MEMORANDUM

To: Directors and Alternate Directors BDS95-218

From: Secretary General **Date:** 7 December 1995

Subject: **Report by the Chairman of the Financial and Operations Policies Committee on the Capital Resources Review (BDS95-194 (Rev 1))**

Attached for consideration and approval by the Board of Directors at its meeting on 11 December 1995 is a Report by the Chairman of the Financial and Operations Policies Committee on the Capital Resources Review.

Distribution

President
Executive Committee

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FOR RECONSTRUCTION AND DEVELOPMENT

BDS95-218
7 December 1995

REPORT BY THE CHAIRMAN OF THE FINANCIAL AND OPERATIONS POLICIES COMMITTEE ON THE CAPITAL RESOURCES REVIEW

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PRESIDENT'S RECOMMENDATION

Attached is a Report by the Chairman of the Financial and Operations Policies Committee on the Capital Resources Review.

I recommend that the Board of Directors approve the Report.

Jacques de Larosière

Report of Chairman of the Financial and Operations Policies Committee on the Capital Resources Review (BDS95-194 (Rev 1))

1. Background

1.1 The Financial and Operations Policies Committee discussed the Capital Resources Review at its meetings of 20 and 27 November and 4 December 1995. The Committee had conducted its review of the paper in an open way, with extensive participation by Committee members and other Directors. The Committee warmly commended the high quality of the work produced by the team and thanked the team for its very considerable effort. The Committee also expressed its appreciation for the very constructive participation of the management team in the Committee's discussions.

1.2 The Committee noted that the sections of the paper dealing with corporate governance had been reviewed by the Audit Committee. In addition, the Committee noted that the paper had been reviewed by both the Bank's current and former External Auditors, who had provided valuable feedback to the drafting team.

1.3 The paper brought together the various strands of the exercise and, for the first time, provided a comprehensive presentation of management's proposals for the capital review. The Committee acknowledged that the scope and substance of the paper clearly reflected previous Committee and Informal Board discussions.

1.4 The review of this document was a further step in the orderly process to prepare for the decision by the Board of Governors at the Fifth Annual Meeting in Sofia, Bulgaria on 15/16 April 1996 on the future resource requirements of the Bank to finance its ordinary operations. This is in accordance with Resolution No. 50 of the Board of Governors, approved on 11 April 1995.

2. Committee Overview

2.1 The Committee supported and endorsed overall thrust and direction of the paper as reflected in the Summary of Principal Observations. The Committee considered these Principal Observations provided a logical framework for the further steps in the Capital Resources Review, and for the decisions to be made in due course with respect to the capital increase.

2.2 In endorsing the overall thrust of the paper the Committee concluded:

- the progress of the Bank provided strong evidence of its commitment to the operationally focused mandate which had been endorsed by shareholders;
- the development of the Bank's portfolio demonstrated the Bank's effectiveness in progressing this mandate;
- the Bank faced considerable uncertainties in terms of potential external developments;

- the need for a capital increase to sustain operations under the endorsed manageable growth scenario; and

- the need to maintain the Bank's 1:1 gearing ratio.

3. The Bank's Operational Effectiveness

3.1 The Committee reviewed the sections of the paper outlining the effectiveness with which the Bank has progressed its mandate. In doing so, it acknowledged the Bank's strong operational performance and its achievements in building its portfolio. The Committee noted that these sections of the paper, together with those dealing with the budgetary and administrative framework, addressed the important question of whether the Bank, in terms of its performance and its achievements, deserved more capital.

3.2 In the course of this consideration Committee members and other Directors made a number of constructive suggestions to strengthen and deepen the presentation of the issues relevant to the capital increase. These included:

- further attention to the Bank's critical transition impact role;

- highlighting the innovative initiatives the Bank has taken to respond to the needs of its countries of operations, including in such areas as environment, municipal services and energy efficiency;

- clarification and further explanation of the Bank's catalytic role and the mobilisation of additional investment;

- strengthening the presentation of the linkages between the Operational Priorities endorsed in 1994 and the Bank's endorsed Institutional Priorities and Medium-Term Scenarios 1996-1999, and their impact on the Capital Resources Review;

- further attention to aspects of geographic coverage to clarify the anticipated growth of bank activities in countries at less advanced stages of transition, the Bank's evolving product mix at different stages of transition, and the Bank's continuing role in the more advanced transition countries;

- clarification of the impact of external variables as they emerged from the modelling work supporting the capital review, including the impact of such events on the projections of Bank performance going beyond 1999;

- drawing lessons and conclusions, where appropriate, from the experience of other comparable international financial institutions, particularly the International Finance Corporation (IFC).

3.3 These suggestions were welcomed by management and the Committee has noted that the paper has been revised to incorporate them.

4. The Bank's Budgetary and Administrative Framework

4.1 The Committee acknowledged that the Bank has established a sound budgetary and administrative framework to support its efficient operations, with its resources focused on the agreed operational objectives. The Committee agreed it was important for this aspect of the Bank's operations to be clearly evidenced.

5. The Need for an Increase in Capital Resources

5.1 The Committee specifically endorsed the observation that:

> *"Implementation of the Bank's medium term growth strategy requires continuing productivity enhancement and an increase of its capital resources, in accordance with the agreed timetable, without which the Bank will not be able to respond to accelerating demand in the countries of operations in the near future."*

5.2 It saw this as an important issue which began to address the key question of the Bank's need for more capital, with particular reference to anticipated demand for the Bank's services.

5.3 In this regard the Committee recalled the Institutional Priorities and Medium Term Scenarios - 1996-1999 (BDS95-123) and the manageable growth scenario endorsed by the Board at its meeting of 12/13 September 1995. The Committee (and, in its discussion of the Institutional Priorities paper, the Board) had acknowledged that implementation of the manageable growth scenario would require an increase in capital resources to sustain the level of operations which were envisaged. This conclusion was set against an analysis of the level of demand likely to confront the Bank over this period and the level and nature of response by the Bank which might be appropriate, particularly having regard to the implications for the Bank as countries moved to and through the various stages of transition. In this respect, the conclusions reached in the Capital Resources Review were consistent with the conclusions previously endorsed by the Board.

5.4 The Committee also placed considerable emphasis on quality aspects of the development of the Bank's portfolio. It was essential to recognise and progress the quality dimension of the Bank's mandate as the portfolio grew in size under the manageable growth scenario.

5.5 In its consideration of the need for a capital increase, and the size of that increase, the Committee highlighted the importance it attached to the commitment to pursue a more active policy of portfolio turnover. Committee members noted that this was an essential ingredient of the twin-track approach to capital adequacy, which the Board had previously endorsed. They also drew attention to the link between the size of the capital increase and the prospect that the Bank's capital base would be sufficient to enable it to implement its mandate in line with agreed priorities and objectives without recourse to shareholders for further capital calls for the foreseeable future.

5.6 This issue of capital self-sustainability, and the relevant assumptions, have been highlighted in the revised paper.

6. Equity

6.1 In its consideration of the Observation relating to paid-in capital and the Bank's pro-active equity strategy, the Committee gave considerable attention to the Bank's equity strategy and objectives. The issues covered in this respect included:

- the impact of the projections on the size of the Bank's equity portfolio in 1999 and beyond, (and relevant comparisons with the IFC's equity portfolio development);

- the growth assumptions for equity activities up to and beyond 1999; and

- the relative significance of projected equity commitments, vis-à-vis disbursements, as a basis against which to assess the implications of potential development of the portfolio, in the context of the Bank's need for paid-in capital.

6.2 While acknowledging the arguments for a high level of paid-in capital, there were differing views on the particular level which was appropriate and justified. Several Committee members and other Directors noted that their authorities had not yet reached a final view on this issue. The Committee emphasised, however, that the issue of the level of paid-in capital was significant both in terms of the operational and financial implications for the Bank for the foreseeable future.

6.3 With respect to the operational implications, the Committee acknowledged the statutory link between equity operations and paid-in capital. It also acknowledged the priority given to equity operations in the Bank's endorsed Institutional Priorities and Medium-Term Scenarios. Nonetheless, it emphasised the need to keep issues specifically relating to equity operations in perspective. The presentation of these issues had to reflect the overall sense and balance of the Bank's strategies and objectives.

6.4 The Committee sought clarification of the assumptions relating to equity operations beyond 1999. The reference to growth of nine per cent annually beyond 1999 implied an average of 32 per cent in annual equity commitments between 2000-2005, well above the levels discussed in the medium term scenarios (and above the levels in the portfolio of the IFC). The Committee noted that under the current projections the Bank's equity strategy, in terms of annual commitments since 1994, fluctuated in a range of approximately 20 per cent for 1995 growing to approximately 24-28 per cent for 1998/99. The Committee also noted that the IFC, whose new equity business accounted for 28-30 per cent of total business in fiscal year 1995, was now being forced to reduce its equity investments because it was bumping against the statutory limit imposed by its gearing ratio (as its disbursed equity portfolio is projected to reach 30 per cent of IFC's total portfolio in 1998).

6.5 While noting the significance of the operational link between equity operations and paid-in capital, several members felt the operational case did not clearly establish the need for a paid-in share greater than 20 per cent. It was the view of these Directors that the differing impact of 20 and 25 per cent under scenarios 2 and 3, under base case assumptions, did not appear to be significant.

6.6 The Committee also observed that the Bank's success in the implementation of its equity strategy would be particularly relevant to judgements about the significance of maintaining a high level of equity operations.

6.7 Management noted that the Bank's emphasis on equity operations flowed from the Operational Priorities: Guidelines for the Medium-Term endorsed in 1994. It had been reinforced in subsequent discussions of the Bank's Institutional Priorities and Medium-Term Scenarios 1996-1999, and in the recent discussions on the stages of transition and the Bank's product mix.

6.8 Committee members also drew attention to the important link between the paid-in capital share and financial position of the Bank in the medium term. They noted that higher levels of paid-in capital had a direct and beneficial impact in terms of the objective of safeguarding the Bank's viability. They noted this was an aspect of the capital review process which had to be kept very much in mind.

7. Scenarios and Sensitivities

7.1 The Committee discussed in detail the scenarios and sensitivities underlying the financial and operational assessment of the Bank's performance over the medium term, as presented in the paper, and in Appendix 2.

7.2 Committee members noted that the presentation of the scenarios and sensitivities reflected management’s appreciation of the interaction of the relevant issues which were evident from use of the financial model. These were particularly relevant in the extension of projections beyond 1999. For example, minor uncertainties in the early years of projections could have substantial effects beyond the medium term.

7.3 The Committee carefully noted that the fragility and potential volatility in the markets within which the Bank operated meant the possibility that adverse events might impact on the Bank should not be discounted. The Committee noted that this observation had been emphasised by the Bank's External Auditors in their reading of the paper.

7.4 The Committee also sought further explanation of the IFC's experience. Management noted that the IFC experience, while relevant, nonetheless had to be placed in context as the IFC had the benefit of a wider global portfolio which is more mature, while the Bank's portfolio was regionally concentrated and still young. Therefore, the prospects of confronting adverse developments, such as systemic default, were accordingly likely to be greater for the Bank.

7.5 The Committee welcomed the clarification of these issues. Committee members were sensitive to the need to describe carefully the potential developments which the Bank might face in the foreseeable future, including, importantly, those which might adversely threaten its operational and financial performance. They felt, however, that these issues needed to be canvassed in a balanced way, reflecting a realistic view of potential developments, and having regard to the actions the Bank might then take in response to unexpected developments. The Committee felt the revised text captured this balance in an appropriate manner.

7.6 In line with the views of Committee members the paper has also been revised to emphasise the importance of generating operating profits to build the Bank's reserves towards the agreed target levels and to indicate that the Bank should consider how to allocate "real" profits once these targets have been exceeded.

8. Timetable and Procedures

8.1 The Committee sought clarification of the procedures and timetable governing the effectiveness of a capital increase and concluded that the paper should provide further guidance to Governors in this respect. The Committee also sought further clarification of the effectiveness requirements in terms of the Bank's headroom and the sustainable level of operations following a decision by Governors on the capital increase. These issues, including the distinction between effectiveness in terms of authorised capital and effectiveness in terms of subscribed capital, have been further addressed in the revised text and will be expanded in the final report of the Board of Directors to the Board of Governors in early 1996.

8.2 The Committee noted a memorandum from the Director for Japan concerning the schedule for the capital review process. The Committee noted that the work programme for the capital review had been agreed following the approval of Resolution 50 of the Board of Governors.

8.3 The Committee noted that a report of the Board of Directors to the Board of Governors on the Capital Resources Review would be prepared and would be considered by the Committee, and subsequently by the Board, in early 1996. It was envisaged the paper, and a draft Resolution of the Board of Governors, could form part of the Appendices to the Directors' Report.

9. Membership Issues

9.1 The Committee requested further attention to the various issues relating to membership of the Bank which were raised in Appendix 3. The Committee recalled an earlier Board Workshop which had concluded that these issues should ideally be considered in the context of the first review of the Bank's capital stock. While acknowledging the complexity of these membership issues, Committee members sought the inclusion in Appendix 3 of a clearer indication that the Bank would progress these issues in the context of the capital review, and the framework within which these matters could be progressed. The Committee noted that a further Board Workshop on membership issues was proposed. It agreed this would be necessary if these matters were to be taken forward in an orderly but positive way.

10. Corporate Governance, Controls and Policies

10.1 The Committee endorsed the section of the paper dealing with Corporate Governance, Controls and Polices. It noted in particular that this section had been reviewed and endorsed by the Audit Committee. The Committee also noted that this section of the paper had been read by Bank's External Auditors, who had indicated their satisfaction with it.

11. Conclusions

11.1.1 In its detailed consideration of the paper the Committee:

- gave its strong support for the further growth of the Bank's activities in line with the endorsed Institutional Priorities and Medium-Term Scenarios;

- acknowledged the need for a capital increase to enable the Bank to progress the endorsed manageable growth scenario.

11.1.2 The Committee welcomed the strengthening of paper in line with the constructive comments of Committee members and Directors.

11.2 Size of Capital Increase

11.2.1 The Committee noted the observation that a 100 per cent capital increase would allow the Bank to continue to implement the endorsed manageable growth concept on a sustainable basis without requiring additional capital in the foreseeable future. This observation provided the basis of the paper's conclusion with respect to the size of the capital increase which might be supported. Committee members acknowledged the evidence in the paper that an increase of 100 per cent, when combined with a more active policy of portfolio turnover, provided the prospect that growth in operations could be sustained in the future, possibly even beyond the current manageable growth scenario, without requiring additional capital from shareholders for the foreseeable future.

11.2.2 The Committee noted that not all Directors are yet in a position to formally endorse a doubling of the Bank's capital.

11.3 Paid-in Capital Share

11.3.1 The Committee acknowledged the operational and financial issues relating to the level of the paid-in share of the capital increase. While broadly endorsing the need for a high level of paid-in capital, differing views were expressed on the actual percentage which was required in the light of the projections under the various scenarios.

11.3.2 Some Committee members felt the operational implications of a paid-in share of 20 per cent were not significantly different to those associated with higher figures under base case assumptions.

11.3.3 The Committee noted the revisions to the text in line with the revised formulation of the relevant Summary Observation. The Committee endorsed this formulation.

11.3.4 Several Committee members and Directors noted that their authorities had not reached a final view on the issue of the paid-in capital share.

11.4 Payment and Encashment

11.4.1 The Committee endorsed the proposals to provide greater flexibility in the payment and encashment arrangements which would reduce the annual cash contributions from members. They noted that a specific proposal had not yet been presented, but emphasised that the provision of more extended payment terms was a critical issue for most capitals.

12. Recommendation

12.1 The Committee noted with appreciation the views of the President as contained in his covering Memorandum to Directors. It noted that this Memorandum did not constitute part of the paper or its recommendations. The Committee also noted the text of the President's Recommendation, in particular the observation relating to a 20 per cent level of paid-in capital. The Committee felt it appropriate to clarify that, in endorsing the general thrust of the Capital Resources Review document as recommended by the President, the Board would not be making a commitment to the level of paid-in capital, but rather would be providing the basis for the further work to be undertaken on the review of the Bank's capital needs.

12.2 With the benefit of the comprehensive and detailed examination of the paper which the Committee process had allowed, and against the background of the issues and observations raised above, the Committee recommends that the Board endorse the general thrust of the Capital Resources Review document as requested in the President's Recommendation.

12.3 The Committee also recommends that the Board endorse the Summary of Principal Observations as a statement of the framework within which the Capital Resources Review should now be carried forward.

Alan Morris
Chairman, Financial and Operations Policies Committee