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Who pays for the World Bank?

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Abstract: The allocation of IBRD net income is the lens through which the burden-sharing issue in the World Bank Group is viewed. The paper concludes that (1) the distribution of voting power does not reflect the contribution to IBRD equity made by its borrowing members as the share of retained earnings has risen while the share of paid-in capital has declined over the years; (2) the major shareholders have used their control rights to allocate portions of IBRD net income to serve their interests in ways that have been at the expense of the borrowing members and (3) a continuation of a stagnating loan portfolio in nominal terms and a declining one in inflation-adjusted terms is likely to constrain the Bank's net income from lending operations and to render it increasingly dependent for its continuing profitability on its role as a financial trader and arbitrageur. In order to regain its competitiveness as an international development lending intermediary, it is important to review the pricing of loans and the conditions attached to them as well the restraints that have applied on the purposes for which the Bank lends.

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Introduction: This paper looks at one aspect of the financial governance of the World Bank Group through the lens of the net income earned by the International Bank for Reconstruction and Development (IBRD), the principal income earning unit of the World Bank Group (WBG) as defined in this paper.[1] The first section looks at the growing divergence between voting rights and the contributions made to IBRD equity by shareholders and borrowers as the share of retained earnings has risen while the share of paid-in capital has declined over the years. Section II explains the framework established to guide the allocation of net income and reviews the equity implications of the actual distribution of net income in a recent period (FY 1999-2003). Section III argues that the Bank's net income from its lending operations is becoming increasingly constrained by a stagnant loan portfolio in nominal terms and a declining one in inflation-adjusted terms and suggests that the IBRD is apt to become increasingly dependent for its continuing profitability on its financial trading and arbitrage operations. The last section recommends reviewing the pricing of loans and the conditions attached to them as well the restraints that have applied on the purposes for which the Bank lends in order to reverse the trend of declining net disbursements, that have actually turned negative in the last two years, and to regain its competitiveness as an international development lending intermediary.

[1] The "World Bank Group" consists, in addition to the IBRD, of the following institutions: the International Development Association (IDA), the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for Settlement of Investment Disputes. For purposes of this paper IFC and MIGA are treated as separate, autonomous institutions. References in the paper to the "Bank" are meant to apply to the IBRD unless specifically indicated otherwise.

I. Evolution of IBRD Equity

The IBRD was established in 1946 for the essential purpose of lending to its member-governments for reconstruction and development with an authorized capital of US $ 10 billion.[2] Members were required to pay-in 2 percent of subscribed capital in gold and another 18 percent in their own currencies. The remaining 80 percent constituted "callable" capital that was available to guarantee the Bank's borrowings. In accordance with the weighted voting principle applied in the Bretton Woods Institutions (BWI), voting shares were aligned with contributions to Bank capital, with the USA receiving 23 percent of the total. Subsequently, there have been three General Capital Increases (GCI) -- in 1959, 1979 and 1988 -- and one Special Capital Increase in 1976 to modify relative rankings. The last GCI required only 3 percent to be paid-in and there has been no GCI since 1988.

A large influx of new members (e.g., former Soviet Union countries and Switzerland) in the 1990s' has been accommodated through selective additions to authorized capital. At the end of FY 2003, the authorized capital was $ 190,811 million, of which 189,567 million had been subscribed. Of the subscribed capital, $11,478 million had been paid-in, the rest being "callable". However, a portion of the paid-in subscriptions of members has remained restricted so that only $ 8,581 million of the paid-in capital was available for lending (designated "usable" capital).The Bank's equity base has been built up over the years by addition to reserves derived from retained earnings, which in turn, are based on decisions on the allocation of IBRD net income.

It is pertinent to consider at this stage the burden-sharing implications of the rising share of retained earnings contributing to IBRD equity as shown in the following table:

[2] The US dollar was defined as the "dollar of the weight and fineness of July 1, 1944" and this unit of value was the basis for the determination of the amounts payable by members and for determining the obligations of members to the Bank on account of the maintenance of value with respect to their subscription to the capital stock after the initial payment for it. The unit of value was re-defined in 1973 as equivalent to 1.20635 current dollars and it has been applied thereafter for the valuation of the Bank's capital for meeting .the maintenance of value obligation by members.

Table 1: IBRD: Equity and Reserves (1955-2003)

Years	Equity (US$ billion)	Reserves and Surplus (as % of equity)	Usable capital (as % of equity)
1955-56	1.1	19	81
1968-69	3.2	44	56
1981-82	6.3	58	42
1994-95	25.5	69	31
2002-03	32.8[1]	74[2]	26

[1]Excluding FAS 133 adjustments for comparability with earlier periods

[2]Reserves carried at "fair value"

Source: The World Bank: Its First Half Century, Volume 1 (Table 16-9) and World Bank Annual Report (2003), Volume 2, Table on p.61

In the above table, the Bank's equity is built up from two sources: paid-in capital subscriptions available for lending and retained earnings. Whereas the initial and selective capital subscriptions and the first two GCI required members to pay-in 20% of their subscribed capital shares, the last GCI required only 3% of the capital increase to be paid-in, not all of which was immediately available for lending. The continuous decline in the ratio of usable capital in equity has meant that the percentage contribution made by Part I countries[3] to reducing the cost of Bank funding has steadily declined. The failure to inject new capital through GCI after 1988 has meant that additions to usable equity have come mainly from retained earnings which derive largely from loan charges paid by IBRD borrowers, and to a lesser extent, from income generated by the Bank's investments, designated as the liquid assets portfolio.

It has been argued that even though paid-in capital has been only a very small proportion of the Bank's subscribed capital, the unpaid portion constitutes callable

[3] Countries choose whether they are Part I or Part II based primarily on economic standing. Thus the 27 countries currently identified as Part I are almost all donors to the IDA and they pay their contributions in freely convertible currencies. While mainly industrial countries, the list includes two OPEC members (Kuwait and UAE) and one developing country (South Africa).

capital that is available to meet obligations of IBRD for funds borrowed or loans guaranteed by it. Thus DAC member countries have subscribed $ 110,460 million of IBRD capital, of which $ 103,604 million constitutes the uncalled portion and this amount slightly exceeds IBRD outstanding borrowings (including swaps) at June 30, 2003. This is said to enable the Bank to raise capital on the world's financial markets at the finest rates on offer to an AAA-rated borrower and which the Bank passes through to countries that borrow from it at lending rates that, it is contended, provides an implicit subsidy over what they would have to pay otherwise.

However, no call has ever been made on the Bank's callable capital and the financial and risk planning scenarios of the Bank are explicitly based on an assumption that precludes the possibility of having to make such a call. The fact that transfers from net income have built up reserves exceeding 20 percent of the Bank's outstanding borrowings[4] has created a very substantial cushion. Moreover, the repayment record of Bank customers has been exemplary. At the end of FY 2003, the total amount of principal and interest overdue was only $ 629 million against a total loan portfolio exceeding $ 116 billion. The Bank is a "preferred creditor"[5] and the vast majority of members have been punctilious in meeting their repayment obligations – a fact well known to capital market participants. Hence the subsidy element could just as well be attributed to the very low debt default rates experienced on IBRD loans, reflecting borrower debt servicing discipline, rather than as reflecting the existence of untouched (and presumably untouchable) callable capital.

Nor does the "subsidy" argument take into account several indirect costs of IBRD transactions that are involved in satisfying a variety of safeguards that have the objective of "ring-fencing" the Bank from risk.[6] "The additional administrative costs of these new

[4] Note also that the Bank employs another $ 26-27 billion of its borrowings for its liquid assets portfolio.
[5] It also requires borrowers to adhere to a "negative pledge" to assure the Bank equality of treatment with other creditors and to require them to obtain specific waivers for any deviation.
[6] See Kapur D*: "Do as I Say Not as I Do: A Critique of G-7 Proposals on Reforming the World Bank" G-24 Discussion Papers Series # 20* (April 2003). Kapur has argued that "the increasingly stringent compliance standards of the World Bank...are imposing high financial and opportunity costs on the Bank's borrowers …It is trivially easy for the major shareholders to insist on standards whose costs they do not bear".

safeguard/fiduciary policies were estimated to be about $ 81 million in FY2001. Borrower costs in meeting these requirements were estimated in the range of $ 118 to $ 215 million by Kapur, a member of the team that produced a massive two-volume history of the Bank under the auspices of the Brookings Institution in 1997[7]. He goes on to argue that "the(se) multiple safeguards have turned the Bank into a high-cost operation whose administrative costs have little to do with lending and a lot to do with the bells and whistles that keep many other constituencies satisfied".[8]

To summarize, even if the implicit subsidy associated with callable capital is considered ambiguous in its impact, the direct contribution made by Part I countries to reducing borrower costs is basically restricted to their constantly declining percentage share in IBRD equity, namely their share in the Bank's paid-in capital (approximately $ 7 billion).[9] What is especially important to note is the fact that despite the changing pattern of burden sharing, the historical control rights deriving from weighted voting based on capital shares have remained unimpaired.

II Allocation of Net Income and Associated Issues

The sense of inequity in the allocation of voting shares intensifies as one looks at decisions on the allocation of net income for purposes additional to the building up of reserves. Table 2 provides data on the derivation of Net income on a reported basis for the FY 2001-2003 period and explanatory notes for the Table are placed in the Annex to this paper.

[7] Kapur D, Lewis J and Webb R. (1997). *The World Bank: Its First Half Century.* Washington D.C. Brookings Institution Press.
[8] *o.cit.,fn 6*
[9] It has been argued that the contribution of Part I countries is greater than the amount paid-in because they have not received dividends on their contributions. On the other hand, the same countries have been major beneficiaries of procurement contracts emanating from IBRD loans cumulating to $ 333.5 billion over the years.

Table 2: IBRD Net Income[1]

(In millions of US$)

		FY 2003	FY 2002	FY 2001
	Sources			
1	Income from loans	5,742	6,861	8,143
2	Income from investments	418	734	1,540
3	Service fee revenues	178	155	146
4	Income from staff retirement plans, etc		93	155
5	Other net income	15	21	16
6	Sub-total: Gross income (1 through 5)	6,353	7,864	10,000
	Offsets			
7	Borrowing expenses	3,594	4,903	7,152
8	Administrative expenses[2]	1,038	1,052	1,028
9	Sub-total: Gross income after offsets(6-7-8)	1,721	1,909	1,820
10	Provision for losses on loans and guarantees	+1,300	+15	-676
11	Operating income (9+10)	3,021	1,924	1,114
12	Effect of FAS 133	2,323	854	345
13	Net income (11+12) on reported basis	5,344	2,778	1,489
14	Allocable net income[3]	3,050	1,924	1,144
	Memorandum items			
	Loans outstanding	116,240	121,589	118,866
	Borrowings outstanding	108,554	110,263	106,757
	Cash and liquid investments	26,620	25,056	24,407

[1]On reported basis in accordance with Financial Reporting Standards (FAS 133 and IAS 39).
[2]This figure includes "Contributions to Special Programs, averaging $ 160 million per year for certain high priority development purposes. Excluding these grants, the net administrative expenses attributed to IBRD average $ 850 million per year. However, this is roughly one –half of the World Bank's administrative budget, the rest being allocated to IDA on the basis of an agreed cost sharing formula that reflects the administrative costs of service delivery to countries that are eligible for lending from IBRD and IDA.
[3]Excluding FAS 133 adjustments

Source: Box 1: Selected Financial Data (on reported Basis) vol 2, FY 2003 World Bank Annual Report

The net income concept in Table 3 pertains to "Allocable Net Income", i.e, it excludes the component deriving from the adjustments due to the application of FAS 133. This narrower concept has the advantage of providing comparable figures with the net income of years earlier than FY 2001 when no such accounting adjustments were made and permits our analysis to cover the debates that have revolved around the allocation decision over the years. The debates have been contentious, with differences among the Bank's shareholders running along the North-South fault line in some cases while some other decisions on the use of net income have had a more complicated configuration because they have generated conflicts of interests within the developing country membership, specifically between those eligible to borrow from IBRD and those depending exclusively on the concessionary lending window provided by the International Development Association (IDA).

Table 3: Allocation of IBRD Net Income

(In million US$)

		Transfers to			
Fiscal Year	Allocable net income(1)	Reserves	IDA	HIPC Trust	Other
1999	1,518	976	352	100	90 (2)
2000	1,991	1,318	348	200	125 (3)
2001	1,144	647	302	250	95 (4)
2002	1,924	1,291	300	240	93 (5)
2003	3,050	2,410	300	240	100 (6)

(1) Excluding effects of FAS 133 adjustments

(2) Trust Funds for Gaza and West Bank

(3) Trust Funds for Gaza and West Bank (60), East Timor (10), Kosovo (25), and Capacity Building in Africa (30)

(4) Trust Fund for Kosovo (35), F.R. Yugoslavia (30) and Capacity Building in Africa (30)

(5) Transfer to Staff Retirement Funds

(6) Transfer to "Surplus Account"

Source: IBRD Annual reports (FY 1999-2003)

The allocation decision on IBRD net income has two components: one that the Executive Board is authorized to make, specifically, transfers to IBRD General Reserves and the grant of interest waivers (refunds) to borrowers. A second set of decisions can only be made by the Board of Governors (on recommendation from the Executive Board) for other developmental purposes. The two-step procedure means that decisions on the allocation of net income of a given year are made in the following fiscal year.

Under the framework agreed in 1991 to guide the annual process of net income allocation, first priority is accorded to achieving a targeted "reserves-to-loan ratio" (later broadened to an equity-to-loan ratio). Next in priority is reducing borrower costs by pre-funding waivers of loan interest charges for the following fiscal year (up to 25 basis points) to all borrowers who serviced their loans within 30 days of their due dates during the prior six months. In addition, IBRD waives a portion of the commitment charge on un-disbursed balances on all loans (except for one category of special structural and sector adjustment loans).

Two other uses for the residual net income were identified in the 1991 framework: (i) to support high priority development activities that could be characterized as "global public goods"[10]and (ii) to temporarily accumulate funds in a "surplus account", pending future decisions on their use. The initial rationale for the creation of this account was as a compromise between highly divergent views on the appropriate level of reserves. The creation of this account (with a moveable cap) was meant to be a device that could be added to equity if additional paid-in capital was required but could not be raised through a General Capital Increase (GCI).

In the event, no GCI has been approved after 1988 due to strong resistance from the principal share-holders of the Bank, despite the fact that they did not have to contribute more than 3 percent of the 1988 GCI as paid-in capital. It is one of the curiosities of this period that practically the same shareholders proceeded, at roughly the

[10] See detailed discussion of the concept in: UNCTAD (2003). Kaul I, Conceicao P, Le Goulven K, Mendoza R. *Providing Global Public Goods: Managing Globalization.* New York, Oxford University Press.

same time, to establish a new institution, the European Bank for Reconstruction and Development Bank (EBRD), and to pay 30 percent as paid-in capital to perform many of the same functions that the IBRD was fully competent to discharge.[11]

The Bank's borrowers have recognized that building up the Bank's equity through large transfers from net income had the advantage of reducing the Bank's funding costs, but they were also aware that this did not result automatically in a reduction in their borrowing costs as this depended on a number of offsetting cost entries, of which the largest was the IBRD administrative budget which was already approaching one billion dollars (see Annex Table). Instead of questioning some of these offset elements that bear on the level of net income, borrowers chose instead to focus on the allocation of net income, specifically its use for pre-funding the waiver of interest charges and commitment fees.

The issue of the allocation of net income came to a head in 1997-98 when confronted with a widening gap between the Bank's net income and the demands being placed upon it, the Management proposed an increase in the contractual loan spread (over its borrowing cost) from 50 to 80 basis points, charging borrowers a one percent front-end fee, maintaining the commitment fee at 75 basis points and eliminating -- for the next two fiscal years – the interest rate waiver of 25 basis points on loans that are serviced on time. The strong resistance of borrowing countries resulted in a slight modification of the Management proposal i.e., the interest rate waiver on new loans (which attracted the 75 basis points contractual lending spread) was maintained while it was reduced to 5 basis points on old loans (on which the spread remained at 50 basis points). The rest of the Management proposal was adopted but the vote "was the closest in the World Bank's history"[12] -- a dramatic example of a contention running largely along North-South lines.

[11] It also raised, for the authors of *The World Bank – Its First Half Century* (p.1100): "interesting questions on the relative priorities of the Bank's major shareholders, as well as the perceptions of the European shareholders, concerning the Bank's relative effectiveness and governance"

[12] See Kapur D (2002). *The Common Pool Dilemma of Global Public goods: Lessons from the World Bank's Net Income and Reserves*. World Development, Vol. 30, Issue 30: 337-354. The paper notes that "the resolutions were approved by just nine of the twenty-four Executive Directors (representing 51.7 percent of the votes) while twelve Executive Directors (representing 36 percent) voted against the resolutions while an additional three Executive Directors (representing 12.3 percent) abstained.

A more contentious strand in the debate was the decision to begin transferring a portion of IBRD net income for funding IDA, the World Bank Group's concessionary lending window for countries with per capita incomes below $450 (later raised to $ 750). As indicated in Table 3, these transfers have averaged $ 320 million per annum in the last five years, although in some earlier years, the amounts have been much higher e.g., in 1997, a sum of $ 600 million was transferred to IDA. These transfers have divided developing country members, with IBRD borrowers like Brazil and other Latin American countries, joined by some other developing and transition countries that were not IDA-eligible "insisting that net income be used to lower loan charges rather than supplement IDA."[13]

A second priority has been transfers in support of the Heavily Indebted Poor Countries (HIPC) Initiative, launched by the major shareholder countries in 1996 and greatly expanded by them in 1999 to help the poorest countries achieve a sustainable debt position through a writing down of their sovereign debts to the multilateral financial institutions (in addition to their bilateral official debts). The Bretton Woods Institutions were chosen as the principal instruments for implementing the Initiative[14], with the World Bank Group taking responsibility, through its HIPC Trust Fund, to help some of the regional development banks (notably the African Development Bank) meet their share of HIPC debt reduction claims, in addition to its own.

The use by the major shareholders of the Bank's net income to fund an Initiative, entirely of their own devising, is only the latest instance of a number of other causes that have been funded with IBRD net income: as indicated in the footnotes to Table 3. In three instances, the funds were used to provide technical assistance to countries that were not members at the time the allocations were authorized[15]. To the extent that net income

[13] See *The World Bank – Its First Half Century* , Chapter 16 (p.1083)
[14] For an explanation of how the IMF met its share of HIPC claims, see paper: Mohammed A (2003). Who pays for the IMF? In: *Challenges to the World Bank and IMF: Developing Countries Descriptions.* London, Anthem Press: 37-54 (edited by: Ariel Buira for the G-24 Research Program).
[15] "Several of these cases represent foreign policy interests of some of the Bank's largest shareholders, rather than intrinsic merits of the benefits to the institutions' membership as a whole. Traditionally, the

was attributable to the excess of income from loans over IBRD borrowing costs, its use for purposes, however worthy, could be seen as a transfer from one set of developing countries to another. It could also be seen as a "substitute for declining donor contributions to IDA" while enabling them to maintain their voting power in that institution and to extend decisions made by the IDA Deputies (representing *only* donor countries) to the World Bank Group as a whole[16].

III. The IBRD Role as Financial Arbitrageur[17]

The analysis thus far has focused on the burden-sharing issues associated with the contribution of the industrial non-borrowers and the IBRD' borrowers to its net income. An aspect that needs exploration is the role that the Bank's own Treasury operations have played in contributing to its net income. This operation is based on the Bank's liquid assets portfolio and its liquidity and risk management arrangements.

Under IBRD liquidity management policy, aggregate liquid asset holdings should be kept at or above a specified prudential minimum in order to deal with two sets of risks: (1) the risk of being unable to fund its portfolio of assets at appropriate maturities and rates and the (2) the risk of being unable to liquidate a position in a timely manner at a reasonable price. To this end, the objective of the portfolio is to ensure the availability of sufficient cash flows to meet all of IBRD financial commitments (note the reference to *financial* and not only its *lending* commitments). The prudential minimum is set under current policy as equal to the highest consecutive six months of expected debt service obligations for the fiscal year plus one-half of net approved loan disbursements as projected for the fiscal year. The 2004 prudential minimum is set at $ 18 billion, unchanged from that set for FY 2003. Yet at the end of 2003, the "carrying value" of the

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large shareholders would have funded their interests through direct claims on their budgetary resources, but in the strained financial environment of the 1990s' the cost would be borne by all of the Bank's members".(See *The World Bank – Its First Half Century*, p.1085)

[16] This has been characterized as a "creeping constitutional coup that has fundamentally subverted the role of the Executive Board in the institution's governance" (*Ibid*)

[17] This section draws on material recent IBRD Annual Reports, Volume 2.

investment portfolio (trading and other liquid portfolio instruments) was over $ 26.4 billion, or almost 50 percent above the specified prudential minimum.

Under normal circumstances, there should be a net cost for carrying liquidity, for as the Bank History points out, the Bank's borrowings are primarily medium and long-term while its liquidity investments are short-term and yield curves typically are upward sloping.[18] Yet the Bank carries excess liquidity well above its own prudential minimum, indicating a judgment that, in fact, the management of the liquid assets portfolio is viewed as a net "profit-center" for the Bank[19]. Income from the investment portfolio, as shown in Table 2, was as high as $ 1.54 billion in FY 2001 and while it declined successively in the following two years (due, it was explained in the Annual Reports, to lower interest earnings in a period of falling interest rates) it was still positive at $ 418 million in FY 2003. It appears, however, that this figure for investment income is gross of the "cost-of-carry" and that this cost is included in the overall figure for "borrowing expenses". Support for this view is to be found in the Annual Report for 2003 which shows that investment income, net of funding costs, amounted to $ 36 million in FY 2003 as against $ 140 million in FY 2001,[20] indicating that the IBRD was able to extract a modicum of net income even in the face of the steep yield curve of recent years.

A net return of $ 36 million on a portfolio in the range of $ 26-27 billion must appear trivial and suggests the existence of some additional benefit that the Bank is obtaining from holding such a large liquid assets portfolio. Clearly, this portfolio makes the IBRD an important player in financial markets. According to the Bank History, by the mid-1980s', the liquid portfolio had increased to about $ 20 billion and the Bank was turning it over on average "every two days: this amounts to more than $ 3 trillion a year"[21]. As noted above, by the end of FY 2003, the Bank was managing a liquid assets portfolio exceeding $26.4 billion and if the transaction volume is anywhere comparable

[18] *The World Bank: Its First Half Century*, (p. 1082)
[19] *The World Bank Annual Report 2003: Volume 2,* Washington, DC.(p.15) explains the holding of liquid assets over the specified minimum as required "to provide flexibility in timing its borrowing transactions and to meet working capital needs"
[20] Table 15, Volume 2
[21] *The World Bank: Its First Half Century*, p. 1048

to that obtaining in the mid-1980s, the Bank's Treasury operations could be exceeding several trillions of dollars per year and the Bank must have become a highly significant operator in the explosively growing derivatives markets on its own account.

It is contended that the purpose of these Treasury transactions is essentially to obtain lower cost (i.e., below-Libor) funding in its own borrowing operations in international capital markets and since the IBRD functions as a "cost-plus" lender, the benefit is reflected in the Bank's lower lending rates to its borrowers. However, the savings on this account, it is argued, are not quantifiable because there is a contra-factual element involved in that it is not possible to know what IBRD funding costs would have been, if it did not have at its disposal a substantial portfolio of liquid assets that could be continuously deployed in financial markets to garner opportunities for funding bargains that come its way from time to time.

It appears difficult to accept this argument as the *sole* justification for employing such a large investment portfolio to extract savings of unquantifiable magnitude. The membership should expect to find some demonstration of the putative savings that IBRD borrowers enjoy from the deployment of funds in Treasury operations. That this is a truly massive involvement is illustrated by the fact that on top of its loan assets of $ 116 billion and its own borrowing liabilities of $ 110 billion, the IBRD has erected a superstructure of swaps and other assets and liabilities of almost equivalent magnitude to reach total assets/liabilities figures of $230 billion in its balance-sheet at the end of FY 2003.

In the absence of any other satisfactory explanation, one is led to ask whether the results of the accounting change made in FY 2001 of adopting FAS 133 provide any insight into the non-interest income benefit being obtained from Treasury operations. While the results for the first year are distorted by the one-time costs of transiting from one set of accounting protocols to another, there has been a sharp rise in gains attributed to marking-to-market all derivative instruments, as defined by FAS 133. From $ 345 million in the transition year, the effect has been to raise net income by $ 854 million in FY 2002 and by $ 2,323 million in FY 2003. Profits of this magnitude -- exceeding loan

interest income, net of funding costs, in FY 2003[22]-- raise a question whether the Bank has morphed into a far different institution from that envisaged by its founders.[23]

This issue becomes especially pertinent in light of the fact that the level of outstanding IBRD loans has stayed in the range of $ 116 to $ 121 billion during the past five years[24] while annual commitments have remained in the range of $10.5 to $11.5 billion in the past four. Equally troubling is the fact that while gross disbursements have stayed in the $11-12 billion range in the past three years, net disbursements have turned negative, due to large pre-payments, in the past two. What has caused members to make such large pre-payments – reaching almost $ 7 billion in FY 2003 -- is an important issue to consider if it suggests a certain loss of competitiveness of the Bank as a preferred development lender. [25]

Even more troubling if one looks over a longer stretch of time is the contrast between rising administrative costs (ignoring the rather artificial division of costs between IBRD and IDA) and the negative trend of IBRD net transfers (net disbursements minus debt service payments by borrowers).(Annex Table).

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[22] Income from loans has fallen from $ 8,143 million in FY 2001 to $ 6,801 million in FY 2002 and $ 5,742 million in FY 2003; while this has been offset by a decline in borrowing costs, the net income from the loan portfolio at $ 2,148 million in FY 2003 falls below the addition to net income attributable to FAS 133.

[23] It is contended that FAS 133 profits are not genuine profits *over time* but simply a snapshot of a particular profit/loss position *at a point of time* and that the "unrealized" gains and losses from swap operations get cancelled when specific swap contracts are closed out. For this reason, the Bank does not take FAS 133 profits into its "allocable net income" which, rather than "reported net income", serves as the basis for allocations shown in Table 3 above. Reporting on the basis of the FAS 133 accounting standard became applicable from FY 2001 and the Bank has had to adopt it for reporting its results. However, "because of the extent of IBRD's long-dated funding, the reported volatility under FAS 133 may be more pronounced than for many other financial institutions….IBRD believes that its funding and asset/liability management strategies achieve its objectives of protection from market risk and provision of lower cost funding" and that its current value basis provides estimates of the economic value of its financial assets and liabilities, after considering interest rate, currency and credit risks" that are more meaningful "for risk management and management reporting"(p.5, Vol.2 , Annual Report 2003)

[24] A stagnating outstanding loan volume also begins to constrain the ability to increase lending because of risk-dictated ceilings on commitments to a single borrower; this is already affecting China's access.

[25] The large pre-payments in FY 2003 are attributed to two factors: (1) a one-off repayment of $ 2 billion from an emergency credit extended to Korea at the time of the Asian payments crisis and (2) a strong incentive on the part of borrowers in the single-currency fixed interest rate pool to pay off loans that carry much higher interest rates than are available on variable rate loans or when compared to the very low returns earned on their holdings of foreign exchange reserves. With borrowers no longer willing to enter the single currency pool, these pre-payments are expected to taper off sharply in the next few years.

V. Concluding Reflections .

A continuation of these trends –a stagnant loan portfolio in nominal terms and a declining one in inflation-adjusted terms -- would result in an outcome under which perhaps the finest international lending intermediary created in the post-war period is being pushed out of its traditional role by a growing loss of competitiveness as a lender and is likely to become overly dependent for its continuing profitability – and for its AAA credit rating in capital markets – on its role as a financial trader and arbitrageur. To reclaim its role as a preferred development lender, it is essential for the membership, especially the developing country groupings, to examine whether the pricing of loans and of the conditions attached to them have discouraged creditworthy borrowers from using the IBRD. Also important is to review the restrictions that have been applied on the purposes for which it lends.

The Bank has been essentially a "cost-plus" lender, and as noted in an earlier section, it charges a contractual spread of 75 basis points to its borrowing costs on its "new" loans (i.e., loans signed after July, 1, 1998) to cover its overheads and refunds 25 basis points through interest waivers in the following fiscal year to borrowers who have serviced their loans within 30 days of their due dates during the prior six months. Loans made earlier carry a contractual spread of 50 basis points but the interest rate waiver on these is only 5 basis points. Moreover; it charges commitment fee of 75 basis points (where there is a partial refund) plus a front-end fee of 100 basis points on the entire amount of each loan that is never refunded. A reduction in the front-end fee would provide an immediate cost saving for new loans as would a reversion to the contractual spread of 50 basis points in effect prior to mid-1998 together with a reduction in the time-lag between an adjustment of interest charges on variable rate loans and the borrowing costs of funding them. Similarly, the complex body of safeguard/fiduciary policies that have accumulated over the years for "ring-fencing" the Bank from risk need to be re-examined

A significant change in the composition of Bank lending is also required if the Bank is to fulfill its core mission at a time when public sector development needs are enormous and growing. Bank lending for infrastructure has declined sharply in the past few years, for electric power and energy, for example, from $ 2 billion to $ 0.75 billion; for transportation by 28 percent over the same period and for water and sanitation by 25 percent.[26]. There are additional non-quantifiable costs of the Bank's retreat from these sectors that arise from the fact that "Bank involvement in infrastructure projects, more often than not, reduces both the scope for corruption and inappropriate policies, which can result in substantial costs on a country"

It is essential that the membership review, on an urgent basis, the working of the IBRD with reference to a number of aspects, including *inter alia*:

(a) the factors behind the recent stagnation of the loan portfolio, such that the Bank is operating at roughly one-half of its statutory lending capacity;

(b) the reasons for the trend of declining net disbursements that have actually turned negative in the last two years under review due to large pre-payments by members;

(c) the rationale for the deployment of a 50 percent excess over the statutory minimum requirement for its liquid assets portfolio;

(d) whether the policy conditionalities and ring-fencing stipulations attached to loans are eroding the Bank's competitiveness as a commercial lender.

(e) whether instead of continuing to add to its retained earnings, IBRD net income could be applied to lowering its lending rates; especially for poverty alleviation projects in countries not eligible for IDA funding;

(f) whether the Bank should significantly expand its lending for infrastructure projects.

[26] Op.cit.,fn.6

Annex: What constitutes IBRD net Income?

This Annex sets out the elements that enter into the determination of net income. The Bank has two principal income streams and several subsidiary ones. The first principal stream derives from its lending operations and the second from its investments. The former covers interest earnings and other charges on loans. In FY 2003, the gross income on the loan portfolio amounted to $5,742 million as against $ 6,861 million in FY 2002 and $ 8,143 million in FY 2001.

The second stream results from the income on investments, largely comprised of a liquid asset portfolio that is maintained to ensure sufficient cash flow to meet IBRD obligations. At the end of FY 2003, this portfolio of cash and liquid investments was valued at $ 26,620 million and yielded an income of $ 418 million as compared with $734 million earned from a portfolio of $ 25,056 million in FY 2002 and $1,540 million from a portfolio of $ 24,407 million in FY 2001. The reduction in contractual yield on the portfolio over the three year period is attributed primarily to the lower interest rate environment in the later years.

Among the subsidiary income streams two are identifiable: “service fee revenues” earned by the Bank from non-lending operations and “Income from the Staff Retirement Plan and other post retirement benefit plans”. Finally, there is a non-identifiable category of “net other income”.

Against these sources of income, there are two principal offsets: the Bank’s borrowing costs and its administrative expenses. The former have fallen sharply from a peak of $7,152 million in FY 2001 to $4,903 million in FY 2002 and $3,594 million in FY 2003. The decline reflects primarily a lower cost of borrowing and a reduction in the level of outstanding borrowings over the three-year period, as shown in the Memorandum Items to Table 2.

The second offset is administrative expenses attributable to the IBRD, which have been roughly stable over the period under review at an average level of $ 1.04 billion per annum. However, this item includes "Contributions to Special Programs" averaging $ 160 million annually representing grants made by the IBRD for certain high priority developmental purposes , such as funding for the Consultative Group for International Agriculture (CGIAR) for agricultural research, the Global Development Network (for knowledge creation and dissemination), the Global Alliance for Vaccines and Immunization (preventive health services), the Global Environment Facility (environment protection) and the Global Water Partnership. Two additional grant-like programs have been added in the late 1990s': the Institutional Development Fund (IDF) and the Consultative Group to Aid the Poorest (CGAP). Excluding these special grant programs, IBRD administrative expenditure (net) has averaged $ 850 million per annum.

An adjustment is made to the income remaining after offsetting the two major categories of expense to arrive at the Bank's "Operating Income" This adjustment arises from changes in the accumulated provision for losses on income and guarantees. Management judgments are made as to the appropriate level of provisions for each borrower based on the probability of default, the total size of outstanding loans taken by the borrower and the assumed severity of loss in the event of default. These judgments are based on many factors, including as assessment of borrowers' past and prospective economic performance and its economic policy framework. These risk factors are periodically reviewed and the adequacy of the accumulated provision for losses is reassessed accordingly. A decision to increase the accumulated loan loss provision becomes a charge on operating income while a decrease in the outstanding provision adds to operating income. Thus a sharp increase in operating income in FY 2003 of $ 1,097 million (compared to the previous year) resulted from two sources: (1) a reduction of $709 million in the accumulated provision requirement due to a net improvement in borrowers' risk ratings and a large decrease in loans outstanding, due to substantial negative net disbursements, including $ 6,972 million in loan prepayments and (2) the decision to re-classify loans to the former Socialist Federal Republic of Yugoslavia when

its successor states undertook responsibility for servicing them, resulting in an additional $ 591 million being taken into income.

Finally, one moves from Operating Income to Net Income on a reported basis by taking into account the effects of applying Financial Accounting Standard (FAS) 133 and International Accounting Standard (IAS) 39, which require that derivative instruments be reported at fair value, with changes in fair value being recognized immediately in earnings. During FY 2003, the effects of applying FAS 133 added as much as $ 2,323 million to operating income of $3,021 million compared to additions of $ 854 million in FY 2002 and $ 345 million in FY 2001.

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Annex Table
Selected Financial Data
IBRD and IDA
(US$ Millions)

IBRD	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Disbursements	11,431	11,666	12,942	10,502	12,672	13,321	14,009	19,283	18,205	13,332	11,707	11,154
Repayments	9,282	9,818	10,646	11,320	11,926	12,306	12,021	11,518	10,082	10,491	9,694	12,075
Net Flows	2,149	1,848	2,296	-818	746	1,015	1,988	7,765	8,123	2,841	2,013	-921
Interest and Charges	7,803	7,888	8,081	7,822	8,157	7,922	7,235	6,881	7,649	8,153	8,143	6,861
Net Transfer (IBRD)	**-5,754**	**-6,040**	**-5,785**	**-8,640**	**-7,441**	**-6,907**	**-5,247**	**884**	**474**	**-5,312**	**-6,130**	**-7,782**
IDA												
Disbursements	4,511	4,743	4,913	5,520	5,703	5,884	5,836	5,432	5,843	5,177	5,492	6,601
Repayments	274	324	366	420	498	563	615	682	898	1,285	1,235	1,255
Net Flows	4,237	4,419	4,547	5,100	5,205	5,321	5,221	4,750	4,945	3,892	4,257	5,346
Interest and Charges	347	361	398	417	489	512	537	555	588	619	614	641
Net Transfer (IDA)	**3,890**	**4,058**	**4,149**	**4,683**	**4,716**	**4,809**	**4,684**	**4,195**	**4,357**	**3,273**	**3,643**	**4,705**
Total Net Transfer IBRD + IDA	**-1,864**	**-1,982**	**-1,636**	**-3,957**	**-2,725**	**-2,098**	**-563**	**5,079**	**4,831**	**-2,039**	**-2,487**	**-3,077**
Administrative expenses												
IBRD	574	612	679	731	842	733	781	832	965	951	881	876
IDA	328	395	467	545	571	508	488	474	518	549	551	654
TOTAL	**902**	**1,007**	**1,146**	**1,276**	**1,413**	**1,241**	**1,269**	**1,306**	**1,483**	**1,500**	**1,432**	**1,530**

Source: World Bank Annual Reports, 1991-2003