borrow dollars at say 11 percent, the 11 percent cost goes into the lending rate pool, until it's swapped out; after the swap, the 11 percent rate is replaced in the lending rate calculation by the 6 percent Swiss francs.

There has been distributed to the Board a document, which you may all wish to look at, called, "FY '80 - '84: A Borrowing Retrospective." (SecM84-982). It's a blue-covered brochure which analyzes the Bank's borrowing program over the last five years, broken down by currencies; by official borrowings vs. public borrowings; before swaps, after swaps; short-term, medium-term fixed and variable. You may wish to review it for more detail.

The cost of all Bank outstanding debt is projected at 8.8 percent. Essentially, what we are saying is this: the $51 billion of debt, we calculate -- we may be off a little bit, but we're not going to be off by much -- that the cost of that $51 billion of debt is 8.81 percent. That's for the whole pool of debt, not the marginal cost for this year's program.

For those of you who might ask, "Wait a minute, how come the lending rate is '9.89%' and you said you only added half of a percent. You should understand that the lending rate pool has only started in 1982, while the 8.81% includes the entire funded debt of the Bank - which includes debt contracted (and still outstanding) well before 1982.

Another figure which is important is the last number on the table, 7.81%. The 7.81% is the cost of borrowing to date for this fiscal year's program, for medium and long-term debt.

You may also observe the cost of the short-term debt is 11.6% and the overall before and after swap cost of this year's program, inclusive of short-term debt.

Finally, the last part of that balance sheet reflects the equity of the Bank. Again, let me emphasize what Moeen mentioned -- the $3.4 billion is the projected useable, i.e., released capital of the Bank, as of June 30th, 1985.

That figure represents what member governments have provided, in terms of useable capital to the Bank.

The reserves, i.e., the accumulated retained earnings are $5.9 billion. Therefore the equity base of the Bank is about $9.3 billion - consisting of $3.4 billion of useable capital and almost $6 billion of earnings.

And if you ascribe no cost to those funds, (since the Bank does not pay dividends) you will see that there is a total cost of funds (debt plus retained earnings) of $7.43.

It is the difference between the $7.43 and the $9.53 return on assets which generates the gross income of the Bank and minus administrative expenses, you have the net income.

I must note that any change in that top figure, 11 percent - return on liquidity goes right to the bottom line of the profit and loss statement.

The goal of the Bank, in managing the liquidity, is to have a profit maximizing operation, because to the extent that profits rise on that first line, the Bank can have higher net income and, therefore, lower the charges that it levies on borrowers to produce the same net income.

We only have two income-producing assets: loans and liquidity. The more we earn on the liquidity, if we can, the better for borrowers. If on the other hand, our returns are low, then the Bank still fixes the lending rate, based not on the reduced net income, but based, rather, on its borrowing costs.

As you can appreciate, there is pressure to keep the borrowing costs as low down as possible, both in nominal and effective terms, because these are passed on to LDCs. The function of the treasury operation is to borrow, hopefully, wisely and prudently because our decisions wash through the P and L statement -- through the lending rate and to LDCs.

I want to emphasize that the Bank is not a profit-maximizing institution; it is a profit-making institution. But it operates with a need to meet the tests of the marketplace and to satisfy the demands of a wide proliferation of investors. The delicacy is to balance what the market requires, what the LDCs require -- what Part I countries, if you will, require, so that we all can have an institution which, first, can grow; second, can maintain charges which can be borne by LDCs and, third, which will be recognized as a tight ship, and able to attract increasing funds from the marketplace.

The recent innovations -- the four that I have mentioned -- were simply instituted because they were believed necessary and appropriate to obtain continuing market support, and to maximize the efficiency with which the institution conducted its affairs.

Permit me to conclude by introducing other key staff members you may wish to contact on these matters.

I have already mentioned that Hani Findakly is the Director of the Investment Department. His counterpart on the borrowing side is the Director of our Financial Operations Department, Joseph Uhrig. Mr. Uhrig is responsible for the overall borrowing program and manages four divisions, headed by Mr. Radifera, Mr. van Agtmael, Mr. Harris and Mr. Ardalan -- each of whom is responsible for specific currencies and/or types of borrowings.

Mr. Jean De Boeck is the Director of the Cashier's Department and is responsible for the actual disbursement of currencies to meet our obligations.

My close colleague, Mr. Heinz Vergin, serves as Deputy Treasurer and Director, Treasury Operations. He has the responsibility for coordinating, reviewing and monitoring the treasury operations which I have described.

Also in the "front office" is the Planning and Special Operations Unit, managed by Mrs. Jessica Einhorn, who is responsible for the evaluation and execution of new investment and borrowing operations to assure their internal consistency and appropriateness for the Bank.

All of these people I have mentioned are of course assisted very much by their own able staff and by others, both within and outside the Finance Complex.