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# CO-FINANCING TRANSACTIONS BETWEEN MULTILATERAL INSTITUTIONS AND INTERNATIONAL BANKS

by

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## Table of Contents

**Résumé**

La crise de la dette s'est accompagnée d'un redéploiement des activités des banques commerciales en-dehors des pays en développement. Les banques internationales sont soumises à des pressions compétitives et réglementaires pour renforcer leur ratios de capita et de profitabilité. C'est dans ce contexte que s'inscrit le rôle catalytique des organisations multilatérales pour mobiliser des financements additionnels de source privée. La Banque mondiale a développé ses opérations de co-financement depuis 1983 mais elle s'est heurtée à la réticence croissante des banques pour augmenter leur encours sur les pays en développement. En 1989, la Banque mondiale mis en place un programme de co-financement élargi dans un cadre plus flexible. Le partage des risques avec les créanciers privés prend la forme de garanties du paiement final d'un crédit, de garantie partielle d'émissions de titres ainsi que de participation directe dans des prêts où la Banque devient co-créancier aux côtés de banques commerciales. Néanmoins, le montant et le nombre des opérations sont restés très limités jusqu'à aujourd'hui. Le rapport s'attache à analyser les paramètres juridiques et réglementaires de ces transactions avant de proposer des aménagements pour les rendre plus attractifs. Il reste que le partage des risques trouve ses limites dans la nécessité de maintenir l'accès privilégié de la Banque mondiale aux marchés de capitaux, de part sa cotation d'emprunteur Triple A. Le rapport se termine par un examen des voies et moyens pour stimuler la participation des prêteurs privés dans le financement du développement.



**Summary**

The last decade has exemplified a retrenchment of bank lending in developing countries. International banks strive to boost capital ratios, thereby raising equity, reducing their less profitable assets and rebalancing portfolios towards less risky claims. In that context of underfinanced adjustment and growth programmes in the LDCs, international financial institutions (IFIs) have attempted to mobilize additional financing from commercial banks through co-financing and guarantee operations. The World Bank has been at the forefront of such a role since 1983. The B-loan programme, however, has fallen short of reviving private lending in the LDCs. In 1989, the World Bank introduced an enhanced co-financing operation programme (ECO) geared toward creditworthy borrowers. Risk-sharing arrangements with private banks involve the guarantee of late maturities as well as direct participation in bank loans and partial guarantee of bond issues. Despite more flexible guidelines for the World Bank's participation, the ECO programme has not been very successful thus far. The volume and number of co-financing transactions with private lenders remain modest and keep declining, reflecting the continued reluctance of private sources to take on more exposure in most developing countries. This report examines the legal and regulatory parameters in co-financing operations. It also analyses the various implications of risk-sharing on the World Bank's access to the capital markets. In that regard, to a large extent the Triple-A rating of the World Bank is both the principle and the limit of co-financing operations. The report concludes by examining ways and means of stimulating private lending participation in development financing.

## Preface

This Technical Paper, part of the research programme on "financial policies for the dissemination of economic growth", provides an assessment of the co-financing operations between the multilateral institutions and banks.

In a context of reduced access of most developing countries to the international capital market, the interaction between official and private lenders is of major importance: in principle, co-financing transactions should provide a useful link between official and private finance.

The findings of this report produced by Michel Bouchet and Amit Ghose lead however to pessimistic conclusions. Despite some important institutional changes, such as the introduction of the ECOs program by the World Bank in July 1989, co-financing operations have not proved to be a dynamic source of financing for developing countries. The detailed review provided by the authors show that, in legal as well as in financial terms, the available co-financing schemes have failed to supply risk-sharing mechanism capable of attracting investment by the banks. Moreover, the list of countries eligible for the ECOs programme of the World Bank is very limited, since this programme excludes countries which have restructured their debt in the past five years.

In their conclusion, the authors suggest a number of policy recommendations, aimed at addressing the issues posed by co-financing operations. Regulatory improvements as well as a better structuring of risk-sharing should increase the willingness of commercial banks to participate in co-financing deals. Also, co-financing schemes should be focused on all "graduating" countries, including those, like Chile or Mexico, which have restructured their debt in the recent past.

Louis Emmerij
President of the OECD Development Centre
July 1992.

## I. International Bank Lending to LDCs[1] — A Perspective[2]

Relationships between international banks and developing countries have dramatically changed over the last two decades. In the late 1960s, banks concentrated on trade financing while meeting the requirements of subsidiaries of multinational companies located in the developing countries. In the 1970s, banks went on to become the fastest growing and most flexible source of foreign finance for the developing countries - mainly for balance of payments. Bank overlending and deteriorating country creditworthiness gradually led to the debt crisis of the early 1980s. The last decade has been a traumatic experience for the international banks and their developing country borrowers. There has been a retrenchment of bank lending that has reflected the instability of relationships with the developing country borrowers. The securities market on the contrary had not been a dynamic pool of funds for LDCs, with the exception of a few "emerging markets" mostly in Asia. More recently, however, a number of large developing countries have graduated from debt restructuring and have managed to resume access to the syndicated loan markets. Bond issuance activity, however, is dominated by a small number of borrowers from Latin America (Argentina, Brazil, Mexico and Venezuela) and Asia (South Korea, Indonesia, China and Thailand). Among the negative influences that curb the growth of the markets one can mention credit quality considerations, profitability constraints, and competitive and regulatory pressure to strengthen capital ratios. Creditworthiness and risk considerations by the banks imply that the ongoing reassessment of credit and risk exposure is likely to continue to weigh on the scope for additional bank lending to developing countries.

Contrary to the overwhelming influence of bond markets which characterized the international financial system until the 1930s, lending has been the main form of international bank business in the developing countries since the 1960s. Lending grew rapidly between 1973 and 1981, increasing at an annual average rate of 28 per cent per annum during this period. In 1973 total new international lending amounted to $33 billion, of which 29 per cent went to developing countries. By 1981 new lending reached $165 billion, of which one third went to developing countries. Most of the lending took the form of syndicated Eurocurrency loans carrying five- to ten - year maturity and floating interest rates. Most of the loans were arranged by a core of twenty-five to fifty large commercial banks (often termed the "first-tier" banks) based in industrial countries. Up to 3 000 others ("second-tier" banks) joined in from time to time. They were primarily regional banks from industrial countries, banks from developing and centrally planned economies, as well as consortium banks.

Initially in the 1970s most of international lending activity was carried out by the large US "money center" banks. By 1977 the twelve largest US banks accounted for almost half of their total earnings from international lending, the bulk of which came from developing country loans. Several banks from a number of other countries next increased their developing country exposure - particularly those from Germany, France, and the United Kingdom. Japanese banks also assumed an important role in international lending, but their role was relatively limited given adverse developments in Japan's balance of payments. The second-tier banks from the United States also gradually increased their participation. The most notable entrants, however, were the Arab banks, but banks from other developing countries have also been increasingly active. The ability of non-American banks to participate in this primarily dollar-based market was enhanced by the growth of the international interbank market. This market permitted the distribution of dollar liquidity around the international banking system. The relationship between the banks and the developing countries increased rapidly in the 1970s for two main reasons: changes in the pattern of the global current account balances, and the ability of the banks to act as intermediaries.

After the first major increase in oil prices, when there was a need to recycle large amounts of funds (notionally called the petro-dollars), banks were praised for the success with which they performed this function. Central banks and national banking authorities adjusted supervisory and regulatory frameworks so as to strengthen the international banking system, in particular with more stringent, reserves, capital and liquidity standards. LDCs' preferences also motivated the growth of bank lending in the 1970s. Developing countries were attracted by the general purpose nature of bank finance and by the large volumes and flexibility of instruments available at a time when alternative sources of finance were growing slowly. Contrary to World Bank or IMF money, Eurocurrency credits did not contain any conditionality. Developing countries obviously favoured the low or negative real interest rates charged by banks in preference to conditions attached to some official finance and the strict creditworthiness requirements of the bond markets.

Besides macroeconomic fundamentals, several factors related to banking behaviour were also pushing banks to increased lending. First, the increased efficiency of international banking was more and more noticeable. The growth of the Eurocurrency market was particularly significant, because banks operating there were free of reserve requirements. Banks could therefore afford to offer higher interest rates to depositors and lower rates to borrowers than other banks. Second, banks radically changed their portfolio objectives in the 1970s, attaching greater importance to balance sheet growth than to the immediate rate of return on assets or other profitability objectives. Foreign lending also offered means of diversifying portfolios, which was seen as a way of reducing risks because domestic lending often had an inferior loan-loss record. Third, the development of the cross-default clause, covering publicly guaranteed debt, removed major concerns from the bankers' minds on sovereign risk. A cross-default clause specifies that the loan will be considered in default if the borrower defaults on any other loan. This effectively strengthened the guarantee on sovereign loans and blurred the difference between individual borrowers or projects within the developing countries. Therefore the bankers paid less attention to the viability of the particular projects they financed, and more to macroeconomic conditions in the borrowing countries. Moreover, if a developing country borrower defaulted, the cross-default clause[3] would ensure that all bank lenders would be affected. As a result, a borrower confronted with debt-servicing difficulties had a strong incentive to reschedule its lending rather than default on a loan. This type of lending therefore appeared less risky to banks. Syndicated loans enabled banks to make long-term loans on the basis of short-term deposits - a process of maturity transformation - without having to absorb the interest rate risk themselves, since lending rates were tied to a short-term rate (LIBOR). However this proved to be a volatile element in debt service for borrowers. Last, most changes in regulatory environment were conducive to bank lending to developing countries. The industrial countries eased exchange controls, thus encouraging banks to lend off their base of domestic deposits. The growth of largely unregulated offshore banking centres also gave a significant stimulus to foreign lending.

Consequently, in the late 1970s and early 1980s, banks were becoming increasingly concerned about exposure to both lending and funding risks in their international business. Most developing-country lending had been concentrated in a narrow range of countries. On an average 72 per cent of it went to the upper-middle income countries over the 1978-81 period. The five largest borrowers themselves accounted for 53 per cent of developing country borrowing. Having shifted the interest rate risk onto the borrowers, banks were becoming increasingly aware that in practice they had simply traded off one risk for greater potential transfer and commercial risk. On the liability side, many banks have come to depend on interbank markets for a large part of their funding. This had made them susceptible to sudden funding pressure if concerns about the quality of their assets developed. Moreover, the capital to asset ratios of many banks in the OECD had been falling for much of the period between 1977 and the early 1980s, partly reflecting the growth in international lending, which outstripped the growth of capital. This trend was exacerbated for non-US banks by the strength of the US dollar after 1980. Capital to asset ratios were weakened because a dollar appreciation increased the domestic currency equivalent of a bank's outstanding dollar lending, inflating the denominator of the ratio.

These banking developments were inevitably to strain relationship with developing countries. The relevant trends may be summarised as follows:

— The onset of debt difficulties in a number of developing countries led them to reschedule significant amounts of debt. The sudden deterioration of the perceived creditworthiness of developing countries generated reduced willingness by banks to increase their exposure further. Bank regulators responded to the same concerns by seeking to monitor liquidity and solvency ratios more closely. Moreover, banks were urged to diversify their lending and were also encouraged to set more funds aside in loan-loss reserves. Thus the need to strengthen capital ratios led the banks to place greater emphasis on profitability as opposed to pure growth of assets.

— Profitable lending opportunities evolved in the industrial countries themselves as OECD economies revived. Moreover, financial markets in several industrial countries, especially in the United States and the United Kingdom, began a process of deregulation, and as a result banks faced competition from other financial institutions and concentrated on consolidating their domestic position. A combination of deregulation and regulatory incentives for increasing capital has led to a better equity capital to assets ratio. In the United States, for instance, ratios increased from 6.20 per cent in 1985-86 to 6.8 per cent in 1991.

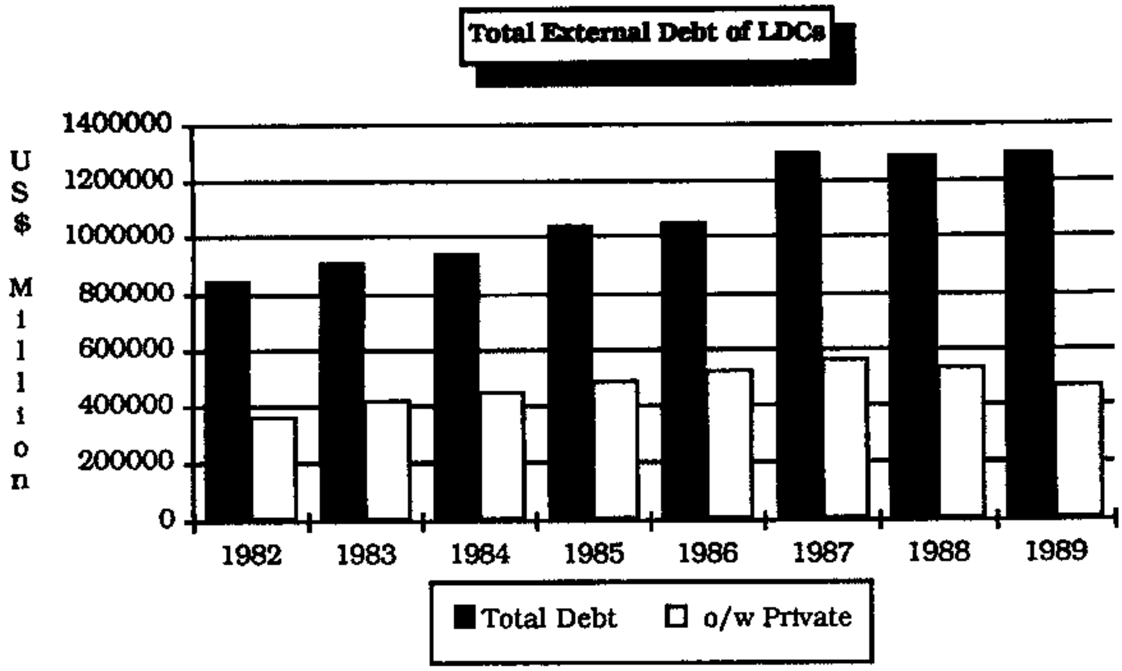
— The era of OPEC surpluses and large bank deposits has given way to an entirely different mixture of surpluses and deficits, with different financial implications. OPEC members as well as industrial countries became net borrowers from the international banks, after having been significant net depositors. Moreover, major imbalances grew in the world economy between the United States, with large current account deficits, and the Federal Republic of Germany and Japan, with large surpluses. Given the nature of the US financial system, the deficit has been financed rather more by trading in financial assets than through bank intermediation. The US had both the assets and the markets to make this feasible. As a result the process of intermediation has been shifting from banking to asset markets even while many developing countries remained deeply dependent on bank financing.

As a result of these factors, bank net lending to developing countries fell significantly after 1981. Spontaneous lending fell most and concerted lending (in conjunction with IMF programmes) became an increasingly important source of funds for developing countries. Most of the spontaneous lending went to East Asia and Europe. Banks had to stem the growth of exposure to developing countries while strengthening the quality of existing assets and boosting capital ratios. Accordingly they adopted a flexible approach to dealing with countries with debt-servicing difficulties. Banks confronted the challenge that rescheduling only principal payments due or in arrears was not enough. Debtors needed more liquidity relief, and banks started to provide "new money" loans along with long-term debt rescheduling in the context of IMF programmes. The systemic risk of a liquidity crisis in many banking institutions in the wake of Mexico's moratorium was a serious concern for bankers and policy-makers in the OECD. International banks were both overexposed and undercapitalized. As a result, banks joined crisis containment operations, thereby accepting incremental LDC exposure so as to protect existing assets. Evolving financing modalities provided developing countries with both money and time, through lower spreads, reduced fees, multi-year consolidation periods, and extension of maturities.

Altogether, net bank flows to the "severely indebted middle-income countries" (SIMICs) reached about $43 billion over the 1982-85 period[4]. In addition, banks restructured about $320 billion of principal payments since the inception of the crisis and have maintained short-term credit lines in the order of $40 billion. Official creditors have enforced the "system's discipline" through orderly and sequential involvement of the IMF, the World Bank, the Paris Club and the London Club. Concerted new money negotiations have been orchestrated by bank steering committees with a set of core rules, dealing in particular with incremental new money exposure and with the rescheduling of existing exposure.

Despite a combination of economic adjustment, debt relief and new lending, the debt overhang problem has not abated for most developing countries. Total external indebtedness of developing countries (excluding IMF credit) reached about $1,280 billion in 1991, compared to $ 840 billion at end 1982[5]. Total commercial bank debt is estimated at about $505 billion at end 1990, or 38 per cent of the total[6].

Diagram 1




Since 1986, external debt grew at a slower pace due to a combination of factors, including debt reduction operations and limited net lending. During 1989 alone, voluntary debt reduction transactions totalled $20 billion. In Latin America, the stock of debt fell slightly in 1991 from the end-1990 level of $432 billion, as debt conversions roughly offset an increase in debt associated with new lending and exchange rate variations. However, in spite of the debt reductions, for most developing countries creditworthiness indicators remained poor.

In the context of the growing difficulty of developing countries' access to international bank lending, it became increasingly imperative to design financing mechanisms with proportionate risk-sharing between different creditors to LDCs. It was in this context that the so-called official and private co-financing programmes have gained great importance. Co-financing operations typically signify a financing arrangement whereby different types of risk (commercial, sovereign etc.) are shared between the different creditors involved. It is precisely the objective of this paper to elaborate on the importance of co-financing operations particularly given the context of LDC indebtedness. In view of the fact that private capital flows into LDCs have eroded over the last decade, the key objective in this paper is to concentrate on the analysis of private co-financing operations of the IFIs, with special emphasis on the World Bank, as it has been the most active multilateral institution in this area. The following section deals with the institutional aspects of the co-financing operations of the World Bank; it then examines some of the salient features of the private co-financing operations of the Asian Development Bank

(ADB), which among all regional IFIs has been so far the most active in private co-financing operations; and concludes by addressing some of the key features of private co-financing operations of certain other multilaterals such as the IFC, the EBRD and the IIC. Section III discusses the legal issues relevant to co-financing operations. Section IV illustrates the regulatory issues surrounding co-financing operations. Section V presents some selected co-financing operations done since 1985 and also adds on an economic analysis of the concept of risk sharing in co-financing transactions. The section concludes with the commercial banks' attitude towards co-financing operations from the perspective of risk sharing. The final section contains financial, economic, regulatory and policy recommendations that may reinforce further private co-financing operations, which would play a critical role to ensure private capital flows into LDCs.

## II. Private Co-financing — The Role of the Multilaterals

This section elaborates on the various private co-financing mechanisms offered by international financial institutions. Given the volume of private co-financing transactions that have happened so far, clearly the World Bank has played the most crucial role in such operations. The following section describes the evolution of the World Bank's co-financing operations, i.e. the B-loan programme and subsequently the ECO Programme. The section following that focuses on private co-financing operations of other multilateral institutions including the EBRD, the IFC and the IIC, with special emphasis on the Asian Development Bank, as it has been the next most active institution in such operations after the World Bank.

### A. Private co-financing operations of the World Bank

The World Bank actively encourages other lenders - bilateral aid agencies, official export credit and banking institutions - to link their financing to its own[7]. The purpose of co-financing instruments is to raise additional amounts of financing for developing countries as well as for longer periods of time. Regarding commercial banks whose natural time horizon is short-term, co-financing enables the World Bank to mobilize longer-term financing from private resources than would be otherwise available. Co-financing thus has a catalytic role. Between 1975 and 1984, the number of co-financed projects has almost doubled, averaging $3.6 billion a year over this period[8].

The type of partner involved in co-financing depends largely on the borrowers. For the poorest countries, lenders offering concessional terms are the principal co-financing sources. For creditworthy developing countries, commercial banks and official export credit agencies are usual co-financiers. Export credit co-financing may play a bigger role in the future, given constraints on official aid, and commercial banks' cautious approach to increasing international exposure.

Co-financing with commercial banks has evolved since the mid-1970s. Initially, banks lent in parallel with standard World Bank loans (known as A-loans in this context), with or without an optional cross-default clause or a memorandum of agreement with the World Bank. In 1983, however, the World Bank introduced its B-loans, which had terms and conditions more closely aligned with those of the co-financiers.

B-loans offered three options designed to extend the range of co-financing instruments and to benefit all three parties — the borrower, the co-financier, and the Bank. These options were:

- funding late maturities of commercially syndicated loans up to 25 per cent of the principal amount of the loans;
- guaranteeing, up to the same amount, late maturities of commercially syndicated loans funded wholly by the commercial banks;

— accepting a contingent obligation, up to the same amount, to finance the balance of principal (if any) of a commercial loan, the annual debt service of which would be based on level payments of principal and interest[9] even though the actual interest rate is variable[10].

A total of 24 B-loan transactions have been agreed upon to date. The B-loan programme was originally introduced as a pilot programme, became it was one of the means by which the Bank assisted its borrowers in mobilizing external finance. Each of the above techniques has been used, although in the single instance in which a contingent obligation transaction was arranged, the loan was subsequently cancelled.

A World Bank review conducted in 1988 concluded that the Bank should be highly selective in providing credit enhancement to encourage new financing in any country restructuring its external debt. The review further concluded that while direct participation co-financing was an extremely attractive and powerful catalytic tool, it should be continued to be used with caution. In particular it should be extended only to countries in which the threat of debt service interruption appeared minimal. Its use should be suspended in countries restructuring their debt.

The B-loan co-financing programme was limited to commercial banks. Since the inception of the programme in the early 1980s, however, the pattern of overall financial flows has changed considerably. Emerging innovations in the capital markets have become widely accepted, broadening the range of instruments available for providing financing to creditworthy borrowers. In the meantime, as a result of the developing country debt crisis and more stringent bank capital requirements, commercial bank lending to developing countries has declined. Recognizing the World Bank's need to adapt its private co-financing programme to changes in credit and capital markets, a programme of Expanded Co-financing Operations (ECOs) was authorized by the Executive Directors of the World Bank in July 1989. The ECO programme follows the same principles and objectives as the B-loan programme, but has wider scope. ECOs are intended to promote additional private financial flows by providing enhancements that would cover risks not otherwise assumed by private lenders. The programme is available to eligible borrowers in order to attract private financing for specific projects or investment programmes that are appraised by the World Bank, and are normally accompanied by World Bank loans.

In general, borrowing countries that are implementing sound economic policies and have reached, or are reaching, market creditworthiness for private loans are eligible for support under the ECO programme. As the programme is designed to help countries close to voluntary private financing, developing countries that have restructured their external commercial debt within the preceding five years are not normally eligible for credit support under the ECO programme.

Table 1

| ECO - Eligible Countries as of June 1991 | |
|---|---|
| Algeria | Malaysia |
| China | Pakistan |
| Colombia | Papua New Guinea |
| Cyprus | Romania |
| Cezchoslovakia | Thailand |
| Fiji | Tunisia |
| Hungary | Turkey |
| India | Zimbabwe |
| Indonisia | |

Table 2 presents the sovereign bond rating of some selected ECO-eligible countries countries.

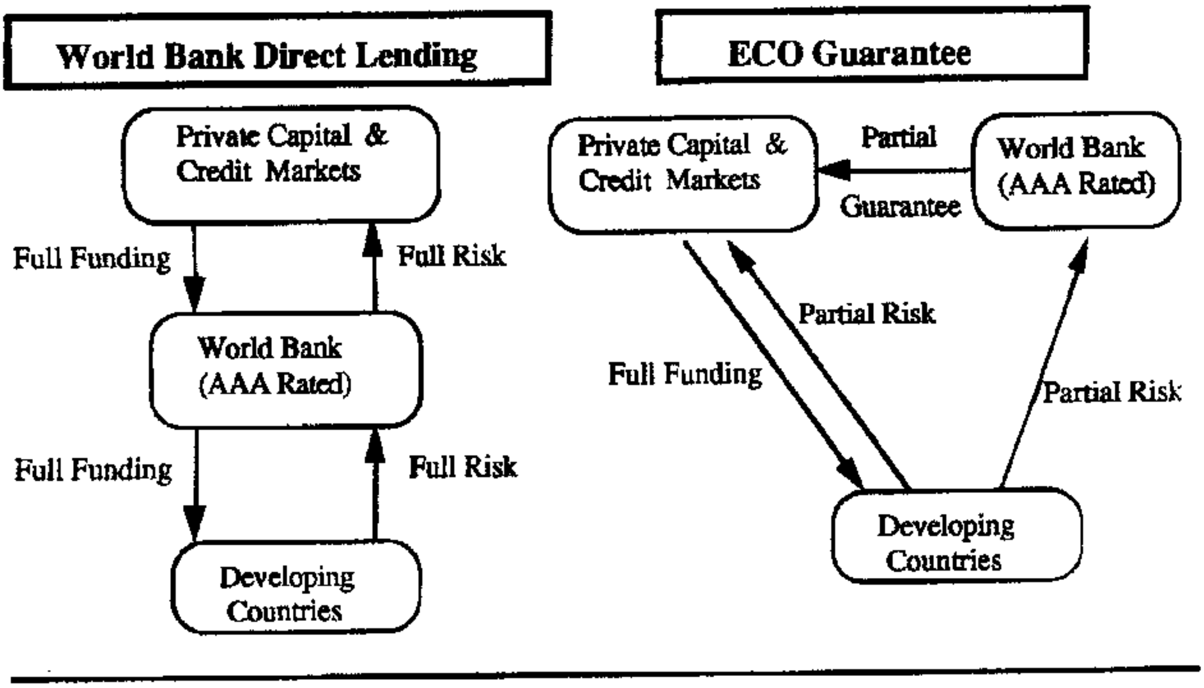
Table 2

| | US Rating Agencies | | Japanese Rating Agencies | |
|---|---|---|---|---|
| | Moody's | S & P | JBRI* | JCR** |
| China | Baa1 | BBB | AA- | NR |
| Hungary | Ba1 | NR | NR | A- |
| India | Ba2 | BB+ | A | NR |
| Malaysia | A3 | A | AA- | NR |
| Thailand | A2 | A- | AA- | NR |

* Japan Bond Research Institute
** Japan Credit Rating Agency
NR = Not Rated

Under the ECO programme, the extent of credit support can be linked to borrower needs and existing market conditions. The World Bank guarantees are normally limited to a maximum of 50 per cent of the financing on a present value basis. However, the actual coverage is negotiated with the borrower and the lender on a case-by-case basis. The following diagram gives a clear idea of how ECOs allow the Bank to share risks with markets. This is quite different from direct Bank lending.

Diagram 2



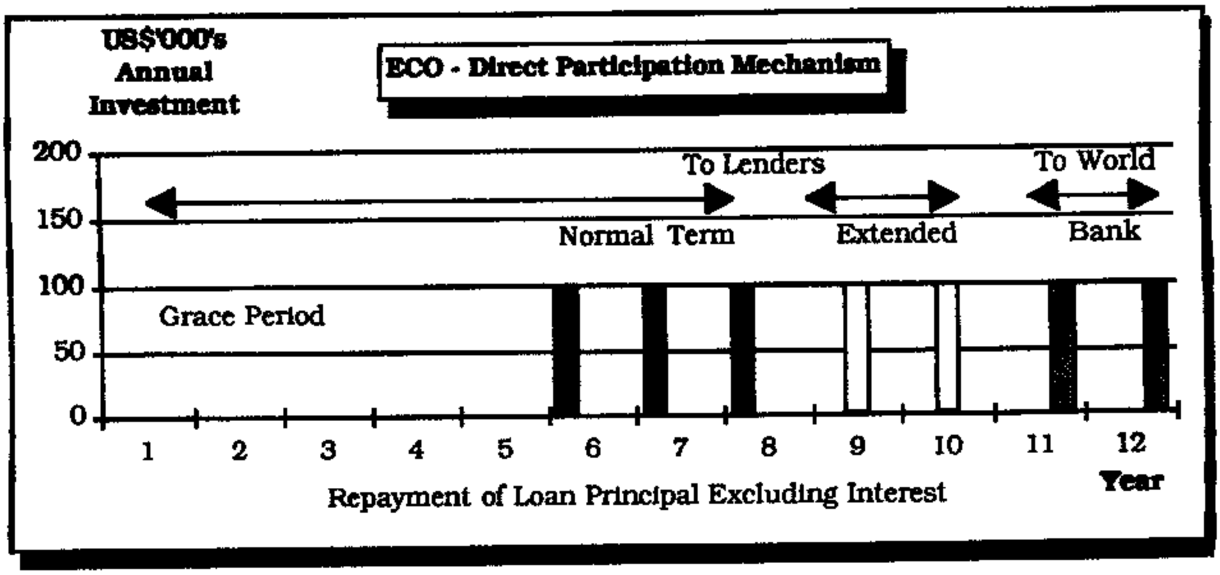

Source: The World Bank, 1991

As Diagram 2 demonstrates, under a direct World Bank loan, the World Bank provides all the financing for a project and accepts all the risks. To fund itself, the World Bank borrows in the capital markets on the finest terms and conditions given its Triple-A rating. Such a rating is rooted in the "preferred creditor status" of the Bank, which is itself illustrated by the non-rescheduling experience of the Bank's loans since its inception in 1945. Arrears, however, have been growing over the last few years. At the end of fiscal year 1991, eight countries were in non-accrual status. The IBRD raised its consolidated provision for possible loan loss to $2 billion. On the other hand, under the ECO programme an acceptable risk/reward structure can be designed through which the private and commercial markets provide direct funding to the project while risks are shared between the providers of funds and the World Bank.

In line with objectives set forth by the ECO programme, specific applications were set out as follows:

***a. Direct participation in commercial bank loans*** (B-Loans): ECOs can be structured so that the World Bank offers direct participation to commercial banks for the earlier maturities and retains only the later maturities for its own books;

Diagram 3




As illustrated in the diagram above, this method provides the banks with the World Bank risk profile protection (11) but does not allow for the flexibility sometimes warranted and preferred by the borrowers. A large and growing share of official multilateral claims in a country's debt structure tends to increase rigidity in debt management due to the non-rescheduling nature of IFIs claims, and hence reduces the flexibility of debt management from the sovereign perspective.

***b. Partial guarantee on commercial loans:*** ECOs can be structured to provide partial guarantees on commercial bank loans raised as co-financing for Bank-approved projects or programmes.

As an example cited in Diagram 4 shows, the ECO programme can provide flexible structures to achieve the desired risk/reward profiles necessary to satisfy commercial lenders' requirements and borrowers' objectives. For example, the World Bank's level of support is within its 50 per cent guideline while providing commercial lenders with a sufficient level of risk mitigation to produce an appropriate level of risk/reward coverage.

Diagram 4

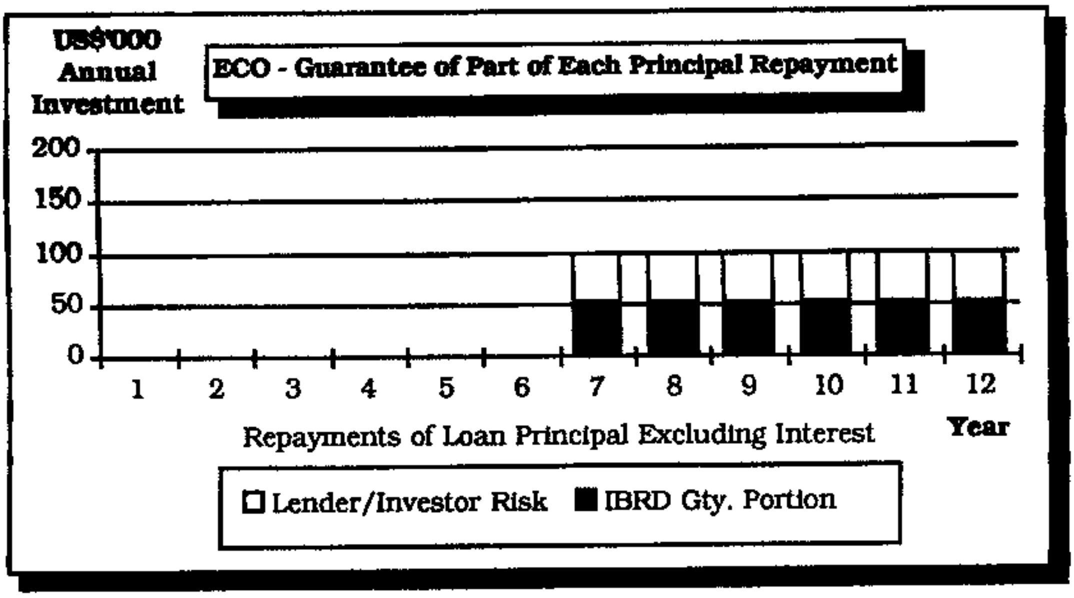
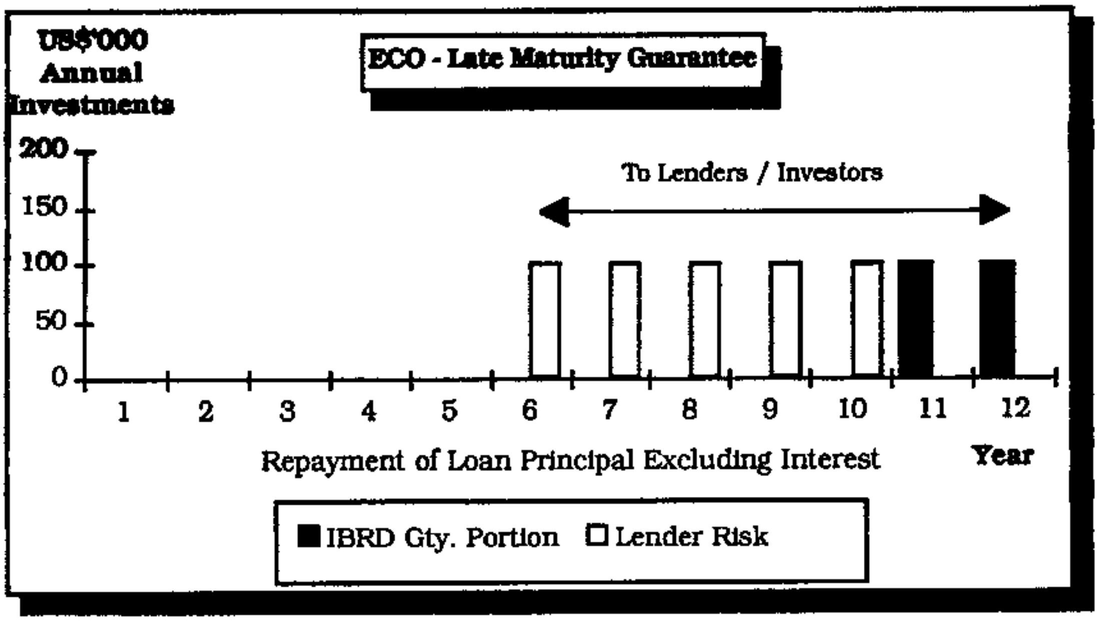



Diagram 5




Recognizing that commercial bank lenders often feel most comfortable assuming the risks of earlier maturities, the partial guarantee scheme illustrated in Diagram 5 can satisfy both lenders' risk tolerance and the longer term maturity needs of most World Bank sponsored development projects;

*c. Partial guarantee on bond issues:* Under appropriate circumstances, ECOs can be used to provide partial guarantees on medium- and long-term bond issues, either publicly issued or privately placed with a small number of institutional investors to co-finance Bank-approved projects. As illustrated in Diagram 4, the principal payment of a 10-year bond issue is guaranteed by the Bank, while the investor bears the interest risk of the bond issue;

*d. Contingent obligations:* ECOs can be structured as contingent obligations in a variety of ways. Bonds can be issued to co-finance Bank-approved projects, for example, with an option to "put" them to a third part such as the Bank (in case the borrower's credit perception is insufficient to support the put) under predetermined circumstances. Contingent credit support could also be provided for syndicated lending or capital markets transactions through a put obligation. A syndicate of commercial banks would lend for a Bank project and hold the loan for a specific period. The Bank would then agree to take out the commercial syndicate at their option at the end of the period. Such arrangements would be attractive to commercial lenders willing to finance Bank projects, but are not be prepared at the onset to extend long-term financing.

*e. Support for project finance:* ECOs present a way in which the Bank can provide support in the context of limited recourse project financing[12]. In such an instance, project sponsors invest in developing countries, but require certain undertakings from the host government in support of the private financing that is provided to the project. Very often these undertakings take the form of financial commitments to the lenders in the event that risks beyond the control of the sponsors occur.

In the World Bank's fiscal year ending in June 30, 1991, its aggregate co-financing deals amounted to $8.98 billion of which $3.77 billion came from multilateral sources, $3.28 billion from bilateral sources, $1.49 billion from export credit agencies and $434 million from private sources. With increasing liberalization, deregulation and privatization of the formerly state-controlled economies, the World Bank is increasing its own emphasis on projects involving "private sector development"[13]. The table in Annex I summarizes the World Bank's co-financing operations by source (official, export credit and private) between the fiscal year 1985 and 1991.

## B. Private co-financing operations of other multilateral institutions

Among the regional multilateral banks, the Asian Development Bank (ADB) is one of the most active in terms of co-financing operations. The ADB's co-financing operations can be categorized in two areas: parallel financing and joint financing. Under certain circumstances, co-financing occurs through special arrangements such as umbrella or stand-by financing, participation financing, or channel financing, depending on the timing of co-financing availability and preferences of co-financiers. The different ADB co-financing arrangements are as follows:

*a. Parallel financing:* The project is divided into specific and identifiable components. Each project component is financed separately, either by the Bank or by the co-financiers. This arrangement is often applied when co-financiers have procurement policies and procedures different from the Bank's and administer the loans themselves;

***b. Joint financing:*** ADB funds and co-financiers are pooled to finance a common list of goods and services, in agreed proportions, required for the project. The Bank's procurement guidelines govern goods and services procurement;

***c. Umbrella or stand-by financing:*** In this case, the ADB initially finances an entire project but cancels a portion of its loan when co-financing becomes available;

***d. Channel financing:*** Occasionally, co-financiers prefer an indirect financial relationship with a Developing Member Country (DMC) by channelling their funds through the Bank. This mode is feasible only if co-financiers accept the Bank's guidelines and procedures on recruitment of consultants, procurement, loan disbursement and project supervision. This mode of co-financing is often used by the ADB when bilateral sources provide grant funds for Bank technical assistance operations;

***e. Participation financing:*** A co-financier, normally a commercial bank or other financial institution, can purchase earlier maturities of ADB loans or participate in the ADB's Complementary Financing Schemes (CFS). Under CFS, the ADB arranges co-financing with private financial institutions such as commercial banks, insurance and casualty companies, and pension funds. Under such an arrangement, the ADB can provide guarantees for the later maturities of private financial institutions if warranted by the market. CFS are used with commercial sources only, for both public and private sector projects and programmes.

While appraising the projects with potential for co-financing, the ADB pays particular attention to the project's procurement requirements, restrictions on the use of co-financiers' funds, other likely co-financier terms and conditions, and the technical, financial and economic feasibility of the project. In particular, during appraisal, the ADB pays special attention to the following:

— The amount of co-financing based on project capital requirements and the amount of the ADB loan;

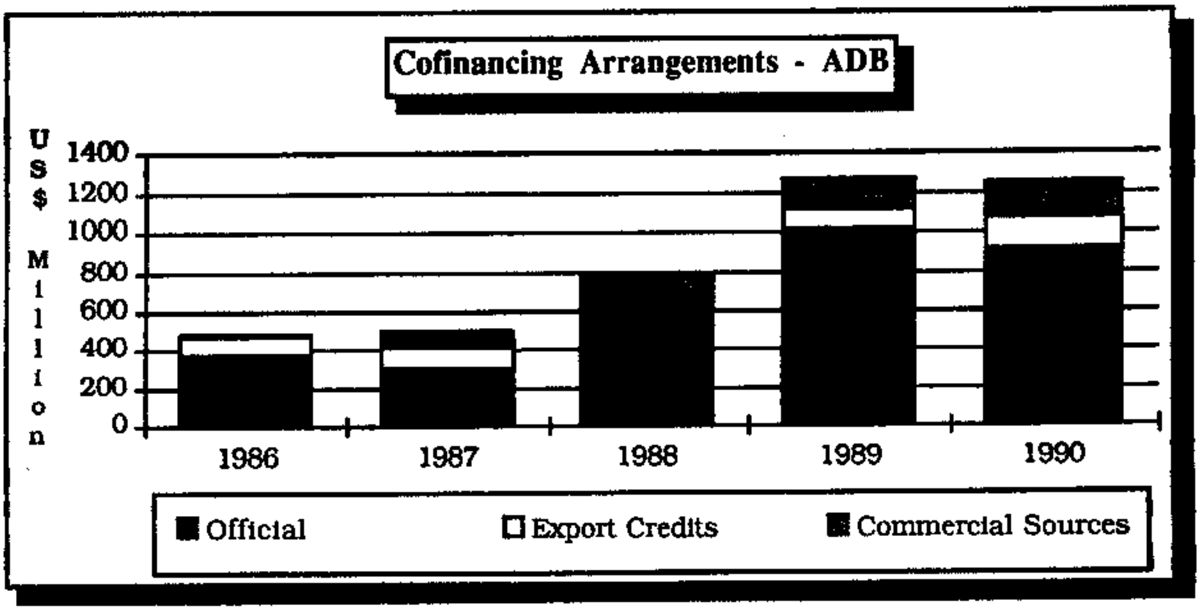
— The optimal mode of co-financing to meet project and co-financiers' requirements, and in the case of parallel financing, the identification of components to be selected for the ADB financing and the co-financing, and;

— Arrangements with executing agencies, co-financiers and the ADB relating to the approval, implementation and administration of the project.

The ADB's Business Opportunities (Proposed Projects, Procurement Notices and Contract Awards, (ADBBO) is a monthly publication, which lists all the loans and technical assistance projects which the ADB contemplates financing. When a particular project is perceived as needing co-financing, it is mentioned in the ADBBO. Commercial co-financing may be arranged by the ADB at the request of the borrowers or executing agencies. Information on projects for potential co-financing may be obtained from the ADB's quarterly publication "Project Profiles for Commercial Co-financing".

Through the various mechanisms described above, co-financing is now an established and important part of ADB operations. On a cumulative basis, between 1970 and 1990, 314 projects totalling over $9.65 billion involved co-financing - about $9.6 billion were provided by co-financiers with $13.5 billion provided by the ADB. This accounted for about 29 per cent of the ADB's total cumulative loan portfolio of $32.6 billion. However, the largest portion of the co-financing came from official sources (74 per cent), followed by commercial sources (14 per cent), and export credits ( about 12 per cent). Official sources of co-financing contributed $957 million through 24 projects in 1990. Co-financing from commercial sources accounted for $300 million through eight projects during the same year. Co-financing with commercial banks and insurance companies (excluding export credit sources) amounted to $145 million, an increase of about 30 per cent over the previous year.

Diagram 6




Source: Asian Development Bank, 1991

Among the other multilaterals, it is likely that the European Bank for Reconstruction and Development (EBRD) will soon take up a similar role as the ADB. However, at this stage the EBRD has indicated that the actual rules and regulations of such a programme have not been laid out explicitly. According to the first and latest annual report of the bank: "In the course of its operations, the Bank will work closely with multilateral institutions and other interested sources of financing, both public and private". The EBRD has so far concluded only one co-financing operation together with the World Bank, a $50 million equivalent loan to Poland for a heat supply restructuring and conservation project, where the World Bank's contribution was $20 million. In 1991, the EBRD and NMB Bank created a $100 million line of credit for small and medium size enterprises in Central and Eastern Europe. The EBRD is the lender of record while NMB Bank takes a funded participation of 60 per cent in each loan. With such complementary co-financing transaction, NMB Bank shares fully the EBRD's preferred creditor status.

In contrast to the World Bank co-financing mechanisms, the "extended creditor status" of the IFC has drawn a large number of banks in co-financing operations. The legal structure of IFC's co-financing loans is such that it is attractive for commercial banks for accounting and regulatory motivations despite the fact that IFC lends without guarantees. Normally there is a single loan agreement between the IFC and the borrower for the full amount of the finance to be provided by IFC and the commercial banks. The IFC loan is divided into two portions. The first is the loan for IFC's own account (A-loan) and the second (B-loan) is funded by the participating commercial banks, on agreed terms and conditions. A separate Participation Agreement is signed between IFC and each participating commercial bank. The commercial bank's relationship with the borrower is therefore indirect, through IFC, which acts as the sole lender of record and loan administrator. In practice, for regulatory purposes, the main advantage of co-financing with IFC is that it requires no loan provisioning. Recently, in June 1991, IFC offered several banks the possibility to participate in a $10 million syndicated IFC B-loan to Compana de Telefonos de Chile SA[14].

Similar legal structures as the IFC are applied by the Inter American Investment Corporation (IIC) in co-financing transactions with commercial banks. The first IIC co-financing for Banca Serfin in Mexico in late 1991, was oversubscribed by the participating banks[15].

## III. Legal Issues Pertaining to Co-financing[16,17]

### A. Introduction

Legal jurisdiction pertaining to co-financing operations should reflect the mutual interest of private and official creditors. A-loan contracts are governed by the World Bank's Articles of Agreement and comprise official financial support to LDCs. B-loan agreements are usually governed by the lender country's jurisdiction; for example, by English, Japanese, or New York State law. The lender's national courts have the jurisdiction to try any court suit, action or proceeding, as well as to settle any other disputes that come about. This represents a compromise on the part of the World Bank in favour of the commercial banks. Consequently, two separate legal regimes govern the relationship between the Bank, the co-lenders, guarantors and borrowers for a co-financed project. The A-loan is governed by international law and arbitration, whereas the B-loan is governed by municipal court law and jurisdiction.

Though the Bank has made several concessions aimed at providing real "legal comfort" to commercial banks, these concessions contain certain clauses that permit the Bank to retain a special status. Since the provisions are specifically instrument-directed, Section B. below will examine the legal issues pertaining to the "direct financial participation", and "the provision of partial guarantee" co-financing instruments. It will become clear that the legal clauses surrounding these various instruments do in fact raise serious doubts and questions in the mind of the commercial banks as to how far they should participate in co-financing operations. However, it should be borne in mind that with the available legal tools, one cannot rule out the possibility of commercial banks exercising legal remedies in the case of a default iOn a co-financed loan with the World Bank. Such legal remedies may have serious implications for the World Bank, which are elaborated in Section C. Section D. presents "other forms of legal comfort" from which the commercial banks benefit in a co-financing transaction with the World Bank.

### B. Legal issues specific to co-financing instruments

#### *Direct financial participation*

The legal clauses that specify the rights of the World Bank in a direct financial participation are the "non-rescheduling option" and the "cross-default clause". The parallel legal rules for the commercial creditors are the "pro-rata sharing clause", and the "cross-default clause".

Through the "non-rescheduling option", the commercial bank recognizes that the Bank portion of the loan will not be subject to rescheduling, following the normal procedure for Bank loans.

For the commercial banks, syndicated credit agreements stipulate that lenders agree to share loan service payments on a pro rata basis, hence preventing discrimination. The pro rata sharing clause is a key feature of commercial syndicated loan agreements and is designed to ensure that no one lender is favoured by the borrower with respect to loan recovery. It also addresses the issue of shortfalls in payments due, and provides a 'hierarchy' of payment obligations so that any particular obligation can only be satisfied once the obligations above it have been satisfied. Due to accounting and regulatory considerations, interest due and accumulated arrears are usually paid before principal.

The cross-default clause is a provision by which the lender is entitled to accelerate or suspend its loan if the borrower has defaulted on other loans, particularly in respect to payment obligations. Lenders have the option to choose whether to exercise cross-default clause remedies when a borrower has failed to meet his obligations as detailed in the loan agreement, or when the lenders believe that the state of the borrower's affairs suggests he will be unable to meet obligations. Typically, commercial banks may exercise legal remedies through the optional cross-default clause if the borrower defaults on any other loan. However, the Bank's cross-default clause differs from that of commercial banks. The Bank's cross-default clause pertains to default on other loans for the project being co-financed, and is therefore project-related. The commercial bank cross-default clause pertains to default on any loans taken by the borrower. Therefore the latter is extremely wide in scope and can be instigated by any lapse in the creditworthiness of the borrower.

Given these overall framework of the legal clauses, we now analyse their implications due to their interactions, both for the World Bank and the commercial banks, in the context of co-financing operations.

When the World Bank participates through direct financing, the co-lender, the borrower, and the Bank agree that the entire co-financing loan obligations cannot be rescheduled without the Bank's consent. This significantly profits the commercial banks as the borrower thinks twice before asking consent from the Bank to reschedule, even if the Bank's own portion of the loan is not under review. In certain circumstances, however, the Bank may agree to a rescheduling of the commercial bank portions, while the Bank portion remains untouched. Hence, though the commercial banks may expect to be able to profit, as co-lenders, from the World Bank "umbrella", by offering better terms to borrowers than those normally available to them, this is not always the case. The following three paragraphs explain how.

In the event that a borrower experiencing loan repayment difficulties faces various loan agreements, he can repay a particular lender if he is the sole source of that particular loan. This can be done at the expense of servicing other loans. But through the "pro-rata sharing clause" these "other" lenders can contractually prohibit the borrower from pledging his assets to secure any particular lender's loan without providing equal or equivalent security to these lenders' loans. Generally, payments are pooled in the hands of an agent who then distributes the proceeds to all lenders equally, thereby assuring that no one lender is favoured. The World Bank, despite its usual preferred creditor status, officially adheres to the clause. In practice, however, when the Bank is involved in direct funding, its non-rescheduling policy supersedes the pro rata sharing clause thereby retaining its preferred creditor status.

The Bank only funds the late maturities of B-loans and funds those exclusively. It is under no obligation to share any payments with its co-lenders during the period prior to the due date of the first maturity owed the Bank, as long as the co-lenders have no fees or interest payment due and owed them. During the amortization period, prior to the date upon which the Bank's first maturity is owed, the Bank need only share received payments (interest and/or fee obligations) if non-principal payment obligations are due and owed to other co-lenders.

Therefore, the profits that might be gained from the association with the World Bank whose international "authority" inspires borrowers to respect agreements, are only partially harvested. In practice, the rules and rights pertaining to the commercial banks are not, in effect, identical to those of the World Bank[18].

Another point worth noting is that the legal clauses pertaining to the B-loan agreements do not affect or interfere with the A-loan, the Bank's primary exposure to the borrowing member country. When the World Bank is involved in direct financial participation in a commercial syndicated loan, the cross-default clause agreed to is broader than usual for the Bank. The B-loan can be declared in default if there is material debt service failure to the Bank for more than 45 days by the borrower or the guarantor. Default can also be declared if the Bank accelerates its A-loan for the project, but under no other circumstances can a B-loan be cross-defaulted to the Bank A-loan.

Commercial banks have attempted to persuade the Bank to include a mandatory cross-default-clause in B-loan agreements. This would legally oblige the Bank to exercise remedies on the A-loan once a commercial bank had decided to exercise cross-default remedies (suspension,acceleration or cancellation) on its portion of the B-loan. Such automaticity however, goes against the principle of independent power of decision for each respective lender, and the Bank's Board has not agreed to its inclusion so far. As a "co-operative institution", the World Bank aims to encourage the mobilization of additional financing without becoming "hostage" to private creditors.

The purpose of the cross-default clause is to give to the lender(s) the right to exercise certain remedies when any of the triggering events occur. The lender is under no obligation to do so though, as cross-default clauses are optional. In so far as the co-financed loan agreements generally take place between several banks and the World Bank, how decisions are made, and what discretionary remedies are exercised must be agreed upon, at least in theory. This limits discretionary power of individual banks.

In essence, in direct funding agreements, the Bank generally agrees to be treated like its commercial bank loan partners. Implementation of the pro rata clause means that though the Bank only funds late maturities, it shares in the risks of interest payment from the beginning. It is this fact which suggests that B-loans may be considered as preferred credit. The Bank cannot legally prevent a formal rescheduling of the commercially-held portions of the loan. The Bank's legal clout is limited to having the ability to have the pro rata sharing clause not apply in respect of lenders who agree to a rescheduling. Though the Bank takes a portion of the management fee, the commercial banks pay nothing directly for this "guarantee" or protection.

In effect, the pro rata clause means that default in interest due to the commercial banks translates into default to the Bank, unless there is rescheduling of the loan in question. The borrower can never entirely meet its payment of principal obligations to the Bank without also entirely paying all interest due to the co-lenders. Amounts owed to the Bank can be accelerated in the event of a default as a result of a decision made by the co-lenders, and not necessarily the Bank. This is due to the decision-making vote procedures. As the loan is progressively repaid, however, the percentage of outstanding Bank loan commensurately increases compared to the commercial counterpart, thereby providing the Bank with greater voting power.

***Provision of partial guarantee***

In the guarantee option, all funding must be provided by the commercial banks who typically assume the entire interest payment risk for the loan. The commercial banks pay the World Bank (through the guarantee fee) for the risk it assumes, i.e. - non-payment of final maturities. The World Bank may recover amounts paid out under the guarantee even though the other lenders have amounts due them unpaid. The commercial bank's ability to accelerate the guarantee is not a standard aspect of loan agreements, though it can occur on occasion. Under the guarantee option the World Bank does not accept a role identical to that of the commercial banks. The Bank's exposure is clearly separable and it takes the firm position that it will not agree to subordinate its own claims on the borrower in event of a payment under its guarantee.

Besides the cross-default clause and the pro-rata sharing clause described above, the two other legal clauses that specifically apply to the partial guarantee scheme are the "rights of subrogation and indemnity" and the "non-rescheduling" of the guarantee portion.

The right of subrogation permits the Bank to acquire whatever rights the lenders had, since it has in effect, 'stepped into their shoes'. Under some jurisdictions, however, if a subrogation covenant is not included in the loan agreement, the guarantor can be prevented from exercising the right to invoke the subrogation covenant against the borrower until all the guaranteed lenders have been totally repaid. But the courts can also uphold an express contractual covenant between the guarantor and the lender stating that the guarantor may exercise his subrogation rights and therefore be paid in full prior to the lenders. For this reason, the World Bank includes a specific provision on subrogation in B-loan agreements as it wishes to avoid subordination to the other lenders.

Typically, the guarantee covers principal due at the end of the loan, but not payment of interest on guaranteed principal. Therefore, though the commercial bank is to some extent covered, this coverage is incomplete. This is of particular concern to guaranteed lenders since, due to the Bank's special creditor status, the borrower is likely to pay the Bank with its scarce resources, thereby making it less likely to repay unguaranteed obligations still due, including accrued interest in respect of guaranteed maturities. Commercial banks have tried to incorporate terms providing that any Bank claim arising from payment under the guarantee must be subordinated to remaining claims that the other lenders have against the borrower. To date, however, the Bank has not agreed to include any such provision. On occasion the Bank has issued letters indicating, without a specific legal commitment, the Bank's willingness to work out with the borrower reasonable terms and conditions for payments of amounts due to the Bank while taking into consideration the interests of the other lenders and the borrower.

The ultimate contractual remedy available to lenders for breach of obligation by the borrower is acceleration. The lender can limit interest rate payment risks without qualifying the Bank's subrogation right, or formally subordinating its claims. Acceleration is a remedy by which the loan is made immediately due in its entirety. If, therefore, the borrower fails to meet an interest payment, the lenders may accelerate the loan. This results in the principal being repaid, and therefore, interest obligations cease thereon to increase. For this reason, whether and to what extent principal is repaid is an important issue for the commercial banks. If the Bank is not reimbursed the cross-default clause is triggered.

As already indicated, when the Bank participates in direct funding there is a possibility that the commercial bank portions of the loan can be rescheduled even though the Bank portion of the loan cannot. The partial guarantee has the effect of "excluding" the amount of the loan that is guaranteed from rescheduling. This is because since the Bank has agreed to repay the lender if the borrower is unable to do so, then the portion of the loan that is so guaranteed cannot be subject to rescheduling since it would be paid immediately by the Bank. This falls under the "non-rescheduling" clause of the guarantee portion.

The Bank concedes to the commercial syndicated loan majority voting provisions in order to further enhance the B-loan programme for commercial banks. If, therefore, the Bank is merely acting as a guarantor, it has no voting rights since it is not actually a lender. Usually, however, there are provisions in the B-loan agreement that stipulate that certain decisions must be consented to by the Bank, as they could have implications on the Bank's position as guarantor. Once again the Bank retains an exception to the rule. In this case, the Bank, despite its "no-voice" position, has in reality a rather important power of veto.

Another issue worth mentioning in this context is the "guarantee fee" charged by the World Bank in the partial guarantee scheme. In several instances, the guarantee fee has led to protracted difficulties in reaching an agreement between the Bank and the lenders. Commercial banks have displayed a lot of resistance in "voluntary" lending situations to the reduction in their spread caused by the guarantee fee, for the benefit of obtaining credit coverage limited to principal only, for risks they were not prepared to take in any event.

## C. Implications for the World Bank should private lenders exercise legal remedies

The World Bank and other multilateral development organizations are co-operative institutions. They rely on borrowing in the world capital markets to raise resources for development-oriented projects. Capital market borrowings, however, are not enough to meet the financial requirements of developing countries. The co-financing operations are a crucial instrument of the World Bank and other multilateral institutions in that regard. Because co-financing operations create a partnership relationship between private and official institutions, risk-sharing arrangements might have negative implications on the IFIs' creditworthiness should repayment problems arise. The fact that the IFIs pay due regard to the prospects of repayments, coupled with careful analysis of the project's viability, do not rule out any debt servicing difficulties. The purpose of this Section B. is to examine what implications, if any, there would be for the World Bank in the event that commercial bank creditors were to exercise legal remedies in case of default against a particular member country. In specific, this section addresses:

— the implications for the World Bank's future lending operations in the country;

— the implications under existing World Bank loan agreements with the country;

— the implications for the World Bank's role as a "lender of last resort";

— the implications of World Bank's borrowing operations in the capital markets.

### *Implications for the World Bank's future lending operations*

The Articles of Agreement of the World Bank do not contain any explicit requirement to the effect that a failure of a member country to service its external debt obligations to its commercial bank creditors, or the exercise of legal remedies by such commercial bank creditors in respect of payment defaults, render the member country automatically ineligible to receive World Bank loans. However, review of the history of the drafting of those Articles shows that this issue was specifically considered by the draftsmen, who ultimately decided that it was not appropriate or necessary for World Bank to evaluate its credit risks by reference to private banking standards. It is relevant to note in this context that about half of the countries represented at Bretton Woods were in default on their obligations to private investors in the United States, Britain, France and the Netherlands. It is therefore likely that the drafters did not rule out lending to member countries which were in default to other creditors.

The Bank's concern about a member country not being able to meet debt service obligations is manyfold. One, the existence of a dispute over external debt suggests that the debtor may be faced with problems, such as unfavourable economic conditions, unsound economic or fiscal policies or administration, or lack of discipline or willingness to pay even at some sacrifice, or unwillingness to make politically difficult decisions; any of these problems interfere with the economic progress of that country quite apart from the effect of the default itself. Two, since the Bank is not intended to supply all the external capital requirements of its member countries, they must seek funds from other public sources — the private capital market or direct private investment; a record of unsettled disputes over external debt defaults may jeopardize the country's effort to obtain external capital from sources other than the World Bank. Three, the World Bank must also rely on capital markets of the world to replenish its own resources[19]; if it were to make new loans to countries which fail to make reasonable efforts to resolve disputes over defaults, its own market standing might suffer.

***Implications under existing World Bank loan agreements***

It is often argued that a serious dispute over external debt defaults, particularly when it involves a large number of commercial bank creditors and a large amount of debt, could have an adverse affect on the future ability of the borrower to service World Bank loans. This may particularly be the case where commercial creditors have exercised legal remedies against the borrower so as to seriously affect the country's financial position or the specifics of a given project.

The "General Conditions" of the World Bank's loan agreement with the debtor country do not contain any explicit provision which requires the Bank to take any action in the event of disputes or the exercise of legal remedies in respect of external debt defaults to other creditors. However, if the World Bank was so inclined, it could act pursuant to its "General Conditions" in the event that it considered a particular debt default situation to be "an extraordinary situation" which made it improbable that the borrower would be able to fulfil its financial obligations under the Loan Agreement or Guarantee Agreement.

There is no obligation on the part of the World Bank to review whether it should also exercise remedies under Bank loan agreements in the event that commercial banks exercise remedies against a member country. However, in case of World Bank projects which are co-financed with other creditors, including commercial banks and official sources, it is customary to include the optional cross-default clause. This clause merely obliges the Bank to consider whether it should suspend the right of the borrower to make withdrawals under the Bank's loan agreement for the co-financed project. The mere occurrence of a payment default by the member country does not warrant a review by the World Bank. However, when the commercial banks have actually exercised remedies such as cancellation, termination etc. then the World Bank is obliged to review whether it should suspend the right of the borrower to make withdrawals under the Bank's Loan Agreement.

In co-financed projects where the World Bank is a direct participant with the commercial banks in a syndicated loan agreement (B-loans), the Bank would be obliged to consider the exercise of remedies under such an agreement in conjunction with the commercial banks. Since such syndicated loan agreements frequently contain broader cross-default clauses than would be permitted by long-standing World Bank policy, the Bank does, however, reserve the right to decide that any acceleration of the B-Loan on this ground will not apply to its portion of the loan.

### *The World Bank as "lender of last resort"*

In making the judgement whether to lend, the World Bank also takes into account other provisions of the Articles of Agreement, including particularly Article III, Section 4(v), which requires the Bank "to act prudently" in the interests of both the member country and "of the members as a whole". As a part of its long-term planning for assistance to developing member countries and its policy dialogue, the Bank establishes mutual understanding with these countries on their overall development priorities and the size of the investment programme. A determination is then made of the financing support available from the Bank for various sectors and projects. This is done having taken into consideration the country's access to all potential sources of external capital consistent with their long-term debt-servicing capacity. In essence, Bank's lending is quite a small proportion of external finance in countries that can service a high volume of debt on commercial terms. When a country can finance the whole of its investment programme on a sustainable basis without the Bank financing, the lending is phased down and ultimately ceases through graduation. This approach also ensures that there is no displacement of foreign lending from other sources.

### *Implications for the World Bank's borrowing operations in the capital markets*

The major portion of the World Bank's resources that are used in its lending operations comes from the proceeds of its borrowing in the international capital markets. Given the magnitude of Bank's borrowing and its dependence on the international capital markets for its lending resources, it is needless to emphasize the importance of maintaining its high credit rating as a borrower. However in the context of the debt crisis it became quite an important issue whether exercise of legal remedies by commercial banks could jeopardize Bank's ability to borrow and at favourable terms. What that crisis in fact highlighted was the question whether the exercise of legal remedies by commercial banks against a given debt-ridden member country (and/or the continued lending of the Bank to such a country) could precipitate legal action by bondholders against the World Bank.

The fact that the Bank has to borrow the major portion of its loanable resources means that its financial position must be publicly disclosed and updated. Hence, it is closely and constantly scrutinized. The two main sources of scrutiny are on the one hand the rating agencies and on the other hand the underwriters, analysts and investors in the various markets.

Regarding the rating agencies, for example Moody's, they take into account various factors for determining the credit rating. In the case of the World Bank, though Moody's makes reference to the liquidity problems of the several borrower nations, it does not appear to be concerned by this for two reasons. One, the liquidity problem has not affected the countries' payments to the Bank, and two, Moody's is satisfied that the Bank's policy creates a strong incentive for timeliness in payments. The main concern of the rating agencies is the issuer's ability to honour its payments in respect of principal and interest. The World Bank has never defaulted on any of its bonds to-date. Hence, given the variety of substantiative considerations which influence the rating agencies in giving the Bank its triple-A rating, it is most unlikely that the exercise of legal remedies by commercial banks against certain Bank member country will in itself jeopardize its triple-A rating, at least until such exercise begins to affect a substantial portion of the Bank's portfolio.

For the benefit of the market participants, the World Bank prepares and issues a prospectus of its bond issue, which is filed with the relevant stock exchange or securities regulatory agency. In any event the prospectus is made available to purchasers of the World Bank's bonds. The prospectus is the basic information document which is used by the Bank to disclose all relevant and material particulars about itself, including its operations and financial conditions. If one carefully reads any such prospectus prepared by the Bank, it will be observed that the Bank has followed a policy of making a full and complete disclosure of its lending policies and criteria, and also of its problem loans. The Bank also puts forward the view that payment delays on these problem loans will not result in any material loss to the Bank. If and when commercial banks exercise legal remedies against a givn member country, and such action threatens to affect that country's ability to service World Bank loans as evidenced by actual defaults, the Bank will be obliged to consider disclosing those defaults in future prospectuses.

## D. Other forms of legal "comfort"

### *Monitoring the use of loan proceeds*

As is the case for A-loan agreements, B-loan agreements require a clear definition of the project and project components to be financed so as to clearly highlight the purpose of each loan. Special provisions are made to ensure that the proceeds of the loan are disbursed and used for the defined objectives, and can be closely monitored by the Bank. Usually cross-reference is made to the Bank's A-loan agreement. The B-loan programme allows quick drawdowns usually within weeks or months of signature, which accommodates private bank and borrower needs. This is done by establishing special accounts for the borrower or its central bank in which the proceeds of the co-financing loan are deposited and available for disbursement as required. However, these accounts must fulfil the annual report and audit requirements pertaining to normal Bank loan agreements and a special clause defines the arrangement procedures. In other words, goods and services procured via a Bank- financed B-loan portion must follow the Bank's procurement procedures. Funds advanced by commercial banks do not have to do so. This applies to all B-loan instruments. Generally, these monitoring provisions have been accepted by the commercial banks as a necessary feature of project financing.

***Issuance of statements***

Statements may cover matters such as confirmation of the borrower's continued eligibility to draw down Bank loans, or confirmation of net resource transfers from the Bank to the borrower. These statements benefit the commercial banks who require them before allowing disbursement actions. This in turn benefits the borrower (assuming positive confirmation) as the commercial banks then disburse.

***Linkage to disbursements***

In a few cases, the commercial banks have structured credit disbursements in tandem with World Bank loan disbursements so as to benefit from World Bank conditionality. Such examples can be found in Mexico and other countries. In case of Banobras, the commercial banks provided $1 billion coupled with a $500 million guarantee from the World Bank. The package also included a $500 million growth contingency co-financing under which the World Bank provided a 50 per cent guarantee.

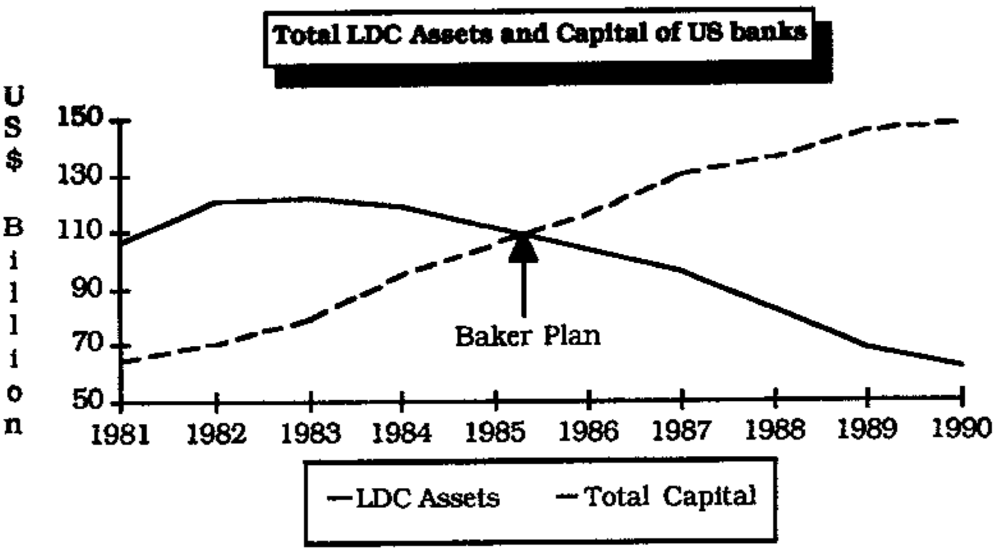
## IV. The Influence of Bank Regulatory Regimes on Co-financing Transactions

### A. Introduction

Co-financing transactions aim at providing private creditors with risk-sharing under the form of specific contractual provisions. For commercial banks, risk-sharing procedures with official entities have regulatory and accounting benefits. These benefits, in turn, alleviate the banks' competitive and regulatory pressure to strengthen their balance sheets.

Many of the same banks that participated in syndicated credit operations in the 1970s and early 1980s have been unwilling to increase exposure that is taxed by loan-loss provisions and contaminated by secondary market discounts. Bank behaviour is thus increasingly driven by tax, accounting and regulatory issues. Because rating agencies and stockholders reward strong reserve and capital positions of financial institutions, banks have considerably boosted their loan-loss reserves against LDC assets in 1989 and 1990. In the meantime, international banks have increased their capital while reducing LDC exposure. As shown in Diagram 7, the US banks thus doubled their capital between 1982 and 1990 while cutting by half their LDC assets as a result of loan sales, debt conversions and write-offs.

Diagram 7




To a large extent, bank regulatory regimes are important because they determine the impact of financial transactions on a commercial bank's profit and loss account as well on its capital position. Other things being equal, a bank will strive to maximize its profit while minimizing capital and reserve needs, so as to limit the funding costs of assets. The higher the level of loan-loss provisions, the greater is the cost of carrying existing assets, the stronger is the bank's capital position, and the less is the additional cost of realizing a loss, both in terms of reported income and capital. General loan-loss reserves are assimilated to quasi-capital because they must be available as a cushion to absorb unexpected shocks, contrary to specific reserves which reflect identified threats against a bank's capital position.

Bank portfolio management strategy is driven by several factors, including amount of exposure relative to capital, disclosure requirements, monitoring by shareholders and rating agencies, long-term business interests, and banking regulations. Of particular importance for banks is the timing of capital loss recognition for accounting and tax purposes.

Most international banks strive to meet the Bank for International Settlements (BIS) capital ratios of 8 per cent of risk-weighted assets by 1993. They act to bolster capital and cut asset growth through a combination of measures, including raising equity, increasing reserves, and reducing claims on troubled debtor countries. Capital ratios are influenced by the regulatory treatment of loan-loss reserves as well as by the credit risk of the banks' assets.

## B. Risk-weighted capital adequacy guidelines

The so-called "Cooke Committee" of the BIS in 1988 adopted the definition of a dual structure for bank capital, namely, core or Tier 1 capital and supplementary or Tier 2 capital. The Committee also specified a limited inclusion of loan-loss reserves in capital. Finally, the BIS established risk-weighting factors in order to define capital targets. The main impact of risk-based capital rules is to make bankers more selective in the use of precious risk-based capital and impose drastic asset portfolio rebalancing decisions. As a result of the new capital targets, banks can either mobilize capital, reduce assets, or restructure the balance sheet depending on various risk factors. Under the new risk-weighted capital standards commercial banks can free capital by changing the composition of their investment portfolio while maintaining or even expanding the size of their assets.

According to the Basles framework, Tier 1 capital consists of equity capital and disclosed reserves. Supplementary capital comprises undisclosed reserves, asset revaluation reserves, general loan-loss reserves, and subordinated term debt. Certain restrictions apply to the supplementary capital. In particular, Tier 2 elements are limited to a maximum of 100 per cent of Tier 1 elements, i.e., core capital should be at least half of total capital. Subordinated term-debt should be limited to a maximum of 50 per cent of Tier 1 elements. While specific reserves are excluded from capital, general loan-loss reserves may be included in amounts up to 1.25 per cent of risk assets. Access to Tier 1 capital is the overriding objective of commercial banks, since Tier 2 resources cannot exceed Tier 1 capital. Banks had to reach a minimum 7.25 per cent target ratio of capital to risk-weighted assets by the end of 1990, and by the end of 1992 a ratio of 8 per cent of which the core capital element should be at least 4 per cent.

The level of loan-loss reserves and its limited inclusion in capital has a large bearing on bank profitability ratios. Other things being equal, international banks will prefer to lend to customers free of reserves and, in the case of mandatory reserves, to include general reserves in capital. Table 3 illustrates the accounting and tax treatment of general loan-loss reserves in the nine major OECD countries.

Table 3

| Country | Average Reserve Levels | Tax Deduction | Capitalisation |
|---|---|---|---|
| France | 58 % | Yes max. 60 % | Yes |
| Belgium | 45 % | No | No |
| Canada | 35 % min. | Yes max. 45 % | No |
| Germany | 70 % | Yes | No |
| Japan | 15 % | 1 % only | 14 % |
| Netherlands | 65 % | Yes | No |
| Switzerland | 65 % | Yes | No |
| United Kingdom | 50 % | Yes | No |
| United States | 58 % money-center | No | Yes |
| United States | 75 % regionals | No | Yes |

## C. Credit risk of co-financing operations

In order to evaluate bank capital adequacy, five different categories of assets are assigned weights according to their perceived relative riskiness. These asset types are assigned weights of 0 per cent, 10 per cent, 20 per cent, 50 per cent, and 100 per cent respectively to reflect their varying its inherent risk characteristics. By this method, higher risk assets will demand higher levels of capital support. For example, LDC claims on central government that are denominated in local currency receive a 0 per cent risk weight. Short-term loans as well as claims guaranteed or collateralized by the IFIs receive a 20 per cent risk weight.

In all co-financing transactions, the World Bank made sure of keeping its preferred creditor status, thereby refusing to reschedule its portion of the loans. Though interest payments are paid on a pro rata basis through the Agent bank, the Bank has always stipulated that it does not tolerate rescheduling its loans. The country thus faces two categories of creditors, private and official. In the case of co-financing deals with IFC and the IADB, the legal structure is such that the banks are protected by the senior creditor status of the two IFIs. The debtor country faces one creditor, namely the IFI. Bank regulators accordingly take into account the stricter legal structure of IFC and IADB co-financing transactions.

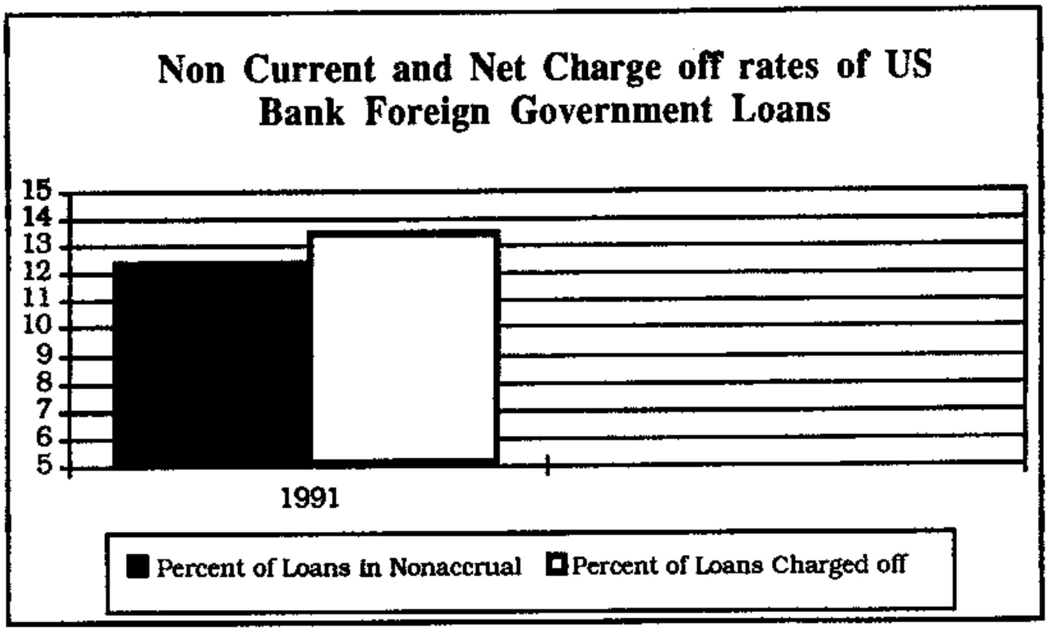
Bank regulators in the OECD countries have drawn accounting conclusions from the varying legal structures of co-financing transactions. Thus, in France, co-financing with IFC is excluded from the provisioning base of country-risk assets. However, B-loan co-financing operations with the World Bank must be reserved[20]. Because banks must reserve LDC assets at the average level of the French banking community, i.e. 60 per cent, reserving World Bank co-financing operations substantially reduces the profitability of such transactions.

In the United Kingdom, the Bank of England has set up a Matrix system which determines a range of provisioning guidelines. In 1990, the Bank of England revised its Matrix, hence requiring higher levels of provisions against country risk. The system retains the same method of calculating provision levels according to a series of risk factors with corresponding tax allowance provisions. The Bank of England stipulates that co-finance lending must be included in the provisioning base of risk assets. However, lending with bilateral or multilateral guarantee does not require provisioning.

## D. Conclusion

Different strategies of commercial banks' LDC loan portfolio have implications on financial returns and capital ratios. Commercial banks are required by law to operate with a minimum ratio of capital to assets. Assets, however, are weighted according to their risk level. The BIS capital guidelines make lending new money less and less attractive for commercial banks. Major international banks are still burdened by large portfolios of non-current loans to LDCs. Thus, Diagram 8 shows that in the United States, non-current LDC loans amounted to 12.33 per cent of total assets in 1991 while LDC loans charged off reach 13.4 per cent of all loans[21].

Diagram 8




Market analysts and rating agencies evaluate the capitalisation of banks according to the BIS criteria. Faced with the task of improving their capitalisation, international banks have three choices: they can raise capital, selloff assets or, as a result of the system of risk weights, they can change the composition of their investments. The first two options are likely to be the most expensive. Raising capital means diluting the ownership of existing shareholders. Selling off assets means reducing the size of the banks.

One of the most meaningful strategies is to change the composition of the bank's asset portfolio in such a way that its risk-weighted assets have been reduced, although the size of the unweighted asset portfolio may remain unchanged. In fact, banks can free capital by changing their portfolio structure while maintaining or even expanding the size of their assets. Alternatively, a bank can increase its capitalisation without raising new capital in equity markets or reducing assets, if it changes the structure of its investments towards assets which carry lower capital coefficients as defined by the BIS guidelines. Banks can improve capitalisation ratios by selling off the lowest-yielding of their risk assets and buying the highest-yielding of the low-risk assets.

The regulatory treatment of co-financing transactions shows that, for all purposes, co-financing is not synonymous with risk-free assets for commercial banks' balance sheets. Bank regulators allocate a minimum 20 per cent risk weight to transactions involving multilateral institutions. On the other hand, the partial "umbrella" extended by the World Bank often translates into eroded spreads and fees for the bank co-creditors. The profitability of co-financing transactions is therefore questioned by international bankers. Accordingly, such reasons coupled with others have resulted in shrinking numbers of co-financing transactions over the years. As the World Bank states: "Since the establishment in 1983 of the B-loan programme for co-financing with commercial banks, the patterns of overall financial flows to developing countries have changed. With the onset of the debt crisis and, more recently, of stringent capital and mandatory reserve requirements by banking regulators, commercial bank lending to developing countries has declined precipitously"[22]. In 1991 the volume of co-financing kept declining to a record low of $434 million (see Table 4), reflecting the continued reluctance of private lenders to take on new exposure in most developing countries.

Table 4

IBRD Co-financing Transactions with Private Creditors

| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|
| Number of transactions | 11 | 5 | 5 | 9 | 6 | 6 | 7 |
| Co-financing amt. ($m) | 1463 | 849 | 533 | 752 | 1259 | 654 | 434 |
| Share in total co-financing | 24.5% | 21% | 10% | 11% | 11.6% | 4.9% | 4.8% |

Two examples further illustrate this reluctance.

In 1985, the World Bank and the banks agreed on a $40 million B-loan operation for **Côte d'Ivoire**'s Second Highway Sector Project. After RCI suspended payments to the London Club on March of 1987, the co-financing suffered from payment delays vis-à-vis both the World Bank and the banks, in particular in December 1987. CCF, acting on behalf of the banks, sent repeated warning telexes to the World Bank and to the debtor country. The banks' line was that the commercial banks were "surprised" that such a state of affairs could be permitted to arise in a B-loan. The banks insisted that the Bank should remind borrowers that B-loans are to be regarded as distinguishable from general commercial debt.

In January of 1987, the World Bank and the international banking community agreed on a co-financing operation for **Cameroon**. The B-loan's amount reached $120 million, of which the World Bank's share amounted to 15 per cent. Initially, CCF was negotiating with the World Bank on behalf of the banking community jointly with IBJ. CCF decided to give up participating in the B-loan owing to insufficient risk protection from the World Bank. According to the commercial bank, it would have been too difficult to exercise the Bank's guarantee in case of default. In particular, the non-acceleration feature of the late payment guarantee proved to be an insufficient protection for commercial bank lenders. In addition, the thin margin on the loan did not offset the perceived risk. Cameroon suspended servicing the co-financing loan on January 16, 1992. Following a 60-day period, the loan could technically be called in default, should 80 per cent of the syndicate of creditors decide it.

As mentioned in Section II, in contrast with the World Bank co-financing mechanisms, the extended "preferred creditor status" of IFC has drawn a large number of banks into co-financing operations. The bank's relationship with the borrower is **indirect**, through IFC, which acts as sole lender of record and loan administrator. In practice, for regulatory purposes, the main advantage of IFC co-financing is that no loan provisioning is required.

## V. Private Co-financing Operations - Economic Risk-sharing

### A. Introduction

Hitherto, the World Bank co-financing programme has taken shape under the so called B-loan and ECO programme. During the late 1970s, formal parallel co-financings were initiated which featured specific linkages to World Bank loans that gave co-lenders some additional comfort. In such cases, a Memorandum of Agreement was concluded providing for exchange of information on the progress of the project, coupled with an optional cross-default clause in the World Bank's loan agreement. In 1983, the World Bank initiated the B-loan programme which created new broader instruments for co-financing with commercial banks. They were designed to link the World Bank with finance provided by commercial banks more closely than through formal parallel co-financing.

Since fiscal year 1984, i.e. from the beginning of the B-loan programme, 24 transactions have been concluded. In 1985, the only "contingent obligation" (one of the B-loan structures) deal was structured for Paraguay under the project heading "Livestock VII". This loan was however not disbursed, and was subsequently cancelled by Paraguay. Annex III lists all the twenty-four B-loan transactions that have taken place to date since the inception of the Programme in 1983[23]. This section attempts to throw light on the financial structure of these transactions, starting with Hungary's B-loan operation in 1985. The loan was granted directly to the National Bank of Hungary under the project name "Industry". The IBRD direct loan (A-loan) was of an amount of $110 million. In the B-loan, the IBRD exposure was $35 million opposed to the commercial exposure of $350 million, making a total B-loan financing of $385 million. It is worthwhile mentioning that under such a "direct participation" structure, the World Bank A-loan follows typical World Bank pipeline lending terms and conditions (interest rate, grace, maturity etc.), whereas the Bank's B-loan follows the same terms and conditions as commercial lending. Up till 1989 (when the ECO programme was initiated), B-loan transactions were done for countries such as Paraguay, Cote d'Ivoire, Chile, Turkey, Uruguay, Cameroon and Algeria. As is obvious from the list in Annex III, even though the B-loan programme did not stipulate that "eligible countries" would include countries which have not rescheduled their debt, there was not a wide coverage of countries. Most of the countries were large developing countries with some access to the capital markets.

### B. Critical observations on the B-loan programme

As pointed out above, the B-loan programme did not succeed in covering a large array of countries, particularly those which did not have easy access to the international capital markets. In fact most of the countries covered such as Thailand, Turkey, Algeria etc. were relatively creditworthy countries. Moreover, countries such as Turkey and Thailand have traditionally traded in the secondary market of LDC debt at any observable discounts. For such cases, one can find serious difficulties in justifying a World Bank "umbrella" for lending to such countries, not only from the viewpoint of "necessity", but also the context of "market perception".

Under the B-loan programme, one notices that most of the deals were structured for a given sector of the countries' economy, as opposed to specific projects. Even in cases such as the "Highway II' project in Mexico (1987), or the "Water Supply and Sewerage" in Algeria (1987), one did not have a clear idea of the foreign exchange requirements for those projects. In other words, for all practical purposes, most of the B-loan transactions could be viewed as Balance of Payments financing, as opposed to pure project financing. By its very nature, such Balance of Payments (BOP) lending does not ensure returns comparable with those earned by Project Lending. This in itself dilutes the main motivation of the commercial banks. Even in cases of the subsequent ECO programme, where the concept of "project" was far more emphasized, only one out of the three transactions designed to date is perhaps truly an example of project lending (HUB River project in Pakistan). The other two ECO deals, viz. the Housing Development Finance Corporation in India, and the Hungary State Development Institute, could for all practical practices be interpreted as BOP financing.

It was implicit in the B-loan structures that given the World Bank umbrella (legal comfort), the commercial banks could envisage their lending as practically risk-free , even for countries such as Mexico. However, given the external debt situation of Mexico during that period (i.e., 1987, when the B-loan transaction took place), the terms and conditions did not seem to reflect the credit risk accurately. In other words the implications of minimal country risk that the commercial banks were told to be assumed, did not materialize in the financing structure.

### C. Risk-sharing between the World Bank and the commercial banks in some selected projects

For the purpose of illustration, we have chosen three countries to depict the financial risk-sharing in the three particular B-loan transactions. The choices of the countries/projects are, however, purely arbitrary, being taken from two relatively opposite spectrums and from the middle of the country risk band. Turkey's external commercial obligation, the first example is likely to trade at par (there are no discounts offered in the secondary market). Furthermore Hungary, the second example, has relatively more country risk inherent on commercial lending. Cameroon, the third example, is perhaps at the high end of the country risk band.

If one interprets the legal clauses evoked (in Section III above) surrounding the World Bank's part of the lending in a co-financing transaction, one can reasonably assume that the Bank's exposure is risk-free, particularly in the context of the non-rescheduling and subrogation clauses. This is even more true if one goes a step further and observes what happens in reality when a country is in near default to the World Bank. Under such circumstances, in most cases the Bank refinances its previous exposure through new lending, which is often interpreted by economists as rescheduling, though legally speaking this is not the case. From the commercial banks' perspective, however, the exposure in a co-financing transaction is not risk-free, in spite of the World Bank shadow. Such a philosophy is what esentially underlies the "Scenario I" (see below) of each country analysis.

As indicated in Section III above, one of the serious implications that may be observed when commercial banks exercise legal remedies in case of default, is the World Bank's capability of borrowing in the capital markets. The World Bank may well have to shift its ideology towards thinking more commercially, as opposed to relying on such policies as refinancing. In that respect, the World Bank and the commercial banks should view the country risk identically. This has led us to our "Scenario II" type country analysis.

For the purpose of comparing the World Bank risk exposure with that of the commercial bank, we have taken as a yardstick the ratio of the Net Present Value (NPV) of expected repayments per dollar of exposure[24] in the B-loan syndicate of the commercial bank to that of the World Bank. There are two scenarios in each country analysis based on the basic assumptions/philosophy described above. Scenario I compares the Net Present Value (NPV) of the interest and principal payments received by the creditors (the World Bank and the commercial bank) per dollar of exposure, where it is assumed that the World Bank considers the lending to be risk-free, whereas the commercial bank does not. This is reflected by using a risk-free discount factor (6.5 per cent) for all the repayments received by the World Bank, and a risk-adjusted discount factor (in a range between 6.5 per cent and 45 per cent) for the commercial creditor. Scenario II has the similar yardstick, except that here the World Bank also considers the lending to be as risky as the commercial bank creditors (so an identical range of discount factor between 6.5 per cent and 45 per cent is used for both creditors). It may be worth noting that the riskiness of the creditor's exposure for a particular project is reflected by the discount factor used to derive the NPV of all the payments received by the creditor.

For a B-loan type lending (syndicated with the World Bank) involving commercial banks, there is a 20 per cent risk factor assigned to the commercial bank's portfolio by the regulators as opposed to a 100 per cent risk factor assigned to a pure commercial lending to LDCs. A 100 per cent risk factor implies an 8 per cent capital backup of the total amount of exposure, hence a 1.6 per cent capital backup for a 20 per cent risk factor. In other words, the commercial banks were required to put aside a 1.6 per cent of the total exposure as the capital backup in any B-loan transactions. We viewed such provisioning as a foregone opportunity cost for the purpose of our analysis. Thus to arrive at the NPV of the payments received per dollar of exposure, we assumed such capital backup as an exposure, to the extent that such an amount could have been put in a risk free interest bearing deposit account as an alternative investment[25].

Annex IV illustrates the results of the three-country analysis. The interest rate on the B-loan was assumed to be fixed as the average of the LIBOR between the year the project was signed till the present. In the first country analysis (Turkey), Scenario I shows the ratio of NPV of all payments received by the commercial bank per dollar of exposure to that of the World Bank, given a range of risk-adjusted discount factor used for the commercial bank. Scenario II presents the same ratio where the identical range of risk-adjusted discount factors are applied to both the commercial bank and the World Bank. Similar analysis was applied in the cases of Hungary and Cameroon.

In a true risk-sharing environment, the NPV of repayments received per dollar of exposure for all creditors should be identical, and ought to be "1" for a risk-free lending. In Scenario I, only at a discount factor of 6.5 per cent is the ratio of NPV of repayments received by both creditors nearly equal 100 per cent, and goes on decreasing at higher discount factors for the commercial banks. Such a result is not striking given the assumptions, but the point is to emphasise that given the perspective of the two creditors involved, it is not surprising that commercial banks would be less inclined to participate in co-financings in risky countries. In other words, given the reality of the perspectives of the World Bank and the commercial banks, one fails to see the added financial incentive to the commercial banks to participate in such transactions. One could therefore easily misinterpret incentives such as the Bank takes later maturities due etc., though in financial terms the reality remains that if the commercial banks assume their lending to be risk-free then they are on an equal footing with the Bank, and not otherwise.

Since possibly the commercial banks envisage the B-loan programme as bearing some form of risky lending — as indeed should the World Bank if it abstains from refinancing type policy — we were led to design our Scenario II type analysis. Here it is assumed that both the World Bank and the commercial banks assign an identical risk factor to their exposure. Interestingly enough, it should be noted given the choice of our three countries (which have quite different risk profiles), one can draw on a fairly general conclusion. The NPV ratio (as defined earlier) goes up until a discount factor of about 30-35 per cent and then starts declining. In other words, if both the World Bank and the commercial banks assume the B-loan to be a risky form of investment (which in all fairness is perhaps true), the loan portfolio in terms of expected return makes sense for countries ranging from low risk to moderately low-medium risk[26]. In fact such a generalisation is based on a sample of countries in our analysis, representing the low, median and high side of the country risk band. Such a conclusion falls in line with the pattern of lending that has gone on under the B-loan programme. The bulk of lending, based on volume and those relatively close to commercial terms, has gone to countries which are precisely between low-risk and low-medium risk in terms of creditwortiness.

Therefore, in general terms, let us attempt to conclude on the concepts of risk- sharing as between the World Bank and the commercial banks under the B-loan programme. According to the Charter of the World Bank, a country cannot reschedule its obligation to the Bank, thereby giving the Bank an implicit senior creditor status. This could be interpreted as meaning that the World Bank lends to its member countries as if there were no country risk involved given the legal covenants. Under the B-loan programme, the Bank precisely wanted to provide an equal comfort to commercial banks while trying to promote private capital flows to its member countries. Credit enhancement from the World Bank failed, however, to mobilize substantial additional amounts of private financial resources. The catalytic role of the IBRD has been modest in magnitude. Given the implicit risk involved in the so-called Bank's senior creditor status, the commercial banks were careful in selecting the deals and the countries to whom they lent. They agreed on participating in a very limited number of countries as the target or eligible group.

On the one hand, it may be argued that for countries like Turkey, such flows might have taken place anyway, without the World Bank providing any form of support or "umbrella". On the other hand, it would seem that such financing structures definitely did not promote private capital flows into regions where they were most needed. In our next and concluding section, we attempt to indicate precisely what changes could help to go that extra mile.

## VI. Summary, Conclusions and Policy Recommendations

### A. Summary

Co-financing constitutes a risk-sharing transaction between an international financial institution and another financial entity. As such, it is intended to mobilize additional flows of funds to developing countries from both official and private sources. The essence of co-financing is to provide developing countries with larger amounts of resources and on better terms. Co-financing boils down to substituting World Bank (or other official development institutions) risk for that of the ultimate users of funds — the developing countries. Co-financing then must be assessed according to the incremental amounts of financing flows to LDCs and the robustness of the risk-sharing arrangements between the co-lenders.

This report has focused primarily on co-financing schemes between the World Bank and commercial banks. Our analysis has addressed the financial structure of co-financing, the legal clauses pertaining to risk-sharing contracts, as well as the accounting and regulatory implications of co-financing operations. The salient features of the present report are as follows:

— The **volume and number of co-financing transactions** with commercial banks remain modest and keep shrinking. In addition, the relative share of private funds in co-financing operations has declined from about 25 per cent in the mid-1980s to less than 5 per cent in 1990-91. Since the B-loan programme was approved in January 1983, a total of twenty-four transactions with banks have been concluded. Most of these have involved the use of the direct funding option. Six transactions have involved the use of guarantees and one has involved the use of contingent obligations. Twelve countries have benefited from the B-loan programme: Algeria, Brazil, Cameroon, Chile, Colombia, Hungary, Côte d'Ivoire, Mexico, Paraguay, Thailand, Turkey and Uruguay. Altogether, the total amount of funds generated from commercial banks through co-financing arrangements is over $4 billion.

Over the last few years, however, co-financing has slowed down. According to World Bank data, private co-financing dropped from $1 060 million in 1989, to a mere $654 million in 1990 and $434 million in 1991, "reflecting the continued reluctance of private lenders to take on new exposure in most developing countries"[27]. Since the establishment of the "B-Loan" instrument in 1983, the patterns of overall financing flows to developing countries have changed. With the onset of the debt crisis, and more recently, of stringent capital and mandatory reserve requirements by banking regulators, bank lending to LDCs has declined precipitously. Today, banks face growing competitive and regulatory pressure to boost capital ratios and to restructure portfolios with low-risk assets.

As a result of these changes, banks have welcomed the return of creditworthy borrowers in Latin America to international capital markets. Financial innovations have become widely accepted and have broadened the range of instruments for financing projects in the emerging markets. For these creditworthy borrowers, co-financing deals are not necessary to catalyse additional flows of funds from private sources. For non-creditworthy debtors, however, it seems unlikely that co-financing will provide private lenders with adequate risk-sharing vehicles.

— Protracted reluctance of banks to resume lending to LDCs has not been alleviated by the **legal structure of risk-sharing transactions** with official creditors. Co-financing is designed so as to provide banks with "legal comfort" through contractual provisions in loan documentation which result in a sharing by the IFI of risk incurred by banks in making a loan. The stronger the risk-sharing however, the larger the relative risk incurred by the World Bank. The Board of the World Bank has always been wary of an excessive shift of risk from private to official lenders, thereby undermining the capacity of the Bank to maintain its preferred creditor status and to obtain privileged refinancing access in the capital markets. The Triple A rating of the World Bank is, therefore, both the principle and the limit of co-financing transactions.

For commercial banks, the purpose of participating in a co-financing deal is to join the "rescheduling umbrella" of the Bank. B-loans can be considered as preferred credit because the pro rata sharing clause transforms the World Bank in a co-lender with equal rights and duties. Specifically, in a direct funding operation, the Bank shares in the risk of an interest payment default at the onset of the loan. However, the Bank's legal comfort is limited in that it can exclude the pro rata sharing clause in respect of lenders who agree on a rescheduling. Similarly, the scope of cross-default clause between the Bank's loans and the co-financing credit is limited due to the "optional" nature of the clause. The optional cross-default clause in B-loan documentation has been applied to the more recent ECOs. Thus, the Bank protects its non-rescheduling status without sharing it totally with its co-lenders.

Turning now to the tail-end guarantee, the banks pay the World Bank for assuming the risk of non-payment of final maturities. The Bank's support is provided as a backstop. Such a guarantee, however, is not accelerable; this postpones the "umbrella" in the final years of the loan, whereas bankers are most interested in the short-term risk of their portfolio. Moreover in the event of payment under its guarantee, the World Bank does not agree to subordinate its own claims to commercial bank claims. This principle of non-subordination is reflected in the subrogation clauses included in co-financing covenants.

For commercial banks, risk-sharing procedures with official creditors have **regulatory and accounting benefits**. These benefits, in turn, alleviate banks' regulatory pressure to strengthen their balance sheets. Under the risk-weighted standards of the BIS, banks can free capital by changing the composition of their balance sheets while maintaining the size of their asset investments. Alternatively, a bank can improve its capital ratio without raising new capital or reducing existing assets if it changes the structure of its investments towards assets which carry lower capital coefficients.

Bank regulators in the OECD have drawn accounting conclusions from the legal structures of co-financing. Thus, most OECD country regulatory authorities follow the BIS capital guidelines, thereby applying a 20 per cent risk weight on IFI guarantees. In contrast, claims on OECD governments carry zero risk weight. In France, co-financing operations with the World Bank must be reserved. Since banks must reserve LDC assets at an average 60 per cent level, reserving World Bank co-financing operations severely reduces the profitability of such transactions. The stronger legal linkages of IFC co-financing exclude the IFC from the provisioning base of country-risk assets. Likewise, in co-financing with the EBRD, the official entity is the lender of record, hence the banks' relationships with the debtor country are indirect. Similarly, the Inter-American and Asian Development Banks sell sub-participation to commercial lenders in official loans that are made on commercial terms. With such complementary co-financing arrangements, international banks share fully in the IFIs' preferred status. Thus the legal structures of loan covenants have direct implications on bank regulatory regimes, hence on capital and profitability ratios.

— The limited success of the B-Loan instrument led the Board of Directors of the World Bank to carry out a review of the commercial co-financing programme in 1988-89. The review concluded that a more flexible stance on the part of the IBRD — and in particular, a more active use of the guarantee authority -- was necessary for the Bank to perform an effective catalytic role in fostering private financial flows to the developing countries. **Enhanced Co-financing Operations** (ECOs) have, however, failed to revive commercial bank lending to the LDCs. In fact, the severe restrictions imposed by the Bank's Board on its guarantee authority have the following consequences:

For "emerging market countries" which have graduated from debt rescheduling practices, ECOs are of little help since the World Bank imposes a five-year grace period following the last rescheduling. For "market borrowers" which enjoy ongoing access to international capital markets, ECOs are unlikely to help mobilize substantial additional funds and might even cast a shadow on the countries' creditworthiness. Regarding "heavily indebted countries", ECOs are not available "given the financial uncertainties facing these countries and the difficulties in distinguishing between voluntary and concerted finance"[28]. In addition, concern have been expressed that providing support to capital market transactions may prejudice the borrower's ability to continue to access markets on its own without the World Bank credit enhancement. This "precedent" issue would encourage other borrowers to seek Bank guarantees at the expense of any enduring catalytic effect.

On the basis of this summary on co-financing operations, it becomes possible to formulate a number of **policy recommendations in the following four distinct areas**, with a view to enlarging the scope for transactions with commercial banks.

## B. Legal clauses

It is the legal structure of co-financing transactions that determines the risk-sharing arrangement between co-creditors as well as the regulatory and accounting treatment of these transactions. The World Bank's legal comfort is limited by the optional nature of its sharing clause and by the fact that the Bank can exclude the pro rata sharing clause in respect of lenders who agree on a rescheduling. For commercial banks, legal clauses in co-financing covenants provide a limited "umbrella" that prevents them from sharing in full the seniority status of the World Bank. Hence structuring co-financing operations with the IBRD in a way similar to IFC and EBRD co-financings would strongly encourage commercial bank participation.

## C. Regulatory issues

The main impact of risk-based capital rules is to make bankers more selective in the use of precious risk-based capital and to impose drastic asset portfolio rebalancing decisions. As a result of the new capital targets, banks can either mobilize capital, reduce assets, or restructure the balance sheet depending on various risk factors. Under the new risk-weighted capital standards commercial banks can free capital by changing the composition of their investment portfolio while maintaining or even expanding the size of their assets.

In fact, co-financing with the World Bank is not attractive for commercial banks from a regulatory viewpoint. Since regulatory authorities require a 20 per cent risk weight on claims guaranteed by multilateral development banks, this represents a substantial foregone opportunity cost, particularly when large sums of lending are involved. Reducing the 20 per cent risk weight on claims on or guaranteed/collateralized by international financial institutions would therefore give a much needed impetus on co-financing transactions with commercial bank creditors. In addition, removing the need for provisioning co-financing deals with the World Bank would also encourage banks to participate in these transactions.

## D. Financial structure

For all practical purposes, most of the B-loan operations have taken the form of general purpose financing, i.e. balance of payments support. As illustrated in Section V, the financial structure of the B-loan reflects an interest-free loan on the part of commercial bank creditors. In fact, analysis of the legal and regulatory parameters of the co-financing instruments have shed light on the "riskiness" of these transactions. In other words, these loans carry a risk of default for the banks, and that risk is reflected by the need to build up loan-loss reserves against co-financing exposure. The conclusion is that the credibility of B-loan transactions lies in the category of developing countries eligible for such operations. From a commercial bank's perspective, only a small group of creditworthy countries or "graduating" countries can be attractive for co-financing operations.

## E . Eligibility criteria for co-financing operations

The ECO programme is open to countries that have not rescheduled their external debt during the last five years. The objective underlying this restriction is " to provide a simple and easily-understood rule, for both staff and commercial lenders, that would ensure that ECOs would not be associated with concerted lending or otherwise undermine debt or debt service reduction operations assisted by the Bank"[29]. Thus far, only two operations have been implemented, namely Hungary's State Development Institute and India's Housing Development Finance Corporation. The strict five-year rescheduling rule of the ECO programme *a priori* excludes all those LDCs which are graduating from the debt-restructuring process, such as Chile, Mexico or Morocco.

Flexibility in the Bank's eligibility criteria would clearly increase the scope for larger bank capital flows following successful debt reduction operations. It is worth mentioning in this context that the World Bank has recently created a clear distinction between official and private co-financing. Following Hungary's acceptance, the private co-financing operation is temporarily inactive. Debt relief coupled with strong macroeconomic programmes would much benefit from expanded co-financing schemes that are selected on a case-by-case basis so as to reward adjusting LDCs. A more flexible stance was proposed by the Bank staff to the Board of Executive Directors in December 1990. The Bank suggested that it would seem "appropriate" that the question of inclusion of ECOs for countries that are emerging from the debt crisis be dealt with on a case-by-case basis. Such flexibility seems indispensable to revive the co-financing programme of the IBRD with commercial banks.

## Notes and References

1. Less Developed Countries.

2. The authors wish to thank former colleagues of the World Bank as well as commercial bankers for information and fruitful dialogue, and Mr. Jean-Claude Berthélemy and Miss Ann Vourc'h of the OECD Development Centre for their helpful comments.

3. For definition see Section III on legal issues pertaining to co-financing.

4. The 19-country SIMIC group is a World Bank analytical grouping which is based on key ratios, namely, debt to GDP, debt to exports of goods and services, accrued debt to exports of goods and services, accrued debt service to exports, and accrued interest to exports. See World Debt Tables, 1989-90, Volume 1. The World Bank.

5. See World Economic Outlook, International Monetary Fund, September 19, 1990, and World Debt Tables, The World Bank, April 1990.

6. New lending minus repayments on existing liabilities.

7. The word "Bank" with a capital "B" has often been used throughout this paper instead of the World Bank.

8. Likewise, the African Development Bank sustains its catalytic role by mobilizing additional resources through co-financing operations. As at end 1991, the Bank had co-financed a total of 389 projects for a cumulative amount of $40 billion, out of which the Bank Group contributed about 20 per cent. Thus, for each dollar, the Bank Group had devoted to co-financed operations, it attracted $4 dollars.

9. The total debt service (principal and interest payment) would be the same each year even though the interest rate may be variable, and hence a variable principal payment.

10. Contingent obligations can be utilized in a number of ways. For example, a bond can be issued with an option to "put" them to the borrower or (if its credit perception is insufficient to support the put) to a third party such as the Bank. In terms of the credit support being provided, contingent obligations are similar to straight guarantees, but there are qualitative differences. A call on a guarantee would presuppose a payment default, whereas the exercise of a put can be carried out without any negative connotations.

11. Identical grace and maturity period. However, banks receive the earlier principal payments and hence reduce their risk.

12. Limited recourse financing is defined as a lending which is secured on the cash flow and earnings of the project rather than the guarantees from (i.e. recourse to) the project owners/sponsors.

13. A term used commonly in the World Bank meaning "privatization".

14. The final participating banks include BNP, Crédit Lyonnais, NMB Bank, UBS, Deutsche Bank, Dresdner Bank, and Giro Central.

15. The final participating banks included Banesto, Deutsche Bank, NMB Bank, Fuji Bank, and Tokai Bank.

16. Much of the technical information in this section has been obtained from World Bank publications.

17. A "Glossary of Legal Terms" is provided in Annex II.

18. In addition, the negative pledge clause, as defined in the World Bank's General Conditions, requires the Bank to ensure that no other external debt of its foreign borrowers shall have priority over its loans in the allocation of foreign exchange held under the control or for the benefit of the borrowing member. If any lien is created on any of the borrowing member country's public assets as security for any external debt, the lien must, unless otherwise agreed by the Bank, equally and ratably secure the Bank's own loans; or the borrower must provide the Bank with an equivalent lien.

    The negative pledge clause commonly found in commercial bank loan agreements provides that the borrower will not create any lien on any of its properties or assets to secure the payments of external debt owed to its other creditors. The Bank can agree to waive the negative pledge clause. For example most Brady debt restructuring agreements containing collateralized bonds have been eligible for exception, e.g. in the cases of Mexico, Uruguay, Nigeria.

    Commercial bank loan agreements usually contain a *pari passu* provision under which the borrower agrees that its payment obligations under the agreement will rank equally and ratably with its obligations under all other external indebtedness. The essence of this provision is to maintain parity between creditors.

    Whereas the *pro rata* sharing clause pertains to the legal relationship between syndicated loan creditors, pari passu covenants pertain to the relationship between creditors of different loan agreements.

19. On an average, the World Bank borrows $11 billion per annum in the capital markets.

20. Commission bancaire, Note du 21 janvier 1991.

21. FDIC Quarterly Bulletin, Fourth Quarter 1991.

22. World Bank Annual Report, 1990, page 86.

23. As the Terms of Reference (TOR) have made it mandatory to look into co-financing transactions only since 1985, the first country to be eligible for a B-loan co-financing since that data was Hungary.

24. Per dollar of exposure eliminates another variability in the analysis, given unequal exposure of the two creditors.

25. The NPV of provision (Annex IV) is added to the total exposure to derive the NPV of payments received per dollar of exposure.

26. As explained earlier, the discount factor used to calculate the NPV of repayments received reflects on the riskiness of the lending, i.e. the country risk. The higher the discount factor, the more risky is the country in question.

27. World Bank Annual Report 1991, page 78.

28. "IBRD Role in Financial Intermediation Services: Expanded Co-financing Operations", World Bank Memorandum from the President dated March 13, 1989.

29. "Expanded Co-financing Operations: Review of the Pilot Program", Memorandum from the President, December 10, 1990.

Annex I

**World Bank Cofinancing Operations FY82-91**
**By Source of Cofinancing**
**(US$ Million)**

| | **Official** | | **Export Credit** | | **Private** | | **Total** | |
|---|---|---|---|---|---|---|---|---|
| Fiscal Year | No. | Amount | No. | Amount | No. | Amount | No. | Amount |
| 1985 | 93 | 3287.8 | 18 | 1211.2 | 11 | 1463.0 | 122 | 5962 |
| 1986 | 105 | 2745.9 | 9 | 311.4 | 5 | 849.1 | 119 | 3906.4 |
| 1987 | 104 | 3704.3 | 13 | 1166.1 | 5 | 533.8 | 122 | 5404.2 |
| 1988 | 96 | 4777.8 | 9 | 1527.5 | 9 | 752.1 | 114 | 7057.4 |
| 1989 | 130 | 7553.0 | 13 | 2013.0 | 6 | 1259.7 | 149 | 10825.7 |
| 1990 | 124 | 9307.1 | 13 | 3518.5 | 6 | 654.5 | 143 | 13480.1 |
| 1991 | 122 | 7056.5 | 7 | 1494.5 | 7 | 433.6 | 136 | 8984.6 |

## Annex II

GLOSSARY OF LEGAL TERMS

| | |
|---|---|
| **Direct financial participation** | The World Bank directly participates in a commercial syndicated loan, with a status similar to the commercial banks |
| **Partial guarantee option** | The World Bank agrees to guarantee the final maturities of a syndicated loan (up to 25%), without participating in the funding |
| **Put option** | Considered by the World Bank as a contingent obligation. At end of grace period, commercial banks can assign to the Bank all or part (up to 25%) of final maturities of the loan, during a period of time determined by the exercise period length |
| **Cross-default clause** | The clause entitles the lenders in a loan agreement to accelerate (or suspend) their loan if the borrower has defaulted under its other loans, particularly in respect of payment obligations |
| ***Pro rata* clause** | Pertains to the legal relationship between creditors of a syndicated loan whereby lenders agree to share loan service payments on a *pro rata* basis |
| ***Pari passu* clause** | Pertains to the legal relationship between creditors of different loans, under which the borrower agrees that its payment obligations under the agreement will rank equally and ratably with all its other external obligations |
| **Negative pledge clause** | In loan agreements this provides that the borrower will not create any lien on any of its properties or assets to secure the payment of external debt owed to its other creditors |
| **Partial guarantee under expanded co-financing (ECO)** | ECOs can be structured to provide partial guarantees on commercial bank loans raised as co-financing for Bank-approved projects or programmes |
| **Partial guarantee on bond issues under ECOs** | ECOs can be used to provide partial guarantees on long and medium term bond issues, either publicly placed or privately issued, to finance co-financing agreements |

## ANNEXE III

## COFINANCING: B - LOAN OPTIONS

| YEAR | COUNTRY | Project Title | Proj.approval date by Board | Direct Contribution Option: Total Project Cost | IBRD Direct Loan | IBRD Amnt Syndicated Loan | Comm. Amt. in Synd. Loan | Total Amount | (TERMS...: Currency | Signing date | Grace period/.../overall final maturity | Interest rates per annum ...) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1985 | Hungary (NBH) | Industry | 3/27/84 | 319.0 | 110 | 35.0 | 350.0 | 385.0 | US$ | 7/19/84 | 6/4/10 | 3 or 6 months LIBOR + 1.125% or US Prime + 0.75 (f)% fixed |
| | | Petroleum | 3/27/84 | 519.7 | 90.0 | 12.2 | 61.3 | 93.5 | Yen | 7/25/84 | 10/5/12 | LTPR + 0.2% fixed; LTPR + 0.1% variable |
| | | Livestock | 2/4/85 | 325.2 | 80.0 | 36.0 | 264.0 | 300.0 | US$ | 11/6/85 | 8/5/10 | LIBOR + 0.625% |
| | | Fine Chemicals | 2/4/85 | 311.5 | 73.0 | | | | | | | |
| | | Transport | 5/28/85 | 215.5 | 75.0 | 13.5 | 102.2 | 115.7 | Yen | 6/19/85 | 10/5/12 | LTPR + 0.2% fixed; LTPR ....variable: LTPR + 0.1% semi-fixed |
| Total FY 85 | | N° Comm. Loans: 5 | | 1690.9 | 453 | 96.7(a) | 777.5 | 894.2 | | | | |
| 1986 | Côte d'Ivoire (Gov'L) | Highway Sector II | 6/13/85 | 230.7 | 110.0 | 6.0 | 32.0 | 40.0 | $:FF:ECU | 9/19/85 | 3/8/10.5 | ECU LIBOR or FF LIBOR + 1.75% or US Prime + 1.375% |
| | Turkey (Gov't) | Kayraktape Hydropower | 2/25/86 | 716.4 | 200 | 19.0<br>33.0 | 111.8<br>200.0 | 130.8<br>233.0 | Yen<br>US$ | 1/4/86<br>1/4/86 | 10/5/12<br>8/5/10 | JLTPR + 1.0% variable;JLTPR + 1.1% semi-fixed;<br>LIBOR + 1.25% for 3 yrs/ 1.375% thereafter |
| Total FY 86 | | N° Comm. Loans: 3 | | 947.1 | 310.0 | 58(a) | 343.5 | 403.5 | | | | |
| 1987 | Turkey (Gov't) | Financial Sector Adjustment Loan | 10/6/86 | 530.0 | 300.0 | 32.9<br>20.0 | 197.1<br>80.0 | 230.0<br>100.0 | Yen<br>US$ | 10/9/86<br>5/2/87 | 10/5/12<br>6/10/10.5 | LTPR + 1.0% variable; LTPR + 1.1% semi-fixed<br>LTPR + 1.1% fixed |
| | Cameroon | Highway IV | 6/18/85 | 295.5 | 125.0 | 20.0 | 100.0 | 120.0 | US$/FF | 1/16/87 | 5/10.5/15 | 10.5 FF TVM + 0.75%; LIBOR + 0.75% |
| Total FY 87 | | N°. Comm. Loans: 3 | | 825.5 | 425 | 72.9(a) | 377.1 | 450 | | | | |
| 1988 | Turkey | Energy Sector | 6/25/87 | 1005.0 | 355.0 | 30.1 | 171.8 | 201.9 | Yen | 9/24/87 | 10/5/12 | LTPR + 1.0% variable; LTPR + 1.2% fixed; 5yrs, adj. 2nd 5 yrs. |
| | Algeria | Water Supply & Sewerage | 5/25/87 | 630.0 | 250.0 | 20.0 | 180.0 | 200.0 | US$ | 1/29/88 | 4.5//8.5 | LIBOR + 0.75% variable, 6 yrs.; LIBOR + 0.625% variable after |
| Total FY 88 | | N° Comm. Loans: 2 | | 1635 | 605 | 50.1(a) | 351 | 401.9 | | | | |
| 1989 | Turkey | II Financial Sector Adj. Prog | 9/14/88 | 1100.0 | 400.0 | 29.8 | 268.7 | 298.5 | Yen | 9/20/88 | 5/10.5/12 | LTPR+1% variable;LTPR+(1.1% var.;1.1% var.) 5yr. LTPR |
| Total FY 89 | | N° Comm. Loans: 1 | | 1100.0 | 400.0 | 29.8(a) | 268.7 | 298.5 | | | | adjust. 2nd 5 years |

## *Partial Guarantee Option*

(TERMS.................................................................)

| YEAR | COUNTRY | Project Title | Proj.approval date by Board | Total Project Cost | IBRD Direct Loan | IBRD Amnt Syndicated Loan | Comm. Amt. in Synd. Loan | Total Amount | Currency | Signing date | Grace period /.../overall final maturity | Interest rates per annum | IBRD Fee per annum |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1985 | Paraguay | Livestock VII | 3/1/84 | 121.1 | 25.0 | 3.8 | 15.0 | 15.0 | US$ | 3/22/85 | 10/5/10 | | 0.5% guarantee fee |
| | *Loan not disbursed & subsequently cancelled | | | | | | | | | | | | |
| Total FY85 | | No° Commercial Loans:0 | | 0 | 0 | 0 | 0 | 0 | | | | | |
| 1986 | Chile(Gov't) | Road Sector III | 6/20/85 | 656.0 | 140.0 | 150.0 | 300.0 | 300.0 | US$ | 1/11/85 | 10.5/12/12 | Initial rates: | |
| Total FY86 | | No° Comm. Loans: 1 | | 656.0 | 140.0 | 150.0(a) | 300.0 | 300.0 | | | | LIBOR + 1.625% or PRIME + 1.25% | Guar. fee 1.125% for yrs 1-61.25% thereafter |
| | | | | | | | | | | | | Effective Jan. 88: | |
| | | | | | | | | | | | | LIBOR + 1.125% or PRIME 1.125% | Guar.Fee 0.625% till year 6, 0.75% thereafter |
| | | | | | | | | | | | | Effective Jan. 89: LIBOR + 0.875% | Guar.Fee 0.375% till year 6; 0.5% thereafter |
| 1987 | Uruguay(Gov't) | Power Sector Rehabilitation | 9/19/85 | 130.6 | 45.2 | 22.5 | 45.0 | 45.0 | $ | 2/10/88 | 10/3/12 | Libor + 1.625% or 3 month CD rate or PRIME 1.625% | Guar.Fee 1% for yrs 1-7 1.375% thereafter. |
| | Mexico (Gov't.) | Highway II | 5/20/84 | 1601.5 | 200.0 | 500.0 | 1000.0 | 1000.0 | multi(b) | 3/20/87 | 5/17/17 | Ref. rate (fixed or variable) +.8125% | Guar.Fee 0.375% |
| | | Railway V | 11/6/85 | 2123.6 | 300.0 | | | | | | | | |
| | | Growth Contingent Facility | | | | 250.0 | 500 | 500 | multi(b) | 3/20/87 | 5/17/17 | Ref.rate (fixed or variable) +.8125% | Guar.Fee 0.375% |
| Total FY87 | | No° Comm. Loans: 3 | | 3855.7 | 545.2 | 772.5(a) | 1545.0 | 1545.0 | | | | | |

## *Contingent Obligation Option*

(TERMS.......... ....................................................)

| YEAR | COUNTRY | Project Title | Proj.approval date by Board | Total Project Cost | IBRD Direct Loan | IBRD Amnt Syndicated Loan | Comm. Amt. in Synd. Loan | Total Amount | Currency | Signing date | Grace period /__/overall final maturity | Interest rates per annum | IBRD Fee per annum |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1985 | Paraguay Gov't: * | Livestock VII | 3/1/84 | 121.1 | 25.0 | 3.3 | | | | | | | Contingent Fee:0.125% |

*Loan not disbursed & subsequently cancelled.: Totals: N/A

Footnotes:

(a): Total amount is the sum of the IBRD amounts shown against individual loans.

(b): Austrian Schilling,Belgian Francs,Canadian Dollars,Deutsche Marks, Dutch Guilders,French Francs, Italian Lira, Japanese Yen, Pounds Sterling, Swiss Francs,USDollars.

**Annexe IV**

**Project:**
Turkey - 1989 (II. Fin. Sector Adj. Program)
(all figures in US$ million)

| | | | |
|---|---|---|---|
| Risk-free rate: | 6.5% | Capital Backup (US$ Million): | 4.30 |
| Investment Return: | 9.5% | | |
| Average Int. rt. on B-Loan: | 8% | (average between 1989 and 1991) | |

**Scenario I: No Country Risk for WB**

| | **1989** | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** |
|---|---|---|---|---|---|---|---|---|---|
| C.B. Pmt. Receipt-Int+Prin | 20.72 | 20.72 | 20.72 | 20.72 | 20.72 | 47.59 | 45.52 | 43.44 | 41.37 |
| Investment Foregone upto | 4.71 | 5.15 | 5.64 | 6.18 | 6.77 | 7.41 | 8.11 | 8.89 | 9.73 |
| NPV of provision: | 6.95 | | | | | | | | |
| **Discount-Risk Factor** | 6.5% | 10% | 15% | 20% | 25% | 30% | 35% | 40% | 45% |
| NPV of Pmt. Receipt - CB | 292 | 231 | 171 | 131 | 105 | 86 | 72 | 62 | 54 |
| NPV per US$ invested: | 1.06 | 0.84 | 0.62 | 0.48 | 0.38 | 0.31 | 0.26 | 0.22 | 0.19 |
| W.B. Pmt. Receipt-Int+Prin | 2.30 | 2.30 | 2.30 | 2.30 | 2.30 | 2.30 | 2.30 | 2.30 | 2.30 |
| NPV of Pmt. Receipt - WB | 34 | | | | | | | | |
| NPV per US$ invested: | 1.14 | | | | | | | | |
| **NPV per US$ invested (CB / NPV per US$ invested (WB)** | 93% | 74% | 54% | 42% | 33% | 27% | 23% | 20% | 17% |

**Scenario II: Country Risk Assumed Same for CB and WB**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Discount-Risk Factor** | 6.5% | 10% | 15% | 20% | 25% | 30% | 35% | 40% | 45% |
| NPV of Pmt. Receipt - CB | 1.06 | 0.84 | 0.62 | 0.48 | 0.38 | 0.31 | 0.26 | 0.22 | 0.19 |
| NPV of Pmt. Receipt - WB | 1.14 | 0.80 | 0.54 | 0.40 | 0.32 | 0.26 | 0.22 | 0.19 | 0.17 |
| **NPV per US$ invested (CB / NPV per US$ invested (WB)** | 93% | 104% | 114% | 119% | 120% | 119% | 117% | 115% | 113% |

**Project:**
Hungary (N.B.H.) - Industry, 1985
(all figure in US$ million)

| | | | |
|---|---|---|---|
| Risk-free rate: | 6.5% | Capital Backup (US$ Million): | 5.6 |
| Investment Return: | 9.5% | | |
| Average Int. rt. on B-Loan: | 9% | (average between 1985 and 1991) | |

**Scenario I: No Country Risk for WB**

| | **1985** | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** | **1993** |
|---|---|---|---|---|---|---|---|---|---|
| C.B. Pmt. Receipt-Int+Prin | 31.50 | 31.50 | 31.50 | 31.50 | 89.83 | 84.58 | 79.33 | 74.08 | 68.83 |
| Investment Foregone upto | 6.13 | 6.71 | 7.35 | 8.05 | 8.82 | 9.65 | 10.57 | 11.57 | 12.67 |
| NPV of provision: | 7.87 | | | | | | | | |
| **Discount-Risk Factor** | 6.5% | 10% | 15% | 20% | 25% | 30% | 35% | 40% | 45% |
| NPV of Pmt. Receipt - CB | 400 | 332 | 260 | 209 | 171 | 143 | 121 | 104 | 91 |
| NPV per US$ invested: | 1.12 | 0.93 | 0.73 | 0.58 | 0.48 | 0.40 | 0.34 | 0.29 | 0.25 |
| W.B. Pmt. Receipt-Int+Prin | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 |
| NPV of Pmt. Receipt - WB | 25 | | | | | | | | |
| NPV per US$ invested: | 1.24 | | | | | | | | |
| **NPV per US$ invested (CB / NPV per US$ invested (WB)** | 90% | 75% | 59% | 47% | 39% | 32% | 27% | 24% | 21% |

**Scenario I I: Country Risk Assumed Same for CB and WB**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Discount-Risk Factor** | 6.5% | 10% | 15% | 20% | 25% | 30% | 35% | 40% | 45% |
| NPV of Pmt. Receipt - CB | 1.12 | 0.93 | 0.73 | 0.58 | 0.48 | 0.40 | 0.34 | 0.29 | 0.25 |
| NPV of Pmt. Receipt - WB | 1.24 | 0.92 | 0.65 | 0.49 | 0.38 | 0.32 | 0.27 | 0.23 | 0.20 |
| **NPV per US$ invested (CB / NPV per US$ invested (WB)** | 90% | 101% | 112% | 120% | 124% | 126% | 127% | 126% | 124% |

**Project:**
Cameroon (Govt.) - 1987
(all figure in US$ million)

| | | | |
|---|---|---|---|
| Risk-free rate: | 6.5% | Capital Backup (US$ Million): | 1.6 |
| Investment Return: | 9.5% | | |
| Average Int. rt. on B-Loan: | 8% | (average between 1987 and 1991) | |

**Scenario I: No Country Risk for WB**

| | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** |
|---|---|---|---|---|---|---|---|---|---|
| C.B. Pmt. Receipt-Int+Prin | 7.71 | 7.71 | 7.71 | 7.71 | 7.71 | 17.71 | 16.94 | 16.17 | 15.40 |
| Investment Foregone upto | 1.75 | 1.92 | 2.10 | 2.30 | 2.52 | 2.76 | 3.02 | 3.31 | 3.62 |
| NPV of provision: | 2.58 | | | | | | | | |
| **Discount-Risk Factor** | 6.5% | 10% | 15% | 20% | 25% | 30% | 35% | 40% | 45% |
| NPV of Pmt. Receipt - CB | 109 | 86 | 64 | 49 | 39 | 32 | 27 | 23 | 20 |
| NPV per US$ invested: | 1.06 | 0.84 | 0.62 | 0.48 | 0.38 | 0.31 | 0.26 | 0.22 | 0.19 |
| W.B. Pmt. Receipt-Int+Prin | 1.54 | 1.54 | 1.54 | 1.54 | 1.54 | 1.54 | 1.54 | 1.54 | 1.54 |
| NPV of Pmt. Receipt - WB | 23 | | | | | | | | |
| NPV per US$ invested: | 1.14 | | | | | | | | |
| **NPV per US$ invested (CB** / **NPV per US$ invested (WB)** | 93% | 73% | 54% | 42% | 33% | 27% | 23% | 20% | 17% |

**Scenario I I: Country Risk Assumed Same for CB and WB**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Discount-Risk Factor** | 6.5% | 10% | 15% | 20% | 25% | 30% | 35% | 40% | 45% |
| NPV of Pmt. Receipt - CB | 1.06 | 0.84 | 0.62 | 0.48 | 0.38 | 0.31 | 0.26 | 0.22 | 0.19 |
| NPV of Pmt. Receipt - WB | 1.14 | 0.80 | 0.54 | 0.40 | 0.31 | 0.26 | 0.22 | 0.19 | 0.17 |
| **NPV per US$ invested (CB** / **NPV per US$ invested (WB)** | 93% | 105% | 115% | 120% | 121% | 119% | 118% | 115% | 113% |