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Why Multilateral Development Bank Practices Are So Far from Their Potential

The preceding chapters have shown that developing countries usually have underdeveloped long-term domestic currency markets and limited access to insurance and risk-management products that would help them deal with adverse exogenous shocks. This can be attributed in part to domestic reasons (weak technical capacities, political economy problems, and faulty policies and institutions) but also to market failures associated with first-mover, liquidity, and coordination costs and problems and to significant externalities thereon. It has also been shown that, in each of these cases, multilateral development banks are in a position to help overcome those first-mover, liquidity, and coordination costs and problems. At the same time, they can help governments improve their institutional and policy environments, strengthen their technical capabilities, and overcome inhibiting political economy problems that are currently limiting the use and penetration of existing and new products in developing countries. That is, multilateral institutions can help in solving both demand and supply market limitations. They can thus play a very useful role as market developers. In particular, we found that the global reach and convening power of multilateral institutions can be especially useful to help develop global markets for developing countries' domestic currencies and terms of trade or GDP-indexed debt as well as to achieve higher global coverage of catastrophic insurance solutions.

Our review shows that most multilateral development banks have been indeed promoting the development of some of these markets through different financial innovations. Furthermore, the speed of innovation appeared to be accelerating before the recent international financial crisis, and there were several recent promising initiatives. Still, our assessment is that current practice is still quite far from what it might be and that there are several areas in which developing countries would benefit if multilateral development banks were to take a more decisive role as market developers and more quickly mainstream their current limited offering of new financial products. This is the case, for example, with their still-limited supply of loans and guarantees in domestic currencies and of currency and domestic interest rate derivatives, though this is an area in which there are several promising initiatives such as the IFC's MATCH program and The Currency Exchange (TCX), in which several regional development banks will participate. The World Bank's GEMLOC initiative can also have an important effect in helping developing countries' domestic currency bonds become a significant asset class.

Current practice is also far from what it might be in multilateral development banks' supply of catastrophic insurance instruments, though there are several important recent and ongoing initiatives in this area promoted, in particular, by the World Bank. The lack of innovation and market-development initiatives is even more noticeable in the area of indexed debt instruments. Finally, even if multilateral institutions can only help mitigate problems associated with private capital flow volatility and potential liquidity shocks in the margin, areas in which the major role belongs to the IMF, they appear to be doing much less than is possible. In particular, their lending is often as procyclical as private capital flows, and there is very limited development of contingent disbursement instruments.

Why has the actual role of multilateral development banks in these areas differed so much from their potential role? Why has the push for helpful financial innovations and for assuming the role of market developer been just a recent development? We can identify four potential, probably complementary, answers to these questions.

First, as indicated in several chapters above, multilateral development banks' own risk-management policies have considerably limited their potential support for their clients' risk-management options. In particular, with few exceptions, multilateral institutions have been basically willing to retain only their clients' credit risk on their balance sheets. By so doing, they have limited their potential support to their clients in several ways. As an example, they merely intermediate other risks such as currency risks, which in practice has limited their offer of loans and guarantees in domestic currencies, or of currency swaps, to those countries that already have relatively well-developed local currency or swap markets. In those cases, the intermediation of the multilateral development banks has often reduced costs substantially because they retained the country's or issuer's credit risk, but this practice has left out all those countries that have less-developed domestic currency and swap markets—precisely those that would benefit most from multilateral support in this area.[1]

As discussed in chapter 4, multilateral development banks, especially those with global reach such as the IFC and the World Bank, would be in a position to achieve significant currency risk diversification through global pools, but this would require that they be willing to retain residual currency risks on their balance sheets. The IFC's MATCH initiative is designed precisely to take advantage of global currency risk-diversification opportunities and will permit the IFC to help develop domestic currency markets in frontier countries. In a complementary way, the GEMLOC initiative expects to eventually help private investors diversify currency risks over a wider variety of developing country currencies than is now the case, while producing a useful benchmark for this asset class. In these initiatives, the IFC and the World Bank expect to use their convening powers to solve coordination problems to achieve the full potential of global risk diversification, and to support and stimulate developing countries in enhancing required technical capabilities and undertaking necessary regulatory reforms. The potential for currency risk diversification at a regional level is significantly more limited, though still substantial. That is why several regional development banks have opted to join the TCX initiative, which would allow them to jointly benefit from the higher global currency risk-diversification potential.

Similarly, multilateral development banks with global reach are in an especially advantageous position to help achieve significant risk-reduction benefits through global diversification of other developing country risks, such as those associated with natural disasters. These multilateral institutions are the natural promoters of global solutions that would cover many developing countries in different regions, as the World Bank is beginning to do in the area of catastrophic insurance through a variety of initiatives. As shown in the case of the Caribbean Catastrophic Reinsurance Facility, there are substantial benefits of catastrophic risk diversification even for a limited number of neighboring countries. Available studies backing the launch of the Global Catastrophe Mutual Bond and the Global Catastrophe Reinsurance Facility show that benefits would be much more substantial with global coverage of risks and countries. Again, the convening power of multilateral development banks is extremely valuable in solving coordination and political economy problems in this area, and their technical support can be key to supporting complementary institutional and policy actions.

Similarly, and for the same reasons, multilateral development banks with global reach would be in the best position to help develop global markets of indexed debt, such as GDP-indexed debt, that could be extremely attractive for issuers and investors

1. As a further example, some multilateral development banks offer contingent credit lines that disburse when natural disasters happen. However, this kind of support falls short of insurance-type solutions, which require the retention of some disaster risk against multilateral development banks or special vehicle capital (as in the case of the Caribbean Catastrophic Reinsurance Facility), given that it is not generally wise to burden disaster-stricken countries with additional debt.

alike, provided that global diversification benefits are indeed achieved and first-mover costs are overcome. Unfortunately, multilateral development banks have not yet undertaken initiatives in this area.

Regional development banks can also achieve important risk-diversification benefits with respect to natural disaster risks or output risks at a regional level, although such benefits would be significantly lower than those that can be achieved through global diversification. They may benefit, though, from global diversification benefits by either joining forces through global funds, just as TCX is doing with respect to currency risks, or by joining in the initiatives promoted by multilateral development banks with global reach.

As with currency risks, these possibilities require a willingness on the part of multilateral development banks either to retain risks other than credit risk on their balance sheets or to allocate capital to special vehicles or funds that would retain some of these risks. Are multilateral development banks in a position to retain these additional risks and make the corresponding capital allocations? Table 7.1 indicates that they have been strengthening their capital positions (as measured by their equity-to-loan ratios) during the past 10 years. More to the point, a recent comparative study by Standard & Poor's indicates that most of the multilateral development banks have very high risk-bearing capacity available (defined as equity against total "development-related operations"—loans, guarantees, equity, and derivatives), especially when callable capital is taken into account. The upper panel in table 7.2 shows Standard & Poor's estimates of the narrow risk-bearing capacity of different multilateral development banks (when only paid-in capital is taken into account), and the lower panel shows the corresponding figures when callable capital is also taken into account (at a discount).[2]

These figures suggest that most multilateral development banks could retain additional risks on their balance sheets without impairing their ratings and that such idle capacity has been growing in the last decade. Facing the recent crises and increased demand from developing countries for traditional fast-disbursing loans, multilateral development banks are making a major effort to respond and hope to nearly double their previous lending levels. However, once the effects of the current international crisis are overcome and international private financial markets resume lending, we will likely see a continuation of the trend under which a growing number of higher-middle-income country governments (which were obtaining investment-grade ratings or just a few notches below them, were borrowing in private markets at relatively low spreads, and had accumulated significant amounts of international reserves) were rapidly reducing their borrowings from multilateral development banks and paying back portions of their outstanding debts.

Eventually, once the current crisis is over, several multilateral development banks (especially those that lend only or mainly to sovereign governments) will probably

2. Standard & Poor's (2007). Figures are made comparable by making suitable adjustments to the reported balance sheets of each multilateral development bank.

Table 7.1. Multilateral development banks' equity-to-loan ratios (Percentage)

	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
World Bank	22.06	21.44	20.65	21.23	21.54	22.90	26.59	29.35	31.44	32.94
Asian Development Bank	44.54	36.79	34.29	35.23	35.10	38.79	46.37	50.89	49.48	47.72
Inter-American Development Bank	35.66	31.86	28.88	28.68	28.91	29.24	33.38	37.13	38.38	41.17
African Development Bank	39.73	41.60	41.80	48.16	50.34	62.28	70.24	80.84	76.55	82.03
European Bank for Reconstruction and Development	73.08	60.18	52.49	55.50	62.70	62.03	65.71	63.93	82.12	91.08

Note: Except for the World Bank, the fiscal years of multilateral development banks coincide with calendar years.

Source: From Cordella and Levy Yeyati 2007, table 3.6.

Table 7.2. Multilateral development banks' risk-bearing capacities (Percentage)

	World Bank	IFC	Inter-American Development Bank	Asian Development Bank	European Bank for Reconstruction and Development	African Development Bank	Inter-American Development Corporation	Andean Development Corporation	European Investment Bank
Narrow risk-bearing capacity/Development-related operations (loans, guarantees, equity, derivatives)									
2001	28	83	31	35	56	53	86	35	13
2002	33	77	32	39	58	62	95	35	13
2003	33	77	33	46	64	67	102	37	13
2004	37	85	37	50	64	78	106	40	13
2005	35	85	38	48	79	82	103	44	12
2006	40	86	42	45	89	85	91	44	12
Broad risk-bearing capacity/Development-related operations (loans, guarantees, equity, derivatives)									
2001	82	83	108	74	136	116	86	35	45
2002	97	77	112	86	14	143	95	35	44
2003	102	77	110	118	148	153	102	40	58
2004	112	85	119	128	150	172	106	42	63
2005	111	85	123	122	154	178	103	47	58
2006	120	86	130	116	156	186	91	47	56

Source: Standard & Poor's 2007

face the dilemma of either accepting to retain a wider variety of developing country risks on their balance sheets, not just credit risk, or seeing a higher proportion of their capital remain idle, thus calling into question their development effectiveness. This is perhaps the main reason multilateral development banks had been speeding up their rates of financial innovation in recent years. It is possible, though unfortunate, that the present increase in demand for traditional loans will reduce the incentives to innovate and delay the pace of financial innovation during several months or a few years. But the need to innovate will remain, and it is to be hoped that, eventually, the recent pace of rapid financial innovation will resume.

It is frequently argued that multilateral development banks face statutory limitations to retaining developing country risks other than credit risk on their balance sheets. Inspection of their articles of agreement suggests that this is not the case: most multilateral development banks, like most financial institutions, seem to be allowed to make diverse equity and portfolio investments against their capital.[3] The real issue appears to be with current risk-management policies and practices.

In particular, those multilateral development banks that work mostly with sovereign governments and that benefit from a de facto preferred creditor status are actually accustomed to bearing very limited risks from their development-oriented operations. It is not surprising, therefore, that a highly conservative risk-management culture has prevailed in which there is little appetite to retain and manage more complex and higher risks. In contrast, those multilateral development banks that work only or substantially with the private sector are more used to retaining and managing more diverse and higher risks. It should not come as a surprise, therefore, that they have often been pioneers in financial innovation among multilateral development banks. As an example, the IFC, the European Bank for Reconstruction and Development, the European Investment Bank, and FMO have been pioneers in lending in domestic currencies. As mentioned, recent initiatives by the IFC (MATCH) and FMO (TCX) would take lending in domestic currencies a necessary step further by achieving risk reduction through global pooling and retaining some residual currency risks on the balance sheets of these institutions, as discussed in chapter 4. Similarly, these institutions have often been more aggressive in offering different types of guarantees and other structured products (see tables in the appendix).

A second factor that has limited the mainstreaming of financial innovations in many multilateral development banks has to do with bureaucratic culture, procedures, and inertia. This is again more noticeable in those institutions that lend only or mostly to sovereign governments. In these cases, procedures and incentives are closely linked to traditional lending operations bundled with technical assistance and supervisory support. Financial innovations normally appear as stand-alone financial products that are offered and managed by specialized treasury or financial unit officials and are

3. An important issue to clarify is whether they can retain all types of risks against their total capital, including callable capital, or just against their paid-in capital.

not well integrated with the more operational units' procedures and incentives. New financial products need to be promoted to the clients because their use often requires improved technical capabilities and associated institutional and policy reforms, as well as overcoming political economy problems. This is a role for country operational units. However, in practice, the fact that most technical support is bundled with traditional lending operations creates a major internal bias in operational units in their favor and thus against the mainstreaming of new financial products.

Many observers have noticed that the pervasive practice of bundling technical support with lending, while having evident synergies and benefits, has drawbacks.[4] Most noticeably, the practice limits the capacity of multilateral development banks to maintain the intellectual and technical leadership that is more easily achieved with "global practice" groups of excellence that can offer technical support and advice on a flexible, free-standing basis and are subject, at least partially, to a market test. In practice, some of the most successful areas of technical support in many multilateral development banks are stand-alone groups whose services are not necessarily bundled with traditional lending operations.[5] While these issues go beyond the scope of this paper, it should be emphasized that they seem absolutely key to unlocking the capacity to innovate and to mainstream innovations in multilateral development banks, with respect to both financial and knowledge products.

More generally, bureaucratic culture and incentives are very often not conducive to experimentation and change. A strong preference for taking on few risks, or just the risks that one is already familiar with, is a common bureaucratic trait in all types of institutions. It is perhaps just somewhat more pervasive in official institutions, especially in official institutions that have only or mostly official stakeholders and clients. Those multilateral development banks that deal only or more significantly with private clients do tend to develop a more pro-innovation and risk-taking culture than those that deal primarily with sovereign governments.

A final and related limiting factor is perhaps the most crucial one: the frequent lack of stakeholder push and support for financial innovations. Although there are some notable exceptions, multilateral development bank boards have usually been more reluctant to innovate than management in this and other areas. This may be to some extent an unavoidable limitation of collective action: it is not easy to achieve consensus for change among representatives of many developed and developing countries with widely different interests. But, more profoundly, it seems to be associated with a lack of a common view among stakeholders about the basic roles of the multilateral development banks in a world with more access to private capital flows.

4. See, for example, Birdsall, Rodrik, and Subramanian (2005) and Birdsall and Subramanian (2007), p. 63.

5. Examples include the Foreign Investment Advisory Service (advisory services for promoting foreign investment) at the Multilateral Investment Guarantee Agency, and Private Participation in Infrastructure (an advisory program for promoting and structuring private-public partnerships in infrastructure) at the World Bank and IFC.

While few would dispute that multilateral development banks still have a major role to play in supporting lower income countries, though the most adequate means are hotly debated, views have been sharply divided with respect to their role vis-à-vis middle-income countries. Differences in views have been closely associated with the concentration of multilateral development banks in traditional lending operations. The most radical critics of actual practices at multilateral development banks[6] have argued that their lending to middle-income countries is not adding any value from a development perspective, given the increased access of these countries to international private capital markets. Even more, they claim that by continuing to lend to these countries at subsidized rates, multilateral development banks are hindering the sound development of private markets. Furthermore, they argue that multilateral institutions should give grants and not loans to low-income countries because poor countries should not be burdened with debt. They cite the Highly Indebted Poor Countries initiative as a late recognition of this failure. In short, they argue for the conversion of multilateral development banks into development agencies that would limit themselves to distributing grants and providing technical assistance to low-income countries, and be essentially deprived of financial intermediation functions.

Unfortunately, most multilateral development banks' responses to these critics have been unduly defensive. They have essentially claimed that multilateral development banks' traditional lending has development value, even when countries have access to private markets, because of its bundling with technical assistance (former arguments about the constructive role of conditionality having been basically abandoned). They have also disputed the view that developed countries subsidize their lending. Furthermore, they have claimed that soft loans are better than grants from the point of view of their own financial sustainability because it is easier to bundle loans with technical assistance over a longer period of time. Admittedly, none of these responses is wholly convincing even to those who believe that multilateral development banks still have an important financial role to play.

What the radical critics systematically overlook, and what multilateral development banks' own defenses often underscore, is that many or most of the developing countries that have gained access to international private capital markets remain highly vulnerable to a variety of exogenous shocks, that the procyclicality of private capital flows and the usual denomination of international financial flows in foreign currencies amplify the severity of the effects of these shocks, and that international private capital markets are, on occasion, themselves the source of exogenous liquidity shocks to middle-income developing countries, as is presently the case. They also overlook the fact that low-income countries are normally even more exposed than middle-income countries to real shocks, whether related to terms of trade and abrupt changes in external demand or the occurrence of natural disasters. By overlooking

6. The most influential voices among these have probably been Meltzer (2000); Lerrick (2006); and Einhorn (2001 and 2006).

these facts, the radical critics do not even discuss whether there is enough access by developing countries, both low- and middle-income ones, to insurance or hedging instruments in private financial markets that could help them mitigate the effects of these vulnerabilities. Hence, they fail to address the key question: whether there is a role for multilateral development banks in helping develop access by developing countries to insurance and hedging instruments. We hope that this report, by providing a systematic treatment of these highly important issues, will facilitate a new consensus among stakeholders about the potential financial roles of multilateral development banks in a world with more access to private capital flows.

The frequent procyclicality of lending by multilateral development banks is an example of how the lack of focus on these issues by most critics and defenders of multilateral development banks alike precludes progress in arriving at a more consensual view. Traditional lending by multilateral development banks to middle-income countries could be defended as having developmental value, as long as it could be shown that it complements, and not substitutes for, the action of private markets. Although multilateral development banks have long realized this, and they actually frequently claim that their lending is countercyclical, more often than not this is not the case in practice, as shown in chapter 3. Bureaucratic culture and incentives and a lack of internal consensus in multilateral development banks about their own developmental role seem to be behind this fact, as discussed in that chapter. By failing to adopt a more prodevelopmental, countercyclical stance in their lending, multilateral development banks are playing into the hands of their more radical critics.

It should be noted, however, that most of the public debate and differences in views on multilateral development banks' financial developmental roles are focused on their lending to sovereign governments. In contrast to the variety of reports and articles on these issues, there is a virtual absence of analysis and debate on multilateral development banks' developmental role through direct financial support to the private sector. There may well be a general feeling that multilateral institutions are fulfilling a useful role in this area, complementing and not substituting for private markets. We noted above that those multilateral institutions that lend solely or significantly to the private sector are, in practice, more flexible and responsive to actual client needs and more prone to innovate. Furthermore, there is apparently significant effective demand for lending and other forms of financial support from multilateral development banks to the private sector in all developing countries, in contrast with what is happening with lending to the governments of middle-income countries, given the higher spread differentials. Thus, these operations have been growing rapidly, while aggregate net disbursements to sovereign governments have been stalling or diminishing.

It could be argued that the lack of a sharply drawn debate about the *raison d'être* and the developmental effectiveness of multilateral development banks' financial operations with the private sector of developing countries has facilitated innovation in and growth of the institutions' private sector arms. Yet, to guarantee their effectiveness, it would seem useful to subject these operations to a more critical analysis of their "additionality," while avoiding the ideological radicalism that has plagued the debate on the financial role of multilateral development banks with respect to sovereign governments and that has resulted in so much harm by blocking progress toward a shared view on needed change and innovation.

In sum, to bridge the gap between the actual practices of multilateral development banks and their potential developmental contributions through financial innovations examined in this report, it seems necessary to reconsider their current risk-management policies and practices, as well as to undertake some internal reforms that would remove existing biases in favor of traditional lending bundled with technical assistance and against financial innovations. But, more important, it seems indispensable to achieve greater consensus about multilateral development banks' financial roles among stakeholders in the current international environment. It is hoped that this report contributes to building such a consensus.