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INTERNATIONAL AGENCIES AND THE CAPITAL FORMATION PROCESS

Lester Nurick*

I. INTRODUCTION

The theme of my address will be (a) the principal means by which the international public lending institutions (principally the International Bank for Reconstruction and Development (the World Bank), the International Development Association (IDA), the International Finance Corporation (IFC), and the Inter-American Development Bank (IADB)) join with others in the channeling of funds from private, governmental and other international sources for development projects, and (b) some of the main legal problems which arise.

An operation of this kind is usually called a joint financing operation. However, it should be noted that in a sense every loan by an international organization for a project involves joint financing, since the organization finances only a portion of the cost of the project and the balance will come from the borrower's own resources or elsewhere. I will deal primarily with cases where the balance for financing the project is obtained through foreign borrowing or the provision of equity from foreign sources.

I should also point out that I shall not discuss the raising of capital by the sale of debt obligations of the international organization itself. I thus _omit_ a very important aspect of the capital formation process. The World Bank alone has sold some $7.5 billion of its debt obligations and the IADB has sold about $500 million, but that is a subject for another address.

There are several basic reasons why the international organizations take an active role in trying to help raise other funds for channeling into projects which they finance, as follows:

(a) Under their charters they are not permitted, in effect, to finance a project for which other funds, particularly from private sources, are available on reasonable terms. One way to comply with this injunction is to see to it that they join with funds of others in a particular financing.

(b) Many projects involving substantial sums of money could not, as a practical matter, be financed unless other sources (in addition to those of the sponsor) were tapped.

(c) Where a project is privately owned, the owners may themselves want the participation of an international

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organization because of their feeling that this will give them some protection against arbitrary or unreasonable interference by the host government. And, conversely, the host government may welcome, and indeed actively seek, the participation of the international organization of which it is a member, because the international organization will often be able to give it technical assistance in the working out of arrangements for the project and help investigate whether the arrangements are fair to the government.

There are so many different kinds of joint financing arrangements that it would be impossible for me now to describe them all, even in general terms. However, I have tried to break down the bulk of them into a number of broad categories, drawing particularly on the experience of the World Bank which has been most active in this field.

II. JOINT WORLD BANK-PRIVATE MARKET OPERATIONS

In the early years after World War II, the creditworthiness of foreign governments was not strong enough for them to be able to borrow in the United States private capital market, and during this period the main source of external funds for many of these countries was the World Bank. As the economies of these countries became stronger efforts were directed towards opening up the United States capital market to their bond issues. The World Bank actively participated in these efforts. Accordingly, joint World Bank-private market operations were arranged, particularly between 1954 and 1960, to provide finance for development projects in a number of member countries. Under these arrangements, agreement was reached with U.S. investment banking houses whereby a World Bank loan was made to coincide with the raising of additional funds from private investors either by means of (a) public offering of the borrower's bonds, (b) private placement of securities with institutional investors, or (c) by a combination of these two methods.

Fifteen such operations were undertaken between December 1954 and December 1960 involving a total amount of $562 million, of which $252 million was in World Bank loans and $310 million in sales of the borrower's securities. The borrowers involved were the Governments of Austria; Belgium; Denmark; Federation of Rhodesia and Nyasaland; Japan; Norway; South Africa; the Cassa per il Mezzogiorno, an Italian Government agency; the international airlines of Australia (Qantas) and India (Air India); and the Kawasaki and Sumitomo Steel Companies in Japan.

The proceeds derived from the market and from the World Bank's loan were applied in each case to a common purpose: the financing of a particular development program within the member country involved. Agreement as to use of the proceeds was reached beforehand by representatives of the borrowing country, the investment banking firms, and the World Bank.

The legal problems in these operations were of two main kinds: (a). Questions arising under the Securities Act of 1933 where a public issue was involved; and (b) complications arising from the necessity to synchronize the Bank loan and the market issue.

As far as the Securities Act was concerned, the main problem for the underwriters of the issue was to make sure, where the borrower was a government, that the prospectus included an adequate description of the borrowing country. The Securities Act has no prescribed form governing prospectuses for government issues and in those days there was little precedent to guide the lawyer responsible for the prospectus. The pattern has since evolved for these issues, but in those days it was unclear.

As far as the synchronization of the loan and the issue were concerned, the effectiveness of the Bank loan was made conditional on the sale of the public issue. In addition, in some cases the World Bank loan and the bond issue were linked in other ways, such as provisions in regard to the closing,cross-defaults, and prematuring of the loans. In other respects the private bond issue was set up in normal form and the World Bank loan similarly followed the normal practices of the Bank with regard to effectiveness, disbursement, supervision, and administration of the loan. Of course, questions concerning the pricing and maturity of the private bond issue, as well as its timing, all had to be considered in relation to the fact that the Bank was making a loan to the same borrower at the same time.

III. SALES OF LOANS TO PRIVATE PURCHASERS

The international organizations have raised substantial sums of money by sales to investors by private placement of the obligations of its borrowers received in connection with its loans to them. These sales are now not made with the guarantee of the international organization although in the early days of the World Bank's operations they were sold with the Bank's guarantee. The IADB has sold only one loan with its guarantee. There are two basic types of transactions of this kind. In some cases the sales are arranged at about the time the loan contract is signed and funds are called when disbursements are made. These transactions are called "participations." In other cases sales are made after a loan contract has been signed and disbursements have been made. These sales are called "portfolio sales."

For the most part the obligations sold have been relatively short-term and have been sold to private commercial and savings banks and other similar institutions. In these cases the interest of the purchaser is a relatively simple one and consists essentially of the right to receive a certain principal amount of the loan together with interest,

as it is paid off. In these cases the purchaser has no rights in the administration and supervision of the loan, and its interest is expressed in a relatively simple participation agreement.

In a number of cases, however, insurance companies have bought substantial segments of the entire loan and complicated investment agreements have been negotiated under which the insurance companies are given certain rights in the administration of the loan. In some cases sales of this kind have been arranged by investment banking houses who negotiated the deal with the World Bank and were responsible for finding the purchasers.

By June 30, 1967, the World Bank had arranged to sell over $2 billion of the obligations of its borrowers. However, while these sales represented a very substantial adjunct to the financing of the Bank's loan operations, these sales have steadily declined since 1963. This decline has been an outcome of the worldwide scarcity of capital in recent years and the resulting increase in the general level of interest rates. This increase has made it difficult for the Bank to offer yields on loans in its portfolio as attractive as those in other investments. Consequently, early in 1967 the Bank decided to discontinue selling loans out of its portfolio except in special circumstances but it has continued to make participations in loans available to private investors.

An interesting aspect of these arrangements is the fact that for the most part investors have been willing to rely on the international organizations to administer the loans and protect their rights. Several of them have made independent checks themselves as to the procedures which the Bank follows in making and disbursing the loans and the extent to which the Bank satisfies itself as to the legal formalities, but on the whole, these problems have been left for the Bank to deal with. It should also be noted that these obligations of borrowers when sold without the Bank's guarantee are not exempt from the United States Securities Act and consequently could be sold in this country only by private placement. They could, of course, be sold by a public offering if it was desired to go through the process of registration, but so far this has been regarded as impractical and unnecessary.

IV. JOINT VENTURES

The most significant, and for the lawyer the most interesting, of the ways in which the international organizations channel international capital into the financing of projects is the so-called joint venture financing operation. By this I mean, generally speaking, the case where the international organization joins with one or more other foreign sources of capital (private or public or both) to finance a given project under agreed arrangements regarding their

participation in the project. These cases vary greatly both in the nature of the participants and in the complexity of the arrangements. I think that the best way for me to deal with these joint operations is to describe several of them. I hesitate to say that these cases are typical because they vary so greatly, but I can say that these cases illustrate some of the techniques which are followed and some of the problems which have to be faced.

A. Alcominas Project

The first kind of case is where the participants other than the Bank and the sponsors have interests which are primarily financial. The Alcominas project in Brazil is an example of this kind of case. In this case two large American companies, Alcoa and Hanna, together with Brazilian investors, organized the Alcominas Company, a Brazilian corporation, to finance an aluminum smelter in Brazil. In addition to equity subscribed by the shareholders, loans to Alcominas were made by certain New York banks and by the World Bank. The World Bank's loan was guaranteed by Brazil. Aside from the questions concerning the merits of the project itself, the main problems which arose were primarily of a financial nature, e.g., the basis on which the shareholders would participate in the venture, the security arrangements for the lenders, the relationship between the New York bank loans and the World Bank loan, and the position of Brazil as guarantor. In addition, the familiar problems concerning the effect of United States restrictions on overseas investment had to be considered. I won't attempt to describe these problems in any detail because, complicated as they were, they were substantially similar to those which arise in an ordinary private financing where an international organization is not involved.

B. Private Development Corporation of the Philippines

A more complicated kind of case and one which is becoming more common and important is where the financing comes from some combination of national and international development agencies, each of whose interests are broader than those of an ordinary creditor. In some cases, private investors may also join in the financing, further complicating the arrangements.

National aid agencies, such as the AID or Eximbank or their counterparts in other countries, often have their own national interests to consider and protect when participating in a joint venture, and these interests may be different from or inconsistent with those of the international lending agency. For example, the national aid agency may tie its loans to procurement in its own country. A restriction of this kind may either affect the availability of funds

to complete the project or may result in the imposition of unduly high costs to the borrower. Or the national aid agency may provide in its agreement that it can suspend disbursements on its loan on grounds which are political in nature. These types of restrictions are sometimes difficult to reconcile with those of the international agency. Similarly, there may be conflicts among the international financing agencies themselves regarding such matters as procurement, security arrangements, terms of the loan, and responsibility for supervision of the use of the money and for checking on the project. And finally, private investors have still different interests. They, of course, are particularly interested in the financial safety of their investment and in their own financial return. These interests may well dictate such matters as the form in which they put in their money, the relation of debt to equity, the security arrangements they require and the assurances to be obtained regarding repatriation and protection. Here again, these interests may not in a given case completely coincide with those of the public lender and will have to be reconciled. Consequently, in these cases it is necessary to work out arrangements to insure that (a) the project will yield an adequate economic return to the borrowing country, (b) the project is adequately financed and completed, (c) the financing documents are consistent, (d) the repayment provisions are coordinated, and (e) there is no conflict in administration and project supervision.

An example of this kind of case was the financing in 1963 of the Private Development Corporation of the Philippines (PDCP), a privately owned investment corporation in the Philippines. The financing package was as follows:

- (a) World Bank loan of $15 million, to the Philippine National Bank for re-lending to the PDCP, guaranteed by the Republic of the Philippines;
- (b) AID loan of 27.5 million pesos;
- (c) Share capital of 25 million pesos, of which
  - (i) 70 per cent was to be sold to Philippine investors by public sale and to IFC:
  - (ii) 30 per cent was to be sold by private placement to foreign banking and investment institutions in the United States and other countries;
- (d) A standby commitment by IFC of some of the shares to be sold to the foreign investors.

The legal problems which were raised by this operation were many and complex. On the Philippine side there were the normal problems arising in connection with the formation of a company and the flotation of its securities. Interestingly enough, there are laws in the Philippines which are very similar to the United States Securities Act of 1933 and the Investment Companies Act of 1940, and these

laws had to be taken into account. In addition, since the Republic of the Philippines was to guarantee the IBRD loan it was necessary that there be Philippine legislation covering the guarantee, a substantial matter by itself. On the United States side, since securities were being sold to United States investors at the same time as a public offering was being made in the Philippines, consideration had to be given to the question whether registration was required under the Securities Act.

As far as the relationship between the IBRD and AID was concerned, their differing procurement requirements had to be reconciled and agreement had to be reached as to who would bear the burden of project administration. And finally, in order to assure each lender or investor that all the others would go ahead, it was necessary to make arrangements for a joint closing at which time all parties simultaneously became bound to make their funds available as agreed.

C. Joint Financing of Mineral Concessions

By far the most complicated of these arrangements is where a joint financing is arranged to finance a mineral concession. Since these projects usually involve large sums of money, they often require financing from many of the sources described before. In addition to the complications this presents, this type of project often requires the building of infrastructure facilities. If so, this adds to the complications, especially where the infrastructure is owned by the government which, by itself may not be credit-worthy for a bank loan and financed separately from the mining part of the project itself. These arrangements often provide for the furnishing of special security to the various lenders (e.g., shareholders' guarantees, take-or-pay contracts) and the establishment of trusts outside the borrowing country in order to implement the security arrangements. Furthermore, again in view of the large sums involved, the private sponsors may want a special regime under which they will operate in the country concerned, and this regime (usually embodied in a concession) will have to be carefully negotiated by the country and reviewed by the international agency. The private sponsors may seek investment insurance against political risks, e.g., under the AID investment guaranty program, and this too will have to be carefully negotiated and dovetailed into the other financing arrangements. And this is not to mention the myriad of local problems which often arise in these joint ventures.

Let me describe a case which illustrates what I mean: the Volta project in Ghana, the agreements for

which were signed in 1962.

1. Volta Project in Ghana. This project was set up as separate but related components. First, a dam would be built by the Government of Ghana and financed from public sources. Second, an aluminum smelter would process alumina into aluminum ingot and would be financed by private capital - with some governmental help - and run as a private commercial operation. Probably never in financial history have so many lawyers worked so long and produced so many documents with so many complexities as in this project. While, therefore, the project is not typical, it does incorporate in one package many of the features found scattered in other projects. It also illustrates the unique role an international agency can sometimes play in projects of this kind, for while the amount of the World Bank's loan was large, the role of the Bank in helping to work out the arrangements for the project was larger still. There were so many conflicts - financial, legal and political - and the interests involved were so substantial that it was highly desirable that a non-political, objective party be available to provide at least a forum for the negotiations and to render its good offices, when called upon, to try to settle differences. This role was filled by the World Bank.

The parties and the financing were as follows:

1. The dam, estimated to cost $196 million and to be built by the Volta River Authority, a Ghana Government agency, was financed as follows:

World Bank	- $47 million
AID	- $27 million
Eximbank	- $10 million
United Kingdom	- $14 million
Ghana	- the balance (estimated 50 per cent of total)

2. The smelter, estimated to cost $128 million and to be owned by a private Ghanaian company called Valco, which was owned entirely by the Kaiser and Reynolds Aluminum Companies, was to be originally financed as follows:

Sponsoring shareholders (Kaiser and Reynolds)	$12 million (equity) $20 million (debt)

Eximbank $96 million

AID - Political risk guaranty of Kaiser and Reynolds' investment in Valco

The economics of the project were such that the dam would not be economic unless the smelter bought a substantial part of the power to be generated; and the smelter could not operate unless it were assured of a continuous, inexpensive supply of power from the dam.

The problem arose therefore, as far as both the Volta River Authority and the lenders to the Authority were concerned, as to how they could be assured that Valco, the smelter company, would build the smelter and then, having built it, be able to pay for the power. The problem was complicated by the fact that it would take about five years to build the dam and about two years to build the smelter; thus almost all the dam money would have been spent before the smelter was even started. Because of this, the Authority and its lenders wanted legal assurances that if the dam were built the smelter would be built also.

On the aluminum side, the converse problem arose, namely how could the aluminum companies be assured that if they built the smelter they would be assured of a continuous supply of power. Also, a whole set of problems arose because of the fact that the smelter was being built in Ghana, a country whose policies at that time under Nkrumah presented certain difficulties to a private investor.

These problems were met by a complex set of agreements. The two principal agreements in defining the relations between the Government of Ghana and Valco were the Master Agreement and the Power Contract. These two agreements were the foundation on which all the other agreements rest.

The Master Agreement is a concession agreement on a very comprehensive scale and covers the basic elements involved in doing business in Ghana - taxes, exchange authority, port, water and land rights, and other matters.

The Power Contract does two main things: It provides that certain specified amounts of power will be made available to Valco over a 30-year period at a fixed price, thus assuring Valco of a firm power supply. It is also a so-called "take-or-pay" contract-that is, it provides that Valco will either buy a specified amount of power, or in any event pay a minimum charge whether or not used. This take-or-pay arrangement is intended to assure the Authority of amounts sufficient to pay its loans.

This was all right as far as it went, but it did not go far enough so far as the lenders to the Authority were concerned. It was not enough to receive assurances only from Valco that the smelter would be built and power paid for. After all, Valco would be only a corporate shell until

the smelter was built. It was also necessary to obtain assurances from Valco's shareholders, Kaiser and Reynolds.

A straight guarantee of payment of the loans would, of course, have been fine for the lenders, but for various reasons, including restrictions in their outstanding indentures, a guarantee was not acceptable to the aluminum companies.

As an alternative, agreement was reached on a Voting Trust arrangement under which:

(a) the stock of Valco owned by the aluminum companies was deposited with a voting trustee, Morgan Guaranty Trust Co.; and
(b) if Valco defaulted in its obligations either to build the smelter or make required payments, the voting trustee was to install a new management until the default was cured.

In addition, under two other agreements the shareholders agreed to subscribe certain moneys to build the project (the Subscription Agreement) and to use and pay for over a 30-year period the smelting services of Valco in amounts sufficient to pay the debts incurred to build both the dam and the smelter (Tolling Contracts).

So far as the aluminum companies were concerned, in addition to the protection in the Master Agreement and Power Contract, they wanted protection against certain political risks. This was afforded by two additional agreements: (a) the Political Risk Guaranty, which Kaiser and Reynolds obtained from AID, and (b) the Valco Current Accounts Trust, under which moneys received by Valco were to be paid to a trustee in New York who was directed to use them for certain specified purposes.

Together with these problems there arose the problems I have described before in coordinating the requirements of each lender. Each lender was interested in the success of the entire project and the simplest thing would have been to have one common agreement. However, the particular requirements of each lender made that impractical. For example, World Bank loans cannot be tied to purchases in any particular country. The Eximbank loan was tied to United States purchases; the AID and United Kingdom loans were also tied, but not so rigidly. Interest rates varied among the lenders. For these and other reasons, each lender ended up with a separate agreement, but nevertheless with interlocking covenants and events of default.

A final word for those interested in conflict of laws. Questions of applicable law, force majeure and jurisdiction turned out to be, as they often do, crucial and difficult matters to negotiate.

The applicable law clauses in the main agreements were as follows:

Agreement	Applicable Law
Concession, Power Contract, and Subscription Agreement	Ghana, at time of signing of contract; but subject to arbitration under the rules of the International Chamber of Commerce in Switzerland
Trusts and Tolling Contracts	New York
World Bank Loan Agreement	International
Eximbank Loan Agreements	New York
AID Loan Agreement	District of Columbia
United Kingdom Loan Agreement	No clause specified

As you can see, the Project and the financing represented a blend of international and national institutions, of private and public capital, all joined in a common cause.

2. Boké Project in Guinea. A more recent example of this type of joint venture is the financing of the Boké project in Guinea, one of the richest bauxite deposits in the world. These agreements were signed in September 1968, and the project is now being built. The project consists, as did the Volta project, of two inter-related elements: (a) the construction of a railroad and related facilities to be used primarily for the transport of bauxite, and (b) the construction of bauxite mining installations. The infrastructure facilities were to be owned and operated by the Government of Guinea and to be financed by loans from the World Bank ($64.5 million) to finance the foreign exchange cost and from AID (the equivalent of $21 million in Guinean francs) to finance local currency costs. The bauxite mine, expected to cost about $100 million, is to be constructed, operated and owned by a private Guinean company (CBG), owned jointly by the Halco Mining Company (51 per cent) and the Guinea Government (49 per cent). Halco in turn is owned by large international aluminum companies. The private shareholders have agreed, in effect, to complete the mining installations in accordance with an agreed schedule, to buy substantial amounts of bauxite, and to provide special security arrangements to secure repayment of the World Bank loan. The return to the Government of Guinea will come primarily from a tax on CBG's profits.

Again as in Volta, the American sponsors obtained a political risk guaranty covering their investment from AID. As you can see, the structure of the project and the problems which had to be faced were similar to those in the Volta.

V. CONCLUSION

The examples I have given in this talk deal primarily with cases where there have been large American interests involved, both from private and public sectors. But there are many cases where projects have been financed from private and public sources in other countries, particularly French, British, German, and Swedish. And, while these joint financings raise many of the same problems I have described before, they also differ in many respects because of different national requirements and different legal systems. But that too is the subject of another talk.