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On the
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REVIEW OF IBRD AND IFC FINANCIAL CAPACITIES

Attached for the April 25, 2010, Development Committee Meeting is a background document entitled "Review of IBRD and IFC Financial Capacities", prepared by the staff of the World Bank.

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Abbreviations

ADB	Asian Development Bank
bp	basis point
DC	Development Committee
DGF	Development Grant Facility
E/L	Equity-to-loans and long-term investment assets
EMBI	Emerging Market Bond Index
FY	Fiscal Year
GCI	General Capital Increase
GEP	Global Economic Prospects
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFL	IBRD Flexible Loans
IFC	International Finance Corporation
IGP	Institutional Grant Programs
IMF	International Monetary Fund
LTIP	Long-Term Income Portfolio
MDB	Multilateral Development Bank
MIC	Middle-Income Country
NCPIC	National Currency Paid-in Capital
PEBP	Post-Employment Benefit Plan
PFC	Pension Finance Committee
PV	Present Value
RDB	Regional Development Bank
RSBP	Retired Staff Benefits Plan
SCI	Selective Capital Increase
SLL	Statutory Lending Limit
SPBF	State and Peach Building Fund
SPP	Staff Pension Plan
WBG	World Bank Group

REVIEW OF IBRD AND IFC FINANCIAL CAPACITIES

Introduction

1. After the worst crisis in 50 years, the world economy faces an uncertain and uneven recovery with new risks to jobs and growth. The World Bank Group (WBG) has been called upon to play a historically large role to protect the poor and lay the foundations of recovery. In Spring 2009, the G-20 leaders called for additional $100 billion in lending by multilateral development banks (MDBs); the Development Committee (DC) also called on the IBRD to make "optimal use of its balance sheet with lending of up to $100 billion over three years."

2. The WBG has risen to this challenge, and the speed and scale of our crisis response have been unprecedented: the WBG has provided over $90 billion in total support since the start of the crisis and will likely be over $100 billion by the time of our Spring Meetings. This record level of assistance, however, has left us with limited resources for clients going forward, and little capacity to play the same role should the recovery falter.

3. In its Spring 2009 Communiqué, the DC considered the potential need to deploy additional resources and asked the WBG to "review the financial capacity, including the capital adequacy, of IBRD and IFC." In response to this request, management presented a report entitled *"Review of IBRD and IFC Financial Capacities – Working with Partners to Support Global Development through the Crisis and Beyond"* at the October DC meeting. The report provided a review of IBRD and IFC's financial capacity, including the impact of the two institutions' record level of crisis response on their capital adequacy, the measures that have been undertaken to enhance their financial capacity, and options to fill remaining gaps.

4. The October 2009 DC Communiqué "welcomed the progress in examining measures to improve the WBG's financial capacity and sustainability and committed to ensure that the WBG has sufficient resources to meet future development challenges." The Committee "asked for an updated review, including on the WBG's general capital increase needs, to be completed by Spring 2010 for decision" and requested that the review also "address all possible contingent approaches as well as keep in mind the infusion of capital that would come from a special capital increase for voice reform." In considering the potential general capital increase needs of the IFC, the Committee requested that the review "should also examine the use of hybrid capital."

5. Since October, management has worked with members towards the targets set in the DC Communiqué through efforts on various fronts, including a large number of bilateral consultations with Executive Directors' offices as well as capitals and multiple Board seminars and meetings from December through April to discuss related topics, ranging from WBG post-crisis directions and reform agenda to voice reform and financial capacity. Board discussions on the updated financial capacity review included - on the IBRD part, the contingent capital options, restoring loan maturity to the maximum level before 2008 with the option to extend with a premium, further refinement of the general capital increase (GCI) needs, modalities for the GCI, and potential principles for pricing and income allocation; and on the IFC part, four capital options were discussed including a general capital increase, a selective capital increase, a hybrid instrument and earnings retention.

6. This paper consists of two chapters, with Chapter 1 devoted to IBRD and Chapter 2 to IFC. The IBRD Chapter starts with a summary of the October DC paper in the Background section; it then updates, in Section II, the financial projections and usable equity gap and, in Section III, the actions that are currently being pursued and the proposal to fill remaining gaps; in Section IV, it discusses various topics related to the structuring of the GCI, including national currency paid-in capital (NCPIC), paid-in vs. callable capital, subscription period, and contingent options. Finally, Section V concludes the IBRD part of the report and presents management's recommendations. The IFC Chapter starts with an executive summary and background; it then discusses, in Section II, the impact of capital position on future development impact opportunities; in Section III, it presents on updated view on the Corporation's financial position and projected financial capacity needs; in Section IV, it summarizes the options to strengthen the Corporation's financial capacity. In the last section, Section V, Management's recommendations for meeting IFC's financial capacity needs are presented.

Chapter 1. IBRD Financial Capacity and Capital Adequacy

I. BACKGROUND

7. With its strong capital position prior to the crisis, IBRD was able to respond with strength and speed when the crisis first hit and lean forward at a time when its clients needed it the most. It delivered a record $33 billion in new commitments in FY09, almost tripling the level a year earlier, and is currently on target to deliver another record $44 billion in FY10. Total lending in response to the crisis is projected to reach $136 billion for the FY09-12 period, which would well surpass the $100 billion goal that the DC called for in its Spring 2009 Communiqué. This record level of assistance, however, is projected to soon stretch IBRD's capital adequacy beyond its long-term strategic capital adequacy range.[1]

8. Meanwhile, despite signs that a global recovery is underway, many analysts anticipate that the recovery will be slow, weak, and bumpy; significant spare capacity and high unemployment is expected to characterize both advanced and developing countries for some time. What happened recently in Dubai and Greece and the global market's reaction further highlights the fragility of the recovery. Developing countries, in particular, will continue to suffer disproportionately the consequences of a weak external environment, and they remain especially vulnerable to the downside risks that characterize the recovery.

9. IBRD continues to have a key role to play in contributing to opportunities to boost global growth and economic recovery. Demand for IBRD assistance remains high. However, we are already constrained in our ability to plan all projects that would translate into commitments to clients beyond the current calendar year. Should the recovery falter in 2010 or 2011, we would not have the capacity to respond as we did in the past in the absence of a capital injection.

10. Before turning to members, management has already taken a number of actions to address the capital constraints by first maximizing the use of its existing resources, while continuing to maintain its prudent financial management approach – the same approach that has led the IBRD out of the current crisis financially unscathed, in contrast to many other institutions, public or private. At the time of the October 2009 DC meeting, management reported that IBRD has already leveraged its balance sheet more than Regional Development Banks (RDBs), allowed reasonable flexibility in its main capital adequacy measure - the E/L ratio - relative to its long-term strategic range, introduced a new exposure management framework that makes more efficient use of existing capital, and redeployed risk capital intended for the Long-Term Income Portfolio (LTIP) to support loan growth. In addition, it has also kept remarkable budget discipline by delivering record assistance while keeping operational expenditures flat in real terms.

11. In August 2009, IBRD also instituted a 20 basis point (bp) general pricing increase pursuant to its annual loan pricing review. While the objective of this pricing increase was to improve the institution's financial sustainability, it would also gradually enhance IBRD's capital

[1] IBRD is currently projected to only be able to lend $8 billion a year after FY12 if no further actions were to be taken to enhance its capital.

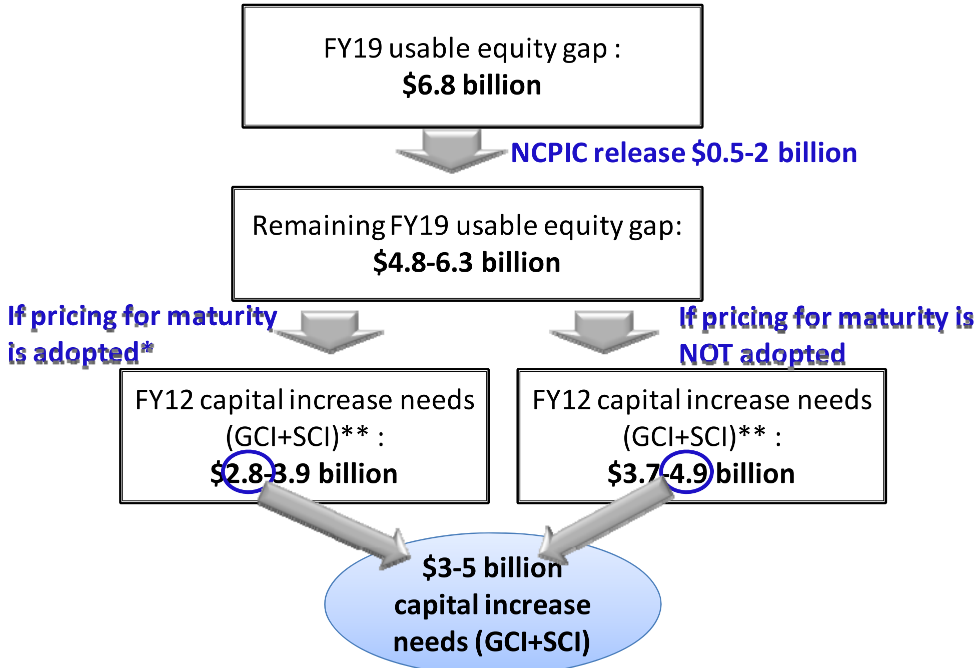
position as higher income is added to reserves over time. It was projected that this pricing increase would enhance IBRD's end-FY19 usable equity by about $2.0 billion.

12. Even with these measures already in place and under a modest post-crisis lending scenario where IBRD's nominal post-crisis annual lending returns to $15 billion, the average level over the decade prior to the crisis in real terms, IBRD was still projected, at the time of the October DC paper, to face a usable equity gap of $6.8 billion by the end of FY19.

13. In the October DC paper, management also reported that the IBRD was actively working with relevant members to release their existing national currency paid-in capital (NCPIC) so that it can be used as risk capital in support of lending operations. It reported that by the time of the paper, it had obtained indications for the release of $0.5 billion of the total $2 billion unreleased NCPIC. In addition, management noted that the selective capital increase (SCI) being discussed under the voice reform would also generate usable paid-in capital to enhance IBRD's financial capacity.

14. In light of the remaining capital gap, management presented two options in the October paper - a GCI and the potential restoration of loan maturity to the maximum level before 2008 with the option to extend with a premium, which would reduce IBRD's FY19 usable equity gap by $1.2 billion. Management provided, in the October paper, an estimated range of $3-5 billion for the GCI and SCI combined, with the upper and lower bound of the range reflecting scenarios where the measure of restoring loan maturity to the maximum level before 2008 with the option to extend with a premium is either adopted or not adopted. Figure 1 below provides a summary of the derivation of the capital increase needs as presented in the October DC paper.

Figure 1. Derivation of capital increase needs (as presented in October 2009 DC paper)



*The measure that was presented in the Oct. DC paper on restoring maturity to the maximum level before 2008 with the option to extend with a premium is expected to reduce the FY19 usable equity gap by $1.2 billion from $4.8-6.3B to $3.6-5.1B.
** The FY12 capital increase range is derived by discounting the FY19 usable equity gap ($4.8-6.3B if no adoption of maturity measure and $3.6-5.1B with implementation of maturity measure) to the equivalent of a capital increase starting from FY12 and paid in over 5 years.

II. UPDATED FINANCIAL PROJECTIONS AND USABLE EQUITY GAP

15. Since October, management has updated IBRD's financial projections to reflect movements in market rates and updates in other financial parameters. This section provides a summary of the updated financial projections and the resulting usable equity gap.

Lending

16. *Crisis lending.* In the October DC paper, management projected that after a record $33 billion lending in FY09, IBRD would continue to face strong demand from its clients over the FY10-12 period. It projected new commitments to reach $44 billion in FY10, $33 billion in FY11 and $26 billion in FY12.

17. Since October, actual lending year-to-date and updated pipeline suggests that IBRD is well on track to meet, if not exceed, the $44 billion level it had projected for the current fiscal year. Disbursements also reached a record level of $16.5 billion in the first half of FY10, representing a 75% increase from a year earlier. Bottom-up estimates suggest that client demand for IBRD lending will remain strong beyond FY10 as the recovery is expected to be weak and uneven with significant risks for slippage. The previous $33 billion projection for FY11 and $26 billion for FY12 hence continues to be management's base case expectations for the next two years.

18. *Post-crisis lending*. Unlike some RDBs that have assumed significant growth in their post-crisis lending relative to the period prior to the crisis, IBRD has presented a post-crisis lending scenario where nominal annual commitments from FY13 onwards return to $15 billion, its average level in real terms for the decade prior to the current crisis. This figure is not a demand assessment, but rather represents a reasonable and practical capacity target for the purpose of the capital discussions. It balances considerations for the expected post-crisis global economic environment, the WBG's vision for its roles in the post-crisis world, and the effort to minimize burden on shareholder governments and their taxpayers.

19. The $15 billion level for post-crisis lending is, first of all, a modest figure considering that the fallout from the crisis will "change the landscape for finance and growth for a protracted period."[2] Private capital flows are expected to be volatile with uneven access and external financing needs of developing countries are expected to remain large in the medium term. Market supply of funding is not expected to rebound to pre-crisis level any time soon - syndicated cross-border bond and bank lending, as well as portfolio equity flows, are constrained by the new global financial environment; in addition, foreign bank participation in developing country domestic financial systems has declined due to the need for parent banks in advanced countries to build up their capital in a more restrictive regulatory environment, as well as through "financial protectionism" that places pressure on banks to concentrate more on home markets. While some emerging economies have started to regain access to the private market, the recovery has taken place mainly in the bond market; commercial bank lending has not resumed. Furthermore, many of IBRD's client countries that had only sporadic and costly access to the market even before the crisis would continue to face challenges in accessing enough funding for their development needs. Client feedback suggests that IBRD's financing is highly valued by

[2] 2010 Global Economic Prospects (GEP).

these countries - it not only provides valuable long-term financing that is not available in the private market, but also avoids crowding out the private sector; in addition, IBRD lending also comes with policy advice and technical assistance that significantly enhances the development impact of the financing.

20. The $15 billion post-crisis annual lending capacity also represents a modest level of lending in the context of the strategic vision that management has presented in the concurrently issued DC report entitled "*New World, New World Bank Group: (I) Post-Crisis Directions.*" As outlined in that paper, WBG has a key role to play in the building of the "new multilateralism" to address the increasingly complex global development challenges in the post-crisis world, including in mobilizing global actions to address climate change after Copenhagen – via innovative financing instruments such as the Climate Investment Funds that leverage substantial additional resources for climate solutions. The five strategic priorities identified in that paper – targeting the poor and the vulnerable, creating opportunities for growth, promoting global collective action, strengthening governance, and preparing for crises – would support an annual lending program of at least $15 billion for the IBRD.

Changes in market rates and other main financial parameters

21. Since the end of June 2009, when the projections underlying the October DC paper were prepared, various market parameters have changed. On the one hand, positive factors such as higher average 10-year forward interest rates and projected improvement in liquid asset investment returns have resulted in improvement in IBRD's projected capital position. On the other hand, however, negative factors including depreciation of the euro against the dollar, which decreased the dollar-equivalent value of IBRD's usable equity denominated in euro as well as associated equity earnings, are projected to push down usable equity. These opposite effects are expected to mostly offset each other and result in a small net increase in IBRD's FY19 usable equity gap of about 0.1 billion.

22. Meanwhile, while refining its financial projections, management also revisited its assumption about future annual external non-IDA transfers from the surplus account and revised it from the previous level of zero to a more reasonable and fiscally conservative level of about $100 million. The $100 million annual level would allow IBRD to continue its support to the West Bank/Gaza Trust fund (approximately $55 million p.a.) and meet unexpected urgent needs, which will certainly arise in the future; it is also consistent with IBRD's average transfers of $121 million from the surplus account approved by the Board of Governors over the last five years. This adjustment in surplus transfer assumptions is projected to raise IBRD's FY19 usable equity gap by about $1.2 billion.

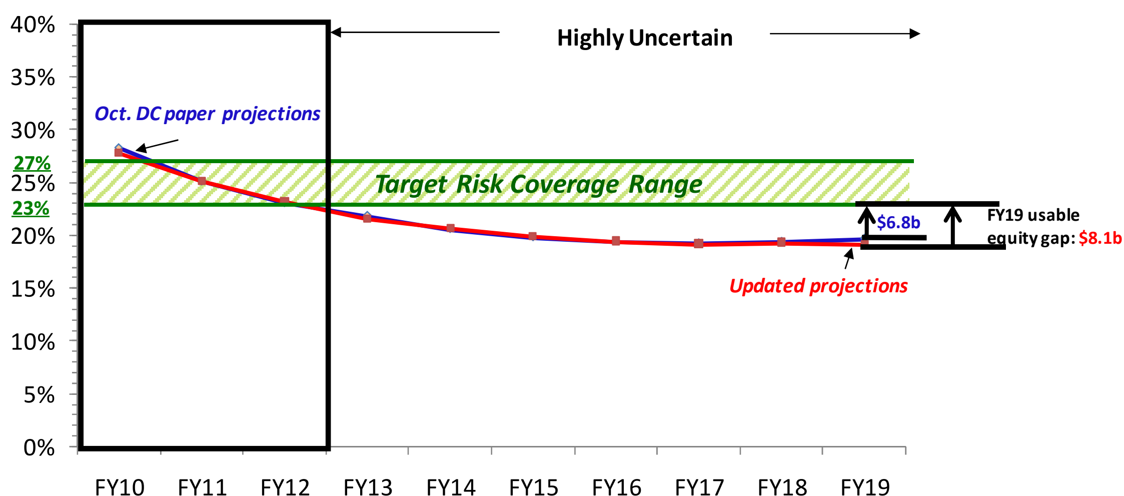
23. A combination of these various effects is projected to result in a total increase of about $1.3 billion in IBRD's FY19 usable equity gap compared to that presented in the October DC paper. However, as the "Voice" discussion evolves, there are indications that proceeds of an SCI could generate up to $1.6 billion in paid-in capital. Nevertheless, this paper assumes $1 billion

for the SCI paid-in portion, recognizing that changes in this assumption may lead to a modest augmentation of the capital projection over the horizon.[3]

Updated E/L ratio projections and usable equity gap

24. Figure 2 below shows the updated E/L trajectory and FY19 usable equity gap of IBRD in comparison to those in the October DC paper. As the chart indicates, IBRD is currently projected to face a usable equity gap of approximately $8.1 billion by the end of FY19 after incorporating the effects of changes in market rates and other financial parameters since October. Annex I provides detailed assumptions underlying the projections.

Figure 2. IBRD's projected E/L ratio and usable equity gap



III. UPDATES ON MEASURES BEING PURSUED TO ENHANCE IBRD'S FINANCIAL CAPACITY

25. Management indicated in the October DC paper that, in addition to the measures already implemented, it planned to continue pursuing a number of measures to further enhance its financial capacity. These measures included release of NCPIC, budget discipline, and SCI related to the voice and participation reform.

Release of NCPIC[4]

26. Considering that $1.6 billion of the $2 billion unreleased NCPIC is from 20 members, management has adopted a targeted approach to work first with these 20 members to release their NCPIC. Since October, management has constructively engaged in a large number of bilateral discussions with these shareholders with customized approach for each and worked with multiple levels of the governments in an effort to seek an agreeable solution. With the

[3] For example, if the SCI generated $1.6 billion rather than the assumed $1 billion, the additional $500 million would be less than 10% of the equity gap of $8.1 billion. But this may or may not be achieved depending on the other variables such as interest rates to which IBRD has a high sensitivity. If indeed more capital is raised, this would have the effect of modestly accelerating the reaching of the 23% minimum of the E/L target.

[4] In this paper, the term "release" of NCPIC means NCPIC that is made fully usable in the Bank's operations.

cooperation of members, the IBRD has so far made progress with some of these countries with indications for potential release of $1 billion of their NCPIC, in a phased manner. Management is striving to have as much NCPIC released as possible and encourages members with remaining unreleased NCPIC to explore the various release options in an effort to find a suitable mechanism; these efforts will demonstrate the spirit of responsibility-sharing that we have been advocating for addressing today's increasingly complex global challenges.

Budget discipline

27. The Bank has demonstrated cost control and sound budget management within a net administrative budget that has been effectively flat in real terms since FY99. In nominal terms, the Bank has one of the slowest growing budgets among the major international financial institutions. For example, even post-reforms, the IMF budget has grown at twice the rate of the Bank's over the last decade. Within the flat budget environment, Bank spending has stayed below Board-authorized levels by 2% or more since FY05. A series of actions have also been taken to maintain cost effectiveness, with traditional efficiency measures generating about 15% of net administrative budget in savings over the last four years and key cost saving reforms freeing a total of around $170 million (FY09 USD) per annum in resources over the last decade. The institution has continued to adhere to the tight budget discipline even during the current crisis when it tripled its level of assistance to client countries.

Box 1. Examples of cost-saving reforms over the last decade

- Off-shoring: Moving accounting, disbursement, and some budget and IT functions to Chennai ($23 million p.a.)
- Productivity tax to incentivize cost consciousness ($45 million p.a.)
- Pension Reform, reducing contributions while expanding membership ($40 million p.a.)
- Compensation and Benefits Reforms ($44 million and $36 million p.a. respectively)
- Cheaper travel: Preferred Airline Program ($20 million p.a.)
- Targeted VPU resizing, e.g., in ISG and HRS ($26 million)
- Space Efficiency Program, reducing leased HQ office space by 75% ($19 million p.a.)
- Joint IMF/Bank/IFC Procurement ($6 million p.a.)

28. Going forward, management is determined to build on past efforts and to continue maintaining tight budget discipline. The budget reform agenda offers an opportunity for the planning and budgeting function to further refine budget processes and align resources to priorities. Major changes include:

- Strengthening the links among the Bank's strategic focus, results, and budget allocations. Among other actions, the Bank will develop a Corporate Scorecard to translate institutional priorities and reforms into monitorable objectives and provide a focus on corporate level results.
- Expanding the planning and performance management discussions to cover all elements of the work program, including those funded by trust funds.

- Simplifying and streamlining processes and systems to provide budget flexibility commensurate with an increasingly volatile external environment while continuing the focus on cost efficiency through program reviews.

SCI for voice

29. In the October DC Communiqué, the Committee agreed that the second phase of the voice reform should generate in the next shareholding review a significant increase of at least 3% of voting power for under-represented developing and transition countries and it recommitted to reaching an agreement by the 2010 Spring Meetings. Since October, management has been working with members towards an agreement by April and the progress is detailed in the concurrently issued DC report entitled *"World Bank Group Voice Reform: Enhancing Voice and Participation of Developing and Transition Countries in 2010 and Beyond"*. There is a broad consensus that a SCI should be the means for achieving this shareholding realignment. While the final numbers are still under discussion, different options require an SCI in the range of $19-23 billion. Assuming a 6% historical average paid-in ratio with all-callable shares for protection of voting power of the smallest poor, the SCI would generate as much as $1 billion in usable paid-in capital to enlarge IBRD's capital base. [5]

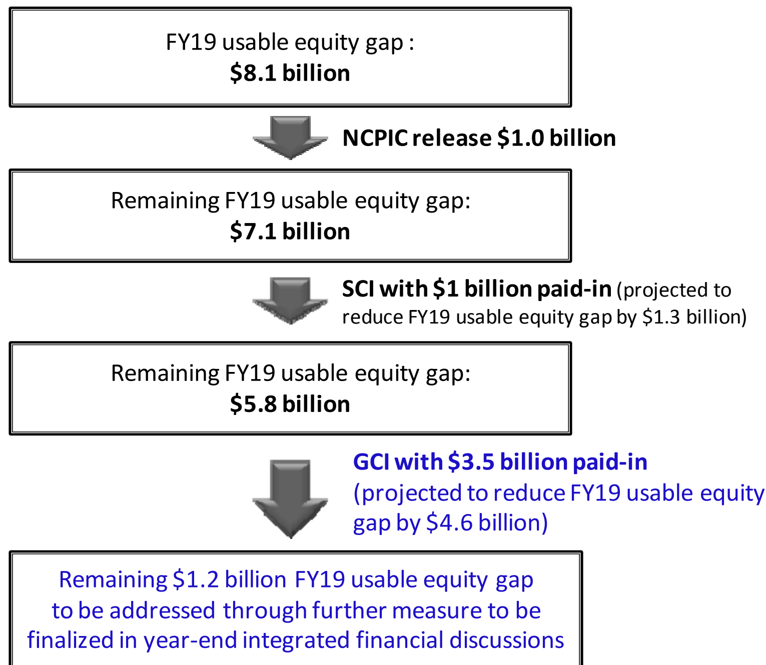
GCI

30. A paid-in capital increase is the most direct and effective way to enhance IBRD's capital position and financial capacity, and is perceived by rating agencies and the markets as the strongest indication of shareholder support to the Bank. In addition, it also represents the fairest burden-sharing among members.

31. Figure 3 below presents the derivation of IBRD's updated capital needs. As Figure 3 shows, IBRD is estimated to be in need of $5.8 billion capital by the end of FY19, after taking into consideration updated financial projections, updates on NCPIC release, and estimated amount of paid-in capital from the SCI. This gap could be met with a GCI with $3.5 billion in paid-in capital and further measure to be finalized during the year-end integrated financial discussions. This is discussed further in the next section.

[5] See paragraph 24.

Figure 3. Updated IBRD GCI needs assessment



Reform of loan maturity terms

32. In February 2008, the Board approved management's recommendation to simplify and extend the maturity limits for IBRD loans as part of the strategy to strengthen the Bank's engagement with middle-income countries. While recognizing that the loan maturity extension would lead to higher capital utilization over time, no extra loan charges were proposed at that time considering IBRD's then strong capital adequacy position. In light of the recent changes in IBRD's capital adequacy outlook, one of the potential options to enhance IBRD's capital capacity while still retaining the simplicity of the current maturity policy would be to restore the maturity limits to the maximum level before 2008[6] while offering borrowers the option to extend the maturity with a premium.

33. This approach was presented in the October DC paper and also discussed with the Board at an informal meeting in January; it will be finalized during the year-end integrated discussion on budget, net income and pricing in June.

34. In addition, on the broader sustainability of general loan pricing, work is underway to develop principles to link loan pricing to cost coverage. Preliminary discussions at a Board seminar in March indicated broad consensus on the general principle that pricing should cover lending-related costs. Remaining issues on this topic will be further discussed in April-May as well as during the FY10 year-end integrated financial discussions in June.

[6] This refers to the maximum maturity limits for variable-spread loans before 2008.

IV. STRUCTURING OF GCI

35. This section discusses the various issues related to the structuring of the GCI, including NCPIC, the ratio of paid-in vs. callable capital, subscription period, and contingent options. It reflects outcome of multiple rounds of bilateral and Board discussions, as well as feedback from DC Deputies.

National currency paid-in capital

36. In prior capital increases, IBRD members have been required only to contribute 10% of their paid-in portion of a capital increase in gold or US dollars, which could be freely used by the IBRD in its operations; the remaining 90% could be paid-in in the national currency of the subscribing member. The use of this national currency paid-in capital is subject to significant restrictions absent further member consents that allow this capital to be usable for the Bank in its operations. As discussed earlier in this paper, currently about $2 billion of IBRD's total $12 billion paid-in capital is in the form of unreleased NCPIC and is hence not fully usable by the Bank in its operations. Management has worked extensively with relevant members to seek release of their non-usable NCPIC and will continue its effort to seek the maximum release.

37. As only the released national currency paid-in capital is considered usable and available to support IBRD's lending, the usability of the national currency paid-in capital in the current GCI has a significant impact on the amount of the paid-in capital required. For example, if only 50% of the NCPIC in the current GCI is released, the required paid-in capital increase would nearly double from the current $3.5 billion level. Similarly, a low rate of usability in the paid-in capital from the SCI due to unreleased NCPIC would also increase the amount of the paid-in capital required from the GCI.

38. In light of the above, management will recommend unrestricted and immediate usability of NCPIC be made a condition of the subscription to both the current GCI and SCI so that their entire paid-in portions can be used to support IBRD operations.[7] Unrestricted usability of paid-in capital from the SCI will reinforce the linkage between increased IBRD shareholding and voice and increased responsibility for contributions to IBRD's capital resources.

Paid-in vs. callable capital

39. While usable paid-in capital is the form of capital most needed by the IBRD in supporting its lending, a higher level of callable capital will provide the following benefits:

- Allowing a reasonable cushion between IBRD's projected disbursed loan exposure and the Statutory Lending Limit (SLL) as defined in the Articles to ensure there is no risk of breaching that limit in the projection horizon. Currently disbursed and outstanding loans are projected to reach 97% of the SLL limit by FY19. Extra cushions relative to the SLL limit would also help minimize the likelihood for

[7] One method to effect unrestricted usability would be to establish a structure similar to a "repurchase" of NCPIC so that a member would pay for its subscription in its national currency which would be immediately converted by the Bank as the member's agent into a currency that it uses in its operations (EUR, JPY, USD, etc.). For members where this mechanism would not work because their national currency is not freely convertible, a convertible currency of the member's choice could be required to ensure full usability.

members to return to their legislatures for additional callable capital given the infrequent nature of GCIs.
- Directly addressing the concern of some shareholders that IBRD's total loan exposure including undisbursed commitments[8] would start to exceed SLL from as early as FY12.
- Preventing IBRD's total capital size from falling below that of other MDBs.
- Providing additional comfort to IBRD bondholders.

40. IBRD currently has a total subscribed capital of $190 billion, of which about 6% has been paid in, reflecting the average historical paid-in ratio. Applying this 6% historical average ratio to the current GCI with $3.5 billion in paid-in capital would result in an increase of $58 billion in total subscribed capital and a $55 billion increase in callable capital.

41. Analysis of IBRD's projected lending and the SLL requirements indicates that a $58 billion increase in total subscribed capital would be consistent with the amount required to ensure that loan exposure including undisbursed loans do not exceed the SLL and that loan exposure excluding undisbursed loans also do not exceed 80% of the SLL limit. This amount would also help ensure that IBRD's total capital size would not fall below that of other MDBs, considering the $110 billion approved capital increase for the Asian Development Bank and the capital increase plans in other MDBs.

42. While a $55 billion callable capital increase is lower than the amount of callable capital increase in any of the last three GCIs adjusted for inflation (see Figure 4 below), management considers it a reasonable amount which strikes an appropriate balance between the need for ensuring that IBRD maintains a reasonable cushion relative to its Articles-required SLL limit and the effort to limit contingent liability on members during the current challenging times.

Figure 4. IBRD's Historical GCIs

Year of GCI	Increase of Subscribed Capital	Increase of paid-in capital (paid-in ratio)	Increase of callable capital	Increase of paid-in capital in FY09$	Increase of callable capital in FY09$
1959	$10B	0	$10B	0	$74B
1979	$40B	$3B (7.5%)	$37B	$9B	$110B
1988	$74.8B	$2.2B (3%)	$72.6B	$4B	$133B

[8] Even though the SLL as defined in the Articles is only applicable to the disbursed and outstanding loans, some Board members have expressed concerns about disbursed and undisbursed loans projected to exceed SLL because (1) there is a risk that undisbursed loans may disburse faster than expected, especially under crisis situations, and (2) the Board may be uncomfortable approving new loans when disbursed and undisbursed loans are approaching or exceeding SLL. This adjusted SLL test is conservative in assuming that all loans disburse immediately (although it also makes the less conservative assumption of no additional non-accruals).

Subscription period

43. The $3.5 billion GCI figure presented earlier in this paper was derived based on the assumption of a 5-year subscription period, which was the subscription period adopted in IBRD's historical GCIs; it assumes that there will be a uniform pay-in of the $3.5 billion over the FY12-16 period.

44. In response to some members' initial interest in an extended subscription period, management explored the option of extending the subscription period from 5 years to 8 years. Due to time value of money, any extension of the subscription period would result in an increase in the required FY12 GCI amount. Extending the subscription period from 5 years to 8 years would result in an increase in the required FY12 GCI paid-in amount from the current $3.5 billion to $3.8 billion. In light of this and based on subsequent feedback from members regarding associated budgetary benefits and costs, management recommends the adoption of a 5-year subscription period for the GCI in keeping with past practice.

Contingent approach

45. In response to the October DC Communiqué request that management considers contingent approaches to the capital increase, management conducted extensive exploration on a wide range of possible contingent approaches and discussed its analysis with the Board at a Board seminar in December. At that seminar, management presented potential options for both the contingent pay-in and contingent pay-out mechanisms. Annex II provides a detailed discussion of all these options, as well as their advantages and disadvantages.

46. *Contingent pay-in*. By making paid-in capital payable only upon a certain trigger such as E/L ratio falling below a certain level, a contingent pay-in mechanism would help address some members' concerns that crisis lending demand might be lower than expected. Two options were discussed at the seminar under the contingent-in mechanism, including, first, GCI with 100% callable capital with a paid-in portion contingent upon a certain E/L trigger and, second, GCI with 100% callable capital with contingent convertible debt equal to the desired paid-in portion. In addition, in response to the suggestion from one member, management also explored the option of making the second half of a GCI contingent on a mid-term review of capital adequacy.

47. While all the options would allow the pay-in of the capital increase to be contingent upon either a pre-defined trigger such as E/L falling below 23% or a review at a predetermined time, they have a number of disadvantages including complexity as well as uncertainty, which would result in the GCI being heavily discounted in the eyes of bond investors and rating agencies and raise questions about shareholder support. These limits would inhibit IBRD's market access and hence its effort to continue supporting the global recovery and boosting economic growth through these uncertain times; they would in particular carry negative implications for how the market views supra-sovereign credits[9] at a time when government credit risks are being reassessed. They also do not offer significant budgetary or legislative benefits for many members. Feedback from members at the December seminar indicated that there is little interest in the contingent pay-in mechanism among members.

[9] MDBs are considered supra-sovereign credits by rating agencies.

48. *Contingent pay*-out. A contingent pay-out mechanism, by returning capital when no longer required, addresses some members' concerns that post-crisis lending levels might not require permanent capital increase. Four potential options were discussed for implementing a contingent pay-out, including returning capital via a share cancellation provision, multi-year dividend, transfers to IDA or other uses, and redirecting capital to LTIP. Options on using an external indicator or the internal E/L ratio as the trigger for the pay-out were also discussed.[10]

49. While some members expressed interest in the option of transferring to IDA once the GCI is no longer needed by the IBRD, others raised concerns about the complexity and legislative challenges of such approach. This intention could be met through an existing mechanism such as the income allocation process. Should the GCI no longer be needed by the IBRD to back lending in the future, it would be redirected through the annual income allocation process to other purposes as decided by members,[11] with strong considerations given to IDA transfers to support the poorest countries. Subject to future Board decision, the redirection of the GCI resources would start after IBRD's E/L ratio has reached the upper bound of its capital adequacy range, currently 27%. In addition, a review would take place after the E/L ratio had reached the middle of the capital adequacy range, currently 25%, to determine, in the context of IBRD's capital adequacy and financial sustainability, the timing of the redirection of the GCI resources. The review would also take into consideration external indicators such as EMBI spreads, interest rate environment and private financing flows to developing countries, as well as IBRD's financial sustainability, in particular, whether its capital adequacy is projected to further strengthen after reaching the indicated trigger ratio and result in an appropriate level of capital cushion. In the interim, the relative rate of income allocations to reserves and transfers will be determined under a net income allocation framework, noting the base line of the current IDA transfer of $583 million per year. Discussions on considerations surrounding such a framework already started at a seminar in March and will be continued during discussions in April-May as well as the FY10 Net Income paper in June. At the March seminar, management also proposed to synchronize the decision-making process for annual deliberations on income allocation with both budget and loan pricing to further strengthen the financial model.

V. CONCLUSION

50. Since the current crisis first struck, IBRD has responded with speed, innovation and force. Its record level of assistance to its clients in response to the crisis is projected to stretch its capital adequacy and significantly constrain its ability to deliver further assistance to the developing world and foster global growth. While recovery from the crisis remains fragile and demand for IBRD assistance remains high, IBRD is already constrained in how much it can deliver with existing resources. Should the recovery falter in 2010 or 2011, IBRD would not have the capacity to respond as it did in the past in the absence of a capital injection.

51. The institution has already taken a number of measures to enhance its financial capacity, including a 20 basis point pricing increase in August 2009, maintaining real flat budget even when it tripled its lending, and working with relevant members to turn the portion of its existing capital that is not fully usable in operations into fully usable risk capital to support lending. It

[10] See Annex II for discussions on using external triggers.
[11] Under those circumstances, members could also collectively decide, through the annual income allocation process, to allow individual member choice as to how they would like to redirect their shares of the GCI.

has also started discussions with the Board on developing principles for loan pricing and income allocation to further strengthen its financial model.

52. Further actions, however, are needed to ensure that after the current crisis, IBRD will continue to have the financial capacity to deliver its development roles. A $58 billion GCI with $3.5 billion in paid-in capital, IBRD's first GCI for 20 years, would be accompanied by the other measures including continued budget discipline, further effort to seek release of existing NCPIC, expected capital injection from the SCI, and reform of loan maturity terms, which will be finalized during the year-end integrated financial discussions in June. Reflecting mutual responsibility and sharing of interests, such a package will allow IBRD to continue its assistance to the global recovery from the crisis and return to a modest level of $15 billion in annual lending in nominal terms after the crisis, which represents the average of its actual lending for the decade prior to the crisis in real terms. A GCI of the proposed size will also build a reasonable cushion relative to the SLL limit required by the IBRD's Articles. If approved, this GCI will increase IBRD's paid-in as well as total subscribed capital by approximately 30%.

53. In light of the above, management recommends a $58 billion GCI, with 6%, or $3.5 billion in paid-in capital for the IBRD. The GCI would be agreed with a clear understanding that if it is no longer needed by the IBRD to back lending in the future, it will be redirected through the annual income allocation process to other purposes as decided by members, with strong considerations given to IDA transfers to support the poorest countries. In order to ensure the full amount of the paid-in capital from the current GCI and the current SCI can be used in support of Bank operations, management further recommends that subscriptions to both the current GCI and the current SCI be conditioned upon unrestricted and immediate usability of the NCPIC.

Chapter 2. IFC Financial Capacity and Capital Adequacy

I. EXECUTIVE SUMMARY AND BACKGROUND

Executive Summary

54. The recent IFC Road Map, FY11-13 paper (Board Report IFC/SecM2010-0025) discussed at the joint meeting of Committee on Development Effectiveness (CODE) and the Budget Committee on March 17, 2010 were based on a projected growth rate of 9% to 10% p.a. in investment commitments over the next six years. Although IFC has grown at about 18% p.a. on average for FY2001 to FY2009, given the constraints IFC's management believes that a 10% annual growth rate presents the best trade-off between financial capacity constraints and the tremendous needs in IFC's market place and the extraordinary demand for private sector finance.

55. Management would like to highlight that even at a 10% p.a. growth rate investment growth will be slower compared to the recent past. IFC's investment program growth was 39% in FY2008; 23% in FY2007 and 25% in FY2006, with new commitment slower in FY09 (-7%) as a result of the crisis and the emerging capital constraint. The period of high growth facilitated IFC's recent crisis response as well as its strong move into IDA and frontier markets.

56. The previous reviews of IFC financial capacity since September 2009 were based on alternative growth scenarios ranging from 6% p.a. to 10% p.a. While the reaction of shareholders has been generally supportive, IFC Management has been asked to present an alternate intermediate scenario. Accordingly, in the interest of reaching a consensus, Management is now proposing an investment growth rate of 7% to 8% p.a. as an indicative base case for the FY11-FY16 period.

57. The rate of growth of investment commitments is the primary driver of IFC's financial capacity requirements. If consensus is achieved around the 7% to 8% investment growth rate, this would require an enhancement in IFC's financial capacity of $1.7 billion, as described in Section III of this Chapter. This aggregate enhancement could be achieved through a package of options consisting of Voice Reforms at IFC with shares acquired through a Selective Capital Increase, a long-term hybrid instrument, and earnings retention, with net income designations to be decided by the Board in line with established practice.

Background

58. The global economy appears to be on a path to recovery, although progress is likely to be slow, uneven and fragile. Developing countries will be an important engine of growth, aided by a resurgent private sector. The crisis set back the fight against poverty and made development challenges even more formidable. Although there is increased demand for private sector-led development, as governments face fiscal constraints, the private sector itself is facing a financing gap that is likely to persist for years, particularly in IDA countries. The demand for IFC's services has never been greater.

59. As the largest multilateral provider of finance to the private sector in developing countries, and as part of the World Bank Group (WBG), IFC is uniquely able to address the global challenges of the new normal across regions and sectors, through its investment, advisory

and mobilization activities, and in bringing together a combination of public and private approaches. The challenge for the Corporation is to be selective and to optimize constrained resources while maximizing reach and impact.

60. With sufficient financial capacity, IFC could achieve compound growth rates of 7% to 8% p.a. in investment commitments between FY11-16, with additional growth through mobilization. IFC would continue to focus on those priority areas where development impact and additionality are greatest, but with enhanced emphasis on reaching the most vulnerable, in particular through investments in Africa and Fragile Situations, financial inclusion, and social needs and physical infrastructure, on climate change, as well as on building up IFC's equity.

61. By contrast, in the event that IFC's financial capacity is constrained at current levels, IFC's projected investment program would be significantly impacted, with a need to possibly reduce new commitments for FY10 and constrain growth rates to 5% to 6% p.a. going forward. Total FY11-16 commitment volume in this scenario could be up to $10 billion lower than if IFC had sufficient financial capacity for higher growth. Whatever the growth path endorsed by the Board, we will continue to have a strong focus on frontier markets, especially IDA countries, on climate change, where we can take a leadership role in the private sector involvement, on micro and small and medium enterprises and the needs at the base of the pyramid (BOP), and on financial inclusion, infrastructure and food security. However the extent to which we can pursue these priorities, especially the riskier areas, will depend on IFC's financial and operational capacity.

62. This Chapter provides an overview of IFC's reach (Section II), explains the Corporation's current financial position and projected financial needs (Section III), summarizes the options to strengthen the Corporation's financial capacity (Section IV) and proposes conclusions and next steps (Section V).

II. DEVELOPMENT IMPACT OPPORTUNITIES

External Environment and the Demand for IFC's Services

63. In response to the deepest global recession since the Great Depression, governments stabilized financial markets with exceptional monetary and quantitative easing, liquidity injections and fiscal stimulus, and the world is slowly coming out of the crisis. Markets seem to believe that the worst part of the crisis is over. However, the ongoing global economic recovery remains fragile, and the fallout from the crisis is expected to change the global economic landscape for several years to come.

64. Despite a return to positive growth, it is expected to take several years before economies recoup the losses already suffered. Within an environment of reduced financing flows to developing countries and budget constraints, governments are struggling to address these enormous challenges. With these challenges, the demand for private sector-led development has increased significantly.

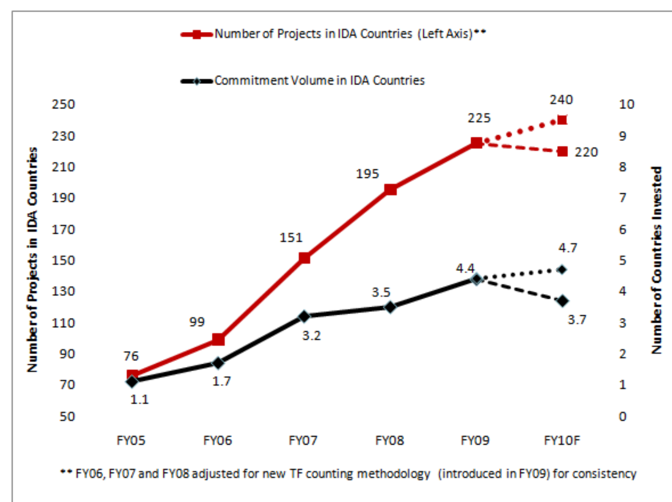
65. The demand for IFC's services has never been greater. The private sector itself faces a financing gap that is likely to persist for years, and the investment climate and gaps in local

private sector know-how in most developing countries continue to constrain the potential for sustainable private-sector-led solutions. Other IFIs are also stepping up activity, but the response falls far short of meeting the need. In fact every dollar of capital in IFC supports $1.20 of investment in IDA.

IFC in IDA and Other Frontier Markets

66. IFC has placed the poorest countries and the "Base of the Pyramid" at the top of its agenda. In FY09, IFC new investments in IDA countries totaled 225 projects worth $4.4 billion, accounting for 50% of all IFC projects, an increase from 47% in FY08 (Figure 5). This significant increase in commitments and advisory spend in these markets is a result of concentrated effort and accelerating decentralization.

Figure 5. IFC Investments in IDA Countries (FY05-FY10F)



67. The number of IDA commitments tripled between FY05 and FY09, from 32% in FY05 to 50% of FY09 projects in IDA countries. IDA commitment volume quadrupled over the same period to $4.4 billion, or 42% of volume (from $1.1 billion, or 21% in FY05). The compound annual growth rate (CAGR) of IDA investments was 41% in the FY05-09 period (50% without India), compared to 18% for IFC as a whole and 4% for the BRCT[12] (without India).

68. IFC's record shows that it has consistently been willing to move out of countries or sectors where it could no longer play its catalytic role and re-focus its activities to where the needs for IFC were greater. This is illustrated by our recent growth in poorer frontier markets and move away from countries such as Poland and the Baltics, and by the streamlining of our advisory activities. Within countries, particularly those which are more developed, we have shifted away from areas where our role is complete and additionality was declining, in particular by sharpening our Middle Income Country focus on strategically important areas such as climate change and reaching the under-served. Examples of where IFC has done this in the past include Russia, where IFC is no longer active in the mortgage-finance market, which it helped to open

[12] BRCT: Brazil, Russia, China and Turkey

up, and Eastern Europe micro-finance projects, where we are being much more selective in markets which have successfully developed this industry.

69. IFC has substantially increased the number of countries served in recent years, reaching 103 in FY09, 60 of which were IDA countries, a significant increase from 29 countries in FY05. Several of these were small states in Africa, the Caribbean and the Pacific. Being more decentralized has allowed IFC to reach further into the frontier, not only in terms of volume but also in terms of geographic reach. IFC plans to open nine new offices over FY10-11[13] of which seven would be in IDA countries or post-conflict states.

70. Sub-Saharan Africa has been a particular focus of IFC's activities, and as a result of these efforts IFC investment volume grew by 161% and its projects by 142% between FY06 and FY09. IFC also increased the number of Sub-Saharan African countries in which it is active with both investment and advisory services, from 21 in FY02 to 37 in FY09. Despite the crisis, IFC's investment volume in this focus area grew to $1.8 billion in FY09, 17% of overall IFC investments and an increase of 32% above FY08. This was the only region to show an increase in commitments in FY09, and is forecast to be the fastest-growing region over the FY11-13 period, reaching around $3.2 billion, subject to IFC having sufficient financial capacity.

71. **Future of IFC in IDA and other Frontier Markets**. In order to address poverty, unemployment and conflict, and to provide high levels of additionality, IFC will continue to have a geographic focus on IDA countries and other frontier markets. Around 50% of IFC's projects, and nearly 60% of advisory project spend, are expected to be in IDA countries. Sub-Saharan Africa is expected to be IFC's fastest growing region, with investments at 21% of IFC volume by FY13, and with advisory project spend growing to nearly 30% in FY13, with significant additional reach across sectors. Including North Africa, Africa's share of overall volume for own account is projected to increase from 21% in FY09 to around 25% by FY13. IFC will also continue its efforts to address poverty and lack of access in the frontier regions of Middle Income Countries.

72. IFC has an increasing focus across its investment and advisory businesses on the needs "at the base of the pyramid," whether in IDA or in Middle Income Countries. IFC's strategy in this area is to increase the number of financially sustainable, inclusive business models operating at scale, so as to address the issue of access to goods, services, and livelihoods for billions of low-income people. Through this strategy IFC will support firms that are incorporating the poor into their business models as producers, consumers and distributors with investment and advisory services. IFC is also aiming at a broader impact beyond its client base.

III. UPDATED FINANCIAL CAPACITY NEEDS

Background

73. IFC entered the crisis with a strong capital position. As of end-FY07, total resources available were at $13.8 billion, well in excess of the minimum required level at that time of $7.9 billion to support IFC's AAA rating. Deployable Strategic Capital (DSC), as of end-FY07, was at its high-point of $4.5 billion, which translates to about 33% of total resources available. This financial flexibility helped IFC weather the crisis and maintain financial strength to play an

[13] Dar, Lusaka, Ouagadougou, Bamako, Baghdad, Kolkata, Thimpu, Kingston, Asuncion

effective role, as well as helping to support private sector to take a lead in the ongoing economic recovery.

74. Beginning in FY08, however, there has been a steady decline in the Corporation's financial flexibility in terms of capital available to support growth. As of end-FY09, Deployable Strategic Capital was 16% of Total Resources Available, about half of the peak level reached in FY07 (see Figure 6). In addition to the decrease in DSC, the peak to trough decrease in IFC's unrealized capital gains was about $5 billion. The lower deployable strategic capital levels were due to: (i) slower increase in resources available, during FY08 and FY09; and (ii) rapid rise in resources required during the two years.

75. Growth in resources available was affected by crisis-related write-downs, especially in IFC's equity and treasury portfolios, as well as the high level of designations, particularly related to IDA15 ($1.15 billion has been distributed since FY08). Rapid growth in resources required arose from both portfolio growth and an increased share of equity investments.

76. This rapid change in financial flexibility, over just two years, highlights the sensitivity of IFC's capital adequacy to volatile market environments and economic crises.

Financial Capacity Projections

77. IFC's methodology for calculating DSC is set to allow IFC to maintain a AAA rating over an economic cycle; this methodology was externally validated by PricewaterhouseCoopers in FY09 and is consistent with Basel II.

78. The Crisis Reserve which has been added to IFC's capital framework is defined as the financial resources needed during a crisis event to provide for a short one year 'surge' in investment commitments over and above the limited commitment growth that would otherwise be available. Maintaining a Crisis Reserve is consistent with IFC's mandate to provide private sector support in times of financial crisis. By contrast, the countercyclical buffer equates to the increased financial resources required to for the existing portfolio in the event of a downturn, aligned with the recent Basel Committee proposal. The Corporation has estimated the Crisis Reserve to be 5% of Total Resources Available, an amount that would provide additional commitments of about 20% to 25% above the program assumptions (i.e. about $2.5 billion - $3 billion) in the year of crisis. Post-crisis, the reserve would be rebuilt to ensure that IFC was in a position to respond should there be further crises.

79. Incorporating the 5% Crisis Reserve in this paper allows for a simpler and more transparent approach to estimate financial capacity to withstand crises in that we are now analyzing only the base case economic scenarios and how the projected results relate to the Crisis Reserve, as illustrated in Figure 6. This reserve can also be used in place of the downturn scenario discussed in earlier papers.

Key Definitions

Total Resources Available: Net worth plus general and specific loss reserves (i.e. net worth plus total loss reserves). This is the level of available resources under IFC's risk based capital adequacy framework.

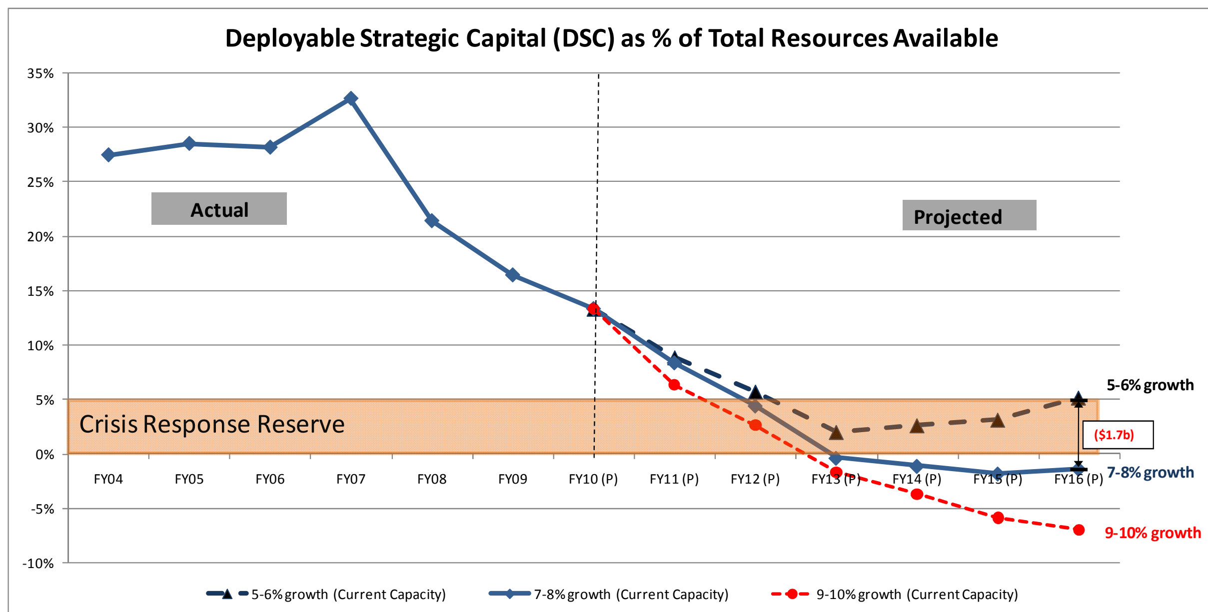
Deployable Strategic Capital (DSC): the minimum capital required to maintain IFC's AAA rating during a downturn.

Please see IFC FY09 Annual Report on Financial Risk Management and Capital Adequacy, July 30, 2009 (IFC/R2009-0202/2).

80. IFC's financial capacity reports in September 2009 and February 2010 assessed required financial capacity based on an average of the estimates for a projected shortfall in deployable strategic capital in FY16 under the base case as well as in a downturn scenario. This paper reports resource requirements based on the capital shortfall with respect to the DSC and Crisis Reserves. The results of the two approaches are based on similar assumptions and the results remain roughly comparable, but the updated approach provides increased transparency in that the results are not dependent on the numerous downturn performance assumptions that drive results for the downturn scenario.

81. Figure 6 presents the financial capacity implications of the above updates. As shown, the weakening of IFC's financial flexibility continues even under moderate growth assumptions, highlighting IFC's capital constraint over the medium term. IFC's current capacity only supports FY11-16 investment program growth in the range of around 5% to 6% p.a. without depleting the Crisis Reserve. Higher growth rates will result in capital shortfalls and depletion of IFC's crisis response capability.

Figure 6: IFC's Financial Flexibility (FY04-FY16P) – Implications for Investment Growth Scenarios (5% to 6% p.a. 7% to 8% p.a. and 9% to 10% p.a.) with Current Financial Capacity



82. As shown in Figure 6, in the case of 7% to 8% p.a. growth shown by the middle, solid line on the chart, the projected deployable strategic capital reaches FY16 with DSC slightly negative and with the crisis response reserve fully depleted. In this case, $1.7 billion in additional financial capacity would be needed to ensure that DSC remains positive and to rebuild the Crisis Reserve. In the case of 9% to 10% p.a. growth (depicted by the dotted line), DSC would be severely depleted by FY16, with about $1.7 billion in capital resources required just to bring DSC to zero, but still leaving the Crisis Reserve fully depleted. Projections estimate that under a 9% to 10% p.a. growth scenario $3.0-$3.2 billion of additional financial resources would be

needed to restore the Crisis Reserve by FY16. With reduced investment growth in the remainder of FY10 and a 5% to 6% p.a. growth for FY11-FY16, DSC decreases at a lower rate and projections indicate that the Crisis Reserve would be rebuilt by FY16 leaving IFC with no need for additional financial resources.

83. Besides capital requirements and growth, the key assumption in these projections is return on equity which is IFC's largest driver of income and is highly volatile. These capital capacity projections include updated FY10 Net Income projections, driven largely by increases in equity gains and dividend rates. While FY10 income has increased considerably compared to prior estimates, the impact on the overall results is less dramatic because the projections cover a long time horizon (6 years or so). In addition to the improved income profile for FY10, IFC's financial capacity estimates have also been updated for key FY11-FY16 assumptions based on actual results from the first half of FY10, as described in Annex III.

Financial Capacity Enhancement Needed

84. As shown in Figure 7, the updated projections indicate that IFC's capital is constrained over the medium term and there is still a financial capacity shortfall of $1.7 billion at the end of FY16.

Figure 7: Projected Capital Shortfall at end-FY16 (Sep 2009, Feb 2010 and Mar 2010)

(Figures in US$ billion)	Projected Capital Shortfall Base Case	Projected Capital Shortfall Downside Scenario	Required Increase in Financial Capacity
September 2009	(1.3)	(3.2)	1.8 - 2.4
February 2010	(1.1)	(2.7)	1.8
March 2010	(1.7)		1.7

85. In the financial capacity estimates performed in September 2009, the range of the capital shortfall was between $1.3 billion and $3.2 billion and the financial capacity need was estimated in the range of $1.8-$2.4 billion. Updated projections in February 2010 indicated a shortfall range that was slightly smaller (i.e. $1.1 billion to $2.7 billion) resulting in an estimated financial capacity need of about $1.8 billion. The capital shortfall based on the March 2010 update combines the impact of base case and recession projections in that the downside capital needs are incorporated into the crisis response reserve and counter-cyclical buffer when estimating financial capacity needs. At a base case growth rate of 7% to 8% p.a., the overall financial capacity need using this updated projection approach is $1.7 billion, slightly lower than previous estimates.

86. The following section presents various options to mitigate the financial capacity gap.

IV. OPTIONS TO STRENGTHEN FINANCIAL CAPACITY

87. Over the past year, Management has developed and presented to shareholders several options that could potentially augment IFC's financial capacity. We are now recommending a package of options that have emerged from consultations with Executive Directors' offices as well as capitals, a series of Board engagements and guidance from the Development Committee Deputies Meeting on February 19, 2010. The proposed options include: (i) Selective Capital Increase (SCI); (ii) Long-term Hybrid Capital (LTH); and (iii) Earnings Retention.

88. The General Capital Increase (GCI) option that was included in earlier papers has been excluded from the scenarios proposed since it appears that a consensus amongst shareholders around a package involving GCI cannot be achieved at this time.

Selective Capital Increase

89. The IFC Voice Reform with the purpose of increasing representation by Developing and Transition Countries (DTC) at IFC is making progress. Funds that would be contributed in connection with Voice Reform will also improve IFC's financial capacity and demonstrate shareholder support. However the funds raised through an SCI, while helpful, will not be sufficient to address the Corporation's financial capacity constraint.

Long-term Shareholder Hybrid Capital

90. The long-term hybrid capital (LTH) instrument is an innovative financing source for extending IFC's capital base. The LTH offers a flexible new instrument for managing future financial capacity augmentation, in line with recent Basel Committee recommendations for developing contingency capital plans to enhance banking institutions' resilience. The LTH, in combination with other capital enhancement mechanisms such as the SCI and earnings retention, can close the financial capacity gap while at the same time creating a new strategic instrument for capital management.

91. The subscription to the long-term hybrid capital issue by IFC's shareholders would be voluntary and would carry no voting rights, and therefore would not impact the discussions on Voice. The proposed hybrid capital issue can be executed under IFC's existing statutory authorities, but would be approved in advance by IFC's Board of Directors.

92. The hybrid capital is being structured to obtain high capital credit from the major rating agencies, targeting an equity credit of at least 75% of the issue amount, based on discussions with the rating agencies so far. The structural features that have been proposed to attain high capital credit are: (i) Subordination to all other IFC debt; (ii) Contingent and Non-cumulative Coupons: Coupon payments that are contingent on IFC generating sufficient net income to provide for the resources required to maintain IFC's AAA-rating and other financial directives from the Board; and (iii) Perpetual maturity, but callable beginning in (say) year 15, and every 5 years thereafter. In order to call the issue, IFC's capital adequacy after such redemption would need to remain at a level consistent with IFC's financial policies. In addition, a sinking fund would be established from the 6th year to provide for redemptions. Annual payments into the sinking fund would be at the discretion of IFC in consultation with its Board of Directors, and would be contingent on IFC's income and financial position.

93. The interest rate paid by the Long-term Hybrid Capital instrument is yet to be determined, but could possibly be the 15-year U.S. Treasury yield. This interest rate has been suggested since U.S. Treasuries are a widely used return benchmark among IFC's shareholders' investment portfolios, and it would also demonstrate shareholder support for the issue.

Earnings Retention

94. IFC's capital position is affected not only by the amount of new capital received, but also by the earnings distributed. Until FY05, IFC had retained 100% of earnings to support future growth and risk bearing capacity. Beginning in FY05, IFC has used an 'income based sliding scale formula' to set aside a portion of income for funding advisory services, IDA grants and other higher risk but innovative and high impact initiatives.

95. Since the adoption of the 'income based formula' which has been accepted by the rating agencies IFC has designated only up to the maximum level determined using this sliding scale formula. In FY08, IFC provided an indicative undertaking of $1.75 billion to IDA15 and has already transferred $1.15 billion. This undertaking reflected assumptions of continued strong financial performance and given the volatility of IFC's returns over the period such indicative commitments faced substantial constraints. In FY09 when IFC's income did not allow for any designations according the formula, the Corporation reallocated $200 million from prior designations for other special initiatives on an exceptional basis.

96. IFC's earnings volatility over the past few years has highlighted the need to build up sufficient retained earnings during years of strong performance in order to meet minimum capital requirements and its development mandate during years of economic downturn. Current projections assume that 40% of IFC's new commitment volume will be in IDA countries by FY16, and Management anticipates that this strategic shift in IFC's investment portfolio could result in a further increase in volatility as well as an increased need for IFC to deliver "surge" resources during times of financial crisis.

Linkages Between Capital Raising Options

97. Important linkages exist between the potential sources of capital for IFC. Interest in the long-term hybrid was originally tied to the General Capital Increase which has now been removed. Demand for the LTH option is still uncertain; while some shareholders have expressed interest in examining this option further, indications are that they would provide further feedback only after satisfactory resolution of the IFC Voice exercise and there is clarity on potential earnings retention. There appears to be a positive correlation between the size of the SCI and that of the hybrid, partly because shareholders who are satisfied with the outcome of the IFC Voice exercise will have less difficulty obtaining authorization for a hybrid subscription. A good resolution on the IFC Voice Reforms will create goodwill for the long-term hybrid and could generate a positive momentum among shareholders.

98.

99. The amount that can be raised with the long term hybrid also depends on shareholder views regarding potential earnings retention. Successful subscriptions to the long term hybrid will require assurance to participating shareholders that their investment will result in an actual

increase in IFC's financial capacity. Management expects possible subscriptions to the long-term hybrid instrument to happen only after the SCI and earnings retentions have been addressed.

V. CONCLUSIONS

100. IFC is committed to reaching the poor but the development impact, reach and investment program growth that are possible, over the medium term, will depend on IFC's aggregate financial capacity and the level of crisis response capacity required to withstand future crises.

101. At current capacity, the Corporation can only plan for an investment program in the range of 5% to 6% p.a. (from FY11 through FY16) with a possible need to reduce FY10 new commitments from current projections. Growth levels in this range would allow the Corporation to rebuild capacity to better serve its crisis response role in the future by gradually adding to a Crisis Reserve through FY16. Even in this scenario, IFC will continue to have a strong focus on our strategy and program plans including frontier markets , especially IDA countries. However, the extent to which we can pursue these priorities, especially in the riskier areas, will depend on IFC's financial and operational capacity.

102. On the other hand, with sufficient financial support IFC is well positioned to deliver significant strategic impact. For example, with a financial capacity enhancement of about $1.7 billion the Corporation could rebuild its ability to respond during economic downturns while delivering an investment program with 7% to 8% commitment growth p.a. from FY11 through FY16. Although this scenario requires reassessment of IFC's strategy and program plans, the impact on IDA and other Frontier markets would be much less severe.

103. Management is recommending a 7% to 8% p.a. investment growth rate as an indicative base case for the FY11-FY16 period, which if endorsed by shareholders will generate a $1.7 billion financial capacity requirement. Management is asking for endorsement of a package of options to combine increase in Voice at IFC with shares acquired through a Selective Capital Increase, the issuance of a long-term hybrid to shareholders to boost capital, and earnings retention – subject to further Board decisions.

104. The proposed package can close the financing gap and restore IFC's financial flexibility. The chosen options also incorporate innovative approaches and greater financial discipline. Shareholder support for financial capacity enhancement as outlined above can have the potential to send a strong signal to IFC's clients, partners and investors on member country support for the Corporation's pre-eminent role in private sector development.

Annex I. Assumptions underlying IBRD Financial Projections

1. This annex presents the key assumptions underlying the updated projections of the expected scenario.

2. **Interest Rates.** Tables 1 below show the current expected scenario interest rate projections for six-month LIBOR and 10-year swap rates in US dollar, EUR and JPY, which are based on implied forward market rates at the end of February 2010.

Table 1: Interest Rate Assumptions Based on Implied Forward Market Rates (Percent)

USD	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
6 Month	0.57	1.28	2.52	3.55	4.21	4.69	4.93	4.83	5.00	5.50
10 Year	3.76	4.25	4.69	4.99	5.18	5.30	5.36	5.40	5.46	5.48
EUR	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
6 Month	0.95	1.57	2.41	2.93	3.48	3.86	4.16	4.37	4.49	4.58
10 Year	3.48	3.69	4.00	4.25	4.43	4.56	4.63	4.67	4.67	4.65
JPY	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
6 Month	0.49	0.47	0.60	0.76	1.01	1.32	1.70	2.04	2.36	2.63
10 Year	1.44	1.61	1.85	2.08	2.31	2.51	2.69	2.83	2.94	3.01

3. **Loan Volume.** The expected scenario financial projections are based on the Expected Case of the Interim Update of the FY10 2nd Quarterly Corporate Lending Projection.[14] This gives IBRD loan commitments of about $44 billion for FY10, $33 billion for FY11, $26 billion for FY12, and $15 billion flat from FY13 onwards.

4. **Loan Composition.** The current expected scenario projections assume that the composition of new loan commitments between fixed spread loans and variable spread loans is 15:85 for FY10, 20:80 for FY11, 25:75 for FY12, and 30:70 from FY13 onwards. Of fixed spread loans, 20% is assumed to take advantage of the automatic rate fixing on disbursed amounts. The expected scenario projections assume that 82% of new commitments are in US dollar, with the rest in EUR, and that the composition between adjustment (fast disbursing) and investment (slow disbursing) loans is about 50:50 for FY10, 27:73 for FY11, and 22:78 for FY12 based on near-term projections, and 25:75 from FY13 onwards in line with long-term expectations.

[14] The Quarterly Corporate Lending Projections reflect detailed, bottom up, country-by-country forecasts yielding a possible range (Expected, High and Low Cases) for the three years (FY10-12), which are approved by Regional Vice Presidents and Managing Directors. Traditionally, these projections are firmer in the current year of the projection period and less precise in capturing potential IBRD demand in outer years, especially given that development policy operations (DPO) type operations usually appear in the pipeline closer to their approval dates, within the same fiscal year.

5. **Loan Prepayments.** Prepayments are assumed to be about $1.2 billion in FY10[15], $0.25 billion in FY11, and $0.35 billion from FY12 onwards.

6. **Loan Loss Provisions (LLP).** Under the expected scenario, LLP expenses are currently projected to be $23 million in FY10, $121 million in FY11 and $106 million in FY12. For FY13 and beyond, projected LLP expenses result in a ratio of loan loss provisioning to the accrual portfolio including the present value of guarantees of about 1.1 percent.

7. **Funding Cost.** It is assumed in the expected scenario projections that the cost of debt funding the IBRD Flexible Loan (IFL) fixed spread product is 6-Month LIBOR + 5 bps, and the cost of debt funding the IFL variable spread product and debt funding liquidity is 6M LIBOR - 15 bps over the forecast period.

8. **Loan Charge Waivers.** On old loans, the expected scenario projections assume continuation of current waivers of loan interest charges of 25 and 5 basis points on post-1998 and pre-1998 loans, respectively, in FY10 and beyond. Commitment charge waivers of 50 basis points on old loans are also assumed as continuing over the forecast period.

9. **Administrative Expenses.** The expected scenario assumes that IBRD administrative expenses, including pension-related expenses and DGF (Development Grant Facility), IGP (Institutional Grant Programs) and SPBF (State and Peace Building Fund), are $1,189 million, $1,240 million, $1,271 million, and $1,315 million, respectively, for FY10, FY11, FY12, and FY13 as shown in Table 2 below. The expected scenario assumes that (i) the net administrative spending in real terms, will decline from the high in FY10 (where the full 2% flexibility band was utilized) to return to flat budget levels by FY13; (ii) the price adjustment factor on administrative expenses (excluding DGF/IGP/SPBF and pension-related expenses) is projected to vary from 2.2% in FY11 to 3.3% in FY13 and is expected to increase at an annual nominal rate of 2.9 percent from FY14 onwards; (iii) funding for DGF/IGP/SPBF is currently assumed to be $171 million for FY10 and $201 million from FY11 onwards.

Table 2: IBRD Administrative Expense Assumptions

$ Million	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
(1) IBRD Administrative Expenses, Excluding	905	919	935	962	990	1,019	1,049	1,079	1,110	1,143
Pension Related Expenses and DGF/IGP/SPBF	7.1%	1.5%	1.8%	2.9%	2.9%	2.9%	2.9%	2.9%	2.9%	2.9%
(2) IBRD Pension Related Expenses	112	121	134	151	168	166	170	174	179	184
	23.7%	7.4%	11.5%	12.5%	11.3%	-1.3%	2.3%	2.6%	2.6%	2.6%
(3) DGF (Development Grant Facility), IGP (International	171	201	201	201	201	201	201	201	201	201
Grant Programs) and SPBF (State and Peace Building Fund)	-14.3%	17.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total IBRD Administrative Expenses	1,189	1,240	1,271	1,315	1,360	1,386	1,420	1,455	1,491	1,527
	4.7%	4.3%	2.5%	3.5%	3.4%	2.0%	2.4%	2.5%	2.5%	2.5%

10. **Pension-Related Expenses.** IBRD's projected contribution rates to the Staff Pension Plan (SPP), the Retired Staff Benefits Plan (RSBP) and the Post-Employment

[15] Around $900 million of the $1.2 billion of prepayments in FY10 was from one country approaching the Single Borrower Limit (SBL).

Benefit Plan (PEBP) are based on estimated asset returns and portfolio values as of end calendar year 2009 and standard actuarial assumption of 3.5 percent real return for the SRP and RSBP thereafter. IBRD's projected contributions to the plans, which are included in administrative expenses, are arrived at by applying these contribution rates to the projected salary bill in each of the respective years. Based on these assumptions, IBRD's share of contributions to the pension plans is currently projected to be $121 million in FY11, $134 million in FY12, and $151 million in FY13,[16] with an average $156 million during the FY10-19 period. These projected contributions reflect the new methodology approved by the Pension Finance Committee in November 2009. The new funding methodology is expected to result in the same present value (PV) of IBRD contributions over the life of the plans as the old methodology; nevertheless, over a short or medium term horizon, differences can arise between the two methodologies. For example, in the FY11-19 period, the new methodology is currently projected to result in cumulative pension contributions being lower by about $450 million, even though this amount is expected to be offset by higher contributions over a longer horizon. Based on the PV neutral expectation and considering that any positive or negative effect of the new methodology in the medium term will be offset over a longer horizon, for the purpose of the capital discussion, an adjustment has been made to the FY19 usable equity to exclude the effect of the new methodology.[17]

11. **Long-Term Income Portfolio (LTIP)**. The expected long-term average return on the LTIP is currently projected at about 7.2 percent over the projection horizon, while the draw into allocable income from the LTIP is based on a long-term draw rate of 5.0 percent p.a. as approved previously by the Board.[18]

12. **External Transfers.** It is assumed in the expected scenario projections that annual transfers to IDA from IBRD will be $383 million for FY10[19] and $583 million from FY11 onwards. These transfers are assumed to be drawn down by IDA immediately upon annual Board approvals by IBRD for the IDA15 replenish period (FY08-10), and on a pro rata basis with other IDA donors from FY11 onwards. The expected scenario also assumes that IBRD transfers, by way of grants, $110 million (including $55 million to the Trust Fund for Gaza and West Bank approved by the Board in July 2009) out of surplus in FY10 and $100 million in FY11. From FY12 to FY19, $100 million of surplus is assumed to be transferred out of IBRD each year, with surplus being topped back to $100 million at the end of the fiscal year in the net income allocation process.

13. **Exchange Rates**. Current expected scenario financial projections are based on exchange rates prevailing as of end February, 2010: JPY against US dollar was 89.265,

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[16] These figures are the Bank's estimates of possible, middle of the range, future pension related payments for IBRD only and have not been reviewed or endorsed by the Pension Finance Committee (PFC).

[17] The adjustment also included secondary effect.

[18] See "Increasing IBRD's Allocable Income by Investing in a Long Term Income Portfolio", R2008-0053, dated March 13, 2008.

[19] As discussed in the FY09 Net Income Paper, IBRD front-loaded its remaining IDA15 undertaking by $200 million at the end of FY09 and will hence transfer $383 million at the end of FY10.

and US dollar against EUR was 1.35865. No exchange rate variations are assumed over the forecast period.

Annex II. Contingent Options for IBRD General Capital Increase

1. This annex provides a detailed discussion of the various contingent options that management has explored and discussed with the Board, as well as their respective advantages and disadvantages.

Contingent pay-in

2. A contingent pay-in feature, by making paid-in capital payable only if E/L falls to a certain level ("pay-in E/L trigger"), helps address concerns that crisis lending demand may be lower than expected. There are two possible mechanisms for implementing a contingent pay-in:

1) GCI with paid-in payment conditional upon E/L trigger
   - **Concept** (illustrative example): $50 billion GCI with only callable capital, with contingent paid-in portion of $5 billion, payable if E/L of 23% is triggered.
   - **Advantage**: If FY10-12 lending turns out to be less than expected and as a result, the E/L stays above 23%, members will not be required to provide paid-in capital.
   - **Disadvantages/concerns**:
     - Separation of GCI approval process from pay-in approval process increases dependence upon future governments.
     - If triggered, any non-payment could result in reassessment of entire callable capital structure by rating agencies and capital markets.
     - Uncertain timing of capital call may be problematic for some members.
     - Legislative pre-appropriation of contingent pay-in amount could mitigate the above risks, but (1) IBRD has no institutional mechanism to ensure this, and (2) there may be no budgetary benefit for members.
     - Without certainty on capital payments, it would be difficult to make loan commitments based on contingent capital inflow.

2) GCI with 100% in callable capital + contingent convertible debt
   - **Concept** (illustrative example): $50 billion GCI with 100% callable capital, bundled with $5 billion contingent convertible debt, subscribed pro-rata.
     - Convertible debt carries US Treasury rates so long as not converted.
     - If triggered by E/L falling below 23%, $5 billion of the callable capital will be "called", with payment obligation satisfied by conversion of the debt.
     - If not triggered, debt will be redeemed at par after, say 15, years.
   - **Advantage:** Addresses FY10-12 demand uncertainty while addressing financial management concerns (since funds are already with IBRD), enabling loan commitments on the back of assured capital inflow if required.
   - **Disadvantage/concerns:**
     - May have upfront budgetary impact on members in spite of interest-bearing nature and the possibility of redemption at par.
     - Potential accounting complexity for member governments.

Contingent pay-out

3. A contingent pay-out feature, by returning capital when no longer required ("pay-out E/L trigger"), addresses concerns that post-crisis lending levels may not require permanent capital increase. There are four possible mechanisms for implementing a contingent pay-out, which can be triggered when IBRD's E/L ratio reaches a pre-defined trigger level.

1) Return capital via Share Cancellation provision
   - **Concept**: If E/L remains above pay-out trigger, capital is returned to members.
   - **Advantage**: Addresses shareholder concerns about post-crisis demand levels.
   - **Disadvantages/concerns:**
     - Accounting classification issues: if payout certain, this equity would be classified as a liability, creating risk of investor misunderstanding.
     - World Bank Governance: redemption feature may be hard-wired in Governors' GCI resolution, but may not bind future Governors.
     - May not allow members to redirect capital to IDA without going through national budgets.
     - Hard-wired redemption reduces flexibility to respond to the outlook prevailing when the trigger is hit.
     - May raise questions on permanence of existing capital base. IBRD has never transferred directly from capital.

2) Return capital via annual dividends
   - **Concept:** If E/L remains above payout trigger, IBRD issues annual dividends until capital is fully redeemed.
     - Multi-year dividends to avoid dipping into reserves.
     - Individual shareholder election to transfer dividend directly to IDA or other purposes.
   - **Advantage:** Addresses concerns about future demand without raising issues of IBRD governance, classification or permanence of existing capital.
   - **Disadvantage/concerns:**
     - May have to go through national budgets before redirection to IDA.
     - Potential for negative market perception about the initiation of dividends.

3) Return capital via transfers to IDA or other uses
   - **Concept:** If E/L remains above payout trigger, capital returned through increased IDA transfers or other uses.
   - **Advantage:** Addresses budgetary problems for members who want to transfer capital to IDA directly.
   - **Disadvantage/concerns:**
     - Income transfers to IDA currently not recognized in ODA calculations by OECD.
     - Likely to increase contentious nature of income allocation discussions.

4) <u>Redirect buffer capital to Long-Term Income Portfolio (LTIP)</u>
   - **Concept:** Buffer capital is invested in LTIP, with income dedicated to IDA.
   - **Advantage:**
     - Stable source of additional income for IDA transfers.
     - Ability to later reverse decision (i.e., redirect capital from LTIP to lending) allows for maintenance of cushion for potential future lending needs.
     - Retention of capital means the trigger could be lower than other options, allowing more efficient use of capital.
     - Avoid potential negative market perceptions on returning capital.
   - **Disadvantage/concerns:** Members who want their share of GCI to be transferred directly to IDA may prefer immediate transfer (upon trigger).

External triggers

4. In response to some members' concern of the potential "moral hazard" issue associated with using the E/L ratio as the sole trigger, options on using an external indicator such as the EMBI spread, private financing flow to developing countries, and external country credit ratings as the trigger for the pay-out were also discussed. However, it is extremely difficult to find external triggers that can serve as a close proxy for IBRD's internal capital adequacy measure - the E/L ratio; the use of any external trigger that does not mirror IBRD's E/L ratio could potentially lead to contingent pay-out being triggered while IBRD is still having a low E/L ratio or not triggered even when IBRD's E/L has already stayed high for a number of years.

Annex III: Changes to IFC Estimates from September 2009 and March 2010

1. IFC's FY10 mid-year results show improvement in profitability, consistent with increasing emerging market equity valuations. As a result FY10 income for capital adequacy purposes is now projected at about $1.6 billion to $1.7 billion compared to the roughly break-even level projected last summer. The higher income is mostly a result of higher income from equity investments as compared to earlier projections. The Corporation has improved its expected FY10 financial results partly through a bringing forward of equity sales but, bringing these sales forward will increase current year income at the expense of dividends and capital gains in subsequent years. The upward revisions also highlight the volatility in the Corporation's earnings and the challenges of projecting IFC's financial capacity over the long-term.

2. In addition to the improved income profile for FY10, IFC's financial capacity estimates have also been updated for key FY11-FY16 assumptions. Contributing to the change in income estimates are increases in projected equity gains and dividend rates. Also updated are the cancellation and prepayment assumptions, for which FY10 cancellations have been adjusted upward and prepayments downward for consistency with Q1 and Q2 FY10 results. Projected interest rates have been updated replacing interest rate term structures from September 2009 with March 2010 term structures. Non-performing loan estimates have been left unchanged as FY10 actual results to date are in line with the September 2009 estimates.

3. Compared with the September 2009 estimates the current financial capacity projections factor in designations as per IFC's Board Approved designation formula, including designations for IDA. In the most recent update designations from FMTAAS are assumed at $110 million for FY10, increasing at 10% each year thereafter and the remaining IDA15 designations are assumed at $600 million in FY10. In addition beginning in FY11 additional amounts available for designations using the Board approved sliding scale formula are assigned for IDA16 or IDA17 for indicative purposes.

4. Projections in this paper incorporate higher capital and expense requirements to support the increased portfolio balance toward riskier areas going forward. The proposed focus on commitment growth in riskier areas will gradually change the portfolio risk profile and therefore the associated capital requirements for the portfolio.