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Yes, MDB Shareholders Can Act Now: Six Very Feasible Near-Term Decisions

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Spurred by the polycrisis and explicit calls from shareholders and other stakeholders, multilateral development banks (MDBs) are considering reforms that will give them the capacity to address country and global challenges, as Secretary Yellen recently put it, "with the urgency and scale that is required."

The World Bank is in the most visible position as it works on its evolution roadmap. But change is needed across the MDB system to enable these institutions to play a more effective and a much bigger role in helping the world meet these challenges. Together they hold about $500 billion in shareholder equity, which can be leveraged many times over in lending. Collectively they are already the largest external source of public climate-related lending to emerging markets and developing economies (EMDEs). MDB knowledge and expertise accumulated over decades, on-the-ground presence, capacity to help countries integrate climate and development objectives, and array of financial and non-financial instruments are valuable assets, from which the world can and should reap greater returns.

The next year to 18 months are a critical test for MDBs, individually and collectively, and for both shareholders and MDB management. The world will be watching to see if MDBs can transform themselves to meet 21st century challenges. If they cannot, governments may increasingly turn toward bilateral instruments, exacerbating what is already a badly fragmented landscape. Finding the political will to add more capital to MDBs should not be taken for granted, especially if current capital is not better utilized.

The stage has already been set for reforms to use MDB capital more efficiently. The G20 has welcomed the report of the independent panel of experts on MDB capital adequacy frameworks (the CAF report). The report offers a robust case that current MDB capital adequacy policies and capital management exceed the prudential requirements of AAA ratings. The two largest credit rating agencies (CRAs) agree and see potential lending headroom. The report notes that the MDBs as a system could potentially lend hundreds of billions of dollars more if the report's recommendations were implemented.

The recommendations include strengthening the shareholder role in defining risk tolerance, giving prudent value to MDB callable capital, pursuing financial innovations at scale that add to available capital and free up capital for additional lending, engaging more closely with CRAs on strengthening methodologies, benchmarking MDB CAFs to support stronger shareholder governance, and releasing more data on MDB credit performance to CRAs and private investors to make their risk assessment more accurate. Some of the recommendations serve the dual purpose of expanding MDB lending capacity while also offering SDG finance opportunities to private investors and insurers at scale—at the portfolio level, not just transaction by transaction.

After initial reluctance, the risk and treasury departments of some of these MDBs are beginning to embrace some of these steps. President Malpass of the World Bank recently noted that the bank can lend $6 billion more per year without endangering its AAA rating. That is nearly a 20 percent increase over IBRD's 2022 lending. And the World Bank is considering additional measures recommended by the report, including recognizing the financial value of callable capital.

This progress is clearly being driven by a resolute shareholder and G20 stance supporting CAF reforms. Without a sustained shareholder push, progress could easily falter. The opportunity to advance momentum at the spring meetings should not be missed. The first step is to develop specific implementation plans, with options for shareholder decisions as needed.

Here are six areas where the Development Committee and the G20 could mandate action. The first three are steps to add to available capital or free up capital to enable more MDB lending that can be scaled over time. The second three are systemic improvements that lay the foundation for more fundamental changes in capital adequacy methodologies, more efficient capital usage, more accurate risk assessment, and better shareholder governance.

Adding to available capital

1. Hybrid capital

The CAF report recommends that MDBs issue hybrid capital instruments that can leverage additional lending. (Hybrid capital instruments generally have long tenors, include coupon payments that can be suspended under defined circumstances, and require purchasers to hold them for some period of time before exiting.) This is a highly scalable means of adding to available capital in ways attractive to shareholders and large-scale institutional investors interested in increasing the SDG shares of their portfolios. CRAs assign considerable equity value to it for commercial firms and have clearly indicated their willingness to do so for MDBs, ensuring the leverage power of hybrid capital issuance.

Such capital would not confer voting rights to asset holders or affect MDB governance. The African Development Bank (AfDB) has already received approval from its board to issue hybrid capital and, in fact, just submitted to the IMF staff a hybrid-capital-based solution for the channeling of SDRs to MDBS that would preserve their reserve asset status based on IMF criteria. The solution developed by the AfDB in collaboration with the Inter-American Development Bank can be used by MDBs to substantially increase their lending capacity.

Decision: Call on the World Bank and the regional MDBs to develop individual plans to issue hybrid capital and to form a working group to consult on a common hybrid capital design in order to build a scalable asset class. Report back on progress by the annual IMF/World Bank meetings.

2. A donor portfolio guarantee fund for MDB climate change mitigation and adaptation loans

The CAF report explores the benefits of donor portfolio guarantee funds that take risk off MDB balance sheets to free up space for more lending. Funds constructed in this way multiply the power of donor funds through MDB leverage. Such a fund has already been designed in the education sphere. The International Financing Facility for Education (IFFEd) is efficient. It is capitalized by a relatively small amount of paid-in capital from highly rated shareholders, along with additional contingent capital commitments in the event MDB borrower arrears exceed a certain threshold. IFFEd offers portfolio-level guarantees on loans from multiple MDBs (and some grant finance for use in making lending terms concessional for poorer countries.)

This model could be used for climate finance with clearly defined results-measurement criteria to determine the scope of climate-related loans that are eligible (which might also improve results reporting). It is an efficient model with very limited administrative expenses because it would not originate loans or require a governance structure for loan approval. It would simply expand the lending envelope available for borrowing countries' climate investment priorities. It would be particularly useful for countries that are bumping up against MDB country exposure limits, as the portfolio guarantees would free up space for more lending. It would work well to expand lending headroom for countries with their own well-developed climate strategies and investment plans, such as those defined in Country Climate and Development Reports and Just Energy Transition Plans.

The current architecture for concessional climate finance is highly fragmented and often difficult to access. It requires ongoing donor infusions to sustain or increase flows. Some part of the guarantee funds could, in fact, come from consolidating or drawing funds from existing climate trust funds and climate financial intermediary funds (FIF).

Decision: Key climate donors call on the World Bank and other MDB representatives to work with them to develop a plan for creating a climate donor guarantee fund, with options for size, funding sources, and criteria for loan eligibility. Report on the plan at the annual IMF/World Bank meetings. Individual donors indicate willingness to make contributions to the guarantee fund or to transfer some of their funds from existing climate trust funds or climate FIFs.

3. MIGA insurance

Insurance can also be used to take risk off MDB balance sheets to expand lending headroom. The World Bank Group already includes a strong insurance arm, the Multilateral Investment Guarantee Agency. MIGA has a global mandate and diversified portfolio, political and non-honoring contract risk insurance products, a well-established performance track record, excellent access to private reinsurers (reinsuring more than 60 percent of its portfolio), the ability to take on public and private exposure, and authority to partner with other MDBs as well as the World Bank Group. Currently it works on its own firm-level transactions or with other MDBs on a transaction-by-transaction basis.

As recommended in the CAF report, it is time to move forward with an ambitious plan for MIGA to partner with other MDBs at the portfolio level, freeing up MDB capital for more lending by leveraging off MIGA's efficient risk transfer platform and ability to diversify risks. The plan could target climate- as well as development-related portfolios.

Decision: Task MIGA to develop a plan for MDB portfolio risk transfers, accessible to multiple MDBs, with options for MIGA exposure size, insurance products included, and MDB lending portfolios eligible. Report on the plan at the annual IMF/World Bank meetings.

More efficiently leveraging existing capital and strengthening capital adequacy information, methodologies, and governance

4. Benchmarking MDB capital adequacy

To make sound decisions about where best to put capital and whether their capital is being used efficiently, shareholders need the ability to review key capital adequacy metrics and concepts, clearly and consistently defined across MDBs. The CAF report recommends that regular capital adequacy benchmarking across MDBs be conducted with a standardized format and with consistent concepts, definitions, and measurement. This should be a shared responsibility of risk and strategy officers.

Remarkably, no such comparative benchmarking is possible at the moment because different MDBs deploy different capital adequacy concepts, ratios, and methodologies. While there may be good reasons for these differences, it is still possible and important to create a common template that translates these differing approaches into harmonized metrics to allow comparisons across MDBs and to make it possible to assess the capital adequacy of the MDB system as a whole. This is especially critical during periods of crisis, such as the current moment, when shareholders will need to make difficult decisions about the size and allocation of new MDB capital, and must justify that taxpayer money is being used as efficiently and impactfully as possible. Regular benchmarking and a more uniform treatment of the different components of capital adequacy across MDBs also can encourage the evolution of the currently highly divergent methodologies used by CRAs to evaluate MDB creditworthiness.

Decision: Instruct MDBs to work together to develop and prepare a common annual benchmark report on capital adequacy. Report on progress at the annual meetings of the IMF and World Bank and issue the first report in early 2024.

5. MDB task force on callable capital

A large part of the shareholder capital subscriptions to many MDB is in the form of callable capital, a shareholder guarantee that holders of MDB bonds will be repaid if the MDB is at risk of insolvency. Callable capital is not the same as paid-in capital, but that guarantee has value, as CRAs recognize and include in their methodologies. It should allow MDBs to take on some additional risk and leverage, while maintaining AAA ratings.

Careful analysis will need to be done in each institution of how best to give value to callable capital in their CAFs, based on their distinct shareholding and operational contexts. Such analyses should offer clear options to shareholders about how callable capital could be included in CAFs, with risks and benefits explained. One obvious first step would be to undertake industry-standard reverse stress tests for each MDB, to give shareholders a clear understanding of the real-world circumstances that could lead to a capital call and evaluate their probabilities.

Although institution-specific, such analyses would benefit greatly from common terms of reference—common concepts and measurement definitions—to permit clear understanding and comparison by shareholders across MDBs. An MDB task force should work together to define these terms of reference. The task force should include representatives from risk, treasury, and operations departments to ensure inclusion of different perspectives. It should jointly engage with CRAs, together with shareholders. The task force could also explore ways to increase transparency on the processes for executing capital calls, including shareholder processes, to reduce uncertainty about how calls would work.

Decision: Call on MDBs to form a task force to agree on common terms of reference for assessing the scope for valuing callable capital in capital adequacy frameworks. Report on progress on the annual meetings of the IMF and World Bank.

6. Global Emerging Markets (GEMs)

Twenty-four MDBs and development finance institutions contribute to the Global Emerging Markets database. It contains data for over three decades on default probabilities and expected losses for loans to sovereigns and to the private sector. It is one of the world's largest credit performance databases. And yet only the contributing institutions have access to it. Making more data available would impact the risk weights assigned to MDB portfolios by CRAs, especially for lending to the private sector, and it would enable private investors to better assess the risks of partnering with MDBs and SDG lending generally. Preliminary analyses commissioned by the G20 CAF panel show that the performance of MDB loans is significantly better than loans to the same borrowers by private lenders. The CAF report recommends creating and funding a purpose-built organization to receive GEMs data, ensure its quality and consistency, publicly report statistics and analyses based on the data, and provide appropriately anonymized data to private investors and CRAs.

Decision: Task GEMs member institutions to agree on a plan to establish and fund the new GEMs organization, with commitments by members to regularly supply the organization with data and agreement on data disclosure standards. Report on the plan at the annual meetings of the IMF and World Bank. Publish the first disaggregated GEMs report in early 2024.

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