

security in its operations. But it should not seek special protection in respect of any risks inherent in the projects which it finances, and should be steered away from the temptation to rely on government guarantees as the main element in its own creditworthiness. If a significant proportion of the enterprises supported by the Bank fail, it, too, will have failed, and its shareholders will stand to lose their equity stake. We believe that this risk should be faced, as a necessary discipline in the Bank's operations. We do not believe that the areas of need which we have identified require an institution which is set up to make losses.

59. For an institution which both borrows and lends on essentially commercial terms there is, however, a more general risk relating to the creditworthiness of borrowing countries. Indeed, the question arises whether operations on such terms are appropriate to some of the poorer Commonwealth countries with particularly difficult development tasks. In this connection, we consider that the case for a bank of the type that we envisage rests partly on evidence which suggests that even in the poorest countries there are projects offering the potential of high economic returns, but which are held up by problems of assembling the needed financial, technical and managerial package. Probably all countries resort to borrowing on commercial terms in addition to assistance received on concessionary terms. By helping to ensure that such borrowing would be undertaken on the most favourable terms and conditions, and that the projects financed would be effective in earning or saving foreign exchange, a Commonwealth Investment Bank would in fact strengthen the creditworthiness of the borrowing country. This would not be sufficient in itself to guard against the possibilities of balance of payment and debt-servicing difficulties in borrowing countries. However, on the assumption that Commonwealth countries would value the services provided by a Commonwealth Investment Bank, it would be important that they should protect the Bank's own ability to borrow by avoiding default on their debt service liabilities to the Bank.

V. RECOMMENDATIONS

Functions of a Commonwealth Investment Bank

60. We propose the establishment of a Commonwealth Investment Bank with the following principal functions:

- (a) to take a financial participation in and to assist the efforts of Commonwealth countries to diversify and enlarge their sources of external capital;
- (b) to assist Commonwealth countries in the identification and preparation of projects, especially projects in the productive sectors, and in the mobilisation of finance for such projects;
- (c) to assist Commonwealth countries in organising the capital structure of projects on a sound financial basis, especially projects in which governments or public enterprises are major participants;
- (d) to assist Commonwealth countries in the identification of and negotiations with suitable foreign partners in the promotion of joint ventures;

- (e) to act generally as a financial intermediary, especially in fields in which other financial entities involved are likely to include both commercial and concessionary sources of capital.

Our remaining recommendations are intended to provide the outline of a bank which we believe to be both feasible and appropriate to the functions that we have listed.

Operations

61. The essential characteristic of the proposed bank is that it should operate constantly with and among the following main groups:

- (a) Commonwealth country governments;
- (b) Commonwealth country public enterprises and public/private joint ventures;
- (c) Commonwealth country private companies;
- (d) foreign companies investing in Commonwealth countries;
- (e) banks acting for (d), and other commercial banks;
- (f) export credit agencies;
- (g) international development banks;
- (h) international development finance corporations;
- (i) bilateral aid agencies.

It would act primarily for (a) and (b) as its clients, mobilising finance on the best possible terms from (e) and (f), in close cooperation with (g), (h) and (i). To this end, it would normally reckon to take a small participation of its own in whatever financing it arranged, but only under exceptional circumstances would it take the position of lead bank or principal source of finance. The bulk of its operations would take the form of putting packages together in the ways best suited to its clients, rather than direct lending for projects in accordance with some set policy of project-financing.

62. It should aim, therefore, to keep its average participation - i.e. the loan and equity investments on its balance sheet, expressed as a percentage of the total investment costs of the enterprises in which it is a participant - well below the level typical of a development finance corporation, and closer to the level preferred by merchant banks.¹ We believe

¹ The CDC, a corporation which is conspicuous in its willingness to take a relatively large holding, with the concomitant managerial responsibility, estimates its overall level of participation at 20 per cent. The IFC, in its annual report for 1972, gives 19 per cent for the year's operations, rising to 31 per cent for new business in 1973, when improved prospects for selling participations in its own investments enabled it to increase its initial share. The preference of merchant banks, according to one assessment given to us, is for a share ranging from 10 per cent in relatively small projects to as little as 3 per cent in cases in which large total amounts are required, while in some banks there is a trend towards operating purely on a fee-earning basis.

that it should aim for an average participation of 10 per cent initially, and that this percentage should decline as the Bank's reputation as an effective mobiliser of capital for its clients becomes stronger. The Bank would then be using its own loan and equity capital as an earnest of its support for projects in which its main purpose would be to arrange much larger amounts from the mixtures of sources suggested in the preceding paragraph.

63. It should be empowered to make equity investments, but it should use this power initially only when an equity contribution is an essential element in a larger package. It should not regard direct investment in equity as a major instrument in its operations.

64. These operations would yield an income, in the form of the margin on the Bank's lending and investigation and management fees which it would charge for its services.

Size of Capital, Sources of Funds and Scale of Operations

65. We consider it desirable to keep both the issued capital and the balance sheet of the Bank relatively small, in keeping with the emphasis given to the raising and syndication of finance from a wide range of sources. If the suggested participation level of 10 per cent can be held, we believe that an initial paid-up capital of some £6m would provide an adequate base, though some assessments suggest that an issued capital of, say, £10m would give a more than proportionate increase of confidence to potential depositors.

66. On top of a £6m equity base, the Bank would need an initial assurance of medium and long-term loans to become available as its operations develop, because it will not be able to borrow on the market until its operations have established a satisfactory "track record". In the first phase of its evolution, a reasonable aim might be to build up a debt/equity ratio of 3:1, giving a total balance sheet of, say, £25m. We have considered four main ways in which this initial expansion could be financed:

- (a) callable capital as backing for bond issues, on the model of existing international development banks;
- (b) a guarantee by the shareholders, to back borrowing for a limited and fixed period, say seven years, until the Bank can borrow on the basis of its own record and balance sheet;
- (c) an issue of debentures underwritten by the shareholders, so that any shortfall in the issue will be taken up by the shareholders themselves;
- (d) a commitment of medium and long term loans by the governmental and public sector shareholders, to be taken up as operations require it, contributions to which would be on a negotiated basis rather than pro rata to shares in the equity.

We do not recommend (a), on the ground that this type of capital structure would give the Bank an image too close to that of existing development banks and would make it too dependent on the backing of its strongest members. We believe that method (d) would be the most consistent with the establishment of a businesslike banking institution which would inspire its

commercial partners with confidence. Methods (b) and (c) might involve lengthy procedures. However, if it appeared that method (b) or (c) gave better prospects than (d) of raising the sums needed on reasonably favourable terms then they would have to be seriously considered.

67. In addition to the initial resources of £6m equity, plus £19m raised in the form of loans as envisaged in the previous paragraph, we would also expect the Bank to develop the ability to raise and place deposits on the London Inter-Bank Market and from the surpluses available from Commonwealth governments (our assumption concerning the latter source being that there is room for an additional financial institution in this field, in which the Crown Agents and some commercial banks are already active), and in due course to increase its debt/equity ratio to a still conservative 6:1, giving a balance sheet total of, say, £40-45m. We would expect this process to take perhaps between five and seven years from the effective beginning of operations. During that period, we would expect on a conservative basis that the Bank would have disbursed 50 per cent of its equity and loan capital, or, say, £13m in long-term loans and equity participations in Commonwealth projects. The total finance mobilised from all sources for these projects, on the basis of the Bank's average participation of 10 per cent, would be £130m. We would also expect the Bank to get a similar leverage on 20 per cent of the deposits raised on the market (say £4m) in shorter term loans, resulting in participation in a further investment of perhaps £40m, giving the Bank a participation in total investments amounting to £170m from all sources.

68. We believe that further prognostication concerning the extent of business to be undertaken would now be premature. However, we would emphasise that the figures suggested here relate only to the period during which the Bank is establishing itself, for which cautious estimates are most necessary. It would clearly be desirable to provide for the possibility of steady expansion once this difficult initial phase is completed, by equipping it to increase its equity base at a later stage in its development. This could be achieved by giving it an authorised capital in the region of £30m.

Capital Structure

69. We believe that the Bank will be best equipped to carry out its functions if Commonwealth developing countries have a dominant though not necessarily a controlling position in it, with Commonwealth developed countries and commercial banks as their partners. We also believe that this is feasible within the amounts suggested above. We have considered reducing the burden on developing countries by such devices as the subscription of part of the capital in the subscriber's own currency, but we have rejected them, for the same reason as our rejection of the notion of a large element of callable capital. Such devices should not be necessary with a capital of the size that we envisage, and could introduce an element of ambiguity into the Bank's business-like image and into its loyalties. The paid-up capital should in our view be wholly subscribed in convertible currencies, in a single instalment.

70. We have in mind an apportionment of the capital roughly as follows:

- (a) 40 per cent or more to governments and public corporations in Commonwealth developing countries;

- (b) 30 per cent or less to governments and public corporations in Commonwealth developed countries;
- (c) 30 per cent or less to Commonwealth commercial banks, or to banks in which Commonwealth banks have a minimum holding of, say, 25 per cent.

Within the first two categories, a country quota system would have to be devised as a guide for the first capital issue, but we hope that this system would not be rigidly maintained, and that Commonwealth countries which wanted to take up more than their allotment could do so, if it emerged that the allotments of other Commonwealth countries had not been fully taken up. Alternatively, or perhaps additionally, the first issue could provide for allotments amounting to a total of £8.6m with the agreement entering into force when 70 per cent (£6m) has been subscribed. This would allow some Commonwealth countries to come in at a later stage without the need for agreement on a second issue of capital.

71. In those developing countries where it is legally possible, it would be preferable if the shares allotted could be taken up by local development banks and other public enterprises concerned with the productive sectors, though the finance would presumably have to be provided by governments. Similarly, the possibility might be explored in developed countries of attracting as shareholders public enterprises with a commercial or financial interest in developing countries, rather than financing the developed countries' allotments out of their aid programmes.

Management

72. The general policies and operations of the Bank should be under the control of a non-resident Board of Directors, who would elect a Chairman from among themselves. A Board of ten elected directors would permit proportionate representation of the three main groups of shareholders, i.e. four directors elected by developing country shareholders, three elected by the developed countries' governmental shareholders, and three elected by the private shareholders. The exactly representative character of this Board should make it possible to avoid elaborate formal voting structures. We envisage each director having a single vote. The exact structure of the Board and its relationship with the management would need to be worked out with great care.

73. The day-to-day management of the Bank should be under the control of a chief executive appointed by the Board of Directors. He would have a seat on the Board, making a Board of eleven members in all, including the Chairman and the chief executive.

74. The annual general meeting of the Bank's shareholders, to which it would of course be answerable, could conveniently be held to precede the Commonwealth Finance Ministers' annual meeting.

Organisation and Staffing

75. The Bank would need to be organised along functional lines. We envisage a central core consisting of a treasury division (resource mobilisation), a banking division (financial services) and a secretariat with legal capacity (which would have assistance in contractual negotiations as one of its major functions). Additional functional divisions would be specialised in

terms of the tasks identified in Section IV, e.g. a minerals division, an agricultural products division, etc. To the extent that it needed research capacity, this could be incorporated in a "special services unit", but the alternative might be considered of research capacity fully integrated into the banking division.

76. In the initial period, it seems likely that most of the Bank's staff will have to be recruited from Commonwealth developed countries. The possibility should be explored, however, of attaching potential developing country staff to the Bank's private shareholders for periods of one or two years, to be taken in as the Bank expands. This would eventually achieve a desirable staff balance without the problems associated with rigid country quotas.

Location

77. The argument that we have advanced in paras. 20-21 together with the functions that we have outlined, constitute in our view an overwhelming case for locating the Bank in London.

78. Since we assume that the Bank, as a commercial institution based in London, would be subject to UK tax law, we have not examined in detail the possibility of special tax concessions. In further exploration, the tax position would need to be carefully investigated.

79. Representation in other Commonwealth countries could be achieved by two means:

- (a) very frequent travelling on the part of the Bank's staff, especially by the members of the banking division;
- (b) participation in local merchant banking consortium arrangements where these exist.

We do not consider that the functions we envisage require the establishment of permanent regional offices.

Geographical Scope

80. We assume that it would be a legal requirement that all activities of the Bank should be of interest to one or more Commonwealth developing countries. It might simplify the allocation of shares if operations could be permitted in Commonwealth countries which have chosen not to be shareholders, as might be the case with some very small countries. The regulation would need to be drafted in a manner that did not restrict the Bank to financing entities physically located in Commonwealth countries. Under a production sharing agreement, for instance, a Commonwealth developing country might want the Bank's support for its participation in a joint venture with a non-Commonwealth country. Also, while we have endorsed the argument of the Orion Study, we think that the Bank should not be precluded from the financing of projects in which Commonwealth developing countries have an export interest.

Non-Commercial Risk

81. We have argued that the Bank should not seek special protections against commercial and non-commercial risk, other than those normally

available. However, its operations would be severely curtailed if repayments and dividends were blocked by exchange control. We believe that a case can be made, on the ground that its operations will normally contribute to increased foreign exchange earnings or import savings, for special treatment in this one respect, for which there are precedents in the treatment of existing development corporations. We do not see a need for formal agreements in this respect. If the Bank is seen to be succeeding in the performance of its task, borrowing countries individually and collectively will see the damage that would be done by imposing exchange controls on outflows connected with the enterprises that it is supporting.

Other Proposals to be Considered

82. While we consider that the Bank that we have proposed would meet some major needs for which a suitable instrument does not yet exist, that the case for establishing such an instrument within the Commonwealth is especially strong, and that it would yield a larger addition to the resources available to Commonwealth developing countries than any alternative instrument of plausible dimensions, we do not regard our proposal as conflicting with or precluding other possibilities that might usefully be explored. In particular, we have noted the possibility of establishing a concessionary fund financed by Commonwealth countries, and the possibility of expanding the functions of the CFTC in some specialised areas, notably in relation to shipping and insurance. We hope that these possibilities will indeed be explored. However, we also believe that the need for an instrument of the type we have proposed has become, in the light of recent developments in international economic relations, extremely urgent, and that our proposal is worth pursuing regardless of what view is taken on these other issues.