



# **World Bank (IBRD) Resources and Debt Cancellation**

**By**

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## **The context of the Paper**

One major reason why the ongoing discussions about multilateral debt cancellation has not yet produced concrete results is that there is no agreement about the best way to fund the debt cancellation. We feel that the funding for debt cancellation should be evaluated in tiered manner; the most desirable and least controversial source of funding should be exhausted before the next tier is mobilized.

The first tier, which is both additional and does not require higher aid budgets is the sale of IMF gold which can generate as much as \$35 billion to cancel both IMF and World Bank debt.

The second tier should be additional contributions by creditor countries as suggested in the current UK debt relief proposal. Together, these two sources of funds should generate enough resources to allow 100% multilateral debt countries for a number of the poorest countries in the world.

However, in case there is a requirement for residual funds, we believe that there exists a third tier of funds. The (IBRD) International Bank for Reconstruction and Development can generate as much as \$17.5 billion of resources without any significant impact on its operations.

This paper shows how this can be done

## **Executive Summary**

The IBRD is one of the most resource rich financial institutions in the world with more than \$236 billion in effective capital. It is financially very sound and is in fact stronger than it has ever been in its 60 year history. The net income has averaged \$1.95 billion in 2000-04 up from \$1.2 billion 1995-99 and the equity to loans ratio has climbed from 20.7% in 1999 to 29.3% in 2004. Moreover, for a number of years, the IBRD has been using only about 50% of its lending capacity. The IBRD has been accorded a AAA credit rating, the highest rating possible.

Since the IBRD is in such a robust financial situation, it can easily transfer up to \$10 billion from the \$37 billion that it holds as reserves and paid in capital for the purpose of the cancellation of poor country debt owed to IDA – the concessional lending arm of the World Bank. Additionally, the IBRD can appropriate as much as \$600 million every year from its net income which is at historically high levels. Such a transfer can generate \$7.5 billion by 2020.

The AAA credit rating of the IBRD, which is critical for its normal operations, is not affected by such transfers. In fact, according to analysis by Fitch, a respected credit rating agency the IBRD would still have more than 465% of the capital that it requires in order to hold on to a AAA rating after allocating \$10 billion from its reserves for debt cancellation.

The capital adequacy ratio (a measure of the financial strength of a financial institution) of the IBRD at 115% is 8 times that of other highly rated banks and the equity to loan ratio (another measure of financial soundness) is 13 times.

Such a strong balance sheet and political support from OECD countries means that the IBRD has one of the lowest borrowing costs in the international capital market and is able to borrow at interest rates only marginally higher than the rates at which the US government (traditionally considered the safest borrower) is able to borrow.

At such high levels of capital adequacy and equity to loans ratio, any further increase in the strength of the balance sheet does not lead to lower borrowing rates as the saturation point has been reached. Similarly, a decrease in the capital adequacy ratio from 115% to 107% will not result in any increase in the rate of borrowing.

The IBRD has two sources of funds, its equity & reserves and borrowing. These funds are then used in two ways – to buy liquid investments and to lend to borrowing countries. If the IBRD allocated \$10 billion from its reserves for debt cancellation then it would need to borrow an additional \$10 billion in the market to compensate. This would entail an additional interest cost of about \$260 million every year in the current interest rate environment.

The IBRD usually charges a slightly higher interest rate to its borrowers than what it borrows at in the capital markets and this generates a net income. The IBRD could finance the additional interest cost highlighted above by:

***Option I - Keeping lending interest rates constant and financing the additional interest expense through the net income. This would result in a 10-15% lower net income on average. Given that the IBRD has been earning record levels of net income, this would not affect operations.***

***Option II - Keeping net income constant and financing the additional interest cost through higher lending interest rates. This would increase prevailing lending rates by about 6% of the lending rate. So the 4.02% that the IBRD charged in 2003-4 would need to have been 4.26%<sup>1</sup>.***

***Option III - Or by distributing the cost between Option I and Option II. This would entail a net income decrease of about 10% and an interest rate increase of about 3% of the prevailing level***

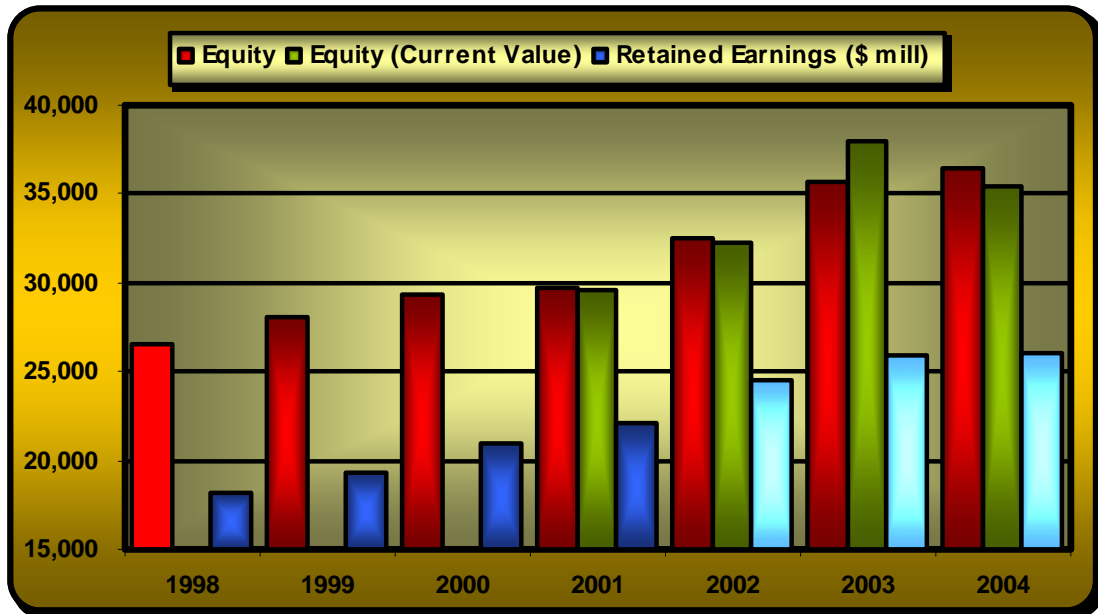
**We very strongly favour Option I for the IBRD financing of debt cancellation as it does not entail a higher borrowing cost for IBRD borrowers and does not affect the normal operations of the IBRD in any significant way.**

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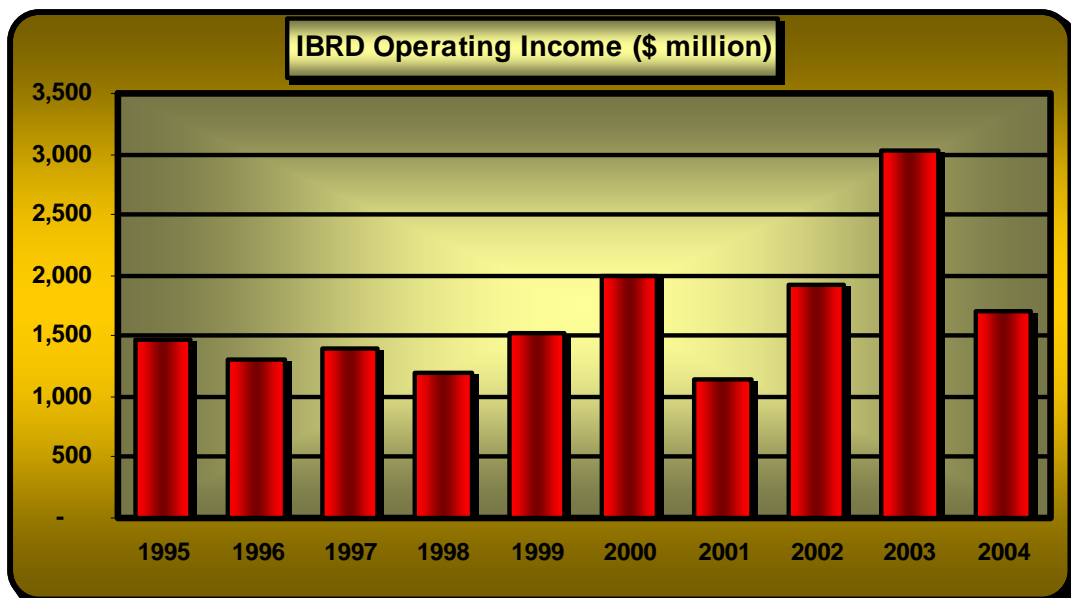
<sup>1</sup> Most IBRD borrowers derive significant financial advantage by being able to borrow at a discount to the much higher market rate that they would need to pay to borrow directly in the capital markets. This benefit has been in excess of \$6 billion every year for the past three years. A small increase in the interest rate would mean that some of this benefit is eroded. In the case of Brazil, for example, which has saved about \$3.5 billion over the past 6 years, this benefit would have been about \$3.3 billion instead.

## The World Bank (IBRD) is in a very strong financial position

Both the IBRD (International Bank for Reconstruction and Development) and the IDA (International Development Association) are parts of the World Bank group. The IBRD, which is responsible for the non-concessional lending by the World Bank, is one of the most resource rich financial institutions in the world. It has more than \$236 billion of effective capital of which about \$37 billion is in the form of reserves and paid in equity and the rest can be drawn in case of need to pay liabilities arising out of borrowings. The IBRD has accumulated more than \$11 billion of reserves since 1998 while the level of borrowing and lending has remained roughly constant.



Concurrently, its net income has gone up averaging \$1.95 billion in 2000-2004 as compared to \$1.2 billion in 1995-1999. The equity to loans ratio, the banks own measure of financial prudence has climbed steadily from 20.7% in 1999 to 29.3% in 2004.



Every way one looks at it, the IBRD is in an enviable financial situation and currently using only about 50% of its lending capacity. We firmly believe that the IBRD has enough resources to fund significant amounts of poor country debt cancellation.

The Bank's own assessment<sup>2</sup> of its financial situation presented below seems to agree with ours

"The World Bank has been rated AAA, the highest possible rating available, for more than 40 years by the major credit rating agencies. This quality assessment is confirmed by the capital markets which have been welcoming World Bank debt instruments since the issuance of the first World Bank bond in 1947.

There are six main reasons for the high degree of quality of World Bank debt instruments.

First, World Bank debt is backed by the Bank's 184 sovereign shareholders. Second, the World Bank follows highly prudent financial policies that restrict its lending to a maximum of one dollar in loans per one dollar of total capital - the current ratio is as low as 53 cents in loans per one dollar of capital. The financial leverage is equally low as the World Bank's borrowings currently account for less than 60% of its total capital. Third, the World Bank has been consistently profitable with a net annual income exceeding USD 1 billion for over 15 years. Fourth, the World Bank maintains a highly liquid asset base in order to be flexible in the timing of its new debt issuance. Fifth, the World Bank's prudent lending policies, loan concentration limits ensure the high quality of the World Bank's loan portfolio. And finally, the World Bank only lends to sovereigns and sovereign-guaranteed projects and is recognized by the major rating agencies to enjoy a preferred creditor status with its borrower shareholders."

Below we consider a sources of funding for World Bank debt cancellation and show how this do not have any significant impact on any of the six factors, behind the AAA rating, that the World Bank has listed above.

### **It can generate up to \$17.5 billion of resources for debt cancellation**

We believe that for the purpose of debt cancellation, the IBRD could easily appropriate up to \$10 billion from its general reserve, which currently stand at \$21.5 billion (total equity \$37 billion). Such a transfer would merely take the IBRD's reserves to the level they were at in 1997 at which point the Bank was active and successful (and rated AAA) as it is now.

Such a transfer would be worth \$10 billion in NPV<sup>3</sup> terms.

We also argue that the IBRD could transfer up to \$600 million annually from its net income to the HIPC trust over the next 10 years. The IBRD's net income (profit) has

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<sup>2</sup> <http://www.worldbank.org/debtsecurities/faqs.htm>

<sup>3</sup> Net Present Value, All debt is not the same and it varies in terms of the interest rates, the period of repayment and other terms. In order to ensure comparability between debts owed at different terms, finance professionals use the concept of the Net Present Value which uses some assumptions to define how much the debt issued under various terms would be worth today.

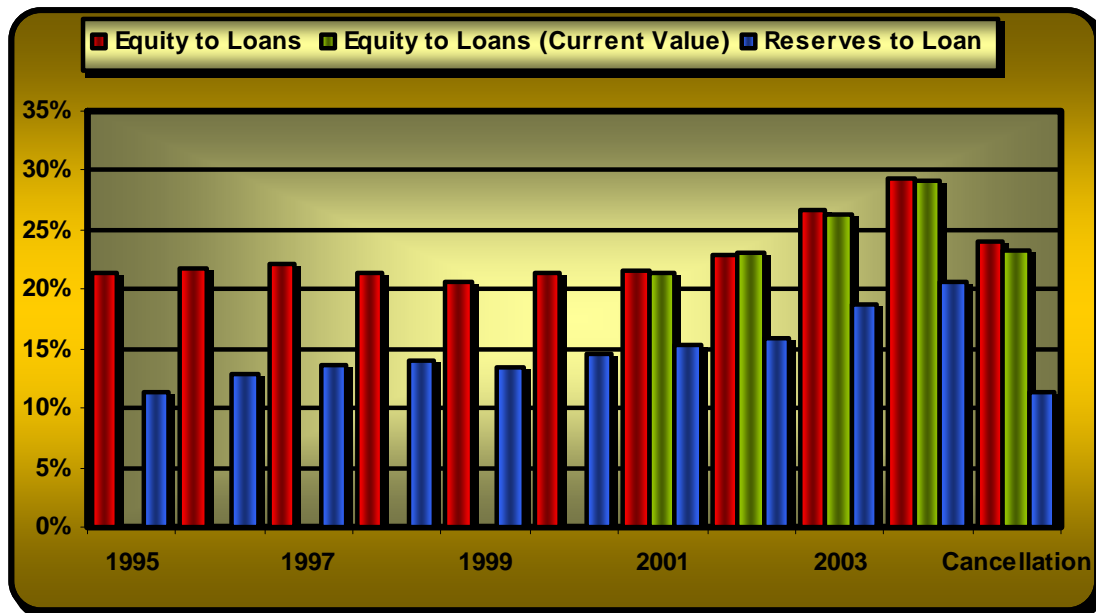
been more than \$1 billion annually for more than 15 years in a row and has averaged \$1.6 billion over the past 10 years.

Such a transfer of \$600 million every year till 2020 would generate<sup>4</sup> \$7.5 billion in NPV terms.

**Hence we maintain that the IBRD could easily afford to mobilize up \$17.5 billion in NPV terms for the purpose of IDA debt cancellation. In the past, the IBRD has already transferred more than \$7.5 billion to IDA from its annual earnings.**

**This would not jeopardize the financial strength of the IBRD**

The bank's own measure of prudence the equity to loan ratio has improved from 20.7% in 1999 to 29.4% in 2004. As the following graph illustrates, the cancellation of debt using IBRD reserves of \$10 billion would in fact only lower this to 24.1% which is still higher than it has been anytime in the bank's history except for the last two years.



We now assess the affects of these resource transfers on the major sources of strength for the IBRD balance sheet as listed by the IBRD itself.

*First, World Bank debt is backed by the Bank's 184 sovereign shareholders.*

Our proposal for resource transfers from the IBRD has no affect on the support from the 184 sovereign shareholders

*Second, the World Bank follows highly prudent financial policies that restrict its lending to a maximum of one dollar in loans per one dollar of total capital - the current ratio is as low as 53 cents in loans per one dollar of capital. The financial leverage is equally low as the World Bank's borrowings currently account for less than 60% of its total capital.*

<sup>4</sup> Using a discount rate of 3%

Our suggestions would have no impact on the Bank's policy of restricting its lending to a maximum of one dollar in loans per dollar of capital. It would, in the unlikely and extreme event of the Bank being stretched to its lending limit, decrease the lending capacity by 4.5%. However, given this small decrease and the fact that the Bank has never come close to reaching its lending limit, such an effect has no bearing on the Bank's financial strength or day to day operations.

In fact, as the Bank itself says, it is lending only at 53% capacity. As a result of the suggested transfer of resources, this capacity utilization would go up to 55%, a completely insignificant change. The Bank's borrowing is as it says, less than 60% of its capital; our suggestion would change it to about 62% - again an insignificant change.

*Third, the World Bank has been consistently profitable with a net annual income exceeding \$1 billion for over 15 years.*

The immediate transfer of \$10 billion would have a small impact<sup>5</sup> on the Bank's income generating capacity but given the high levels of income the Bank has been generating in recent years (\$3.4 billion in 2003) this would not materially affect its ability to consistently earn much more than \$1 billion every year.

*Fourth, the World Bank maintains a highly liquid asset base in order to be flexible in the timing of its new debt issuance.*

Given that this transfer of retained earnings can be done over a period of a year or more it gives the Bank ample time to manage its liquidity which is usually administered on a much shorter horizon. So the Bank can easily plan and time the transfer of the retained earnings so this has no discernable impact on liquidity. The regular income transfer of \$600 million that we have proposed would be known months and years in advance and hence can be factored into managing the liquidity position of the Bank. Also, \$600 million is only about 2% of the Bank's normal liquid assets of \$25 billion.

*Fifth, the World Bank's prudent lending policies, loan concentration limits ensure the high quality of the World Bank's loan portfolio.*

The transfer of income and retained earnings has no impact on the Bank's prudent lending policy or the quality of the loan portfolio.

*Finally, the World Bank only lends to sovereigns and sovereign-guaranteed projects and is recognized by the major rating agencies to enjoy a preferred creditor status with its borrower shareholders.*

The preferred creditor status of the IBRD would not be in question most debts to be cancelled are IDA debts. The IDA is legally a distinct entity.

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<sup>5</sup> The Bank has earned between 1% and 2% margin on its lending (between its lending income and lower borrowing costs). This implies that the loss of \$10 billion in retained earnings would only diminish the Bank's annual income by about 1%-2% of that \$10 billion or \$100 million - \$ 200 million every year.

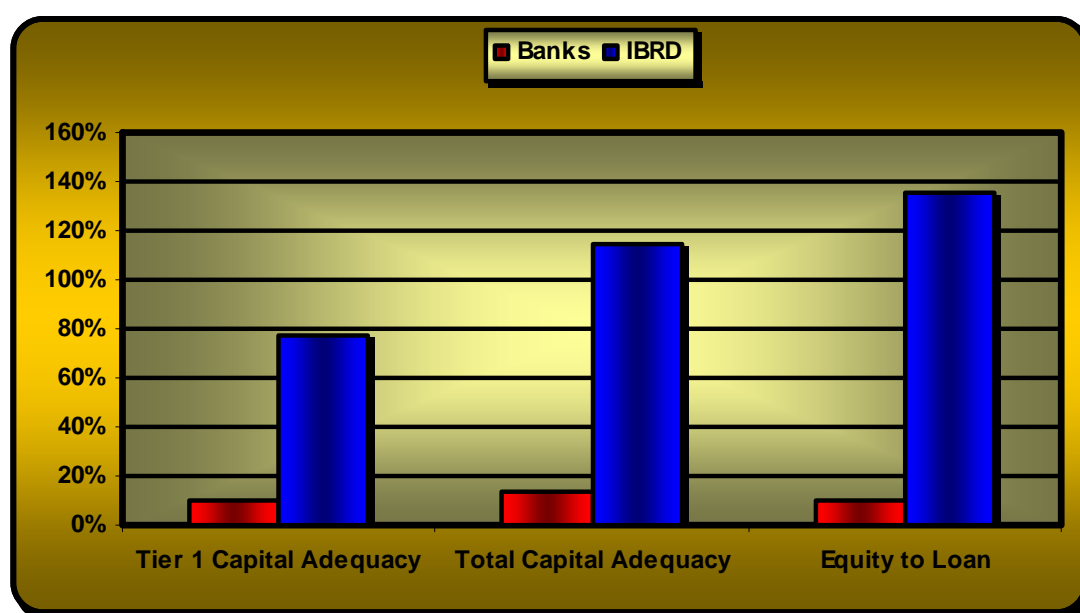
## **This transfer would not threaten the AAA credit rating of the IBRD<sup>6</sup>**

IBRD is accorded the highest credit rating AAA by all three of the internationally recognized credit rating agencies Fitch<sup>7</sup>, Standard & Poors<sup>8</sup> and Moodys<sup>9</sup>. The rating agencies seldom differ much on the ratings they assign to organizations. There is no interagency difference between the ratings assigned to the multilateral development banks and they also all agree<sup>10</sup> on the ratings assigned to the world's five safest banks<sup>11</sup>.

Fitch finds that in fact as of 2003 the IBRD had 490% of the minimum capital required to maintain a AAA rating<sup>12</sup>. It is clear from this, that the IBRD is not an organization tethering on the edge – in danger of losing its AAA rating but in fact is in a very strong position – exceeding the requirements of a AAA rating by a wide margin of 390%.

**It is clear from this that an allocation of \$10 billion of its reserves to IDA for debt cancellation would in no way threaten its AAA rating. In fact, according to analysis by Fitch, the IBRD would still have more than 465% of the capital that it requires in order to hold on to a AAA rating.**

The following graph illustrates how the IBRD compares with banks that have been accorded very high rating<sup>13</sup> by the three rating agencies. The detailed analysis is presented in the Appendix. **On average, the IBRD's capital adequacy ratio is 800% that of highly rated banks and its equity to loans ratio is 1300%.**



<sup>6</sup> Also see Appendix I

<sup>7</sup> IBRD credit update, Fitch 14<sup>th</sup> June 2003

<sup>8</sup> IBRD Research, Standard & Poors 20<sup>th</sup> February 2004

<sup>9</sup> IBRD, Moodys October 2003

<sup>10</sup> Except on Rabobank to which Fitch has assigned a rating of AA- that is one notch lower than the AAA rating assigned by the other agencies.

<sup>11</sup> Annual Survey 2004 World's Safest Banks, Global Finance.

<sup>12</sup> Risk Analysis of Multilateral Development Banks and other Supranationals, Fitch March 1999 and IBRD credit update, Fitch 14<sup>th</sup> June 2003

<sup>13</sup> AAA or AA

### ***Comparison with the African Development Bank***

The African Development Bank (AfDB), another similar multilateral financial institution which is financially weaker than the IBRD faced serious financial and management problems in the mid 1990s. "Morale is as low as I have ever known it to be," said one insider. "The bank has lost direction, it is demoralized, and the entire lending machinery has come to a grinding halt."

Percy Mistry, putting together a report on the African Development Bank in 1993 said "The bank kept lending very large dollops of hard money to countries which simply could not afford its terms. I have still not got a satisfactory explanation for why this has happened." Another report on the AfDB said that "it (the AfDB) may end up destroying itself".

However, despite these very serious problems that would have bankrupted a private sector financial institution, the AfDB was given top credit ratings and its borrowing costs in the market stayed amongst the lowest. Uwe Bott, an analyst with Moody's in New York, said that the bank remained fundamentally sound. He pointed out that, although the quality of the loan portfolio had deteriorated, net income in 1993 was still positive, at just under \$72 million. "For there to be a capital call, the bank's assets must deteriorate sufficiently to absorb all net income," said Bott. "Then the bank must draw on its reserves to pay its creditors. Only when reserves are depleted must the bank draw on its capital base, and it is backed by a large pool of triple-A-rated capital. This could only happen after a number of years of the bank making losses."

**Clearly the IBRD, which will be in a much stronger position than the AfDB was in the early 1990s even after the implementation of our proposals, is under no threat of losing its AAA credit rating.**

**The above discussion clearly shows that the AAA credit rating of the IBRD would stay intact even after the implementation of our proposals to use its reserves and income to cancel poor country debt.**

### **The interest rate at which the IBRD borrows would stay unchanged**

The IBRD has amongst the lowest costs of borrowing in the international financial market being able to borrow at interest rates that are only marginally higher than the rates that investors charge to lend to the US government<sup>14</sup>. In fact, the IBRD's borrowing costs are even lower than those of Agencies<sup>15</sup> such as the Freddie Mac and Fannie Mae that have the implicit backing of the US government.

This ability to borrow at very low interest rates is very important for the operation of the IBRD as this enables it to lend to developing countries at interest rates that are far lower than the rates investors would charge to lend to them in the international financial markets. For example, when the interest rates charged by international investors to the Brazilian government shot up to 23% in January 2003 the IBRD was still charging Brazil only about 4.7% - a discount of 18% to the market rate.

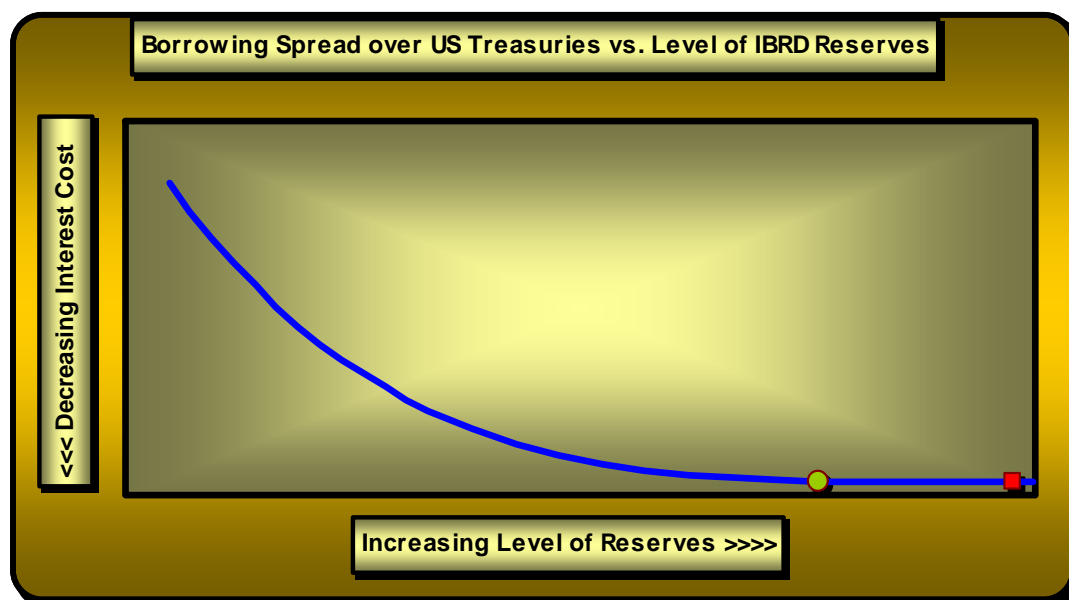
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<sup>14</sup> US government bonds are perceived to be the safest assets in the world.

<sup>15</sup> These Agencies have the full implicit backing of the US government and are hence considered to be very safe investments

It is the strong financial position of the IBRD that allows it to borrow at such low costs in the market. The factors important to investors are – its extremely high capital adequacy, its reputation in the international financial system and the fact that it is the most diversified multilateral financial institution<sup>16</sup>.

At present, the IBRD is able to borrow at a margin (spread) of only about 0.2% above the interest rate that the US government borrows at. This makes it the lowest cost non-governmental borrower in the financial markets. However, it is important to note that even if the IBRD became safer – by having an even higher capital adequacy its borrowing cost is not expected to fall any further. At the kind of high levels of capital adequacy (115%) and reserves (\$22.5 billion) that the IBRD has, the borrowing interest rate does not decrease with a higher level of reserves<sup>17</sup>. This is also supported by historical evidence that shows that the IBRD's borrowing margin over US government borrowing has hovered around the 0.2% - 0.25% mark since the late 1990s though there has been an increase of more than \$10 billion in reserves since 1998. The current interest rate payable by the IBRD is represented by the square point in the graph below.



<sup>16</sup> The regional multilateral financial institutions such as the African Development Bank and the Asian Development Bank have much more concentrated lending portfolios than the IBRD as they regional in scope. This makes them riskier than the IBRD.

<sup>17</sup> The IBRD has a capital adequacy of 115% as compared to an average of 13.6% for other highly rated banks. The typical borrowing costs for such banks vary from spreads of 70 bps (1 bp-basis point is one hundredth of a percent) for AA rated Barclays to about 35-40 bps for AAA rated Rabobank and Rentenbank. AAA rated GE Capital, Ford Motor Credit and Heller Financial all non bank financial institutions can borrow at spreads of about 45-55 bps over US Treasury bonds (UST).

While there are definite benefits from having higher capital adequacy ratio we can see that in getting from Barclays (Tier I capital adequacy 7.7%, borrowing cost UST + 70 bps) to Rabobank (Tier I capital adequacy 10.2%, borrowing cost UST + 40 bps) to IBRD (Tier I capital adequacy 77.1%, borrowing cost UST + 20 bps) we have reached the limits of those benefits in terms of lower borrowing costs. The incremental benefits from an addition to reserves decrease with an increasing level of reserves. This is clearly illustrated by the following graph where the current financial position of the IBRD is indicated by the (square) point.

Hence, the IBRD does not stand lower its cost of borrowing even if it were to increase its reserves. **Similarly, a very modest reduction in the capital adequacy ratio from the current 115% to 107% as would happen under our proposal for debt cancellation would not lead to any increase in the borrowing interest rate for IBRD.** This new post debt cancellation borrowing rate for the IBRD is indicated by the (circle) point on the graph above.

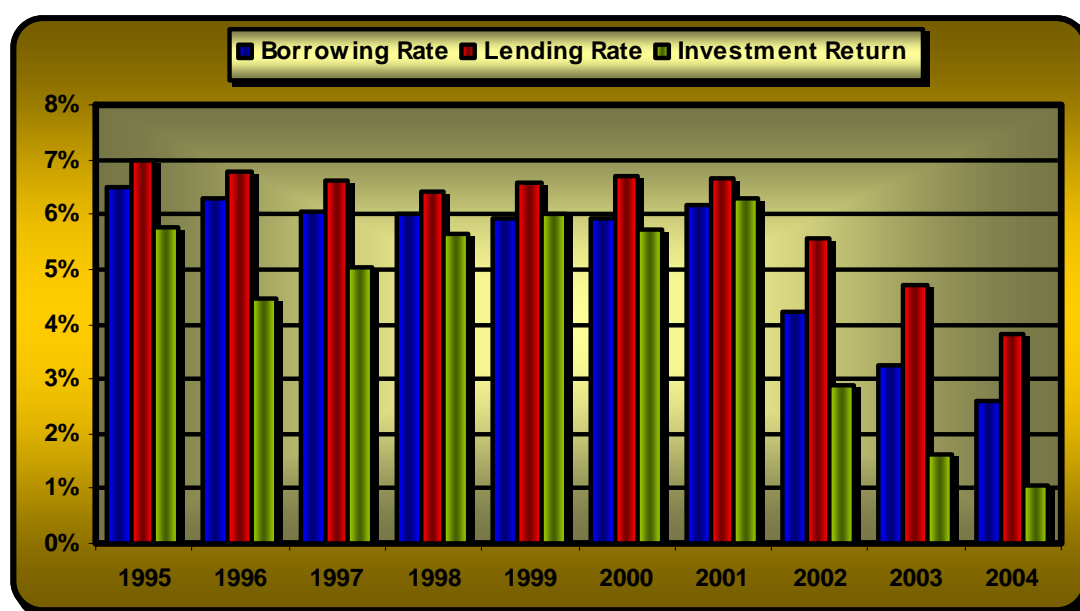
This conclusion is also supported by comparisons with the African Development Bank. Even after the AfDB was downgraded by S&P from AAA to AA+ it was able to borrow at an interest rate of only 0.23% above US government bonds in 1997. This rating has since been restored and in the most recent issue in 2003 the AfDB was able to access the market at 0.28% above US government borrowing rates.

### **Borrowing from the IBRD brings significant financial benefits**

#### ***The IBRD does not have a profit motive but makes a margin on lending***

The World Bank borrows in the international capital markets and lends the money to developing countries at a slightly higher interest rate. This enables the Bank to pay for its operating expenses and to make a profit. In 2004, for example the Bank's average borrowing costs were 2.6% and the return on outstanding loans 3.8%. An equivalent way of saying this would be that the Bank was able to borrow at about 2.6%, lent this money at about 3.8% and made an income of \$1.6 billion.

The bank does not have a profit motive and adjusts its lending rate according to a target level of income. The changes in the average lending and borrowing rates are illustrated in the graph below.



The decreasing trend does not mean anything in itself but merely reflects the trend of decreasing worldwide interest rates.

The Bank has two sources of cash, its equity and the money borrowed from the markets. Some of this money is put into highly liquid investments such as OECD

government bonds and highly rated corporate securities in order to maintain essential operational liquidity. The rest of the money is lent on to its borrowing member countries. The following table lists the sources of funds – equity and borrowing, the uses they were put to – investment and lending and the return they generated each year between 2000 and 2004.

	2000	2001	2002	2003	2004
<b>Equity</b>	<b>29,289</b>	<b>29,570</b>	<b>32,313</b>	<b>37,918</b>	<b>35,463</b>
<b>Borrowing</b>	<b>110,379</b>	<b>106,757</b>	<b>110,263</b>	<b>108,554</b>	<b>108,066</b>
<b>Effective Borrowing Rate</b>	<b>6.5%</b>	<b>6.7%</b>	<b>4.5%</b>	<b>3.3%</b>	<b>2.6%</b>
<b>Interest Paid</b>	<b>7128</b>	<b>7152</b>	<b>4907</b>	<b>3594</b>	<b>2789</b>
<b>Loans Outstanding</b>	<b>120,104</b>	<b>118,866</b>	<b>121,589</b>	<b>116,240</b>	<b>109,610</b>
<b>Effective Lending Rate</b>	<b>6.8%</b>	<b>6.9%</b>	<b>5.6%</b>	<b>4.9%</b>	<b>4.0%</b>
<b>Interest Received</b>	<b>8,153</b>	<b>8,143</b>	<b>6,861</b>	<b>5,742</b>	<b>4,403</b>
<b>Liquid Investments</b>	<b>24,331</b>	<b>24,407</b>	<b>25,056</b>	<b>26,620</b>	<b>31,126</b>
<b>Rate of return on investments</b>	<b>6.5%</b>	<b>6.3%</b>	<b>2.9%</b>	<b>1.6%</b>	<b>1.0%</b>
<b>Income on Investments</b>	<b>1,589</b>	<b>1,540</b>	<b>738</b>	<b>418</b>	<b>304</b>

In 2003-2004, the IBRD had \$143 billion of which \$35 billion came from equity and \$109 billion was borrowed at an average rate of 2.6%. It used \$31 billion to invest in liquid securities at a 1% rate of return and \$109 billion to lend to member countries at an average of about 4%.

#### ***Financial benefits accrue to most IBRD borrowers***

Borrowing from the IBRD generates significant benefits for most of its member countries. All IBRD borrowers are developing countries that on average have much lower credit ratings than OECD member countries. They are perceived to be high credit risks and hence investors charge them high interest rates to lend them money. For example, a BB rated country such as Mexico has on average had to pay a full 700 bps (8%) more than the US government in order to borrow in the international finance markets (1997-2003). However, Mexico has been able to borrow from the IBRD at only about 100-200 bps (1-2%) more than the US government rate or at a discount of 6% to the market rate. This generates significant cost savings for Mexico. In the following table we consider the example of Brazil.

	1998	1999	2000	2001	2002	2003
<b>Borrowing (\$ billion)</b>	<b>7.3</b>	<b>6.7</b>	<b>5.7</b>	<b>8.2</b>	<b>8.1</b>	<b>8.6</b>
<b>Market Rate</b>	<b>14%</b>	<b>15%</b>	<b>13.50%</b>	<b>12.50%</b>	<b>18%</b>	<b>8%</b>
<b>IBRD Rate</b>	<b>6.5%</b>	<b>6.8%</b>	<b>6.9%</b>	<b>5.6%</b>	<b>4.9%</b>	<b>4.0%</b>
<b>Brazil Saving (\$ mill)</b>	<b>548</b>	<b>550</b>	<b>379</b>	<b>562</b>	<b>1,058</b>	<b>343</b>

This shows that Brazil, as a result of being able to borrow from the IBRD has saved almost \$3.5 billion over the past six years. If it were not able to access the IBRD facility, it would need to borrow at much higher rates from the bond market.

Argentina, Mexico and Indonesia are some other major borrowers which save significant sums of money as a result of being able to borrow from the IBRD. **Our calculations show that in aggregate countries that borrow from the IBRD have saved more than \$6 billion every year since 1998 as a result of having access to the IBRD.**

Another way of evaluating the benefits to IBRD borrowers would be to compare the market value of the loan portfolio of the IBRD with its face value. For most well-performing banks these values do not differ by more than 5%-10%. However, for the IBRD, we expect the values to be significantly different as it lends at a significant discount to the market.

The US Congressional Budget Office has performed these calculations and shows that the market value of the IBRD loan portfolio would be about 30% less than the face value. **This is a measure of the subsidy offered to the developing countries that borrow from the IBRD and for 2003 amounted to about \$33 billion – a significant sum of money.**

**We see from this discussion above that many of the countries that borrow from the IBRD derive significant financial benefits from it.**

### **Debt cancellation would have a minimal effect on these benefits**

We use the example of the figures from the financial year 2003-2004 to illustrate what effect our proposal for debt cancellation could have on the IBRD borrowing members. The calculations in this section are predicated on an immediate transfer of \$10 billion from the IBRD to IDA for the purpose of poor country debt cancellation. This would entail an instantaneous and one-time reduction in the level of equity by \$10 billion.

In the preceding section we saw that the IBRD uses equity and borrowing to fund its investments and lending. We consider that the level of investments and lending remains unchanged. This means that the IBRD would need to borrow an additional \$10 billion to keep its operations the same. The average cost of borrowing for the period was 2.6%. A previous section also established that the rate at which the IBRD can borrow in the market would not be affected. So the \$10 billion of additional borrowing entails an additional cost of \$260 million.

The World Bank Board would need to take a decision about how to account for this additional interest cost. It could either keep lending the interest rate constant and decrease income or it could keep income constant and increase interest rate<sup>18</sup>.

#### ***Keeping lending rate same with lower net income***

**(Option I) The Board could decide to keep its lending rate unchanged; then its net income would be reduced by \$260 million. This would have reduced its net income in 2003-2004 from \$1,696 million to \$1,438 million – a significant but nonetheless small decrease of only about 15%.**

The tables below detail what effect an appropriation of \$10 billion of reserves for debt cancellation would have had on income each of the past 3 years if the IBRD choose to keep the interest rates the same.

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<sup>18</sup> In the long term, both of these options could be equivalent as the benefits of reserve accumulation from a higher net income could be passed on to borrowing countries as lower borrowing rates. However, this equivalence is dependent on IBRD Board policy. In any case, the two options differ in having constant interest costs now (1<sup>st</sup> option) vs. higher interest costs now with the possibility of lower interest costs in the future (2<sup>nd</sup> option)

	2001-2002	2002-2003	2003-2004
Original Income	1,924	3,021	1,696
Revised Income	1,479	2,690	1,438
Percentage Decrease	23%	11%	15%

We see that the IBRD would have seen a small decrease in its net income in each of the years. This would not have had any significant impact on its operations. This is our preferred option. We do not want the interest costs to IBRD borrowers to increase.

*Keeping net income same with higher lending rates*

(Option II) Or the Board could decide to keep its income unchanged and increase the lending rate. This would mean that the lending rate would need to go up by (\$260 million/\$109,610 million) or about 0.23%. So the effective lending rate would have been 4.2% instead of the actual 4%. This is a relative rise of only about 5.75% in the lending rate – a small but significant increase.

This next table shows what effect our proposal would have had if the IBRD chose to keep its net income constant but increased the interest rates on lending. This shows that the lending rate would need to go up but only fractionally – about 6% of what the original lending rate would have been.

	2001-2002	2002-2003	2003-2004
Original Effective Lending Rate	5.60%	4.90%	4.02%
Revised Lending Rate	5.97%	5.18%	4.26%
Percentage Increase	6.49%	5.77%	5.86%

The effect of such a decision on individual borrowing members is highlighted by once again using the example of Brazil discussed above. The following table shows that had option II been implemented, Brazil would still have accrued \$1,896 million of benefits from access to the IBRD. This is only marginally smaller – only about 4% - than the benefits of \$1,969 million that actually accrued to Brazil during this period. However, for a country such as China, which was recently able to borrow in the international capital markets at interest rates only marginally higher than the World Bank borrowing rates, even a small increase in the IBRD lending rate can significantly erode any financial benefits that it derives from being able to borrow from the IBRD.

	2001	2002	2003	Total
Borrowing (\$ mill)	8,200	8,100	8,600	
Market Rate	12.50%	18%	8%	
IBRD Rate	5.60%	4.90%	4.02%	
Brazil Saving (\$ mill)	566	1,061	342	1,969
IBRD Revised Rate	5.97%	5.18%	4.26%	
Brazil Revised Saving (\$ mill)	536	1,038	322	1,896
Decrease in Brazil Saving (\$ mill)	30	23	20	
% Decrease in Brazil Saving	5.3%	2.2%	5.9%	3.7%

*Distributing the interest cost between net income decrease and lending rate increase*

**(Option III) The IBRD is not restricted to using either one or the other of the options discussed above and could use a combination of both to compensate for the loss of reserves. If the IBRD choose to distribute the cost equally between lending rate increase and lower income would imply a loss in income of about 10% and an average relative increase in interest rates of only about 3% above current level.**

## **Appendix I**

### ***Other rating agencies and IBRD AAA rating***

Standard & Poors, says that its AAA rating of the IBRD is based on

- Very strong capital adequacy and liquidity;
- Prudent financial management and policies;
- Excellent franchise value; and
- Strong membership support, including expected continued treatment as a preferred creditor.

In the main body of the report, we have already shown above that the suggested transfer of resources would not have any material impact on either the Bank's capital adequacy & liquidity or its financial policies. The IBRD's franchise value, membership support and preferred creditor status also remain unaffected. **Hence, our proposals pose no danger the IBRD's AAA credit rating.**

Moody's, lists the following factors as reasons for assigning its highest Aaa rating to the IBRD.

- The Bank's solid capital structure;
- Its preferred creditor status;
- Financial policies that greatly reduce the Bank's exposure to financial risk while achieving adequate profitability; and
- Strong support from Aaa/Aa member countries

as the reasons behind assigning the IBRD its highest Aaa credit rating. **Our proposal does not have any material affect on the factors listed above and thus do not endanger the IBRD's Aaa credit rating.**

## Appendix II (Bank Financial Data)

Bank	Year	Ratings			Capital Adequacy		ELR
		Fitch	S&P	Moodys	Tier 1	Total	
<b>Bank Nederlandse Gemeenten</b>		AAA	AAA	Aaa			
	2003				25.0%	27.0%	4.3%
	2002				26.0%	27.0%	4.5%
	2001				25.0%	26.0%	5.1%
	<b>Average</b>				<b>25.3%</b>	<b>26.7%</b>	<b>4.6%</b>
<b>Landwirtschaftliche Rentenbank</b>		AAA	AAA	Aaa			
	2002				8.4%	14.3%	
	2001				9.2%	15.1%	
	2000				10.1%	16.9%	
	1999				11.0%	17.5%	
	<b>Average</b>				<b>9.7%</b>	<b>16.0%</b>	
<b>Rabobank Group</b>		AA+	AAA	AAA			
	2002				10.1%	10.3%	8.7%
	2001				10.2%	10.5%	9.7%
	2000				10.3%	10.6%	9.4%
	1999				10.0%	10.5%	8.8%
	<b>Average</b>				<b>10.2%</b>	<b>10.5%</b>	<b>9.1%</b>
<b>UBS AG</b>		AA+	AA+	Aa2			
	2003				11.8%	13.3%	18.6%
	2002				11.3%	13.8%	20.1%
	2001				11.6%	14.8%	21.0%
	2000				11.7%	15.7%	19.5%
	<b>Average</b>				<b>11.6%</b>	<b>14.4%</b>	<b>19.8%</b>
<b>Barclays Bank plc</b>		AA+	AA	N/R			
	2002				8.2%	12.8%	7.6%
	2001				7.8%	12.5%	8.1%
	2000				7.2%	11.0%	9.2%
	1999				7.5%	11.3%	7.8%
	<b>Average</b>				<b>7.7%</b>	<b>11.9%</b>	<b>8.1%</b>
<b>BNP Paribas</b>		AA	AA-	Aa2			
	2003				9.4%	12.9%	15.4%
	2002				8.1%	10.9%	14.2%
	2001				7.3%	10.6%	12.2%
	2000				7.5%	10.2%	10.9%
	<b>Average</b>				<b>8.1%</b>	<b>11.2%</b>	<b>13.2%</b>
<b>Danske Bank</b>		AA-	AA-	Aa2			
	2003				7.2%	10.0%	6.5%
	2002				7.6%	10.5%	6.3%
	2001				7.3%	10.3%	6.1%
	2000				6.8%	9.6%	5.9%
	<b>Average</b>				<b>7.2%</b>	<b>10.1%</b>	<b>6.2%</b>
<b>Deutsche Bank AG</b>		AA-	AA-	Aa3			
	2003				9.6%	13.1%	19.5%
	2002				9.6%	12.6%	20.0%
	2001				8.1%	12.1%	15.4%
	2000				7.8%	13.1%	14.7%
	<b>Average</b>				<b>8.8%</b>	<b>12.7%</b>	<b>17.4%</b>
<b>ABN Amro Bank N.V.</b>		AA-	AA-	Aa3			
	2003				7.6%	11.1%	5.0%
	2002				7.5%	11.5%	5.1%
	2001				7.0%	10.9%	5.1%
	2000				7.2%	10.4%	6.0%
	<b>Average</b>				<b>7.3%</b>	<b>11.0%</b>	<b>5.3%</b>
<b>Societe Generale</b>		AA-	AA-	Aa3			
	2003				8.7%	11.7%	9.5%
	2002				8.1%	11.1%	9.2%
	2001				8.4%	11.5%	9.6%
	2000				8.9%	12.5%	9.2%
	<b>Average</b>				<b>8.5%</b>	<b>11.7%</b>	<b>9.4%</b>
<b>Average For Ten Highly Rated Banks</b>					<b>10.4%</b>	<b>13.6%</b>	<b>10.3%</b>
<b>IBRD</b>		AAA	AAA	Aaa			
	2003				82.9%	120.7%	142.5%
	2002				73.8%	117.6%	132.8%
	2001				70.0%	114.7%	132.4%
	2000				79.6%	113.8%	130.0%
	1999				78.6%	112.4%	131.6%
	1998				77.3%	109.9%	141.5%
<b>Average for International Bank for Reconstruction and Development</b>					<b>77.1%</b>	<b>114.8%</b>	<b>135.1%</b>

## Appendix III

### *World's safest banks list<sup>19</sup>*

Global Finance Annual World's Safest Banks Survey					
Rank	Bank	Moody's	S&P	Fitch	Assets
					\$ billion
1	Landesbank Baden-Wuerttemberg	Aaa	AAA	AAA	327.7
2	CDC Ixis	Aaa	AAA	AAA	263.1
3	Bank Nederlandse Gemeenten	Aaa	AAA	AAA	77.2
4	Landwirtschaftliche Rentenbank	Aaa	AAA	AAA	67.3
5	Rabobank Group	Aaa	AAA	AA+	393.2
6	Kreditanstalt fur Wiederaufbau	Aaa	AAA	N/R	262.3
7	UBS	Aa2	AA+	AAA	851.7
8	Banco Popular Espanol	Aa1	AA	AA	44.0
9	Barclays	N/R	AA	AA+	637.8
10	BNP Paribas	Aa2	AA-	AA	745.4
11	Royal Bank of Canada	Aa2	AA-	AA	236.6
12	National Australia Bank	Aa3	AA	AA	194.7
13	Credit Agricole	N/R	N/R	AA	609.5
14	Groupe Caisse d'Epargne	N/R	N/R	AA	374.8
15	Dexia	N/R	AA	N/R	368.0
16	Banco Bilbao Vizcaya Argentaria	Aa2	AA-	AA-	288.5
17	Danske Bank	Aa2	AA-	AA-	247.3
18	UniCredito Italiano	Aa2	AA-	AA-	223.9
19	Commonwealth Bank of Australia	Aa3	AA-	AA	133.9
20	Norddeutsche Landesbank Luxembourg	Aa2	N/R	N/R	25.6
21	HBOS	N/R	AA-	AA	512.1
22	State Street Corporation	N/R	AA-	AA	85.8
23	Deutsche Bank	Aa3	AA-	AA-	795.7
24	ABN AMRO Holding	Aa3	AA-	AA-	583.5
25	Societe Generale	Aa3	AA-	AA-	526.0
26	Abbey National	Aa3	AA-	AA-	284.1
27	DePfa Deutsche Pfandbrief Bank	Aa3	AA-	AA-	159.4
28	Bank of Montreal-Banque de Montreal	Aa3	AA-	AA-	157.8
29	Svenska Handelsbanken	Aa2	A+	AA-	140.9
30	Caja de Ahorros y Pensiones de Barcelona	Aa2	A+	AA-	107.6

<sup>19</sup> The Banks highlighted in Orange are the ones that we have used in our analysis

## Appendix III

### *Key Financial Data for the IBRD*

Years	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
(\$ million)										
Equity	30,461	28,300	27,228	26,514	28,021	29,289	29,744	32,466	35,675	36,421
Equity (Current Value)							29,570	32,313	37,918	35,463
Reserves	13,922	14,202	14,452	14,952	15,703	17,516	18,134	19,425	21,835	22,515
Retained Earnings \$ mill)	17,662	17,542	17,662	18,192	19,263	20,916	22,093	24,478	25,880	26,020
Capital										
Borrowings Outstanding	108,290	96,719	96,679	103,589	115,739	110,379	106,757	110,263	108,554	108,066
Total Loans Outstanding	123,499	110,246	105,805	106,576	117,228	120,104	118,866	121,589	116,240	109,610
Provisions for Loan Losses	3,740	3,340	3,210	3,240	3,560	3,400	3,959	5,053	4,045	3,505
Operating Income	1,473	1,300	1,405	1,195	1,518	1,991	1,144	1,924	3,021	1,696
Equity to Loans	21.4%	21.8%	22.1%	21.4%	20.7%	21.3%	21.5%	22.9%	26.6%	29.4%
Equity to Loans (Current Value)							21.4%	23.1%	26.4%	29.1%
Reserves to Loan	11.3%	12.9%	13.7%	14.0%	13.4%	14.6%	15.3%	16.0%	18.8%	20.5%