

**REVIEW OF WORLD BANK CONDITIONALITY:  
LEGAL ASPECTS OF CONDITIONALITY IN  
POLICY-BASED LENDING**

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## **ACRONYMS**

BP	Bank Procedure
CAS	Country Assistance Strategy
DPL	Development Policy Lending
ESW	Economic and sector work
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
OD	Operational Directive
OP	Operational Policy
OPCS	Operational Policy and Country Services

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# **REVIEW OF WORLD BANK CONDITIONALITY: LEGAL ASPECTS OF CONDITIONALITY IN POLICY-BASED LENDING**

## **EXECUTIVE SUMMARY**

1. This paper discusses the legal aspects of conditionality in World Bank policy-based lending operations. These operations are authorized under the “special circumstances” provisions in IBRD and IDA’s Articles of Agreement. They are processed under Operational Policy (OP) 8.60 and Bank Procedure (BP) 8.60. Unlike investment loans made for specific projects, policy-based operations provide rapidly disbursing policy-based financing for a borrower’s actual or anticipated development financing requirements. These loans were initially introduced in the Bank’s lending menu in 1980 in the form of structural adjustment lending. The concept of “conditionality” evolved from the borrower’s program of reforms and actions that formed the principal basis for the Bank’s support.

2. ***What is Conditionality?*** There is no formal definition of “conditionality” in the Bank’s legal framework or operational policies. Paragraph 13 of OP 8.60 policy identifies three essential requirements for the Bank to make disbursements in a policy-based loan. They are: (a) maintenance of an adequate macroeconomic policy framework; (b) implementation of an overall program in a manner satisfactory to the Bank; and (c) compliance with critical policy and institutional actions.

3. These requirements are the Bank’s “conditions” for its policy-based operations. They are reflected in the applicable legal agreements. Besides these conditions, an operation’s program matrix includes various other elements, such as triggers, outcomes, and benchmarks. These elements are not reflected in a program’s legal agreements as “conditions,” and they are not determinative of disbursements.

4. ***Articles and Conditionality.*** The Bank’s Articles of Agreement do not specifically prescribe or regulate conditionality in policy-based lending. However, the use of conditionality in these operations can be regarded as consistent with certain key Articles provisions:

- The “special circumstances” provision is the statutory basis for policy-based lending. The Bank enjoys wide discretion in fashioning its response to special circumstances. Through the Bank’s practice, conditionality in the form of a borrower’s program of specific policy and institutional actions has become an essential aspect of policy-based lending under “special circumstances.” (IBRD Articles, Article III, Section (4) (vii) and IDA Articles, Article V, Section (1) (b).)
- All Bank activities must conform to the developmental “purposes” including the concept of productive purposes enshrined in the Articles. Even when responding to “special circumstances,” the Bank’s policy-based loans must be in accordance with the “purposes” identified in the Articles. Thus, where certain policy and institutional actions and measures are considered necessary for an operation to achieve the Bank’s development purposes, these “conditions” may be validly justified under the Articles. (IBRD and IDA Articles, Article I.)

- The IBRD Articles recognize that the institution may provide financing for productive purposes on “suitable conditions,” while under its Articles, IDA may provide financing on appropriate terms. (IBRD Articles, Article I (ii) and IDA Articles, Article V, Section 2 (b).)

5. ***Conditionality in Bank Legal Agreements.*** A borrower’s “program” of actions, objectives, and policies constitutes the basis for Bank support through a policy-based loan. Legal agreements for policy-based operations require the borrower to “exchange views” with the Bank on any actions that could materially reverse a program's objectives or any specific actions listed in the legal agreements. The borrower’s commitment to execute its program has been generally regarded as not contractually enforceable. But the Bank has certain disbursement options if a borrower fails to undertake program conditions. These options can be exercised in three situations.

- ***Failure to consult the Bank on program changes after disbursement.*** The Bank may provide notice, and could after 60 days, accelerate the loan (although it has never exercised this option).
- ***Failure to comply with tranche-release conditions.*** The Bank has four options: (a) refuse to make the tranche release; (b) suspend future disbursements; (c) cancel the loan after 30 days of suspension; and (d) cancel the loan if the borrower does not take satisfactory steps to comply with conditions in 90 days.
- ***Inconsistent actions after tranche-release conditions are satisfied.*** The Bank may refuse to make the tranche release or suspend the right to future disbursements under the loan.

# REVIEW OF WORLD BANK CONDITIONALITY: LEGAL ASPECTS OF CONDITIONALITY IN POLICY-BASED LENDING

## I. INTRODUCTION

1. This background paper discusses the legal aspects of conditionality in World Bank policy-based lending operations.<sup>1</sup> It provides an overview of the principal legal considerations based on the history, evolution, and general practice of using conditionality in policy-based lending, and it does not purport to offer new legal pronouncements on this matter.

2. ***Policy-Based Operations.*** Policy-based operations are authorized under the “special circumstances” provisions in IBRD and IDA Articles of Agreement.<sup>2</sup> They are processed under Operational Policy (“OP”) 8.60 and Bank Procedure (“BP”) 8.60 and financed through IBRD loans, IDA credits, or IDA grants. Consistent with the review exercise this paper focuses only on conditionality in policy-based lending.<sup>3</sup>

3. ***Structure of the Paper.*** This paper is organized as follows. Section III traces the evolution of the term “conditionality” and explores its meaning in the Bank’s policy-based operations. Section IV examines the legal basis for conditionality under IDA and IBRD’s Articles of Agreement. Section V discusses the manner in which conditionality is incorporated in the Bank’s legal agreements with borrowers. Finally, Section VI identifies certain legal and policy issues that have arisen through the use of conditionality in the Bank’s policy-based operations. To effectively handle these issues, that section highlights certain legal and operational considerations that should guide the formulation of conditionality in future operations.

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<sup>1</sup> In this paper, unless expressly indicated to the contrary or the context requires otherwise, references to “the Bank” or the “World Bank” include both the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA); the “Board” denotes the Boards of Executive Directors of IDA and IBRD; “borrower” includes a borrower under an IBRD loan and a recipient of an IDA credit or grant; “IMF” or “Fund” refers to the International Monetary Fund; “Articles” means both IDA and IBRD’s Articles of Agreement; “lending” includes making an IBRD loan and an IDA credit or grant; “loans” include IBRD loans and IDA credits and grants; “loan agreement” includes an agreement between the Bank and the borrower providing for an IBRD loan as well as an agreement for IDA financing (through a credit or grant). For subnational policy-based operations, certain references in this paper to the “borrower” also include the relevant subnational units (such as states or provinces) that are supported by these operations.

<sup>2</sup> See IBRD Articles, Article III, Section (4) (vii) (“loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development”). There is a similar provision in Article V, Section (1) (b) of IDA’s Articles.

<sup>3</sup> The Bank has two principal lending instruments: investment loans and policy-based loans. Investment loans provide financing for a wide range of activities that create physical and social infrastructure necessary for poverty alleviation and sustainable development. See Operational Policy and Country Services (OPCS), *World Bank Lending Instruments: Resources for Development Impact 5* (2001). Policy-based loans provide rapidly disbursing policy-based financing, which the Bank provides in the form of loans or grants to help a borrower address actual or anticipated development financing requirements that have domestic or external origins. See OP 8.60 ¶ 1.

## II. PRELIMINARY CONSIDERATIONS

4. Conditionality was a relatively unused term in Bank operations until the introduction of structural adjustment loans in 1980.<sup>4</sup> Until that time, Bank operations generally involved lending for “projects,” although the Bank also made certain loans that were not for specific projects.<sup>5</sup> Project lending did not generally include any macroeconomic or policy-based conditions. These policy reforms and actions were, however, a common feature in the IMF’s balance-of-payments support operations.<sup>6</sup>

5. Structural adjustment loans formally introduced the concept of “conditionality” in Bank operations. These loans were initially designed to help countries with severe balance-of-payments problems undertake economic policy reforms. To obtain an adjustment loan, a borrower would propose a reform “program” to correct imbalances in its economy.<sup>7</sup> This program would comprise a series of policy changes and institutional reforms to achieve efficient use of resources.<sup>8</sup> The Bank’s financing supported this program.

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<sup>4</sup> See Jacques Polak, “The World Bank and the IMF: A Changing Relationship” in, *The World Bank: Its First Half Century* vol. 2, 473-523, 486 (Devesh Kapur, John P. Lewis, and Richard Webb eds., Brookings Institution Press 1997), which notes that a prominent historical treatise on the Bank written in the 1970s used the term “conditionality” to describe conditions imposed by the Fund.

<sup>5</sup> The Bank’s Articles require that loans and guarantees be made for “specific projects” except in “special circumstances (IBRD and IDA Articles, *supra* n. 2). In 1946, the Bank’s Executive Directors interpreted the Articles to recognize that, in special circumstances, the Bank could make economic reconstruction loans, including long-term stabilization loans. IBRD Board Committee on Interpretation, *Authority of the Bank to Make or Guarantee Loans for Programs of Economic Reconstruction* (September 20, 1946) (“*Authority to Make Loans for Programs*”). In fact, the first four loans made by the Bank were not for specific projects, but rather for the reconstruction and economic recovery of France, the Netherlands, Luxembourg, and Denmark. Before the introduction of structural adjustment loans, non-project lending under “special circumstances” mostly comprised “general-import loans” that financed agreed lists of imports. See generally, Memorandum from the Vice President and General Counsel, *Authorized Purposes of Loans Made or Guaranteed by the Bank*, SecM-88-517, ¶ 13 (May 10, 1988) (“*Authorized Purposes Opinion*”), which discusses the history of Bank operations under the “special circumstances” provision. For a discussion of the evolution of investment loans, see Operations Policy and Strategy, *Programmatic and Emergency Adjustment Lending: World Bank Guidelines 2* (September 29, 1998) (“*Programmatic Guidelines*”).

<sup>6</sup> The origin of the term “conditionality” at the Fund can be traced to the Article V (3) (a) of its Articles of Agreement. See generally Joseph Gold, *Use of the International Monetary Fund’s Resources: “Conditionality” and “Unconditionality” as Legal Categories*, 6 *Journal of International Law and Economics* 1-26 (1970). This provision, which is captioned “conditions governing use of the Fund’s general resources,” reads:

The Fund shall adopt policies on the use of its general resources, including policies on a stand-by or similar arrangements, and may adopt special policies for special balance-of-payment problems that will assist members to solve their balance-of-payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

IMF Articles of Agreement, Article V (3) (a). Note, however, that although the Bank and the Fund’s Articles overlap in some respects, the responsibilities of each institution differ in some vital aspects as do the obligations of their respective members states. See Ibrahim F.I. Shihata, *The Relationship Between the Bank and the Fund – Distinct and Overlapping Responsibilities*, in *The World Bank Legal Papers 773-797* (Martinus Nijhoff Publishers 2000).

<sup>7</sup> See Memorandum from the President, *Structural Adjustment Lending*, R80-122, IDA R80-83, ¶ 13 (May 9, 1980) (“*Structural Adjustment Lending Memorandum*”).

<sup>8</sup> See Vice President and Secretary, *Progress Report on Structural Adjustment Lending*, R84-150, ¶ 4 (June 6, 1984).

6. The Bank’s policy guidance on adjustment lending was codified in December 1992 through the adoption of Operational Directive (OD) 8.60. This directive identified certain pre-conditions for adjustment lending and contained various prescriptions regarding conditionality.<sup>9</sup> Over time, responding to changing borrower requirements, the Bank gradually developed a diverse menu of adjustment lending options. Traditional structural adjustment loans were supplemented by sector adjustment loans and credits, subnational adjustment loans and credits, programmatic adjustment operations, and poverty reduction strategy credits to handle varying borrower requirements.<sup>10</sup> These changes were reflected through successive operational memoranda to update the provisions of OD 8.60.<sup>11</sup>

7. In August 2004, a new framework for policy-based lending was introduced through OP 8.60. Among other things, the new policy replaced the existing types of adjustment loans with a single instrument called a development policy loan.<sup>12</sup> According to OP 8.60, development policy lending aims to help countries achieve sustainable reductions in poverty through a program of policy and institutional actions that promote growth, enhance the well-being and increase the incomes of poor people.<sup>13</sup> As this paper explains below, compliance with *critical* program measures and actions, maintenance of an adequate macroeconomic policy framework, and satisfactory program implementation constitute “conditions” for the Bank to release loan proceeds.

8. ***What is Conditionality?*** There is no formal definition of “conditionality” in OP 8.60 or in any other Bank policy or procedure. Paragraph 13 of OP 8.60, however, refers to the term “conditions” in the following manner:

The Bank determines which of the agreed policy and institutional actions by the country are critical for the implementation and expected results of the program supported by the development policy loan. The Bank makes the loan funds available to the borrower upon maintenance of an adequate macroeconomic policy framework, implementation of the overall program in a manner satisfactory to the Bank, and compliance with these critical program conditions.

9. The policy states that three essential conditions or requirements must be satisfied for the Bank to make disbursements in a policy-based loan. These conditions are: (a) maintenance of an adequate macroeconomic policy framework; (b) implementation of an overall program in a manner satisfactory to the Bank; and (c) compliance with critical policy and institutional actions

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<sup>9</sup> See O.D. 8.60 ¶ 47. This directive replaced an earlier operational circular. See Operational Manual Circular 87/06, *Guidelines for Preparing and Processing Adjustment Loans and Credits* (November 23, 1987).

<sup>10</sup> The Bank also made special structural adjustment loans to countries affected by the East Asia crisis in the late nineteen nineties. See OPCS, *Adjustment Lending Retrospective: Final Report* ¶ 2 (June 15, 2001) (“*Adjustment Lending Retrospective*”).

<sup>11</sup> See, e.g., OPCS, *Adjustment Operations – Documentation of Policy Performance in Initiating Memoranda* (March 31, 1988); *Tranche Release for Adjustment Operations*, (January 21, 1992); *Simplifying Disbursement under Structural and Sectoral Adjustment Loans*, (February 8, 1996); *Guidelines for Special Structural Adjustment Loans*, (April 19, 1999); *Guidelines for Programmatic Adjustment Loans/Credits*, (February 11, 2000); and *Interim Guidelines for Poverty Reduction Support Credits (PRSCs)* (May 31, 2001).

<sup>12</sup> See OPCS, *From Adjustment Lending to Development Policy Lending: Update of World Bank Policy* ¶ 20 (August 2004) (“*Development Policy Lending Update*”).

<sup>13</sup> OP 8.60 ¶ 2.

that are critical for the implementation and expected results of the program. Thus, from a policy perspective, these conditions are what the Bank considers to be “conditions” in its policy-based operations, and are appropriately reflected in the legal agreement for these operations.<sup>14</sup>

10. Policy and institutional conditions in a program vary in number, scope, and content depending on the operation.<sup>15</sup> They may include institutional actions, modifications in policies, sustained implementation of policies, maintenance of a satisfactory macroeconomic framework, and even analytic work.<sup>16</sup> But, as a general rule, only those actions and measures deemed *critical* for achieving the outcome of a program constitute conditions for the Bank to disburse funds together with the other requirements of a satisfactory macroeconomic policy framework and satisfactory program implementation.<sup>17</sup>

11. ***Single-Tranche versus Multitranche Loans.*** Policy-based loans can be structured with either a single or multiple tranches. In a single-tranche operation, the entire loan amount is made available for withdrawal when the legal agreements are declared effective. This usually takes place after the borrower complies with all the conditions for the Bank to make disbursements under the loan. In a multitranche operation the loan is disbursed in several stages or tranches as successive program conditions are met.<sup>18</sup>

12. ***Programmatic Approach.*** The Bank’s policy lending to a borrower may follow a programmatic approach that includes a series of single-tranche operations within a medium-term framework. Where such an approach is used, the borrower’s compliance with all conditions necessary for disbursement under one single-tranche loan should be distinguished from actions necessary to satisfy triggers or benchmarks (discussed below) for future Bank loans under the medium-term program.<sup>19</sup>

13. ***Prior Actions.*** Critical conditions (policy and institutional actions) in a single-tranche operation are usually met before the operation is presented to the Board for approval. These conditions are referred to as *prior actions* and are listed in a schedule to the legal agreement between the Bank and the borrower for the operation. It is possible that in some single-tranche operations certain conditions can only be met after Board approval. In such cases, the conditions

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<sup>14</sup> In some subnational policy-based operations, these conditions may also be reflected in a project agreement with the subnational unit.

<sup>15</sup> See OPCS, *Review of World Bank Conditionality: Issues Note 4 ¶ 9* (January 24, 2005) (“*Issues Note*”).

<sup>16</sup> See OPCS, *Designing Development Policy Operations*, in *Good Practice Notes for Development Policy Lending* Section V, 12-20 (October 2004) (“*Design Good Practice Note*”). A companion paper to this legal paper explains the different categories of conditions used in policy-based operations. OPCS, *Review of Conditionality: Recent Trends and Practices* (2005).

<sup>17</sup> In subnational policy-based operations, these critical actions and measures may be the responsibility of subnational units, such as states and provinces, which are supported by these operations.

<sup>18</sup> See OP 8.60 ¶ 14.

<sup>19</sup> While complying with prior actions for an operation before board presentation, a borrower may elect under the “deferred drawdown option” to defer a single-tranche loan’s disbursement for up to three years. Disbursements under this option are contingent on satisfactory program implementation and a macroeconomic policy framework. See OP 8.60 ¶¶ 21-22.

must be satisfied before the loan is declared effective, and they are formulated as special conditions of effectiveness, which are indicated in the legal agreement.<sup>20</sup>

14. ***Tranche-Release Conditions.*** In these operations, the borrower may comply with certain conditions after Board approval and effectiveness. These conditions are included as tranche-release conditions. They must be satisfied for subsequent tranches, after the first one, to be released. Tranche-release conditions are also reflected in the legal agreement.

15. ***Triggers, Outcomes, and Benchmarks.*** Aside from the critical policy and institutional actions, which constitute a program’s “conditions” together with a satisfactory macroeconomic policy framework and program implementation, a policy-based operation usually includes other substantive elements. These elements include triggers (used in programmatic operations to assess achievement of outcomes, they are expected prior actions for future loans); outcomes (desired changes that result from the actions); and benchmarks (standards against which performance or achievements are assessed).<sup>21</sup> These elements are usually reflected together with the critical conditions in an operation’s program matrix.<sup>22</sup> But triggers, outcomes, and benchmarks are not reflected in a program’s legal agreements as “conditions,” and they are not determinative of disbursements.

16. Triggers are especially significant to programmatic policy-based lending, which usually consists of a series of single-tranche loans in support of a government’s medium-term program. Triggers represent a notional set of expected prior actions for future operations that are essential to the medium-term program’s sustainability. Compliance with triggers indicates sufficient progress to move from one loan to the next if other general requirements, such as satisfactory macroeconomic framework and program implementation, are met. Triggers for the first operation are expected to become prior actions for the subsequent one. Using triggers in programmatic lending as indicative measures of progress provides greater operational flexibility than multitranche operations, since tranche-release conditions must be waived if they are not complied with. They are not reflected in the legal agreement for an operation, although they may become prior actions for subsequent operations.<sup>23</sup>

17. ***Standard Contractual and Fiduciary Requirements for an Operation.*** It is also important to distinguish “conditionality” from standard contractual and fiduciary requirements in Bank legal agreements regarding the use of loan proceeds. All legal agreements for policy-based operations generally include a negative list of excluded expenditures for which the borrower may

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<sup>20</sup> Note that a distinction should be made between “standard” and “special” conditions of effectiveness. Standard conditions of effectiveness apply to all Bank loans. They require the borrower to show that the execution and delivery of legal agreements between the Bank and the borrower have been duly authorized or ratified by all necessary governmental or corporate actions. Special conditions of effectiveness consist of specific actions or measures that may vary depending on the nature of the operation. See OP 13.00 *Signing of Legal Documents and Effectiveness of Loans and Credits* ¶ 2. Both standard and special conditions of effectiveness must be complied with before the legal agreements for a loan can be declared effective.

<sup>21</sup> For an explanation of these and other terms used in policy-based lending, see OPCS, *Good Practice Note on Results in Development Policy Lending* (June 2005).

<sup>22</sup> See *Good Practice Note on Designing Development Policy Operations*, supra n. 16 at 24.

<sup>23</sup> See OPCS, *Programmatic Adjustment Lending Retrospective* ¶¶57-63 (January 2004).

not use the loan proceeds.<sup>24</sup> But this limitation—as well as the financial management, audit, and loan repayment provisions—is not considered part of a policy-based operation’s conditionality.

### III. CONDITIONALITY AND THE ARTICLES OF AGREEMENT

18. Except for minor references to “suitable conditions” of Bank loans and “terms” of IDA financing, the concept of “conditionality” is not explicitly discussed in either IBRD or IDA’s Articles.<sup>25</sup> Nor do the Articles specifically require, control, or regulate “conditionality,” as that term is used in policy-based lending (discussed in Section III of this paper). Instead, as successive General Counsel have emphasized, the Articles cannot be subject to a strict literal reading. The Articles must receive a great measure of purposive interpretation to reflect the Bank’s changing role as a development institution.<sup>26</sup>

19. ***Special Circumstances Provision.*** As noted earlier, policy-based lending takes place under the “special circumstances” exception in the Articles. This exception allows the Bank to depart in “special circumstances” from its traditional practice of making or guaranteeing loans only for specific projects.<sup>27</sup> This general rule regarding Bank financing for projects (and the “special circumstances” exception) is listed as one of the “conditions” on which the Bank may make loans and guarantees.<sup>28</sup>

20. The scope and extent of the “special circumstances” provision is not defined in either institution’s Articles. This omission was, in some respects, a deliberate one. The framers sought to give the Bank wide discretion in responding to a special circumstance.<sup>29</sup> Through 60 years of the practice, the “special circumstances” provision has been interpreted in an evolving manner.

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<sup>24</sup> See *Development Policy Lending Update*, supra n. 12 at 29 (stating that the negative list serves as a self-implementing “code of conduct” for borrowers which could trigger the Bank’s enforcement of its legal remedies only in exceptional cases); and Ibrahim F.I. Shihata, *Interim Report on Adjustment Lending – Statement by Mr. Shihata*, SecM88-322, ¶¶ 8-9 (March 23, 1988) (noting that the negative list enables quick disbursement and efficiency, while ensuring that the development purposes of the Bank’s financing are served more clearly).

<sup>25</sup> See discussion in paragraphs 36-38 of this paper. Cf. Gold, supra n. 6 at 20-25 (noting that the IMF’s Articles does not give any express guidance on what policies the Fund should encourage members to follow as part of its conditionality).

<sup>26</sup> See *Authorized Purposes Opinion*, supra n. 5.

<sup>27</sup> See supra n. 2.

<sup>28</sup> See IBRD Articles, Article III, Section 4 and IDA Articles, Article V, Section 1.

<sup>29</sup> See Henry Bittermann, *Negotiation of the Articles of Agreement of the International Bank for Reconstruction and Development*, 5 *International Lawyer* 76 (1971); and Shihata, supra n. 24 at ¶ 3 (noting that authors of the Bank’s Articles gave Board sufficient latitude in interpreting this provision).

21. As a general principle, “special circumstances” are those, which in the Board’s judgment, justify a departure from the general rule that Bank loan proceeds should finance “specific projects.”<sup>30</sup> Special circumstances are usually country-specific, related to a certain period of time, or result from a general economic situation that affects some or all borrowing countries.<sup>31</sup> At first, it was determined that Bank loans under “special circumstances” would be appropriate only if a country’s growth prospects were seriously affected by actual or prospective external imbalances and the necessary inflow of external resources could not be mobilized through more conventional financing.<sup>32</sup>

22. Subsequently, the understanding of “special circumstances” evolved to justify Bank assistance where countries faced a gap in actual or anticipated external financing requirements that could have balance-of-payments or fiscal origins.<sup>33</sup> With the introduction of development policy lending, the “special circumstances” provision has been applied to assist a borrower in “special circumstances” address its actual or anticipated development financing requirements that may have either domestic or external origins.<sup>34</sup>

23. ***Link between Conditionality and Special Circumstances.*** Neither the “special circumstances” exception nor any other provision of the Articles explicitly requires conditionality for policy-based lending. However, when the Bank introduced structural adjustment lending in 1980, it made a borrower’s “willingness to formulate a suitable program of structural adjustment” an important precondition for these operations. The Bank’s support for a borrower’s “program” was linked to various changes that a country would make in its export-import balance, policies, institutions, and investment guidelines.<sup>35</sup> It was envisaged that these changes or “conditions” would enable the borrower to meet its development requirements.<sup>36</sup>

24. As the share of adjustment lending increased, the importance of conditions associated with these operations grew.<sup>37</sup> Virtually every adjustment operation included a list of “conditions” of actions or measures embedded in a borrower’s program that a government should take, or refrain from taking. This link between conditions in a borrower’s program and the Bank’s financial support has been emphasized through successive iterations of operational

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<sup>30</sup> *Authorized Purposes Opinion*, supra n. 5 at ¶ 7; and Ibrahim F.I. Shihata, *Project and Non-Project Financing under the IBRD Articles*, SecM-84-1053, ¶¶ 8-10 (December 21, 1984) “*Project and Non-Project Financing*” (discussing the distinction between project and non-project lending, and noting that in the Bank’s practice, “project lending” has used a broad definition of the term “project” to include programs where specific goods and services are allocated for well-defined purposes).

<sup>31</sup> See *Project and Non-Project Financing*, id. at ¶ 11.

<sup>32</sup> See Senior Vice President and General Counsel, *Legal Note on Development Policy Lending* ¶ 3 (July 26, 2004) (“*Development Policy Lending Legal Note*”).

<sup>33</sup> See id. at ¶ 4.

<sup>34</sup> See id.

<sup>35</sup> See id. at ¶ 2.

<sup>36</sup> See id. at ¶¶ 12-13 (noting that the justification for Bank support lies in the policy measures and institutional changes, which the government has decided to carry out to achieve its objectives) and, see also, Memorandum from the President, *Program Lending*, R68-206, 7-11 (November 5, 1968) (emphasizing that government policies form the basis of “program loans” under the special circumstances provision and that these policies are important to the *effectiveness* and *justification* of these loans) (emphasis added).

<sup>37</sup> See Ibrahim F.I. Shihata, *The World Bank in a Changing World* vol. 1, 59 (Martinus Nijhoff Publishers 1991) (noting that conditionality evolved from macroeconomic measures to detailed reforms affecting public administration).

policy governing policy-based lending under the “special circumstances” provision.<sup>38</sup> Thus, through 25 years of Bank practice, conditionality involving a program of specific policy and institutional actions has become an essential aspect of policy-based lending under the “special circumstances provision.”

25. ***Purposes of IDA and IBRD.*** Any activities undertaken by IBRD and IDA, including lending for specific projects or programs, including special-circumstances lending, must be in accordance with their “purposes.” Article I of IBRD’s Articles lists the institution’s purposes and they may be summarized as follows:

- (i) to assist in the reconstruction and development of members by facilitating investment for productive purposes;
- (ii) to promote private foreign investment and, when private capital is not available on reasonable terms, to supplement private investment by providing financing, on suitable conditions, for productive purposes out of its capital or funds raised by it and its other resources;
- (iii) to promote the long-term balanced growth, international trade, and the maintenance of equilibrium in balance of payment;
- (iv) to arrange loans or guarantees for projects so that the more useful and urgent projects, large and small alike, are dealt with first; and
- (v) to conduct its operations with due regard to the effect of international investment on business conditions in its members.

26. Similarly, Article I of IDA’s Articles enumerates IDA’s purposes as follows:

“to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world included within [IDA]’s membership, in particular[,] by providing finance to meet their important developmental requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans, thereby furthering the development objectives of [IBRD] and supplementing its activities.”

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<sup>38</sup> See *Structural Adjustment Lending Memorandum*, supra n. 7 at ¶ 2 (1980) (a precondition for structural adjustment lending is the government’s willingness to formulate a suitable program of structural adjustment); Operational Manual Circular 87/06 ¶8 (1987) (identification of “minimum conditions” is necessary for an adjustment operation to proceed); O.D. 8.60 ¶ 6 (1992) (adjustment lending operations seek to achieve structural changes and they range from support for macroeconomic and institutional reforms to a relatively limited set of sector-specific policy actions); Operational Memorandum from Vice President, OPCS, *Clarification of Current Bank Policy on Adjustment Lending* (1998) (structural and sectoral adjustment operations support macroeconomic and sectoral policy measures); and OP 8.60 ¶ 2 (2004) (development policy lending assists poverty reduction through a program of policy and institutional actions that promote growth, enhance well-being, and increase incomes).

27. The Articles of both IBRD and IDA require that the institutions must be guided by their respective purposes in all decisions.<sup>39</sup> These purposes form the principal reference points for the Bank's operations and allow it to adapt its mandate to the continuously changing environment.<sup>40</sup>

28. As discussed above, the Articles provide little guidance on the manner in which lending under "special circumstances" is to take place. But even in these circumstances, the Bank's operations must be in accordance with the "purposes" identified in the Articles. As a practical matter, however, the Bank enjoys a substantial degree of operational freedom in determining how it will achieve these purposes. Thus, if the Bank agrees with a borrower that certain policy and institutional actions or "conditions" are necessary in order for a policy-based loan to accomplish development purposes, these conditions may be validly justified under the Articles.

29. ***Productive Purposes Requirement.*** Among the various purposes of the Bank, the concept of "productive purposes" is seminal.<sup>41</sup> It constitutes an indispensable ingredient in any Bank lending operation. In a 1988 legal opinion, the then General Counsel noted the Articles place an "overwhelming" emphasis on the concept of "productive purposes."<sup>42</sup> The Articles' *travaux préparatoires* reveal that this concept was especially important at the Bretton Woods Conference, which led to establishment of the IBRD and the IMF. Delegates were very anxious to avoid the negative experiences of past international lending, where loans were manipulated for speculative purposes.<sup>43</sup> Thus, the concept of Bank financing for "productive purposes" was enshrined prominently in the Articles, and it has been consistently reiterated through the Bank's policy and practice over the last 60 years.

30. "Productive purposes" applies not only to regular investment or project-specific lending, but also to policy-based lending under "special circumstances."<sup>44</sup> Thus, all loans, credits, and grants made by the Bank must be for "productive purposes" whether they are for specific "projects" with eligible expenditures identified or for policy-based loans or programs with no specific earmarking of loan proceeds.<sup>45</sup>

31. As an operational matter, in the investment lending context, the Bank ensures that its "productive purposes" requirement is achieved through specific legal covenants that require the borrower to carry out a project (designed to achieve specific productive and development objectives) with due diligence and efficiency. A corresponding mechanism in policy-based

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<sup>39</sup> See IBRD Articles, Article I and IDA Articles, Article I.

<sup>40</sup> See *Development Policy Lending Legal Note*, supra n. 32 at ¶ 5.

<sup>41</sup> See IBRD Articles, Article I (ii).

<sup>42</sup> See *Authorized Purposes Opinion*, supra n. 5 at ¶ 8.

<sup>43</sup> Id. See generally, Andreas F. Lowenfeld, *International Economic Law 501-502* (Oxford University Press 2003) (discussing manipulative practices that distorted international finance before World War II).

<sup>44</sup> See *Authorized Purposes Opinion*, supra n. 5 at ¶ 11. The General Counsel explained why the "productive purposes" test also applies to non-project lending under "special circumstances" as follows:

No special circumstances can justify the use of the Bank's loan proceeds for purposes unrelated, directly or indirectly, to development or reconstruction. The argument that money is fungible and that any financing by the Bank may release equivalent funds for use by the borrower for other purposes cannot be used as a legally acceptable reason to allow the Bank to violate its mandate or act outside the scope of its Articles. Thus, Bank loans which do not purport to finance a specific project must still aim at facilitating or supporting productive purposes.

<sup>45</sup> See *Project and Non-Project Financing under the IBRD Articles*, supra n. 30 at ¶¶ 8-10.

operations is conditionality, since it is used to further development objectives. Conditionality serves the role of a useful navigational aid to keep the borrower's development program on course to ensure its productive outcomes and objectives are achieved.<sup>46</sup> Thus, the careful use of conditionality in policy-based operations could be justified under the "productive purposes" test of IDA and IBRD's Articles as a means to ensure that the borrower achieves growth and sustainable reductions in poverty.

32. **Bank Financing on "Suitable Conditions" and "Terms."** In reciting IBRD's purposes, Article I (ii) of IBRD's Articles recognizes that the institution may provide financing for productive purposes on "*suitable conditions* (emphasis added)." Similarly, Article I of IDA's Articles declares that IDA's purposes include providing finance for its members to meet their important development requirements on *flexible and less onerous terms* than those of conventional loans (emphasis added).

33. It is evident from the context that framers of the Articles used the expressions "conditions" and "terms" to refer mainly to financial and credit aspects of Bank financing. Yet, they chose to not expressly restrict these references to financial matters only. Therefore, these expressions offer an additional statutory basis for policy-based conditionality in the Articles.<sup>47</sup> Accordingly, the use of conditionality in policy-based lending as evidence of a borrower's commitment to its program of policy and institutional actions could be regarded as fulfilling the Articles' expectation that the Bank's loans are made on "suitable conditions" or "terms."

34. **Appropriate Terms of IDA Financing.** Article V, Section 2 (b) of IDA's Articles states that IDA may provide financing on terms that it may deem appropriate "having regard to the economic position and prospects of the area concerned and to the nature and requirements of the project." This provision does not have a corresponding equivalent in IBRD's Articles. Yet, it constitutes an additional justification for conditionality in IDA-financed development policy lending since it gives the institution broad discretion in responding to development needs. In exercising this discretion, IDA may provide development financing on the basis of borrower's program of policy and institutional actions by treating them as conditions to ensure that IDA's financial support makes an effective development contribution.<sup>48</sup>

#### IV. CONTRACTUAL ASPECTS OF CONDITIONALITY IN LEGAL AGREEMENTS

35. This section discusses the manner in which conditionality is reflected in the Bank's legal agreements. The Bank's legal agreements set forth the principal terms and conditions of loans

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<sup>46</sup> See *Adjustment Lending Retrospective*, supra n. 10 at ¶ 117-118 ("Conditionality thus links financial support to the implementation of a program of reforms considered critical for the country's economic and social adjustment."); Aron Broches & Piero Sella, "International Bank for Reconstruction and Development," in *Foreign Development Lending – Legal Aspects* 86 (Seymour Rubin, ed., American Society of International Law 1971) ("the Bank is also concerned that the projects for which it lends be successfully and efficiently executed and operated so that the loan will make the maximum contribution to the economic development of the member").

<sup>47</sup> The expression "suitable conditions" was introduced at the Bretton Woods Conference to provide flexibility in making Bank loans. See Bitterman, supra n. 29 at 72 (discussing the drafting history of this provision).

<sup>48</sup> See *Report of the Executive Directors on the Articles of Agreement of the International Development Association* ¶ 14 (January 26, 1960).

provided by the Bank to its borrowers.<sup>49</sup> In investment operations, the agreements describe the project objectives and components, while in policy-based operations, the agreements refer to the borrower's program supported by the loan.<sup>50</sup> These agreements set forth the financial terms and conditions of the loan and restrictions regarding the use of loan proceeds. They also set forth remedial measures that the Bank may take when the borrower fails to comply with loan obligations. Legal agreements are supplemented by the Bank's General Conditions, which normally contain the standard terms and conditions that apply to all borrowers. General Conditions are incorporated by reference in the legal agreements.<sup>51</sup>

36. ***Borrower's Program.*** Policy-based operations do not fit readily with the Bank's traditional contractual framework for investment or project-based lending. In regular investment operations, the legal agreements between the Bank and the borrower usually require that the borrower or the project implementing agency (which the borrower appoints or agrees to) *carry out* the "project" with "due diligence and efficiency" in conformity with appropriate practices. The borrower is also required to provide funds, facilities, services, and other resources. The "project" is described in the legal agreement, which sets forth the project's development objective and its various components.

37. In the case of policy-based financing, however, the focus is on the borrower's "program" of actions, objectives, and policies designed to achieve growth and sustainable reductions in poverty. This program is described in a communication from the borrower called the "letter of development policy" that is received before Board presentation. The letter summarizes the salient elements of the program to be supported by the loan and declares the borrower's commitment in executing the program.<sup>52</sup> On this basis, the Bank makes a loan in support of the borrower's program. As this paper noted earlier in Section III, critical conditions, which usually consist of specific policy and institutional actions, are included in the legal agreement as either

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<sup>49</sup> As a general matter, it should be noted that the legal agreements between the Bank and its member-state borrowers are considered international agreements. See generally, Aron Broches, *International Aspects of the Operations of the World Bank*, 98(3) *Recueil Des Cours* 297, 353 (1959).

<sup>50</sup> Legal Vice Presidency, *Simplification of IBRD and IDA General Conditions and Standard Legal Documents* ¶ 6 (May 5, 2005).

<sup>51</sup> See IBRD, *General Conditions for Loans*, Section 7.02 (July 1, 2005) ("*IBRD General Conditions*"); and IDA, *General Conditions for Credits and Grants*, Section 6.02 (July 1, 2005) ("*IDA General Conditions*").

<sup>52</sup> See OP 7.00 *Lending Operations: Choice of Borrower and Contractual Agreements* ¶ 16.

prior actions or as special conditions of effectiveness or, when multiple tranches are involved, as prior actions and tranche-release conditions.<sup>53</sup>

38. Unlike a borrower's legal obligation to carry out a specific project in the investment lending context, its commitment to execute its program has been generally regarded as not contractually enforceable under the legal agreement for the operation.<sup>54</sup> As the former General Counsel stated:

The Bank cannot deem the failure of a borrowing government to take these measures as a violation of the government's legal obligations under the loan agreement, as the latter does not obligate the borrowing country to carry out those measures.<sup>55</sup>

39. There are several reasons for such a position. First, it is within the sovereign prerogative of a member state whether or not to take the critical policy and institutional actions that constitute conditions for disbursing a policy-based loan. Some of these actions may entail delicate and sensitive domestic considerations and involve internal decisionmaking, including parliamentary approval. It would be unwise and inappropriate for the Bank to be seen as influencing or interfering with these processes. Second, treating a borrower's failure to implement a policy action as a breach of a legal obligation owed to the Bank could create significant financial repercussions for the country. Aside from negative consequences for future Bank and other donor support, the borrower's standing in international financial markets could be seriously affected.<sup>56</sup>

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<sup>53</sup> Another important difference between policy-based lending and project or investment-type operations relates to the linkage between disbursements and the use of funds for specific expenditures. In the case of projects, as a general rule (and with the limited exception of special account advances) the Bank reimburses the borrower only for eligible expenditures incurred for goods, works, and services. The legal agreement usually defines the types of eligible expenditures. See generally, OP 12.00, *Disbursements* ¶ 1. In policy-based lending, however, funds are not linked to any specific imports or other expenditures. See *Development Policy Lending Update*, supra n. 12 at ¶ 26 (citing 1996 operational memorandum on simplifying disbursements in structural-adjustment loans). Disbursements are made against compliance with critical conditions (policy and institutional actions), satisfactory implementation of the program, and the maintenance of a satisfactory macroeconomic policy framework. The borrower commits not to use funds for ineligible expenditures. See OP 8.60 ¶ 18. The loan agreements for policy-based operations contain a negative list of expenditures (such as military items, precious stones, etc.) that cannot be financed under the operation. But it is important to note that this negative list is not regarded as a part of a policy-based operation's "conditionality." It is a standard fiduciary requirement that applies across all such operations.

<sup>54</sup> See Acting Senior Vice President and General Counsel, *Bangladesh – Jute Sector Adjustment Credit – Request for Inspection – Legal Opinion* ¶ 2 (January 29, 1997) ("*Bangladesh Inspection Opinion*").

<sup>55</sup> See Ibrahim F.I. Shihata, *The World Bank Inspection Panel: in practice* 39 (2<sup>nd</sup> ed., World Bank, 2000). See also, *Conditionality and Unconditionality*, supra n. 6 at 438 (noting, in the context of Fund operations, that a borrower does not violate any legal obligations to the Fund if it departs from policies in support of which the Fund made its resources available); "Legal Aspects of Foreign Development Lending," in Rubin, supra n. 46 at 211 (Bank General Counsel's oral intervention noting "severe limitations" on trying to bind a country with regard to general policy issues).

<sup>56</sup> Certain commercial banks include a cross-default provision in their loan agreements with foreign sovereigns that are triggered if the borrowers default on their debt to multilateral institutions. See Lee Buchheit and Mark Walker, "Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers", in *Sovereign Lending: Managing Legal Risk* 139-157 (Michael Gruson & Ralph Reisner eds., Euromoney Publications 1984).

40. Therefore, since the introduction of structural adjustment lending, it has been the Bank’s practice not to regard prior actions or tranche-release conditions as imposing binding legal obligations on the borrower. But, as this paper discusses below, if the borrower fails to carry out these conditions, the Bank may have certain remedies with respect to disbursements.

41. ***Obligation to Consult the Bank on Program Changes.*** Legal agreements for development policy operations require the borrower to exchange views from time to time with the Bank on the progress in carrying out the program and any tranche-release conditions that are listed in the legal agreement. A specific provision is also included that requires the borrower to “exchange views” with the Bank “on any proposed action” that would have the effect of “materially reversing the objectives of the program, or *any action taken* under the program” (emphasis supplied).

42. In multitranche operations, this obligation extends to exchanging views on actions relating to tranche-release conditions as well. Therefore, although a borrower cannot be legally required to carry out an agreed policy-based program, it is under a legal obligation to consult the Bank if it seeks to make any changes or revisions to *any* action or condition—taken or to be taken—that is a part of the program supported by the financing.

43. ***Tranche-Release Conditions.*** Disbursements in a development policy operation may consist of a single or multiple tranches.<sup>57</sup> The initial tranche is released upon effectiveness.<sup>58</sup> Subsequent tranche releases depend on whether the Bank determines that three basic requirements are met. First, the Bank must be satisfied with the borrower’s progress in carrying out the program. Second, the macroeconomic policy framework of the borrower must be satisfactory. And third, the borrower must have taken specific policy and institutional actions (known as “specific tranche-release conditions”) listed in a schedule to the agreement.<sup>59</sup>

44. ***Approvals of Tranche-Releases and Waivers.*** After the loan agreement is declared effective, the Bank engages in effective supervision to verify whether the program conditions are complied with.<sup>60</sup> For each tranche after the first one, the Bank prepares a tranche-release document that discusses the status of the program supported under the operation. On this basis, Bank management may approve a tranche release. However, any waivers to tranche-release conditions must be approved by the Executive Directors.<sup>61</sup> If no waivers are granted, and the Bank is not satisfied that the borrower has met the three requirements listed above, it may give notice to the borrower specifying the actions that should be carried out. If the borrower does not take satisfactory steps to resolve the matter within 90 days, the Bank may give notice to cancel the remaining undisbursed loan amount or a portion of it.

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<sup>57</sup> See OP 8.60 ¶ 14. Whether to include tranches or not depends on a number of factors, including the country’s policy environment and capacity, its financing requirements and other available financing, and the content and phasing of the program being supported by the development policy operation. See *id.* Tranching ensures compliance with any yet-to-be-taken condition in a program agreed with the Bank. However, if all conditions are met in advance, then there is no need for tranching. See Senior Vice President and General Counsel, *Loan to Indonesia for Private Sector Development*, SD89-44, ¶ 9 (October 20, 1989).

<sup>58</sup> In some cases, release of the first tranche may be delayed after effectiveness where the borrower elects to pay the front-end fee from its own resources and fails to do so.

<sup>59</sup> See OP 8.60 ¶ 14.

<sup>60</sup> See OP 8.60 ¶ 16.

<sup>61</sup> See *id.* ¶ 31. Procedures for tranche releases, including waivers of conditions, are set out in BP 8.60 ¶¶ 19-21.

45. ***Bank's Options when Borrower Fails to Comply with Conditions.*** The Bank's practice not to contractually require a borrower to carry out its program does not imply that the Bank has no legal options if the borrower fails to implement agreed-upon actions. The circumstances, however, are somewhat limited for the Bank to exercise these remedies.<sup>62</sup> And where grounds exist for the Bank to invoke its remedies, it is not legally obliged to exercise them.<sup>63</sup> The Bank exercises its judgment in determining whether to invoke a remedy taking into account the circumstances of the case, the purposes under the Articles, its own interests, and the interests of its members as a whole.<sup>64</sup> Resort to either remedy does not imply that either the prior actions or the tranche-release conditions are legal obligations of the borrower.<sup>65</sup>

46. ***Failure to Consult Bank before Taking Inconsistent Actions after Disbursement.*** As noted above, the borrower is under an obligation to exchange views with the Bank on any proposed actions, after the loan has been disbursed, that materially reverse the program's objectives or any actions taken under it, including any tranche-release conditions. Thus, in either a single-tranche or a multitranchise operation, if the borrower proceeds to take such action without exchanging views with the Bank, the Bank may, after a 60-day notice period, accelerate the maturity of the loan under the General Conditions for the borrower's default in performing an obligation (the requirement to exchange views with the Bank) under the legal agreement.<sup>66</sup>

47. ***Failure to Comply with Tranche-Release Conditions.*** If the borrower fails to take actions specified for tranche releases, the Bank has the following options:

- (a) The Bank is not obliged to release the tranche to the borrower.
- (b) If the Bank determines that the failure is due to a situation that shall make it improbable that the program (or a "significant part" of the program) will be carried out, it may suspend—in part or in full—the borrower's right to withdraw the loan proceeds.<sup>67</sup> Note, however, that if the Bank

<sup>62</sup> See World Bank Inspection Panel, *Report and Recommendation on Request for Inspection - Argentina Special Structural Adjustment Loan* ¶ 17 (December 16, 1999) ("Argentina Adjustment Inspection Request").

<sup>63</sup> See *Structural Adjustment Lending Memorandum*, supra n. 7 at ¶ 13 (stating that the Bank would not suspend disbursements in structural adjustment loans or take any other remedial actions open to it without being certain that a default, in the sense of failure to take an agreed action, was a significant one). Note that, besides these remedies, a standard provision in legal agreement for a policy-based loan allows the Bank to request the borrower to refund any loan amounts used to finance excluded expenditures on the negative list.

<sup>64</sup> See Senior Vice President and General Counsel, *Remedies Available to the Bank and IDA under the Loan and Credit Agreements on the Sardar Sarovar Projects*, Sec M-92-0994, IDA/SecM02-291 ¶ 18 (July 16, 1992) (the "Sardar Sarovar Opinion").

<sup>65</sup> See *Argentina Adjustment Inspection Request*, supra n. 62 at 46-47 n35 (management's response discussing legal opinions for the Bank in an adjustment operation).

<sup>66</sup> See *IBRD General Conditions*, Section 7.07 (b) and *IDA General Conditions*, Section 6.06 (b) and *Bangladesh Inspection Legal Opinion*, supra n. 54 at ¶ 3. Acceleration implies that the Bank may declare the principal of the loan then outstanding to be due and payable immediately together with the interest and other charges thereon. In practice, however, this last option (acceleration of maturity) has never been exercised by the Bank. See *Sardar Sarovar Opinion*, supra n. 58 at ¶ 8.

<sup>67</sup> See *IBRD General Conditions*, Section 7.02 and *IDA General Conditions* Section 6.02. Legal agreements for policy-based loans have traditionally included language to the effect that the Bank may suspend the loan if "a situation has arisen which shall make it improbable that the program, or a significant part thereof, will be carried out." Note that this situation does not have to involve an act or omission on the borrower's part. It could arise due to a natural disaster, such as an earthquake, which may be beyond the borrower's control.

suspends disbursements under this option, it could also suspend the borrower's right to withdraw under all other loans to the borrower financed by the Bank (including those for investment projects).<sup>68</sup>

- (c) If the borrower's right to withdraw loan proceeds remains suspended for a continuous period of 30 days, the Bank has the option to cancel the undisbursed amount of the loan or credit.<sup>69</sup>
- (d) If, by the expected date of compliance, a tranche-release condition is not satisfied, the Bank may review the situation and provide notice to the borrower on the actions that should be carried out within 90 days. If the borrower fails to carry out these actions within this period, the Bank may cancel the undisbursed amount of the loan.

48. ***Inconsistent Actions after Tranche-Release Conditions are Satisfied.*** Once the borrower complies with the tranche-release conditions, the Bank usually notifies the government that it is entitled to make a withdrawal. However, if the government takes an action inconsistent with the program between the date of this notice and the actual date of withdrawal, the Bank may exercise its rights to suspend disbursements under option (b), above.<sup>70</sup> However, this remedy is ineffective if the borrower's default takes place after all tranches have been released. Generally, however, the borrower's failure to fulfill a single, isolated condition, or a few minor ones, has not been used as a basis for invoking suspension.<sup>71</sup>

## V. OTHER LEGAL AND POLICY ASPECTS OF CONDITIONALITY

49. This section summarizes certain legal and operational considerations that arise from the Bank's practice in using conditionality that were the subject of legal opinions or advice in the past.

50. ***General Consistency with Articles and Applicable Operational Policies.*** As an operational principle, conditionality is carefully conceived, drafted, and negotiated balancing the legitimate objectives of the borrower and the purposes of the Bank. Agreed conditions in a program are in accordance with the Bank's purposes and other provisions of its Articles. Conditions in policy-based lending are confined to only those aspects that are essential for the operation to meet its objectives. Conditions are reasonable in number, and realistic and reasonable in substance and in their time horizon, and monitorable.<sup>72</sup> Task teams should ensure

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<sup>68</sup> See OP 13.40, *Suspension of Disbursements* and BP 13.40 (prescribing detailed steps to be taken if the Bank is to suspend disbursements to a borrower). In single-tranche loans, this option is of limited utility because the loan is usually disbursed after the legal agreements are declared effective, unless the loan contains a deferred-drawdown option.

<sup>69</sup> See *IBRD General Conditions*, Section 7.03 and *IDA General Conditions*, Section 6.03. Cancellation procedures are found in OP 13.50 and BP 13.50.

<sup>70</sup> See *Bangladesh Inspection Opinion*, supra n. 54 at ¶ 3.

<sup>71</sup> See *Argentina Adjustment Inspection Request*, supra n. 62 ¶¶ 13-18 (management's response discussing scope of Bank's legal options in adjustment operations).

<sup>72</sup> See OP 7.00 ¶ 14 (prescribing standards for covenants or undertakings in Bank contractual documents).

conditionality does not violate the Articles' prohibitions on political matters discussed below and is consistent with the applicable operational policies and procedures of the Bank.<sup>73</sup>

51. ***Political Activities Prohibition.*** The Bank's Articles contain two general prohibitions on the Bank's involvement in "political" matters. These prohibitions should be respected when designing and formulating conditionality in policy-based operations.

52. The first prohibition is found in Article IV of IBRD's Articles. The Article forbids the Bank from interfering in a borrower's political affairs and from using political considerations in its decisions. It reads:

The Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decision by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purposes stated in Article I.<sup>74</sup>

53. A similar prohibition is also found in IDA's Articles.<sup>75</sup> This prohibition really consists of two separate rules. First, the Bank must not interfere in a country's domestic politics or foreign partisan affairs. Second, the Bank's financing decisions cannot be influenced by the "political character" of a member country.<sup>76</sup> The second prohibition in the Articles requires the Bank to make arrangements to ensure that its funds are used only for the purposes of the loan and without regard to political or other noneconomic influences.<sup>77</sup>

54. As a consequence of these prohibitions, conditionality in Bank-financed operations is based on economic, rather than political, considerations.<sup>78</sup> In making decisions, the Bank views these factors impartially to achieve its purposes.<sup>79</sup> However, this position does not imply that the Bank should completely ignore political implications or consequences when deciding whether to lend to a borrower.<sup>80</sup> In the policy-based lending context, especially, the Bank needs relevant knowledge of the political situation in the country involved and to appreciate underlying social

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<sup>73</sup> Note that certain operational policies do not apply to development policy lending. The Inspection Panel has received at least three requests for inspection alleging that specific policy-based programs have not complied with the Bank's operational policies. See also, Shihata, *Inspection Panel*, supra n. 49 at 39-42 (discussing whether Inspection Panel has jurisdiction over policy-based operations).

<sup>74</sup> See IBRD Articles, Article IV, Section 10.

<sup>75</sup> See IDA Articles, Article V, Section 6.

<sup>76</sup> See Roberto Danino, *Legal Aspects of the World Bank's Work on Human Rights: Some Preliminary Thoughts* 10-11 (New York University School of Law, March 1, 2004).

<sup>77</sup> See IBRD Articles, Article III, Section 5 (b) and IDA Articles, Article V, Section 1 (g).

<sup>78</sup> See generally Senior Vice President and General Counsel, *Prohibition of Political Activities under the IBRD Articles of Agreement and its Relevance to the Work of the Executive Directors*, SecM87-1409 (December 23, 1987); and *Issues of 'Governance' in Borrowing Members – the Extent of Their Relevance Under the Bank's Articles of Agreement*, SecM91-131 (February 5, 1992) ("*Governance Opinion*").

<sup>79</sup> See generally, Yozo Yokota, "Non-Political Character of the World Bank," *20 Japanese Annual of International Law* 39-64 (1976).

<sup>80</sup> See *Legal Aspects of Human Rights*, supra, n. 76 at 10.

and cultural factors to ensure that conditionality is suitable to country circumstances and the loan will achieve its objectives.<sup>81</sup>

55. But as the then General Counsel cautioned in 1992, any attempt, however simplistic, to introduce political transformation through policy-based lending in the form of politically motivated conditionality might contravene the Articles.<sup>82</sup> Thus, conditionality is carefully formulated based on strong economic justifications supported by rigorous analytic underpinnings to avoid any criticism that conditionality could be perceived as blatant or disguised political interference.

56. **Legal Due-Diligence.** Adequate constitutional, legal, administrative, and regulatory due diligence is necessary in designing conditionality. The Bank should consider whether a borrower (acting through its designated ministries or agencies) is reasonably capable of carrying out agreed conditions in a program. In the case of subnational policy-based operations, this due diligence should include determining whether the relevant subnational units (acting through their agencies and institutions) have the constitutional and legal competence to undertake actions and measures that are included as loan conditions. The Bank investigates whether the conditions can be undertaken by executive action or if they need parliamentary or legislative approval.<sup>83</sup> Thus, in the past, Bank teams have been advised to be cautious in requiring a borrower's government to complete actions that may be well beyond its control.<sup>84</sup>

57. **Conditions Affecting Constitutional Provisions.** Similarly, Bank teams have been cautioned against including conditions that are contrary to express provisions in the borrower's constitution. A constitution is at the core of a state's sovereignty and nationhood. Therefore, a borrower cannot be expected to violate its own constitution when undertaking a program.<sup>85</sup>

58. **Borrower Ownership.** Strong borrower ownership of conditionality is an important requirement for a policy-based operation. Therefore, while it is important to undertake adequate

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<sup>81</sup> See Senior Vice President and General Counsel, *Prohibition on Political Activities in the Bank's Work*, SecM95-707, 18-20 (July 12, 1995).

<sup>82</sup> See *Governance Opinion*, supra n. 78 at IV (2).

<sup>83</sup> See Operations Evaluation Department, *Economies in Transition 22* (2004) (finding inadequate understanding of economic and political situation in Ukraine that resulted in parliament rejecting a negotiated loan).

<sup>84</sup> For instance, it may be unrealistic to include a dated condition in a policy-based operation requiring the government to sell an enterprise. This could result in a forced sale or a sale at any price that could be unfair to the seller. However, if the privatization is one of the loan's principal purposes, the actual sale of the enterprise may be made a tranche-release condition. The borrower would be entitled to receive the financing proceeds only after the condition is fulfilled. See *Shihata, Legal Papers*, supra n. 6 at 384.

<sup>85</sup> For example, some constitutions forbid the privatization of certain public enterprises. Thus, the Bank may not ask a government to violate its own constitution by undertaking privatization of state-owned enterprises. See Vice President and General Counsel, *Credit to Bosnia and Herzegovina for Emergency Farm Reconstruction, and for Water, Sanitation and Solid Waste*, SD96 18 (oral statement at Board discussion, April 9, 1996). Note, however, that a state may not defend its actions or any course of conduct that are inconsistent with this agreement by relying on its domestic law or legal system. See Vienna Convention on the Law of Treaties, Article 46 (1), (May 23, 1969). This principle is incorporated in the Bank's legal agreements with its borrowers by a provision in the General Conditions, which makes the rights and obligations of both parties (the Bank and the borrower) valid and enforceable "notwithstanding" any contrary law of a state or political subdivision. See *IBRD General Conditions*, Section 8.01 and *IDA General Conditions*, Section 7.01.

consultations with various nongovernmental groups and other actors,<sup>86</sup> the final decision on what conditionality to include in an operation is taken together with the government.<sup>87</sup>

59. ***International Trade Negotiations.*** In recent years, multilateral, regional, and bilateral trade negotiations have considerably transformed the landscape of international trade. These negotiations often involve vital economic and political interests that influence relative bargaining positions among nations. It would be unwise for the Bank to be seen as interfering in these sensitive processes. Thus, in the past, the Bank has generally avoided requiring borrowers to eliminate or reduce trade measures that are already the subject of sensitive multilateral or bilateral negotiations. It could also be perceived as very unfair if the Bank is regarded as inequitably restricting a borrower's ability to use its legitimate remedies under international trade law, such as antidumping duties, to deal with problems such as dumping.<sup>88</sup>

60. ***Conditions Requiring Enactment of Laws or Regulations.*** Policy-based operations often require the enactment of a law or a regulation as part of the agreed reform program. As an initial consideration, it might be preferable to avoid including a condition in a policy-based loan explicitly requiring a borrower to *enact* a law. Instead, the condition could require the borrower to ensure that draft legislation is submitted to its parliament for approval. Requiring the passage of a law could cause problems between the executive and legislative branches of a borrower's government because this condition assumes that the legislature will inevitably approve the envisaged legislation, thus taking its action for granted.

61. However, there are often situations in policy-based lending where legislative action is absolutely essential to the viability of a program. In these cases, the Bank may consider asking for this action to be taken before Board presentation as a prior action or as a tranche-release condition.<sup>89</sup> It may be preferable if conditions and tranche-release conditions avoid setting any specific dates for legislative action for such stipulations could be perceived as interfering with sovereign legislative prerogatives. Another reason why dated conditions should be avoided is that if, whatever reason, the necessary actions are taken after the required date, a waiver of the condition would be necessary.

62. ***Careful Formulation and Drafting.*** Policy and institutional action that the Bank and the borrower agree as important ingredients for a policy-based operation is reflected in that

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<sup>86</sup> See OP 8.60 ¶ 6 (encouraging consultations with and engaging key stakeholders in the process of formulating a country's development strategies).

<sup>87</sup> See Senior Vice President and General Counsel, World Bank, General Counsel, IFC, and Vice President and General Counsel, MIGA, *Legal Note on Free Prior and Informed Consent*, SecM2004-0369/IDA SecM2004-0559 ¶ 3 (August 3, 2004) (noting that, under the Bank's governance structure, member governments play a critical role in making decisions regarding Bank Group financing).

<sup>88</sup> See Shihata, *Legal Papers*, supra n. 6 at 388-390 (memorandum from the Vice President and General Counsel to the Loan Committee on December 19, 1994 relating to a proposal requiring Senegal to cap its antidumping duties).

<sup>89</sup> See OP 7.00 n.14 (legislative steps to be undertaken are normally described in the letter of development policy, but may also be part of the specific actions incorporated in the loan agreement such as conditions of Board presentation or conditions of disbursement of particular loan tranches).

operation's program matrix and in the government's letter of development policy.<sup>90</sup> Those actions that are critical are normally incorporated as precisely worded conditionality in the legal agreement between the Bank and the borrower as prior actions, special effectiveness conditions, or tranche-release conditions. The language used in the legal agreement to describe any of these conditions is clear and cogent.<sup>91</sup> It is important to synchronize this description in the legal agreement with the text in the program document, the letter of development policy, and the policy matrix to avoid any ambiguity among these documents.<sup>92</sup> If the borrower's program is supported by other donors, and includes actions to be taken that are outside the Bank's operational mandate, it may be necessary to clearly identify those actions supported by the Bank's operation through arrangements or understandings with other donors and the borrower.<sup>93</sup>

63. Tranche-release conditions explain precisely the measures expected from the borrower, and to the extent possible, the yardsticks by which those measures will be monitored. These conditions are formulated in a manner that will avoid, rather than invite, future disputes.<sup>94</sup> Besides the conditions included in the legal agreement, the other elements or ingredients of the operation, including triggers, milestones, and outcomes indicated in the policy matrix or program document, are described precisely to avoid any confusion.

64. ***Cross-Conditionality and Coordination with Other Donors.*** Cross-conditionality has been a fairly contentious topic since the Bank introduced structural adjustment loans in 1980.<sup>95</sup> As a preliminary matter, it is important to understand what "cross-conditionality" means. As used in the Bank and Fund's literature, this term implies:

A situation where one institution refers in its agreement with a borrower to conditions required by the other institution and considers noncompliance with these conditions vis-à-vis the other institution an event of default under its own agreement. This type of conditionality would theoretically happen, in the case of the Bank, if it included in a loan

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<sup>90</sup> Neither the CAS nor the Board's discussion on it should be used as an opportunity to add "additional conditionality" on a borrower. See Vice President and Secretary, *Report of the Ad Hoc Committee on Board Procedures*, R92-103, ¶¶ 22-28 (May 28, 1992).

<sup>91</sup> See OP 7.00 ¶ 14.

<sup>92</sup> See World Bank Inspection Panel, *Report and Recommendation on Respect for Inspection – Papua New Guinea Governance Promotion Adjustment Loan* ¶¶ 23-24 (May 28, 2002) (citing management response to inspection request in adjustment operation acknowledging that the program matrix did not accurately reflect actions set out in the letter of development policy).

<sup>93</sup> A division of focus among the donors may also be spelt out in the letter of development policy itself. It is not legally appropriate, however, for other donors to co-sign the legal agreement between the Bank and the borrower.

<sup>94</sup> See Shihata, *Legal Papers*, supra n. 6 at 382.

<sup>95</sup> See generally, Polak, supra n. 4 at 488.

or guarantee agreement a reference to a condition or conditions required by the Fund and deems noncompliance with such conditions vis-à-vis the Fund a default under the Bank agreement.<sup>96</sup>

65. Executive Directors of the Bank and the Fund decided in 1989 to avoid cross-conditionality.<sup>97</sup> It was felt that, as separate institutions, each entity should stipulate its own conditions without referring to those of the other.<sup>98</sup>

66. Although, as a strictly legal matter, the Bank and the Fund avoid cross-conditionality, the Bank's policy-based programs do take into account the Fund's satisfaction with the macroeconomic framework in the borrowing country. Thus, as the then General Counsel cautioned in 1992, the "reality of this situation" should not be ignored in a meaningful discussion of cross-conditionality.<sup>99</sup> A situation of cross-conditionality should also be distinguished from parallel conditionality, where two or more creditors stipulate the same conditions. In these cases, the conditions of the Bank are very similar to those of the Fund. But they do not cross-reference each other. Thus, if there was a default it would be under the conditions stipulated by the Bank, not by cross reference to a condition made by the Fund.<sup>100</sup>

67. Avoiding cross-conditionality does not imply, however, that the Bank may not cooperate or coordinate its policy-based lending operations with other multilateral, regional, or bilateral donors, including the Fund. In the case of other international organizations, such cooperation is even recognized in the Articles of the Bank.<sup>101</sup> Thus, in the context of development policy lending, the Bank collaborates with other development partners, including the IMF, in preparing development policy operations,<sup>102</sup> and seeks to "harmonize" its conditions for a policy-based loan with them in consultation with the country.<sup>103</sup>

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<sup>96</sup> Mechanics of a cross-conditionality may vary depending on the circumstances. As the General Counsel explained:

Cross-conditionality could be drafted so as to automatically trigger remedies or to simply give the institution requiring it the right to take remedies against the borrower. In the Bank's loan agreements for projects co-financed by others an "optional cross-default clause" is often included. According to such clause, the Bank considers default in payment to another co-financier as an event which gives the Bank the right to take the remedies available to it in case of default in payment to the Bank.

Senior Vice President and General Counsel, *Bank-Fund Coordination – Questions in Respect of the Recent Note on Collaboration Regarding the States of the Former Soviet Union*, SecM92-0640, 8-9 (May 14, 1992) ("*Questions on Collaboration*").

<sup>97</sup> See *Bank-Fund Collaboration in Assisting Member Countries*, R89-45, 8 (March 31, 1989).

<sup>98</sup> See OP 8.60 ¶ 13 (citing *Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality*, SecM2001-0461 (August 23, 2001)).

<sup>99</sup> See Senior Vice President and General Counsel, *Questions on Collaboration*, supra n. 96, at 9-10

<sup>100</sup> See Vice President and General Counsel, *Loan to Korea for Economic Reconstruction*, SD97-76, ¶ 30 (January 30, 1998).

<sup>101</sup> See IBRD Articles, Article V, Section 8 (Bank may cooperate with any general international organization and may consider these organizations' views when making decisions on applications for loans or guarantees relating to matters directly within the competence of that organization); and IDA Articles, Article VI, Section 7 (the Bank may enter into cooperation arrangements with other international organizations).

<sup>102</sup> See OP 8.60 ¶ 7.

<sup>103</sup> See OP 8.60 ¶ 13.