Int. Bank

FINANCING OF THE INTERNATIONAL BANK
FOR RECONSTRUCTION AND DEVELOPMENT.

The International Bank for Reconstruction and Development proposed at Bretton Woods and now being discussed in Congress will be the largest borrower, apart from the United States Government itself, ever to enter the American capital market. Although its capital of 9.1 billion dollars will be subscribed by the member governments, only a small part of this will actually be used for the Bank's own lending operations. Most of it will be kept on call as a safety fund to secure loans floated in the market under the Bank's guarantee or under its own name. The bulk of the funds actually employed will therefore come from private investors, the purchasers of the securities guaranteed or issued by the Bank. The aggregate obligations of the Bank - including guarantees - may thus eventually reach 7 - 9 billion dollars. This will represent a financing job of spectacular magnitude.

The decision to let private enterprise do most of the financing, instead of putting the job in the hands of governments, is an important one. Investors will be given a chance to participate in international lending through high-grade, though not completely riskless, media. The somewhat more attractive yield of the new securities should be a welcome relief, particularly to institutional investors, from their recent diet of 2 1/2 per cents. For the securities industry the job of distributing the Bank's obligations, perhaps as much as 2 billion dollars a year, represents a real challenge as well as a source of legitimate profits.

This paper will deal with the methods which the Bank may adopt to finance itself, with the investment characteristics and soundness of its securities, and with the arrangements to be made for their distribution. To begin with, we shall survey the various sources of funds upon which the Bank may draw for its operations.

I. Sources of Funds.

The Bank's authorized capital is 10 billion dollars, of which 9.1 billions are to be subscribed by the forty-four nations represented at Bretton Woods, each in its own currency, while the remaining 0.9 billion are left for allocation to new members. Of the amount subscribed by each nation only 20 per cent is to be used for the Bank's loans, the remaining 80 per cent being held in reserve as a safety fund. The reason for limiting the use of the Bank's own capital in this form is (aside from the general purpose of deferring to private investments) that most of the member countries are in no position to engage in much long-term international lending. Most of the loans will have to come from a few countries capable of exporting capital, chiefly the United States. The subscriptions of the other nations exist mainly to be drawn upon in case something should happen to these loans. A few countries, in other words, will be doing most of the lending, but the risk will be shared by all.

1. Freely Available Funds. Very probably, even the 20 per cent quota of each country's subscription will frequently not be available for direct loans except for a small amount of 2 per cent which members must contribute in gold or United States dollars. Many countries will not be able to afford even very limited capital exports, and to protect them the statutes provide that this part of their subscription cannot be used without their consent. Only the United States, Canada, and perhaps a few other countries will be able to give this consent freely in the immediate postwar period. Others probably will do it only in special cases, if at all.

It may roughly be estimated, therefore, that in its early stages the Bank can only count on something like 1 billion dollars to be available for direct loans out of its total 9.1 billion capital, consisting of 20 per cent of the American subscription (635 million), the 2 per cent gold contribution of the other countries (118.5 million), and perhaps 200-300 million out of the direct loan quotas of a few other countries. The last-named figure may increase

as more countries reach the point where they can permit capital export and as some of the financially strong neutrals join the Bank.

While this freely available fund of 1 billion is small relative to the potential lending power of the Bank, its importance will be great. Some time may elapse before the market becomes sufficiently familiar with the securities issued or guaranteed by the Bank to permit their flotation on the scale required by the Bank's operations. During this period the Bank will have to rely upon its free funds for part of its loans. Later the Bank might gradually refinance these loans in the market, pulling out its own funds. At all times there may be some loans which would benefit from a little seasoning in the Bank's portfolio before being offered for public subscription, with or without the Bank's guarantee. There may also be some loans, certain types of stabilization loans, for instance, which it would not be convenient to finance through either public offering under guarantee or through debenture issues. In both instances the free funds will come in handy. Finally, these funds could be used to make loans during a depression, when the market's willingness to absorb large blocks of the Bank's obligations may be limited. At that time they could also be employed to stabilize the market for the Bank's obligations and perhaps to take care of defaults. The possibility that in a depression the Bank may have to rely rather heavily upon its free funds suggests that they should be used sparingly whenever money can be raised in the market and that, once engaged, they should be pulled out and put back into liquid form as quickly as possible.

2. Funds Raised in the American Market. Much larger than the funds freely available out of subscriptions will be the amounts to be raised in the open market. The securities to be issued may consist of direct obligations of foreign borrowers floated with the guarantee of the Bank or of the Bank's own obligations - debentures - the proceeds of which would be employed by the Bank for its lending operations. The Bank could also borrow in some form other than

through security issues - from commercial banks, for instance - but debentures would probably be the most convenient instrument.

The sum total of guaranteed issues and debentures may go above 9 billions, since the Bank's aggregate commitments - loans out of capital, loans out of funds raised through debentures, and guarantees - are permitted to equal its unimpaired capital, surplus, and reserves. If a substantial volume of loans is made out of the Bank's own free funds, the amounts that can be raised in the market are correspondingly reduced. Since the United States will be the country best fitted for international lending and will proabably have the lowest interest rates, the bulk of the securities will undoubtedly be floated in this country.

Who are to be the American buyers of these securities? In the first place, the Bank's debentures and guaranteed issues should appeal to individuals looking for fairly high-grade material with a yield better than government's or AAA corporates. These investors, however, could hardly supply all the funds that will be needed. The big market to be tapped is that of personal trust accounts, commercial and savings banks, insurance companies, and other institutional investors. Assuming that the intrinsic quality of the securities warrants their purchase by these investors (some evidence on this point will be presented later), the question arises, therefore, whether the securities would be "legal investments" or otherwise admissible.

The situation in this respect is somewhat complicated, for conditions vary not only as between different groups of institutional investors, but also from state to state. Security investments of commercial banks are subject, in general, to the regulations issued by the various supervisory authorities. Savings banks in New York State are guided by the so-called legal list published by the Superintendent of Banks; the Banking Board has fairly broad powers to add to the list securities not otherwise eligible. At present there are no foreign securities on the "legal list," not even Canadian. Investments by

fiduciaries in New York are limited to substantially the same securities as savings banks, unless wider powers are provided in the individual trust instrument. Insurance company investments, apart from statutory limitations, are subject in some cases to certain discretionary powers of the supervisory authorities. In general, therefore, interpretations or amendments of present regulations and statutes will be required for most of the institutional investor groups if they are to become significant purchasers of the Bank's securities.

It is to be expected that the necessary actions will be taken, so as to permit such investments within reasonable limits, since they clearly seem to be in the interests of these groups. In the case of commercial banks, a ruling would probably be required by the Comptroller of the Currency, supplemented by appropriate action on the part of state supervisory authorities. As to savings banks and fiduciaries in New York State, the Banking Board may have sufficient authority to include the Bank's securities in the legal list. Insurance companies in New York might, in certain cases, be allowed to purchase small amounts of the Bank's securities and in particular might acquire issues guaranteed by the Bank if the Superintendent of Insurance feels justified in declaring the issues to be "amply secured"; beyond this, however, legislation probably would be required.

These readjustments obviously will take time. As soon as the Bank is established, therefore, it will be necessary to urge the various authorities to take the required action. This process probably could be helped along by interesting the various investor groups in the opportunities open to them if the securities are made legal.

3. Government Subscriptions. In addition to individual and institutional investors, there is the possibility that agencies of the United States Government, such as the R. F. C. or the Export-Import Bank, might purchase the Bank's securities. This may be of particular importance during periods of depression when the capital market may not be receptive to the Bank's securities.

Although it is not likely that the supply of investment funds will dry up completely at such times, the amount of securities that can be placed might become greatly restricted, particularly if conditions abroad should deteriorate and the Bank be caught in a number of defaults. It is important that the Bank be able to continue its operations during such periods in order to avoid the abrupt cessation of foreign lending which so greatly aggravated international financial problems at the start of the last depression. Since foreign lending outside the Bank will undoubtedly fall off again when the first postwar depression strikes, the Bank may even find it advisable at that time to intensify its own operations, - to operate, in other words, "anti-cyclically." Unless the Bank by then has established an extremely high credit rating, some support by Government agencies might become necessary.

It might be argued that if the American Government engages in foreign lending, it should do so directly and with full control over the conditions of the loans, rather than through the Bank, whose decisions are, in part at least, determined by foreign countries. In doing so, however, the American Government would forego what is the main advantage of the Bank: the distribution of risk among all members. The question is whether the gain in control is worth more than the spreading of risks. In general, it seems that fairly adequate control over the use of American money can be achieved even when loans are made through the Bank. No dollar loan can be made or guaranteed without the consent of the American Director on the Board of the Bank, and his general bargaining position would of course be greatly strengthened if the American Government were the sole investor willing to take the loan. A good case can therefore be made for letting the American Government make foreign loans through the Bank if private offerings are unsuccessful, once it has been decided that loans by the government in one form or another are necessary.

It is important that, under the terms of the enabling legislation

now before Congress, a loan to the Bank by a government agency would require Congressional approval. Presumably this means that approval would also be required if a government agency wanted to purchase securities issued by the Bank immediately upon offering. It is not quite clear whether or not purchase of securities already outstanding in the market would likewise have to be approved. Neither is it entirely clear whether there is anything in the injunction upon loans by government agencies which would bar the latter from purchasing securities guaranteed by the Bank. The purpose of inserting the injunction undoubtedly was to reassure Congress that the American Government would not invest more in the Bretton Woods institutions than Congress had originally authorized. The manner of its phrasing, however, seems to leave open a loophole through which the Government might render indirect assistance to the Bank which would have virtually the same effect as direct loans.

4. Securities Floated Abroad. It appears unlikely that substantial flotations of the Bank's securities could take place outside the United States and Canada. Some of the European neutrals, after gaining admission, might offer a fairly good market for the securities, but Britain, France, Holland, and most of the other countries which in the past engaged in foreign lending will be able to afford capital exports at best on a very modest scale.

Moreover, in so far as any of these countries should be willing to permit capital exports through the Bank, they will probably prefer to have the loans made out of the 18 per cent quota reserved for this purpose, instead of through a flotation of securities in their markets. The reason for this is that whenever the Bank makes a loan out of its own capital, it gives the borrower the currency of the country where he has decided to spend the proceeds of the loan. If a borrower, for instance, wishes to acquire British railroad equipment, Britain can supply this on credit by permitting the Bank to give the borrower sterling funds from the British subscription. In that way, while Britain would not receive gold or foreign exchange for her equipment export, she is certain at least that the capital export cannot directly lead to a loss of gold and exchange through withdrawals by the borrower. When securities issued or guaranteed by the Bank are floated in the London market, on the other hand, the statutes of the Bank provide that the borrower may spend the proceeds wherever he wishes. He may, for instance, convert them into dollars and buy American equipment, thus draining away Britain's dollar resources. As a means of protecting her exchange resources, therefore, it will generally be in Britain's interest to let her capital exports through the Bank take the form of a loan out of the 18 per cent quota, rather than of a flotation of securities.

Nevertheless it would be very desirable to make at least token flotations of a large variety of issues in the largest possible number of countries. If the Bank should be forced to make calls on the subscriptions of its members in order to meet defaults, a political outcry might be raised to the effect that the members were being called upon purely to bail out American investors, unless a certain amount of securities were held outside the United States. Although the obligation of the members to meet calls is quite unambiguous, political pressure might be brought to bear on the respective governments to stall on their obligations. The best way of avoiding

this would be to spread ownership of the Bank's securities over a sufficient number of countries.

II. Debentures or Guaranteed Issues?

From the discussion of the potential buyers of the Bank's securities, we now turn to the securities themselves. The main question is whether it is preferable for the Bank to operate primarily by guaranteeing issues which are being floated by various borrowers or whether it should itself borrow by issuing debentures and lend out the proceeds for its own account. In public discussions of the Bank, emphasis has been placed mainly upon guaranteed issues. It is becoming increasingly plain, however, that the debenture method has a number of advantages over the guarantee procedure. These advantages, in fact, are so considerable that certain special merits which guaranteed issues do possess may not receive adequate attention. The advantages of the respective methods are listed below, beginning with the debentures.

a. Control over use of funds. The debenture method gives the Bank better control over the use of the loan by the borrower. When the Bank makes a direct loan, whether out of capital or from funds raised with debentures, it opens an account against which payments are made in accordance with the specific purposes of the loan. In the case of a guaranteed loan, the borrower will probably receive the proceeds directly from the underwriter. The Bank, therefore, is unlikely to have the same close control, in spite of the clause requiring it to make arrangements to ensure the proper use of the funds.

b. Gradual disbursement. In the case of a loan financed with debentures, the Bank will disburse funds gradually, as they are needed. The borrower, therefore, saves interest on the unused part of the loan.

c. <u>Blanketing of small loans</u>. Since the loans made or guaranteed by the Bank, with some exceptions, are to be for specific projects, there will be a good many small loans which would not warrant a public issue. The most convenient procedure for the Bank would be to float an issue of debentures to obtain funds for an entire series of small loans.

d. <u>Management of liabilities</u>. The Bank would find it easier to manage its liabilities, with a view to convenient maturities, call features, etc., if these liabilities consist of its own direct obligations than if they are contingent liabilities in the form of guarantees.

e. <u>A homogeneous debt</u>. The guaranteed issues of relatively strong and weak debtors would probably not sell at the same prices, since the market will evaluate them on the basis of the goodness of the obligor as well as on the strength of the guarantee. Such differentials might be embarrassing to the Bank precisely because they would make it obvious that its guarantee is not sufficient to give all guaranteed issues a uniformly high rating. They might likewise be embarrassing for certain debtors on whose credit standing they might seem to cast an adverse reflection. The issuance of debentures would eliminate this difficulty.

f. <u>Transfer moratoria</u>. On its direct loans, the Bank may decide to grant the borrower a transfer moratorium of up to three years, permitting him to continue service in his local currency instead of in the currency stipulated by the loan contract. The Bank may also modify the terms of amortization and extend the life of the loan. The flexibility which these provisions permit may turn out to be of considerable value to borrowers if a new era of foreign exchange shortages should set in. In the case of guaranteed

loans, the Bank may make arrangements to take over the service temporarily under the same conditions, but the market for issues serviced in this form would probably suffer.

g. Redemption of defaults. When a guaranteed issue goes into default, the Bank may either assume interest and sinking fund payments or it may redeem the entire issue at par, if resumption of service by the borrower cannot be arranged. To do the latter in the face of large-scale defaults, however, the Bank might have to make very heavy calls upon its subscriptions which many of the members would find it hard to meet. In fact, members are protected against heavy calls for redemption purposes by a clause limiting such calls to 1 per cent of the total subscriptions during any one year. If widespread defaults occur on guaranteed issues, the chances are that only current service will be assumed by the Bank. American investors, however, do not like issues serviced under a guarantee, because the guarantor's failure to redeem the issue immediately is not unreasonably regarded as an indication of lack of strength on his part. For this reason, a guaranteed issue is not particularly favored by the market even while it is being serviced by the original obligor. Under these circumstances, the market may prefer the Bank's debentures to guaranteed issues where there is any likelihood that the latter may go into default.

h. Effect of guarantees upon quality of debentures. For a number of reasons, some of which have become evident in the foregoing paragraphs, such guaranteed issues as may be floated are likely to be those of relatively strong borrowers. The quality of the assets behind the debentures, however, would obviously be weakened if a preponderance of the good loans were made under

guarantee and thus did not become part of the assets of the Bank, while the less desirable loans were being made by the Bank directly. Since the Bank in any case is to deal only with borrowers not strong enough to borrow advantageously on their single name, its loan portfolio ought to contain at least a fair proportion of the reasonably good risks which it can get.

Not all considerations, however, speak for the debenture method. The following points may be adduced in favor of guarantees:

a. Wider market. Under present legislation, the market for guaranteed issues may be somewhat broader than that for the Bank's debentures. Insurance companies, for instance, could under certain conditions buy guaranteed issues but would probably be barred from debentures. Somewhat similar considerations may apply to purchases by government agencies in the absence of Congressional authorization. As far as insurance companies are concerned, however, it is probably to be expected that these limitations will be removed by legislative action.

b. Partial guarantees. In certain circumstances the Bank may find it convenient to guarantee only a certain proportion of the interest and amortization of an issue. This possibility would exist, for instance, where a borrower's credit just falls short of permitting him to borrow under his single name at a reasonable rate. A partial guarantee, in the manner made familiar by the FHA, might suffice to make his securities marketable. It would be an obvious advantage if the Bank could stretch its loan powers in this way.

c. Protection to the investor. Where the credit standing of the borrower is fairly high, the investor might prefer a guaranteed issue to a debenture of the Bank, because the former

gives him the protection of two signatures. In either case, of course, he can look to the Bank for payment, but with a good guaranteed issue he may continue to receive service even if the Bank itself should go into default. The debenture holders are correspondingly worse off because they must share the protection afforded to them by the Bank's general assets with holders of guaranteed issues. The debenture holders, in other words, are in the position of general creditors, whereas the holders of guaranteed issues occupy that of creditors to whom special collateral has been pledged.

If the Bank should default and its assets be distributed, guaranteed bond holders may find themselves considerably better off than debenture holders even if their own loans do not work out better than the Bank's loans. The statutes provide (VI 5-d) that guaranteed bond holders shall share "ratably" with other creditors in any distribution of assets. Presumably it was the intention of the drafters that both classes of creditors should come out equally <u>after</u> taking into account what the guaranteed bond holders can realize on the loans underlying their issues. Since these loans, however, do not form part of the Bank's assets, the above clause may well be taken to mean that an equal percentage of the claims of both types of creditors is to be satisified regardless of how much the guaranteed bond holders can realize directly. If, for instance, they can realize 30 per cent of the value of their own loans, they would have a claim on the Bank for the remaining 70 per cent. If the Bank's assets in turn are sufficient to satisfy 50 per cent of the claims of all creditors, the guaranteed bond holders would receive another 35 per cent of the amount of their original loans. They would then salvage a total of 65 per cent of their investment against 50 per cent for debenture holders.

It is not suggested that there is any likelihood that the Bank's operations would yield such unfavorable results. However, in a market so first mortgage conscious as the American, the possibility

of a difference in the status of debentures and guaranteed issues would be significant, unless a binding interpretation to the contrary can be obtained.

In this connection, it is important to observe that the Bank may be sued like any other corporation, although the working of the statutes does not make it quite clear at what point of the proceedings a judgment obtained against it can be executed. The American enabling legislation removes all suits to the jurisdiction of the federal courts.

d. The borrower's viewpoint. The borrower might prefer a guaranteed issue if by keeping his name in the market he can hope to prepare the way for an unguaranteed issue later on. The greater freedom from control over the use of the funds might be another, although not entirely laudable, attraction.

e. Stronger control over dollar loans. The control which the United States Director has over the use of American funds derives from his power to deny the Bank access to the American market. A debenture issue, however, blanketing a number of small loans to be made by the Bank, might water down his power. In that situation he might at times have to choose between allowing an undesirable loan to go through with a group of desirable ones or blocking the desirable loans in order to catch the one black sheep. With a guaranteed issue, his decision would be based solely on the merits of the individual case.

All this seems to show that the question of debentures versus guarantees ought not to be decided altogether on general principles. On the whole, the majority of considerations clearly speak in favor of debentures. The interest of the Bank, the investor, and the borrower, however, are not always identical in this respect. The attractiveness of debentures seems to be greatest from the viewpoint of the Bank, least

from that of the borrower. Each case, therefore, will have to be decided on its own merits. During the Bank's early years, before its securities have found a broad market and before their soundness has become established beyond all doubt, guaranteed issues may at times be the more practicable medium. Later on, the Bank may be able to concentrate more exclusively upon debentures.

III. Other Features of the Securities.

The precise features of the securities to be issued or guaranteed by the Bank cannot be specified at this time. A few general principles, however, seem to suggest themselves immediately.

1. Maturities. In setting the maturities of its debentures, the Bank presumably will follow the normal practice of approximately matching the maturities of its liabilities with those of its assets. The bulk of its loans probably will be for fairly long terms, since in the short and short-to-medium term fields it would come into competition with the commercial banks and the Export-Import Bank. The fact that most of the debentures, therefore, will also have to have fairly long maturities may at first make their sale somewhat more difficult, since the introduction of a new kind of security in the market is generally easier if the maturity is on the shorter side.

A certain amount of short-term financing will be justifiable, however, even if it is not balanced by short-term loans. From its debenture issues as well as from certain other receipts the Bank will ordinarily tend to have a certain amount of funds on hand for which there is no immediate employment. By arranging the maturities of its liabilities in such a form that a certain part can be made to run off whenever idle funds are on hand, these funds can be put to better use than if the Bank were itself to seek employment for them in the market within the limit permitted by its statutes. Stabilization loans in so far as they are granted by the Bank, might also be financed out of

short-term notes sold by the Bank. Since the time period for which stabilization loans are needed is uncertain, they might take the form of renewable short-term loans which the Bank could refinance in the market in a like manner. Finally, if very severe difficulties should be encountered in the placement of the bank's long-term issues, the Bank could safely finance itself through short-term issues up to the amount of free funds available from gold contributions and the 18 per cent quotas. These could be drawn upon to pay off any indebtedness which could not be refinanced otherwise.

2. Call Feature. Since the yield of the Bank's debentures may decline relative to market yields as its credit becomes more firmly established, the Bank may soon have occasion to call its earlier issues for refunding. It will therefore be advisable to arrange the call feature of the debentures accordingly. This also applies to guaranteed issues. The Bank might consider the possibility of reserving the right to call its guaranteed issues on its own initiative, provided it can offer the debtor more favorable terms for refinancing. In that way it could protect itself against being saddled with a guarantee which, because of its maturity or other features, might no longer fit into its over-all financing pattern. The right to call guaranteed issues would also allow the Bank to shift its entire financing to a debenture basis should that become desirable at some later date.

3. Sinking Fund. There can be no question that the Bank's guaranteed issues, as well as the loans which it makes directly, should be amortized by means of regular sinking fund arrangements. The reasons which make sinking funds desirable are familiar; in the international sphere they are reinforced by the need to avoid a sudden burdening of the balance of payments with heavy transfers.

Doubt can exist only whether the Bank's debentures should likewise be amortized regularly. The statutes seem to indicate that the debentures are to be amortized pari passu with the amortization of the Bank's loans but do not make this unambiguously clear. Since the Bank is to be a permanent institution, it might be argued that sinking fund payments received by it should be plowed

back into new loans instead of being used for redemption of debentures. ~~(Under the Bank's statutes any lending out of sinking fund receipts would be possible only with the consent of the country whose currency is involved.)~~ The investor, however, would very probably welcome a sinking fund for the debentures. It would increase his confidence in the soundness of the Bank, gradually reduce his commitment in any particular issue, and supply market support whenever the debentures were selling below par. The investment quality of the debentures would be enhanced, and the maturities which the Bank could place upon them for a given yield would be lengthened.

For the Bank the need to make sinking fund payments would mean that it would have fewer funds which, with certain qualifications, it could use to "play around with." This inducement to more rigorous financial management, however, would be salutary, although probably not needed as such. All these considerations seem to argue strongly in favor of equipping the debentures with a sinking fund proportionate to the amortization schedule of the Bank's own loans.

4. Interest Rates. It is too early at this time to discuss the interest rates at which the Bank's securities could be marketed. At best one can speak in terms of the differential with respect to the yield structure for government securities. Securities issued in countries where government yields are higher than the United States would obviously have to carry a correspondingly higher coupon. Some comments on the investment quality of the Bank's securities will be made below; at present it may suffice to suggest that these securities ought perhaps to yield 1/2 - 1 per cent better than equivalent government maturities. At the present time this would mean a rate of 3 - 3 1/2 per cent for the longest-term securities. With a guarantee commission of 1 - 1 1/2 per cent, the cost to the borrower would be 4 - 5 per cent, which would be reasonable, although not very cheap. The differential vis-a-vis government securities should gradually decline as the Bank proves itself in the eyes of investors.

IV. Investment Quality of the Securities.

The Bank constitutes a new departure in the technique of international lending, and the investment quality of its securities is not easy to evaluate. The goodness of the securities rests on the soundness of the Bank's loans and upon the ability of members to meet calls upon their subscriptions. Neither of these factors offers 100 per cent certainty. Even the most cautious management may see some of its loans go into default. Likewise, even among a loyal and well-intentioned membership there may be some who at times find it impossible to meet calls upon their subscriptions. It will be necessary, therefore, to analyze the factors which determine the possibility of defaults on loans and subscription calls.

1. Soundness of the Bank's Loans. It is perhaps not over-optimistic to say that our past unhappy experience with foreign lending need not be taken as an indication of what is to be expected in the future. What happened to foreign loans during the depression was due in part to the fact that hardly anybody believed it could happen. Neither lenders nor borrowers had counted on the possibility of almost a complete breakdown in the machinery of international finance. After the worst of the depression was over, some of the debtors coasted along in a state of partial or complete default in spite of evident ability to do better, because there was no concerted effort to reconstitute the traditional international credit mechanism. The general atmosphere was one of demoralization.

There is good reason to think that in the future we shall do better. We have learned a little about what not to do and shall be more careful as to the purposes for which foreign loans are made. We also know that a large creditor country, if it wants to be paid, will have to contribute its share to the maintenance of reasonable prices and markets for the products of its debtors. The latter, in turn, will be more interested in maintaining a good credit rating when they see that there is an institution willing to lend to those who are willing to pay. It seems clear that on both sides sincere

efforts will be made to prevent a recurrence of the earlier debacle and that, if defaults do occur again, more energetic endeavors will follow to remedy them. Debtors not yet sufficiently convinced of the desirability of meeting their obligations may change their minds after hearing from their fellow members in the Bank who are being called upon to make good.

It is quite likely, moreover, that the American investor has formed exaggerated notions of the actual losses incurred in our foreign lending. A recent study by the Department of Commerce shows that of a total of 29.4 billion dollars due American investors on account of interest and principal on foreign dollar bonds issued between 1914 and 1933, losses caused by factors other than the war amounted to only 2.7 billions. It needs to be pointed out, however, that what matters, from the viewpoint of the investor in securities, is not only how the loans work out after a period of years but also how they stand up at any given moment. The consequences of seeing the price of his bonds go down to 50 may be grave, particularly for an institutional investor, even if he is able to hold on and finally realizes 100 per cent. From the viewpoint of the borrower's ability to float new loans, too, the market value of his obligations at that time, rather than their ultimate fate, is decisive. It is important to note, therefore, that, according to Madden and Nadler,[1] at the end of 1935, only 61.4 per cent of outstanding foreign dollar bonds were being fully serviced. The proportion of defaults at that time, in other words, was much higher than losses over a longer period would seem to indicate. The fact, therefore, that in 1935 over 38 per cent of our foreign dollar bonds were in default must be considered side by side with the relatively favorable verdict of the Department of Commerce study.

1/ John T. Madden, Marcus Nadler, and Harry C. Sauvain, The Experience of the United States as a Creditor Nation, New York, 1937, p. 123.

The Bank's statutes give every indication that the lessons of the past will be heeded. They provide numerous safeguards to ensure sound lending practices and to protect the Bank against diverse dangers. The following deserve to be mentioned:

(1) A competent committee must study each proposed loan to be made or guaranteed by the Bank and submit a written report.

(2) If the borrower is not a government or governmental agency, the loan must be guaranteed by the government of the country where the borrower is located, or by its central bank or some comparable agency.

(3) The rate of interest and other charges must be reasonable, and interest and amortization charges must be appropriate to the project.

(4) Except in special circumstances, loans must be for the purpose of specific projects of reconstruction or development, and they are to be limited to the cost of the imports which the project occasions.

(5) The Bank must pay due regard to the prospects that the borrower or guarantor may be in a position to meet his obligation and shall act prudently in the interests both of the country receiving the loan and of the members as a whole.

(6) The Bank's assets are protected by agreement among the members against confiscation and against restrictions and regulations which would prevent the Bank from carrying out its functions.

(7) The danger that loans financed through debentures might be affected by currency depreciation is met by requiring the Bank to adhere to the familiar commercial bank practice of balancing assets and liabilities in each currency.

It is true that the quality of the Bank's loans in general will tend to be weakened somewhat by the requirement that the Bank shall make or guarantee only those loans which otherwise could not be floated under "reasonable conditions." The cream of international loans, therefore, will not go to the Bank. Under present conditions, however, very few countries probably will be able to borrow advantageously on their own name, so that it would be wrong to think that the Bank would only get the least desirable business.

The Bank's loans would be endangered, of course, if the borrowers, having obtained conservative amounts of money from the Bank, subsequently over-borrowed in the market. If world conditions should so improve that almost every country could borrow as freely as during the 'twenties, bad loans piled on top of good ones might again bring down the entire credit structure. The Bank will have to protect itself by gradually establishing a name as the ultimate authority on foreign lending, which would put it in a position to discourage the flotation of unsound loans through private sources.

Similarly, the Bank's dollar debentures and guarantees, over the issuance of which the American Director has control, could be weakened if the Management, overriding him, should extend doubtful loans and finance them in other currencies and markets. With 35 per cent of the votes, however, the American Director will not be easy to override, and since the Bank must rely mainly upon the American capital market, the rest of the Management will be loath to offend him. Moreover, there is no reason to think that the Management - primarily the President and the twelve Executive Directors - would be other than competent and conservative individuals, even though a small majority of the voting power might rest with debtor countries.

In a broader sense, the outcome of all international lending will depend on world economic conditions over which the Bank has no control. It

can contribute in a modest way to the expansion and stabilization of international trade by the judicious distribution of loans and particularly by continuing to lend during depressions, when other sources of funds dry up. Much more than this, however, will be required. Industrial debtors will be able to export enough to service their loans only if their customers abstain from extreme protectionism. Raw material countries will mainly require stabilization of world prices at reasonable levels. The success of the Bank will be considerably influenced, therefore, by whatever is done in the field of commercial policy and commodity stabilization. In this sense, the establishment of the Bank makes concerted international action in other fields more, not less, urgent.

Sound economic conditions should make for a largely satisfactory loan experience. There remains the possibility of political complications. In the past cautious investors have preferred loans to countries with which their government had close political relations. The Bank as an international institution cannot entertain such viewpoints, although each Director could bar the use of his country's funds for loans which his government does not favor. If reasonably harmonious international relations are maintained, the political angle will not be important. Otherwise, however, it is not unthinkable that the main threat to the Bank may eventually arise from political complications. If a large proportion of loans should be made to a few countries and political friction with the latter should later arise, the consequences might be grave.

2. Goodness of Subscriptions. Apart from the soundness of its loans, the investment quality of the Bank's securities will depend on the Bank's ability to meet defaults by drawing upon reserves and calling in subscriptions. The latter, particularly, will be the principal mainstay. How good are these subscriptions, and how completely do they cover the Bank's liabilities?

All members are contractually obligated to meet any calls upon their subscriptions which the Bank may make to meet its own liabilities and to permit their conversion into whatever currency the Bank needs; the value of the subscriptions, moreover, is protected against depreciation by a gold clause. Nevertheless, since we are considering the possibility of default on loans, we must also envisage defaults on calls upon subscriptions. The only subscription which the American investor can count on with virtually absolute certainty is that of the United States. In the first place, since most of the Bank's securities are likely to be issued in dollars in the United States, the funds put up by the American Government will serve mainly to safeguard American investors, whom the Government has no reason to let down. Payment of the American subscription, in the second place, will be facilitated because no transfer problem is involved in so far as payments are made to holders of dollar securities. Finally, under the present enabling legislation, the Secretary of the Treasury is authorized to borrow the necessary funds whenever needed, so that Congressional action will not be required later. These are strong material and psychological safeguards.

A number of other countries can also be counted upon with a high degree of probability to meet calls on their subscriptions. For most of them, however, the difficulties involved will be greater than for the United States. Unless a large amount of securities was floated in their currency, their contribution will have to be made convertible into dollars. In a depression this might result in a painful drain upon their exchange reserves. Political capital, moreover, might be made by critics out of the fact that the payments are made to bail out American investors. Some defaults upon calls must therefore be expected. In particular, calls on countries which have already defaulted on their loans will almost certainly not be heeded. As defaults on loans spread more widely, the number of countries meeting the growing volume of calls will shrink.

Apart from defaults on calls, there are other factors which may cause a dilution of the Bank's financial strength. If the Bank, after the original obligor has defaulted, pays interest on a guaranteed issue, it will be dissipating its capital. Likewise, if a loan financed through debentures goes into default, dissipation of capital will occur if the Bank services the debentures instead of redeeming a corresponding amount. In view of the limitations upon redemption written into the Bank's statutes (calls for this purpose must not exceed 1 per cent per annum), some dissipation of capital will probably take place. This may also occur if the Bank grants transfer moratoria on loans financed with debentures. If the defaults eventually are made up, the Bank's capital will be reconstituted, but past experience does not warrant such an expectation.

In spite of the possibility of dilution, the Bank's securities are very amply covered, as a few examples will show. The problem of defaults has two sides: (1) The crisis aspect - are enough funds available to the Bank to maintain service during a crisis, when the volume of defaults may be large and many countries may fail to meet their calls; (2) the long-run aspect - will the Bank's funds suffice to work off the permanent defaults which remain after some of the services interrupted during the crisis have been partly or wholly resumed, and some of the members have caught up with all their calls? Beginning with the crisis aspect, we shall first see how far the Bank can get with the Special Reserve accumulated from loan commissions. Table I shows the volume of defaults which could be serviced out of the Reserve for three years if the defaults occur after five or ten years, respectively, and if annual interest and sinking fund payments aggregate 7 per cent.

TABLE I

Debt Service out of Special Reserve Fund[1/]

	Reserve Commission 1%		Reserve Commission 1 1/2%	
	Reserve Fund	Loans Serviced	Reserve Fund	Loans Serviced
After 5 years	227.5	1.315	341.25	1.950
After 10 years	682.5	3.415	1,023.75	5.050

1/ It is assumed that the volume of loans is built up to 9.1 billions within the first five years, and maintained at that level thereafter. Commissions on solvent loans received during the respective three-year periods when loans are serviced from the reserve are taken into account. The aggregate cost of interest and sinking fund is taken at a fixed 7 per cent per annum.

It appears that if the Special Reserve is built up at a standard commission rate of 1 per cent and a sharp crisis strikes after five years, 1,315 million (14.4 per cent of 9.1 billion of obligations) could be serviced from the Reserve for three years. If the commission rate is 1 1/2 per cent and the crisis occurs only after ten years, 5,050 million (55.5 per cent) could be so serviced. There would be no need at all in these cases to call upon members' subscriptions. If the defaults are larger, and if the Bank has accumulated no other reserves from its earnings, calls on subscriptions will become necessary. The United States' contribution alone, however, considerably exceeds the cost of a three-year service on 9.1 billion dollars of obligations at 7 per cent. A three-year crisis therefore could be weathered with the aid of the United States' subscription and the Special Reserve alone, even in the utterly unthinkable case that all borrowers suspended payment and none of the other members met their calls.

It is evident, so far, that if there can be any threat to the solvency of the Bank, it would come, not from temporary defaults during a

crisis, no matter how widespread, but from long-run developments. Let us again consider an extreme case: what volume of permanent defaults could be taken care of with the aid of the American subscription and of currently received commissions on solvent loans, again assuming a 7 per cent service on the original loan amount, if all other members should fail to meet their calls?

It can easily be shown that if under these conditions the Bank should find 30 per cent of a total commitment of 9.1 billions exposed to complete default, no subsequent payments being received whatsoever, and no new loans being made, its obligations could still be met.[1/]

Even under these extreme conditions, therefore, the Bank would be in a fairly strong position to meet defaults. However, there is utterly no reason to think that all other countries will fail to meet calls on their subscriptions. The annual cost to each member of servicing even a heavy volume of defaults is not large. Assuming, as in the above example, that the defaults are amortized over a period of twenty years, the annual payments to be made by Britain (subscription 1,300 million) would average

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1/ It is assumed, for purposes of illustration, that annual debt service amounts to 7 per cent on the original value of the loan, interest being at the rate of 3 1/2 per cent, the remainder going to sinking fund. On this basis, loans would be completely amortized after twenty years, the amount left over from sinking fund payment growing each year. (If securities can be bought for the sinking fund below par, redemption will be quicker.) Total payments would aggregate 140 per cent of the original loan value. The amount of defaults that could be covered, therefore, would equal 71.5 per cent of the sums available for service, consisting of the United States' contribution of 3,175 millions, plus commissions on the outstanding balance of solvent loans. It can easily be shown that defaults aggregating slightly more than 2,700 millions out of total commitments of 9,100 millions (29.7 per cent) can be met from these sources. No account is taken here of funds which would be available from earlier accumulations in the Special Reserve unless exhausted in a prior crisis, which might add several percentage points to the coverage. It would not make much difference if it were assumed that 20 per cent of the American contribution had been tied up in direct loans, since (1) additional receipts of interest and commissions would then be available, (2) at least part of these commitments would eventually become liquid and available to meet other obligations, and (3) obligations to private investors would be correspondingly smaller.

65 millions, those of France (subscription 450 million) 22.5 million, those of Czechoslovakia (subscription 125 million) 6.25 million. It is true that for a few years after the defaults have first occurred, the annual payments probably would be a good deal heavier, given the probable maturity structure of the defaulting loans. Nevertheless, if the members are otherwise solvent, the burden imposed by calls upon their subscriptions should not break their backs. Defaulting upon the sums involved would not be worth while.

If we count merely on Britain, Canada, Holland, Belgium, France, Norway, and Czechoslovakia, we have a total of 2,750 millions which, added to the United States' subscription, makes 5,925 million. This amount, plus commissions on solvent loans, would be sufficient to work off losses of at least 50 per cent, a loss ratio experienced not even during the 'thirties.[1] With such coverage, the owners of the Bank's securities will enjoy a very high safety factor.

The effectiveness of a given volume of subscriptions would be even stronger if defaults, once hope for their prompt settlement was lost, were met by full redemption of the particular issues - in case of guarantees - or of a corresponding amount of debentures. The contributions of the above-mentioned countries would suffice to take 5,925 millions of securities (65 per cent of 9.1 billions) out of the market - not counting the funds that may have accumulated in the Special Reserve. This procedure, however, would require members other than the United States to make very substantial transfers within a short period of time, which their balance of payments might be unable to stand, and against which they have protected themselves by limiting calls for redemption purposes to 1 per cent annually. Small scale redemptions, however, are likely to take place if the need for them should arise. Coverage

1/ If earlier accumulations in the Special Reserve are available, the coverage would be even better.

of the remaining securities will benefit accordingly.

3. A Forerunner - The Austrian International Guaranteed Loan.

In view of the unusual character of the Bank's securities, it is interesting to cast about for something in the nature of a precedent. The issue most closely resembling the securities of the Bank seems to have been the Austrian International Guaranteed Loan of 1923. This loan was a direct obligation of the Austrian Government and was guaranteed severally up to given proportions by the governments of Britain (24 1/2 per cent), France (24 1/2 per cent), Czechoslovakia (24 1/2 per cent), Italy (20 1/2 per cent), Belgium (2 per cent), Sweden (2 per cent), Denmark (1 per cent), and Holland (1 per cent), the total of the guarantees amounting to 100 per cent of the issue in question. As security the guarantors deposited with the Swiss National Bank their own bonds of like currency and tenor; the American tranche of the loan - 25 million dollars - was therefore collateralized with dollar bonds of the various governments in the proportions indicated.

It is illuminating to observe the price movement of the American issue, which was floated at 90, with a 7 per cent coupon, to mature after twenty years, and to compare with it the valuation which the market put upon outstanding dollar issues of the guarantors of similar maturity.

TABLE II

Prices and Yields of Austrian 7s'43 and of Certain Bonds of the Guarantor Governments in New York

	June 1923		June 1930		June 1932	
	Price	Yield (Per cent)	Price	Yield (Per cent)	Price	Yield (Per cent)
Austrian 7s'43	91 1/2	8.0	104	6.5	62 3/8	13.7
United Kingdom 5 1/2s'37	103 1/2	5.1	104 3/4	4.7	102 5/8	4.9
French 7 1/2s'41	92 1/2	8.3	122 5/8	4.7	118 3/4	4.8
Italy 7s'51	96 1/4 1/	8.5	97 3/8	7.3	85	8.6
Czechoslovakia 8s'51	94	8.6	109 7/8	7.1	69	12.2
U. S. Treasury's		4.4		3.3		3.8
Aaa Corporates		5.2		4.5		5.4

1/ 6 1/2s'25

Table II shows that the Austrian bonds normally sold somewhere in between the issues of the guarantor governments, but at a wide discount from United States Treasury bonds or triple A corporates. In 1932, during the bad days following the Creditanstalt failure,they dropped to the pretty grim level of 62, but quickly recovered to 90. In 1932, the Austrian Government actually suspended service for a short period, and the guarantors were forced to draw upon reserve funds in their possessions. Subsequently, however, the Austrian Government caught up and in 1935 the loan was converted, under fairly similar conditions, to lower interest rates.

Marketwise, the experience of the Austrian issue was not particularly favorable, even though in the end the securities worked out satisfactorily. This, however, is probably not at all indicative of the reception which the Bank's securities may expect to find, for there are important differences between them and the Austrian loan. While the coverage of the guarantee of the

Austrian loan was more complete than the coverage which the Bank's securities in the aggregate (not individually) will have through its members' subscriptions, the guarantors as a group probably were weaker than the leading members of the Bank will be. More importantly, we are here dealing with a single issue which permitted no diversification of risks. In the Bank's case, the latter possibility will be an important element of strength. There can be little doubt that the Bank's securities should rate considerably higher than the Austrian loan.

V. Selling Arrangements. It has repeatedly been said by the sponsors of the Bank that its financing would be done through "normal channels" - i.e., presumably by enlisting the aid of the securities industry. In the case of guaranteed issues, the need for the usual underwriting and distributing services seems to follow almost inevitably from the logic of the process. These flotations may be expected to follow the same pattern as in former years, except for the study of the project by the Bank preceding the extension of the guarantee, and making allowance for SEC requirements.

In the case of debenture issues, however, it is conceivable that the Bank could dispense with the services of underwriters and distributors and could sell its obligations in the same way as the Federal Government, through a fiscal agent. It has been argued, in fact, that an institution of the Bank's standing should make a point of avoiding direct contact with the securities industry, although this view seems to be unduly exacting in view of the fact that foreign governments of the highest standing have traditionally employed such channels for their American borrowings. If the Bank should decide not to use these channels, it is evident that the question of guaranteed issues versus debentures would acquire very considerable importance for the industry.

It is far from certain, however, hardly even likely, that the Bank

during its early years will be able to market the required volume of debentures by merely announcing an issue and waiting for the oversubscriptions to flow in. Good as they may be, the debentures are not United States Government bonds, and they will have to overcome the resistance and inertia which so novel a medium is bound to encounter. As an example, one might point to the Federal Land Bank bonds, which are now much in demand but which during their early period required a considerable selling effort by a broad distributing group.

At the very least, the introduction of the securities should be accompanied by a thorough educational campaign, to familiarize investors with their characteristics. In this connection, it will be necessary to make it quite clear that the United States Government assumes no responsibility beyond the limits of its subscription. In view of its sponsorship of the Bank, there is some question, in any case, whether the government can completely free itself from all kinds of moral responsibility. But whether or not the Government, in case of failure of the Bank, should decide to do something on behalf of American investors, this possibility ought not to figure explicitly in the promotion of the securities. The Bank's statutes provide that securities which are not the obligation of a government should bear an imprint to that effect, but since few investors ever see their securities face to face, something more is needed.

In addition to an educational campaign, it will be necessary, as said before, to broaden the market by making the securities "legal" for the various types of institutional investors. Even this, however, will probably not be enough to insure sufficiently broad acceptance from the start. Hence the employment of the regular distributing channels must be envisaged. This should not be regarded as a reflection upon the standing of the Bank. The same procedure has been adopted by the Federal Land Banks, whose capital stock, like that of the Bank, was and in part still is government-owned.

In Europe it has been quite customary for government securities to be sold by syndicates on the basis of a moderate commission.

Quite likely, however, the Bank may be able to dispense with <u>underwriting</u> services proper and may find it advisable to employ houses which specialize in the maintenance of a wide distribution service. So long as its own free funds are not completely tied up, it can use them for the temporary financing of loans which it subsequently refinances in the market, as conditions permit. The main problem will be not to obtain money at a given moment, but to tap as large an investment market as possible.

It would probably help if the first few issues were made for projects which are likely to enjoy general approval and with not too extended maturities -- at the start perhaps only medium term. The early issues should not be too richly priced, for if the Bank should attempt to extract the last penny, the issues may be slow in moving from dealers' shelves, and the industry will ~~beocme~~ become chary of them. Larger maturities and relatively lower coupons will become possible as the Bank proves itself in the eyes of investors.

The type of relationship which the Bank should establish with the securities industry will probably become subject for considerable debate. The possibilities range all the way from competitive bidding to the formation of a single permanent syndicate of the type that used to be customary on the Continent but which does not exist in the American market. At the start at least, competitive bidding might not be the best procedure, in view of the untried character of the securities. The formation of a permanent syndicate, on the other hand, while perhaps attractive from the angle of the Bank's dignity, would not be in harmony with American traditions. Moreover, it probably would not yield as good results, in terms of width of distribution as well as of interest rates, as the existence of several competing groups.

Perhaps something along the lines which the City of New York has followed in its financing, with two large groups regularly competing for new issues, and allowing for the possibility of their getting together for very big issues, might prove a good solution.

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