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SHAREHOLDING REVIEW:
PROGRESS REPORT TO GOVERNORS AT THE 2017 SPRING MEETINGS

Attached is the final version of the document entitled “Shareholding Review: Progress Report to Governors at the 2017 Spring Meetings” prepared by the World Bank Group for the April 22, 2017 Development Committee Meeting.

SHAREHOLDING REVIEW: PROGRESS REPORT TO GOVERNORS AT THE 2017 SPRING MEETINGS

Introduction

1. The 2015 Shareholding Review Report to Governors[1] defined a Roadmap to Implementation of the Review ('the Roadmap') that was endorsed by Governors at the 2015 Annual Meetings in Lima. As part of the Roadmap, Executive Directors committed to work to develop a Dynamic Formula and this work was concluded by the 2016 Annual Meetings. The Roadmap further called for Executive Directors to work towards decisions at the 2017 Annual Meetings on potential Selective and General Capital increases. The financial needs of the World Bank Group are discussed in a separate paper. Nevertheless, there are important linkages between discussions of the financial resources of the WBG institutions and the balance of their shareholding.

2. This Report to Governors for the 2017 Spring Meetings takes stock of progress in the discussions on rebalancing shareholding building on the agreement on the Dynamic Formula. The discussions so far have considered the gap between the distribution of post-2010 shareholding and the calculated shareholding produced by the Dynamic Formula. They have identified the issues that need to be addressed in order to conclude an agreement. Illustrative simulations of rules based share allocations have provided an initial range of options and a basis for discussion of how the allocation rules interact.

3. This is a Progress Report and it is to be stressed that at this stage of discussion the options remain open. Executive Directors are clear that the different elements of a potential Selective Capital Increase – the size, allocation rules, and other adjustments – are related to one another and will need to be agreed together. Therefore, the discussions are proceeding on the basis that nothing is agreed until everything is agreed. Further options that have not yet been discussed may emerge in upcoming discussions.

4. On the basis of this technical work there is scope for a potential Selective Capital Increase for IBRD that meets the declared objective of "*a balanced outcome in the upcoming SCI that addresses under-representation of individual countries while avoiding excessive dilution*".[2] Future discussions will further assess the options in order to identify a proposal for Governors to consider. Overall, simple and transparent approaches to allocating shares are preferred. Governors are invited to take note of progress and endorse the continuing work.

Context

5. In 2010 Governors agreed a set of reforms that enhanced the voice and participation of Developing and Transition Countries (DTC) in the World Bank Group, notably through an

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[1] DC 2015-0007 "Shareholding Review Report to Governors", September 28, 2015.

[2] DC 2016-0010 "Dynamic Formula – Report to the Governors – Annual Meetings 2016", September 20, 2016.

increase in voting power, and realigned shareholding in line with economic weight. Building on the steps taken in 2010, the 2015 Review identified shareholding review principles that Governors endorsed at the Lima Annual Meetings:

(a) *Regular shareholding reviews will take place every 5 years based on agreed principles and a dynamic formula.*

(b) *The guiding principle for shareholding realignments is to achieve an equitable balance of voting power. This can be assessed by looking at the balance of voting power between country groups and/or under-representation country-by-country*[3].

(c) *As a global cooperative, all voices are important. Where possible decision making is by consensus. All members have Basic Votes, protected in the constituent documents of the respective WBG entities.*

(d) *The smallest poor member countries shall be protected from dilution of their voting power.*

(e) *Shareholding brings both rights and responsibilities, and all shareholders have an interest in the long term financial sustainability of the WBG, including IBRD and IFC's AAA credit rating, contributing in line with their capacity to do so.*

6. Governors further endorsed additional formula guidance that was reflected in the work on the Dynamic Formula in 2016, specifically:

(a) *The formula should reflect and be consistent with the roles and responsibilities of shareholders in the WBG.*

(b) *The formula should be simple and transparent, producing results that can be readily understood and that are broadly acceptable to the membership.*

(c) *It should be based on readily available, timely and high quality data, and should capture broad economic trends avoiding excessive volatility.*

(d) *It will be based primarily on economic weight and the WBG's development mission, including measures of GDP and IDA contributions. Other variables that are consistent with this guidance may be considered.*

(e) *Shareholding Reviews will base their work on the output of the formula which will give clear guidance for adjustments in shareholding.*

7. In completing their work on the Dynamic Formula, subsequently endorsed by Governors, Executive Directors recommended that it include two variables: a measure of Economic Weight with a weight of 80 per cent and a measure of contributions to IDA with a weight of 20 per cent. Economic Weight is measured by a five-year average of GDP, using a blend of Market Exchange Rates (60 per cent) and Purchasing Power Parity (40 per cent). IDA contributions are measured

3 The 2015 Shareholding Review Report to Governors noted that "there are different interpretations of equitable voting power, in particular whether to give priority to a fair balance of voting power country by country or between groups of countries" (DC 2015-0007 paragraph 40).

by a variable that combines the most recent three IDA replenishments with a weight of 80 per cent and earlier replenishments with a weight of 20 per cent. Donors contributing to IDA for the first time are provided with a booster to ensure that their contribution receives the full weight of the recent component of the IDA variable. A compression factor of 0.95 is applied to the overall formula results.

8. Executive Directors further identified a package of commitments for the next stage of discussions that was submitted to Governors at the 2016 Annual Meetings:

   (a) A continued commitment to sustain the steps taken so far in voice reform and to the agreed shareholding review principles endorsed by Governors in Lima, aiming to build on (and not to reverse) the steps towards equitable shareholding over time.

   (b) A commitment to use the dynamic formula, as described in this paper, to deliver voice reform in manageable steps with broad support from the membership. In order to balance the distribution of calculated shareholding between the smallest and largest economies we recommend using a 0.95 compression factor.

   (c) A commitment to focus on rebalancing shareholding in the next phase of the Roadmap and not to discuss changes to the Board size, structure or regional composition.

   (d) A commitment to the objective of producing a balanced outcome in the upcoming SCI that addresses under-representation of individual countries while avoiding excessive dilution. The formula will be used along with transparent share allocation rules which will be explored, including limits on dilution.

   (e) A commitment to discuss the options in the next stage for a principles-based approach to forbearance in order to smooth shifts in shareholding in the collective interest of achieving a broadly supported outcome in terms of voting power.

   (f) A commitment to explore a range of options including an increase in Basic Votes and additional share allocations to the smallest poor members as part of the upcoming SCI to ensure meaningful representation for all shareholders.

9. The current discussions of rebalancing shareholding build on these three pillars which provide both context and guidance: the agreement on the Dynamic Formula and accompanying package of commitments; and the previously agreed shareholding review principles and formula guidance.

Technical Preparations

10. A new Shareholding Simulation Model (SSM) has been developed and made available to Executive Directors. It allows for simulations based on different sizes of share allocation, using the different allocation rules discussed so far. The model offers the option to adjust Basic Votes and introduces limits on voting power dilution. Protection of the voting power of the smallest poor is built into the results produced by the model.

11. The database used to produce the calculated shareholding for the SSM has been updated to reflect GDP/PPP data as of January 2017[4], adjustments to past IDA Replenishments and new IDA18 pledges. Final adjustments to the database due in March 2017 will reflect the latest available GDP dataset and any additional IDA18 pledges[5], together with any adjustments to post-2010 shareholding upon the completion of the 2010 SCI. See **Box 1** for further detail on data sources and methodology.

<u>Box 1:</u> Data Sources and Methodology

Economic Weight Data

The primary source of GDP data is the World Bank's World Development Indicators (WDI). These data are supplemented when necessary, using the IMF's World Economic Outlook (WEO) database. Both the WDI and WEO databases are updated quarterly, to reflect new time series and incorporate data revisions. These data sets and principles are consistent with the Fundamental Principles of Official Statistics and the Principles Governing International Statistical Activities of the United Nations Statistical Division (UNSD). The customary cutoff date for a similar data set gathered by the IMF for their yearly Quota calculation exercises is January 31.

IDA Data

IDA donor contributions are based on IDA replenishments that occur every three years. The dataset includes pledged contributions from initial IDA replenishment through IDA18, and contributions to MDRI using the IDA18 cost update. Amounts include grant and supplemental contributions, contributions for HIPC, arrears clearance, grant compensation, and grant element of concessional partner loans, where applicable. They also include the additional investment income arising from accelerating the standard encashment schedule from 11 to 9 years. All amounts are in US$ using the reference exchange rate for each replenishment.

<u>Progress in Discussions</u>

12. The Report to Governors at the 2016 Annual Meetings[6] noted that: "The role of the Dynamic Formula is to provide the necessary anchor for shareholding discussions...It will be an important part of IBRD Governance, providing a basis for assessing the balance of shareholding at periodic shareholding reviews." The calculated shareholdings produced by the Dynamic Formula provide an input to these discussions by establishing a basis for assessing over- and under-representation of shareholders[7].

13. A comparison of post 2010 shareholding with calculated shareholding from the Dynamic Formula shows that 41 countries are "under-represented" and 148 countries are "over-represented". For many shareholders the differences are not large but for others they are more significant and in a

[4] WDI data as of January 3, 2017, supplemented by WEO data as of October 2016 where necessary.
[5] Including any adjustments to MDRI.
[6] DC 2016-0010 - paragraph 3.
[7] Throughout this note the terms over- and under-representation are used to describe cases where post-2010 shareholding is above and below shareholding as calculated by the Dynamic Formula (calculated shareholding).

few cases they are very large. The largest deviations from calculated shareholding are among the under-represented countries.

14. It is expected that calculated shareholding will serve as an input for shareholding discussions and not as the final outcome, with actual shareholding moving towards calculated shareholding over time. The focus is on how to achieve this. Careful consideration needs to be given to the pace of adjustment which depends on a number of factors, including the commitment to move in manageable steps, and whether or not agreement can be reached on a balanced package where the dilution of some shareholders in order to increase the shareholding of others is kept within acceptable margins. There are trade-offs to assess: notably for example, for a given allocation of shares whether to focus the additional shares on the most under-represented countries, or to allocate to all under-represented countries, or to all countries.

15. Executive Directors have focused discussion on the size of the SCI and the allocation rules that determine how shares are allocated, Smallest Poor Protection (SPP), dilution limits, forbearance, size of SCI, and Basic Votes.

(i) <u>Size of SCI</u>

16. One key decision would be the number of shares to allocate in the Selective Capital Increase (SCI), as it is the allocation of shares that is the mechanism for rebalancing shareholding. Shares in IBRD have a fixed cost of $120,635 per share with a portion that is paid-in and the balance that is callable. The total cost determines the overall size of an SCI. On average, IBRD capital has been paid-in at a ratio of 6 per cent, and this ratio was used in the 2010 capital increases. The Articles of Agreement provide for a paid-in portion up to 20 per cent[8].

17. The 2010 SCI consisted of 230,374 shares (a capital increase of $27.8 billion with $1.6 billion paid-in subscriptions and $26.2 billion in callable subscriptions). Of these SCI shares, 11,357 shares were allocated for smallest poor protection and were fully callable, thus, did not have a paid-in component.

18. As a general principle, increasing the number of shares available for allocation increases the scope for an adjustment of shareholding, though of course the greater the upward adjustment of under-represented shareholders, the greater the implied dilution of others. The illustrative simulations prepared in the course of the work so far have shown options from 200,000 shares up to 700,000 shares, with 300,000 shares as a base case scenario. They have shown that there is a trade-off between the size of the allocation and the selection of allocation rules. With smaller allocations, adjusting the position of the most under-represented countries requires greater use of *ad hoc* allocation rules that may lead to distortions elsewhere in the distribution. This is discussed further below.

(ii) <u>Allocation Rules</u>

19. The role of allocation rules is to provide options for transparent and rules-based allocations of shares to address the gaps between actual and calculated shareholding. This section outlines the four allocation rules that have been used in the illustrative simulations prepared so far.

[8] IBRD Articles of Agreement, Article II, Section 5(i).

a. An allocation in line with the formula

20. Each shareholder is allocated the proportion of the total shares issued equal to its calculated shareholding from the Dynamic Formula. Following the allocation, each shareholder's total shareholding is a weighted average of its current and calculated shareholding, where the weights are determined by the relative size of the existing capital base and the size of an SCI.

21. An allocation in line with the formula moves shareholders incrementally from their current shareholding towards their calculated shareholding. Under-represented countries (in terms of the Dynamic Formula) will become less under-represented, and over-represented countries will become less over-represented. Use of this allocation rule, for any given size of SCI, is likely to provide the smoothest adjustment as all countries receive an allocation in proportion to calculated shareholding. It requires that countries being diluted subscribe to shares in the SCI, as well as in any GCI that accompanies it.

22. The incremental nature of adjustment under this allocation rule means that the most under-represented countries move toward their calculated shareholding over time. This implies that they may well remain very under-represented even after the allocation and there will be a case either to consider a larger allocation or to supplement a formula based allocation with one or more other allocation rules.

23. In light of the commitment noted above "*to smooth shifts in shareholding*", this type of allocation has a clear role to play. Many Executive Directors favor an allocation based largely on a formula based allocation in combination with another allocation rule or rules in order to present a balanced proposal that addresses the position of the under-represented.

b. An allocation to under-represented

24. An allocation of shares only to countries that are under-represented relative to calculated shareholding, or a subset of them, would address their position more aggressively than an allocation of the same size to all countries in line with the formula. It is necessary to define the group of under-represented countries to receive shares – in the limiting case, this could be all under-represented countries, but the allocation can also be focused on the most extreme cases of under-representation.

25. Such an allocation does not require subscription to shares by countries that are over-represented relative to calculated shareholding, although as a result they do not benefit from the smoothing effect of an allocation to all in line with the formula.

26. Illustrative simulations have shown that an allocation of this type can, if not carefully designed, lead to some under-represented countries moving further away from calculated shareholding rather than closer to it. This results from the interaction of two effects: an *increase* in shareholding due to the allocation of shares to the country and the *dilution* of shareholding caused by the allocation of shares to other countries. For countries that, while under-represented, are relatively close to calculated shareholding, the second effect can dominate the first. In other words, the shares allocated are not sufficient to offset the dilution from the shares allocated to others. An approach to limiting such cases, by putting a "floor" under the shareholding of the under-represented that would otherwise be diluted by the rule, has been presented.

27. A selective allocation to under-represented countries can have a role to play in a balanced proposal, especially where there are some countries that are highly under-represented but it will need careful design to minimize distorting effects and avoid complexity.

c. An equal allocation to all countries

28. An equal allocation to all countries is independent of the formula and of whether countries are under- or over-represented and so does not adjust shareholding towards the formula calculations, as the same number of shares would be allocated to all. Rather, the distributional impact is similar to that of an increase in Basic Votes, tending to increase the shareholding of smaller countries relative to large countries. However, the financial impact is different as Basic Votes do not carry any cost to the countries as they do not require a capital subscription.

29. Illustrative simulations including equal allocations have been prepared. Allocations under the rule can have the effect of reducing the number of countries being diluted by turning a number of very modest dilutions into small gains, although they do not address gaps between actual and calculated shareholding. They can result in some over-represented countries becoming more over-represented. Given that there are other features of the model - Basic Votes, compression in the Dynamic Formula, and Smallest Poor Protection - that shift voting power from larger to smaller countries, an equal allocation to all countries has had only limited support from Executive Directors.

d. A "Special Allocation"

30. Illustrative simulations have also been prepared showing the use of a targeted Special Allocation of shares to supplement the main allocation(s). The simulations showed two options for using a Special Allocation: to adjust for cases of under-representation; and to offset dilution. As with an allocation to the under-represented as described above, a Special Allocation would need careful design to avoid unintended distortions, but it could help to address particular issues in a targeted way and so complement a more general allocation to all shareholders.

(iii) Adjustments to Allocations

a. Limits on Dilution

31. As noted in the introduction the agreement on the Dynamic Formula included a commitment to "*…a balanced outcome in the upcoming SCI that addresses under-representation of individual countries while avoiding excessive dilution. The formula will be used along with transparent share allocation rules which will be explored, including limits on dilution*."

32. The Shareholding Simulation Model applies limits on dilution of over-represented shareholders at the level of voting power. Where a limit is set, no shareholder's voting power can fall below the limit. Members are allocated shares to prevent their dilution beyond the limit, and these shares are no longer available to reduce the under-representation of others. In other words, a limit on dilution constrains the potential upwards adjustment of under-represented shareholders.

33. The key decision will be at what level to set a dilution limit should the need arise. In 2010, no specific limit was set. The highest dilution of a single shareholder was 12.4 per cent and 27 countries in total were diluted by more than 10 per cent.

34. There is interest in exploring dilution limits further. Different views have been expressed on the appropriate level of a limit, given the need on the one hand to ensure a smooth realignment with broad support and on the other to address the severe misalignments in the current pattern of shareholding. Setting a limit at a level that protects a large number of countries would affect the scope for adjusting the under-represented and a fair sharing of the burden of adjustment. While quantitative dilution limits have not yet been discussed in detail, there has been interest expressed by some shareholders for limits on dilution of around 5 to 10 per cent.

b. Principles-Based Forbearance

35. In some past SCIs, some shareholders have voluntarily chosen not to take up some or all of the shares allocated to them by the allocation rules. For example, in 2010 China, Germany, Greece, Portugal, Spain and the United States all agreed not to take up eligible shares[9]. Such forbearance can play a useful role in an SCI and has usually been implemented on a country by country basis and at a later stage of negotiation.

36. In concluding the discussions on the Dynamic Formula, it was agreed "to discuss the options in the next stage for a principles-based approach to forbearance in order to smooth shifts in shareholding in the collective interest of achieving a broadly supported outcome in terms of voting power." Discussion has not yet focused on the type of principles that could guide such an approach.

37. There are different ways in which countries may agree to limit their increase in shareholding in order to smooth shareholding shifts, which can be considered forms of forbearance. These include limits on dilution, smallest poor protection and the use of compression in the Dynamic Formula. Allocations that leave countries below their calculated shareholding could also be seen as a form of forbearance, as the alternative would be further adjustment. There are different perspectives on these issues and further discussion is planned.

38. As discussions progress they will consider whether a further commitment to principles based or voluntary forbearance by some countries – on top of the allocation mechanisms and adjustments already built into the model - would help reach agreement.

c. Basic Votes

39. Basic Votes were established at the inception of the IBRD with the specific purpose of ensuring adequate and fair representation in the institution and protecting smaller members. The amendment of the Articles of Agreement that became effective on June 27, 2012 replaced the fixed number of Basic Votes (250 per member) with a fixed proportion to total votes: the sum of all members' Basic Votes now represents 5.55 per cent of total votes. This means that a subscription increase of any member will automatically lead to a change in the number of Basic Votes for all members, such that the proportionality of 5.55 per cent of Basic Votes to total votes is maintained. This mechanism was introduced to ensure that Basic Votes would no longer be diluted over time as new shares were allocated, as had happened in the past.

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9 DC2010-0006/1 "WBG Voice Reform: Enhancing Voice and Participation of Developing and Transition Countries in 2010 and Beyond", April 25, 2010, paragraph 14.

40. By setting Basic Votes as a fixed percentage of the total stock of votes, a substantial amount of protection for the voting power of smaller countries is already embedded in the system. The necessary adjustment to voting power takes place as the final stage of any share allocation[10].

41. Increasing Basic Votes as a percentage of total votes has the attraction of reducing the need for additional share allocations for Smallest Poor Protection, although it would require an Amendment of the Articles of Agreement. While it is not clear whether this is a viable option at this time some chairs have expressed an interest to keep the option open.

d. Smallest Poor Protection (SPP)

42. The Shareholding Review principles agreed by Governors in Lima state that "The smallest poor member countries shall be protected from dilution of their voting power." SPP is therefore defined in terms of voting power, rather than shareholding. The automatic upward adjustment of Basic Votes described above is likely to provide much of the necessary adjustment in voting power, but may need to be supplemented by some additional share allocation to members of the SPP group where they would be diluted even after the Basic Votes adjustment. Discussion has focused on the definition of the countries to be protected.

43. The approach used in 2010 for SPP was based on the World Development Indicators (WDI) classification of countries by income group. The smallest poor members eligible for protection consisted of two groups: *Low income countries* under the WDI classification, July 2009; and *Lower middle income countries* listed in WDI with less than 0.4 percent IBRD shareholding.

44. In 2010, these groups consisted of 76 countries. Updating this definition of smallest poor countries with the WDI data as of December 2016 shows that 30 countries now qualify as low income and 44 as lower middle income with shareholding below 0.4 per cent. The total number of countries qualifying on 2016 data is therefore 74, and they account for 7.57 percent of post-2010 IBRD voting power.

45. There is broad support for continuing to use the 2010 definition, using updated data as of 2016, and simulations have continued to be based on this definition, though some chairs expressed a preference to keep the issue open until discussions have developed further.

IFC

46. While much of the focus of this report has been shareholding and voting power in IBRD, the Lima timeline also calls for consideration of General and Selective Capital Increases for IFC. As already noted, the financial needs of the WBG institutions – including IFC - are discussed in a separate paper.

47. IBRD Executive Directors are *ex officio* members of the IFC Board, so the Board structure of the institutions is aligned. However, there are differences in shareholding, voting power and in some of the voting thresholds. The DTC group has 39.4 per cent of IFC shareholding compared to 47.2

[10] Basic Votes could be changed once more to further extend this protection although this would require an amendment of the IBRD Articles of Agreement which requires approval by 85% of the membership's total voting power.

per cent at IBRD. The 2010 reforms increased the share of the DTC group by around 6 per cent in IFC and increased Basic Votes to 5.55 per cent of the total votes, in line with IBRD.

48. Historically, IFC shareholding has been linked to IBRD shareholding, reflecting their common role in the World Bank Group. Initial subscriptions were set in relation to IBRD shareholding in 1956 and for new IFC members subsequently. Over time, however, the distribution has been allowed to diverge to some extent as capital increases have taken place at different times, members have joined at different times and IFC has issued additional shares that Members have been able to subscribe to. In other words, the link between the shareholding of the two institutions has been interpreted flexibly over time and shareholders have understood and accepted this.

49. IFC has traditionally developed Selective Capital Increases around shareholder interest in increasing their shareholding in the institution. In 2010, shareholders were consulted through Executive Directors offices on their interest in either maintaining or increasing their IFC shareholding, bearing in mind the overall aim to increase the voting power of developing countries, and a package was put together based on the interest expressed. A consultative approach based on shareholder interest would be one way to prepare a potential SCI for IFC that sought to address the gaps that have emerged over time between IFC and IBRD shareholding.

50. Executive Directors intend to discuss further how to proceed in their upcoming meetings, bearing in mind the important linkages to the wider capital discussion and the financial needs of IFC within the WBG.

Conclusions

51. Discussions so far have reflected the collaborative spirit that has characterized the implementation of the Lima Roadmap. They have confirmed the issues with the current distribution of shareholding, including the pattern of under-representation with a few examples of highly under-represented countries.

52. Discussions have also clarified the costs and benefits of different types of allocation rules, and the implications of using them in varying proportions. The ability to generate a range of options using the modelling toolkit available, and the illustrative simulations so far prepared, suggests that there is scope for a Selective Capital Increase in line with agreed principles and commitments that meets the declared objective of "*a balanced outcome in the upcoming SCI that addresses under-representation of individual countries while avoiding excessive dilution*". Upcoming discussions will focus on developing and refining some proposals that can achieve this.

53. There is broad agreement on certain features of the approach to take, based on the commitments reflected in paragraph 8. Simple and transparent approaches in manageable steps are preferred. Adjustments in one direction that require further offsetting measures should be avoided as far as possible. Discretionary thresholds should apply only if deemed necessary. An approach that makes the most possible use of a formula based allocation in combination with other allocations is likely to satisfy these criteria best. Other possible features of a final package will need further discussion.

54. Executive Directors will continue their discussions with a view to reaching agreement on a balanced set of proposals. As noted at the outset the elements of the package to be agreed, including the size of the SCI and the allocation rules are connected and will need to be settled

together. Nothing is agreed until everything is agreed. We underline the connections between the different tracks of this roadmap. We remain committed to the necessary work to bring discussions to a successful conclusion in line with the Lima roadmap, and invite Governors to take note of progress and endorse the continuing work.