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"The Investment Role of International Development Institutions"

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Abstract

This paper examines the roles currently played by international development institutions (IDIs) in relation to lending and other investment activities in the public and private sectors with a view to considering whether such roles can and should continue in the future. The paper is divided into four sections: introduction; a discussion of what investment roles IDIs should play; a detailed analysis of the investment roles of the IBRD and IFC both as lenders/investors and as catalysts for investment; and a critical appraisal of the arguments for and against IDIs maintaining their investment role in the future.

Introduction

The last few years have witnessed an intensification of the debate concerning the role of international development institutions (IDIs) in relation to the financing of the macroeconomic and microeconomic development of emerging countries, centring largely on the role of the World Bank group the International Bank for Reconstruction and Development (IBRD); the International Finance Corporation (IFC) established in 1965; and the International Development Association (IDA), established in 1960 though in reality much more on the roles of the IBRD and IFC than that of the IDA. This is understandable, in that the World Bank group constitutes the most high-profile and important group of IDIs and also the most politically scrutinised, particularly in the USA.

A great deal of the debate concerning the role of the World Bank institutions appears to centre around the issue of how those institutions might best fulfil their developmental role, and specifically the relationship between their activities and those of commercial lenders and investors. Central to this debate in recent years has been the growing size and importance of private finance, and specifically capital markets, as the principal source of investment capital. In volume terms, private capital has long since constituted the major proportion of available investment capital, but that capital has largely been available only to those borrowers and in those countries which were perceived by financiers to constitute the best credit risks. This constituted a mere handful of investments in the context of the overall investment need. That situation has been radically altered by the seismic political events of the last decade notably the collapse of communism in many countries and the more widespread opening up of other public sector monopolies in areas such as telecommunications and transport to private capital. External trade (defined as the sum of exports and imports of goods and services) as a percentage of GDP has barely altered in industrial countries over the last 20 years but has increased significantly over the same period in developing countries, from about 35 per cent of GDP in 1981 to around 48 per cent in 1977.¹

There has also been a simultaneous expansion of capital market activity, in terms of both the opening of new capital markets and the increase in the appetite of investors in developed countries for debt instruments representing indebtedness of, or of entities carrying on business in, developing countries and, in some cases, for equity in emerging country enterprises or funds investing in such enterprises. Between 1990 and 1998 private debt flows (such as bank loans and bonds) to developing countries increased from US\$10bn or thereabouts to over US\$50bn while foreign direct investment increased from around US\$20bn to approximately US\$150bn.²

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The IFC in particular has played a leading role in opening up capital markets in countries in which those markets either had never existed or had ceased to function in a manner which might be conducive to inward foreign investment. However, the irony of this is that the more institutions like the IFC build or expand markets to the point at which private investors will willingly invest in them, the more they invite questions about their continuing relevance as direct investors in those same markets. Similarly, the more the IBRD expands its role to encompass programmes of legislative reform in areas such as environmental control or the promotion of social objectives, the more it invites questions concerning the appropriateness of focusing their activities around its role as a lending institution, other than as a concessional lender in countries in which development institution finance effectively constitutes the main or only available source of foreign currency loans.

So have IDIs in effect outlived their usefulness as lenders (or indeed investors in any capacity), and should a new model IDI now be developed based on the promotion of human development in its wider sense (social, environmental, economic and financial), in the role of facilitator rather than participant?

What Investment Roles Should IDIs Play?

A number of major changes have occurred in the last 20 years which have directly affected the role of IDIs as macroeconomic (structural adjustment) and microeconomic (project) lenders, notably:

- the debt crisis of the early 1980s which radically changed the perception of the sovereign borrowers as credit risks and the resultant introduction of a US government-inspired initiative to contain the damage and its impact on the balance sheets of major financial institutions, culminating in the emergence of a market in collateralised emerging country bonds in 1989³ with the introduction of Brady bonds⁴;
- the virtual disappearance in the late 1980s and early to mid-1990s of external private sector finance in a number of the less developed countries, including virtually all of sub-Saharan Africa;
- the collapse of the state-run economies of Eastern Europe and the former Soviet Union, and their replacement by private sector enterprises;
- the wider tendency to privatise monopolistic state-controlled industries, notably in the energy, public utility transport and telecommunications sectors;
- the creation and growth of capital markets in many developing countries and the growth in ownership of debt instruments and equities traded in those markets; and
- the development of dedicated and purely commercial secondary markets in sovereign debt instruments

The general effect of the above, in broad terms, appears to have been:

- to increase private investment in emerging economies but to concentrate that investment within a limited number of countries and specific areas of the economy, notably privatisations;
- to leave many countries without access to private loan or equity capital other than IDI funds and short-term trade finance;
- to cause the major IDIs, and notably the IBRD, to devote human and financial resources increasingly to structural adjustment lending and debt restructuring support; and
- to increase the categories and numbers of investors holding sovereign debt either as portfolio investments or for the purposes of secondary market trading.

The issue which therefore confronts the World Bank group and other IDIs is whether, and to what extent, they should seek to maintain their traditional lending and facilitating roles in the following areas:

- assuming the role of main foreign lender/investor in those countries which continue to be unable to access private sector capital;
- project lending and loan arrangement;
- structural adjustment lending;

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- helping the more developed emerging economies to increase the size, efficiency and transparency of their capital markets;
- providing planning and other technical assistance to governments, central bankers, financial institutions and local entrepreneurs;
- fostering the development of local financial institutions to act as financial intermediaries serving small and medium-small indigenous enterprises;
- assisting in an "honest broker" capacity in sovereign debt restructurings with third-party creditors; and
- promoting structural regulatory and legal reform in member countries to encourage further private investment.

US Treasury Secretary Lawrence Summers has written⁵: in a world in which private markets are the overwhelming source of capital, the role of the international financial institutions must be to support rather than supplant private finance.

Summers was clear as to how this particular apple should be split in relation to public sector activity. He went on to say of the World Bank⁶: The World Bank should be broadly responsible for international support for growth and lasting human development in the poorest countries. Its role in the emerging market economies should be confined to where it can deploy its unique capacity to apply conditions, to respond to emergencies and to finance crucial social investments. It should have an increased role in supporting the development of global public goods such as vaccines for diseases such as HIV/Aids and for better environmental protection. A number of questions arise in relation to the above. For example, if the reference to the Bank's 'unique capacity to apply conditions' may be taken as a reference to its policy with regard to conditionality as currently applied in relation to structural adjustment and project lending, how will the Bank sustain its power to influence its borrowers (or will they be donees) which it currently derives from its status as a lender? This applies particularly to project-related, as opposed to macro, lending where influence usually derives from its ability to withhold disbursement of future loan monies if conditions are not met. More generally, how would the Bank 'apply conditions' to humanitarian support, such as vaccine production, or to 'crucial social investment' in a politically acceptable manner? Again, will support for the development of 'global public goods' come in the form of loans or grants to developing country consumers, or to multinational producers and what are 'global public goods' in this context?

Of course the remarks quoted above were made in a political context⁷ and there is no knowing whether Mr. Summers would now modify his own position in the light of changing circumstances.⁸ However, there appear to be certain common assumptions underlying the position of Mr. Summers and those of more extreme protagonists within the US Congress, namely: the investment role of the World Bank (and, by implication, IDIs generally) is anachronistic, and must be refocused (and probably reduced); the lending roles of IDIs can be assumed by other lenders; and the World Bank (and by implication other IDIs) can perform other roles, such as procuring structural economic reform, introducing environmental legislation and governance and supporting world health programmes effectively on a stand-alone basis rather than as part of an integrated strategy with a lending programme at its heart.

Self-evidently, IDIs should play a lending role in those situations in which there is no or no better alternative in relation to structural adjustment lending for example, or where the IDI acts as lender of last resort or as the grantor of a soft loan or credit. The more difficult question is whether IDIs shall have a general investment role to play within economies in which commercial lenders and private investors provide the majority of external financial investment.

Current Investment Roles of the IBRD

Development institution guidelines usually require IDIs making investments in the public sector to play the role of lender of last resort, though in many of the poorest countries IDIs have become, sadly, the 'lenders of only resort' as foreign commercial banks have withdrawn their operations and terminated their lending activities. The IBRD's main lending activities in this capacity comprise⁹:

- loans to finance projects and sector programmes (groups of projects within an economic sector, eg, palm oil production);
- structural adjustment facilities;

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- the provision of guarantees of two types: sovereign risk/force majeure guarantees and partial credit guarantees (usually to extend maturity dates of third-party loans by guaranteeing later maturities or supporting roll-over provisions)¹⁰; and
- debt service reduction loans.

Thus the IBRD's lending activities in fact extend beyond its original remit as laid down in its Articles¹¹, which provide that:

Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction and development.

Project Financing

Appraisal

Potential projects, if they are to be analysed for their development value, need to be appraised in numerous different ways. The appraisal process embraces:

- economic appraisal
- financial appraisal
- technical appraisal
- environmental appraisal
- social impact appraisal
- risk appraisal (including political risk)
- legal appraisal

IDIs, and particularly the IBRD and the other major regional IDIs, have far greater resources to make available for the purposes of such appraisals than commercial banks, and the latter would in any event be primarily concerned with the financial appraisal of the project. Even where commercial banks undertake to arrange loans for project-related purposes, they will frequently rely on World Bank and other IDI compiled statistics and information for the purposes of such appraisal. In-depth project appraisals of the type carried out by the IBRD are important not only financially and economically but also because they enable the IBRD and its co-lenders to identify the requisite conditions precedent to be imposed on the sovereign borrower or its relevant agency.

Co-financing

Most IDIs have a policy of seeking co-financiers in their project, both to allow them to spread their investments more widely and to open territories or areas of investment to new investors. Many new investors would be unable to access investment opportunities if they were not made available in this way for example, because such opportunity is only available to IDI-led finance or because the political or credit risk would be unacceptable without IDI participation. The IBRD co-finances with other development institutions and also with commercial lenders.

Co-financing in relation to lending may take one or more of the following forms:

- joint financing, where the loans of the IDI and its co-financiers are applied to finance the same goods and services in agreed proportions;
- parallel financing, where the loans of the IDI and co-financiers finance different goods and services for the same project;
- syndication, where the IDI arranges a loan to be funded by a syndicate of lenders including itself, and each of these lenders will have an obligation to provide its portion of the loan but no obligation to make good any deficiency resulting from the failure of any other member of the syndicate to provide its portion in whole or in part;

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- participation, similar to syndication but where the IDI is the sole lender of record and the co-lenders' contributions are provided in the form of deposits made with the IDI ('funded participation'). In practice, it is believed that most participations are funded participations.

It should be noted that syndicated and participated loans are more usually found in relation to private sector projects in the context of IDI financings; and that joint financing is more usual than parallel financing, but parallel financing may be required where the lending policies of co-financiers are different from those of the IDI for example, where the co-financier's finance is tied to the purchase of goods and services procured from a specified origin and not through international competitive bidding.

Political Risk Insurance

Political risk insurance is offered by the World Bank's Multilateral Investment Guarantee Agency (MIGA)¹². The agency guarantees foreign private investors against investment risks in relation to projects in developing countries such as currency repatriation risk, expropriation and nationalisation risk, war and civil disturbance risk, and breach of contract by the host government for which judicial remedy is not available. However, a subtler (and cheaper) form of political risk insurance is available to co-financiers of IBRD and other IDI projects in the form of the presence of the IBRD (or the relevant IDI) as a lender. Even where co-financiers cannot benefit automatically from the IDI's de facto immunity from default, such as in the case of the IBRD where loans are made through separate loan agreements, there is little doubt that in practical terms their exposure to default is lessened by the presence of the IDI.

Investment terms and conditions

A couple of areas in which it is possible to distinguish between the approach of development institutions such as the IBRD and that of commercial lenders are worth noting.

Conditions precedent

IDIs present advantages and disadvantages to borrowers and co-financiers in relation to their philosophical approach to conditions precedent to disbursement. On the positive side, the presence of an institution like the IBRD should facilitate the imposition of conditions which have macroeconomic or political ramifications, such as changes in legislation, or the reorganisation of government agencies (which borrowers might welcome as a means of achieving objectives which could not, for political or other reasons, be initiated by them). On the other hand, IDIs will wish to impose conditions precedent of a non-financial nature, such as the carrying out of environmental audits, the taking of steps to reduce environmental risk, or taking action to reduce the social impact of the project for example, by resettling local inhabitants, which may delay the implementation and/or increase the cost of the project. Of particular concern are environmental conditions most, if not all, IDIs now have guidelines which effectively require projects to be graded in terms of environmental impact, with the most affected projects necessitating full environmental audits and possibly expensive remedial measures. Such requirements, though environmentally justifiable and beneficial in the long term, may provoke an adverse reaction from the host government if perceived to constitute an attempt to direct national policy.¹³

Consequently, the imposition of non financial conditions precedent to disbursement may be at the same time advantageous (to the environment, economy or social structure of the host territory) and disadvantageous (To project costs, co-financiers or politically and/or financially to government).

It should be noted that conditionality in the context of micro (project) financing discussed above is different from (and is treated in this analysis separately from) conditionality in the context of macro (structural adjustment) lending (discussed below).¹⁴

Other terms and conditions

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IBRD loan and guarantee agreements comprise a number of general terms and conditions which are set out in a preprinted booklet¹⁵ and a separate loan agreement embodying specific terms and conditions of the particular investment, including any special conditions such as additional conditions precedent or undertakings. Evidence of the immutability of the general terms and conditions is the fact that the current version of the general conditions is the one first published in 1985. The relative simplicity of the provisions and the fact that they have been largely accepted by borrowers and guarantors as standard and non-negotiable for many years constitute advantages not only with respect to the IBRD's own loan negotiations but also for co-financiers seeking to impose equivalent terms and conditions and borrowers seeking to limit the imposition of more draconian terms and conditions by co-financiers. There are, however, a couple of provisions of the general conditions which might present a challenge to borrowers, and possibly co-financiers.

The first such provision is the negative pledge provision.¹⁶ In fact, the section is headed 'Negative Pledge' but mostly deals with the creation of liens¹⁷ in favour of the IBRD in the event that liens are granted in favour of other external creditors.¹⁸ Section 9.03(a)(i) provides that if the borrower creates a third-party lien over its assets¹⁹, such lien shall 'ipso facto' and at no cost to the Bank²⁰ 'equally and rateably' secure the Bank's loan (or the guarantor's guarantee obligations, as the case may be).²¹ The section further provides that the borrower shall 'make express provision to that effect', failing which the borrower shall create an equivalent lien in favour of the Bank over 'other (public) assets satisfactory to the Bank'.²²

There are a number of potential issues which might be raised by the concept of ipso facto liens being created over security, particularly in respect of the already secured assets. For example:

- if the property is legally situated within a specific jurisdiction, does the law of that jurisdiction embrace the concept of a lien created 'ipso facto' by the creation of a third-party lien (and if not, how would it enforce the provision if, for example, the arbitration tribunal convened pursuant to the provisions of Section 10.04 see below made an award to that effect)?;
- what if the creation of valid security under the law of the borrower is subject to compliance with formal requirements, such as documentation in a prescribed form, registration or third-party notification, but these requirements are not complied with do the general conditions override municipal law provisions which might render the security void in such circumstances?;
- how will the 'express provision' in the third-party security document relating to the ipso facto lien be enforceable against the third-party creditor if the concept is not recognized by the governing law of the third-party security document?;
- if an equivalent lien over other public assets is required, is it the lien, or the assets, or both which must be satisfactory to the Bank, and what, if any, principle of law or general equity requires the Bank to act reasonably in such circumstances?;
- how far does a lien created in favour of the Bank over the same assets as the third-party lien automatically carry the rights and benefits of such third-party lien for example, if third-party rights are freely assignable, are the rights of the Bank also freely assignable?

The second challenging provision is the enforceability provision. The general conditions do not provide for a governing law. Instead, Section 10.01 provides, in effect, that the general conditions will be enforceable in accordance with their terms 'notwithstanding the law of any State or political subdivision thereof to the contrary'. This provision should be read in conjunction with the provisions of Section 10.04, which provides for any controversy between the parties and any claim under the loan agreement or guarantee agreement to be submitted to arbitration, and for awards of the arbitral tribunal to be final and binding on the parties.

The efficacy of Section 10.01 therefore depends first on the ability of the arbitral tribunal to interpret the general conditions without a reference base in the form of a municipal legal system, and secondly on the willingness of the courts of the borrower and guarantor to implement the tribunal's award. The first of these assumptions may be more troubling than the latter, since governing law clauses are principally interpretation provisions which provide for agreements not only to be governed by but also to be construed in accordance with the relevant chosen law, precisely because it cannot be assumed that all provisions have a natural meaning capable of literal interpretation. Moreover, borrowers' familiarity with the general conditions may well increase the difficulty encountered by co-lenders in persuading their borrower to accept the more conventional governing law and submission to jurisdiction provisions found in commercial loan agreements and those of

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bilateral development institutions.

Procurement

The major IDIs have policies governing the procurement of goods and services funded by them. These policies are usually embodied in written rules which are generally available to borrowers. For the purposes of illustration, reference is made herein to the procurement policies and rules of EBRD²³ but the principles are similar to those of other IDIs.

The fundamental principles which underlay procurement rules are quite simple. First, loans may be conditional on international invitations to tender being arranged for goods or services procured for the project²⁴ and secondly, procurement procedures must be in accordance with best practice, or in the language of the EBRD, used 'with due attention to considerations of economy and efficiency' (Article 13, para xiii). This means that tenders should in most cases be open, transparent and international, and should not discriminate between local and foreign suppliers (a principle sometimes referred to as 'international competitive bidding' or ICB). However, there is usually provision for selective tendering and some discrimination in favour of local suppliers in certain specified cases.

for example, where the value of the contract is too low to warrant the cost of ICB. The introduction of procurement rules such as the EBRD rules helps to ensure that project costs reflect the best market prices for goods and services while enabling major multinational enterprises to bid on equal terms for the supply of goods and services.

Sovereign default

Although provision is made in the World Bank's articles of agreement for a borrower's obligations to be 'adjusted' in the event of default (Article IV(7)(a)), the Bank's policy is to decline to reschedule the indebtedness of its borrowers, so important is its AAA credit rating and its ability to find a market for its bond issues. If debt relief is made available, it will be by programme lending and then only to the poorest countries. As noted earlier, although the Bank's policy in this respect does not, ipso facto, protect co-financiers, in practice it acts as a general deterrent to the 'unilateral rescheduling' of indebtedness incurred in relation to projects to which IBRD is a lender.

Non-project²⁵ lending roles off

Non-project or policy-based lending by the IBRD comprises loans to its members which are usually known as structural adjustment loans, stabilisation loans²⁶ or, in the case of sector-specific loans, sectoral adjustment loans, and may be made available in the event of a deterioration in the borrower's balance of payments on condition that the borrower is willing to take IMF-prescribed medicine (such requirement being known as 'conditionality'), through a structural adjustment 'package' involving a possible range of economic measures such as currency devaluation and the abolition of subsidies, and in some cases legal measures such as the introduction of regulatory regimes, and changes in banking or insolvency laws. Such measures are intended to open up the economies of borrowers which have sought to insulate themselves from external market forces.

Apart from the obvious advantages to lenders and potential lenders of the provision of macroeconomic support, together with measures to increase the stability, transparency and reliability of the borrower's financial and legal regimes, the provision of non-project financing also enhances the reliance of the borrower on the IBRD and underpins the project-lending activities of World Bank institutions (though of course it also raises the stakes for the lender in the sense of greater credit exposure to the borrower). It must also improve the due diligence capability of the IBRD in its capacity as a lender, by 'opening the books' of the borrower to its scrutiny.

However, some observers question the extent to which the introduction of policy-based lending might have been motivated by the World Bank's desire to maintain its lending programme in the face of reduced opportunities for project lending in the 1980s, as a result of the debt crisis, and to maintain the Bank's position as a net lender, particularly in Latin America. Certainly, it would be unfortunate if the effect of macroeconomic lending was to reduce either the funds available or the appetite of World Bank staff for identifying and negotiating individual project loans. Equally, it would be unfortunate for

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co-financiers if decisions of the IBRD in relation to specific projects were to be influenced by the relationship between the IBRD and the borrower at a macroeconomic level.

Apart from structural adjustment lending, IDIs may assist directly or indirectly in the promotion of project implementation and general business activity in ways that commercial lenders would not normally deem appropriate or beneficial. The most important example of this type of assistance is probably the provision of loans to financial intermediaries (also known as development banks) which in turn lend the proceeds of these loans to a number of local entities to support projects or businesses which are too small to merit the cost of direct investment by the IDI or to make direct loans to groups such as small farmers. This permits IDI funds to be channeled into small and medium-sized projects and businesses, while at the same time providing a training ground for local lenders, particularly in the disciplines of financial appraisal and due diligence, which hopefully results in a general raising of standards among local financial institutions.

IDIs also frequently provide or fund the provision of technical assistance in respect of both macroeconomic areas, such as sector development or institutional or judicial reform, and microeconomic areas, such as project appraisals or local studies.

IDIs can also assist attempts to use innovative debt structures sympathetic to its wider policy objectives. Examples of this type of initiative include:

- **commodity bonds:** bonds issued by borrowers intending to service their debt obligations out of the proceeds of sale of specific commodities, such as coffee, sugar or palm oil, under which payments of interest and repayments of capital may vary up or down in line with the market prices of the commodities in question; and
- **'debt for nature' swaps:** the purchase of commercial debt by government agencies and non-governmental organisations (possibly at a significant discount in the secondary debt market) which is then exchanged with the debtor's central bank for local currency or currency bonds used to fund environmental activities in the host country.

It is, however, difficult for those IDIs which need to maintain an AAA credit rating for borrowing purposes to participate directly in such initiatives.

Finally, IDIs may be able to provide loans to support debt reduction programmes of their sovereign borrowers, even if they do not permit the rescheduling of their own loans or participate directly in debt rescheduling discussions in relation to third-party loans. The IBRD makes such loans, in tandem with the application of structural adjustment measures.

Current Investment Roles of the IFC

The investment role of the private sector IDI is somewhat different from that of the public sector IDI. Once again, the current 'market leader' is the World Bank, in the shape of the IFC, whose core activity is the provision of debt and equity finance to private sector entities in developing countries. However, the IFC can in practice operate far less widely than the IBRD, since it can only operate where private enterprise and commercial lenders will also operate. According to one report²⁷, in 1998 87 percent of outstanding long-term debt of 41 heavily indebted poorer countries was provided by official lenders. The same limitation also applies to the type of project in which the IFC and other IDIs operating in the private sector can participate, and a great deal of their finance goes into certain specific sectors, notably the energy sector.

In recent years the IFC has also played a leading role in the creation or resuscitation of capital markets in developing countries, and the development of debt and equity instruments suitable for trading in those markets. Such initiatives have been invaluable, but they do create problems in the sense of inherent conflicts between the various roles. As a creator and facilitator of capital markets activity and a lead player generally in private sector financing, the IFC is well placed to use its position to leverage the potential returns to itself and its investment partners (promoters as well as co-lenders) as owners of equity capital. As a lender of last resort, however, and one whose participation may be a condition precedent to the willingness of other investors to participate, it has the power to impose onerous conditions on its borrowers, including those in respect of equity participation, the value of which might be released or enhanced by the borrower's accession to local capital markets. Thus the issue of how much equity to take in project entities, and on what terms, may be highly sensitive, and there are some critics who do not believe that the IFC always strikes a fair balance between its various interests.²⁸

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Nevertheless, even those who maintain that the IFC does not always split the cake fairly would admit that in many cases there would be no cake at all without its participation.

The financing role of IDIs operating in the private sector comprises:

- project appraisal: co-financiers may rely on the IDI to provide the feasibility study, or to review the borrower's proposals and negotiate modifications;
- lending on commercial terms to project entities;
- equity participation;
- taking the agent/lead manager role in some cases in relation to procuring the participation of private sector financial institutions in the project financing, and/or acting as 'lender of record', i.e. the contractual lender under the loan agreement; and
- debt restructuring in relation to projects in difficulties.

The facilitating or catalytic investment role of the IDI may include:

- the carrying out or financing of studies relating to particular financial techniques, eg finance leasing;
- assisting in the creation or development of capital markets;
- 'institution building': assisting in the creation of a prudential legal and/or regulatory environment for private sector financing.

Project financing

The structure of the arrangements between the IFC, its co-financiers and its borrowers, and the terms and conditions of its loan documents differ fundamentally from those of the IBRD. IDIs operating in the public sector rely on fairly simple structures loans to or guaranteed by sovereign states made on terms and conditions evidencing a high degree of standardisation. As noted above, the IBRD, for example, utilises printed standard terms and conditions of loan and guarantee, supplemented by special conditions related to each particular investment. Standard terms and conditions bear some resemblance to those in equivalent private sector project finance agreements, but there are significant differences (see above). The number of provisions which are regarded as negotiable are therefore limited.

IFC-led private sector loans, on the other hand, usually utilise structures and documents which are broadly appropriate for an equivalent commercial bank financing.

Loans may be made as co-financings with commercial lenders using separate loan documents on comparable terms and conditions, or may take the form of syndicated or (more usually) participated²⁹ loans arranged by the IFC. Where separate loans are made, or in the case of syndications, the IFC and the commercial banks will share in the same security package mortgages or charges over land and other physical assets and security assignments of sales proceeds or other receivables, for example usually on a pari-passu basis.

In pure commercial bank financings, where the syndicate members are identified ab initio the loan would probably be syndicated rather than participated. In the case of IFC-led loans, however, making the IFC the sole lender of record enables both the borrower and the IFC's co-financiers to take advantage of its status as a World Bank affiliate. There may be several aspects to this benefit, for example:

- it may facilitate the formation of the lending syndicate where the IFC's participation is perceived to improved the credit risk;
- it may help the borrower to obtain the necessary governmental permits and authorisations for the project;
- it provides automatic political risk protection for co-lenders and the borrower;

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- it may enable the project to be appraised in more depth than would normally be possible for the purposes of a commercial arranger's information memorandum;
- it may encourage co-financiers with no previous expertise of financing projects in the relevant territory to participate;
- it enables co-lenders to shelter behind the IFC's bargaining strength as a lender of last resort; and
- it enables the borrower to accept loans partially funded by commercial banks with which it would not want to enter into a direct contractual relationship.

In short, institutions such as the IFC act as umbrellas under which projects which would not otherwise be able to access the requisite financing can be implemented and financed. There are, however, some disadvantages which may arise out of the IFC's participation, such as:

- cost: IFC finance is not concessionary and finance costs may well exceed those of commercial lender;
- the IFC's requirement for a prescribed percentage equity participation at par may increase the effective cost of the equity contributions of the project sponsors and/or may materially dilute the prospective profits of the project sponsors in their capacity as equity owners;
- the IFC's appraisal process may be longer and more searching than that of a commercial lender;
- the IFC's status as an IDI may cause it to require projects to be implemented in accordance with its policy, for example, as regards environmentally sensitive aspects of the project, and this may increase costs and/or delay implementation;
- decisions regarding the taking of enforcement action in the event of a default by the borrower may be influenced by the IFC's role and status within the territory in question and as a World Bank affiliate rather than made on purely commercial grounds;
- the IFC's participation and interests as equity owner may conflict with the interests of the 'pure' lenders, for example, in relation to the choice of what course of action to take if the project is in difficulties.³⁰

Other Investment Roles

Private sector IDIs may play equivalent roles in the private sector to those performed by organisations like the IBRD in the public sector (and in the case of organisations operating in both sectors such as the EBRD, may perform both roles). These include:

- provision of equity and loan capital to financial intermediaries for on-lending to/investment in small and medium-size enterprises;
- assisting the implementation of regulatory and legal frameworks in the areas of banking, finance and financial services;
- 'institution building': helping to create and support banks and other financial and regulatory institutions generally, and as tools for creating or resuscitating capital markets;
- the creation or adaptation of financial instruments for use in capital markets; and
- improving the accessibility of emerging country borrowers and markets to potential investors. The IFC, for example, regularly publishes statistical information in relation to emerging markets which enables potential investors to make more informed judgments with respect to their analysis of investment risks and rewards.

Procurement policies do not normally apply to private sector projects as they do to public sector projects because the project sponsors, as commercial organisations operating for profit, should naturally seek the most competitive prices available from international and national suppliers. Issues may arise, however, where a contractor or supplier to the project (the 'contractor') is an affiliated company of the shareholder or one of the shareholders of the company which is implementing the project (the 'owner') for example, where the contractor is the parent of the owner, or the contractor and the owner are in common ownership, but there is little the IDI can do in such a situation, if it wishes to participate in such an arrangement, other than to monitor the financial and other terms of the arrangements.

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IDIs have (or should have) a different perspective from commercial lenders with respect to projects in difficulties. Unlike loans made to or guaranteed by governments, which may or may not be rescheduled according to the policy of the IDI (the IBRD's policy being, as stated above, not to reschedule the indebtedness of its borrowers, although its articles of agreement permit it so to do)³¹, decisions regarding the restructuring and rescheduling of loans made to private sector entities should always be made on a case-by-case basis.

The principal determinant of such a decision, particularly where there are commercial co-lenders, must be whether restructuring is the best available option for maximising debt recovery. Even for commercial lenders, however, there may be wider issues, such as the impact of the action taken on the lender's wider interests in the particular territory, or its other relationships with the borrower's sponsors, or its reputation with third parties such as its other borrowers. In the case of IDIs, all these considerations apply, but are given sharper focus by their mission to promote economic development and reconstruction.

IDIs can add value to the restructuring process in several ways. To begin with, they may have more resources to make available to the appraisal of the options. Secondly, where steps in the restructuring process can only be implemented with the consent of governmental or other public sector agencies, the IDI's influence may be key to obtaining the necessary consents and authorisations for example, as regards the designation of restructured debt for exchange control purposes. Again, the IDI may have more flexibility than the banks with respect to the terms of its restructured debt, for instance, in relation to its duration. Also, since the IDI inevitably operates in a higher risk environment than commercial banks, it is more likely to have experienced similar past situations which might provide relevant restructuring models. Finally, the IDI's existing relationships with local financial institutions can be of great value where restructurings require their cooperation or even the parallel restructuring of local indebtedness.

There may also be some negative aspects for co-lenders in IDI-led restructurings. First, and most obviously, the IDI's developmental mission may result in it pursuing financial and developmental objectives in parallel, which might not be entirely compatible with a strategy driven by a pure debt recovery objective. Secondly, IDIs are naturally bureaucratic organisations with longer (or broader) management lines than purely commercial organisations and this may slow down the negotiation process. Thirdly, the IDI must be seen to be adopting an even-handed approach between projects in all member countries, which may incline it to be precedent driven and prefer to replicate previous project and investment structures and terms and conditions of investment rather than being accused of a lack of impartiality between borrowers or projects in different member states. Finally, the potential conflict referred to above between its position as an equity holder might arise, or be perceived to have arisen, in relation to the choice of a particular restructuring option or the implementation of that option.

Should IDIs Maintain Their Investment Role?

It seems reasonable to suggest that advocates of the abolition or material reduction of the lending role of IDIs, if they are to succeed in persuading others to recognise the feasibility of such a position, need to demonstrate that:

- the investment role of IDIs providing finance to the private sector can be fulfilled by commercial lenders;
- the investment role of IDIs providing finance to the public sector can be fulfilled by commercial lenders (in respect of borrowers whose credit risks are acceptable) or by IDIs from a much diminished lending base;
- structural macroeconomic reform can be imposed on borrowers to whom structural adjustment loans will still have to be made notwithstanding the reduced dependence of the sovereign borrower on the IDI in respect of project and programme financing;
- the range and quantity of projects which would be accepted for financing by lenders other than IDIs will be maintained as well as the overall amount lent; and
- the other roles of the IDI, such as institution building, the promotion of legal and regulatory reform, and the implementation of sound environmental policies and procedures could still be performed by the IDI shorn of its lending muscle.

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It is suggested that it would be difficult to substantiate fully any of the above propositions. The very nature of IDIs as lenders of last resort precludes their replacement by commercial lenders, for there is a world of difference between being prepared to follow where IDIs lead as a co-financier, and taking on the burden of lead investor. Moreover, even if other institutions were prepared to assume at least some of the IDI's responsibilities, it is probable that the projects they would identify would be different in nature³² and scale the project appraisal would probably be of a purely financial nature rather than an economic nature, the payback period would need to fit the requirements of commercial markets, which might preclude projects requiring long-term loans, and the requirements of lenders in relation to the terms of the loan and such issues as security would undoubtedly be affected by the removal of the political risk protection afforded by the presence of the IDI as lead financier. Loans made by commercial banks, however large, are also more likely to be affected by economic events in the lender's main business territory for example, the need to liquidate assets to deal with problems arising from non-performing domestic loans, as has been the case in relation to Japanese banks in recent years.

As regards the ability of the IDI to operate from a diminished lending base, a material reduction in lending would presumably lead to a continuing reduction of the loan portfolio, and a consequent reduction in the ability to reinvest, and could eventually endanger the AAA status which most IDIs enjoy, which would in turn reduce the IDI's access to loan funds and increase the cost of those funds (and thereby the rates charged to borrowers). The only way to alleviate this problem would be to increase the subscriptions of the IDI's members that is, the cure would be worse than the disease.

As for the suggestion that IDIs might continue to perform their other roles effectively, notwithstanding any reduction in their project financing role, this seems doubtful. Taking the case of the IBRD, if it were to retain its role as structural adjustment lender, particularly in tandem with the IMF, it would no doubt continue to exert such influence as the weapon of conditionality would permit, which should help to effect macroeconomic reforms of general benefit to project implementation and financing, as well as institutional reforms and legal and general reforms of wider benefit. However, any material reduction in its ability to operate at a microeconomic level would reduce the numbers of projects and programmes which could be implemented, and would deprive the affected sectors of the economy of the very benefits of structural reform. It needs always to be borne in mind that institutions like the IBRD are both investors and catalysts for investment, so the real loss which would result from their exclusion is several times greater than the value of their own investment.

The most important issue, however, is the maintenance of project and programme lending to the poorest countries. The suggestion made in the report to the US Congress cited above, namely that grant-based funding should be substituted for loans, is one for which Mr. Summers has little time. As he points out, since roughly half the funds in question currently come from existing debt servicing, the result would be a drastic reduction in the available resources. There are other objections. First, as Martin Wolf argues³³, it is difficult to combine grant aid with conditionality, simply because it is not repayable. By contrast, poorest country debt tends to be constantly rescheduled, and each rescheduling represent another opportunity to introduce conditionality, or to insist on compliance with existing conditions. Secondly, debt which needs to be serviced has to be utilised productively, or the amount of indebtedness will grow. Thirdly, the line has to be constantly redrawn between those countries which qualify for grants and those which must borrow, and those countries which are only just above the line discouraged from deliberately falling below in order to avail themselves of grant aid. In fact it is difficult to envisage a regime that would be better than that currently utilised by the IDA and other IDI providers of long-term low-interest loans and credits.

In conclusion, it has been the objective of this paper to argue that: while IDIs play a much greater role in the global economic process than that of pure lenders, it is nevertheless the lending activity which is the engine of that activity, and that in consequence the maintenance of effective and influential IDIs with a lending presence in both public and private sectors equivalent in real terms at the very least to that currently enjoyed by them is beneficial not only to themselves and their borrowers, but also to other multinational lenders and investors; and that IDI lending and commercial bank lending are fundamentally different in quality as well as quantity, and therefore not interchangeable. It is hoped that these arguments have at least in some part been substantiated.

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1 World Bank, World Development Indicators 1999 quoted in the World Development Report 1999/2000, World Bank, at p. 5.

2 Ibid. p. 7. However, it is noted later in the same report (at p. 37) that 50 per cent of such investment in 1997 was received by five countries: Argentina, Brazil, China, Mexico and Poland.

3 The concept was articulated in a speech by Mr. Brady on 10th March 1989 to the Brookings Institution and the Bretton Woods Committee Conference on Third World Debt.

4 Collateralised US dollar denominated bonds issued by sovereign borrowers and named after Nicholas Brady, US Treasury Secretary, who was credited with originating the concept. Brady bond indebtedness is secured on US Treasury securities maturing contemporaneously with the underlying debt service obligations, and was originally offered to existing creditors in exchange for the cancellation of greater amounts of unsecured indebtedness of the issuer. Since Brady bonds are transferable, an active secondary market in them has evolved.

5 Summers, L. (2000) 'The Troubling Aspects of IMF Reform', Financial Times, 23rd March, p. 29.

6 Ibid.

7 In response to the majority report of the International Financial Institutions Advisory Committee to the US Congress, which advocated reform of the IMF by restricting its lending to a relatively small number of countries selected largely on financial criteria, and substituting grant-based funding for loans in the majority of World Bank programmes (which would result in those programmes having to be drastically cut back).

8 That is, the removal of the threat in June 2000 when Congress failed to take up the suggested reforms.

9 For a more detailed description see Hassan, T. (1988) 'Legal Aspects of World Bank Financing', Part 1, Journal of International Banking and Financial Law (JIBFL) July/August, pp. 284-289 and Part 2, JIBFL September, pp. 347-351.

10 Ibid. p. 286.

11 Article III(4)(vii).

12 Commonly known as MIGA and established by convention in 1985. It came into operation on 13th April, 1989.

13 For a general discussion of this topic see Auerback and Shutter (1995) in Norton, Auerback and Gaba (eds) 'Environmental Liability for Banks', Lloyds of London Press, Chapter 7.

14 Conditionality in the latter context is analysed in Gold, J. (1979) 'Conditionality', IMF Pamphlet Series No. 31; and in Guitian, M. (1981) 'Fund Conditionality: Evolution of Principles and Practices', IMF.

15 The General Conditions Applicable to Loan and Guarantee Agreements Dated 1st January 1985 (hereafter the 'general conditions').

16 Section 9.03(a) of the general conditions.

17 In the broad sense of security interests rather than the narrow sense of possessory security.

18 Ironically, Nicholas Brady, when US Treasury Secretary, singled out negative pledge clauses as a barrier to debt restructuring by sovereign borrowers (see J. M. Clark in (1992) 'International Economic Law and Developing States', British Institute of International and Comp. Law, p. 230).

19 Being 'public assets' (as defined in Section 9.03(a)(ii)) in the case of borrowers who are members of the Bank or assets generally in the case of other borrowers.

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20 IBRD being so defined in the general conditions.

21 The provisions do not relate to third party security created over assets to secure the purchase price of such assets and debt maturing in accordance with its terms and conditions not more than one year after the date of its incurrence.

22 Section 9.03(b) contains equivalent provisions in respect of non-member borrowers.

23 20th March, 1996 edition (hereafter 'EBRD rules').

24 See Article 13 of the agreement establishing EBRD: Article 13, para (xii).

25 The extension of project lending to nonproject lending has been achieved by what has been coyly referred to as 'an interpretation of the Bank's Articles of Agreement' (Hassan, ref. 9, p. 289)

26 Such loans first appeared in 1980.

27 Wolf, M. (1999) 'The Debt Myths'. Financial Times, 23rd June, p. 22.

28 See for example Hartshorn, T. (1999) 'IFC: Privatise or Ossify', Infrastructures Journal, October/November, pp. 38-42.

29 See the section 'Co-financing' above for an explanation of these terms.

30 See Hartshorn ref. 28, pp. 40-41. However, the solution proposed – to separate the IFC's lending and equity investment roles along Glass-Steagall lines – does not create any obvious solution to such a problem unless there is to be a real separation of personnel, which would presumably increase establishment costs (and thereby the base cost of lending).

31 Article IV(7)(a).

32 According to the World Bank, investment in service industries accounts for two-thirds of capital flows into developing countries, while the share invested in manufacturing has been falling (World Development Report 1999/2000 at p. 72).

33 See ref. 27 above.