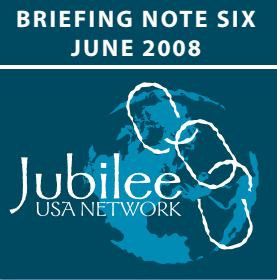




**American Friends  
Service Committee**



**BRIEFING NOTE SIX  
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## **World Bank Group Resources & Debt Cancellation**

By Thomas Chupein

American Friends Service Committee • 1501 Cherry Street • Philadelphia, PA 19102  
tel 215.241.7000 • [africa@afsc.org](mailto:africa@afsc.org) • [www.afsc.org/economic](http://www.afsc.org/economic)

Jubilee USA Network • 222 E Capitol St NE • Washington, DC 20003  
tel 202.783.3566 • fax 202.783.3566 • [coord@jubileeusa.org](mailto:coord@jubileeusa.org) • [www.jubileeusa.org](http://www.jubileeusa.org)

## EXECUTIVE SUMMARY

Debt cancellation provided over the last decade has proven a highly effective tool to combat poverty. But even with the laudable efforts of the Heavily Indebted Poor Countries (HIPC) initiative and Multilateral Debt Relief Initiative (MDRI), low-income countries continue to send \$100 million every day to wealthy bilateral creditors, the International Monetary Fund and the World Bank. This new paper by Jubilee USA and the American Friends Service Committee identifies up to \$23.4 billion in World Bank resources that could be mobilized to fund a significant portion of the cost for further debt cancellation efforts.

In a recent review by the World Bank of its capital adequacy strategy<sup>1</sup>, the Bank notes that the International Bank for Reconstruction and Development (IBRD) has a “capital buffer” of \$10 billion. The Bank also assumes a 3% annual loan growth rate through 2028. This projected growth rate is unlikely and unreasonable based on the steady decline in IBRD lending, which dropped nearly 20% in the last five years alone. In this joint paper, we estimate that the Bank could mobilize up to \$11 billion from reserves by 2020 without affecting its AAA credit rating, based on a more reasonable assumption of a 0% loan growth rate. In addition to a transfer from reserves, this paper concludes that the IBRD could transfer an additional \$500 million per year from its net income to yield up to \$6.5 billion by 2020. For the last 10 years, the IBRD has had an average annual profit of \$1.7 billion; an additional annual transfer of \$500 million could be made without affecting the Bank’s operational ability or credit rating.

In addition to the \$17.5 billion that the Bank could mobilize from IBRD reserves and annual income, the paper estimates the Bank could generate as much as \$5.9 billion from International Finance Corporation (IFC) reserves and income transfers by 2020. With a one-time transfer of 20% of its undesignated retained earnings, the IFC could generate \$2 billion for debt cancellation. With an additional transfer of \$300 million each year from its operating income, the IFC could mobilize another \$3.9 billion by 2020. This is a conservative proposal, and represents only 20% of the IFC’s average annual income for the last five years.

The paper concludes that by employing the three strategies above, the World Bank could mobilize as much as \$23.4 billion of the Bank’s additional resources toward the cost of World Bank debt cancellation, without compromising the Bank’s operational capacity or financial strength.

<sup>1</sup> “Review of IBRD Strategic Capital Adequacy.” (2008). Washington, D.C.: World Bank Group.

In the decade since the introduction of the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), \$70 billion in low-income country debt has been cancelled (net present value). It is expected that after all eligible countries reach completion point in these programs, total debt cancellation will exceed \$100 billion. Despite these important efforts, the world's most economically impoverished countries continue to send \$100 million every day to the International Monetary Fund (IMF), the World Bank (the Bank) and other wealthy creditors in order to service debt.

Ample evidence demonstrates that debt cancellation is an effective tool by which to reduce poverty.<sup>2</sup> This paper identifies one potential source to help fund an expansion of debt cancellation to additional low-income countries provided they demonstrate the commitment and capacity to direct released funds towards poverty eradication programs.

It should be noted that there are a number of ways to mobilize sufficient resources to finance expanded debt cancellation such as that proposed by the Jubilee Act for Responsible Lending and Expanded Debt Cancellation (HR.2634/S.2166). One important source of funding is the limited, strategic sale of IMF gold reserves<sup>3</sup>, which have a current market value of nearly \$100 billion.<sup>4</sup> This method provides purely additional funds and does not require higher aid budgets. Another important additional source of funds — reviewed in detail in this note — is the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), both members of the World Bank Group, which together could mobilize up to \$23.4 billion by 2020. This would require less than 5% of the Bank's vast assets and would not significantly impact the Bank's operations or credit rating. While the bulk of the funding necessary to finance multilateral debt cancellation could come from these sources in the IMF and World Bank, expanded commitments from World Bank donor governments could also be necessary to finance the debt cancellation that is needed to help meet the Millennium Development Goals (MDGs).

This briefing note argues that the reserves and operating income of the IBRD and IFC can finance a significant level of debt cancellation and further the Bank's mission to end poverty.

### THE FINANCIAL POSITION OF THE IBRD AND IFC

The IBRD is one of the most resource-rich financial institutions in the world, with more than \$208 billion in effective capital. In fact, the IBRD is more financially sound now than ever before in its 64-year history. It perennially nets an income in excess of \$1.5 billion. These high profits have contributed to the Bank's record-high level of reserves, which now surpass \$38 billion.

As its resources climb, the IBRD's lending has dropped to 44% of capacity. Its current equity-to-loans ratio (E/L ratio), a key indicator of financial strength, stands at 34.5%. This represents an increase of 38% in only six years. Its capital adequacy ratio, another key financial indicator, exponentially exceeds that of other highly rated banks.<sup>5</sup> Put simply, the IBRD's financial position far exceeds what is necessary to safeguard its normal operations and perfect AAA credit rating.<sup>6</sup> As we will see, the World Bank shares this view.

The IFC, the private sector development arm of the World Bank, has a similarly powerful financial profile.<sup>7</sup> Total assets exceed \$40 billion, with undesignated retained earnings exceeding \$10 billion. The IFC has turned a profit every year since its inception in 1956. In fact, the IFC realized a record-high \$2.6 billion income in FY 2007 — 85% higher than 2006 and nearly 400% higher than 2003. Its total capital increased by 27.6% in the past year alone.

### THE WORLD BANK CAPITAL ADEQUACY REPORT

Recently, the World Bank produced an internal review of its capital adequacy strategy.<sup>8</sup> This report corroborates the financial picture described above and makes clear that the Bank's current equity to loans ratio is significantly higher than what is necessary to cover risk and generate sufficient income. The IBRD identifies a target E/L ratio range of 23-27%. Given that the projected E/L ratio for FY 2008 is 38%, 11 percentage points higher than the upper bound, the report identifies a \$10 billion "capital buffer" and proceeds to lay out three strategies by which this money could be mobilized:

- (a) Increased external transfers to entities such as IDA.
- (b) Targeted subsidization of interest rates for selected development initiatives. (\$10b @ LIBOR-200bp)
- (c) Re-investment of the resources in a more "diversified higher-return", yet riskier portfolio. (\$10b @ LIBOR+300bp)

Figure 1 on the next page reproduces the IBRD's projected outcome of the abovementioned scenarios through FY 2028.

<sup>2</sup> "International Development Association and International Monetary Fund Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation." (2007). Washington, D.C.: IDA and IMF.

<sup>3</sup> "Recent Developments on IMF Gold Sales and Debt Cancellation." (2008). Jubilee USA Network.

<sup>4</sup> Calculation based on market value of gold, April 2008.

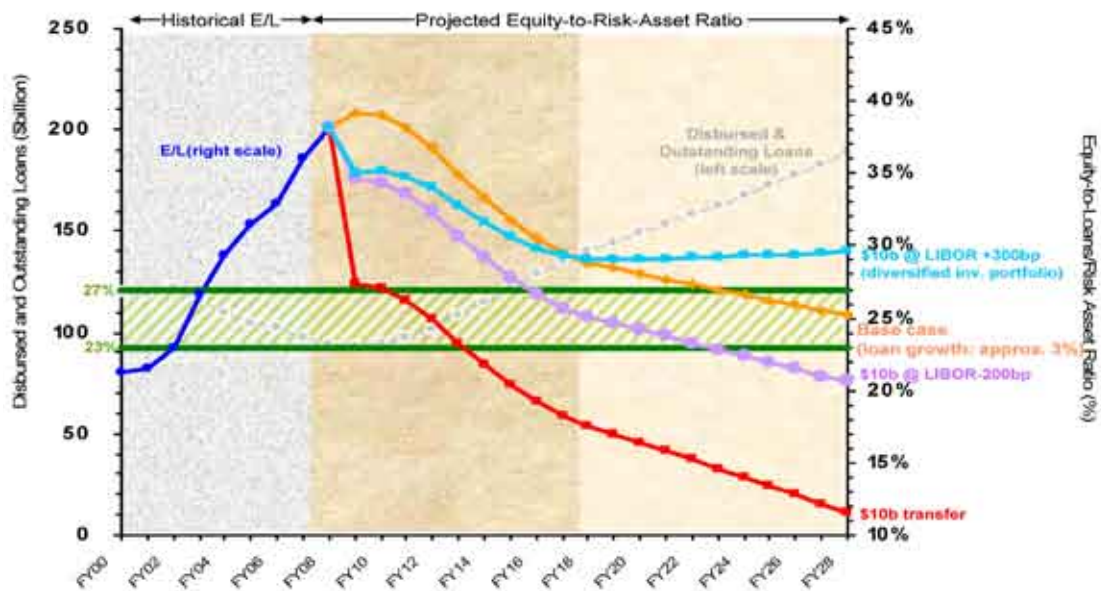
<sup>5</sup> See Table 1.

<sup>6</sup> See Table 2.

<sup>7</sup> See Table 3.

<sup>8</sup> "Review of IBRD Strategic Capital Adequacy." (2008). Washington, D.C.: World Bank Group

**FIGURE 1: IBRD'S OPTIONS FOR USING THE CAPITAL BUFFER**

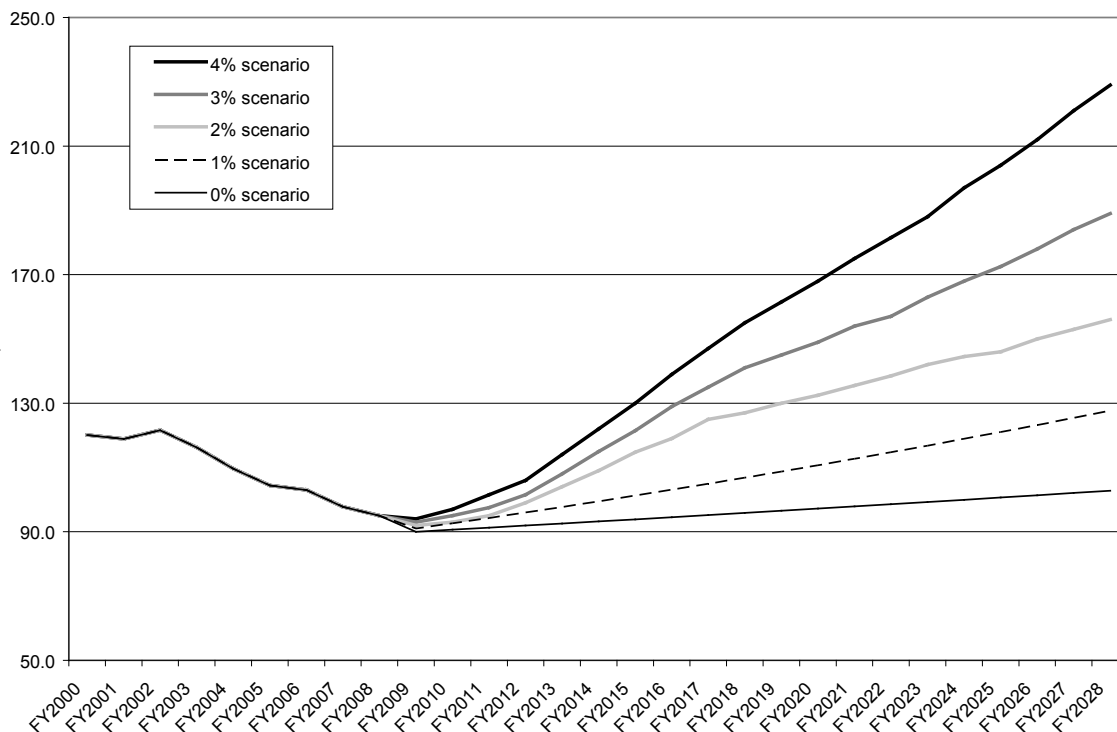


Source: IBRD, 2008.

The Bank paper favors the third strategy — diversification of the Bank’s investment portfolio to include higher-return risk assets — arguing that over the long-term such investment will guarantee higher income and sufficient capital adequacy. This call for increased income generation stems from the Bank’s concern that over time this \$10 billion capital buffer will evaporate.

This expectation of future reserve loss is predicated on a key assumption: an unsubstantiated loan growth rate projection of 3% per year through 2028. Historical trends in Bank lending do not in any way support this projection. The total amount of outstanding loans owed to the Bank has dropped by nearly 20% in the last five years alone. In fact, lending has actually decreased at an average annual rate of 2% since 1995. Combined with the fact that many of the Bank’s largest historical borrowers now enjoy increased access to global financial markets and hold an unprecedented level of reserves, a 3% annual loan growth projection simply does not square with reality. For the sake of comparison, Figure 2 below presents the World Bank’s loan projection rates alongside more realistic loan growth rates of 2%, 1% and 0%.<sup>9</sup>

**FIGURE 2: ESTIMATED LOAN GROWTH SCENARIOS**

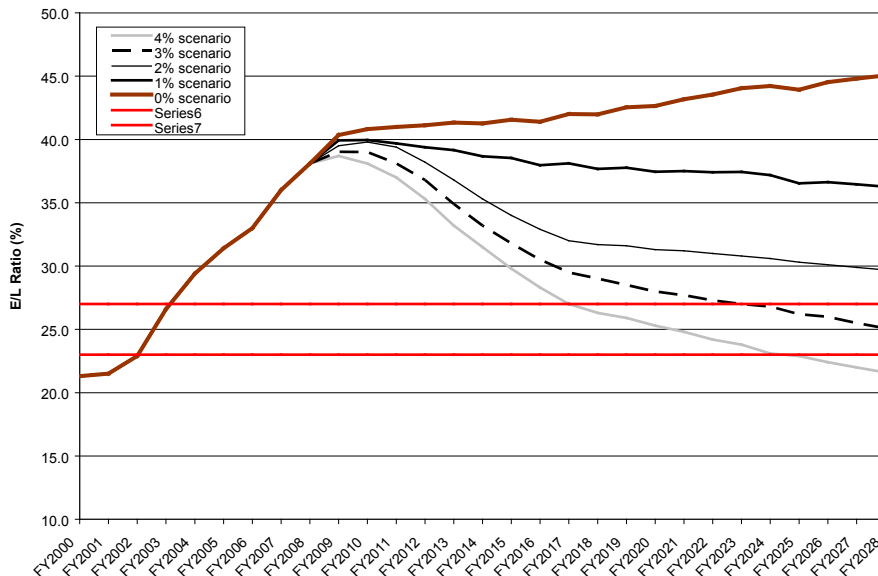


Source: Center for Economic and Policy Research (CEPR), 2008

<sup>9</sup> Jubilee USA and the American Friends Service Committee would like to thank the Center for Economic and Policy Research for their assistance with research and analysis of IBRD scenarios.

If the World Bank’s unrealistic projections of nearly \$200 billion in outstanding loans by 2028 do not materialize, its \$10 billion capital buffer will not disappear. Figure 3 below illustrates projections for the E/L ratio under the same loan growth scenarios as above. These “base-case” projections assume that none of the strategies discussed by the Bank paper are employed. Note that under the more realistic loan growth scenarios (0%-2%), the E/L ratio in 2028 ranges from 30%-45%, significantly higher than the Bank’s target range of 23%-27%.

**FIGURE 3: E/L RATIO UNDER DIFFERENT AVERAGE ANNUAL LOAN GROWTH SCENARIOS**

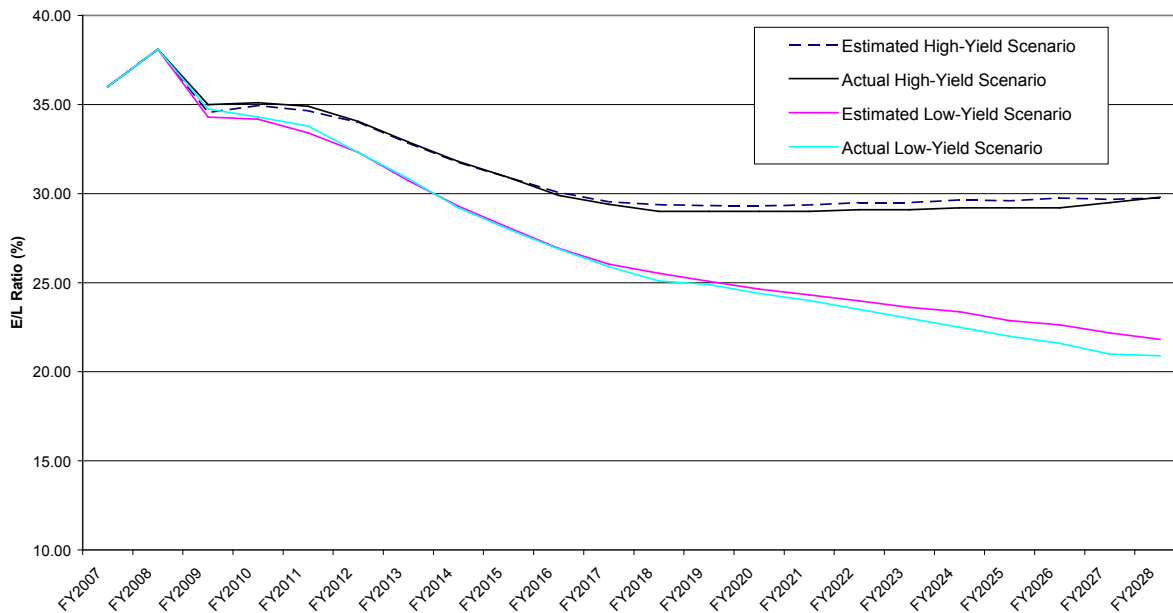


Source: CEPR, 2008

While strategic investment of a portion of the capital buffer may be a wise long-term strategy to generate income and ensure greater future transfers to IDA, in the short-run the favored investment strategy of the full \$10 billion does not advance the Bank’s mission to reduce poverty.

In order to evaluate alternative scenarios to the ones proposed by the IBRD memo, we have approximated the original memo’s scenarios, since the underlying data and assumptions are not available. The details of how this approximation to the original model is done can be found in the Appendix. However, note that in Figure 4 below, the differences between the original and estimated scenarios for the E/L ratio are surprisingly small, given the lack of information available.

**FIGURE 4: BANK VS. ESTIMATED HIGH-YIELD (\$10BN AT LIBOR+300BP) AND LOW-YIELD (\$10BN AT LIBOR-200BP) SCENARIOS**



Source: CEPR, 2008

**MOBILIZING IBRD RESOURCES FOR DEBT CANCELLATION**

The IBRD and IFC can mobilize up to \$23.4 billion by 2020 to fund significant debt cancellation without affecting the Bank’s operations, credit rating or the interest rates at which it borrows. Here’s how:

**A) The Bank can employ a mixed strategy for its capital usage and generate up to \$11 billion from its general reserves.**

One portion of the \$10 billion could be transferred to IDA to invest and fund debt cancellation in the short-term as in option (a). The remaining portion could be invested in a high-yield portfolio as suggested in option (c) in order to ensure a higher level of allocable income in the future. Note that under scenario (c) in Figure 1, the E/L ratio seems to level off at 30% after 2018 (and in fact, seems to slightly increase after that year). This suggests that only a portion of the \$10 billion capital buffer would be needed to maintain an E/L ratio around the upper bound of the target range (27%). The rest can be used for debt cancellation. Note: this assumes 3% average annual loan growth.

If lending actually tracks at a rate lower than the Bank projection of 3% per year, the portion of the capital buffer that could be used for debt cancellation increases. Therefore, it is advisable to regularly review any capital usage strategy (e.g. every 5 years) in order to evaluate whether the Bank is accumulating additional equity due to a continued decrease in lending or if greater income generation proves necessary.

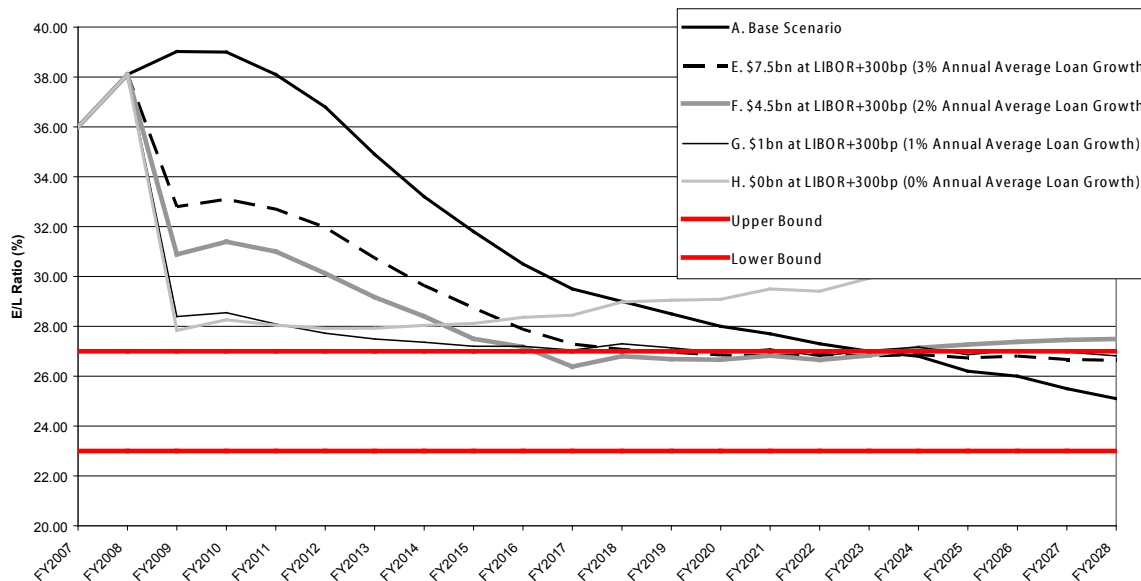


Figure 5 shows the original base case scenario alongside the mixed strategy proposal under the Bank projection of 3% annual loan growth as well as 2%, 1% and 0% loan growth rates.

**FIGURE 5: ALTERNATIVE USES OF IBRD CAPITAL BUFFER**

Source: CEPR, 2008

As shown in Figure 5, in order to sustain an E/L ratio along the upper bound of the capital adequacy target range established by the IBRD (27%), our model suggests that only around \$7.5 billion needs to be invested, given an annual loan growth rate of 3% per year through FY 2028. This leaves around \$2.5 billion available immediately for debt cancellation. However, if we project a loan growth rate of 1%, then the amount of resources available for debt cancellation, while ensuring the E/L ratio remains at the upper bound of the Bank target range, climbs to \$9 billion. With an annual loan growth of negative 2% since 1995 — which includes the spike in lending associated with the Asian Financial Crisis in 1997 to 1998 — we contend that 1% loan growth through FY 2028 is a reasonable forecast.

Under the assumption of a \$9 billion transfer, it is important to note that a significant portion of it will get invested as the amount needed for debt cancellation for the World Bank totals an estimated \$4.7 billion for the first three years under proposed legislation. While economic modeling is underway, it is expected that investment income would amount to at least \$1 billion before the principal is exhausted. If the Bank experiences a flat loan growth rate, which is zero percent, through 2028, then the entire \$10 billion capital buffer could be directed to IDA and with subsequent investment income, could generate at least \$11 billion total for low-income country debt cancellation.

**B) The Bank can transfer an additional \$500 million per year from its net income to yield up to \$6.5 billion by 2020.**

For the last 10 years, the IBRD has had an average annual profit of \$1.7 billion. The Bank report cited above projects that in FY 2008 the IBRD would have a net allocable income of \$1.25 billion. Since 2004 it has transferred an average of approximately \$600 million

each year from this income to IDA and the HIPC Trust Fund.

Calculations for the above E/L ratios deduct the entire projected allocable income under option (c) — investment of the entire \$10 billion capital buffer in a high-yield portfolio (see Figure 1) — before deriving estimated equity values for each mixed-strategy scenario shown in Figure 5. Therefore, a transfer of reserves to IDA for the purposes of debt cancellation would not affect core allocable income vis-à-vis the estimated E/L ratios presented under the mixed strategy proposal.

Under Bank projections shown in Figure 1, option (c) as well as in our mixed scenarios (Table 5, options (e) through (h)), core allocable income would average \$1.56 billion annually between FY2008-28. Increasing income transfers to IDA to 70% of allocable income would provide an additional \$500 million annually and would generate \$6.5 billion in net present value terms by 2020 for purposes of debt cancellation without impacting the Bank's financial strength or sustainability. Since 100% of allocable income is deducted before deriving the estimated equity values in this paper's mixed-strategy scenarios, the proposed increase in income transfers presented above is quite reasonable.

### **MOBILIZING IFC RESOURCES**

The International Finance Corporation (IFC) can generate as much as \$5.9 billion from reserves and income transfers by 2020.

With a transfer to IDA of 20% of its undesignated retained earnings the IFC could generate \$2 billion for debt cancellation purposes and still retain more in the account than it held just last year. In 2006, the IFC initiated income transfers to IDA with a \$150 million grant. In light of record high profits, the IFC committed to an increased income transfer of approximately \$600 million annually over the three-year IDA 15 replenishment period. With an additional transfer of \$300 million each year from its operating income (\$2.6 billion in FY 2007), the IFC could generate another \$3.9 billion by 2020. Such a transfer proposal represents only 20% of the IFC's average income for the last five years. It leaves the institution with ample resources to expand its operations and its perfect AAA credit rating.

The IFC's stated goal is to "create opportunity for people to escape poverty and improve their lives." Mobilizing a small portion of its vast resources to help finance debt cancellation for low-income countries is a proven means by which the IFC can achieve substantial progress toward this goal.

Any IBRD and IFC resources mobilized for debt cancellation in this manner would not come at the financial expense of other middle- or low-income World Bank borrowing governments. In other words, this paper's proposals are not tantamount to "robbing Peter to pay Paul." The resources that would be dedicated to debt cancellation come from existing allocable income and from a capital buffer that, if transferred and invested at the appropriate level, would ensure a sufficient level of reserves and capital adequacy in both the short- and long-term to prevent further borrowing by the Bank. Without the need to increase income or borrow in order to replenish reserves, there would be no legitimate reason to increase interest rates on loans to borrowing governments.<sup>10</sup> Finally, any income and reserve transfers to IDA would be purely additional income and would not limit IDA's capacity to extend grants and credits to eligible countries at its current concessional rates.

Employing the three strategies above, the World Bank could mobilize as much as \$23.4 billion toward the cost of World Bank debt cancellation without compromising the Bank's operational capacity or its financial strength.

### **RECOMMENDATIONS**

Debt cancellation is a proven means to reduce poverty. In recent years, recipient governments have invested released funds in health care, education, infrastructure, job creation and economic development initiatives. The Jubilee Act for Responsible Lending and Expanded Debt Cancellation (HR 2634/S2166), a bill pending in the U.S. Congress, would expand debt cancellation to additional low-income countries and help millions more people exit poverty.

The World Bank is committed to "Working for a World Free of Poverty." As one of the richest institutions on earth, the Bank has accrued assets that exceed the combined economies of the 70 most low-income countries in the world. Its annual income currently exceeds the GDP of at least 12 individual African states. To fund debt cancellation for all eligible low-income countries, additional transfers from the IBRD and IFC to IDA would require less than 5% of the Bank's vast assets and would not impact its operational capacity or financial strength. This relatively small portion of the World Bank's assets could go a long way towards achieving the

<sup>10</sup> Furthermore, if any borrowing did become necessary in the future, the Bank's credit rating would remain the same as would the rates at which it borrows, thereby negating any need to pass on higher borrowing costs to borrowing governments. See Kapoor, Sony. (2005). "World Bank Resources and Debt Cancellation."

<sup>11</sup> Inclusive of debt owed to IDA, the Inter-American Development Bank (IDB), the Asian Development Fund (AsDF), the African Development Fund (AfDF) and others.

Bank's stated purpose and provide a significant portion of the necessary funding to provide 100% multilateral debt cancellation<sup>11</sup> for those countries likely to be immediately eligible under the Jubilee Act. Based on the evidence presented, Jubilee USA and the American Friends Service Committee wholeheartedly support appropriate use of IBRD and IFC resources to expand debt cancellation to additional low-income countries.

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<sup>12</sup> Banks: Bank Nederlandse Gemeenten, Landwirtschaftliche Rentenbank, Rabobank Group, UBS AG, Barclays Bank plc, BNP Paribas, Danske Bank, Deutsche Bank AG, ABN Amro Bank N.V., Societe Generale.

## APPENDIX

The IBRD memo has several figures from which visual estimates can be derived for their projections of the E/L ratio, the level of loans outstanding and disbursed and the impact on the IBRD's allocable income. With this information, it is possible to derive equity levels and plausible assumptions about the market interest (LIBOR) rate.

In any given year (t), the change in equity is equal to the income generated with the previous year's equity level minus allocable income (i.e. amounts available for transfers to the International Development Association and for other uses). The level of loans outstanding and disbursed is given, so that the Equity-to-Loans Ratio can be computed. This lending level grows at an annual average rate of 3 percent over the FY2007-2028 period, but it first drops in the first two years to start growing again in FY2010. Since this 3 percent loan growth scenario is the base case scenario, the level of lending is constant in the alternative scenarios.

$$1. (E / L)_t = [Et-1 * (1+rt) - At] / [Lt-1 * (1+ st)]$$

In the high-yield scenario, the capital buffer of \$10bn (K0) is taken out of equity at the beginning of FY2009 and put into a high-yield portfolio at an interest rate equal to the market rate (LIBOR rate) plus 300 bp. In our estimates, the average annual market rate (R) used is 2 percent. The interest on this capital buffer is reinvested every subsequent year. At the same time, the capital buffer appears in the denominator as a risk asset, together with loans outstanding and disbursed, in the E/L ratio. Thus,

$$2. (E / L)_t = [E t-1 * (1+rt) + Kt-1 *(1+R+0.03)- At] / [L t-1 * (1+ st) + K0]$$

In the low-yield scenario, the capital buffer is used to subsidize loans and thus, the return is lower than under market conditions (assumed by the IBRD at a LIBOR rate of 200bp). Thus,

$$3. (E / L)_t = [E t-1 * (1+rt) + Kt-1 *(1+R-0.02)- At] / [L t-1 * (1+ st) + K0]$$

In the alternative scenario proposed here, the capital buffer K is lowered to \$5.5 billion.

Since the underlying data and assumptions used in the original IBRD calculations are unknown, the results obtained with the model outlined here represent a crude approximation of the original. Evidently, obtaining the original data and assumptions could lead to more accurate projections.

TABLE 1: CAPITAL ADEQUACY OF IBRD VIS-À-VIS OTHER HIGHLY RATED BANKS

BANK	CAPITAL ADEQUACY RATIO		ELR
	Tier One	Total	
Average for Ten Highly Rated Banks (AAA or AA) <sup>12</sup>	10.40%	13.60%	10.30%
Average for IBRD	77.10%	114.80%	135.10%

TABLE 2: KEY IBRD FINANCIAL DATA

YEARS	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
(in \$ millions)												
<b>Equity, Current Value</b>	28,300	27,228	26,514	28,021	29,289	29,744	32,466	35,675	36,421	36,943	37,590	38,613
<b>Equity</b>	--	--	--	--	--	29,570	32,313	37,918	35,463	38,588	36,474	39,929
<b>Reserves</b>	14,902	14,452	14,952	15,703	17,516	18,134	19,425	21,835	22,515	23,205	24,241	25,277
<b>Retained Earnings</b>	17,542	17,662	18,192	19,263	20,916	22,093	24,478	25,880	26,020	27,171	24,782	27,831
<b>Borrowings Outstanding</b>	96,719	96,679	103,589	115,739	110,379	106,757	110,263	108,554	108,066	101,297	95,835	87,759
<b>Total Loans Outstanding</b>	110,246	105,805	106,576	117,228	120,104	118,866	121,589	116,240	109,610	104,401	103,004	97,805
<b>Provisions for Loan Losses</b>	3,340	3,210	3,240	3,560	3,400	3,959	5,053	4,045	3,505	3,009	2,296	1,932
<b>Operating Income</b>	1,300	1,405	1,195	1,518	1,991	1,144	1,924	3,021	1,696	1,320	1,740	1,659
<b>Income Transfers:</b>	--	--	--	--	--	--	--	--	-645	-642	-650	-957
<i>To IDA</i>	--	--	--	--	--	--	--	--	300	300	400	800
<i>To HIPC Trust Fund</i>	--	--	--	--	--	--	--	--	240	290	210	0
<i>To Other Use</i>	--	--	--	--	--	--	--	--	105	52	40	157
<b>Equity to Loans, Current Value</b>	--	--	--	--	--	21.40%	23.10%	26.40%	29.10%	30.80%	32.40%	34.50%
<b>Equity to Loans</b>	21.80%	22.10%	21.40%	20.70%	21.30%	21.50%	22.90%	26.60%	29.40%	31.40%	33.00%	35.00%
<b>Reserves to Loans</b>	13.50%	13.70%	14.00%	13.40%	14.60%	15.30%	16.00%	18.80%	20.50%	22.20%	23.50%	25.80%

TABLE 3: KEY IBRD FINANCIAL DATA

YEARS	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
(in \$ millions)												
<b>Total Assets</b>	--	--	31,621	33,456	38,719	26,170	27,739	31,543	32,361	39,560	38,420	40,550
<b>Total Capital</b>	--	--	5,084	5,344	5,733	6,095	6,304	6,789	7,782	9,798	11,076	14,130
<b>Undesignated Retained Earnings</b>	--	--	--	2,998	3,378	3,723	3,938	4,425	5,193	6,871	7,859	10,723
<b>Operating Income</b>	--	--	212	249	380	241	161	528	982	1,953	1,409	2,611
<b>Capital Adequacy Ratio</b>	--	--	49%	48%	48%	48%	49%	45%	48%	50%	54%	57%