



# A Liquidity Line for MDBs

## SDR Rechanneling Revisited

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### Abstract

World leaders are calling on the multilateral development banks (MDBs) to greatly increase development and climate finance for developing countries using their capital more efficiently. MDBs hold large amounts of liquidity on their balance sheets as well as capital. The International Bank for Reconstruction and Development (IBRD) and the four main regional development banks manage more than US\$200 billion of high credit-quality, liquid assets principally from the world's leading economies. This paper describes how a liquidity line from major central banks backed by SDRs, a natural liquidity instrument, could save MDBs money. A US\$50 billion line, about 8 percent of the top 20 central banks' SDR holdings, could boost MDB net income between US\$413 million and US\$792 million per year under normal market conditions. This would deploy unused SDRs, assist G20 countries comply with their SDR rechanneling commitments, be a step forward towards a more coherent and integrated MDB system, as recommended by various G20 committees, and promote international financial stability. If the savings were retained as additional MDB capital, it could drive between US\$31.3 billion to US\$60.4 billion of additional development lending over 20 years, complementing other reforms to enhance balance sheet efficiency.

## A Liquidity Line for MDBs: SDR Rechanneling Revisited

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# 1. Introduction

As a response to the COVID crisis, world leaders agreed to a US\$650 billion SDR issuance in 2021 to bolster central bank reserves.<sup>1</sup> While countries across the world benefitted, the lion's share of SDR allocations are concentrated in larger economies. The G20 and other advanced economies received around US\$500 billion of that total.<sup>2</sup> The G20 agreed to rechannel US\$100 billion of their SDRs to developing countries. To date recycling mechanisms remain limited, comprising principally the IMF's Resilience and Sustainability (RST) trust, and the IMF's prior creation, the Poverty Reduction and Growth (PRGT) trust.<sup>3</sup>

At the same time, the G20 has called on the multilateral development banks (MDBs) to do more to assist developing countries attain the UN Sustainable Development Goals (SDGs), including climate challenges. G20-commissioned reports have proposed ways to improve MDB efficiency so that MDBs can lend more (or mobilize more private financing) with their existing capital base as well as calling for capital increases.<sup>4</sup>

The African Development Bank (AfDB) and the Inter-American Development Bank (IDB) have proposed the use of SDRs for additional hybrid capital. If the main MDBs increased capital through this means, they could lend greater amounts to developing countries while maintaining their current AAA ratings, which permit borrowing and hence lending, at relatively low interest rates. Still, the amounts of SDRs this would involve would be limited.<sup>5</sup>

At the same time, the MDB financial model requires liquidity as well capital. MDBs carry substantial volumes of liquid assets. According to their internal rules, most MDBs are required to hold, at the least, enough liquidity to cover 12 months of estimated cash-flow needs in case they are not able to access financial markets. In practice, MDBs tend to hold even more than this standard. Additional liquidity might be needed if there is an unexpected demand for new lending or loan reprogramming, or if borrowers suspend payments on debt (MDBs refer to this as a non-accrual event). Typically, MDBs employ stress tests to indicate additional liquidity needs. This paper explores the idea of using SDRs for a liquidity line for MDBs.<sup>6</sup>

The International Bank for Reconstruction and Development (IBRD) and the four main regional development banks hold liquid assets for around 34 percent of their combined debt outstanding, which amounts to some 36 percent of their developmental assets. For every three dollars of developmental lending, more than one dollar is then invested in relatively short-maturity,

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1 See <https://www.imf.org/en/Topics/special-drawing-right/2021-SDR-Allocation>

2 See *Data Dive: Special Drawing Rights – ONE Data & Analysis*

3 See Plant (2021) and ECA-ECLAC (2022) for discussion.

4 See G20 (2022) and G20 (2023).

5 The African Development Bank is initially seeking US\$1.25 billion of SDRs from five central banks—US\$250 million from each institution. See Plant (2023a). The IMF board recently approved the use of SDRs as hybrid capital—see IMF (2024).

6 This idea was mentioned in the *Capital Adequacy Framework* report, G20 (2022), but not developed further.

highly rated assets predominantly from advanced economies. The investment portfolios of the five main MDBs sum to over US\$200 billion.<sup>7</sup>

As MDBs wish to maintain high ratings, the treatment of liquidity within the methodologies of the main rating agencies is also relevant. In general, liquidity is considered on a par with capital, providing an additional motive for carrying such large amounts of liquidity. As MDBs ramp up lending through additional capital, or through seeking greater efficiency with current capital levels, even greater amounts of liquidity will be deemed necessary to support expanded operations.

Holding such large amounts of liquidity over many years does not come for free. A new liquidity line for MDBs could reduce these costs. The savings could be used to finance grants, knowledge, technical assistance, or concessional lending, or plowed back into capital to finance increased lending in the future. Simulations suggest, if savings are retained, a liquidity line of US\$50 billion in total, for the IBRD and the four main regional development banks, could result in an increase of between US\$31.5 billion and US\$60.4 billion of development lending over 20 years.

The costs of holding liquidity are not readily apparent in recent MDB income statements. Some MDBs consider their investments as financed by equity. But their equity was donated by member governments that are not paid dividends. It is more appropriate to consider the liquidity financing cost to reflect the cost of debt. The current inverted yield curve may suggest low or even positive returns, but current conditions are exceptional and likely to change in the coming months. In practice, MDBs manage their investment portfolios across many types of assets to obtain higher returns taking market or credit risk and using derivatives to hedge risks. These strategies consume capital, to back credit and counterparty risks, which could otherwise have been leveraged and developmental lending then increased.

In this paper, I outline the argument for a new liquidity backstop for MDBs as an additional means of SDR rechanneling. In the following section, I review the structure of MDB balance sheets and the costs of their liquid asset holdings, and I explain how rating agencies consider liquidity in their respective methodologies. In section 3, I turn to the supply side of the proposed liquidity line and consider the relevant mechanics of SDRs and the position of G20 and other advanced economy central banks. In section 4, I outline a potential structure for a liquidity line for MDBs. Section 5 details more precisely the potential benefits of the liquidity line as proposed, and section 6 concludes. The G20 (which includes the larger shareholders of the MDBs) has been pressing MDBs to be more efficient and optimize their balance sheets to provide greater assistance to developing countries. This proposal to further deploy allocated but unused SDRs would go precisely in that direction.

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<sup>7</sup> Figures from MDB reports, further details below.

## 2. Liquidity, MDB balance sheets and rating agencies

MDBs hold considerable amounts of liquidity. Table 1 details selected statistics from the balance sheets of the IBRD and the four main regional development banks. While each institution has its own characteristics, internal rules, and regulations, the balance sheets are mainly composed of a few similar, broad categories. On the asset side, two important entries are development assets (including loans, guarantees, and in some cases equity and debt) and the liquidity portfolio, made up of high-quality, relatively short-maturity liquid assets. On the liability side of the balance sheet, two significant entries are the equity and the borrowings of the MDB that finance the assets.

**TABLE 1. Key variables from MDB balance sheets (USD mn)**

	IBRD	IDB	AfDB	ADB	EBRD	Total
<b>Investments</b>	74693	32421	18315	47483	32362.86	205274.86
<b>Development Assets</b>	253126	116239	28260	146516	31574.22	575715.22
<b>Borrowings</b>	272302	113358	31339	131571	46628.34	595198.34
<b>Equity</b>	62447	38846	13798	54214	20496.16	189801.16
	Simple Average					
<b>Liquidity/Debt</b>	27.4%	28.6%	58.4%	36.1%	69.4%	44.0%
<b>Liquidity/Development Assets</b>	29.5%	27.9%	64.8%	32.4%	102.5%	51.4%
	Aggregate Ratios					
<b>Liquidity/Debt</b>	34.5%					
<b>Liquidity/Development Assets</b>	35.7%					

Note: IBRD is International Bank for Reconstruction and Development (part of the World Bank Group), IDB is the Inter American Development Bank, AfDB is the African Development Bank, ADB is the Asian Development Bank and EBRD is the European Bank for Reconstruction and Development.

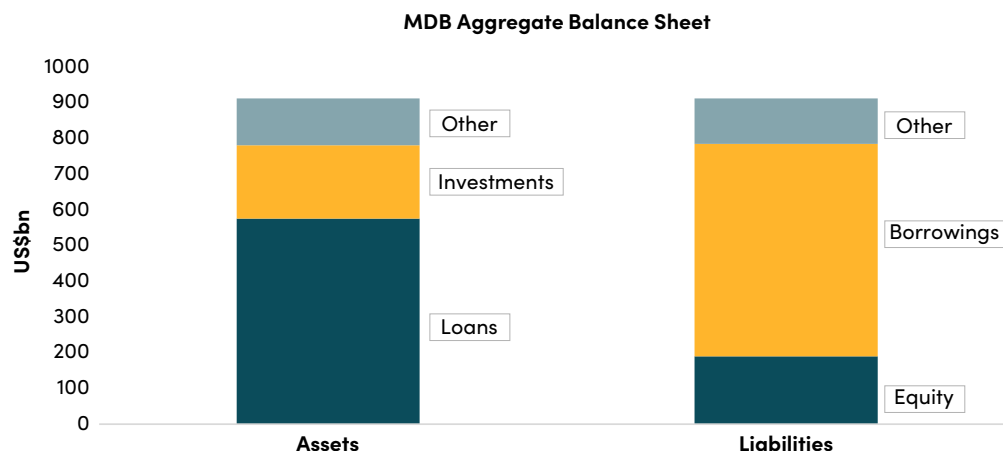
Sources: Annual Financial Statements of each MDB, Dec 2022 with the exception of the IDB which is 2023 and the AfDB in which case the data comes from a presentation to investors, June 2023. ADB (2023), AfDB (2023b), EBRD (2023), IBRD (2023), IDB (2023) and Author's calculations.

MDBs have other assets and liabilities, but they tend to be relatively small compared to the four entries detailed above, with the exception in some cases of swaps and other derivative contracts. MDBs are significant users of these instruments, principally to hedge currency and interest rates risks. MDBs may lend or borrow in several currencies but then swap the relevant cashflow to hedge risk, where that risk is generally assessed in a particular currency (or basket of currencies).<sup>8</sup> MDBs may also use interest rate swaps to hedge rate risks. Figure 1 illustrates a schematic aggregate balance sheet for the IBRD plus the four main regional development banks but where appropriate, the assets and liabilities have been adjusted to net out most of the derivative operations.<sup>9</sup>

<sup>8</sup> As an example, the IDB had outstanding borrowings in 18 different currencies in 2023 and 17 in 2022. In 2023, this was heavily concentrated in US dollars but with substantial amounts in British pounds, and Australian, Canadian, and New Zealand dollars. The IDB calculates risk in US dollars, which is its unit of account.

<sup>9</sup> Some MDBs present balance sheets net of derivative operations.

**FIGURE 1. Schematic aggregate MDB balance sheet**



*Notes:* The graph depicts actual figures from the IBRD, ADB, AfDB, EBRD and IDB for development assets, liquid assets, equity, and borrowings. Other assets and other liabilities were adjusted to take out swaps and derivative operations.  
*Sources:* ADB (2023), AfDB (2023), EBRD (2022), IBRD (2023), IDB (2023) and author's calculations.

It is evident from Table 1 and Figure 1 that the liquidity portfolio represents a significant element of MDB balance sheets. For the aggregate MDB balance sheet (the total of the five MDBs listed in Table 1), the investment portfolio sums to over US\$200 billion. Liquid assets are around 34 percent of total debt outstanding or about 36 percent developmental assets. For each dollar of development lending financed through equity or debt issuance, over 30 cents is invested in relatively short-maturity, high-rated assets generally from advanced economies, rather than lent to their developing country clients. Considering the simple average across the five MDBs rather than the aggregate gives even higher liquidity ratios—around 44 percent of debt issued or just over 50 percent of development assets.<sup>10</sup>

In general, holding liquid assets has represented a cost for MDBs but this is not immediately evident from recent MDB balance sheets. For example, the IDB notes the overall return on its investment portfolio as 5.63 percent for 2023 and 1.65 percent for 2022—the higher returns in 2023 due to higher US interest rates. Interestingly, this includes a whopping 12.3 percent return on its US\$349 million portfolio of liquid assets held in local currencies in 2023 (12.53 percent for the US\$359 million for 2022).<sup>11</sup> However, this is just the return. What was the cost of financing this portfolio? The financial cost of equity is not a useful concept for an MDB, as capital is provided by donor countries and MDBs do not pay dividends to their shareholders. The IDB does not provide an overall interest cost on borrowings in its financial information statement, but for 2023 it had interest payments of some US\$6.018 billion on total borrowings (at the end of the year) of US\$113 billion, giving an implicit

<sup>10</sup> The simple average gives greater weight to the EBRD, which has considerably higher liquidity than the IBRD and the other regional multilateral development banks.

<sup>11</sup> "Local currencies" refers to the currencies of borrowing countries.



interest rate of 5.3 percent.<sup>12</sup> The simple comparison suggests the IDB made a profit on its investment portfolio in the sense that it cost an estimated 5.3 percent to finance and 5.64 percent was gained.

However, the borrowing cost here does not take into account the cost of derivative transactions used to hedge risks associated with those borrowings nor to hedge any risks on the investment portfolio. As noted above, the IDB borrowed in 18 currencies in 2023 and the investment portfolio included investments in several currencies, including local ones. Moreover, it does not take into account the risks taken on the investment portfolio, including price risks, the credit risk on the investments themselves, and the counterparty risk stemming from any derivative transactions related to the investment portfolio or related to the borrowings to finance those investments. Additional capital is required to back the various risks involved.

As an example of the credit risk on the investment portfolio, in 2023 the IDB had US\$300 million of exposure to firms with a rating of BB or lower, about US\$2 billion of A risk, US\$16.3 billion of AA risk, and about US\$10.9 billion of AAA risk (all net of collateral). The total exposure amounted to some US\$31.7 billion. If the counterparty risk on the investment portfolio was reduced, then the capital “released” could be devoted to additional lending. Other MDBs also have a mix of assets in their treasury portfolios, in terms of credit quality, currency, and maturity.

Given the current treasury policies followed by MDBs, there are many elements to the cost of holding such large volumes of liquidity. The true cost should reflect the cost of financing and the cost of the developmental objectives sacrificed, given that capital must be devoted to back the risks being taken and the counterparty risk of hedging operations.

Rather than considering the actual liquidity policies of MDBs, a purer way to think about the cost is simply to consider the slope of the yield curve. Here for convenience, I refer to the US Treasury curve. Suppose financing was at 10 years while liquidity was held in the form of a 3-month Treasury bill. In that case, the cost of holding liquidity would be the spread between these two instruments. As they are in the same currency and have very low credit risk, this provides a reasonable measure of the pure cost. The average spread between a 10-year US Treasury and a 3-month US Treasury bill was 1.83 percent between 2010 and 2019.<sup>13</sup>

If MDBs issued at 10 years and held 3-month US Treasury bills, then for US\$200 billion of liquidity, the cost over those years was roughly US\$3.7 billion per annum. If MDBs issued instead at 5 years and bought 3-month Treasury bills, then the cost would have been about US\$2.2bn per annum.

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12 As the IDB financial information statement explains, overall borrowing interest rates are hard to calculate as borrowings consist of a variety of floating and fixed rate interests in many currencies, so this should be thought of as an *ex post* estimate. MDBs sometimes apportion a subset of their borrowings to finance their liquidity portfolios, but as funds are fungible I prefer to consider overall funding costs.

13 Data taken from Federal Reserve Bank of St Louis, FRED database.

The pure slope of the yield curve might be an underestimate of the true cost for an MDB that issues at a (relatively small) premium over US Treasuries.

These estimates are based on the US yield curve for the decade before the pandemic. But we have not been living in normal times. After the global financial crisis, US policy interest rates were zero for about seven years and long rates were pushed down through quantitative easing—the Federal Reserve purchased longer maturity US Treasuries and other assets, particularly mortgage-backed securities. The yield curve was upward sloping but yield spreads were compressed. As a result of the pandemic, there were then further massive injections of liquidity and a huge expansion of the Federal Reserve balance sheet (to over US\$7 trillion) compressing spreads at the long end. Then as inflation rose after the pandemic and proved to be more persistent than expected, short-term rates were raised, and the curve became inverted. Most analysts, and the Federal Reserve itself, predict that short term rates will fall, and the slope of the yield curve will become positive again in the months to come. The Federal Reserve has also begun to shrink its balance sheet, which may put further upward pressure on longer-term rates. The large volume of US federal debt, and its somewhat worrying refinancing requirement, may also put upward pressure on longer rates. All these considerations suggest that yield spreads will revert towards normal levels in the months and years ahead.

MDBs may also wish to hold a substantial amount of liquidity (frequently in excess of the minimum laid down in their own rules) to ensure rating agencies continue to award a very high rating. The four main regional development banks and the IBRD each maintain a AAA rating or its equivalent from the three main rating agencies—Fitch, Moody’s, and Standard and Poor’s. As an example, Standard and Poor’s combines the strength of liquidity and funding, and the strength of capital adequacy, into what it refers to as the Financial Risk profile of the MDB. The Financial Risk profile is then combined with the Enterprise Risk profile and the strength of Extraordinary Support (such as the availability and quality of the callable capital) to obtain the final rating. Table 2 provides the current scores for these aspects and the final rating of the IBRD and the four main regional development banks. Each MDB is assessed at **aaa** according to its stand-alone credit profile (SACP), each has funding and liquidity rated as Very Strong or Strong, and each has capital adequacy rated as Extremely Strong or Very Strong.<sup>14</sup>

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14 The stand-alone credit profile (SACP) is expressed in small letters as S&P does not consider it a rating per se.

**TABLE 2. Comparative standard and poor's scores for selected multilateral development banks**

Name	Rating	Outlook	SACP	Enterprise Risk Profile	Policy Importance	Governance and Management Expertise	Financial Risk Profile	Capital Adequacy	Funding and Liquidity
African Development Bank	AAA	Stable	aaa	Very strong	Very strong	Adequate	Extremely strong	Extremely strong	Very strong
Asian Development Bank	AAA	Stable	aaa	Extremely strong	Very strong	Strong	Extremely strong	Extremely strong	Strong
European Bank for Reconstruction and Development	AAA	Stable	aaa	Very strong	Strong	Strong	Extremely strong	Extremely strong	Very strong
Inter-American Development Bank	AAA	Stable	aaa	Extremely strong	Very strong	Strong	Very strong	Very strong	Strong
International Bank for Reconstruction and Development	AAA	Stable	aaa	Extremely strong	Very strong	Strong	Extremely strong	Extremely strong	Strong

Notes: SACP: Stand Alone Credit Profile. Lowercase letters are used for the SACP's to highlight that these outcomes are not themselves ratings, S&P says that they are indicative credit assessments that inform the ratings which also incorporate extraordinary outside support such as callable capital not included in this table.

Source: Standard and Poor's (2023a) Comparative Data: Supranationals Edition 2023: Comparative Data For Multilateral Lending Institutions, 12 Oct, 2023.

The way that Funding and Liquidity is combined with Capital Adequacy implies a tradeoff between the two. Table 3 shows how the two concepts are aggregated to obtain the Financial Risk Profile. For example, if Funding and Liquidity is rated as Adequate, then the Financial Risk Profile can still be Very Strong, assuming Capital Adequacy is rated as Extremely Strong. On the other hand, if Capital Adequacy is rated as Strong, then Funding and Liquidity must be Very Strong for the overall Financial Risk Profile to be Very Strong. The AfDB and the European Bank for Reconstruction and Development (EBRD) both have Liquidity and Funding, and Capital Adequacy, at the highest rating available, but could have lower capital or liquidity ratios, and still have an Extremely Strong, Financial Risk Profile. The Asian Development Bank (ADB) and the IBRD each have Strong Liquidity and Funding but combine that with Extremely Strong, Capital Adequacy to obtain an Extremely Strong Financial Risk Profile. The IDB is the only one of the MDBs listed to have a Very Strong, Financial Risk Profile (rather than Extremely Strong) but combines that with an Extremely Strong Enterprise Risk Profile and so still obtains a *aaa* stand-alone credit profile (SACP), as per the other MDBs.<sup>15</sup>

**TABLE 3. Multilateral development bank financial risk profile according to standard and poor's**

	Capital Adequacy						
	Extremely Strong	Very Strong	Strong	Adequate	Moderate	Weak	Very Weak
<b>Funding and Liquidity</b>							
Very strong	Extremely strong	Extremely strong	Very strong	Strong	Adequate	Moderate	Weak
Strong	Extremely strong	Very strong	Strong	Adequate	Moderate	Weak	Very weak
Adequate	Very strong	Strong	Adequate	Moderate	Weak	Very weak	Very weak
Moderate	Strong	Adequate	Moderate	Weak	Very weak	Very weak	Very weak
Weak	Moderate	Moderate	Weak	Very weak	Very weak	Very weak	Very weak
Very weak	Weak	Weak	Very weak	Very weak	Very weak	Very weak	Very weak

Notes: The Financial Risk profile, which results from the combination of the assessment of Capital Adequacy and the assessment for Funding and Liquidity, is in the body of the table. The Financial Risk profile is then combined with the Enterprise Risk Profile to obtain the indicative stand-alone assessment.

Sources: Standard and Poor's (2022), MLI Rating Methodology.

In order to assess the strength of Funding and Liquidity for each MDB, Standard and Poor's considers the strength and potential volatility of funding by reviewing the funding mix and funding profile, and considers a set of key ratios to assess the strength of the liquidity position. There is almost no tradeoff between liquidity and funding in the assessment, in the sense that to obtain a Very Strong (the top score) for the Funding and Liquidity assessment requires both a top score for Liquidity

<sup>15</sup> Strictly speaking the stand-alone credit profile (SACP) is not a rating, S&P considers it an indicative assessment.

(Very Strong) and a top score for Funding (Positive). If either score dips below these top levels, then the Very Strong Funding and Liquidity Assessment would drop to Strong. A weaker liquidity position cannot be compensated with a stronger funding assessment or vice versa.

The liquidity assessment focusses on the ability to manage liquidity needs in adverse market and economic conditions and the likelihood that the MDB might be able to function normally in such conditions for an extended period of time. Liquidity ratios are calculated at different time horizons under different assumptions. For example, the sum of discounted liquid assets for each period (one, three, six, and 12 months) is calculated as a proportion of liabilities including loan disbursements. The denominator for each ratio is then the sum of all liabilities maturing by or on the horizon date, while the numerator is the sum of the assets discounted for either credit risk or liquidity risk. Scenarios where the MDB halts loan disbursements may also be considered. Still, if the shorter time period ratios fall below 1x then liquidity would typically be assessed as Weak or Very Weak, which would limit the SACP at bb or even b- respectively. This would be unacceptable to the MDBs listed above, and their internal rules stipulate that liquidity should at a minimum cover all cashflows for at least 12 months. Table 4 provides recent data for 12-month liquidity ratios for the five MDBs using Standard and Poor’s definitions. They are all greater than 1 and the average in the most recent years is 1.5.

**TABLE 4. 12-month liquidity coverage ratios**

	IBRD	AfDB	ADB	EBRD	IADB	Average
2022	1.3	1.8	1.2	1.9	1.4	1.52
2021	1.3	1.6	1.0	1.9	1.5	1.46
2020	1.1	1.3	1.2	1.5	1.6	1.34
2019	1.2	1.5	1.3	1.2	1.4	1.32
2018	1.2	1.7	1.8	1.2	1.4	1.46

*Source:* Standard and Poor’s (2023a), Supranationals Edition 2023: Comparative Data For Multilateral Lending Institutions.

The above liquidity ratios incorporate haircuts that depend on the credit quality and the liquidity of the asset in question. The haircut tends to rise with the maturity of the asset and as credit quality decreases. MDBs may also apply such haircuts in their own liquidity ratio calculations. In normal times, these haircuts represent an additional cost for MDBs to comply with liquidity needs.

MDBs clearly combine high liquidity ratios with relatively high capital ratios. After reviewing the role of SDRs on central bank balance sheets and a potential structure for the liquidity line, I come back to the possibility of exploiting the trade-off between capital and liquidity in rating agency methodologies below.

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### 3. On SDRs and central banks

The Special Drawing Right is an international reserve asset. In general, SDR allocations boost the reserves of central banks of IMF member countries although strictly speaking it is the member country that decides where its SDR allocation is held.<sup>16</sup> While the SDR is not a currency per se, it can provide countries with liquidity as SDRs can be exchanged for the freely usable currencies of IMF members in a voluntary market.<sup>17</sup> The value of an SDR is defined according to a basket of currencies.<sup>18</sup>

To date, US\$943 billion worth of SDRs (SDR 660.7 billion) have been allocated including the largest-ever allocation of US\$650 billion (SDR 456 billion) approved on August 2, 2021 in response to the COVID pandemic (and made effective on August 23, 2021). SDRs are allocated proportionately to countries' quotas in the IMF. The implication is that the vast majority of any SDR allocation goes to G20 and advanced economies rather than to non-G20 developing countries. Of the US\$650 billion 2021 allocation, some US\$500 billion went to G20 and advanced economies.<sup>19</sup>

It is instructive to compare countries' SDR holdings and their total (cumulative) allocations. Figure 2 provides this mapping for April 2024. Each (red) dot is a country, and the graph uses a log-scale as many countries have relatively modest allocations and holdings while a few countries have very large allocations and holdings. The (blue) line is the 45-degree line where holdings are equal to allocations. The countries (dots) to the top right of the graph are those with large SDR allocations: mostly advanced economies and large developing ones such as China. The US is the country furthest to the right, with a total allocation of SDR 115 billion and current holdings of SDR 124 billion, some 8.4 percent more than the allocation.

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16 The IMF Articles of Agreement state that SDRs belong to IMF "members," which means national governments.

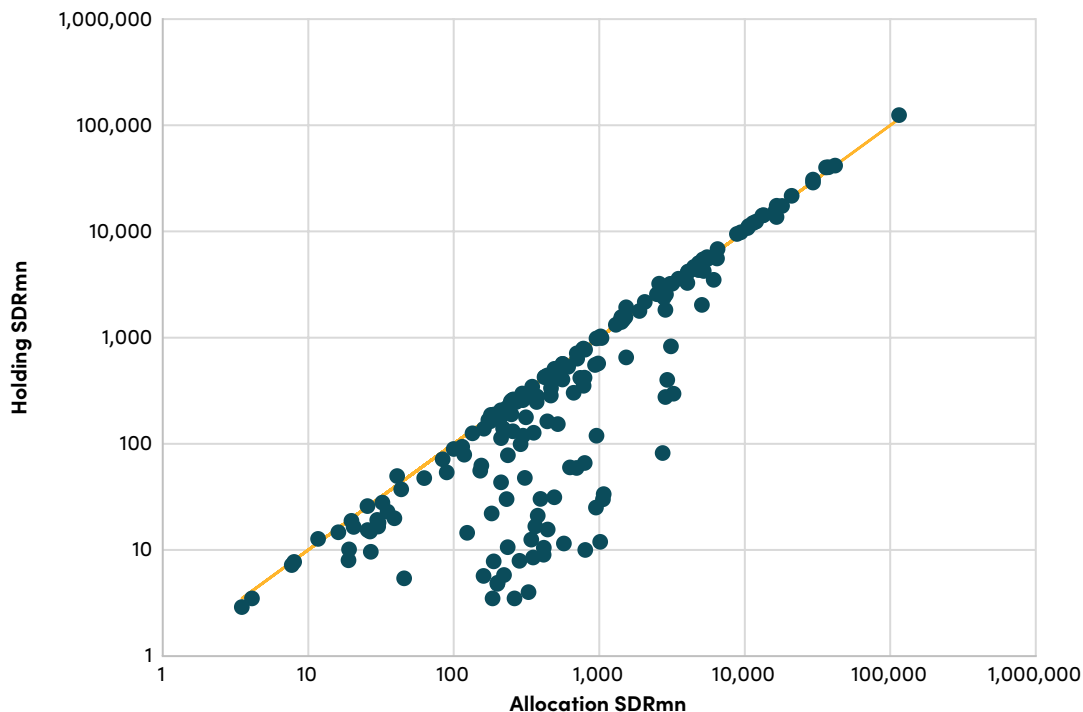
There is some leeway in how individual countries account for their SDRs, although the vast majority are held as reserves in central banks.

17 See the IMF's webpages dedicated to SDRs <https://www.imf.org/en/Topics/special-drawing-right>

18 These currencies are the US dollar, euro, Chinese yuan, Japanese yen, and the British pound.

19 See *Data Dive: Special Drawing Rights – ONE Data & Analysis*

**FIGURE 2. SDR allocations vs. holdings**



Note: Countries with holdings of less than US\$ 1mn are excluded from the graph.

Source: IMF data on SDRs, [www.imf.org](http://www.imf.org).

The US and other advanced countries with large SDR allocations are generally holding more SDRs currently than their cumulative allocations, and so the dots lie slightly above the 45-degree line.<sup>20</sup> This is because others have swapped their SDRs for hard currency with these countries and so these larger economies now have holdings in excess of their allocations. Conversely, there are some countries that lie well below the 45-degree line. These are the nations that have used their SDRs. They may have used them to pay the IMF or swapped them for hard currency (with the US and others) to pay down other debts or finance fiscal spending. This group includes Argentina (3.0 billion), Ukraine (2.9 billion), India (2.9 billion), and Iraq (2.6 billion), where the figures in the parentheses are their allocations minus their current holdings in SDRs. These are the four countries with the largest difference between current holdings and allocations in SDR terms. However, there are many countries with smaller allocations that have used a larger proportion of their SDRs. For example, Zimbabwe, Mozambique, and Antigua and Barbuda have only 1.2 percent of their original allocation remaining—they have used 98.8 percent of their (relatively small) allocations. More generally, 26 countries have used at least 95 percent of their SDR allocations and 34 have used more than 90 percent.

<sup>20</sup> Japan is an exception which holds 99.9 percent of its total allocation.

While the SDR allocations, combined with the voluntary swap market, have allowed countries to pay down other debts and financed fiscal spending during the pandemic, the graph highlights the peculiarities of the system. Countries with large SDR allocations remain very close to the 45-degree line, indicating they have swapped only a very small amount of their huge allocations while several countries with smaller allocations have already used up virtually all of their SDRs. It is no wonder that in these circumstances there is pressure for further SDR allocations. But any new allocation would again primarily boost the already huge holdings of the larger economies. The system was designed to influence the global supply of liquidity in aggregate and is not efficient at providing targeted liquidity to smaller developing countries where arguably it is most needed today.

It should also be noted that swapping SDRs for hard currency does not come for free. Countries must pay the SDR interest rate on the swapped balances. That interest rate is a weighted average of the interest rates on the currencies that make up the SDR basket. While these interest rates were extremely low, they have risen considerably with the general rise in interest rates across the globe. The SDR interest rate was around 0.5 percent in April 2022 but in April 2024 it had risen to almost 4.1 percent.

This discussion highlights the need for mechanisms for SDR rechanneling. The G20 made a commitment to rechannel US\$100 billion of SDRs of the new allocation to developing countries. But mechanisms for recycling remain limited and to date consist principally of the IMF's Poverty Reduction and Growth Trust (the PRGT) and the IMF's Resilience and Sustainability Trust (the RST). The IMF claims that since 2020, some US\$55 billion has been rechanneled through the PRGT with the capacity to mobilize \$40 billion in interest-free loans to its poorest members through 2024, and US\$42 billion of SDRs has been rechanneled through the RST, which may contribute toward meeting an estimated US\$29 billion in affordable financing.<sup>21</sup> These figures represent pledges by countries, which exceeds the actual amount of SDRs lent to these two trusts, and that amount exceeds the amounts actually lent to countries—some SDRs are held on deposit.<sup>22</sup> Still, this means that US\$97 billion of SDRs may eventually be rechanneled through these mechanisms, but this includes SDRs from non-G20 economies countries, so the G20 will still not have reached its US\$100 billion target. Note that SDRs lent to the PRGT and the RST remain as reserve assets and so remain in the central bank holdings.

The AfDB and the IDB proposed the use of SDRs as a source of hybrid capital for MDBs. As the SDRs are neither lent nor granted, this required an authorization by the IMF board.<sup>23</sup> While the IMF board approved the use of up to US\$15 billion of SDRs to be used in this fashion, to date only the AfDB is moving forward, with the idea of having five central banks participate for around US\$ 250 million of SDRs each and a total of US\$ 1.25 billion. This mechanism is then, so far, a modest one in terms of SDR

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21 These are total amounts and so include what would have normally been rechanneled through the PRGT.

22 The trusts maintain a reserve of SDRs as part of the "encashment mechanism."

23 See IMF (2024).



volumes. The bottom line is that these plans still leave a large amount of SDRs on advanced economy and other G20 economy central bank balance sheets.

Different countries and their central banks have different rules regarding the potential use of their SDRs. These rules may be specific to the use of SDRs or reflect more general rules. For example, as employing reserves to finance government spending is generally thought to be inflationary (and may jeopardize central bank independence and credibility), this is prohibited by law (or by independent central bank rules) in some jurisdictions. Other central banks are allowed to finance government activities; for example, they may be allowed to buy government bonds at market prices. During the COVID crisis, most central banks found ways to inject significant quantities of liquidity into their respective economies, where the precise mechanisms adopted depended on what was allowed given local legislation and the charter of the respective central bank.<sup>24</sup> The European Central Bank (ECB) has a rule prohibiting “monetary financing,” EC3603/93, Article 7. The ECB explains that three principal goals of the monetary financing prohibition are “safeguarding (i) the primary objective of price stability, (ii) central bank independence, and (iii) fiscal discipline.”<sup>25</sup>

The discussion surrounding the hybrid capital instrument, as proposed by the AfDB and the IDB, is instructive in this regard. Following this idea, SDRs would be lent to an MDB to finance hybrid capital and given the increase in capital, the MDB would be able to issue more debt and to extend a greater amount of lending to developing countries, financed by that additional capital and debt issued. In the ensuing discussion of this proposal, Christine Lagarde, the European Central Bank (ECB) president, stated that the ECB could not directly finance MDBs as this would be counter to the “monetary financing” prohibition maintained by the ECB, while the IMF had an exception to that rule. Many central banks have lent SDRs to the PRGT or the RST to finance long-term loans to developing countries. In some cases, this seems to be allowed because it is recognized that this does not threaten price stability, central bank independence, or fiscal discipline, while others appear to treat this as an exception.

A potential advantage of the proposal developed below is that the liquidity line would not finance loans at all. The liquidity line would in the first instance simply replace some of the existing, large volume of liquid assets on MDB balance sheets. As the SDRs are not financing additional lending it seems difficult to conclude that this would be “monetary financing.”<sup>26</sup> The direct effect would be a financial gain for the MDB which would save on the cost of holding large volumes of liquidity, net of any commitment fee paid for the line. Assuming that additional income was retained, capital would grow faster than otherwise. On the basis of that additional capital, the MDB could borrow more and lend more. Those additional loans would be financed by the additional capital and debt issues,

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24 See the discussion in Neumeyer and Powell (2021).

25 See ECB (2012).

26 See the discussion in Paduano (2022), Paduano and Maret (2023) and Paduano (2023).

not by the contingent liquidity line. Still, the use of a central bank's SDRs in the liquidity line as proposed would require a close inspection of each central bank's legal operating framework.

Central banks that lend SDRs to the PRGT or the RST in general maintain those SDRs on their balance sheets as reserve assets. This is possible as these trusts have a so-called encashment regime whereby if the lending country suffers a balance of payments crisis, it can reclaim its SDRs. As several central banks participate and the trust maintains some liquidity in reserve, the risk of lending SDRs is reduced. The AfDB-IDB hybrid capital proposal contains a somewhat similar encashment regime. In this case, the proposal states that at least five central banks should participate and as per the IMF trusts, a proportion of liquid resources are to be maintained as reserve and a central bank can reclaim its SDRs in the face of a balance of payments crisis.

The proposal here is quite different. The liquidity line would be a contingent facility triggered only in the unlikely event that the MDB has an urgent need for additional liquid resources. Unless the line is actually triggered, the SDRs would remain on the central bank balance sheets; they are not lent as is the case for the other proposals for recycling SDRs. In the end, however, it is a decision of each central bank or its government, depending on the relevant legal structure, as to what constitutes a reserve asset.<sup>27</sup>

In summary, this proposal recognizes that SDRs are in their essence a liquidity instrument. Employing SDRs to create a liquidity backstop is a natural use, consistent with their reserve asset characteristics. This proposal, though quite different, complements other efforts to employ SDRs to finance long-term lending, such as through the PRGT, the RST, or through additional hybrid capital for MDBs.

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## 4. Liquidity line structure

In this section, I provide some preliminary ideas regarding the size and potential structure of the liquidity line for MDBs. Section 5 then goes into further detail regarding the potential benefits.

MDBs hold over US\$200 billion of liquidity and there are over US\$560 billion of SDRs being held on advanced economy central bank balance sheets. If we net out the US\$98.25 billion pledged to the two IMF trusts and the AfDB's proposed hybrid capital instrument, we are left with over US\$ 460 billion. China and other large emerging economy central banks may also wish to contribute.

For there to be a meaningful potential gain, the liquidity line would need to be a reasonable size. Let us suppose that the liquidity line for the IBRD and the four main regional development banks will amount to US\$50 billion. This would be 24.4 percent of MDBs current liquidity holdings.

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<sup>27</sup> As the SDRs would remain on central bank balance sheets except in the unlikely event that the line was withdrawn, then those SDRs should also be available for use the IMF's Voluntary Trading Arrangements, and central banks that participated should not be considered "SDR deficient" for their participation.

Apportioning this across the MDBs according to their respective holdings of liquid assets would imply a liquidity line of US\$18.2 billion for the IBRD, US\$7.9 billion for the IDB, US\$4.5 billion for the AfDB, US\$11.6 billion for the ADB, and US\$7.9 billion for the EBRD.

If the top 20 central banks, as measured by their cumulative SDR allocations, participated in the line, this would impact 7.7 percent of their current SDR holdings in aggregate. As an example, the US SDR holdings are US\$164 billion and this would impact US\$12.1 billion (or 7.4 percent) of the US Federal Reserve's SDRs. The central bank participant with the lowest cumulative SDR allocation would be the Sveriges Riksbank of Sweden, which has holdings of some US\$9.0 billion and this would impact US\$686 million, or 7.6 percent.<sup>28</sup>

A liquidity line, such as a pre-agreement to conduct a repurchase (repo) operation, is a well-established instrument for liquidity management and the repo market itself is estimated to have a volume of US\$4.6 trillion outstanding (including the US Federal Reserve's own repo window) just in the US.<sup>29</sup> A critical question is how a rating agency would assess a liquidity line arranged between a central bank and an MDB. A precedent exists as the European Investment Bank (EIB) has access to liquidity facilities provided by the European Central Bank (ECB).<sup>30</sup> In rating the EIB, the rating agencies comment in highly favorable terms regarding this access. More generally, central banks tend to be the most credible institutions in each jurisdiction and should be treated at least at a par with the credit rating of the relevant sovereign.

It might be argued that a contingent liquidity line is not the same as having the actual liquidity on a balance sheet. However, if that liquidity is in the form of an asset that must be sold to obtain hard currency, then its liquidity depends on the functioning of the market for that asset at a time of stress. In this case, each central bank would provide SDRs and then if the MDB wished to convert those SDRs to hard currency, this would be effected in the market organized by the IMF. The functioning of that market is backed by a set of voluntary trading arrangements of the leading central banks in the world. To ensure the liquidity line would be considered of high quality, it would be important to ensure that these arrangements guaranteed the possibility of converting SDRs to hard currency if needed.

The liquidity line would be a contingent commitment to lend SDRs to an MDB.<sup>31</sup> For this option, MDBs would pay the central banks a commitment fee. It is difficult to evaluate what the commitment fee should be, as this is a new instrument. Given MDBs' conservative capital, funding, and liquidity policies, as reflected in their AAA ratings, the probability that the line would be drawn should be

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28 These dollar amounts will fluctuate with exchange rates. This calculation uses the SDR to USD exchange rate as of June 18, 2024.

29 See SEC (2021).

30 S&P comments "We view the EIB as a leading supranational borrower with an exceptional market presence and with unique access to the European Central Bank (ECB) as a lender of last resort" – see Standard and Poor's (2023b).

31 As SDRs would be lent subject to a repurchase agreement between a central bank and a prescribed SDR holder, additional authorization may not be required by the IMF board in this case.

very low indeed. Moreover, as discussed below, if drawn the MDB could supply collateral to the central bank to further diminish risk. For illustrative purposes I will work with a commitment fee of 25 basis points. If the commitment fee were 25 basis points, the fee in dollars (for a line of US\$50 billion distributed across the MDBs as specified above), would translate into US\$45.5 million for the IBRD, US\$19.7 million for the IDB, US\$11.2 million for the AfDB, US\$28.9 million for the ADB, and US\$19.7 million for the EBRD.

Ideally the liquidity line contract should be written such that the MDB could draw the line at any time. However, if the line is drawn, there would be an interest rate to be paid. That interest rate should be the SDR interest rate as a minimum. It might be specified as 100 basis points over the SDR interest rate to ensure there would be no incentive for an MDB to trigger the line unless there was a real liquidity need. This would ensure that the liquidity line was “out of the money” and MDBs would naturally prefer to use other sources of liquidity or issue debt rather than draw on the line, under most market conditions. An alternative would be to specify a separate trigger based on an indicator of a serious market dislocation, but such triggers can create their own implementation issues.

If the liquidity line was structured as a contingent repo facility and the line was drawn, the MDB would provide assets as collateral to the central bank. These assets could be liquid securities held on the MDB balance sheet or sovereign loans of specified emerging economies. Note that in the absence of the line, and in the unlikely event of a liquidity problem, the MDB would likely have to sell liquid assets in the open market. This could add to whatever market disruption might be occurring at this time. The existence of the liquidity line might then be seen to be a stabilizing element in a time of market stress.

In the case of loans used as collateral, the MDBs would retain the relationships with the borrowing countries and maintain the loan servicing arrangements. Indeed, rather than transferring the actual loans MDBs could transfer synthetic assets backed by outstanding loans. MDBs have already synthetically transferred assets in exposure exchange agreements and more recently in securitizations.<sup>32</sup> Such (synthetic) loans might be limited to sovereigns above a certain credit rating. The MDB preferred creditor status on sovereign lending would be maintained, in line with recent securitization operations.<sup>33</sup> Some central banks already have swap lines with the central banks in highly rated emerging economies. Allowing the preferred MDB loans to those countries to act as collateral for the liquidity line would be a natural extension.

The liquidity line would have a maturity agreed between the central banks and each MDB. Ideally, the maturity would be a number of years and rolled over by mutual agreement every few months

32 MDBs have swapped exposures in a synthetic fashion between themselves through exposure exchange agreements in order to diversify risk. The African Development Bank Room 2 Run transactions include the transfer of synthetic private and sovereign assets backed by loans—see Galizia et al. (2023) for a discussion. The provision to meet collateral requirements with synthetic loans could help to encourage MDBs towards further securitizations and develop markets in such instruments.

33 See Galizia et al. (2020) for a discussion on this point.

so that the MDB had a constant horizon during which it knew that liquidity coverage was available. For example, maturities could be between three and five years and the line could be rolled over every six months assuming there was no objection by the counterparts. This means that each MDB would have a minimum coverage of at least 2.5 years at any point in time. This arrangement would also underline the idea that this line would be a permanent and not a temporary feature in the international financial architecture.

Still, if the line had not been drawn, and the country of a central bank was experiencing a balance of payments crisis, then the contract could include an option for a central bank to withdraw from the arrangement in the case of a balance of payments crisis. This could be pre-specified according to a set of agreed thresholds being breached (such as above a minimum level of the policy interest rate, above a minimum level of the depreciation of the exchange rate over a period of time, above a threshold for the loss of international reserves over a period of time ,etc.) or it could be determined by the IMF if that was agreeable to the counterparts and the IMF. The IMF normally shies away from such designations, although there is such a clause in the encashment regimes of the PRGT and RST, so this liquidity line could *piggyback* on that determination. The purpose of this clause would be to ensure that each participant central bank could maintain its SDRs as reserve assets.

Assuming this clause is included, it would be critical that a number of central banks participated in the liquidity line for each MDB. Following the example of the encashment regime of the AfDB's hybrid capital proposal that minimum might be set at five central banks, although the greater the number the better. This would minimize the risk that the line would shrink to an unacceptably small value in the extremely unlikely event that more than one donor country might suffer from a balance of payments crisis.

In the unlikely event that the line was triggered, an MDB could trigger it in a partial way or up to the full amount agreed subject to appropriate collateral being transferred to the central bank. The MDB could then maintain the SDRs as reserves, swap the SDRs for hard currency in the IMF's voluntary market, or disburse the SDRs to countries as part of pending loan disbursements assuming the recipients could receive those SDRs under IMF rules.<sup>34</sup> Whatever the use, the MDB would have to have sufficient SDRs to be able to repay the central bank on the maturity of the repo. The maturity of the repo might be set at, say, six months but renewable subject to the agreement of both parties. If there was a failure to repay the central bank, then the central bank may become the owner of the assets lodged as collateral and receive interest and capital payments as due according to the terms of the loan or security.

In addition, there could be a further encashment regime such that if the line was triggered and a central bank had lent SDRs to an MDB and then subsequently suffered a balance of payments crisis,

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34 While these may be alternatives under the contract, given the line would be expensive if drawn, the MDB would likely prefer to use other sources of liquidity and reduce loan disbursements before triggering the line.

the central bank could request the SDRs be returned before the maturity of the repo. Including such a clause may have additional costs to the MDB as it may have to set aside reserves as insurance against this possibility. This would mean that less than the full amount of the liquidity line could be counted as liquidity. Including such a clause may be conditioned on the number of central banks participating. A larger number of participant central banks would help to reduce the costs of such a clause.

A more efficient design for the liquidity line could have a central institution as the operator of the liquidity line. That institution would then have contracts with many participating central banks and with all the participating MDBs. If one MDB triggered the liquidity line, then the institution would call on the central banks to each lend an amount of SDRs (proportionate to their overall commitment of SDRs and scaled by the size of the liquidity required up to the agreed limits) and then pass those SDRs to the MDB that had triggered the line. This design would have the advantage of diversifying risks on both sides and would allow the MDBs to operate as more of a global system as suggested by various G20 committees. The BIS, often referred to as the central bank of the central banks, would be a natural candidate to perform the role of the central institution. However, the BIS has tended to be extremely cautious in taking on new roles. An alternative might be the IMF itself, although this would likely involve a change in its articles of agreement. A further possibility would be for one of the MDBs to play the role, with perhaps the obvious candidate being the IBRD which has the widest geographical reach. It might also be possible to back the line with a MIGA guarantee to reduce or eliminate the need for collateral.<sup>35</sup>

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## 5. The benefits of the liquidity line revisited

As discussed above, a simple way to think about the cost of holding liquidity is simply to take the spread between a 10-year bond (or a 5-year bond) and a 3-month treasury bill. The average 10-year to 3-month spread on US government securities from 2010 to 2019 was 1.83 percent (and for the 5-year to 3-month spread was 1.07 percent).

Consider a set of liquidity facilities in aggregate of US\$50 billion to replace liquid assets on MDB balance sheets.<sup>36</sup> Let's assume that the cost of the liquidity line is 25 basis points per annum and that the line is not drawn. The total financial gain to MDBs in the first year would be between US\$413 million and US\$792 million (depending on whether we take the 5-year to 3-month spread or the 10-year to 3-month spread), compared to total net income of US\$4.4 billion. That is between 9.4 percent and 18.0 percent of current income.<sup>37</sup>

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35 The MIGA guarantee might act on the contract between each MDB and central bank in the unlikely event that the line was called, or MIGA guarantees could act on specified MDB loans to reduce the risk of the line being called in the first place.

36 Where the top 20 are defined according to their current SDR holdings.

37 This is based on actual net income for the last available full year except for the EBRD where I take the average of the last five years; the EBRD made an exceptional and substantial loss in 2022 due to the impacts of the war in the Ukraine.

Assuming these savings are all retained and plowed back into capital, capital would then grow faster than it would have done otherwise. I assume the additional income in the first year adds to capital in the second year which can then be leveraged with additional borrowing given the leverage ratio of each MDB. That additional lending then yields additional income in the subsequent year. MDBs have an estimated spread between their borrowing costs and lending rates of just over 1 percent. This process then continues in the following years. The initial increase in lending is relatively modest, between US\$1.2 billion and US\$2.4 billion in total across the five MDBs in the second year but this then builds up over time as income savings and additional income from lending boost capital. After 10 years the estimated additional developmental lending amounts to between US\$12.4 billion and US\$23.8 billion and after 20 years to between US\$31.3 billion and US\$60.4 billion.<sup>38</sup> Table 5 provides further statistics depending on the size of the line and the assumed cost of holding liquidity. As to be expected, the estimated potential increase in development assets grows the larger the liquidity line and the more expensive it is to hold liquidity.

**TABLE 5. Estimated additional development assets (US\$mn)**

Size of Liquidity Line (US\$mn)		Cost of Holding Liquidity	
		1.07%	1.83%
<b>25,000</b>	Net savings in first year	<b>206</b>	<b>396</b>
	Additional Development Assets in 10 Years	<b>6,209</b>	<b>11,900</b>
	Additional Development Assets in 20 Years	<b>15,751</b>	<b>30,190</b>
<b>50,000</b>	Net savings in first year	<b>411</b>	<b>792</b>
	Additional Development Assets in 10 Years	<b>12,352</b>	<b>23,800</b>
	Additional Development Assets in 20 Years	<b>31,336</b>	<b>60,380</b>
<b>75,000</b>	Net savings in first year	<b>619</b>	<b>1,187</b>
	Additional Development Assets in 10 Years	<b>18,626</b>	<b>35,700</b>
	Additional Development Assets in 20 Years	<b>47,253</b>	<b>90,570</b>

*Notes:* Figures in the table are in US\$mn unless otherwise stated. The assumed cost of holding liquidity is 1.07% (the average 3 month to 5 year US treasury spread) or 1.83% (the average 3 month to 10 year treasury spread) for the decade 2010–2019.

*Sources:* Author's calculations and based on ADB (2023), AfDB (2023a), EBRD (2022), IBRD (2023) and IDB (2023).<sup>39</sup>

Apart from the additional development lending over time, generated from an increase in net income, there is also the possibility of increased development lending due to the trade-off between capital and liquidity in rating agency methodologies. This should be understood as a substitute to the above financial benefits rather than additional, as it treats the liquidity line as additional to the current levels of liquid assets and not as substituting current liquid assets. Depending on the liquidity profile

<sup>38</sup> All estimates are nominal in 2024 dollars. These estimates do not include additional administrative expenses associated nor the cost of any additional liquidity given the additional lending. Naturally, more detailed simulations, and building in alternative assumptions, could provide more specific results.

<sup>39</sup> Income levels are reported for information only. The EBRD reported a loss for 2022, but this makes no difference to the additional lending calculations, which are independent of the reported level of income.

of an MDB, securing additional liquidity could imply a lower required capital ratio while maintaining the AAA rating for each institution. In what follows, I refer to the Standard and Poor's rating methodology, but a similar logic follows for the other agencies.

As noted in Table 2, two of the five MDBs (the AfDB and the EBRD) have a liquidity profile rated at the top of the scale, namely Very Strong.<sup>40</sup> This means securing additional liquidity would not allow them to reduce capital ratios, as they already have the best available assessment for liquidity. There is no tradeoff in these cases. The IDB currently has a Funding and Liquidity Assessment of Strong, a Capital Assessment of Very Strong (the second highest assessment below Extremely Strong) and this is combined with an Enterprise Risk profile of Extremely Strong to obtain a stand-alone credit profile (SACP) of a split aaa/aa+. The other (more subjective) factors considered by Standard and Poor's push this to aaa and the IDB's callable capital then ensures the actual AAA rating. Suppose the liquidity line provides additional liquidity to the IDB and allows the IDB to obtain a Very Strong on Funding and Liquidity. All other things being equal, this would push the SACP to aaa. In theory, the IDB could then lend more and reduce its capital ratio to obtain an assessment of Strong (rather than Very Strong) and, given the stronger liquidity assessment, this would still allow the IDB to retain its SACP of aaa/aa+. A Very Strong capital adequacy assessment is normally associated with a risk-adjusted capital (RAC) ratio of between 15 percent to 23 percent, while a Strong ratio can be obtained with a ratio of 10 percent to 15 percent. Standard and Poor's calculates the IDB RAC ratio at 21 percent (June 2023). The IDB could then already reduce its RAC ratio considerably without a change in its capital adequacy assessment, as it is quite close to the top of Very Strong range. So, while there is indeed a potential tradeoff between liquidity and capital in this case, the S&P quantitative criteria do not appear to bind anyway.

The IBRD combines a Funding and Liquidity assessment of Strong with a Capital Adequacy profile of Extremely Strong to obtain a Financial Risk Profile of Extremely Strong. The Enterprise Risk profile is also Extremely Strong, and this then leads to a stand-alone credit profile of aaa. Again, there appears to be considerable headroom the IBRD to increase its development assets under the S&P methodology. Suppose a new Liquidity Line allows the IBRD to obtain a Very Strong funding and liquidity assessment. The IBRD could then in theory reduce its RAC ratio to obtain an assessment of Very Strong and with the Enterprise Risk profile of Extremely Strong still obtain the initial SCAP of aaa. So once again, while the tradeoff between liquidity and capital exists, the IBRD already has considerable headroom under S&P rules.

The ADB combines a Funding and Liquidity assessment of Strong with a Capital Adequacy profile of Extremely Strong and an Enterprise Risk profile of Very Strong to obtain an initial SCAP of aaa/aa+. Suppose the liquidity line pushes the funding and liquidity profile to Very Strong, then the ADB could reduce its RAC to obtain a Very Strong on capital adequacy, and still obtain the same initial SCAP of aaa/aa+. The ADB currently has a high RAC ratio of 30 percent according to S&P. This could

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<sup>40</sup> This refers to a Standard and Poor's assessment.



then allow the ADB to reduce its RAC considerably, say to just below 23 percent. This could then allow development assets to rise by as much as US\$44 billion.

In summary, there is no scope for the AfDB and the EBRD to trade off a higher liquidity assessment for capital to increase developmental lending. For the IBRD and the IDB, there is a tradeoff and additional liquidity might allow development assets to be increased, decreasing current capital ratios. Still, according to the S&P quantitative criteria these two MDBs could lend more and have lower capital ratios anyway. In the case of the ADB, the addition of the liquidity line could also allow for a lower RAC ratio by increasing development assets. These observations underline the comments by various G20 committees that MDBs should continue to work to optimize their balance sheets.

A further potential benefit of the liquidity line substituting for liquidity currently held on MDB balance sheets is that this would allow capital that is held against that liquidity portfolio to be released. Consider the IDB as an example. The IDB Treasury Portfolio resulted in a total exposure of some US\$31.7 billion at the end of 2023. Its rating composition is detailed in Table 6.

**TABLE 6. IDB Treasury Portfolio, 2023**

	US\$ Millions					Total Exposure	Percentage of Total
	Governments and Agencies	Banks	Corporates	ABS and MBS	Net Derivative Positions		
A1+	909	1031	92			2032	6.4
A1							
AAA	9638	1249				10887	34.3
AA	7799	7066	1478		5	16348	51.6
A	1161	838				1999	6.3
BBB	121					121	0.4
BB	228					228	0.7
B							
CCC							
CC and below	101			4		105	0.3
<b>Total</b>	<b>19957</b>	<b>10184</b>	<b>1570</b>	<b>4</b>	<b>5</b>	<b>31720</b>	<b>100</b>

Notes: The table provides the breakdown of the IDB's treasury portfolio by rating categories. Averages of the 3 major rating agencies are used and each category includes sub-rating categories indicated by a plus or a minus or other means, for example A would include A+ and A- in the S&P scale. A1 and A1+ refer to the highest rating categories for short term instruments. The exposure for derivative positions is the amount "in the money".

Source: IDB (2023).

The IDB does not publish the capital that is required to support the credit and counterparty risk inherent in this portfolio nor does it publish the *assets-at-risk* of the portfolio. To estimate

*assets-at-risk*, Basel III standardized risk weights can be applied to the various exposures.<sup>41</sup> This suggests *assets-at-risk* of around US\$5.2 billion. Using the IDB RAC ratio of 21 percent, this would imply setting US\$1.0 billion dollars of capital aside to back the Treasury portfolio. The ratio of capital to development assets for the IDB is 33 percent and so maintaining this ratio and releasing this capital could in theory result in an increase of development lending of approximately US\$3.2 billion.

This calculation assumes that the liquidity line substitutes liquid assets that are of an average credit quality across the IDB Treasury portfolio. Still, as the financial cost of holding the liquid assets calculated above was based on the pure spread between longer-term US government Treasury bonds and short-term US Treasury bills, it is debatable whether this release of capital should be considered as an additional gain.

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## 6. Conclusions

MDBs hold significant amounts of liquid assets on their balance sheets. Considering the IBRD and the four main regional development banks, for each dollar of capital, these five MDBs borrow about 3.1 dollars on global capital markets. They then lend roughly 3 dollars of that financing to developing countries and retain 1.1 dollars as liquidity. For every 3 dollars lent to developing countries, they retain more than 1 dollar which is predominantly invested in high credit-quality assets of advanced economies. This amounts to more than US\$200 billion.

This liquidity represents a cost. Suppose MDBs borrow at 10 years at US government rates and hold liquidity in the form of 3-month US Treasury bills. For the decade before the pandemic the cost would have been about 1.8 percent. If they had borrowed at 5 years, then that cost would have been about 1.1 percent. This cost is not readily apparent on recent MDB balance sheets given extraordinary market conditions, the fact that MDBs hold a whole range of assets, and as MDBs do not in general compare the returns on their investments with their cost of (debt) financing.<sup>42</sup> In fact, they are significant money managers, holding government, public agency, banking, and corporate paper that have both credit and market risks, and so must set aside capital to back that portfolio. MDBs also buy derivative contracts to hedge currency and interest rate risks and thus need to set capital aside for counterparty exposures as well. The Treasury portfolios may appear to be profit-making but the capital set aside could otherwise have been leveraged and that additional financing deployed for development lending.

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41 See BCBS (2017). This is an estimate for many reasons. For example, it does not take into account market risks including currency risks, if any. Furthermore, the exposure reported in the derivative positions is the amount each derivative is “in the money” (when the IDB has an actual counterparty exposure), however, required capital for derivative operations generally go beyond such “exposures”.

42 The fact that the cost of equity for an MDB is essentially zero (as MDBs do not pay dividends to shareholders) does not imply that there is no cost to holding large volumes of liquidity. The cost could be considered as the cost of debt financing (as considered in this paper) or the opportunity cost of increasing the development assets.

At the same time, the G20 has committed to rechannel US\$100 billion of SDRs to developing countries and the advanced and major emerging economies have significant amounts of underutilized SDRs. To date rechanneling mechanisms are limited to two trust funds managed by the IMF and there is a proposal to deploy a very modest amount of SDRs as hybrid capital for MDBs.

This complementary proposal is for a liquidity line for MDBs to substitute a portion of their considerable liquidity holdings. As SDRs are in essence a liquidity instrument, the case for using them for liquidity purposes is actually easier to make than using them to back longer-term loans through the IMF trusts or hybrid capital, although the latter has much a much larger potential impact on MDB lending.

A liquidity line for MDBs of US\$50 billion, some 24.4 percent of their liquidity holdings, would involve 7.7 percent of the top 20 central bank SDR holdings. The estimated financial savings for MDBs would be between US\$411 million and US\$792 million per annum. Assuming this is retained to add to capital and leveraged by additional borrowing to increase developmental lending, this could increase development lending by between US\$31.3 billion and US\$60.4 billion over 20 years. These estimates depend on the assumed cost of holding liquidity and the size of the line.

The liquidity line could be structured as a contingent repo facility. Each MDB could have contracts with several participating central banks or the facility could be managed through a central agent. This latter option would be more efficient as it would diversify risks both for the central banks and for the MDBs and it would be a step towards creating a more coherent MDB system as recommended by various G20-sponsored committees. The BIS or the IBRD (or possibly the IMF) could be candidates to act as the central agent. Still, contracts could be adjusted depending on the preferences of each participating central bank.

If the line were not drawn, the SDRs would remain on the central bank balance sheets and an escape clause might be added allowing a central bank to withdraw from the facility if it suffered a balance of payments crisis. The SDRs would continue to count as reserve assets. As the SDRs would not be used for any financing (MDBs would continue to finance loans from capital and debt), this should allay any fears that central banks are providing any “monetary financing.” The MDBs would pay a small commitment fee. This would then provide central banks a modest fee on a small portion of their non-utilized SDRs.

In the unlikely event that the line were triggered, the central banks would transfer SDRs to the MDBs. The MDBs could retain the SDRs as liquidity, swap for hard currency in the IMF voluntary market, or potentially disburse to member countries that are able to receive SDRs. MDBs would provide collateral to the central banks which could consist of existing liquid securities or synthetic loans subject to a credit quality threshold. If the line was called, the MDB would pay an interest rate, in excess of the SDR interest rate. The higher rate would reduce the incentive to trigger the line except under truly turbulent market conditions. MDBs would be required to repay the central banks the

SDRs in an agreed timeframe, perhaps six months. The line itself would have a maturity of three-to-five years and could be rolled over every six months unless there were objections from either party, to underline the idea that this would be a permanent feature of the international financial architecture.

This idea would (a) allow the G20 to comply with its commitments for SDR rechanneling, (b) deploy a portion of the vast and underutilized SDR reserves of the major central banks, (c) create a mechanism to reduce the need for MDBs to sell their large holdings of advanced economy assets in a financial crisis, and (d) provide cost-savings for MDBs which could be retained as capital and translate into higher lending capacity going forward. This proposal would complement other reforms to improve MDB balance sheet efficiency, enhancing the critical role of MDBs in assisting developing countries attain the UN Sustainable Development Goals.

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