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As We See It by Sidney Brown

'I Don't Want to Make Invidious Comparisons with Commercia Banks and Other Lending Institutions' — *Eugene H. Rotberg*

SIDNEY BROWN

At a time when the international financial system is on tenterhooks, desperately trying to prevent a maelstrom of debt repayment defaults, can you identify a major lending institution that has no defaults, losses, or rescheduled loans, nor expects any? That anticipates record high profits this year? Trades $1 trillion annually in 20 different currencies? And outside the U.S. Treasury, is the world's largest borrower?

The answer is: the World Bank.

Vice president and treasurer of the World Bank, Eugene H. Rotberg took center stage and faced a skeptical audience of top financial analysts from the Financial Analysts Society and the Fixed Income Analysts Society, who met in New York on March 16. Speaking extemporaneously and candidly, he disabused the analysts who, as consummate readers of *Wall Street Journal* editorials, thought that the World Bank, as the major lender to underdeveloped countries, was in the same precarious bind as other major

After all, for example, doesn't the World Bank have large loans outstanding to Argentina, Brazil and Mexico? But unlike private sector banks, how come there hasn't been a single default? Rescheduling? Moratorium? Non-performing loan? Let alone any write-offs?

Morose World Bankers

Obviously, in order to render an answer, the Temple University graduate lawyer, who became one of the world's brilliant financiers, faced the problem of structuring his reply so that it would not be construed as invidious to the world's international banks, other multilateral development banks, and government lending agencies. A number of international banks, as Carl Gerwitz pointed out in the *International Herald Tribune* of March 21, are "worried that the debt rescue operations undertaken for Mexico, Brazil and Argentine are about to unravel." He observed that, "A feeling of moroseness is enveloping the syndicated loan market." Considering the write-offs to date, the increase in non-performing loans and the U.S.-IMF forced rescheduling of what are essentially short-term loans, and such nerve as Brazil's demand that interbank lines be maintained at the level extant six months earlier, no wonder there is genuine concern.

Consider, for example, the *Wall Street Journal* dispatch from Panama City (March 22) reporting that, "Some small Latin American nations are thinking of banding together in a 'debtors' cartel' to force more generous repayment terms from their foreign banks." No one believes that this OPEC-type of hold-up should be taken seriously, but it is indicative of the tenor of the times. The day before, Venezuela's latest efforts to convince international banks to renegotiate short-term debt (estimated at more than $6 billion) broke off over the weekend without an agreement.

Bankers Say "It's Not So Bad"

Bankers believe the problem has been grossly exaggerated. For instance, senior vice president, chief accounting officer of Citibank and Citicorp, Thomas E. Jones claims that the non-performing loan situation "is not that bad." He told the Bank and Financial Analysts Association at their 13th annual banking industry and bank stock symposium, in New York on March 23, that such loans, "are not extraordinary for a recession ... actually they are a small amount." He contended, in effect, that the problem is one solely caused by the world-wide recession. Once recovery ensues, the debt repayment problem will automatically be righted. Others, however, pointed out that the warning signs were there back in 1981 when oil prices first dropped on June 1, 1981.

Rotberg Concentrates on Principles

Instead of dealing with the world economic situation in general, and the debt repayment problems of the developing countries in particular, Rotberg addressed himself to the glaringly wide differences between the World Bank's lending and borrowing principles, policies and standards and those of other lending institutions. This approach is particularly telling inasmuch as his institution is a prime lender to the very countries that are giving multinational banking spokesmen the exhausting task of defending their lending standards and financial management.

The financier said that the World Bank's operations rest on nine principles. One, the financial world is uncertain, therefore "we do not try to predict interest rates, volume of resources available, exchange rates and what will happen."

Fall Back Positions

Two, loans are objectively assessed, and measures and techniques put in place to minimize risk occurrence. Nevertheless, should a problem occur, there must be in place a fall back position to take care of the problem.

There is always a risk when financial institutions lend money, whether they be domestic or international loans. In a diplomatic way, he criticized banks that believe they must lend the money because it is available. By way of illustration, he said you don't lend money to a Seattle airplane company in order to promote exports, or for military bases. "You lend money for economic development, not because some bright bank manager in a London branch, in anticipation of massive OPEC deposits, has to do something with the liability base pouring into his institution. You do not, therefore, make loans based upon your access to a depository base cost of funds if the loan does not have and the country does not have the strong economic base that is needed to justify the loan itself." (Emphasis supplied:) In a follow-up interview, Rotberg told us that the World Bank does not make loans to basket countries, and its loans should not be confused with the International Bank for Reconstruction and Development's other institution, International Development Association.

Three, managerial capacity to innovate, change direction, act quickly, and not be inhibited by bureaucracy of the institution regardless of whether it is corporate or sovereign.

Full and Open Disclosure

Four, "Errors must be open and admitted. Opportunities lost must be measured and made public. There is no difference between an act that is a mistake in fact and an omission to maximize profitability, or wisdom. Both exist, both must be measured, and both must be made public," the financier contended.

Five, according to Rotberg, there should be a healthy disrespect for all accounting conventions in deciding whether a particular course of action does, or does not, make financial sense. "In short, there must be a healthy disrespect for the bookkeeper and a healthy respect for the present value potential gain of any transaction including the measure of opportunities lost."

Six, the financial system, including both corporate and sovereign entities, must be able to withstand external shock that is not the doing of the institution concerned.

"Big Daddy" Means Disaster

Seven, no institution, whether corporate, multinational or sovereign, should be run as if "big daddy will take care of you by printing money, providing guarantees, safety nets, or subsidies." Rotberg said, "the issuer who comes to the market and says,'don't worry, my debts are guaranteed.' The purchase of the debt is an invitation to disaster because it is a metaphor for a lack of financial integrity and a capacity to make rational choices. The issuer is saying, you can make your decision because I'll be taken care of by someone somewhere."

Eight, an interesting principle that was unexpected, "never underestimate either the cruelty, ignorance, biases or capacity of those who would rather you weren't a factor in the world market." It seems to us that the World Bank has found that some of its critics are callous toward their fellow man who is striving to become more productive in order to raise his standard of living.

And nine, "Don't try to outsmart, outwit the market place. ... Treat customers, underwriters and even rating agencies openly, fairly and honestly. Just always meet the test of the market."

Every Government Is Telexed

If a country is 30 days late, "unlike commercial banks," every government in the world (144 members) is advised by telex "that country is late." The information, thus, "unlike commercial banks," is open to the public, fully disclosed, in short, "notorious". Rotberg could cite only one instance, amounting to $2,000 that was not fully paid until two past months later.

The World Bank, the analysts were told, does not look at loans within the context of defaults. It simply asks the errant country "are you late?" If it is, it jeopardizes any disbursements that are still to be made, even if the slow payer is only a little bit behind. "Everyone is advised, including the stockholders, of the fact. That's what I mean by a balance between the needs of constituent developing countries, financial market place, major stockholders and the theoretical needs of the developing world.

"They [debtor developing countries] do not object to that procedure. They know we do not have any taxing power. That there is no central bank to fall back on. That the Bank needs to rely on careful, meticulous support from the financial markets. The Bank is trusted by the markets and by governments to whom we are lending. They trust our objectivity, our non-political nature [which is a sore point to World Bank critics who object to loans made to socialist and even more left governments, but are silent if loans are made to governments of the other extreme]."

No Blank Check

The World Bank's lending policies do differ from those employed by most banks. It does not hand out any blank checks, for any designated purpose notwithstanding full approval of the purpose of the loan. After all, money is fungible, and borrowers could in the interim decide to change their minds, using the funds elsewhere, hoping to make good before the loan is due.

Unlike private sector world banks, the World Bank does not supply balance of payments loans. Only 30 per cent to 40 per cent of the cost of the approved project is lent, in tranches, as satisfactorily completed. The rest of the funds come from the borrowing country's internal resources, according to Rotberg. [The World Bank has over 1,000 analysts, economists, etc., and spends $550 million on salaries.]

Questions and Answers

In its approach to a loan application, the Bank, the analysts were told, asks: does the project make sense, what is the country's tax base, debt servicing ability, GNP and population growth rate, tariff structure, its five-year program, incentive system. Also, is the country credit worthy, and what will be the financial and economic rate of return? Does the country have a distribution capacity, managerial capacity? What difference will it make to the country?

The job of the World Bank's professionals is to answer these questions. If the answer is, "no," there is no loan. It takes 1-2 years to approve each loan, and 5-7 years to dispurse the loan.

Real Leverage Means No Defaults

The Bank's $35 billion in outstanding loans is so structured that what it owes to developing countries is virtually the same as the amount the developing countries owe to the Bank. The debt servicing of the world's ten largest borrowers is less than the bank's projected disbursement to the countries. "What is the revelance?" the vice president asked rhetorically, "simply that any interruption of debt servicing of interest and/or principal to the Bank would result in a cessation of disbursements to that country. That's what I'd call a trade off ... 'leverage'."

Profits Show It Works

The Bank's profits are extremely high, probably in excess of $800 million, net, the highest in the Bank's history – up $200 million from last year. Its short term portfolio profits alone are currently 25 per cent.

This is quite an achievement in light of the fact that the same countries that are lagging on payments due to lender banks are not one iota in arrears to the World Bank. [Argentina's delinquency on interest payments to commercial banks and delays are causing friction between the country and its creditor world banks. Venezuela has notified its bankers that it will postpone about $2 billion principal payments falling due through July 1, only interest will be paid, but some London banks are waiting for interest due last January.]

We asked experts in this area how they can explain the World Bank's success and their answer fell into two parts. One, World Bank loans are government guaranteed and, two, the massive financial relief packages being put together enable the World Bank to be paid promptly.

But the first answer does not satisfy us because, government guaranteed or not, involved here in the rescue packages are not only private but also government borrowings. The second answer smacks of a case of borrowing from Peter in the rescue operation to pay Paul. Frankly, are the world banks willing to refinance debt due knowing that a portion will be going to the World Bank? There's no way we can ferret out the score here, but we do hope that someone will clarify this.

Cash Management

Unlike a money market fund, the Bank trades $1 trillion a year, actively managed in 20 different currencies.

As noted above, its principle is to ignore conventional accounting with respect to liquidity. "Always," always, Rotberg pointed out, "ignore the accounting implications of a sale ... if a bond at 9 per cent goes to a 14 per cent yield and is trading at 80 and dropping to 79½, you must sell it. Not even my colleagues are even allowed to know the price at which they bought anything. The only issue is what is the rate of return of an investment compared to another instrument. There is no such thing as a hold recommendation. If you got it, you like it, and you would buy it today if you were to start all over again. If you like something else, you sell it. Anything you believe is the poorest instrument you have – irrespective of its book cost – transfer your resources."

Rotberg again emphasized that the measurement of opportunities lost is as important as actual losses. "That's the way we run the institution." Buying a bond at 10 per cent and watching it go to a yield of 16 per cent, priced at 70, and not buying at 16 per cent and the price goes to 130 is the difference between an opportunity lost and the taking a loss. Not knowing the difference between these two environments, Rotberg insisted, is not being financial rational.

Turning to another aspect of cash management, the Bank's financial head noted that some managers permit making mistakes and showing them, not hiding them. Other managers don't follow that policy. "Some managements," he said, "permit

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and insist that you measure opportunities lost, others pretend they do not exist."

The difference between those that do and those that do not make money in the fxed rate interest market, according to Rotberg, is not a function of irrationality or ability to predict interest rates, but is a function of the reward and punishment system which exists with respect to [managers'] decision-making."

Bank's Basic Guidelines

Turning to some basic guidelines, the financier submitted the following to the bank analysts:

- Never borrow only one or two currencies. The Bank borrows 16.
- No one is so clever as to know what the maturity structure should be. The Bank borrows from two days to twenty years.
- Never borrow from one source.
- "Always, always assess currency risk. "Keep in mind that Swiss francs at 5 per cent versus dollars at 11 per cent for a ten-year instrument would require a 75 per cent devaluation of the dollar against the Swiss franc to make it not worthwhile to borrow in Swiss francs. "If a corporate executive is not borrowing Swiss francs," Rotberg noted, "you are buying the paper of an institution which does not have a financial manager. It has a nervous bureaucrat who is afraid of the visibility of error. At the bank, we are massive borrowers of deutschemarks, Swiss francs and yen. We don't know if it is right or wrong, we are doing it because we think we are right and because we are not concerned with the accounting consequences of being wrong. We are looking at the long term effect of the transaction." The Bank, also, it should be noted, hedges.

Bank's Borrowing Costs

Back in 1975, the Bank's outstanding borrowings of $12 billion cost 7.1 per cent; currently, with $40 billion outstanding, the cost is 8.75 per cent. Rotberg attributed this relatively small increase, which includes the turbulent run-away period of 15 per cent-16 per cent for triple-A bonds to not only playing currencies against each other but, also, to following a policy of:

- Not having to borrow when rates are very high because of the institution's policy of building up liquidity when rates were 3 per cent to 6 per cent, in anticipation of the unknown, and drawing it down when rates went sky high.
- Being able to evaluate risks. Liquidity gave the Bank flexibility to accelerate or decelerate its borrowings, resulting in a lower cost of debt.

Discretionary Financing

Whether a borrower is a sovereign or a corporation, they should have directors' approval to go into futures, debt for debt swaps, discount notes, floating rate notes, index bonds, links, swaps, zero coupon bonds, detachable and non-detachable warrants options. "In short, the function of a financial officer should be determined not by what is going to maximize profit, but the range of instruments that a very fragile and uncertain market may wish to use. One can then act quickly to fill that demand, without it, the institution is stripped of financial techniques to meet the demands of the market place."

Reason for Cynicism

The Bank's chief financial officer did not minimize his cynicism about most financial decision makers. What Rotberg criticized, for example, is a decision to go into 8 per cent short-term borrowing, rather than 10 per cent for 10 years, because it made that quarter's profits look better. Such a decision, he told the analysts, is irrational, based upon current pleasure and trying to avoid present pain with the expectation of having an unknown benefit in the future.

Rotberg, in addition, called attention to managers that refuse to go in for debt swaps because it might be construed as an admission of error, making them look bad. The debt remains as is even though it could be refinanced at a lower cost.

The Bank this year will have a total cost of 7 per cent plus equity. The total return for the pool of assets is about 9.40 per cent and a realized return of 12.5 per cent, as a result of borrowing costs of 8.6 per cent with an enormous positive yield spread.

One last caution submitted was, "never, never rely on guarantees." Rotberg stressed that even though the World Bank has $48 billion callable capital, only available to bondholders, which never can be used in the Bank's business, it acts as though it does not have it. Moreover, the Bank operates, he said, as a profit-based enterprise.

"The second you sense an institution is calling attention to its callable capital, or safety nets, or guarantees - you are looking at an institution that is going down hill. Obviously, should a bail out or subsidies be necessary, you can be assured from that point on that the institution will no longer be functioning as a market-based institution."

The Bank's principal policy is to keep its sum total of equity and guaranteed capital at a 1-to-1 ratio to debt. "That's what you call being cautious," Rotberg observed.

Conclusion

In conclusion, he raised the following questions:

Are those in charge professionals or compromising political animals? Can they be trusted?Do they hide mistakes - covering up, window dressing, and hiding behind some sophiticated accounting conventions? Do they recognize risk or bully their way through it and deny there is any risk? How do they plan to cope with adversity and uncertainty? And are stockholders, creditors, customers treated with equal respect?

Our question is, is this the way all banks should be run?