

# The Politics of Loan Pricing in Multilateral Development Banks

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**Abstract:** *This paper explores the political factors that determine the price of loans offered to borrowing countries by multilateral development banks (MDBs). The reasons why MDBs set their prices at a given level and why those prices might vary from one MDB to another has received scant attention in academia, even though inexpensive loan costs are the primary reason countries borrow from MDBs. The paper explores these issues in three MDBs, each with a different composition of shareholding countries—the World Bank (controlled by wealthy non-borrowing countries), the Inter-American Development Bank (more evenly balanced between non-borrowing and borrowing countries) and the Andean Development Corporation (controlled by borrowing countries). Evidence gathered from MDB balance sheets and strategy documents, ratings agency reports and interviews with MDB treasury staff and executive directors indicates that shareholder composition has a major impact on loan prices, in unexpected ways. While the backing of wealthy countries allows the World Bank and IADB to raise resources on capital markets more cheaply than the CAF, the interests of those same non-borrowing countries in using MDB net income in turn makes loan costs significantly higher at those MDBs—especially the World Bank—than they would be otherwise.*

Why do countries borrow from multilateral development banks (MDBs)? One can imagine any number of possible reasons, ranging from desire to gain technical assistance, the use of MDBs to further internal political agendas or a desire to be seen in international financial markets as a “good student” and hence attract investment, among many others. But the most obvious reason is, of course, because MDBs offer loans at very attractive financial terms compared to what borrowing countries could get. The signature characteristic of MDBs, which led to the remarkable success of this particular variety of international organization, is that by pooling risk among rich and poor country shareholders MDBs can borrow cheaply on international financial markets, and hence on-lend resources to borrowing governments at low interest rates with enough margin left over to pay for administrative overhead.

But why, exactly, do MDBs set the price of their loans at a given level? Do those prices vary among different MDBs, and if so, why? Considering that the *raison d’être* of MDBs is to promote development, one might presume that MDBs pick a price considered to be optimal for borrowing countries considering their abilities to pay, and keep this cost relatively steady to make the cost of resource flows more predictable to developing countries. One might further imagine that MDB loan costs vary mainly as a function of the level of wealth of shareholder countries of each MDB, and hence the perceptions of investors buying MDB bonds. For example, the World Bank—backed by most nations of the world, including all industrialized countries—would logically have cheaper borrowing costs than, for example, the regional Inter-American Development Bank (IADB). Both would in turn borrow more cheaply than the sub-regional Andean Development Corporation (CAF), which is majority-controlled by several Latin American countries.

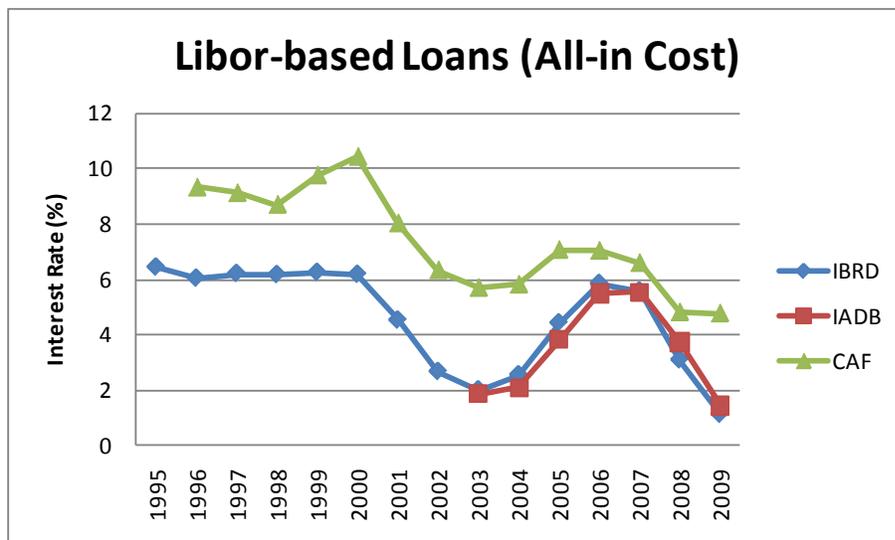
The figures below show the “all-in” loan costs offered to borrowing countries in recent years by the World Bank (63% controlled by industrialized non-borrowing country shareholders in 2009), the IADB (voting control split 50.02% borrower and 49.98% non-borrower country shareholders) and the CAF (controlled by borrowing country shareholders).<sup>1</sup> The loan costs of all three MDBs fluctuate fairly markedly over the years, rather than staying at a steady level, and the rates from all three trend in roughly similar directions over time. This suggests that all MDBs face considerable impacts from global capital market movements, and transfer this funding risk to their borrowers by varying the interest rate they charge for their loans. This finding is not entirely surprising, but it has important implications for social scientists in attempting to understand MDB activities—if MDB loan prices rise and fall due to global capital market conditions, that might have a major impact on the demand for MDB loans on the part of countries that have other borrowing options.

But two other patterns immediately apparent in the figures are more surprising. First, while CAF’s loan costs are higher than the other two MDBs, the gap is not huge and narrowed quite dramatically toward the end of the period. In fact, in 2007 and 2008 CAF loans were priced just marginally above those of the World Bank and IADB—a rather shocking finding, considering the huge wealth gap among country shareholders backing the CAF and the other two MDBs. Second, IADB loans are often slightly cheaper

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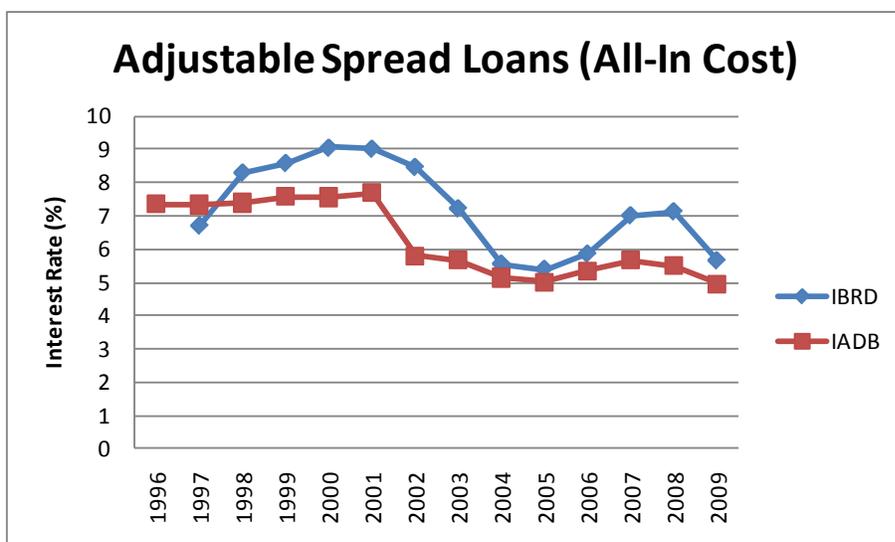
<sup>1</sup> Comparing the pricing for different MDB loans is no simple task, due to issues such as the fees charged, type of interest rate offered and maturity profile, among other issues. The figures depict two types of loans that are directly comparable, with the available years for each MDB in question. See annex for a full discussion of these issues and the methodology behind these figures.

than World Bank<sup>2</sup> loans, especially with the adjustable rate loan instrument, even though the World Bank is obviously a much larger and better-known MDB, with nearly four times the number of country shareholders (48 vs. 186 members, respectively, in 2009).



Source: Methodology for annualizing fee costs taken from World Bank 2010a. Loan interest rate sources: World Bank (IBRD) 2010b, IADB 2010b and CAF 2009a.

Note: “All-in Cost” includes front-end and commitment fees annualized over the life of the loan, as well as a standardized disbursement and repayment profile that is not exact. The methodology is the same used by the World Bank Treasury department to compare IBRD loan costs with other MDBs.



Source: Methodology for annualizing fee costs taken from World Bank 2010a. Loan interest rate sources: World Bank (IBRD) 2010c and IADB 2010c.

<sup>2</sup> When stating the “World Bank”, this paper specifically refers to the International Bank of Reconstruction and Development (IBRD), which is the main lending window of the World Bank. It makes sovereign loans based on the IBRD’s own cost of funding in international capital markets. The concessional International Development Association (IDA) lending window for the poorest countries is funded by regular donations and annual income allocations from IBRD, and does not raise funds on private capital markets.

What explains these curious findings? How is it that the sub-regional CAF is able to offer increasingly competitive loan pricing compared to much larger MDBs backed by the wealthiest countries in the world? And why would the regional IADB offers lower loan prices than the global World Bank? This paper attempts to answer these questions by utilizing a theoretical framework based on the relative balance of power and interests of borrowing vs. non-borrowing country shareholders at these three MDBs. By exploring a critical aspect of MDB activities little explored in academia, the paper hopes to providing ideas and data for further research in this area.

Exhaustively examining every factor going into MDB loan pricing is beyond the scope of an academic paper. Instead, the research limits itself to two sets of critical factors shaping loan pricing common to all three MDBs: (i) the relationship between the capital structure of each MDB and its ability to issue debt on private markets; and (ii) the uses of and hence incentives for MDBs to generate annual net income. The first factor goes a long way toward determining the cost of funding of each MDB, a key component of its loan price. The second set of factors gets at why each MDB—a non-profit organization—might charge borrowing countries more than might otherwise be the case as a way of generating a certain level of net income each year. This paper explores these issues and their links with the composition of country shareholders within each MDB.

### ***Theoretical Framework***

These issues may seem rather arcane for an academic paper, and are in fact almost entirely ignored in the literature, despite their importance for understanding MDB activities. Countries borrow from MDBs in large part because MDBs are willing to lend them money at attractive interest rates. Hence, analyzing decision-making process that goes into the financial terms of MDB lending is essential to grasp why they do what they do. However, serious academic analysis of these financial issues has thus far been limited to a history of the World Bank<sup>3</sup> and two papers on the World Bank's use of net income.<sup>4</sup> A former World Bank senior financial advisor has written a little-known (and one suspects, given the paucity of references to it, even less read) book on the financial mechanics of MDBs, but it was intended for development practitioners, and does not consider political economy implications in any detail.<sup>5</sup> The financial cost of MDB loans might seem more appropriate for business management or finance studies might deter more politically-inclined researchers, but as this paper will hopefully demonstrate, the finances of MDBs are deeply political. The paper is intended to fill an important hole in the literature by comparing aspects of the financial workings of three MDBs from a political economy perspective.

Part of the reason academics examining MDBs have thus far largely side-stepped issues of financing (beyond the understandable desire to avoid delving into balance sheets and interest rates) is that much of the focus of MDB research has a supply-side perspective. That is, researchers have tended to make a theoretical assumption that eligible borrowing countries have a constant and limitless demand function for MDB loans. As such, the focus logically turns to the supply of MDB loans. If a country does or does not get a loan of one or another type from an MDB, a supply-side perspective will assume that decision analytically had nothing to do with the country, but rather the MDB. The MDB's decision to lend, in turn, is explained variously by realist considerations of power politics and the interests of the most powerful

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<sup>3</sup> Kapur et al., 1997. Chapters 14-16 (pp. 905-1118) focus in particular of the World Bank's finances.

<sup>4</sup> Kapur, 2002 and Mohammed, 2004.

<sup>5</sup> Mistry, 1995.

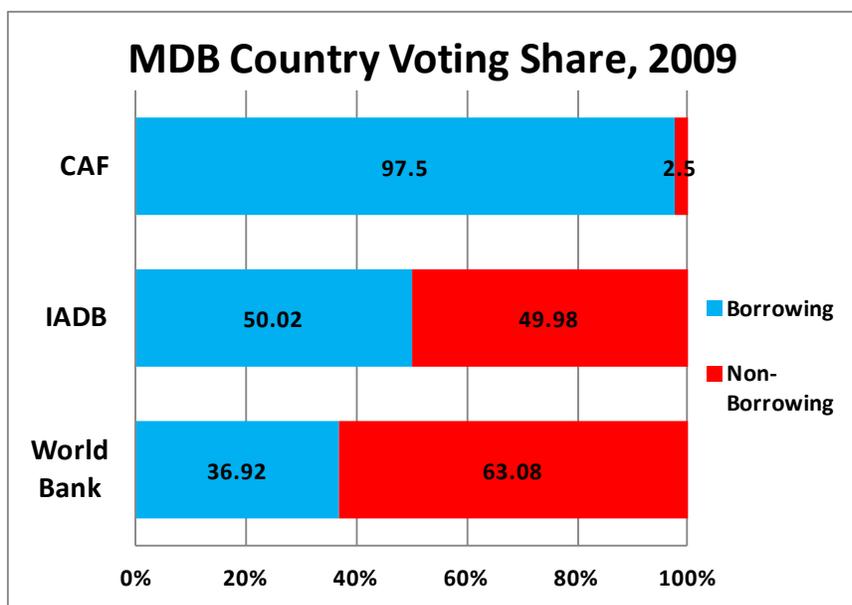
shareholders (cf. Thacker, 1999; Dreher et al., 2009a and 2009b; Kilby 2009, among many others), a “rationalist” focus on the rules of the game and incentives among main actors in MDB activities (cf. Ascher, 1990; Mosley et al., 1995; Vaubel, 2006; Gutner, 2005), or more sociology-based “constructivist” interpretations of norms, values and bureaucratic dynamics within MDBs (Barnett and Finnemore, 1999 and 2004; Babb, 2003). A growing number of scholars are combining constructivist and rationalist approaches, including Lyne et al. (2006), Weaver (2008) and Chwioroth (2005).

While all of these theoretical viewpoints have considerable merit and explanatory power, it is remarkable how little attention academic research on MDBs pays to the views and interests of borrowing countries. The implicit assumption of a constant demand function by borrowing countries for MDB loans might be reasonable when considering a period like the 1980s, with high global interest rates and numerous developing countries in dire circumstances. However, in light of the spectacular growth of many large developing countries in recent years as well as the explosion of international capital flows, this scenario seems unlikely to be realistic now. Countries that have been major borrowers from MDBs in the past, like China, Brazil, India, Mexico, Indonesia, Peru, Turkey and others, have in recent years found themselves in much stronger fiscal positions and also with a great many options for sovereign borrowing, often at very low interest rates. If, for example, China does not receive loans from the World Bank, one suspects that this has a lot more to do with China’s own calculations rather than any decision by the World Bank’s board. Hence, a more realistic and complete picture of how MDBs function requires understanding the role played by borrower demand, all the more in the current fast-evolving global context.<sup>6</sup>

A previous paper (Humphrey and Michaelowa 2011) demonstrated that countries in Latin America have systematic tendencies to modify their borrowing from the World Bank, IADB or CAF depending on economic circumstances, hence justifying the relevance of demand-side factors. The paper hypothesized that these patterns were the result of an interaction between economic circumstances and various characteristics of each MDB, which were hypothesized to be linked to the composition of shareholders behind each MDB—the World Bank dominated by industrialized non-borrower countries, the CAF dominated by borrowing countries, and the IADB relatively evenly split between the two (see figure below). The outcomes were generally consistent with the hypotheses, but the paper did not attempt to establish causal linkages. This paper analyzes whether one key attribute of each MDB impacting loan demand—the cost of MDB loans to borrowing countries—is in fact causally derived from the composition of country shareholders.

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<sup>6</sup> Ratha 2001 is the only existing study that attempts to formally model demand for lending, in that case for one MDB, the World Bank.



Source: Annual reports of World Bank, IADB and CAF, 2009.

Note: CAF in 2009 had a single non-borrowing shareholder, Spain, with 2.5% of CAF's capital. However, because the CAF has different types of voting shares, and Spain has the least "powerful" type (C shares), it actually has less than 2.5% voting power.

The paper has no hypothetical prediction as to how country shareholder composition should impact loan pricing. The most obvious hypothesis is the one stated in the introduction—that the World Bank's loans should be cheapest (due to its backing by the most rich countries), the IADB next (with many rich country shareholders), and the CAF the most expensive (control by developing country shareholders); and that price differences should remain relatively constant. That prediction was quickly shot down by the evidence depicted in the first two figures. Instead, the aim of the paper is to determine whether country shareholder composition does in fact influence loan pricing in ways that lead to the patterns seen, and to describe the causal mechanisms.

The paper is structured as follows. Section 2 briefly addresses the impacts of MDB capital structure on their standing in bond markets. Section 3 discusses the incentives behind net income accumulation, and the consequent impact this has on loan pricing. Section 4 concludes. Evidence in the chapter comes from several sources: data and documents from the MDBs themselves, interviews with high-level financial officials and executive directors (country shareholder representatives) at all three MDBs, interviews and reports from bond rating agencies, and news reports.

## Section 2. The Impact of Capital Structure on MDB Borrowing in Global Capital Markets

Unlike most other international organizations, the vast majority of MDB resources come from borrowing on international capital markets. The fact that MDBs can access international bond markets, use those resources to make loans and cover the bulk of their administrative costs on the margin between borrowing and lending costs—and hence do not require regular budgetary allocations from member governments—has unquestionably been key to the spectacular success of this particular model of international organization. Thus understanding the relationship between MDBs and capital markets is important for a broader understanding of how MDBs function and why they may differ from one another.

The link between shareholder composition and the ability of an MDB to raise resources on private capital markets is relatively straightforward, but requires a brief review of an MDB's financial model. Countries reach an agreement to create an MDB, and contribute a certain amount of capital in actual cash ("paid-in capital"). As well, each MDB builds up a level of financial reserves as a result of its operations, which together with paid-in capital comprise the organization's equity, comparable to the equity of any private financial institution. Uniquely, however, MDBs also have a portion of capital that each member country commits as a guarantee should the MDB ever need it, but does not actually pay in cash ("callable capital"). Armed with equity and callable capital, MDBs issue bonds on international capital markets.<sup>7</sup> Thus, the bond rating and the terms at which international capital markets are willing to lend to each MDB depends to a very large degree its capital structure.<sup>8</sup>

The most important factor in determining the market's perception of MDB creditworthiness is, in turn, the creditworthiness of the country shareholders providing callable capital. This feature of MDBs originated with the creation of the World Bank. Founding countries were required to pay 20% of their capital commitment in cash, with the remaining 80% committed as a guarantee that would be called upon should the bank ever require it to pay off their creditors.<sup>9</sup> Every MDB created since has utilized the same mechanism. This callable capital—and the creditworthiness of the governments providing it—acts as a guarantee to private markets that the credit they provide to an MDB is protected and will be paid off, regardless of whether borrowing countries default on their loans from an MDB. As the bond rating agency Fitch noted in a 2010 report laying out their rating criteria for MDBs, "Suprationals' credit quality derives first and foremost from the support of member states...Support to MDBs is granted through 'callable capital'..."<sup>10</sup>

All three major rating agencies only consider callable capital from industrialized non-borrowing countries to be of any real worth. Callable capital from countries with lower ratings are not counted because, in the words of Standard and Poor's, "At a time of global financial stress sufficient to require an MLI [multilateral lending institution] to issue a capital call, it is unlikely that many of these countries would be able to comply."<sup>11</sup> According to this criterion, the agencies view the IADB and World Bank essentially the same. For both, the sum of callable capital from highly-rated shareholders and total paid-in capital and reserves are consistently more than 100% of total outstanding loans and guarantees. As Standard and Poor's notes referring to the World Bank, this "implies that the bank would remain solvent even if all of its loans were deemed worthless and it had to pay out under all of its guarantees outstanding."<sup>12</sup> Hence both the World Bank and IADB have for decades awarded both the highest bond rating, AAA, despite the fact that borrowing shareholders hold a higher percentage of voting power in the latter. What matters to the markets is how much guarantee capital from rich countries is behind the banks, regardless of voting power.

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<sup>7</sup> MDBs can and do make private bond placements, for example with central banks, but the vast majority of their funding come from capital markets.

<sup>8</sup> The perceived risk of each MDB's loan portfolio is also a factor. According to MDB treasury officials, bond market participants and ratings agency analysis interviewed for this study, portfolio risk is much less important than capital structure, and hence it is not analyzed here in the interests of brevity.

<sup>9</sup> The share of callable capital in total capital has grown steadily over the years for both the World Bank and IADB. As of end-2009, callable capital represented about 94% of total World Bank capital and 96% of IADB total capital.

<sup>10</sup> FitchRatings, 2010a, p. 1.

<sup>11</sup> Standard and Poor's, 2007, p. 7.

<sup>12</sup> Standard and Poor's, 2010a, p. 17.

The CAF faces a very different situation. It was first created without any callable capital. Faced with a total inability to access private capital markets, shareholders committed US\$200 million in callable capital in 1975. This had no impact whatsoever on inspiring the confidence of bond markets, and when the CAF began to work in earnest on winning the trust of markets it did so through its operations, not callable capital.<sup>13</sup> This trend has continued to the present. Unlike the World Bank and IADB, paid-in capital (68% of total capital) is now much higher than callable capital (32%). And of the CAF's callable capital, only the US\$200 million share of Spain was rated AAA, a rating it lost in 2010.<sup>14</sup> Even though it has financial indicators superior in many aspects to the World Bank and IADB, the CAF is currently rated A+ by Standard and Poor's and Fitch, and A1 by Moody's—four steps below the other two—mainly because of the lack of AAA callable capital.<sup>15</sup> Ratings agencies indicate that further upgrades in CAF's ratings would depend in large part on attaining more creditworthy shareholders.

The CAF administration has been very clear that they will not take on non-borrowing shareholding countries to any significant degree, because of the implications it would have in changing the MDB's governance. In an interview with *The Banker* in 2009, President García stated: “Whatever happens, the developed countries will never have more than 10% or 15% of the shares and that makes a lot of difference. Developing countries know we are loyal partners.”<sup>16</sup> Both the IADB and the African Development Bank were founded with the similar intention of being controlled by borrowers, but ended up giving non-borrowing shareholders greater voting power to gain highly-rated callable capital and improve their standing in international capital markets.<sup>17</sup> The CAF has evidently made the decision to forgo the “easy” route to better capital market access through callable capital, and instead maintain borrowing shareholder control and build up market access through its track record and strong financial ratios. A top CAF treasury official addressed the issue candidly in an interview: “From countries that are not investment grade, ratings agencies won't consider callable capital in the same way. But callable capital is not something that we are focused on any more.”<sup>18</sup>

The contrasting composition of shareholders, then, is the single most important factor in defining how cheaply the three MDBs can borrow on international capital markets. Because of the high share of callable capital guaranteed by non-borrowing, highly-rated industrialized countries, both the World Bank and IADB are rated AAA, and consequently issue bonds at some of the lowest rates of any issuer in the world, sovereign or non-sovereign. As one former top World Bank finance official noted, “...ratings agencies do not actually base their rating of the MDBs on the spurious sophisticated and often confusing, if not almost irrelevant, financial ratio analysis they purport to impress their readership with. Instead, they now appear to be basing their judgment solely on the strength of usable callable capital.”<sup>19</sup> The CAF, by contrast, could not get rated at all for the first two decades of its existence, and even now borrows at rates considerably above the other two (though, critically, below any of its member countries). This difference

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<sup>13</sup> Humphrey, 2010.

<sup>14</sup> Standard and Poor's 2010c, p. 12.

<sup>15</sup> FitchRatings 2009, Standard and Poor's 2010c, p. 3, Moodys 2009, p. 1.

<sup>16</sup> *The Banker*, 2009.

<sup>17</sup> Humphrey, 2010 for the IADB; on the experience of the African Development Bank, see for example Strand, 2001 and Mingst, 1990.

<sup>18</sup> CAF interview, December 14, 2010.

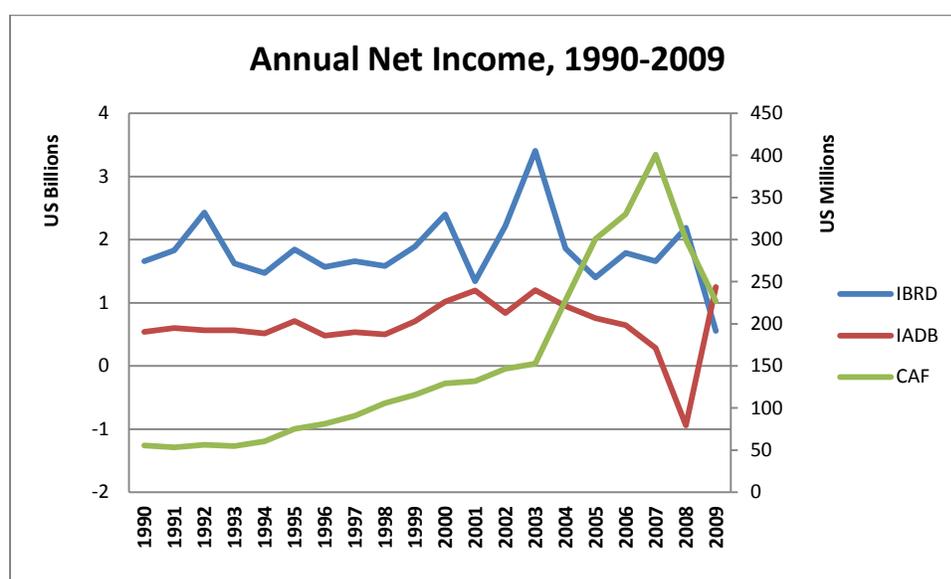
<sup>19</sup> Mistry, 1995, p. 73. His discussion only refers to the World Bank, IADB, Asian Development Bank, African Development Bank and European Bank for Reconstruction and Development, and does not take sub-regional MDBs such as the CAF into account.

in capital market access, in turn, is fundamental in defining the rates at which each MDB is able to offer loans to its borrowers. Hence, there appears to be little difference as far as the markets are concerned between the World Bank and the IADB—both receive a AAA rating, despite the fact that non-borrowing countries have less voting power in the latter.

### Section 3: Net Income, Reserves and Equity

Beyond the price an MDB must pay to borrow from international markets, policies around net income, reserves and equity also have a major impact on the financial terms of its loans. The net income generated by each MDB each year—that is, total income (from loans and other investments) minus total expenses (financial and administrative)—has in most years amounted to a tidy sum of money for each of the three MDBs considered here. From 1980 to 2009, accumulated net income (in 2007 US\$ terms) was US\$53.4 billion for the IBRD, US\$17.8 billion for the IADB, and US\$3.3 billion for the CAF (see figure below).

The first question to be asked when considering annual net income is, why does it exist at all? If an MDB is a non-profit organization, does not the existence of net income imply that it is charging too much for its loans? As a cooperative bank owned by all its members, shouldn't it lower the cost of its loans to the point where it simply breaks even? The fact that MDBs do have net income, and that country representatives as opposed to management decide how to use it, indicates that political considerations are involved. Each of the three MDBs analyzed here set their loan rates in such a way to generate a certain level of net income every year, which is in turn used for three purposes: (i) to increase financial security ii); to expand equity and hence operational capacity; and iii) to fund any other projects shareholders may deem suitable. These three incentives to increase net income translate directly into higher loan costs to borrowing countries.



Source: Annual reports of World Bank, IADB and CAF, 1990-2009.

Note: CAF right vertical axis; World Bank (IBRD) and IADB left vertical axis. Figures in 2007 US\$. Net income figures are taken before FAS133 accounting adjustment, which adjusts the value of certain financial instruments held by MDBs to current market value (“mark to market”). Hence, the figures can be considered net operating income.

### *Uses of Net Income I: Building Reserves to Protect Non-Borrowing Shareholders*

One of the principal reasons for generating net income every year is to strengthen an MDB's financial reserves, which—as the name implies—provide an added level of security, as in any financial institution exposed to potential risks. Both the World Bank and IADB have systematically built up reserves since their inception, making allocations out of net income every year to reach a total of just under US\$30 billion for the World Bank and US\$15 billion for the IADB by 2009. The CAF, by contrast, did not begin building reserves in its early years, and began in earnest only in the late 1980s as it began to seek capital from international markets.<sup>20</sup> The CAF's reserves were just under US\$2 billion at end-2009.

This pattern of reserve accumulation is justified by MDBs as necessary to reassure bond investors that their investment is well protected, even in the event of defaults by borrowers, as well as to cover any unexpected operational expenses. A quote from a 2006 IADB report sets out the basic premise: “The net income target was intended to set a level of net income that would permit the Bank (i) to cover current expenses in the context of changing financial markets, and (ii) to accumulate reserves as a way to protect debtholders and equityholders of the Bank of potential unexpected losses.”<sup>21</sup> However, the pattern of reserve accumulation suggests that protecting bondholders and access to financial markets is not the only consideration in mind, especially for the World Bank and IADB.

The key to understanding MDBs' policy of systematically allocating net income to reserves—at the expense of borrowing countries, who pay the cost for this in higher loan interest rates—is the equity-to-loans (E/L) ratio. This ratio is the principal benchmark by which financial markets consider the capital adequacy of MDBs, and indeed of all banking institutions. The level of an MDB's equity capital is the main indicator by which MDBs themselves measure their own financial health. Equity here refers to an MDB's i) paid-in capital and ii) level of reserves, otherwise known as retained earnings. In essence, each MDB's level of equity defines the amount of lending it is able to make. The World Bank publicly targets an E/L ratio of 23-27%,<sup>22</sup> while the IADB targets an even higher 32-38%.<sup>23</sup> The CAF has no publicly stated official E/L target. In practice, the ratios of all three MDBs have converged to a similar level in recent years, in the 30-40% range (see figure below).

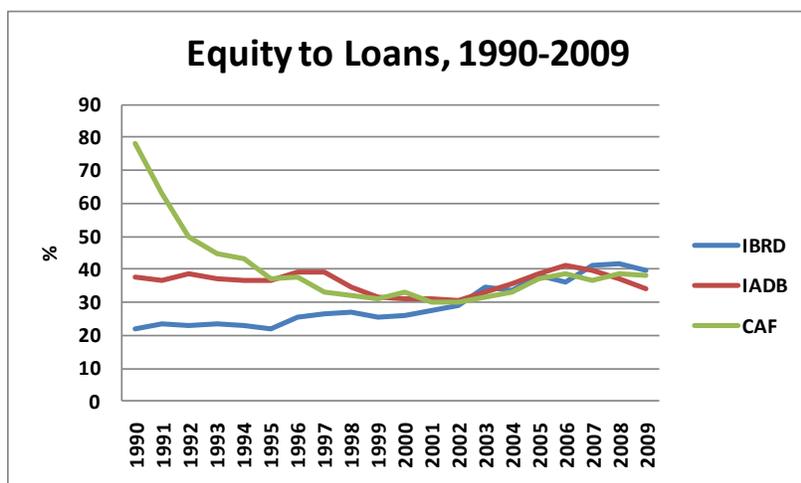
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<sup>20</sup> Humphrey, 2010.

<sup>21</sup> IADB, 2006, p. 18.

<sup>22</sup> World Bank, 2010d, p. 7.

<sup>23</sup> IADB, 2006, p. 20.



Source: Annual reports of World Bank (IBRD), IADB and CAF, 1990-2009.

On the face of it, the level of this relatively technical financial ratio may seem unremarkable. It takes on a new relevance, however, when one realizes that it is very far above the capital adequacy levels of commercial banks. The Swiss banking giant UBS, for example, had a Tier 1 capital ratio<sup>24</sup> of 11-16.7% between the end of 2008 and the third quarter of 2010,<sup>25</sup> while Citigroup had a Tier 1 capital ratio of 12.5% in the third quarter of 2010, down slightly from 12.7% from the previous year.<sup>26</sup> These post-crisis ratios, it should be noted, are well above the single-digit ratios held prior to 2008.

Thus the question arises: why do MDBs have such higher capitalization ratios than commercial banks? Why not, instead, lower the capitalization ratio to a level more akin to commercial banks? This would have the benefit of either requiring less capital contributions from shareholders, less annual allocations to reserves (and hence lower loan costs), or greater lending capacity, or some combination of all three. One might imagine that the answer would be the attitudes of bond markets, due to the political nature of MDB business, but evidence suggests that this is not the case. Referring to the very high E/L level, one World Bank Treasury official stated flatly that, prior to the 2008 crisis, “we could have doubled our loan book and still maintained our AAA rating.”<sup>27</sup> A second Treasury official stated, “We currently [in 2009] have about US\$40 billion in equity and about US\$100 billion in loans, which is about a 40% equity-to-loans ratio. A regular bank has about 8% requirements. So we are way above what the market looks for.”<sup>28</sup> An IADB Treasury official made a similar comment, suggesting that ratings agencies pay more attention to MDBs staying roughly in line with one another, and not any particular level of reserves or equity. “They [ratings agencies] won’t downgrade us if we lower the ratios,” the official said. “Let’s say we lower our equity-to-loan ratio from 30 to 15%. They will look at how it compares to other MDBs—if it’s totally out of whack they will get worried, but if it’s in line with the others, and there’s a good justification, it will be fine. They look at what our competitors do.”<sup>29</sup> A World Bank executive director for one middle-income Latin American country stated in an interview that the E/L ratio “is defined by the board, and there is no

<sup>24</sup> Tier 1 capital, as defined by Basel I and II, is equivalent to equity plus retained earnings as a share of risk-weighted assets. For political reasons, MDBs do not (at least publicly) risk-weight their loan portfolios.

<sup>25</sup> UBS, 2010.

<sup>26</sup> Citigroup, 2010.

<sup>27</sup> World Bank Treasury interview, January 20, 2009.

<sup>28</sup> World Bank Treasury interview, November 17, 2009.

<sup>29</sup> IADB interview, November 15, 2010.

technical or mathematic reason why it is set at this level. Our feeling is that the bank is too conservative, but this decision was made years ago and no longer comes up for discussion, because the ratings agencies are used to it. So when it goes below 23% or so, the ratings agencies see that as risky and they might reconsider their AAA rating of the bank.”<sup>30</sup>

The high E/L ratio is all the more puzzling when one considers that both the World Bank and the IADB (though not the CAF) have a huge amount of callable, guaranteed capital that is not included in equity, but which shareholders are obligated by international treaty to provide in case of need. This vast on-call reserve—totaling US\$172 billion for the World Bank and US\$97 billion for the IADB, both in 2009—is unique to MDBs, and does not exist for commercial banks. Taking into account the additional security of callable capital, the E/L ratio of the World Bank and IADB is even more conservative. Evidence suggests that the callable capital itself, and the fervent desire of wealthy shareholders to avoid any call on it, is a driving force behind MDBs building up equity through net income allocations far beyond the requirements of the market.

Moody’s notes this in its most recent analysis of the World Bank: “The IBRD realizes that by having enough resources of its own to absorb risk, it protects members from a possible capital call. The Bank judges its capital adequacy as the ability of its equity to generate future net income to support normal loan growth and respond to a potential crisis without having to resort to a call on capital.”<sup>31</sup> This use of reserves is substantiated by an interview with a top official in the World Bank’s Corporate Finance division, which sets financial strategy. When asked why the World Bank maintained such high E/L ratio, the official agreed that it was well beyond what bond markets called for, and went on to explain why: “The rating agencies know that callable capital is there to bail bondholders out. But shareholders traditionally have not wanted us to call capital. A call on capital is something they want to avoid, because it’s not something in their budget, it would come out of nowhere. So the history of the Bank has always been to manage its finances to avoid a call on capital.”<sup>32</sup>

Similarly with the IADB, Moody’s writes that “The capital adequacy mandate is to determine the amount of equity required to assure that the Bank operates without exercising a call on callable capital...”<sup>33</sup> An IADB Treasury official confirmed this explanation, justifying high reserves by comparing the IADB to how a commercial bank could face a crisis: “They shed assets, they issue new stock, they can fire a ton of people, they can divest. An MDB cannot do that. We cannot fire a bunch of people, we can’t divest or sell our assets, there’s no one to sell our loans to. So we have to rely on the retained earnings we have over time. Our capital requirements are a lot higher. Ultimate we are trying to protect—in our case it’s not bankruptcy, its callable capital. The main non-borrowing shareholders, especially the US, do not want to get called on.”<sup>34</sup>

The reality for both the World Bank and IADB is that while callable capital is extremely useful for ensuring the best possible rates on international capital markets, it cannot ever be actually used without facing extremely dire political consequences. Wealthy governments are happy to commit callable capital, as long as they never feel that it will actually be called upon. Thus it is incumbent upon the administration

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<sup>30</sup> World Bank ED interview, December 14, 2011.

<sup>31</sup> Moody’s, 2008, p. 4.

<sup>32</sup> World Bank Corporate Finance interview, January 20, 2011.

<sup>33</sup> Moody’s, 2010, p. 10.

<sup>34</sup> IADB interview, November 15, 2010.

of both MDBs to protect against a capital call by building up a very high level of equity as a share of loans, far higher than any commercial bank. It is no coincidence that no MDB has ever made a call on its callable capital—the result would likely be the demise of the MDB itself. As one World Bank executive director put it succinctly almost four decades ago, “Management and the Board should think about callable capital as a Christian thinks about heaven, that it is a nice idea but no one wants to go there because the price of admission is death.”<sup>35</sup> The price for this extremely cautious financial management in the service of protecting non-borrower callable capital is higher interest rate charges on loans to borrowers.

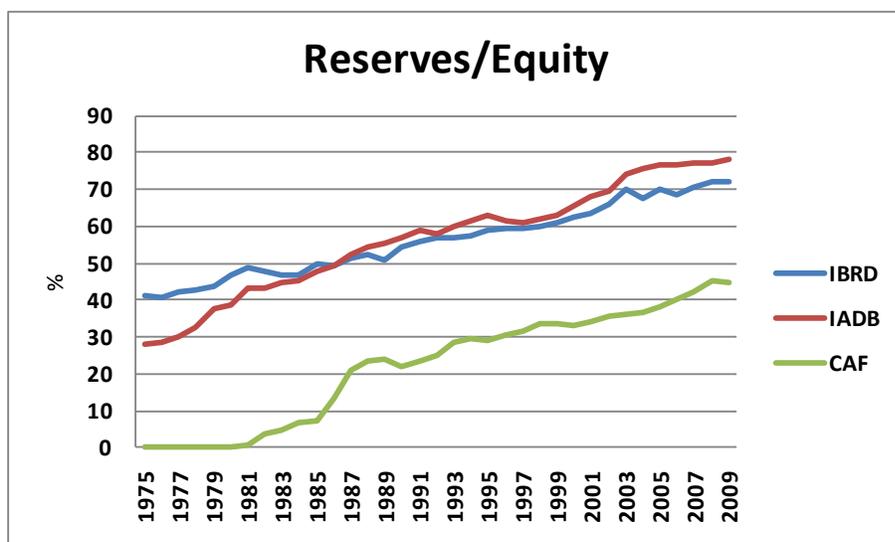
Interestingly, the CAF apparently feels pressure to follow a similar policy, even though it has only minimal callable capital, and presumably less pressure from shareholders to protect it. One can imagine that, as the IADB official quoted above alluded to, ratings agencies may not have a fixed number in mind when analyzing different MDBs, but they expect them to follow a relatively similar pattern. One can also imagine that the World Bank, with its long history and weight in the market, sets the standard, forcing others like the CAF to follow its lead to ensure good bond ratings, even though it does not have a direct financial reason to do so. Hence, one of the motivations MDBs to charge higher loan rates and accumulate net income may have originally been driven by the interest of non-borrowing shareholders to protect against a call on their capital, but it appears to have become a standard benchmark that equally impacts the CAF, even though it has only minimal callable capital. The cause of this policy is evidently divergent shareholder interest (industrialized countries protecting against a call on capital vs. borrowing countries wanting cheaper loans), but the effects appear the same, regardless of the balance of shareholder power in each MDB.

### ***Uses of Net Income II: Building Equity With Reserves Instead of Paid-In Capital***

Once one assumes that MDBs are targeting a given level of equity, the question is then how one achieves it. As noted above, equity is comprised of both reserves (which is accumulated net income) and paid-in capital from shareholders. If an MDB needs to achieve a certain equity target to be able to make a certain amount of loans, why not do so by increasing paid-in capital, instead of being forced to generate reserves out of annual net income, which in turn come from the fiscal accounts of the very countries the MDB is supposed to be helping through higher interest payments on MDB loans? Evidence suggests that building equity through reserve accumulation is simply a lot easier than convincing wealthy shareholders to kick in more paid-in capital through contentious and protracted capital increase negotiations. This is much more of an issue for the World Bank and IADB than the CAF, as can be seen in the figure below—although all three have converged since the mid-1990s toward a roughly similar overall E/L ratio, the World Bank and IADB have relied much more heavily on reserve accumulation to do so, while the CAF has done so more by increasing paid-in capital.

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<sup>35</sup> Statement by Canadian Executive Director Claude Isbister, April 27, 1973, as cited in Kapur et al., 1997, p. 991.



Source: Annual reports of IBRD, IADB and CAF, 1990-2009.

The reasons for these divergent patterns of building equity are directly linked to the composition of shareholders behind each MDB. For both the World Bank and IADB, capital increases—especially of paid-in as opposed to callable capital—are extraordinary complex, conflictive and time-consuming endeavors, and hence both MDBs find it much more expedient to gradually build equity each year by allocating much higher levels of net income to reserves. While both the World Bank and IADB were given capital increases in response to the recent global financial crisis, the process was extremely lengthy and the amount of paid-in capital was at the lower end (for the World Bank) or well below (for the IADB) the amount originally proposed by the MDB itself.

The IADB first announced it was seeking a capital increase on February 25, 2009,<sup>36</sup> and it was not finally approved until July 21, 2010.<sup>37</sup> IADB management itself did not publicly name a figure for the capital increase, but an independent commission created by the IADB proposed US\$150 billion, of which US\$6 billion would be paid-in capital.<sup>38</sup> Shareholders approved only a US\$70 billion increase, of which only US\$1.7 billion was paid-in capital. News reports indicated that the US was the main country trying to limit the size of the increase, while borrowing countries such as Argentina were pushing for a higher amount.<sup>39</sup>

The World Bank formally proposed a capital increase in the Istanbul Annual Meetings in September 2009, and it was granted by April 2010.<sup>40</sup> The World Bank's Development Committee originally proposed a paid-in capital increase of US\$5-11 billion,<sup>41</sup> and shareholders agreed to only US\$5.1 billion paid-in capital increase, out of a total of US\$86.2 billion. Press reports indicate that attitudes about the capital increase were clearly split along non-borrower versus borrower shareholder lines, including

<sup>36</sup> BNAmericas, 2009.

<sup>37</sup> IADB, 2011d.

<sup>38</sup> IADB, 2009, p. 5-6.

<sup>39</sup> Financial Times, 2010.

<sup>40</sup> World Bank, 2010e.

<sup>41</sup> World Bank, 2009a, p. 8.

outright initial opposition by France, Canada, Italy, and the United Kingdom and lukewarm support by the US, with support from major borrowing countries such as Brazil, China and Indonesia.<sup>42</sup>

A top World Bank Treasury official linked loan prices, net income and politics bluntly: “In order to ask for a lower capital increase, we can increase amount of money we earn on loans. This is why the contractual spread on our loans was increased again [in 2009]. This generates greater net income, which is allocated to reserves and hence can be used for lending... We try to minimize capital increases as much as possible, because of the political difficulties involved.”<sup>43</sup> A World Bank strategy paper also alluded to the link between loan pricing and capital, when discussing a loan price increase in 2009: “While the objective of this pricing increase was to improve the institution’s financial sustainability, it would also gradually enhance IBRD’s capital position as higher income is added to reserves over time.”<sup>44</sup>

Borrowing country shareholders have objected to this practice, voicing instead a clear preference for a direct capital increase. As far back as 1995, Argentina’s Finance Minister Domingo Cavallo stated at the Annual Meetings that while his country “supported the policy of sound reserves... If the net income of the Bank were to continue at the levels of recent years, we feel that interest rate waivers could be increased in order to reduce the actual cost of borrowing to our countries.”<sup>45</sup> Brazil’s current executive director at the World Bank pointed out in an interview that price increases in place of a capital increase could make the Bank’s loans unattractive to his and other countries. “Brazil or India or China will say, ‘we don’t want to borrow from you anymore.’ This would be a disaster for the financial cooperative, because the lower middle-income countries would take the burden, and lending costs would have to increase much more significantly than now. That would be unsustainable. So you have to ask whether increasing prices is the best way to address financial sustainability. A direct capital increase would be much better.”<sup>46</sup> Another current executive director from Latin America raised similar objections. “We [middle-income borrowers] don’t have the possibility to influence prices, or when to increase the capital. When lending capacity is at its limit, G7 countries look at pricing policies, and increase prices in order to finance increasing lending.”<sup>47</sup>

The IADB faces a similar dynamic, except that it receives much stronger pressure from its single largest shareholder, the United States. An independent commission convened in 2009 to consider the possibility of a capital increase for the IADB put the issue succinctly: “The Commission fully realizes that there is bound to be resistance to the notion of a general capital increase, albeit one that consists largely of guarantees and of limited actual cash transfers. The United States, at 30% the single largest shareholder of the Bank, is at present facing many demands on its budgetary resources, both for guarantees and for actual cash transfers.” As a result, the IADB “relies on a small amount of paid-in capital, averaging 4 per cent in the last 30 years, augmented by retained earnings.”<sup>48</sup> An IADB Treasury official confirmed the importance of generating retained earnings to avoid requesting capital from major shareholders. “If overall we want to increase lending, we have to increase loan charges to generate retained earnings.” The official went on to note that the reason was the split between borrowing and non-borrowing shareholders:

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<sup>42</sup> See for example Reuters, 2009, Bloomberg, 2009, and BICUSA, 2009.

<sup>43</sup> World Bank Treasury interview, November 17, 2009.

<sup>44</sup> World Bank, 2009b, p. 3.

<sup>45</sup> 1995 World Bank/IMF Board of Governor Proceedings, p. 135-6.

<sup>46</sup> World Bank ED interview, December 12, 2011.

<sup>47</sup> World Bank ED interview, December 14, 2011.

<sup>48</sup> IADB, 2009, p. 4-5.

“The driving force is that non-borrowing countries don’t want to see the bank coming to the trough for capital increases to provide subsidized loans for middle-income countries. The developed countries see themselves as providing paid-in capital allowing the bank to offer rates way below what countries like Mexico and Brazil can access on the market – they don’t want to do that anymore...we know the IBRD is getting similar pressure from its non-borrowing shareholders, but in our case the US is 30%, so it carries a big stick, it has a huge voice.”<sup>49</sup>

The contrast with the CAF is stark. As the figure above shows, a much lower portion of the CAF’s equity comes from retained earnings, and much more from paid-in capital. The reason is simply that shareholders are much more willing to contribute paid-in capital when the organization needs it, thus the CAF is less reliant on building up reserves to achieve a given overall E/L ratio. The recent global financial crisis is a good example. Facing potential financial constraints to service increasing loan demand from member countries, shareholders quickly and unanimously approved a US\$2.5 billion paid-in capital increase in August 2009.<sup>50</sup> A CAF Treasury official detailed the ease of the increase in an interview, with no small note of smugness in his voice: “We asked shareholders for US\$1 billion, and instead they gave us US\$2.5 billion. We can increase the capital base whenever we need to, because the structure of our shareholders is so different. They know we can leverage the capital that they supply as efficiently as possible, which then gives them greater possibilities to take out loans from us. It’s not like that with the IADB and the World Bank, where some shareholders contribute capital and others benefit by taking out loans.”<sup>51</sup> Including paid-in capital from new members, the CAF raised US\$4 billion in paid-in capital following the 2008 crisis, almost as much as the vastly larger World Bank (US\$5.1 billion) and more than twice as much as the IADB (US\$1.7 billion). A ratings agency analyst contrasted the CAF’s capital increase with the IADB’s: “If you see how much trouble IADB has had in getting significant capital injection, it’s been like a Mexican soap opera it’s taken so long, compared to how quickly the CAF got it done.”<sup>52</sup>

As this section makes evident, the structure of shareholding countries has a very important impact on each MDB’s ability to raise paid-in capital, which in turn directly influences whether it has an incentive to raise loan charges as a means of building equity without having to face politically difficult capital increases. The fact that a major share of paid-in capital for both the World Bank and IADB must come from country shareholders that do not borrow from these MDBs means that paid-in capital is much harder to come by. As a result, both the World Bank and IADB have a stronger incentive to generate a relatively high amount of net income every year to build equity without recourse to a capital increase. Accumulating reserves through higher loan charges is an extremely effective way for the World Bank and IADB to expand lending capacity without turning to shareholders for a capital increase. These reserves act, in essence, as a paid-in capital contribution from borrowing members alone, but without any increase in their share of voting power that normally could come with a formal capital increase. As one Latin American executive director put it in an interview, using net income in this way “could be understood as a capital increase, which should give us more voting power. But that’s not how it’s understood.”<sup>53</sup> The dynamic within the CAF is quite different. Shareholders see the CAF as a useful tool to serve their own

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<sup>49</sup> IADB interview, November 15, 2010.

<sup>50</sup> CAF, 2009.

<sup>51</sup> CAF interview, December 14, 2010.

<sup>52</sup> FitchRatings interview, November 22, 2010.

<sup>53</sup> World Bank ED interview, December 14, 2011.

interests, rather than donor aid with dubious effectiveness, and hence increases of paid-in capital are much more easily available. As a result, the pressure to use loan charges and net income as means of building equity is much lower.

### *Uses of Net Income III: Allocation to Shareholder Causes*

A third important reason for an MDB to generate net income each year is that shareholders can allocate that income not only to reserves, but also to special purposes that most often obey the interests of the wealthiest and most powerful non-borrowing shareholders, rather than borrowing country shareholders. This is a major and conflictive issue for the World Bank, and has grown in financial importance in recent years. The issue has a smaller but growing importance for the IADB, and is essentially non-existent for the CAF—thus clearly matching the balance of shareholding power between borrowers and non-borrowers in the three MDBs.

The issue of allocating net income for purposes beyond building reserves first arose at the World Bank when IDA was created, in the early 1960. The Bank had begun accumulating very considerable retained earnings, and was at the time facing pressure from borrowing countries to lower the costs of its loans rather than continue building reserves. At the same time, the Bank faced pressure from many countries—backed by the United Nations and, eventually, the U.S. government—to offer loans at much lower rates to the poorest countries. The creation of IDA allowed the Bank to address both of these issues. It ensured that the new concessional lending window would be housed within the World Bank rather than the United Nations (with the support of the US, which exercised much greater voting power in the Bank and could hence better control the resources), and it offered an opportunity to dedicate some of its net income every year beginning in 1960 in such a way that it stayed “in house” and under the Bank’s control.<sup>54</sup>

Thus began the annual practice of allocating part of the World Bank’s IBRD net income to IDA, which continues to this day. While this might seem reasonable at first, it is important to recognize that this income comes directly from the interest payments made by World Bank borrowers. These borrowers frequently suggest that IDA should be funded not by them, but rather by fiscal allocations from the wealthiest countries. Why, after all, should slightly better-off developing countries be made to pay for loans to the poorest countries? In the words of one researcher, this “could be seen as a transfer from one set of developing countries to another.”<sup>55</sup> Predictably, the annual debates on IDA allocations are invariably split by borrower versus non-borrower shareholders, and just as predictably, non-borrowing shareholders always win. The debate began in the early years of IDA, with especially vocal opposition to transfers from Brazil and other Latin American countries,<sup>56</sup> and continues to this day. One World Bank Treasury official, who has the job of marketing loans to middle-income countries (MICs), said “MICs who pay for IBRD loans say ‘Wait a minute, now we finance IDA? IBRD wasn’t created for that.’ This certainly hurts our ability to be competitive in terms of pricing.”<sup>57</sup>

What’s more, this allocation appears to have become increasingly institutionalized, as a convenient way for wealthy shareholders to use the World Bank’s IBRD net income to minimize the amount of money they are requested to pony up for the regular IDA replenishments. In previous years, shareholders

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<sup>54</sup> Humphrey 2010.

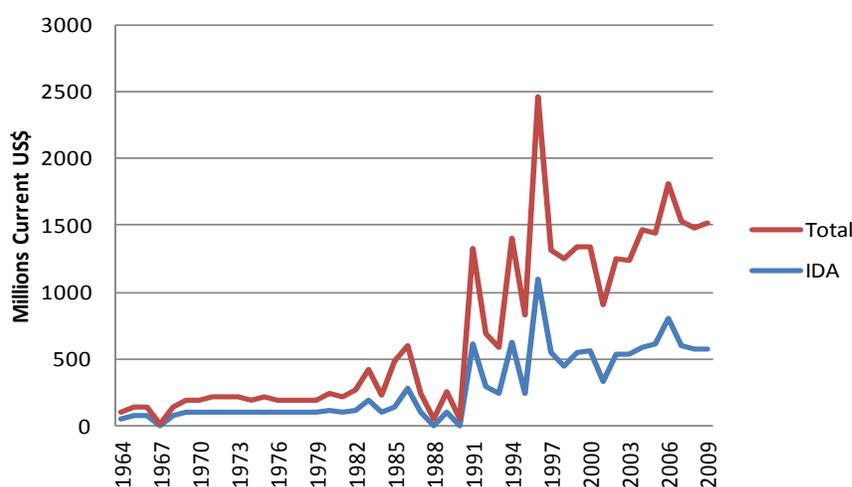
<sup>55</sup> Mohammed, 2004, p. 12.

<sup>56</sup> Kapur et al., 1997, p. 1083, cited in Mohammed, 2004, p. 11.

<sup>57</sup> Interview, World Bank Treasury, September 15, 2010.

understood that the World Bank would give IDA part of IBRD net income as conditions permitted, and the Bank was very clear that this was not an obligation—even going so far to write language to that effect in IBRD bonds, to reassure capital markets of its independence from IDA.<sup>58</sup> More recently, however, IDA replenishments (as well as contributions to HIPC and MDRI debt relief initiatives to IDA countries) have included prior commitments from IBRD of certain amounts of net income allocation. This in effect *requires* IBRD to generate sufficient income through loan charges to meet the commitments.<sup>59</sup> “In the past IDA transfers were sometimes scaled back or stopped if the capital outlook wasn’t good,” said a World Bank Corporate Finance official. “That’s less so the case these days, for sure.”<sup>60</sup> A World Bank Treasury official stated flatly, “Profit allocation for IDA seems to be one of the main goals of the board every year.”<sup>61</sup>

### IBRD Net Income Allocations



Source: IBRD Annual Reports, 1964-2009.

Cumulatively, transfers to IDA and debt relief add up to a very considerable sum of money: US\$13.3 billion since 1960 in nominal terms, and US\$24 billion in real terms. To all intents and purposes, the World Bank’s non-borrowing shareholders are forcing middle-income developing country borrowers to contribute to less developed countries, whether they want to or not. Needless to say, this is not a contribution that borrowing countries generally feel they should have to make. “It’s definitely a negotiation every year, what are prices going to be and what transfers are going to be,” a top World Bank Corporate Finance official said. “There’s a trade-off. Certainly the higher loan prices are, the more can be afforded to transfer out to IDA. And the lower IDA transfers are, the lower loan prices could be...That’s certainly something that’s very different between us and IADB and CAF.”<sup>62</sup>

Brazil’s current World Bank executive director spelled out his country’s position in an interview. “This is definitely coming from the non-borrowing countries. I’ve always found it bizarre that the Bank makes

<sup>58</sup> World Bank Annual Report, 1960, p. 16.

<sup>59</sup> See for example, World Bank 2010d (p. 14 and p. 29), which projects “baseline” allocations to IDA out of IBRD net income to the tune of US\$583 million per year.

<sup>60</sup> Interview, World Bank Corporate Finance, January 20, 2011.

<sup>61</sup> Interview, World Bank Treasury, September 15, 2010.

<sup>62</sup> Interview, World Bank Corporate Finance, January 20, 2011.

such significant transfers to IDA, I don't find it responsible especially when the Bank is facing capital constraints."<sup>63</sup> A second Latin American executive director stated that, "The Bank doesn't consider these allocations as a middle-income country contribution to IDA. They say that 'the Bank' or "the shareholders' contributed to IDA countries...Many MICs are raising the point that the Bank should recognize that transfers to IDA are from MICs, in order to receive an increase in voting share, or at least to compensate."<sup>64</sup> The current Swiss executive director, dismissed these complaints. "All Bank operations are financed by the income generated by its capital. Economically this doesn't have any justification, it's a purely demagogic argument. The client country pays the price they want to pay, and a certain amount of income is generated, that is then allocated. I don't buy that argument."<sup>65</sup>

Shareholders have also taken to allocating grants out of IBRD net income in most years for purposes that are linked to the geopolitical interests of major non-borrowing shareholders. Since the mid-1980s, grants have been allocated to trust funds for the former Soviet Union, Gaza-West Bank, Bosnia, Kosovo, East Timor, Liberia and Lebanon, as well as emergency assistance for Rwanda and post-tsunami recovery in South Asia. A middle-income IBRD borrower in Latin America may wonder why they are in effect paying for a trust fund intended to address the Israeli-Palestinian conflict or ethnic tensions in the Balkans—both clearly of major interest to western Europe and the United States. Between 1985 and 2009, grants out of net income have totaled US\$1.9 billion, or US\$2.4 billion in real terms. Between 2010 and 2019, they are projected to total another US\$100 million per year, equaling US\$1.2 billion in foregone reserve equity.<sup>66</sup> This, of course, translates into higher loan costs to borrowers to make this up.

The World Bank's original Articles of Agreement permitted net income to only be used for three purposes: building reserves, reducing loan charges or distributing dividends to shareholders.<sup>67</sup> Dividends have never been redistributed, while reserves (as described above) have been built up systematically, not to say excessively. However, instead of taking the third option of reducing loan charges, non-borrowing shareholders have instead grown accustomed to using net income as a slush fund, allowing them to fund programs that suit their own interests, and not necessarily those of borrowing countries, without requiring actual direct fiscal allocations out of their own budgets. As the Brazilian executive director put it, "Developed countries don't realize the importance of the institution to global governance—they want to milk it like a cow, to take the place of bilateral contributions." The total amount of these allocations since they began in 1964 and 2009 is US\$18 billion, or US\$29 billion in real terms—an average of US\$630 million per year in real terms. Between 1975 and 2009, the World Bank's IBRD loan income averaged US\$7.5 billion in real terms annually, meaning that if annual allocations out of net income had not occurred, the interest and fee payments made by IBRD borrowers on their loans could have been reduced by nearly 10%.

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<sup>63</sup> World Bank ED interview, December 12, 2011.

<sup>64</sup> World Bank ED interview, December 14, 2011.

<sup>65</sup> World Bank ED interview, January 13, 2012. The Swiss ED requested that it be noted that he was speaking on his own behalf and not stating the official position of his country.

<sup>66</sup> World Bank 2009b.

<sup>67</sup> Kapur et al., 1997, p. 938. The current Articles of Agreement, last amended in 1989, stipulate only that the Board of Governors decide annually how net income should be allocated (World Bank, 2011 Article V, Section 14). According to the IBRD's former general counsel, "There is no mention of grants in the Bank's articles, however...Grants from the IBRD net income were authorized by a formal interpretation issued by the Executive Directors in July 1964." Shihata, p. 85-6.

By contrast, the IADB makes only very limited allocations out of net income annually. The IADB's concessional lending window, called the Fund for Special Operations (FSO), is funded entirely by contributions from both borrowing and non-borrowing shareholders during the capital replenishment processes (there have been nine thus far in the IADB's history, the most recent in 2010). Part of the reason for this may be that FSO lending volumes are so small (only 6% of total lending between 2000 and 2009, compared to 40% for the World Bank's IDA) that it can finance most of its needs from repayments on old loans and on limited income from investing its existing capital stock, and needs only small levels of replenishments. Hence pressure to allocate out of net income from the regular lending window (Ordinary Capital) is much lower. Only for a period of five years, between 2000 and 2004, did a small portion of OC net income go to FSO, totaling US\$136 million.<sup>68</sup>

Similarly, all debt relief contributions from the IADB (totaling US\$4.4 billion through 2010)<sup>69</sup> are financed directly from FSO itself, and not from OC resources. Starting in 2005, the IADB began listing "special programs" under administrative expenses, which were defined in the financial statement as "non-reimbursable and contingent recovery assistance to borrowing member countries",<sup>70</sup> but again the total value was very low, only US\$246 million between 2005 and 2009. The impact of these two sets of allocations on loan pricing is obviously minimal. The ninth capital replenishment in 2010 called for the IADB to allocate US\$200 million annually out of OC net income until 2020 for Haiti reconstruction—the first of this type of regular allocation of this kind.<sup>71</sup> According to several executive directors from both borrowing and non-borrowing countries, this allocation was demanded by the U.S. in return for its support to increase the IADB's capital. Brazil's executive director at the IADB said his country supported helping Haiti, but nonetheless opposed the allocation. "We said to the U.S., 'why us?' Do it by yourself, not with our money, because in the end we take loans and the bank increases the interest rate to transfer this income for Haiti. We argued this with the U.S. government. We have the intention to help Haiti, but we do it directly. But in the end, the request was done."<sup>72</sup>

Whether this allocation signals future use of IADB's net income in ways similar to the World Bank remains to be seen, but by all accounts non-borrowers will continue to push for it. The UK's representative to the IADB's annual meeting in 2008 stated the rational clearly in a speech: "The implication is that in effect the IDB could never be over capitalised and that capital has no opportunity cost. As shareholders we want this capital to be used more effectively. We continue to maintain that allocating at least some of our net income for the poverty work of the IDB is essential. We have heard our FSO colleagues calling for a larger FSO window, and we think this is something that the IDB should consider as an option for the use of its net income."<sup>73</sup> A 2010 U.S. Treasury statement of position<sup>74</sup> on reform priorities states that the IADB should "provide net income transfers to fully support concessional window (FSO)." According to the IADB's Argentine executive director, the issue was raised by several non-borrowers during the recent capital increase. "The non-borrowing countries say they want it to be the

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<sup>68</sup> IADB annual reports 2000-2004.

<sup>69</sup> <http://www.iadb.org/en/about-us/debt-relief,6898.html>

<sup>70</sup> See for example AR 2005, p. 116 note B.

<sup>71</sup> IADB, 2010, p. 38.

<sup>72</sup> IADB ED interview, January 10, 2012.

<sup>73</sup> Tamar Bello, Temporary Alternate Governor for the United Kingdom, April 8, 2008, Miami.

<sup>74</sup> "U.S. Reform Priorities for MDBs", working draft accessed on the U.S. Treasury website [www.treasury.gov](http://www.treasury.gov) on September 7, 2010. The document is no longer available online.

same as at the World Bank. All the industrialized countries came with this issue.”<sup>75</sup> Although FSO allocations did not occur in the recent capital increase, the executive director from a major European shareholder said the issue would likely be raised again by non-borrowers—especially the U.S.—when the FSO next requires replenishment.<sup>76</sup>

The CAF first began setting aside portions of annual net income for special purposes in 1995, in relatively small amounts. Annual allocations have grown progressively over time, to reach US\$70 million allocated out of net income in 2009.<sup>77</sup> However, only a portion of these allocations go to what might be considered “needy” causes—a large portion is dedicated to a technical assistance fund to help countries prepare project proposals, and another sizeable portion is for pre-funding of major infrastructure projects. Both of these funds are better viewed as business development grants intended to result in major CAF loans. A smaller amount goes to the Human Development Fund, “whose objective is to finance preparation and execution of projects which promote sustainable human development among the socioeconomically marginal sectors of member countries, especially those not served by traditional sources of finance.”<sup>78</sup> The exact breakdown of these funds is not available for every year. In 2009, the CAF committed US\$8.2 million via the Human Development Fund, a tiny amount compared to the US\$8.8 billion in total lending commitments that same year.<sup>79</sup> Hence, making use of net income for shareholder purposes beyond reserve accumulation, so prevalent in the World Bank and also present in the IADB though to a much lower degree, is almost non-existent at the CAF, due to the lack of non-borrowing shareholder pressure.

### *Summary of Net Income Issues*

The divergent interests of borrowing and non-borrowing shareholders clearly play a major role in shaping the incentives facing each MDB to accumulate and allocate net income each year, which in turn has a direct impact on the cost of loans. Non-borrowing shareholders have a strong motivation to build up net income to: i) strengthen capitalization ratios well beyond what a private bank needs, to better protect the callable capital for which they would be disproportionately liable; ii) build equity through reserves rather than increasing paid-in capital out of their own budgets; and iii) use “surplus” net income to fund projects and causes obeying their own interests and not necessarily those of interest-paying borrowers. Because net income comes mainly from loan charges—and is hence paid entirely by borrowing countries—non-borrowers have no incentive not to make use of this mechanism.

In the World Bank, non-borrowers have all the voting power necessary to make these allocations each year during the Board of Governors meetings, over any objections from borrowers that net income should be used to reduce loan prices, as provided for in the Bank’s Articles of Agreement. In the CAF, by contrast, control by borrowing countries means that reserves are kept much lower, since equity can be built through paid-in capital increases, while allocations to special projects are minimal. However, the CAF is still forced to follow the lead of the World Bank and other MDBs in maintaining higher capitalization ratios than it might otherwise, to placate bond markets that have come to accept the World Bank’s financial ratios as “normal” for an MDB. The IADB falls between the World Bank and CAF,

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<sup>75</sup> IADB ED interview, January 13, 2012.

<sup>76</sup> World Bank ED interview, January 13, 2012.

<sup>77</sup> CAF annual reports 1995-2009.

<sup>78</sup> CAF, 1995.

<sup>79</sup> CAF annual report 2009.

following a similar pattern as the World Bank in relation to capitalization and equity, but closer to the CAF in relation to net income allocations for special purposes. Evidence suggests that the greater voting strength of borrowers gives them a stronger voice in keeping net income (and hence loan charges) as low as possible, although the U.S.'s veto power over capital increases did result in an agreement to allocate net income to Haiti as part of the most recent capital increase.

#### **Section 4: Conclusion**

The intention of this paper has been to verify whether and how the relative interests of borrowing and non-borrowing shareholders influence the price of loans offered by MDBs to borrowing countries. The evidence indicates that shareholder balance of power does indeed causally shape many financial considerations that impact the cost of each MDB's loans, in ways that generally conform to the positioning of the World Bank at one end of the spectrum, the CAF at the other, and the IADB in the middle.

The World Bank—with dominant voting power by non-borrowing, wealthy countries—has, on the one hand, better access to international capital markets at lower rates, and on the other hand, incentives to boost net income at the expense of borrowing countries to protect and further the interests of non-borrowing shareholders. Hence, while the World Bank can raise capital at extremely low rates, it does not pass on this low cost of funding to borrowers to the degree that it might otherwise.

The CAF, controlled almost entirely by borrowing countries, is at the other end of the spectrum both regarding capital market access—which is much more tenuous due to the lack of wealthy shareholders—and net income incentives—which are almost non-existent, with the CAF resolutely minimizing the cost to borrowers above all other considerations. This dichotomy with the World Bank holds true in all aspects except for the case of maintaining an extremely high (compared to private banks) equity to loans ratio, which is due to the market-defining example set by the World Bank, and followed by other MDBs to meet market expectations for how an MDB should manage its finances. The CAF's strong efforts to hold down loan costs have meant that in times of low global interest rates and narrowing spreads on MDB funding (such as the mid 2000s), the interest rate charged on CAF loans to borrowing countries has come down almost to the level of the World Bank.

The IADB, with a slim voting power majority of borrowing countries, falls somewhere in between the two extremes, although it tends more toward the World Bank than the CAF. The fact that the IADB has a number of wealthy non-borrowing shareholders defines its AAA status and excellent access to low-cost financing, despite the fact that non-borrowers do not hold a majority on the board. Regarding net income allocation, the IADB appears to act more like the World Bank in relation to capitalization ratios and the uses of reserves to build equity as opposed to paid-in capital, while it is more like the CAF in that it allocates very little net income to special shareholder projects, concessional financing or debt relief. This lack of allocations to special purposes may help offset the IADB's slightly higher borrowing cost, thus bringing down the cost of its loans to the same level or even at times below that of the World Bank.

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## **Annex: Comparing the Pricing of MDB Loans**

The first step in considering the differential impacts of shareholder composition on the financial characteristics of three MDBs is to simply compare what each MDB charges a country to borrow. In the end, MDB financial characteristics are only important in how they impact the cost of their loans. Unfortunately for social scientists—to say nothing of borrowing countries themselves—it is no simple task to directly compare the costs of MDB loans. To do so requires a short detour into some financial issues that might seem more suited to corporate finance as opposed to political economy research project, but which are extremely important to the ways in which MDBs and borrowing countries interact.

The first complicating issue for cost comparison is that MDB loan products and terms have varied considerably over time, and most MDBs currently offer a menu of options to borrowers. For much of their history, both the World Bank and the IADB offered a single type of loan for non-concessional borrowers: a loan with a fixed (as opposed to floating) interest rate markup over the MDB's own cost of borrowing, a single maturity, disbursement and repayment schedule, and always in US dollars. Both MDBs added a mark-up over the cost of borrowing to cover administrative costs and generate a certain level of net income (discussed further in Section 3). Because loans were disbursed and repaid over many years, this led to both MDBs being exposed to a certain degree of interest rate risk—if their own cost of borrowing were to increase, but the contractual interest rate to borrowers did not adjust, it would result in a smaller spread or even a loss for the MDB.

When interest rates began rising sharply in the early 1980s, the World Bank began to face severe financial difficulties because of this dynamic. As a result, the World Bank modified the fees it charged on loans and changed to a variable spread lending rate system, in which rates were adjusted semi-annually to reflect the World Bank's evolving cost of borrowing. This placed the risk of interest rate fluctuations on the borrower, rather than the World Bank. In response to requests from borrowers, a fixed-spread loan product was reintroduced in 1995, now including a risk premium that made the loan considerably more expensive than variable rates, to compensate for the World Bank's potential interest rate risk. With some modifications, this basic two-option system continues today. Borrowers can choose from either a fixed or variable spread over the London Inter-bank Offer Rate (Libor), the former with an added risk premium charge.<sup>80</sup> The IADB has generally followed the World Bank's lead in this regard, although with somewhat of a time lag. Currently it also offers a fixed-spread and a variable spread loan instrument.<sup>81</sup> The CAF, by contrast, has always worked with variable spread loans, and only recently instituted a fixed spread option for borrowers.<sup>82</sup> Apart from these changes in interest rates, all three MDBs have at different times offered options regarding maturities, disbursement and repayments, currencies, and interest rate

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<sup>80</sup> Historical information on World Bank loan terms comes from World Bank 2007, Annex 1; current terms are detailed on the World Bank's webpage at [http://treasury.worldbank.org/bdm/pdf/Pricing\\_Basics.pdf](http://treasury.worldbank.org/bdm/pdf/Pricing_Basics.pdf) (accessed March 3, 2011).

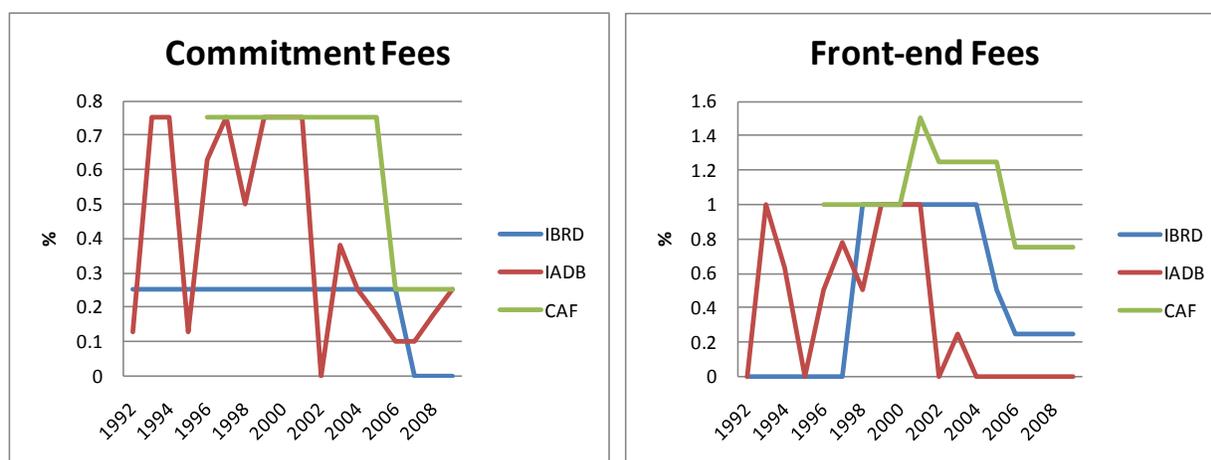
<sup>81</sup> Current IADB loan terms can be viewed at <http://www.iadb.org/en/about-us/idb-financing/financial-terms-of-loans,6037.html>; historical interest rates and fees are available at <http://www.iadb.org/en/about-us/idb-financing/interest-rates,6050.html> and <http://www.iadb.org/en/about-us/idb-financing/ordinary-capital-loan-charges,6052.html>, respectively. All websites last accessed March 3, 2011.

<sup>82</sup> Information on CAF loan terms (both historical and current) was made available to the author by CAF Treasury officials.

and/or foreign exchange rate hedging instruments. The intricacies of these differences need not concern us overly here.<sup>83</sup>

The main point to take away is that one cannot simply compare the interest rate on different MDB loans over time, since the World Bank and IADB offer more than one type of loan, and loan types have varied within the same MDB over the years. Comparing the interest rate on a variable spread loan based on Libor with a fixed spread loan based on an MDB's cost of funding is to compare apples and oranges. To deal with this, I compare two main lending instruments: (i) Libor-based variable spread loans and (ii) adjustable spread loans based over MDB cost of funding, rather than over Libor. The Libor loans began in 1995 for the World Bank and 2003 for the IADB, and are available from 1996 to 2009 for the CAF.<sup>84</sup> The adjustable spread loans began in 1996 for the World Bank and 1997 for the IADB. They were discontinued by the World Bank in 2009, and were never offered by the CAF. While these two series are far from ideal, they do offer a reasonable basis of comparison for similar loan instruments across the MDBs for a number of years, to give at least an approximation of different costs faced by borrowers.

A second major complication in comparing the loan costs of MDBs is the use of fees, which are added on to the interest rate of the loan. Fees for all three MDBs come in two varieties: a front-end fee and a commitment fee. A front-end fee is simply a one-time charge intended to cover the costs of preparing and administering the loan, and is similar to fees used by private banks. The commitment fee is a charge on all undisbursed loan amounts, and is unique to MDBs, since of course private lending institutions disburse loans immediately in their entirety. The commitment fee is intended to cover the MDB's carrying cost of holding in liquid assets to cover the undisbursed loan amount (instead of putting it to another, more profitable use), and serves to encourage borrowers to disburse their loans in a timely manner. This is a particular problem for MDBs in long-term investment projects that are delayed for various reasons, such as lack of country counterpart funding. Fees have varied widely between each MDB and over time (Figures 4.1 and 4.2). Because of the considerable additional cost they imply for borrowers, all fees must be taken into account to give a realistic comparison of borrowing costs from each MDB.



Source: World Bank (IBRD) 2007 and <http://treasury.worldbank.org/bdm/hm/ibrdr.html>; IADB (<http://www.iadb.org/en/about-us/idb-financing/ordinary-capital-loan-charges.6052.html>), using the average of semester rates for each year; CAF supplied by CAF treasury for years 1996-2009 only.

<sup>83</sup> Although the evolution of loan terms will be discussed further in Chapter 6.

<sup>84</sup> CAF used Libor-based loans earlier, but only made data available to the author from 1996.

To incorporate loan fees into the annual interest rate and arrive at a single comparable annual “all-in” cost for each MDB, I utilize a methodology employed by the World Bank Treasury for generating comparisons between the cost of World Bank loans and other MDBs in a given year. This involves generating an annualized value for each of the fees, over the entire life of a loan, and adding that on to the annual interest rate charge. It is important to note that the methodology is of necessity not exact. To make an exact comparison would require including the maturity and disbursement/repayment profile for each loan undertaken by an MDB—obviously a monumental task even for a single year, much less over several years. Instead, the World Bank Treasury methodology assumes an average loan maturity of 17 years and a standardized disbursement/repayment profile. While these assumptions do not hold in reality, they do allow for a useful and relatively accurate comparison between the total cost borrowers face from each MDB. Using this methodology, I compare all-in loan costs (interest rate and annualized fees) for the two types of loans mentioned above for the MDBs in question (Figures 4.3 and 4.4).<sup>85</sup>

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<sup>85</sup> An Excel spreadsheet with the formulas used by the World Bank was provided to the author by World Bank Treasury staff in November 2010.