IBRD and the Capital Markets

Mobilizing Private Savings for Development

THE EVOLVING ROLE OF THE WORLD BANK
The Evolving Role of the World Bank

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Kenneth G. Lay

The World Bank
Washington, DC
The World Bank Group

The World Bank Group is a family of multilateral development institutions owned by and accountable to member governments. These governments exercise their ownership function through Boards of Governors on which each member country is represented individually. All the powers vested in the Board of Governors, with a few exceptions, have been delegated to Boards of Executive Directors, who are appointed or elected by member governments. The President of the Bank Group is appointed by the Executive Directors.

The World Bank Group today includes five international organizations:

The International Bank for Reconstruction and Development (IBRD), the original institution in the group, opened its doors for business in 1946. Today, it is the largest source of market-based loans to developing countries and is a major catalyst of similar financing from other sources. It lends to governments or to public or private entities with government guarantees. It is funded mainly through borrowings on the international capital markets.

The International Finance Corporation (IFC) was established in 1956 to support private enterprise in the developing world through the provision and mobilization of loan and equity financing and through its advisory activities relating to, among other things, capital market development and privatization. IFC is also a major catalyst of both local and foreign private investment. Its lending and equity investment activities are based on the principle of taking market risk along with private investors. Under the terms of its Articles of Agreement, it cannot accept government guarantees.

The International Development Association (IDA) was created in 1960 to provide finance on concessional terms to low-income countries that lack creditworthiness for IBRD borrowing. IDA is primarily funded from grants it receives from donors in periodic replenishments.

The International Centre for Settlement of Investment Disputes (ICSID) was added to the World Bank family in 1966 to provide conciliation and arbitration services for disputes between foreign investors and host governments that arise directly out of an investment.

The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 to provide noncommercial investment risk insurance and technical services that help promote investment flows. It also disseminates information on investment opportunities.

As is now common practice, the "World Bank" or simply the "Bank" are used interchangeably to mean both IBRD and IDA. The "World Bank Group" refers to IBRD, IDA, IFC, ICSID, and MIGA.
Foreword

The world has changed dramatically over the last five decades and so has the World Bank. The Fiftieth Anniversary of the World Bank has provided us with an opportunity to reflect on and learn from the Bank’s experience and to apply the lessons to the Bank’s future agenda.

This series of essays is devoted to improving understanding of the evolving role of the World Bank. Each essay analyzes the Bank’s approach to the major development challenges its borrowing countries have faced, starting with the reconstruction and development needs of Europe and Japan in the 1940s and 1950s and ending with the transition of Central and Eastern Europe and the former Soviet Union. One essay examines the evolution of the Bank’s relations with the world’s capital markets as it mobilizes private savings for development. An overview paper provides a picture of the fifty-year period as a whole.

The story that emerges is one of an evolving and learning institution that has built on its successes and its mistakes. The Bank has responded with vigor and energy to the challenges confronting its borrowers. In this process, it has made a significant contribution to the impressive developmental gains recorded in these past fifty years. In responding to those challenges, the Bank itself has changed, learning from its experiences, deepening its understanding of the development process, and recasting its analytical and financial support to help its borrowers better.

The Bank will continue to nurture its tradition of self-evaluation and learning. These essays will, I hope, contribute to a better-informed debate on the Bank’s future role. They complement the recently issued paper, The World Bank Group—Learning from the Past, Embracing the Future, which sets out the future directions for the Bank Group.

Armeane M. Choksi
Vice President, Human Resources Development and Operations Policy, and Chairman of the Bank Group Committee on the 50th Anniversary
Mobilizing Private Savings for Development

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Kenneth G. Lay

By any measure, the International Bank for Reconstruction and Development (IBRD) has been a bargain for its government owners and their taxpayers and an extraordinarily efficient financial intermediary for developing-country borrowers. Since Bretton Woods, the IBRD has committed close to $250 billion in long-term development finance. Of the amounts it has borrowed to fund these loans (see Figure 1), more than three-quarters have been supplied by bond market investors worldwide—by pension funds and insurance companies, banks and endowments, mutual funds and private trusts, corporations and individual brokerage accounts. The IBRD’s government stockholders, meanwhile, have transferred only $10.7 billion in capital to the institution in payment for their shares.

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This record continues today, with the IBRD borrowing around $10 billion a year to fund loans and other operations. The low cost of these funds is remarkable. In its most recent fiscal year, the IBRD financed itself in U.S. dollars, Deutsche marks, and Japanese yen at interest rates only a few hundredths of a percentage point higher than the rates at which governments borrow in their own currencies. How so? By paying meticulous attention throughout its history to the soundness of the IBRD’s credit and using innovative, sophisticated approaches to achieve the best possible terms for that credit in the financial markets.
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Box 1. The Bank as a Financial Intermediary

Like commercial banks, the World Bank performs a credit intermediation function, lending to lesser credits from the proceeds of its higher-quality obligations. However, the features of the IBRD's major loan product are different from those of commercial bank loans. Most commercial bank lending is at floating rates based on LIBOR, adding a margin over their cost of funds that depends on country-specific factors, the most important being the country's creditworthiness. By contrast, IBRD's lending rate is the same for all its borrowers and is based on its average cost of funds—repriced every six months—and a 0.50 percent spread (0.25 percent for timely payers). The volatility of the IBRD's lending rate is ten times lower than LIBOR volatility (as measured by their standard deviation around its 1989–94 average). Some other comparisons of IBRD's financial intermediation are provided below.

IBRD Terms Compared...
...With Commercial Bank Lending Terms

<table>
<thead>
<tr>
<th>IBRD loans</th>
<th>Syndicated loans</th>
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<tr>
<td>Grace period</td>
<td>3–5 years</td>
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<td>Repayment period</td>
<td>15–20 years</td>
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<td>Interest rate variability</td>
<td>quasi-fixed interest rate</td>
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IBRD Rates Compared...
...With Commercial Bank Rates

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<tr>
<th>IBRD</th>
<th>Commercial banks</th>
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<tbody>
<tr>
<td>Funding costs</td>
<td>LIBOR -0.25% a</td>
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<tr>
<td>Short-term</td>
<td>LIBOR -0.20% b</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
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<tr>
<td>Lending spreads to developing countries</td>
<td>0.25%–0.50%</td>
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...With Developing-Country Bond Issue Costs

<table>
<thead>
<tr>
<th>IBRD</th>
<th>Developing countries</th>
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<tr>
<td>Bond issue costs</td>
<td>U.S. Treasuries +0.20%</td>
</tr>
<tr>
<td>Maturity</td>
<td>Unlimited</td>
</tr>
<tr>
<td></td>
<td>Up to 10 years</td>
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a. Floating rate equivalent of the cost of a six-month maturity U.S. dollar discount note issued by the IBRD.
b. LIBOR equivalent of the cost of a U.S. dollar global bond of ten-year maturity.
c. LIBOR equivalent of the cost of funding in the fixed income market by a AA-rated commercial bank.
d. The lower bound of this range is based on the syndicated loan spread on a ten-year installment loan to a A1/A+ rated sovereign.
The Credit Foundation

Most banks are credit intermediators, lending to lesser credits from the proceeds of their higher-quality obligations. The difference between a bank's cost of borrowing and its lending rates is one source of profits. Fees that other financiers are willing to pay for the bank's guarantees are another. The World Bank's founders assumed that its loans and guarantees would be made to credits that other banks and investors found so questionable that either these credits lacked access to finance from traditional financial institutions or had it only on prohibitively expensive terms.

How could an institution persuade financial markets to fund a portfolio of assets that most market participants would reject financing directly? The key was the application of the sovereign credit of the IBRD's richer shareholders to the credit of the new institution. The genius of the IBRD's financial structure, however, lay in the way in which it applied the sovereign credit of its rich shareholders and leveraged it, so that a modest cash outlay by stockholders to purchase equity in the IBRD has generated dramatic volumes of development finance from private sources.

Figure 1

Total outstanding borrowings* have increased steadily.

*Excludes short-term borrowings and swaps
of development finance from private sources.

The IBRD's founders established the concept of "callable capital," which provides "last resort," rich-country credit backing for IBRD's creditors on a contingency basis, only if necessary for it to make good on its borrowings or guarantees. The charter also limits the IBRD's leverage: outstanding loans can be no greater than equity and callable capital. In the third of the key "framework" financial provisions, the IBRD's charter largely eliminated the most volatile bank financial risk—exposure to exchange-rate fluctuations—by requiring that the IBRD lend in the same currencies in which it borrows.

The Bank's policy is succinct: "No loans are made which, in the Bank's opinion, cannot be justified on economic grounds or which would be for countries not deemed creditworthy."

Over the years, the IBRD has built on this basic credit framework with policies designed to reduce the risk that the unpaid portion of its stockholders' subscriptions would ever be called. Key to this effort is a continuing awareness that the IBRD's risk-bearing capacity should carry the institution's principal business: providing loans and guarantees for borrowers. This has meant, of course, disciplined attention to the quality of the loan portfolio, to the thoroughness and productivity of its lending, and to the prospects for its borrowers to repay. The Bank's policy is succinct: "No loans are made which, in the Bank's opinion, cannot be justified on economic grounds or which would be for countries not deemed creditworthy."

But it has also meant putting emphasis on reducing risks, principally the financial risks associated with managing assets and liabilities. To cover itself against disruption in capital market access, the IBRD has continued to carry substantial liquid assets (currently around $20 billion) to meet disbursement obligations, debt service requirements, and administrative expenses for a substantial period without recourse to market borrowing. It has focused its financing on the medium- to long-term sector of the market, producing a portfolio of liabilities with an average maturity roughly equivalent to that of its loan assets. More recently, it has charged interest rates on loans that
reflect its average cost of borrowings (plus a small additional amount to cover the Bank's expenses), which has largely controlled interest rate risk. It has established a conservative policy in provisioning against the risk in its loan portfolio (and currently sets aside 3 percent of the total amount of outstanding loans and callable guarantees for this purpose). Finally, management and stockholders have consistently recognized the need for the institution to operate at a profit sufficient to build and maintain retained earnings as a principal contributor toward prudent levels of equity capital. The IBRD has been profitable every year since 1947 and sets aside reserves to maintain income capacity (currently aiming at a 13 to 14 percent ratio of reserves to loans) while it has waived for promptly paying clients, in each of the last several years, at least half of the 0.5 percent spread it levies on loans.

Its articles, and the policies built around them, made the IBRD one of the premier credits in world financial markets, with triple-A ratings from major rating agencies since 1959. Against this background, the story of the IBRD funding activity in world financial markets is the story of its efforts to obtain for its stockholders—borrowers and nonborrowers alike—the best possible value for this credit.

Building the Franchise: 1946–80

In its early years, despite its strong sponsorship and solid credit foundation, the IBRD did not find it easy to establish a franchise as a borrower. Most of the available money was in the United States, but after the sovereign-bond debt crisis of the 1930s, American investors remained skeptical of the IBRD’s viability. This, coupled with the ineligibility of its securities under many state laws for pension funds, insurance companies, and other fiduciaries, meant that the IBRD management faced an uphill struggle.

The Bank mounted a major effort to establish itself in the U.S. investment community. On the legal side, an amendment to the Bretton Woods
By 1959, the bond rating agencies were awarding triple-A credit ratings to IBRD bonds.

Agreements Act that had authorized U.S. membership in the IBRD exempted IBRD securities from some cumbersome federal regulations. Later, with the help of several U.S. federal agencies, commercial banks that were members of the Federal Reserve System were permitted to purchase Bank bonds up to 10 percent of their capital and surplus. At the state level, things were more complicated. While trust funds, charitable institutions, and educational endowments were eligible investors, certain insurance companies and savings banks required amendments to state laws. New York, for example, passed a law allowing its savings banks to invest in IBRD securities by March 1946. But in November of the same year, the Wisconsin State Banking Commission voted to prohibit the purchase of IBRD securities by any state bank, savings bank, or trust company. Securing state eligibilities took most of the decade, but by the end of the 1950s, the IBRD had established a comprehensive set of investment eligibilities in most of the United States.

At the same time, the IBRD was moving into bond markets. Its first offering was in 1947, a two-tranche affair for $250 million—an immense amount at the time. The Bank organized the syndicate of securities firms and banks that sold the bonds without the customary help of a managing dealer. Staff decided to invite "all responsible merchants of securities to participate in the distribution," and sent invitation telexes to more than 2,600 firms. The Bank received acceptances that produced a syndicate of 1,725 dealers. The bonds were more than six-times oversubscribed and immediately quoted at a premium, although prices showed some sensitivity to the prospects of the Bank's first borrowers—Holland and France.

The deal was also the first opportunity for the rating agencies to assess the Bank. Standard and Poor's Corporation awarded a single-A, Fitch Investors Service a double-A. By 1959, the bond rating agencies were awarding triple-A credit ratings to IBRD bonds, and by the 1980s, IBRD
bonds had become a regular feature in the U.S. market for government-related securities.

The IBRD’s international character was evident from the outset. Unusual for the time, the IBRD advertised its first U.S. dollar issue outside the United States and attracted significant interest from non-U.S. investors, an interest that continued during the 1950s. As economic and financial vitality returned to post-war Western Europe, the IBRD began to diversify the currency composition of its liabilities. Its second borrowing, in 1948, was in Swiss francs. In the early 1950s, the IBRD launched issues in pounds sterling, Canadian dollars, Dutch guilders, and more in Swiss francs.

By 1965 the IBRD had become a regular borrower in both German and Swiss markets; indeed, in 1968 it borrowed more in German marks than it did in U.S. dollars. By the “dollar crisis” of the early 1970s and the breakdown of the Bretton Woods exchange-rate regime, it found itself with substantial positions in the portfolios of non-U.S. investors. It had also established a network of relationships with the world’s principal investment dealers that was to endure throughout the financially turbulent years that followed.

Even as the IBRD built this market franchise, events were unfolding that would preoccupy its financial managers for almost two decades. Already in the 1960s, as pressure built on the U.S. balance of payments and gold position, there arose official resistance to the IBRD’s raising and exporting of dollars from the United States domestic capital market. The IBRD’s charter requires the consent of members in whose currencies or markets the institution borrows, and it became more difficult to obtain such agreement from U.S. authorities. This contributed to a fall in U.S. dollar borrowing, as well as an awareness that the IBRD could not take for granted the market access necessary to meet its contractual obligations on loan commitments or debt repayments. This concern took center stage in the 1970s (and persisted into the early 1980s).
In 1969–74, the IBRD borrowed 70 percent more than it had borrowed in the previous eighteen years. These borrowings financed increased lending but built liquid reserves as well. The market access lessons of the 1960s had not been lost, and management found it prudent to have enough on hand to stay out of the markets for extended periods if necessary.

Further diversification of financing sources was imperative, given rapidly rising interest rates and continuing problems over access to markets. The IBRD continued to adapt its fundraising activities to follow the money. In the late 1960s it initiated private placements with the Saudi Arabian Monetary Agency. So began a substantial direct call on OPEC members lasting throughout the 1970s and into the 1980s. In 1970 the IBRD began placing securities in Japan, first with the Bank of Japan. It launched its first yen bond issue in 1971 and drew the equivalent of almost US$600 million from that market between fiscal 1970 and 1972.

Concerns about Volume

The evolution of IBRD finance since 1980 has been a response to two major challenges. The first was volume. Undisbursed commitments remained from

![Figure 2: The currency composition of IBRD's capital market operations* has shifted since 1980](image)

*Excluding short-term borrowings and swaps
the tremendous growth in lending in the 1970s, while the debt crisis brought new requirements for high-volume, fast-disbursing support for structural adjustment. IBRD funding needs went from $5.3 billion in fiscal 1980 to over $10 billion by fiscal 1985. In the first half of the decade, moreover, in Japan, Germany, and Switzerland particularly, IBRD borrowings were large compared to market size. And in all of the major industrial countries important to its finances, authorities concerned over the capacity of their markets followed IBRD borrowing closely. Some continued to place constraints on IBRD borrowing. Because of these factors, there remained anxiety among staff concerning the year-in, year-out capacity of the institution to meet its funding requirements.

Another worry in the early 1980s was the extraordinarily bearish tone of the bond markets arising from the industrial country inflation of the late 1970s. In 1980 and 1981, the IBRD faced the prospect that medium- and long-term fixed-rate dollar financings could not be completed, or if they could, that they would be locked into fixed annual interest payments of 15 percent or more on five-year and longer bond issues. To avoid both, the IBRD began issuing short-term paper in the United States' agency discount notes market, a program that continued throughout the 1980s.

Volume concerns also sustained the IBRD's emphasis on direct borrowing from stockholders' central banks, which have been significant buyers of IBRD bonds throughout the Bank's history. Beginning in 1956, the IBRD began offering securities directly to these investors in periodic, two-year bond issues—in U.S. dollars and Swiss francs—to all central banks and in private placements in their own currencies with the Bundesbank and the Bank of Japan. Finally, in the mid-1980s, with central banks increasingly emphasizing the need for liquidity in their holdings, Bank staff designed and implemented a special "central bank facility" in U.S. dollars, which offered securities with a one-year final maturity, an interest rate reset monthly (at
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a small spread fixed to one-year U.S. Treasury bills, and an option to sell the securities back to the IBRD on forty-eight hours notice if the buyer urgently needed the funds. Direct borrowing from central banks, however, was no substitute for borrowings in the market. As bond markets liberalized and expanded in the 1980s and 1990s, this direct borrowing declined both in relative and absolute terms as a proportion of total IBRD borrowing.

As the decade progressed, the concerns over volume waned. Projected increases in IBRD commitments failed to materialize, and the borrowing program plateaued at $10 to $13 billion. At the same time, bond markets grew dramatically with the increasing institutionalization of private savings, elimination of exchange controls in industrial countries, and opening of capital markets to foreign participation.

Dealing with Volatility

The second challenge of the 1980s, ultimately of greater long-term importance to the Bank’s finances, was the increasing volatility of interest and foreign exchange rates. This stemmed from the collapse of the Bretton Woods system, the oil price shocks, and the rapid growth in structural fiscal deficits. In the United States, this led to the separation of financial instruments into distinct, negotiable packages of risk and return and to the surge of derivative instruments such as financial futures and options. New communications and analysis technology encouraged these trends and prompted governments to liberalize, as pressure built for more efficient cross-border financial activity.

By 1980, the IBRD was only just beginning to respond to these developments. In 1980, concerns over the extreme differences in exchange-rate risk of borrowers (because of the IBRD’s essentially unpredictable selection of currencies for disbursement) prompted the IBRD to pool the currencies funding its loans so that all borrowers would share proportionally in the risk. But at the beginning of the 1980s, it
was still making unfunded commitments of long-term fixed-rate loans with several-year lead times before disbursement, a practice that exposed it to excessive interest rate risk. Interest on IBRD fixed-rate loans reached 11.4 percent in 1982.

The IBRD clearly needed major changes in its financial risk management. In 1982, an expansion of the “pooling” concept set out to cover the interest rate risk. The new loan product preserved the currency pooling, but instead of a fixed rate of interest, it carried an interest rate reset semiannually at a spread to the volume-weighted average cost of IBRD borrowings originated during a specified period. This was a virtually complete pass through of both currency and interest-rate risk to IBRD’s borrowers. It ensured that all borrowers shared equally in the value of its financial intermediation capacity. And it eliminated the interest-rate risk it faced from unfunded, fixed-rate loan commitments without placing material constraints on the timing or currency composition of its borrowing.

In the early 1980s, in the face of double-digit interest rates in U.S. dollars all along the yield curve, the IBRD made a concerted effort to borrow and lend currencies with the lowest available nominal interest rate: Swiss francs, Deutsche marks, and Japanese yen. Indeed, the IBRD was the largest nonresident borrower in each of these major markets during the early years of the decade. With the revaluation of these currencies against the U.S. dollar after 1985, however, this approach shifted. Responding to its clients’ concerns about the susceptibility of their effective funding cost to currency fluctuations, the IBRD moved in 1989 to stabilize the currency composition of its lending by adopting stable ratios of U.S. dollars, yen, and Deutsche marks (and Deutsche mark-related currencies—the Swiss franc and the Dutch guilder).

Market Standing

The 1980s saw the market’s view of the IBRD not only unimpaired, but strengthened. The Bank continued its unbroken record of profitability...and it continued retaining a significant portion of profits to bolster its equity position.
IBRD earned US$8.7 billion, and it continued retaining a significant portion of profits to bolster its equity position. A general capital increase in 1988 and steps to minimize the effect of foreign exchange fluctuations on IBRD reserves further strengthened its capital. Finally, IBRD's major borrowers validated its preferred creditor status by continuing to service IBRD loans throughout the debt crisis, even while they suspended payments to commercial-bank creditors. These circumstances put to rest any doubts rating agencies and other market analysts may have had about the soundness of the institution or of its stockholder support. Throughout the transition in its lending-currency policies, Bank staff managed funding strategy against a basic objective: to achieve the best possible sustainable value for IBRD credit in the market.

The Pursuit of Value

In its early years, the IBRD's financial innovation was most obvious in its pioneering efforts to open new markets to its securities, and its creative approaches to negotiating coupon and price, underwriting commissions, and other fees. In other respects, though, the IBRD largely adhered to market conventions established by investors, dealers, and governments. The reasons are obvious. The IBRD still had relatively small financing needs, major efforts were required to market its credit and establish the fundamentals of a market franchise, and there was an overriding preoccupation with access. A substantial component of the fixed-income market, particularly outside the United States, remained the province of the individual investor, whose disinclination to trade the holdings in his portfolio matched his extreme sensitivity to credit. And during most of this time, the markets were remarkably stable. Exchange rates were fixed and even a one-eighth percentage-point change in government-bond yields was a major market move.

In the 1980s, things changed. Institutionalization of savings accelerated in every market. As
the decade progressed, volatile markets, a large volume need, assured access, and a firmly established credit left the IBRD largely free to push for value. And it left its financial staff free to question the conventional wisdom that there is a "right" price for a given credit rating, that it is not possible for one triple-A borrower to get better value for its rating than another. To do so came to mean focusing on the structure and imperfections of markets, and playing a leading role in effecting change. As events developed, financial markets rewarded the IBRD for its innovations.

**Pioneering New Products**

After 1980 the Bank's borrowing program evolved along two distinct lines. First, by initiating currency swaps and using these and other over-the-counter financial derivatives, the IBRD was able to diversify its borrowings into twenty-three currencies while converting the resulting obligations into fixed-rate liabilities in the currencies it preferred. These transactions were extraordinarily cost-effective compared to direct borrowings in the preferred currencies. Because of inefficiencies in world bond markets, investors in one currency tended to price IBRD securities differently (relative to those of other issuers) than investors in others. In some cases, this phenomenon was the result of relative supply and demand. In the early 1980s, for example, the IBRD was a heavy user of the Swiss franc bond market, and its securities commanded lower prices than similar instruments offered by other triple-A issuers. In the U.S. dollar market, the reverse was true. This created the opportunity for the IBRD's first swapped funding transaction, in which it borrowed U.S. dollars while another triple-A credit (IBM) borrowed Swiss francs. The two exchanged the proceeds and, in effect, agreed to service each other's debt at an agreed-upon exchange rate. This left the Bank with a Swiss franc liability (which it preferred) at a lower cost than it could achieve borrowing Swiss francs directly, while IBM effectively converted earlier liabilities in these currencies into dollars in accord with their own liability strategy.

**By initiating currency swaps and using these and other over-the-counter financial derivatives, the IBRD was able to diversify its borrowings into twenty-three currencies while converting the resulting obligations into fixed-rate liabilities in the currencies it preferred**
Similar situations arose as governments began liberalizing capital markets. Because of the Bank's global status and reputation as a responsible market user, some governments began liberalization by giving it and similar borrowers preferred access to their markets. Some accorded tax treatment that made IBRD securities relatively more attractive to investors. The funding-cost advantage could be quite dramatic (a full percentage point or more) and currency swaps permitted the IBRD to deliver these relative cost advantages into liabilities in the currencies it required.

The IBRD began to experiment with other ways to take advantage of market inefficiencies. In the 1980s, the same exchange-rate and interest-rate volatility that affected IBRD loans led to a virtual explosion in sophisticated bond-investment strategies among investors. By the early 1990s, the IBRD and other borrowers found that investors would be willing to pay a price for customized instruments, resulting in a more attractive cost of funds to them than conventional borrowing (after factoring in the cost of the financial derivatives used to produce the cash-flow characteristics of a conventional bond issue). But as financial markets have liberalized, these "structured financings" are substituting for currency-swapped issues, eliminating the preferred capital market access or tax treatment that was a major source of the IBRD's comparative borrowing-cost advantage in those operations.

Even as the IBRD continued elaborating derivative-based tools to profit from market inefficiency, it was active developing other techniques to benefit from promoting market efficiency. This required significant improvements in the design and marketing of conventional bond issues in the major currencies.

From the 1950s to the first half of the 1980s, the technical conventions of IBRD's bond issues—Eurodollar bonds issued in U.S. dollars in markets outside the United States and, less frequently, so-called "Yankee" issues in the United States domestic market—and their method of distribution had little to distinguish them
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from those of other issuers. Low transaction costs, non-U.S. investors' greater familiarity with the IBRD, and the smaller universe of competing products made the Euromarket more competitive than the United States as a source of dollar funds. Meanwhile, in yen and Deutsche marks, Euromarket borrowing was either tightly controlled by government authorities or, in the case of marks, prohibited, and the IBRD made heavy, but conventional, use of the Japanese and German domestic markets. As staff began to focus on evolving investor behavior, it became evident that departing from these conventions could gain the IBRD competitive advantage.

The U.S. Market

The IBRD's first significant product-design innovations in the bond market in the 1980s began in U.S. dollars. By 1985, Bank management was becoming uncomfortable with the extent to which the institution relied on non-U.S. investors for its dollar funding. In April 1986, therefore, IBRD staff settled on a new approach to offering medium- and long-term bonds in the United States. The IBRD launched a direct investor-relations campaign in the United States around its new program, known as "COLTS" (Continuously Offered Longer-Term Securities), for the continuous issuance of longer-term dollar bonds in individual transactions as small as $25,000, with maturities from three to thirty years or longer. Modeled after the "medium-term note" programs of the major auto finance companies (but novel in its extended maturities and streamlined, lower-cost clearing and settlement procedures), the IBRD's always-available product served as the centerpiece for direct conversations with major investors. While Eurobonds continued to be the mainstay of IBRD's fundraising in dollars, the IBRD was back again with a serious presence in the United States. As the COLTS program matured, it became increasingly evident that the structure of the fixed-income market created unnecessary obstacles that made it difficult for issuers such...
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Increasingly, sophisticated institutional investors were buying high-grade bonds and pursuing investment strategies that relied on active trading of their bond portfolios on the basis of views about interest, exchange rates, or the potential for changes in the relative value of securities from different issuers. In the U.S. dollar market, the dramatic increase of U.S. dollar holdings in Europe, the Middle East, and Japan was solidifying a global investor base for U.S. dollar bonds, and the trend toward active portfolio management was creating a notable homogeneity in the bond characteristics these investors valued.

Yet the mechanisms for distributing bonds to these investors were unresponsive to change. Bonds on identical financial terms were offered in different forms in domestic and international markets for U.S. dollar bonds. Underwriting conventions and costs differed widely for the same services. The organization of investment dealers’ businesses and friction in cross-border clearing and settlement prevented the free movement of bonds from one market to another. In 1988, for example, two nearly identical IBRD bond issues, sold within weeks of each other in New York and London, traded at yields one-half a percentage point apart. Yet there was virtually no attempt by London dealers to satisfy European demand for this paper out of the supply trading in New York. All of this, of course, meant that the IBRD had no effective way to ensure that any single bond issue would be offered to all potential buyers or that holders and traders could benefit from the full range of worldwide demand for IBRD bonds.

Global Bonds

In an eighteen-month period in 1988 and 1989, the Bank set about to remedy this situation, developing a new method of distributing and trading securities that came to be known as “global bonds.” The product design was based on extensive interviews with institutional investors (staff met with 125 portfolio managers in sixteen countries) to ensure that the new approach would respond
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In order to bring the transaction to fruition, detailed technical and legal work was required, with major clearing and settlement systems, both international and domestic, to address deficiencies that surfaced during product development. Finally, a successful outcome depended on the agreement of major investment dealers to sponsor the transaction as underwriters (despite the profound skepticism of many) and to alter their internal business arrangements to ensure that the new bonds would receive equal attention from their salespeople and traders in London, New York, and Tokyo.

With the sponsorship of a syndicate of the leading global firms, the IBRD brought the first "global bond" (for $1.5 billion and a ten-year maturity) to market in September 1989. Its reliable primary market pricing, liquid secondary market, and easier cross-market custody, clearing, and settlement proved to have great appeal for investors, leading to significant improvement in the performance of IBRD bonds relative to those of comparable borrowers (see Figure 3). A single, global price for IBRD paper emerged, with the securities now trading at yield levels lower than any other dollar borrower except the U.S. Treasury.

IBRD's financing activity in other major currencies (yen, Deutsche marks, and Swiss francs) focused on the same issues, but at a different pace and against a more difficult background. In these markets, the IBRD experimented with different approaches to improving the relative value of its bonds, approaches that had to adapt to rapid structural changes.

**The Japanese Market**

In Japan, IBRD borrowing grew in a heavily intermediated, highly regulated market, dominated by immense financial institutions operating in clearly differentiated market segments and with specifically-defined roles in financing Japan's postwar expansion. IBRD borrowing in Japan, therefore, continued to involve large-scale loans from relatively fixed bank syndicates almost throughout the 1980s, despite

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The success of the U.S. dollar global bond in 1989 focused attention on the benefits of worldwide distribution and trading of large bond issues, including those in yen.

The cost inefficiency relative to securities market alternatives.

At the same time, however, a yen bond market was beginning to grow. As early as 1971 the IBRD and the Asian Development Bank (ADB)—at the invitation of Japanese authorities—began offering securities in Japan through Japanese securities companies in what came to be known as the “samurai” bond market. In the early 1980s, the government cautiously began permitting these dealers to underwrite and distribute IBRD and ADB bonds in London in the “Euroyen” market.

As market liberalization began to pick up speed, the IBRD proved innovative once again. In 1987, it issued “daimyo” bonds that sought (unsuccessfully) to adapt samurai issuing conventions to permit active distribution and trading in the London market. But the IBRD helped bring down the high transaction costs associated with borrowing in yen. It achieved reductions in fees charged by the commissioned banks that participated in Japanese domestic bond issues and ultimately benefitted from their complete elimination from globally-distributed yen issues. It led efforts by borrowers to renegotiate underwriting and sales commissions to bring greater consistency to international practice, and it began negotiating direct transactions with major Japanese institutional investors to lower the cost of bond-market operations in Tokyo still further.

As these developments unfolded, it grew apparent that the evolving Japanese capital market would be fully able to supply the IBRD’s needs without recourse to the (more expensive) syndicated loans characteristic of the formative period of the IBRD’s yen-borrowing program. By the end of the 1980s, the IBRD was satisfying a growing share of its borrowing needs through bond issues, both daimyo and Euroyen, rather than from syndicated loans. At the same time, extremely low Japanese interest rates in 1986 and 1987 allowed the IBRD to prepay important amounts of its outstanding yen loans.

Meanwhile, the success of the U.S. dollar global bond in 1989...
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Illustrated the benefits of worldwide distribution and trading of large bond issues, including those in yen. Japanese authorities and market participants had, from the second dollar global bond, arranged modifications to certain Japanese domestic market conventions to permit IBRD global issues to be sold in the primary market in Tokyo, and it proved possible to extend these modifications to yen.

IBRD’s first global bond in yen came to the market in March 1992 after the removal of two key regulatory obstacles. The issue was the first in yen to be offered simultaneously in the Japanese domestic market and internationally, and it was also the first domestic yen issue without a Japanese bank in the traditional commissioned bank role. That ten-year deal (for 250 billion yen) was soon established as the most liquid yen instrument in the bond market after the benchmark Japanese government issue. By 1994, yen global bonds (supplemented by occasional structured financings in that currency) were the predominant vehicle for IBRD funding in yen.

The European Market

In Europe as well, IBRD financing kept pace with capital market liberalization. Throughout the 1980s, the IBRD was a major factor in key European markets, particularly in Germany, Holland, and Switzerland, where nominal interest rates remained low relative to those on U.S. dollars and on other European currencies. Indeed, from fiscal 1980 to fiscal 1985, the IBRD completed 18 percent of its annual borrowing program in Swiss francs and another 19 percent in Deutsche marks, making it far and away the largest non-resident borrower in Germany and the largest single borrower of any description in Switzerland.

But these massive demands took their toll, particularly in Switzerland, where—by the mid-1980s—the IBRD began to encounter significant investor resistance to further purchases of IBRD Swiss franc bonds. The Bank’s response was to pull back from direct operations and focus on converting liabilities in other currencies into Swiss francs through the swap

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markets. This approach had its intended effect. By 1991, the Swiss market was receptive again, and the stage was set for the IBRD to improve the relative value of its Swiss franc paper by developing larger, more widely-distributed benchmark issues designed to stimulate lower-cost secondary-market trading.

IBRD funding activities in Deutsche marks underwent an even more basic transformation in the 1980s and early 1990s. At the beginning of this period, the IBRD raised a substantial share of its total financing requirements through direct Deutsche mark borrowings, using diversified instruments targeted toward retail investors. As more attractive funding opportunities emerged in Swiss francs and Dutch guilders (together with the introduction of currency swaps), direct Deutsche mark issues diminished over the 1980s.

In part, this was related to changes in the regulatory environment—for example, successive changes in the withholding tax regime applicable to Deutsche mark bonds. This development and the increasing trend to asset diversification by investors seeking to protect themselves against (or take advantage of) the much more pronounced volatility of exchange and interest rates led the IBRD to reshape its approach to Deutsche mark offerings repeatedly. At the beginning of the 1990s, there were new opportunities through the issuance of innovative instruments (for instance, bonds with embedded currency options and warrants, which the IBRD converted to conventional liabilities by purchasing derivatives with offsetting cash flows) to reduce its borrowing cost. There were early precursors of the IBRD's structured financings in various currencies that developed rapidly in the ensuing few years.

Meanwhile, the Deutsche mark became the anchor of the European exchange rate mechanism. International interest in Deutsche marks and the capacity of the Deutsche mark market were boosted by the liberalization of capital flows and the deregulation of securities markets that swept the major industrial countries.

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requirements associated with German reunification pushed German authorities to liberalize still further and to remove most of the remaining obstacles to participation by foreign borrowers and intermediaries in an international Deutsche mark bond market.

These changes put the IBRD in a position, after considerable development work, to launch the first global Deutsche mark bond—a product focused on broadening distribution, improving liquidity, and reducing transaction costs. This effort brought together the IBRD’s long-standing franchise in the German market, built on a thirty-year history of Deutsche mark borrowing, with a product that had come of age in the world’s other two major financial markets.

Of Things to Come

As of the summer of 1994, almost fifty years of attention to its credit and market franchise and a record of value-oriented innovation have left the Bank . . . capable of delivering to developing countries large-volume funding at costs less than one-half a percentage point higher than the funding costs of the largest industrial countries in their own currencies.

Figure 3

The IBRD has earned favorable terms for its borrowing

<table>
<thead>
<tr>
<th>Interest rate point spread (US T-bill rate = 0)</th>
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<tbody>
<tr>
<td>1.2</td>
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<tr>
<td>1.0</td>
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<td>0.8</td>
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10 year term, fixed rate borrowing in U.S. dollars

AAA Financial Index

AAA Industrial Index

IBRD

countries large-volume funding at costs less than one-half a percentage point higher than the funding costs of the largest industrial countries in their own currencies (see Figure 3). Market evolution has equipped the IBRD with the tools to manage interest rate and currency volatility and the knowledge to use them.

At the same time, however, there is growing interest in the IBRD offering a diversified array of financial products rather than the pooled loan that served so well during the past twelve years. The pooled loan has made a major contribution to the IBRD's evolution—giving it breathing room, in effect, to permit it and the markets to adapt to post-Bretton Woods volatility and the unbundling of financial risk and return. But it is increasingly apparent that the new financial tools available have created opportunities for the IBRD to deliver its financial intermediation capacity in a manner more adaptable to the needs of individual clients and transactions. The IBRD has started down this road with a pilot program that offers LIBOR-based single-currency loans at the same low spreads available in the fixed-rate product.

As the IBRD enters its second half-century, it will seek new tools and a globally diversified financing program so that it can offer its borrowers the benefits of its powerful intermediation capacity and great flexibility in terms.