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ECONOMIC COMMISSION FOR AFRICA
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TEMPORARY INVESTMENT OF SURPLUS FUNDS OF THE AFRICAN DEVELOPMENT BANK

(A study by the Committee of Nine)

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Introduction

1. Under para. (e) of resolution 3 adopted by the Conference of Finance Ministers at Khartoum,1/ the Committee of Nine was requested to take any other initiative in addition to those specifically mentioned in the operative part of that resolution which, in its view, would be consistent with the spirit of the said resolution and would contribute to an early and orderly commencement of activities by the Bank when established. In compliance with such a mandate, the Committee thought it advisable to discuss some problems which may form the subject of policy considerations by the African Development Bank. Consequently, it prepared a preliminary study on temporary investments by the Bank of funds not needed in its operations. Such a study is now transmitted as a working paper to the Board of Directors of the African Development Bank.

Surplus Funds for Investment

2. For the purpose of this paper, surplus funds are those which at a given time are not needed by the Bank in its operations.2/

3. It may be assumed that at the outset funds available for investment will be derived from members' subscriptions received in convertible

1/ Resolution 3 on the Preparatory Work for the Establishment of the African Development Bank.

2/ Working balances required for day-to-day needs are also excluded from surplus funds in this context.

currencies. It is likely that as these are deployed for developmental purposes in the course of the Bank's ordinary operations, they will be replenished and supplemented by new funds raised either from borrowings by the Bank under Article 23, or from assistance offered by friendly non-member countries, or possibly in due course from an increase in capital.

4. Some of these may take the form of Special Resources and, in such cases, their investment may be governed by special arrangements. In this paper, therefore, consideration will be confined to some criteria which may govern the investment of Ordinary Resources of the Bank as defined in Article 9 of the ADB Agreement.

The Continuing Nature of Temporary Investment

5. Such investments may be expected to be highest in the earlier years of the Bank when it will be receiving substantial funds by way of capital subscriptions before its loan and other operations have got under way. As the latter operations proceed, temporary investments will be run down in order to finance them - and interest on loans etc., will replace that from temporary investments as the Bank's principal source of income. This prospect is, however, likely to be qualified if the Bank is successful in raising additional funds by way of borrowing on world markets, or from members or if it is able to secure substantial resources, by way of loan or grant. Furthermore, even when loans are made by the Bank it will normally be a number of years before they are fully drawn down. Thus, although the total level of investments may fluctuate, perhaps by a considerable margin, from year to year, the Bank is always likely to have substantial holdings under this heading, derived either from capital subscriptions, special resources or external borrowing.1/

1/ This is well evidenced by the experience of the International Bank, the investments of which rose in the early years from $150 to $480 millions, fell to $350 millions and then rose by stages to nearly $1,500 millions (1953). The reports of the Inter-American Development Bank and the European Investment Bank also show sustained high levels of investment holdings.

The Temporary and Conservative Character of Investment Policy

6. In discussing investment policy for the African Development Bank it seems appropriate to emphasize that it should be both temporary and conservative in character. Temporary, because the main purpose of the Bank is to invest its funds in the development of member countries; consequently any placing of surplus funds not needed for that purpose will be made only until such time as the funds are so required. Conservative, because it will be directed to conserving the Bank's resources until needed for its principal purpose. This does not mean that the Bank can afford to be indifferent as to whether such funds earn any return or to the rate of return which they may secure. In the earlier years of the Bank's existence at any rate, it may have to look to such earnings to defray the whole or greater part of its administrative and other costs. What it does mean is that the Bank should adopt a cautious policy, combining a high degree of security and liquidity with a reasonable rate of return, and should not engage in the frequent switching of funds from one centre or type of investment to another merely for the purpose of obtaining small marginal gains.

Objectives of an Investment Policy

7. It seems also advisable to suggest that the investment policy of the ADB should be directed towards three main objectives:

(i) the maintenance in value of the Bank's resources;

(ii) the preservation of sufficient liquidity in relation to operational requirements, i.e. that cash resources are readily available when required to meet loan etc. drawings by members;

(iii) the earning of an acceptable income from such investments so as to contribute, particularly in the earlier phases of the Bank's operations, to its administrative and other expenses.

The Maintenance in Value of the Bank's Resources

8. The Bank's capital resources are denominated in units of account, which are defined in gold with a value equivalent to the present value of the United States dollar. There is therefore an implied obligation on the Bank to maintain the value of these resources in gold, not dollars, since it is not excluded that the value of the dollar itself could change. This obligation is in fact specifically imposed under certain conditions upon the Bank and its members themselves by Article 28 of the Agreement which requires members to make good to the Bank any loss on its holdings in a currency of a member country as a result of a reduction in the par value of that currency. Per contra the Bank is required to refund to the member any increase in value of its local currency holdings as a result of any increase in the par value of that member's currency. (Holdings of currency derived from borrowing are excluded from these obligations.) Since the value of the Bank's unit of account is expressed in gold, the only way in which it could be absolutely sure of maintaining the value of its resources would be by holding them in gold or in investments denominated in gold. This, however, is likely to offer only a limited outlet for the Bank's investible resources. Gold bears no interest and investments denominated in gold are very limited.1/ In practice therefore the Bank will be constrained to place the greater part, or even all, of its temporary investments in deposits or securities denominated in currencies which offer the best security of value in terms of gold.

The Investment Practice of Other International Development Banks

9. In this context the experience of the other well-known international development institutions may be instructive. Thus the IBRD makes a

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1/ The European Investment Bank has invested some of its surplus resources in gold, either as "metal deposits", "sight deposits" or "bills repayable in gold issued by one of the member countries", but the amounts involved have been relatively very small, fluctuating between \$6 and $8\frac{1}{2}$ millions, compared with a total of all liquid assets and investments of between roughly \$90 and \$200 millions during the period 1958 - 1962.

practice of holding the overwhelmingly largest part of its temporary investments in US dollar denominated investments; in fact, holdings in other currencies usually seem to reflect only the temporary investment of loans recently raised in the countries concerned. With the Inter-American Development Bank, the American dollar is again the preferred currency for investment purposes, but a very small fraction is however denominated in "non-member" currencies.

10. In both cases the attraction of the US dollar is no doubt partly a reflection of the particularly important role which the United States plays as a source of capital and loan funds for both institutions,1/ and partly of the fact that the American dollar enjoys the longest record for stability and convertibility in terms of gold of all the world's major currencies.

11. The practice of the European Investment Bank, on the other hand, is to spread the bulk of its investments over member currencies, keeping however a minor portion in gold and non-member currencies, usually apparently in the US dollar.2/ However, it must be remembered that these

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1/ In 1963 the USA accounted for:
31% of the Ordinary Capital Stock of the IBRD
43% of the Ordinary Capital Stock of the IADB
and $1,899 m. or 75% of the funded debt of the IBRD
and $ 75 m. or 75% of the bonds outstanding of the IADB.

2/

Currency of Time Deposits and Investments	IBRD	IADB	EIB (1962)
In US dollars	1,262	208	n.s
In European currencies	n.s.	n.s.	152 (m)
"Other non-member" currencies	n.s.	18	36
Gold	–	–	9
Not specified	201	–	–
Total	1,463	226	197 (c)

m = member currencies only
n.s. = not stated
(c) includes $22 m. "call money"

currencies constitute for the most part currencies with long-established reputations and money markets and full convertibility under Article VIII of the IMF Agreement.

Investment in Convertible Currencies: Ordinary Capital Resources

12. As far as the ADB is concerned, the inference would seem to be that it should confine its temporary investment of surplus resources derived from the capital contributions of members to currencies with established par values and full convertibility under Article VIII of the IMF Agreement.

Investment of Ordinary Resources borrowed under Article 23

13. Where resources have been raised by borrowing under Article 23, the Bank may also bear in mind the currency in which such borrowed resources are eventually to be repaid; in this case it may consider a modification of this policy, viz: that surplus borrowed funds may be temporarily invested either in convertible currencies eligible under the arrangements proposed in the preceding paragraph or in the currency in which they have to be repaid.

The Maintenance of Liquidity in respect to the Bank's Investments

14. It will be prudent for the Bank to limit the maturity period of any individual investment. Since generally speaking a higher rate of return will be earned on the longer dated investments, the object would seem to be to spread the Bank's investments over time so as to include a substantial portion in medium dated securities, say from one to four years, but so arranged, however, that some of them are always approaching maturity. Adequate liquidity and flexibility over the Bank's investments as a whole may then be assured partly by carrying a portion of the holding at call or on short term (say between three and six months) and partly by the regular maturity and rotation of these medium-term holdings.

The Importance of Cash Flow Estimates to Investment Policy

15. The actual distribution between the two main groups, and adjustment thereof from time to time, should be t[illegible]aken in the light of periodical

cash-flow estimates for the Bank as a whole. These estimates should project the aggregate receipts and payments of the Bank, quarter by quarter, for say two, three or even four years ahead. They should of course be revised regularly to take account of all current developments in operations or other commitments. From these estimates it will be possible to make an accurate prediction of the net cash requirements of the Bank for about a year ahead, and rather more approximate estimates for longer periods. Investment holdings and the pattern of maturities can then be adjusted accordingly so as to combine a satisfactory rate of earnings with adquate liquidity.

Types of Investment to be considered

16. Further protection and liquidity can and should be secured by so placing the investments that in an emergency they can be realized without much loss. The best way to achieve this will almost certainly be by spreading them between various types of investments such as: (a) Time Deposits with first class bankers and similar institutions; (b) Treasury Bills or other Government Obligations with less than twelve months to run: and (c) other dated Government Obligations not exceeding a reasonable period - say three or four years.[1] The two last named groups should only be eligible if they are marketable in some major money market.

1/ Investments in private bonds or paper are not recommended because it is considered that this would conflict with the "conservative" principle proposed in paragraph 2, viz.: The Bank would either have to devote some of its staff to studying such investments, or accept the local market's rating thereof - neither of which appears to be desirable.

Distribution between Time Deposits and Government Obligations

17. It is suggested that the Bank should not fix any predetermined ratio for the distribution of its investments between time deposits and government obligations since a high degree of security and a wide spread of maturity dates can be secured under both headings.[1] In actual practice this distribution may be influenced by various considerations such as relative rates of interest, the importance of developing working relations with the leading international banking institutions and the possibility (in an emergency) of making arrangements for the earlier withdrawal of time deposits *versus* the corresponding marketability or discountability of government obligations. However, for working purposes, it may be

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1/ In making this suggestion regard has been paid to the widely divergent practices of existing international institutions. Thus the IBRD appears to have placed all its "investments" in government obligations until 1956 and since then to have placed no more than a small proportion in time deposits. On the other hand, the Inter-American Development Bank and the European Investment Bank appear to favour time deposits for the bulk of their investments. This preference for bank deposits as a means of holding surplus funds is even more marked if allowance is also made for their ordinary (sight or call money) deposits. The relevant figures are set out in the Table below:

I. Distribution of Time Deposits and Investments

In $ millions	IBRD (1963)		IADB (1963)		EIB (1962)	
Time Deposits	344	23.5 %	159	70.4 %	134	79.8 %
Other Investments	1,120	76.5 %	67	29.6 %	34	20.2 %
Total	1,464	100.0 %	226	100.0 %	168	100.0 %

II. Ordinary Bank Deposits (including Call Money)

	IBRD	IADB	EIB
Bank Deposits	18	44	22

appropriate to indicate that time deposits with bankers should not be placed for periods longer than 18 months while investments in government obligations should be spread over varying periods from three months to three years. The "balance" between the two classes should then be left to the management, subject of course to the general rule that the prospective pattern of maturities should be matched, with some margin and reserve for flexibility, with the estimated pattern of cash requirements.

Realization of Additional Funds to meet Unforeseen Needs

18. Such a portfolio pattern should enable the Bank to raise additional funds without undue difficulty or loss in the event of some unforeseen need arising which upsets the cash-flow forecasts previously made. Thus it should be possible, in the event of some unforeseen need arising for funds on a substantial scale, to mobilise additional funds either by obtaining short term loans or overdrafts from the banks with whom the time deposits had been placed, or by rediscounting the Treasury Bills or other short term paper, or finally by selling some of the medium dated securities.[1/] In the case of the first the loss would be confined to the payment of a slightly higher rate of interest than that earned on the corresponding deposit, of the second group to the discount on the sale (neither of which is likely to be very high) and in the third to any capital loss on resale, which may be more substantial, but will be limited by the medium term character of the security itself.

The securing of an Acceptable Rate of Interest

19. Within the limitations imposed by considerations set out in the preceding paragraphs, the Bank will wish to secure as high a rate of interest as it can. As already mentioned this may normally point towards holding a reasonable proportion of any securities in <u>medium dated paper</u> -

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1/ It may also be possible to place some funds in short term obligations which have "built-in" provisions for premature encashment (cf the "Roosa" bonds).

subject to the liquidity and other considerations already discussed - but it will also involve a study of international money markets to ascertain where the best rates are obtainable. In the case of the former, interest-rate considerations will be tempered by the liquidity aspects, and in the case of the latter by "maintenance of value" considerations - expressed perhaps in practice by some general rule to the effect that the Bank should not hold more than a certain percentage of its portfolio in any one currency, even though it is fully convertible. Annual Reports of the IBRD, IADB and European Investment Bank do not disclose the effective rate of interest earned on their investments, but in the case of the IBRD and IADB the income therefrom as shown in the Profit and Loss Account represents about 4.1% of the end-year value of time deposits and investments taken together; in the case of the European Investment Bank it represents nearly 4.4%.1/ Such levels of earning may not always be obtainable by confining investments to strictly short term operations, of the three or six months deposit or Treasury Bill variety; a substantial part of the portfolio may have to be placed in rather longer term deposits or medium term paper.

Taxation and Investments

20. In considering the rate of interest to be secured from any investment the Bank will also have to examine the local taxation position. From the Bank's point of view it will no doubt be desirable to secure tax exempt status, as an international institution, from the governments of any non-member countries in which it expects to make investments or undertake other financial transactions. It would seem desirable for the Bank to make an early move in this direction, at least in respect of the principal financial centres, since this general question is likely to

1/ Figures are for 1963 for IBRD and IADB; 1962 for the European Bank. They do not, of course, allow for changes in the portfolio during the year which may affect the yield figures significantly.

have a bearing on many activities other than those connected with temporary investments, e.g. it will desire its future borrowings to be exempt from stamp or transfer duty or other taxes and what is even more important in the long run, to be endowed with "trustee" or "gilt-edged" status so that they become available for investment by trustees and other public and semi-public institutions.

The Geographical Spread of Investments

21. From some of the observations already made it may be noted that neither the IBRD nor the IADB appear to make a practice of any wide geographical spread of investments. Both concentrate the largest part of their placings in US Dollars; the IADB apparently even eschews investments in member currencies (although it holds ordinary bank deposits in such currencies). The European Bank, however, spreads the bulk of its investments over member currencies - but, as already mentioned, these include some of the leading convertible currencies of the world. What policy should be adopted by the ADB?

The Importance of establishing Contacts in World Capital Markets

22. In considering this matter it is suggested that the Bank should bear in mind that its own resources are limited; that if it is to play a substantial part in the development of Africa, it must therefore raise additional resources elsewhere, either by grants or loans for Special Funds or by market borrowings. Although they have only been in existence for a comparatively short time both the Inter-American and European Banks have already entered the world bond markets; the IADB for loans in New York, Italy, London and West Germany; the European Bank for borrowings in Guilders, Italian Lire and Swiss Francs. The IBRD, of course, has raised loans in many countries; its Report for 1962/63 lists $2,519 millions of them of which $1,899 millions have been raised in the USA, the equivalent of $191 millions in Swiss Francs, $275 millions in Deutsche Marks, and the balance spread over Pounds Sterling, Netherlands Guilders, Italian Lire, Belgian Francs and Canadian Dollars. In the case of both

IBRD and IADB, the large uncalled capital subscriptions of the United States Government (not to mention those of other members), and in the case of the European Bank, that of its European members has undoubtedly greatly facilitated the raising of such loans, by offering prospective lenders ample security for their loans to these institutions.

23. The ADB will start with rather less advantage in this respect; the uncalled capital liabilities of its members are smaller, and of course they are all countries which are importers rather than exporters of capital.[1/] Nevertheless the need for external funds will have to be met from some source, and in due time this will surely involve the Bank in public borrowing. With this in view it is suggested that the Bank should consider from the outset the desirability of distributing a substantial portion of its investible resources among those money markets from which it hopes at a later date to obtain funds as a borrower. This process will enable it to secure an entree to such markets, to make valuable contacts and to establish a reputation therein for sound financial management, etc. These should all be very valuable when the Bank wishes to float loans on such markets.

General Conclusions: Management and Policy

24. The general conclusion is that the Bank should permit a wide degree of discretion to the Investment Committee and the President in the management of its investments subject to certain broad considerations, viz.: the surplus funds of the Bank not required for operations, as referred to in Article 23(d) of the Agreement, shall be invested in obligations denominated in currencies which have established par values and are convertible in the terms of Article VIII of the IMF Agreement and specifically in time deposits and government obligations in such manner and proportions as the management may decide from time to time will secure an acceptable return

1/ The original unpaid callable capital of the ADB will not exceed $125,000,000. That of the IBRD is $18,655,770,000; of the IADB $1,675,000,000; and the European Bank $750,000,000.

having regard to the following considerations :

(i) time deposits should be confined to Banks and other financial institutions of first class international standing, and should not be for a period exceeding 18 months;

(ii) government obligations should be of types that are readily rediscountable or marketable in well established markets; they may be spread over varying periods from three months to three years;

(iii) in placing investments consideration should be given to the currencies which it is likely to require or which are most useful for operational purposes, and also the desirability of establishing working contacts and arrangements in the principal monetary centres (with particular reference to those in which it is considered likely that the Bank may wish to float loans at some future date) but without committing an undue proportion in any one centre or currency;

(iv) in determining the period and maturity pattern of investments the management shall take into account the prospective needs of the Bank for liquid funds as indicated by periodical cash-flow forecasts which shall be made in accordance with its directives.

Final Remarks

25. It is appreciated that the application of conservative rules as are suggested in this paper, would, at the present time, preclude such investment in African member countries since these do not yet have convertible currencies or established money markets on a sufficient scale. Whilst it may be agreed that such a limitation should be accepted in conformity with the principles of sound banking, it is hoped that the time will come when African countries are able to offer the necessary guaranties of convertibility and marketability to permit such investments. It is also hoped that the Bank itself will consider how it can, within its terms of reference, assist member countries in the process of developping confidence and creating the conditions required for the establishment of regional and sub-regional money markets in Africa.