CENTER FOR GLOBAL DEVELOPMENT

What Would the Ideal Development and Climate MDB Look Like?

NANCY LEE, VALERIE LAXTON, SAMUEL MATTHEWS

Abstract

If we could reinvent MDBs to respond to urgent development and climate needs and to benefit from 70 years of experience with the model, what would they look like? Many are focused on the scale of MDB finance. This paper focuses on how the model needs to change to effectively deploy more finance. A central question for the model is how country investment priorities are set. This paper advocates that countries should chart their own low-carbon climate resilient development and growth paths, with robust analytical support from MDBs that integrates climate and development challenges, including cross-border challenges, and helps countries set priorities for investments and policies. MDBs should work together as a coherent system to support one country-owned strategy, rather than individually creating their own separate strategies and policy conditions. This approach will help overcome fears by borrowing countries that rich shareholders are compelling them to abandon their own development priorities in favor of other countries' climate priorities. It will also help break down the silos within and across MDBs that thwart collaboration and diminish their effectiveness.

The country strategies should go deep rather than broad, aiming for transformative outcomes in a few priority sectors selected for their importance for achieving the country's sustainable development and climate goals. Success should be measured based on achievement of targeted outcomes, not by the size of financial inputs. Governments, MDBs, and other development partners should all make finance and other commitments under the strategy and be held accountable for their performance. Governments that meet their policy and finance commitments should be assured of consistent, predictable budget support from MDBs, along with investment project and pay-for-results lending. Beyond their own lending, MDBs should focus on improving the terms of market borrowing for sustainable development, making more use of their guarantee and insurance products. And MDB boards should spend less time on individual project approvals and more on monitoring outcome progress at the country level and country contributions to cross-border goals.

A second critical challenge is how to boost MDB performance in mobilizing private finance for climate and development goals. The paper advocates putting mobilization at the center of MDB institutional strategies, setting ambitious mobilization targets, and implementing institutional changes needed to achieve those targets. Two core changes are critical: (1) changing financial product offerings to better match instruments to private capital market gaps, which means less emphasis on senior loans and more deployment of subordinated financial products; and (2) focusing more on creating portfolios of sustainable finance assets to offer private investment opportunities at scale. Partnerships with institutional investors and more risk-tolerant investors are both essential to achieve scale and manage increased risk.

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Executive Summary

The multilateral development bank (MDB) model is a powerful multiplier of shareholder capital in support of development. But much more is expected of MDBs in the 21st century given the magnitude and urgency of development and climate challenges confronting the globe. This paper assesses the performance of the model against borrowing and non-borrowing shareholder priorities and expectations, and asks: what would an ideal development and climate bank look like? The analysis assesses MDB performance across four dimensions to define how the current model should evolve: the financial model, finance instruments for governments, finance instruments for the private sector, and impact measurement and reporting.

We find a compelling case for far-reaching changes in what MDBs do and how they do it, while preserving what is most valuable in the MDB model. The ideal development and climate MDB would retain core advantages: the leverage and financial sustainability, breadth of finance and other tools, human capital and knowledge, ability to integrate development and climate missions, and on the ground presence and relationships with public and private sectors. But it would differ from existing institutions in fundamental ways. It would:

- Define its mission as supporting low-carbon and climate resilient development paths;
- Judge success by defining and measuring country development and climate outcomes, rather than financial inputs;
- Prioritize those sectors and projects that are critical for country development and climate outcomes, rather than spreading financing and interventions across the whole economy;
- Disburse finance to governments based on performance benchmarks under one agreed country-owned development and climate strategy, ending separate MDB policy conditions for individual budget loans;
- Prioritize improved terms for sovereign market borrowing for climate and global public good investments, rather than focusing only on terms for its own lending;
- Deploy strong results and needs-based criteria to allocate concessional climate finance across countries to incentivize larger climate investments;
- Place private finance mobilization, as distinct from own-account finance volumes, at the center of MDB private finance corporate strategies and set and monitor institutional mobilization targets;
- Align the financial instrument mix and risk appetite of MDB private finance arms with key gaps in EMDE capital markets. Deploy more subordinated and risk-sharing products—first loss, other guarantees, insurance, equity, forex risk hedging, subordinated debt—to make more investments bankable.
- Incentivize and equip staff to match instruments with binding financial constraints.
- Manage increased risk and achieve scale in private finance operations using off-balance-sheet structures and partnerships at the portfolio level with risk tolerant, as well as institutional, investors;

- Establish a route for private investors to add capital to MDB balance sheets through non-voting hybrid contributions of capital;
- Adopt a strategy of regularly off-loading the risk of performing assets to private insurers and investors, freeing up capital for new operations;
- Focus governance on shareholder oversight of MDB performance in achieving country, regional, and global outcomes in accordance with the Paris Agreement and the 2030 agenda for sustainable development, instead of the current heavy emphasis on approval of individual loans.

Redefine success. For most stakeholders, it is hard to articulate what MDBs have achieved at the institutional level. Both management and shareholders tend to define MDB success as institutions largely by the volume of finance inputs they supply: climate-related finance targets are an example. Two problems result. First, strategic decisions about finance allocation become a zero-sum game—more finance for one purpose comes at the expense of others (except during infrequent negotiations of general capital increases). And second, donor governments and foundations find it politically easier to justify increased contributions to vertical funds with narrower purposes, such as health interventions, where results can be more easily measured and reported. The combination of these problems drives inefficient fragmentation of funding structures and complexity and excessive administrative costs for recipient countries.

MDB success should instead be defined in terms of specific sectoral output and outcome targets at the country level. These common agreed targets should be jointly set by countries and MDBs, achievable, transparent, on the critical climate resilient development path, and attributable to defined investments, policies, and finance. Outcome targets would be agreed for the top sector priorities of borrowing countries, such as agriculture, health, education, power, transport, water and other natural capital. The paper also proposes that assessments of development and climate impact be integrated into every project to avoid the zero-sum conflict that comes from tagging some projects as climate-related and others as development-related.

A new approach to budget finance for governments that seek it. We propose an end to multiple policy-based loans for budget lending offered by the World Bank and some of the regional development banks. These now condition lending on policy reforms that vary across loans, over time, and across MDB lenders. Instead, MDB budget finance should support integrated country development and climate strategies. The volume of budget finance should be commensurate with government goals and actions under the strategy. Annual MDB commitments, disbursements, and terms should be tied to dynamically assessed performance under the strategy. Governments that meet their commitments should be assured of consistent, predictable budget support from MDBs, along with investment project and pay-for-results lending.

One integrated country strategy for all MDBs. The World Bank's Climate Change and Development Reports (CCDRs) are a valuable innovation and a useful analytical basis for country strategies that integrate climate and development challenges. We propose taking these reports a step further—sharing the analysis across MDBs and other development partners (the analysis could in fact be undertaken collectively by MDBs), setting out targets for priority sectors and strong monitoring systems to track country-level performance for the strategy period, and building on the analysis to formulate the commitments by both countries and MDBs needed to achieve the targets.

Country strategies for this purpose would not be comprehensive development plans, but rather focus on sectors with the greatest development and climate impact, that borrowing countries prioritize, and where MDB support is most needed.

All MDBs should support the same multi-year country strategy with finance, technical assistance, and other forms of non-financial support. MDB budget, investment project (public and private), and results-based lending should all be shaped by the same country strategy.

Help countries borrow from markets on better terms. A growing number of developing country governments rely more on their access to global capital markets for climate and development investments than on borrowing from MDBs. MDBs can play a powerful role in improving borrowing terms through sovereign guarantee instruments, measuring and verifying climate and SDG commitments, and backing and deploying clauses that permit temporary debt service suspension in the event of major climate and health shocks and natural disasters.

Consolidate concessional finance for climate investments. The World Bank has already had major success in allocating concessional finance at scale through the International Development Association (IDA). IDA deploys a performance-based allocation system to allocate finance to eligible countries. We need something similar to consolidate the highly fragmented and inefficient architecture for concessional climate finance that now spans more than 50 climate trust funds and 12 climate financial intermediary funds under the World Bank umbrella alone. More and better-allocated concessional climate finance is essential both for low-income countries and for middle-income countries to incentivize larger investments that generate significant regional and global benefits.

The new model would deploy an analogous country-level allocation system, purpose-built for concessional climate finance, for both low- and middle-income countries. This paper proposes allocation criteria covering: the climate-related (adaptation and mitigation) impact targeted in the country strategy; impact per dollar of concessional finance commitments; the scale of impact in relation to country needs/challenges; the country's fiscal capacity and need for concessional finance; for mitigation finance, the contribution to global emissions reduction; and for adaptation and loss and damage finance, the country ranking in global climate vulnerability indices. The more ambitious the country strategy and the stronger the country performs in implementation, the larger the concessional finance allocation. Finance at the project level would be allocated using the same criteria.

Put mobilization first in private finance. MDB private finance models should change fundamentally from a focus on maximizing the volume of their own finance commitments to a focus on mobilizing private finance from multiple sources. They should set and report on targets for private finance mobilized and for finance mobilized relative to their own commitments, based on a methodology shared across MDBs. This requires changes in their instrument mix, own-account financial targets, risk tolerance, data sharing on credit performance, and their way of collaborating with MDB sovereign arms.

As EMDE banking sectors have developed, constraints in private capital markets at the risky end of the capital stack have become more binding. Investors are reluctant to take equity, first loss, or subordinated debt positions, especially in early-stage investments, including in infrastructure, or in innovative technologies and business models. They also seek to offload risks that are hard to manage like foreign exchange or political risk. Filling such gaps requires different tools than senior lending.

The mere existence of concessional finance for blended finance transactions does not in itself drive scale. Such finance has to be channeled through subordinated instruments that can bear first mover, early-stage, and currency risk. The instruments themselves are not inherently concessional. The concessonality may instead come in the form of accepting below-market returns. MDBs need staff that are able and incentivized to deploy these tools. They also need strategies to manage this increased risk, either on- or off-balance sheets. And they need to break down internal silos that impede prioritization of key sectoral investment climate reforms in country strategies.

A collective MDB approach here would enable more diversification and reduce concentration risk for individual MDBs. It would be more efficient to build one finance vehicle for these activities that are considered or perceived as 'riskier'. This vehicle could partner with multiple MDBs, rather than having several smaller ones spread across MDBs.

Let private investors help capitalize MDBs. There are large institutional and philanthropic investors that are interested in assets that share two characteristics that MDBs can offer: safety with moderate returns and SDG impact credibility. The time has come for MDBs to offer non-voting hybrid capital assets, which can be leveraged by multiples of MDB lending. Government shareholders would retain all shareholding voting rights and control over MDB finance decisions. It is a more expensive source of capital than shareholder equity and does not substitute for general capital increases. But it is a very scalable way to crowd in the private sector (and potentially some governments interested in returns and exits), especially if MDBs collaborate to create a common asset class.

MDBs as climate and SDG investment distributors. Another fundamental change for both sovereign and non-sovereign finance should be a deliberate shift over time to an originate-to-share model. This would allow greater private finance mobilization than the current transaction-based approach. Regular risk transfers to the private sector (or to the Multilateral Insurance Guarantee Agency, MIGA) of performing loan portfolios would free up capital for more MDB lending, accelerate the transition to green portfolios, and build SDG asset classes for private investment at scale. Shareholders and management should work together to address the important implications for managing risk, for MDB profitability, and for budget resources invested in pipeline development.

Assess impact for an integrated climate and development mission. To meet expectations for equitable flows of climate and development finance, MDBs should integrate all three purposes (climate, development and shared prosperity) in assessing impact, guided by the international consensus embodied in the Paris Agreement and the 2030 Agenda (SDGs). Paris alignment must be achieved while sustaining and strengthening development effectiveness. For MDBs it implies aligning development project pipelines and lending with the global temperature goal, incorporating adaptation into projects, supporting investment in climate action, strengthening country's contributions to support long-term decarbonization and transition plans, and increasing reporting and transparency. As the Global Commission on the Economy and Climate[1] has demonstrated, there is no trade-off; delaying climate action will jeopardize economic growth and development, and undercut benefits that are shared globally.

1 "New Climate Economy," World Resources Institute, November 8, 2022, https://www.wri.org/initiatives/new-climate-economy.

Introduction

The scale and urgency of climate and climate finance challenges, combined with equally urgent and pervasive reversals in progress on poverty reduction, health, education, and food security are intensifying the spotlight on multilateral development banks (MDBs) and their bilateral counterparts. Stakeholders and others are asking basic questions of these institutions: How much more finance can they provide, how much can they catalyze, and how can they increase the effectiveness and impact of their work? This authoritative study[2] suggests that MDBs collectively need to triple their climate finance to make their essential contribution to the additional trillion dollars needed for emerging markets and developing economies (EMDEs) per year.

No one can credibly argue that MDBs should abandon their focus on poverty and shared prosperity. Shareholders and MDB management may debate how to adjust or add to the language of mission statements, but it is clear that the challenge is combining the work to address ongoing development challenges with work on the new global challenges, not abandoning one in favor of the other.

But that clarity is not matched by confidence that the MDBs can rise to these challenges, even with more financial capacity. MDBs are well placed in terms of their tools, knowledge, financial track records, presence on the ground, and potential collective scale. For climate-related finance, for example, they already commit about $50 billion per year to EMDEs—not where they need to be but more than any other multilateral or external bilateral source.[3]

But there are no shortage of critics and skeptics who argue among other things that: (1) their capital is underutilized; (2) their loans have burdensome conditions and take too long to negotiate and disburse; (3) their concessional climate finance is deeply fragmented and hard to access; (4) their record in mobilizing private SDG finance is weak; (5) they have not found a model for infrastructure finance in poor countries that works at scale; (6) their country-based approach fails to incentivize enough climate-related investment; and (7) their reporting on results and impact is too limited to judge value for money.

These criticisms undermine shareholder support for increases in capital and concessional finance contributions, already difficult in an environment where most of the big shareholders are fiscally stretched. Yet the world cannot afford MDB underperformance at this moment and in the decades ahead. In recognition of their importance, Secretary Yellen and other major shareholders called for significant MDB reform and the Development Committee's charge to the World Bank in particular to

2 Vera Songwe, Nicholas Stern, and Amar Bhattacharya, "Finance for Climate Action: Scaling up Investment for Climate and Development" (London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science, November 2022).

3 "2021 Joint Report on Multilateral Development Banks' Climate Finance" (EIB, October 14, 2022), https://www.eib.org/attachments/lucalli/mdbs_joint_report_2021_en.pdf.

produce an "evolution roadmap". The work so far has been clearer on the nature and breadth of the issues, what the World Bank is already doing, and why it should be bigger, than on how it needs to change.

To be fair, the specifics of the reform agenda have not been defined or widely agreed, and there are trade-offs that have to be honestly confronted. Much more thinking and analysis must be done to find constructive solutions that can garner support across a broad range of shareholders. We cannot realistically expect that all of those solutions, especially the most difficult, will come from inside these institutions. Shareholders and other stakeholders must play an active role in shaping and supporting reform.

This paper takes a step back and asks fundamental questions about what we want from a global or regional MDB that supports development and climate investments well: what are the benefits of the existing MDB model and what are its constraints? If we were to purpose build an MDB for today's development and climate challenges rather than for reconstruction and development in the post-WWII world, what would it look like and how would it benefit from the lessons of 75 years of experience? This analysis then helps identify the reforms that best address goals and shortcomings and therefore where MDB shareholders, other stakeholders, and management should focus their efforts.

It does not address the question of the overall size of the MDB system or of individual institutions. Nor does it cover MDB capital adequacy reforms, which are already being considered and implemented based on the MDB Capital Adequacy Framework report to the G20.[4] Rather it focuses on what MDBs should do with increased funding and how they should do it.

The paper begins by defining the ideal: what success looks like in our era—the characteristics of an ideal development and climate bank. Next it reviews the core advantages of the MDB model that are important to preserve in decisions about where to put additional resources. Then it assesses MDB performance across four institutional dimensions: (1) the financial model; (2) the instruments for financing governments; (3) the instruments for financing the private sector and mobilizing private finance; and (4) the results and impact goals and reporting. In each of these areas the benefits of existing MDBs and their attributes are assessed against constraints that impede their performance. Following these reviews, the paper draws implications for the most important reforms that would transform existing MDBs into fit-for-purpose institutions.

4 "Boosting MDBs' Investing Capacity: An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks.," 2022, https://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/news/news/CAF-Review-Report.pdf.

The Ideal Development and Climate Bank

As a point of departure and based on analysis of MDB performance in this paper, the ideal bank would have the capability to:

- Assist countries in building integrated development and climate strategies that prioritize the right sectors and investments, policies and regulation, and public institutions;
- Help countries set and deploy ESG, project management, and budget management standards that promote strong implementation of the strategy;
- Help countries measure success, and the MDB contribution to success, by targeting and reporting sectoral development and climate outcomes that are achievable and measurable;
- Support agreed country strategies with predictable, timely MDB finance on a scale commensurate with government efforts and outcome targets;
- Offer finance to the private sector that mobilizes multiples of private investment with development and climate impact;
- Take more risk and offer the subordinated finance instruments that fill capital market gaps, thereby unlocking private finance at scale;
- Support critical investment climate reforms in development and climate strategies in order to expand the size and range of viable private investments that help achieve outcome targets;
- Allocate concessional finance strategically and efficiently to maximize climate and development impact, impact per dollar, impact in relation to country challenges, and global benefits for global public goods;
- Deploy capital efficiently using modern capital adequacy frameworks as proposed by the CAF report to the G20;[5]
- Focus governance on effectiveness in delivering sustainable development finance and on monitoring outcome performance at the country and global level.

This is a long and challenging list. Existing MDBs fall short on a number of these goals, often for good reason. They are subject to conflicting demands and priorities from shareholders, bank management and staff, recipient country governments, and private actors inside and outside recipient countries.

Acknowledging these shortcomings is essential, but, as shareholders decide where to put additional resources, it is equally important to understand the value and track record of the MDB model.

5 "Boosting MDBs' Investing Capacity: An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks."

Core Advantages of the MDB Model

Decades of experience suggest that the following attributes lie at the heart of the power of the MDB model.

- *Size.* Most MDBs are large enough with a broad enough geographic mandate to cover their substantial costs, diversify their risks, and offer finance at a scale that attracts client country demand.
- *Financial sustainability.* MDB lending creates net income. Retained MDB earnings are partly used to add to shareholder equity. That reduces the frequency and size of capital increases, which is welcomed by shareholders. Part of net income is also transferred to concessional windows to expand their finance volume. That takes some of the burden off donors for fresh contributions.
- *Leverage.* MDBs leverage their capital just as other banks do. That stretches scarce government aid dollars deployed as MDB capital contributions.
- *Low cost of capital.* MDBs are highly rated by credit rating agencies, most at AAA. That reduces their cost of funds and, by limiting risk tolerance, protects shareholder capital. Borrowing countries value the better financial terms that come with MDB loans.[6]
- *Financial and non-financial instruments.* MDBs have a broad array of tools to address development and climate challenges. Many have a complete set of financial tools including loans, guarantees, equity investments, insurance, and grants (though loans dominate their portfolios). Many also deploy non-financial tools in the form of technical assistance, policy advice, knowledge sharing, training, and advisory services. No bilateral development finance institution (DFI) or aid agency has as comprehensive a toolkit.
- *Political degrees of separation.* Much development is dependent on the right policy and institutional choices by governments. Advice on reforms and investment decisions is often better received from MDB technocrats than from other governments whose motives can be perceived as politicized, ideological, or self-serving.
- *Human capital and knowledge.* MDB staff have deep and wide policy, institutional, and sectoral expertise, technical skills, and knowledge gained from years of experience across the developing world, which no country or bilateral institution can build on its own.
- *Integrated mission.* Governments invest in infrastructure, human capital, and social protection with multiple aims. MDBs help them integrate their objectives for poverty reduction, growth, inclusion, infrastructure access, health and education progress, and climate-related outcomes in their spending choices.

6 Annalisa Prizzon, Michael Josten, and Hayk Gyuzalyan, "Country Perspectives on Multilateral Development Banks: A Survey Analysis" (London: ODI, April 2022), https://cdn.odi.org/media/documents/Country_perspectives_on_MDBs_-_Executive_summary.pdf.

- *Concessional resources for the poorest countries.* The creation and regular funding of separate windows for the poorest countries, mostly notably IDA in the World Bank Group, pools donor grant funding to create very concessional terms[7] for loans and grants for countries with tight debt sustainability constraints. For donors, the pooled grant funding shares the finance burden. And because IDA funding is committed based on a performance-based allocation system, donors have a way to assess whether their finance is distributed based on need and country performance. For the poorest countries, IDA has been particularly responsive at scale to the impact of the poly crisis. It is one of the most important success stories on the MDB landscape.
- *On the ground presence.* Much experience shows that development cannot be effectively pursued from an MDB's headquarters. An understanding of local goals and challenges and strong relations with local governments and private sectors have played essential roles in successful MDB partnerships with client countries.

This list brings into focus the challenge of building another new MDB, say a bank focused only on lending for climate-related purposes.[8] It would be highly costly in capital, grants, and staffing budgets to reach scale and presence across EMDEs, and probably add to the fragmentation and multiplication of objectives for recipient countries. And, in any case, it could not capture some of these critical advantages, especially those related to long financial track records, accumulated knowledge and human capital, comprehensive toolkit, and integrated development and climate missions.

Shareholders and other stakeholders face difficult decisions about whether the more productive route is to invent new institutions or strengthen the performance of existing MDBs. Doing so requires a clear understanding of both the ideal and actual experience. The analysis below helps better define the specific areas where the current model is succeeding and failing, and what can be done to address failures.

The MDB Financial Model

Benefits

A proven model. When the first MDB was created in 1945, it was not at all obvious that lending for development and reconstruction purposes would be financially sustainable. Now there is a consistent track record shared by global and regional MDBs. Borrowers repay MDB loans. Government shareholders do not force irresponsible lending as feared. MDBs make profits.

7 IDA recipients with a high risk of debt distress receive 100 percent of their financial assistance in the form of grants and those with a medium risk of debt distress receive 50 percent in the form of grants. Other recipients receive IDA credits on regular or blend terms with 38-year and 30-year maturities respectively.

8 Hafez Ghanem, "The World Needs a Green Bank," Policy Brief (Policy Center for the New South, February 2023), https://www.policycenter.ma/sites/default/files/2023-02/PB_06-23_Ghanem.pdf.

Banks rely fundamentally on spreads between their borrowing rates and lending rates for income. The banking model has worked well for MDBs because their high ratings minimize their capital costs and make their lending rates attractive, especially, as in the current period, when global monetary conditions are relatively tight and global risks are high.

From the perspective of shareholders, capital contributions yield much greater financial firepower than if deployed through bilateral and multilateral grants or through bilateral development finance institutions. Each shareholder's capital is multiplied many times over in MDB lending by leverage, the contributions of many other shareholders, and earnings that are ploughed back into capital. For the World Bank, for example, cumulative shareholder paid in capital contributions of about $21 billion have supported around $800 billion in cumulative lending. The profitability of MDBs reduces the frequency of general capital increases, which require very difficult negotiations and political decisions that can create or intensify deep divisions among shareholders.

PCT matters. Another major advantage of MDBs is that they benefit from preferred creditor treatment (PCT), which places MDBs first in line among creditors for loans to sovereigns. While PCT is not enshrined in legal contracts, it is consistently practiced. MDB loans are not subject to official debt rescheduling unless shareholders make specific decisions to include them and agree to compensate MDBs for reflow losses.

Sovereign borrowers almost never go into arrears to MDBs, and arrears never turn into permanent losses. PCT materially lowers the risk of MDB credits. A recent study commissioned by the G20 independent panel of experts reviewing MDB capital adequacy, for example, found that expected losses on MDB loans to sovereigns were 14 times lower than loans to the same borrowers by commercial banks.

MDB loans to private creditors also benefit from strong credit performance—private borrowers are very reluctant to default to MDBs. They highly value the positive signal sent to markets by MDB due diligence and approval, which confers legitimacy and credibility both on financial viability and on SDG impact.

For some MDBs, both loans to sovereigns and the private sector are on the same balance sheet. In theory, the strength of credits to sovereigns could support taking more balance sheet risk in lending to non-sovereigns. And these institutions should be able to expand opportunities for finance to the private sector by deploying their policy tools to strengthen the investment climate. In practice, with the notable exception of the EBRD, there is a strong tendency for MDBs with a shared balance sheet (e.g., AsDB and AfDB) to favor credits to sovereigns over lending to the private sector because they compete for the same capital. Finance to the private sector accounted for 5.5 percent of AsDB total commitments in 2022[9] and 6.5 percent of AfDB commitments.[10]

9 "Statement of the Asian Development Bank's Operations in 2022" (Manila, Philippines: ADB, February 2023), https://www.adb.org/sites/default/files/institutional-document/862326/statement-adb-operations-2022.pdf.

10 "Map Africa," accessed June 14, 2023, https://mapafrica.afdb.org/en/.

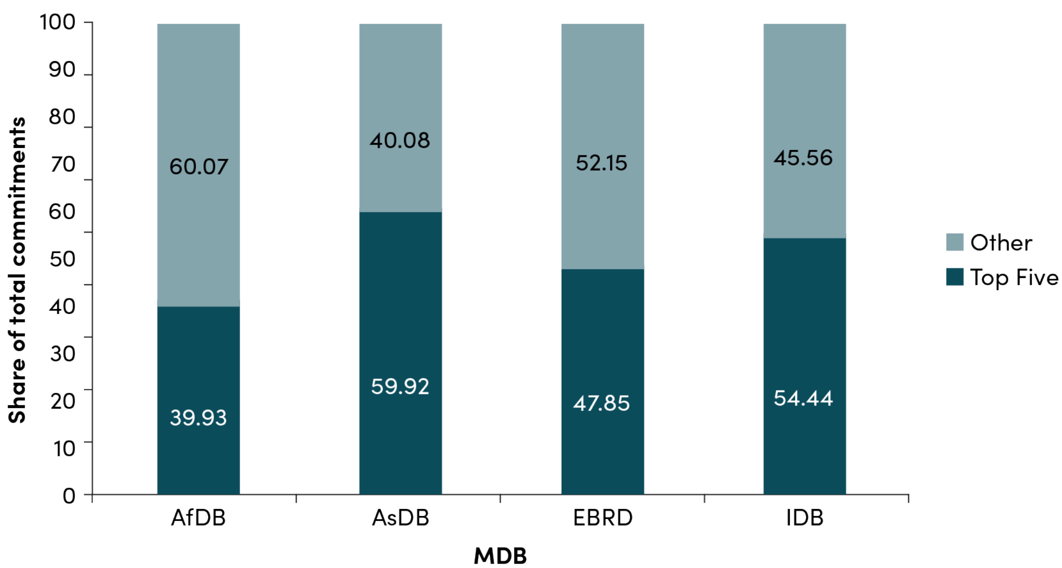
Callable capital: a mixed blessing. Shareholders subscribe to MDBs partly through paid-in capital (cash) and also through commitments of callable capital, an MDB innovation, which must be converted to cash if an MDB is at risk of defaulting on its bonds and issues a capital call. Callable capital allows shareholders to avoid appropriating funds for capital that is not needed. In that sense it is an important efficiency. Such a call has never occurred, demonstrating the viability of the MDB model.

The CAF panel commissioned a study assessing the probability of a call based on a series of illustrative systemic shocks to a stylized MDB. The study found the probability extremely remote, and MDBs would certainly take remedial steps to protect balance sheets long before a call would even be contemplated. At the same time, the absence of experience with capital calls gives rise to uncertainty about whether shareholders would supply more capital to an institution at risk of insolvency.

Constraints

AAA ratings. The banking model requires institutional ratings by credit rating agencies to allow MDBs to issue rated debt to markets. Shareholders must decide on their level of risk tolerance and rating preference. For many MDBs, that has resulted in a AAA target rating, the highest rating by credit rating agencies. That rating has attractions for both borrowing and non-borrowing countries. For borrowers, it means that the institution's cost of capital is extremely low. And non-borrowing shareholders know that their capital is well protected.

Figure 1. Concentration of AfDB, AsDB, EBRD, and IDB commitments in top five recipients, 2022



Source: AfDB, 2023; AsDB, 2023; EBRD, 2023; IDB, 2023.

Certain risks are built into the MDB model, especially for regional banks. Their sovereign lending tends to be concentrated in large countries with macroeconomic policy challenges and debt sustainability problems (Figure 1).

And MDBs are expected to be countercyclical, lending into periods of global and regional crisis as private finance retreats. While they have not always done so, the point here is that the high capital requirements of AAA ratings assure shareholders and bondholders that these institutions can withstand the risks of major external shocks.

"AAAA" performance. There is strong evidence that actual MDB capital adequacy policies and management exceed the prudential requirements of AAA ratings, as concluded in the report to the G20 of the independent panel of experts on MDB capital adequacy frameworks (CAFs).[11] The two largest credit rating agencies, S&P and Moody's, agree. The report finds that the MDBs as a system could potentially lend hundreds of billions of dollars more if the report's recommendations were implemented.

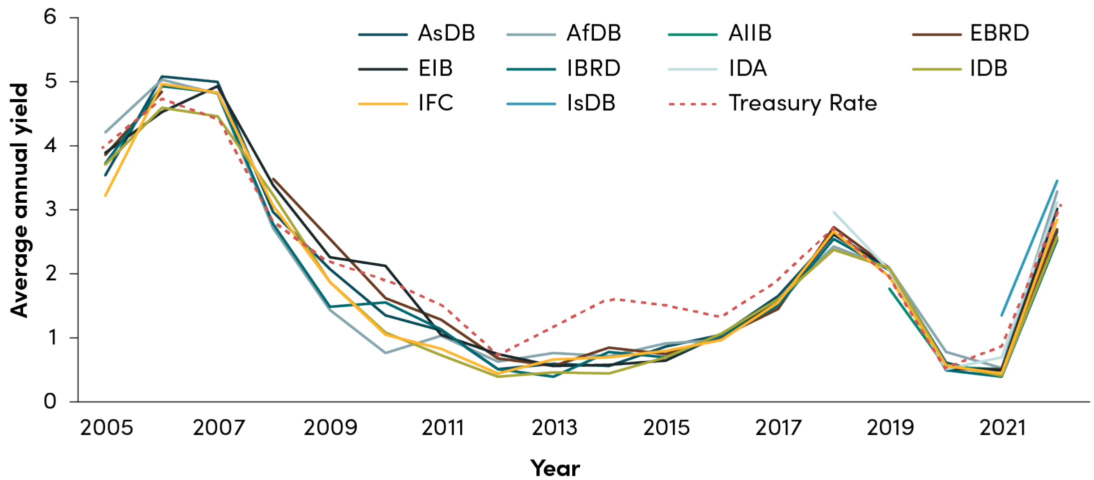
These recommendations include a more active shareholder role in defining risk tolerance; giving prudent value to callable capital; pursuing financial innovations at scale that add to available capital and free up capital for additional lending; closer engagement with credit rating agencies (CRAs) to strengthen 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 and reduce risk premia.

Responding to growing and broad-based shareholder support for CAF reforms, MDBs are beginning to embrace some of these steps. The World Bank, for example, is considering leverage increases that would expand lending capacity by $5 billion annually without endangering its AAA rating. That is a 15 percent increase over IBRD's 2022 lending, a 20 percent increase over 2019 pre-pandemic lending. And the Bank is considering additional measures recommended by the report, such as issuing hybrid capital and giving some value to callable capital, which would yield considerably more lending capacity.

Are AAA ratings needed? The G20 panel did not have the mandate to address the question of whether AAA ratings are necessary for institutions that must prioritize development impact over profits. But such a question is worth pursuing. Figure 2 below shows that the bond yields of AAA rated MDBs are often lower than the relevant U.S. Treasury risk-free benchmark (consistent with the U.S. split sovereign rating). The cost of capital argument for AAA ratings may be overdone.

11 "Boosting MDBs' Investing Capacity: An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks."

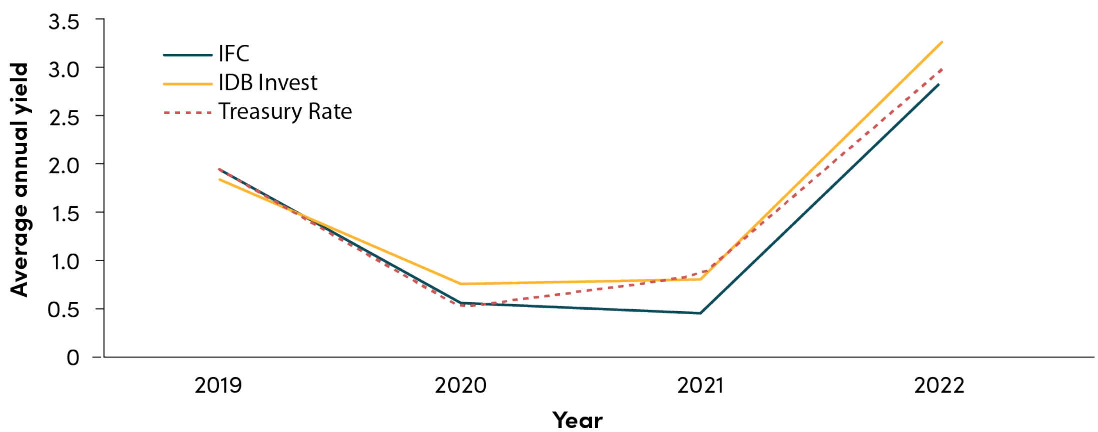
Figure 2. Average annual yields for five-year USD bonds issued by AAA-rated MDBs, 2005–2022



Note: The Treasury rate consists of annual averages calculated from the five-year U.S. Treasury's Daily Treasury Par Yield Curve Rates.
Source: Bloomberg Finance, L.P.; U.S. Treasury.

The rating question is particularly salient for the private finance arms of the MDBs. For two institutions, the IFC of the World Bank Group and IDB Invest of the Inter-American Development Bank, the private finance operations are in separate institutions with separate balance sheets. The IFC is rated AAA and IDB Invest is rated AA+.

Figure 3. Average annual yields for five-year, USD bonds issued by private finance MDBs, 2019–2022



Note: The Treasury rate consists of annual averages calculated from the five-year U.S. Treasury's Daily Treasury Par Yield Curve Rates.
Source: Bloomberg Finance, L.P.; U.S. Treasury.

Comparing IFC and IDB Invest bond yields over time shows that the differences in the cost of capital averaged less than half a percentage point—33 basis points (Figure 3). The average annual yields of five-year USD bonds issued by IDB Invest ranged from 19 to 44 basis points higher than yields of bonds issued by the IFC. The gap widened as global monetary conditions tightened in 2021 and 2022.

Shifting to a AA+ rating goal may be worth the benefits in terms of greater leverage of capital and greater risk tolerance.

Need for more MDB credit performance data. Accurately assessing the risks of lending to EMDE private sectors is key to decisions about capital adequacy for MDBs that do non-sovereign lending. The private counterparties in IFC and IDB Invest transactions are rarely investment grade. In fact, some clients are not rated. Risk perceptions about such clients in EMDEs significantly influence capital charges in capital adequacy frameworks—the amount of capital that must be held against loan portfolios. That means capital could be significantly underutilized if perceptions of risk are too high.

For that reason, it is important to use relevant MDB credit performance data to determine if risk perceptions are accurate. But CRAs use proxies to assess such risk; they use the credit performance of commercial institutions to the same borrowers with some adjustments for MDB advantages. MDBs report that, even with adjustments, the proxies overstate risk for the kinds of sub-investment grade clients where most MDB private transactions are concentrated.

If CRAs had access to granular data on MDB credit performance for loans to the private sector, they would be able to quantify MDB advantages and adjust risk weights appropriately in their methodologies. The Global Emerging Markets (GEMs) database contains such transaction level data.[12] Twenty-four MDBs and DFIs contribute to the database. It contains over three decades of data for sovereign and non-sovereign loans across countries, regions, and sectors. It is one of the largest credit performance databases in the world.

Yet currently only contributing MDBs and DFIs have access to it. One of the key recommendations of the CAF report is to create a new GEMs organization with responsibility for maintaining harmonized and accurate data, making data available to CRAs and private investors (with appropriate anonymization to protect business confidentiality), and regularly publishing statistical reports for a broad audience of MDB shareholders and other stakeholders.

Beyond MDB capital decisions, better access to these data would likely have significant market building impact through correcting risk misperceptions. Dutch pension funds for example recently created the ILX Fund, totaling more than a billion dollars, for co-lending in MDB SDG investments.[13] A key driver was that the pension fund managers were given partial access to GEMs data. The

12 "GEMs—Global Emerging Markets Risk Database Consortium of MDBs and DFIs," accessed June 14, 2023, https://www.gemsriskdatabase.org/.

13 "ILX—SDG-Focused Emerging Market Credit Fund," https://www.ilxfund.com/.

managers found that MDB credit performance for sub-investment grade transactions was well within their return targets and risk tolerance.

The broader context for pipeline development. Finally, as many have observed, a major driver of bankable project pipelines is the climate for private investment, particularly key policies that define public sector roles in shaping the overall environment (e.g., macroeconomic stability, contract enforcement, taxation, business creation, ESG standards, access to infrastructure) and the sectoral environment (e.g., the roles of public utilities, public regulators, tariff setting). Those MDB groups that separate sovereign and non-sovereign lending balance sheets must overcome silos that result in too little internal MDB coordination between those engaging with the public sector on policy priorities and those engaging with the private sector to build bankable projects.

The experience with the IDA Private Sector Window has valuable lessons in this regard. The offer of $2.5 billion in concessional finance was initially not sufficient to drive significant increases in IFC project pipelines in poor countries, and much of the PSW remained uncommitted long after the window was created. Better coordination with the public sector facing parts of the Bank is essential. The World Bank and IFC had to develop different ways of working together, and Bank insiders concede that policy and institutional reforms to strengthen the investment climate are still not well enough integrated into country strategies.

Sovereign Finance Instruments

Benefits

What borrowers want. A comprehensive ODI survey gives us valuable information on the demand side: what EMDEs value and want from MDB instruments.[14] It is a useful picture with important implications for MDB evolution. The report describes EMDE government views across several dimensions, including preferred sectors, preferred products, and MDB performance assessments.

With respect to sectors, the results may surprise those that suggest that an MDB focus on climate-related finance conflicts with EMDE priorities. For the World Bank, 60 percent or more of respondents ranked climate mitigation and adaptation among the top four sector priorities, the others being education, health, and water and sanitation.

For the regional development banks, the picture is somewhat different. Over 50 percent of respondents ranked climate investments among the top priorities for AfDB, AsDB, and IDB, though not for AIIB or EBRD. But for nearly all of these regional banks, the highest priority is an infrastructure sector: energy, transport, or water. (Interestingly, the IDB is an exception: respondents ranked education as the highest sectoral priority.) Infrastructure investment decisions are closely

14 Prizzon, Josten, and Gyuzalyan, "Country Perspectives on Multilateral Development Banks: A Survey Analysis."

intertwined with mitigation and adaptation goals. MDBs are well placed to play a valuable role in helping countries integrate these objectives into investment choices and design.

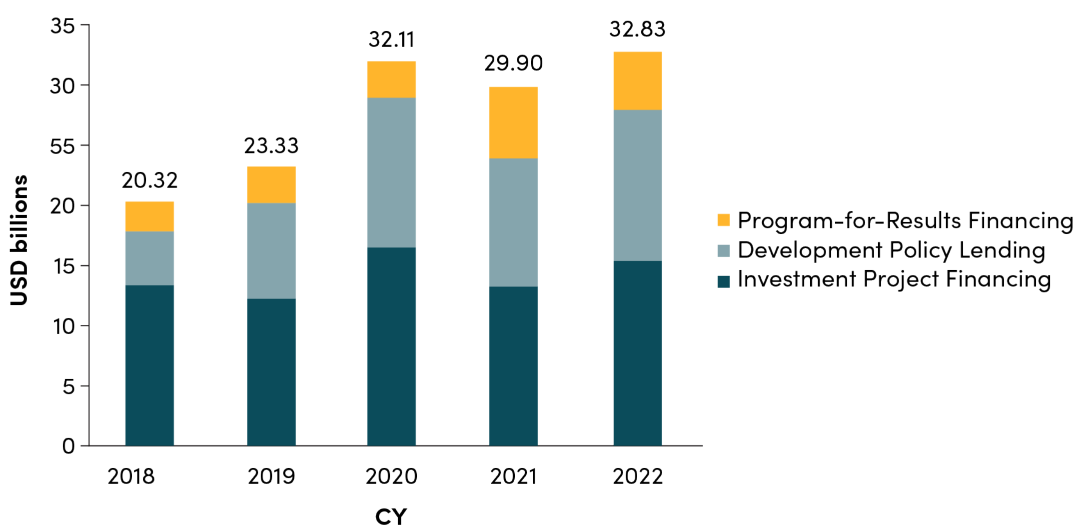
The survey includes EMDE views on characteristics of MDB loans that are most valuable. The top four, ranked in order as important by over 80 percent of respondents, are predictability of funding (certainty about amounts and timing of disbursements), flexible use of finance across sectors and priorities, the long-term tenor of finance, and the availability of grants.

The same themes are evident in the survey's findings with respect to MDB performance. Sixty percent or more EMDE respondents ranked MDB performance as good or very good for loan tenor, predictability, grant and concessional elements, and flexibility.

Predictable, flexible lending. What these results suggest is that EMDEs most want predictable sources of long-term budget finance, on attractive terms, for their infrastructure and climate-related investments priorities. That is not surprising. This kind of financing is desirable for any public investment planning.

When we look at the evolution of the lending instrument mix for IBRD, we see these preferences reflected in the composition of commitments. From 2019 onward, development policy lending has accounted for close to a fifth of total commitments (Figure 4). The share of results-based financing has also increased, suggesting that countries are meeting the targets they set with MDBs, also evidence of an effective partnership.

Figure 4. IBRD commitments by lending instrument, 2018–2022



Source: IBRD Statement of Loans—Historical Data.

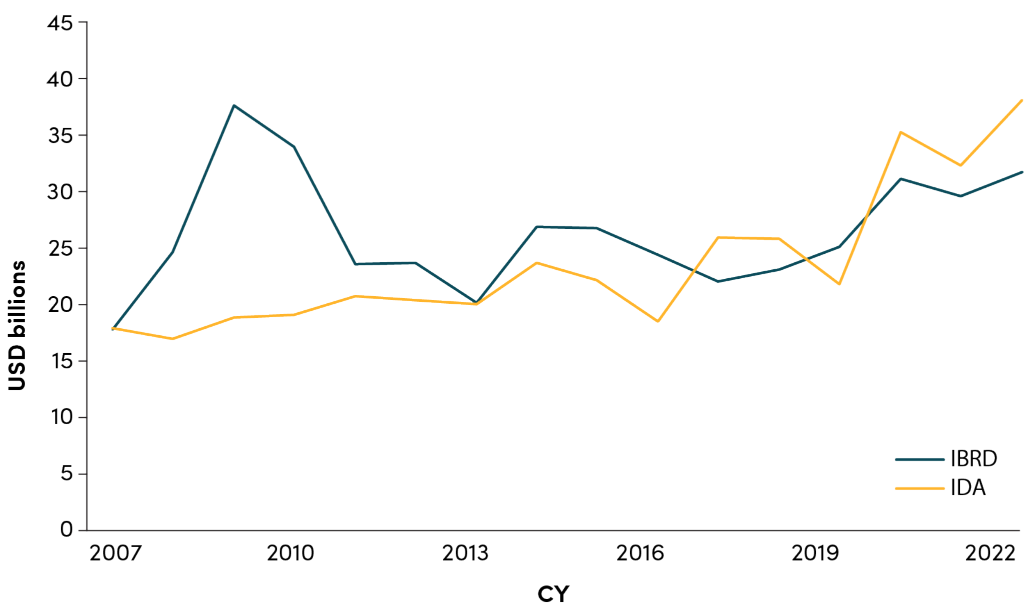
One other important finding from the ODI report concerns how MDBs bundle non-financial support with financial support. When asked about the advantages of finance offered by MDBs, about 70 percent of respondents replied that the combination of MDB finance with policy advice, technical assistance, knowledge, and convening power was the most important MDB strength. In contrast, only 27 percent named low transaction costs as an MDB strength.

With respect to the countercyclical role of MDB lending, IDA stands out as a striking success story for poorer countries, especially when recent performance is compared to that during the global financial crisis. Overall, IDA lending jumped over 100 percent from 2019 to 2020 in response to the pandemic, remained high in 2021, and surged another 25 percent in the polycrisis year of 2022. Donors then replenished IDA's resources early in order to sustain high lending levels, demonstrating their support for IDA performance. Those who doubt the absorptive capacity of IDA countries should take note.

Constraints

A shrinking role in middle-income countries. Growing emerging market sovereign debt issuance in recent years appears to be impacting demand for IBRD policy-based loans. The best performing MIC sovereigns can usually tap private capital markets at favorable rates (without MDB policy conditionality), with the result that MDB portfolios can become increasingly concentrated in lending to the most troubled (and risky) countries. Many emerging markets continued to issue hard currency sovereign debt actively at favorable rates even in the depths of the pandemic.

Figure 5. Total IBRD and IDA lending, 2007–2022



Source: IBRD Statement of Loans—Historical Data; IDA Statement of Credits and Grants—Historical Data.

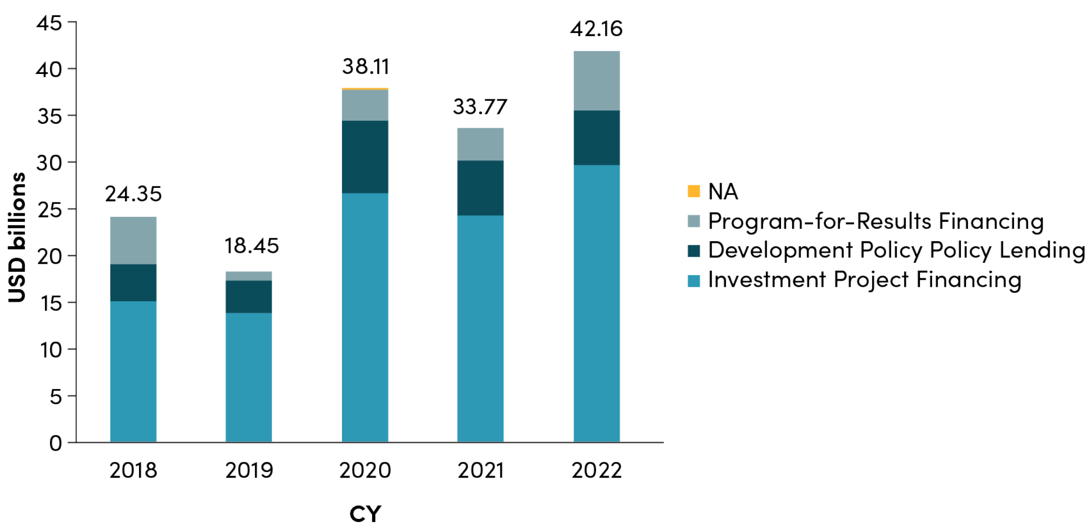
It is notable in this regard that IDA lending during the global financial crisis surged, but the increase in IBRD lending during the global pandemic was more muted (Figure 5). In fact, during the 2020 to 2022 period, IDA lending to poorer countries topped IBRD lending, even though the collective economic size of IDA-eligible countries is far smaller than that of countries accessing IBRD lending.

This CGD piece by Kenny offers additional evidence that the IBRD is no longer playing the role it once played in borrowing countries.[15] He finds that as a proportion of aggregate borrower country GNI, the outstanding IBRD portfolio has fallen from 4.0 percent in 1987 to 0.7 percent in 2020. Similarly, the median borrower's IBRD loans were 5.2 percent of GNI in 1987 but only 1.8 percent in 2020.

With respect to finance terms, there is a difference in the responses to the ODI survey between countries that borrow from IBRD and those that borrow from IDA. For IDA borrowers, more than 70 percent rank (concessional) financing terms as an important factor in borrowing decisions, while for IBRD borrowers, only 40 percent ranked terms as important.

Budget borrowing blues. While the ODI report found that policy-based loans had attractive sectoral flexibility, in practice, respondents were not satisfied with MDB budget support performance. In particular, policy conditionality was viewed as one of the main disadvantages, and it influenced government decisions about borrowing from MDBs. For low-income countries, this dissatisfaction might have been a key factor in driving the preference in IDA lending for investment project financing over development policy loans. The data suggest that budget support is less prevalent for low-income countries than for middle-income countries (Figure 6).

Figure 6. IDA commitments by lending instrument, 2018–2022



Source: IDA Statement of Credits and Grants—Historical Data.

15 Charles Kenny, "If We Want the World Bank to Solve Global Challenges, It Has to Be Bigger—but Also More Cuddly," Center For Global Development, August 26, 2022, https://www.cgdev.org/blog/if-we-want-world-bank-solve-global-challenges-it-has-be-bigger-also-more-cuddly.

In addition, ODI survey results showed that less than 50 percent of respondents rated MDB performance as good or very good on management burdens, reporting requirements, and processing times. So there appears to be scope for exploring possible adjustments to MDB lending instruments to respond to borrower preferences.

Recent CGD analysis by Kenny and Gehan highlights borrowing country concerns about processes that are too slow and complex.[16] It notes that this is the number one weakness in World Bank lending cited by Brazil, Indonesia, and Vietnam, and it ranked second for India and Argentina. Kenny and Gehan find that policy loans take 107 fewer days to reach the Board than investment project loans. This analysis by Kilby shows that World Bank project preparation times are primarily a function of World Bank processes rather than recipient country characteristics.[17]

Minimal MDB role in public-private infrastructure finance. One other indication of the limitations of MDB performance in investment project finance is to look at MDB contributions to financing public-private infrastructure, a core sector for the intersection of development and climate objectives. The World Bank maintains an extensive database of infrastructure transactions with private participation, the PPI database, and reports annually on trends.

The 2021 PPI data report shows no long-term upward finance trend.[18] Global PPI commitments in 2021, at $76 billion, were up substantially from their depressed 2020 level but still 12 percent below their previous 5-year average for 2016–2020. And MDBs account for only about 5 percent of PPI investment volume, which helps to account for China's outsize role, as compared to that of Western development banks, in financing and building infrastructure in the developing world.

Does policy conditionality work? Separate from the question of whether budget loan policy conditionality seems burdensome to borrowers is the question of whether it is working—that is, whether it is improving country performance and outcomes. Independent evaluations of the impact of policy conditionality for budget support by the World Bank, AfDB, AsDB, and the IDB and the regional development banks help answer that question.[19]

Performance and effectiveness vary widely so it is difficult to summarize results. But a number of challenges were seen across MDBs. Standalone policy-based lending was less effective than PBLs that were part of a broader strategy or program (AfDB, AsDB, and World Bank). There was significant variation in the depth or strength of the policy conditions. For AfDB and IDB, policy guidelines were

16 Zack Gehan and Charles Kenny, "If You Want Clients to Borrow from the World Bank for Net Zero Investments, Make It Easier" (Washington, DC: Center for Global Development, March 2023), https://www.cgdev.org/sites/default/files/if-you-want-clients-borrow-world-bank-net-zero-investments-make-it-easier.pdf.

17 Christopher Kilby, "The Political Economy of Project Preparation: An Empirical Analysis of World Bank Projects," Working Paper (Villanova, PA: Villanova School of Business Economics, July 30, 2011), https://core.ac.uk/download/pdf/6835909.pdf.

18 World Bank, "Private Participation in Infrastructure (PPI): 2021 Annual Report" (Washington, DC, 2021), https://ppi.worldbank.org/content/dam/PPI/documents/PPI-2021-Annual-Report.pdf.

19 ADB, 2018b; Gray and Schijman, 2016; AfDB, 2018; WB, 2015a; WB, 2015b; WB, 2015c; WB, 2016a; WB, 2016b.

unclear. For the AfDB, results were rarely sustainable, and result measurement weak. For the AsDB, public sector management PBLs performed better than other sectors. Prior actions were often process oriented. For the IDB, only 15 percent of prior actions were assessed as having "high depth", and attribution was uncertain. For the World Bank, outcomes were missed in some operations and others used indicators that were not aligned with the targeted development impact. For 22 out of 60 World Bank DPOs approved in FY12–14, IEG identified problems in the outcome statements.

A 2019 independent evaluation of IDA lending found that IDA project effectiveness ratings are improving but raised concerns about the quality and effectiveness of IDA's results and monitoring frameworks.[20] Problems included use of too many indicators, use of process- and output- rather than outcome-focused indicators, and in some cases the lack of quantitative baselines and targets. Performance on climate change-related objectives was poor with only 44 percent being rated as mostly achieved or higher. Interestingly, the report finds that the greater focus on climate agreed under the IDA-18 replenishment has been accompanied by declining support for other environmental challenges, e.g., indoor pollution, especially in low-income countries.

It seems clear that these problems in defining and measuring outcomes are likely linked to the borrowing country problems in meeting policy conditions. A more consistent and considered approach needs to be taken in defining policy actions with important development and climate impact. It is also clear that policy actions required in individual loans need to be part of broader programs and strategies in order to be effective.

Paris alignment: a long way to go. This paper from GermanWatch, the New Climate Institute and the World Resources Institute assesses the degree to which MDB budget lending has policy actions aligned with the Paris Agreement.[21] The paper considers budget support Paris-aligned if loan conditions "do not undermine a just transition to climate neutrality by increasing macroeconomic, fiscal, or social exposure to climate risks, and, wherever possible, support and promote long-term macro-fiscal resilience to climate risks and a just transition to climate neutrality."

The paper finds that, "Current practice and procedure for risk screening in PBOs [Policy-Based Operations] is not suited to prevent policy actions from undermining government capability to promote long-term macro-fiscal stability and a just transition to climate neutrality by 2050." More specifically, even though PBOs have potential to do so more systematically as shown in case studies from this paper, MDB diagnostics are not sufficient to determine a country's macro-fiscal exposure to climate risk; MDBs do not systematically assess countries' capacity for climate action; MDBs have not compiled lessons learned from climate action in PBLs; evidence of climate reform benefits from

20 World Bank, IEG, "Learning from IDA Experience: Lessons from IEG Evaluations" (Washington, DC: World Bank, 2016), https://ieg.worldbankgroup.org/sites/default/files/Data/reports/lp_ida_0716_0.pdf.

21 Carolyn Neunuebel et al., "Aligning Policy-Based Finance with the Paris Agreement," Working Paper (Washington, DC: World Resources Institute, October 2022), https://doi.org/10.46830/wriwp.21.00066.

MDB lending remains limited; and MDBs do not mainstream Nationally Determined Contributions (NDCs) in development plans that primarily inform bank activities.

Strategies of their own. Borrowing countries are increasingly intent on developing their own strategies, with MDB help. Just Energy Transition Programs (JETPs) are examples of country-driven strategies that integrate development and climate-related objectives for one sector that is critically important for the whole economy. But they struggle to attract adequate funding levels.

The World Bank has developed analytical reports, Country Climate and Development Reports (CCDRs), that analyze countries' climate and development challenges and underline priorities in both areas. There are currently CCDRs for 25 countries, in the initial stage of development of such reports. The reports serve as comprehensive analytical tools, generally covering the country's current macroeconomic and climate situation; the potential negative impacts of unaddressed climate change; the mitigation pathway to net-zero; adaptation/resilience needs; policy priorities and their sequencing; financing methods and potential obstacles to implementation. The analysis highlights the nexus between development, climate, and equity, combining climate forecasts with macroeconomic predictions and welfare analysis. There are often tables with investment needs by year and sector, or in some cases this is flagged as requiring additional analysis.

But the reports do not yet serve as platforms for country investment or policy commitments or MDB program or finance commitments, nor do they set sectoral development- or climate-related outcome targets. They do include net emissions targets from the country's NDC where available, installed renewable energy capacity, and carbon prices, though these are not framed as outcome targets.

The World Bank's Country Partnership Frameworks (CPFs) do set impact targets for World Bank engagement with the country. CPFs are organized according to focal or engagement areas with corresponding development objectives, where the World Bank can make a contribution. In the CPF results framework, each objective is linked to outcome targets that World Bank country teams are supposed to track. For instance, Burundi's CPF for FY19–FY23 targets increasing the productivity of rice cultivation from 4.1 to 4.9 tons per hectare by 2022 to support the objective of building sustainable food systems under the Strengthening Foundations for Economic and Social Resilience focal area.[22]

However, a recent Independent Evaluation Group report concludes that "the country-level results system does not capture the Bank Group's contribution to country outcomes well...."[23] The ambition and scale of development objectives often do not match that of the indicators that can be feasibly

22 World Bank Group, "Country Partnership Framework for the Republic of Burundi for the Period FY19–FY23" (Washington, DC, June 10, 2019), https://documents1.worldbank.org/curated/en/282471563156135424/pdf/Burundi-Country-Partnership-Framework-for-the-Period-FY19-FY23.pdf.

23 World Bank Group, "The World Bank Group Outcome Orientation at the Country Level" (Washington, DC, November 30, 2020), https://ieg.worldbankgroup.org/evaluations/world-bank-group-outcome-orientation.

tracked at the project level. The IEG report concludes that it is possible to develop new systems that better link project-level results to country-level targets, incentivize the use of the full range of financial instruments, and promote the pursuit of development, climate, and equity outcomes in a way that is transparent and accountable.

Box 1. The Democratic Republic of Congo's World Bank Group Country Partnership Framework

The example of a CPF for a country like the Democratic Republic of Congo is instructive.[a] Challenges and needs are formidable, the World Bank Group (WBG) clearly has an important role to play, and DRC has a relatively recent CPF for FY22–26, presumably reflecting lessons learned as well as the increased focus on climate-related investments. How does the strategy measure success?

The strategy has three broad focus areas: (1) stabilization with reduced risk of conflict, (2) improved infrastructure and other service delivery and human capital development, and (3) strengthened governance for increased private investment. It has 33 objective indicators of success (plus 26 supplementary progress indicators), ranging from the number of direct beneficiaries of social safety net programs, to increased regional trade, to the number of people with access to climate-resilient roads, to the increase in girls' secondary school enrollment rates, to revenue from forest carbon sales, to maintaining macroeconomic stability by avoiding monetary financing of the deficit. Baselines are measured and targets are set, so progress can be tracked. It is a credible and objective results framework.

But with that broad of a program and that many indicators, the challenges of determining whether the partnership is ultimately a success are obvious. It is a comprehensive development program, with interventions across the economy. It is supported by 79 ongoing and indicative future WBG operations. It does not focus on transformation of a few selected sectors, but rather addresses a whole array of admittedly pressing problems. Inevitably some targets will be met, and others will not, but what constitutes success? Meeting more than half? Are some more important than others? Should success be measured by macroeconomic outcomes—growth, poverty reduction?

We can look at past performance reviews to get a sense of how the World Bank itself assesses performance. The Completion and Learning Review (CLR) is the WBG's self-evaluation. The current CPF has an annex containing a CLR for the DRC country assistance strategy (CAS) for FY13–FY17. It is a comprehensive and generally honest assessment. Interestingly, it notes upfront that the CLR, "is not an assessment of DRC's progress toward its development goals, but rather of program achievements directly linked to WBG-supported activities and to WBG engagement in DRC during the CAS period." That makes sense from an attribution perspective, but it also acknowledges that the WBG has to make choices about where to focus.

That CAS had four strategic objectives, not greatly different from those of the current CPF: (1) increase state effectiveness and improved governance, (2) boost competitiveness to accelerate private sector-led growth and job creation, (3) improve social services delivery and increase human development indicators, and (4) address fragility and conflict in the Eastern provinces. The results framework targeted 14 outcomes. One was achieved (increased access to clean water and sanitation), five were mostly achieved, and eight were partially achieved. It is hard to say if that meets the standard for success or not.

But several of the report's lessons for future WBG engagement bear emphasis, perhaps most fundamentally this statement: "the forthcoming CPF should reflect a realistic level of ambition, given the degree of government capacity and demonstrated commitment to the necessary reforms." In that connection, the report urges that future engagement "start small, in a manner commensurate with existing capacity. Similarly, start with those provinces where there is a strong commitment to the desired reforms." The report also urges collaboration across interdependent sectors and between investment project lending and development policy lending to maximize impact, such as between the road/transport program and the investments in agriculture.

a. World Bank Group, "Country Partnership Framework for the Democratic Republic of Congo for the Period FY22–26" (Washington, DC, January 24, 2022), https://documents1.worldbank.org/curated/en/214221646062568502/pdf/Congo-Democratic-Republic-of-Country-Partnership-Framework-for-the-Period-FY22-26.pdf.

More focused strategies. Taking all this together, one can reasonably conclude that the WBG needs an approach that scales back on breadth and boosts depth if it is to convincingly demonstrate success. That suggests a focus on a few achievable targets in perhaps two to three sectors that are on the critical path for—and make large contributions toward—development and climate challenges and are also client government (either central or local) priorities.

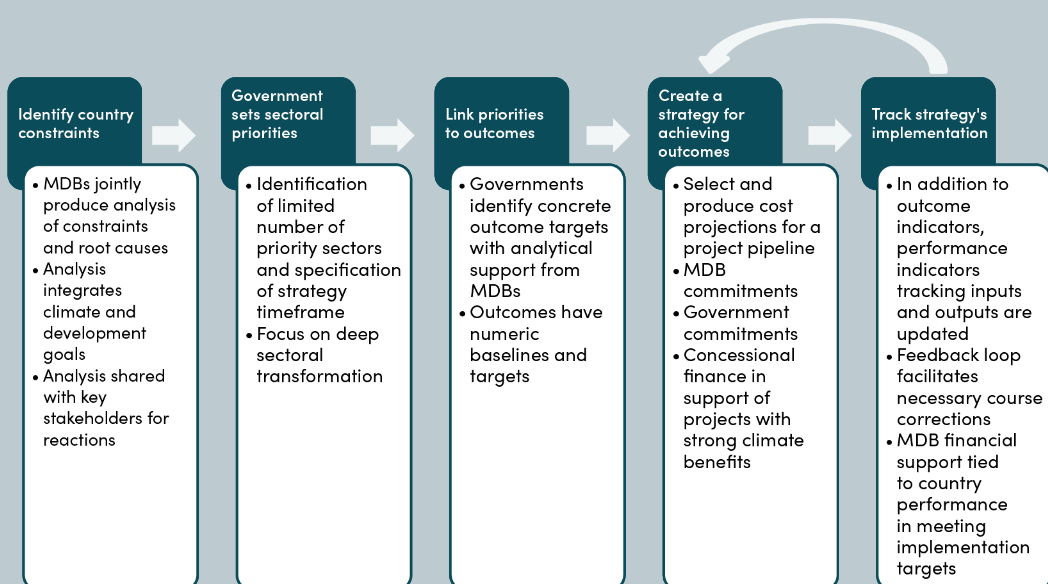
Some will see risk in the notion of going deep in a few sectors rather than broad across the economy. But the aim is to promote more realistic strategies consistent with countries' resources and execution capacity, and also to make it possible to measure success more easily using a limited number of outcome targets, rather than dozens of targets—some of which will inevitably be achieved and others not.

The limited number of sectors would be selected for their important development and climate spillover benefits for the rest of the economy. Going deep means that the sectoral outcome targets would aim for transformational change in those key sectors to maximize those spillovers.

Box 2. Country Strategy Steps

The process of developing one country-owned strategy shaping the support of MDBs and other development partners would begin with an analysis, produced jointly by MDBs in consultation with country experts, of the country's binding constraints. The analysis would combine climate and development challenges, including cross-border challenges, in a manner similar to the World Bank's Country Climate and Development Reports (CCDRs). The analysis would be shared in a collaborative, consultative process with various stakeholder groups, including civil society organizations and the private sector. Relying on this analysis and stakeholder input, the recipient government would identify a limited number of sectoral priorities that maximize desired sectoral transformation. The strategy would link sectoral priorities to concrete outcomes.

In order to achieve these outcomes, partners would commit to a business plan with selected projects, cost estimates, finance sources, policy and institutional reforms, and performance indicators with a regular tracking system. The MDBs would commit to providing a mix of financing (policy-, project-, and results-based--concessional for IDA countries), policy advice, technical assistance, training and knowledge sharing, partnership development, risk-sharing tools, and project development funding. For their part, recipient governments would commit to policy, institutional, and regulatory reforms and for public investment and other spending. The implementation of the strategy and progress on performance indicators would be tracked jointly by governments and MDBs. Disbursal of MDB financial support would depend upon demonstrated performance of commitments under the strategy. The strategy would be subject to ongoing feedback loops and updated to ensure that the country strategy remains flexible and responsive to changing conditions and challenges in the recipient country.



But, if transformation is to be achieved, it will require bringing together all of the tools needed to address, in that sector or sectors, the policy, governance, capacity, project development, and other relevant obstacles, and to finance the relevant investments. MDBs, especially working together, should be good at that.

Finance the strategy, not multiple loans. Putting this evidence together—the desirability of budget loans, the challenges of diverse MDB policy conditionality, the growing country preference for developing their own strategies, MDB advances in support for such strategies—suggests that *MDBs might collectively consider a different approach to budget finance.* Instead of negotiating individual policy-based loans with different MDBs and different conditionality, MDBs could collectively disburse predictably and regularly if the country meets its own goals in the form of an agreed country program or strategy for public investments, contributions to public-private infrastructure investments, and policy reforms in a given sector or sectors. The more ambitious the country strategy and the better the country performance, the larger and more predictable the collective MDB finance envelope.

Help countries borrow from markets on better terms. Countries interested in issuing green, social, and sustainable (GSS) sovereign bonds are in the words of one finance minister "punished by markets." They gain little benefit in terms of the cost of capital. And they face significant costs in building the more complicated transactions necessary and then monitoring and verifying GSS performance.

MDBs can and should play a central role in helping governments issue GSS bonds. MDBs can use guarantees to take on some of the country risk and help lower the cost of capital to incentivize sovereign borrowing for these purposes. MDBs have a range of sovereign guarantee instruments for sharing risk. Internal and external independent assessments have long advocated greater use of these instruments as powerful catalytic tools.

Yet, the institutions consistently favor direct lending over guarantees. As reported in this paper by Le Houérou and Lankes, in dollar terms, the average exposure taken by the World Bank on guarantees has been less than 0.7 percent of annual World Bank commitments made in the form of loans and grants.[24] For a number of reasons, staff are incentivized to prefer direct lending: transaction costs are lower for a given MDB finance volume offered. Guarantees, which inherently involve three (or more) rather than two partners, are less standardized and involve different skills sets compared with those typical for sovereign lending officers. And the capital charges for guarantees are the same as for loans: capital must back the full nominal amount of the exposure, not adjusted for expected losses.

24 Philippe Le Houérou and Hans Peter Lankes, "Mustering the Private Sector for Development and Climate in the Global South—Is It Realistic? Lessons and Recommendations from an on-Going Experiment at the World Bank Group," Working Paper (Paris: Fondation pour les études et recherches sur le développement international, May 7, 2023), https://ferdi.fr/dl/df-WgoecYd2Yzkf1M9sg4o3v4qV/p323-mustering-the-private-sector-for-development-and-climate-in-the-global.pdf.

So, faced with a choice between a loan with lower transaction costs and more difficult guarantee transactions and the same capital treatment, staff choose loans.

Along with their role in mobilization, guarantees can play important roles in improving the terms of sovereign borrowing, especially useful in times of tightened global monetary conditions and a sharp widening of EMDE spreads. The growing number of countries with market access have as much of an interest, in some cases more interest, in MDB help in reducing capital costs—especially for climate and other SDG-related borrowing—as in direct borrowing from MDBs. A recent CGD analysis of policy-based guarantees finds that they have helped governments secure better terms—reducing funding costs by an average of 330 basis points compared to what governments would have achieved had they pursued unenhanced issuances.[25] The analysis also found strong mobilization performance. The sample of $4 billion in guarantees analyzed crowded in $7.2 billion worth of total commercial financing, or 78 percent more than would have been possible using traditional MDB loans.

MDB sovereign guarantees could also be used as a means to spread deployment of climate resilient debt clauses (CRDCs) in sovereign bond issuance. Such clauses allow temporary suspension of debt service, without triggering default, in the event of a major climate shock or natural disaster.[26] Similar clauses for pandemic-like health shocks could be developed. Such clauses should also be standard in MDB loans themselves.

Just as important as improving terms, MDBs can build the market infrastructure for measuring and verifying performance on GSS commitments. No institutions are better placed to define, monitor, and verify GSS performance metrics. As many have observed, the lack of credible, independent arbiters/certifiers of performance is undermining both the growth of the market and GSS impact.

Concessional climate finance to incentivize more climate-related investments, should be part of this equation. There is now a complicated, fragmented architecture for concessional finance for climate change mitigation and adaptation. Donors have contributed more than $50 billion to dozens of trust funds and financial intermediary funds (FIFs) under the World Bank umbrella. The three biggest FIFs collectively commit about $4 billion a year with administrative expenses of $300 million. Certainly, that volume is too small, but adding more donor funding to this fragmented system or creating new funds will not solve the problems of access and efficiency.

There are no common allocation criteria for this scarce concessional finance and no common impact reporting system for mitigation and adaptation. Implementing agencies that use FIF concessional finance do not report results and impact consistently, so FIFs cannot easily aggregate impact across projects. Value for money is impossible to judge across the system. Each FIF has its own

25 Clemence Landers and Rakan Aboneaaj, “MDB Policy-Based Guarantees: Has Their Time Come?” (Washington, DC: Center for Global Development, July 2022), https://www.cgdev.org/sites/default/files/MDB-policy-based-guarantees.pdf.

26 Last November, the UK-led Private Sector Working Group published a standardized term sheet for CRDCs on the International Capital Market Association’s website.

system for selecting and approving projects (and, in some cases, countries eligible for funding) and implementing agencies and its own governance structure. Borrowing countries consistently characterize access to this concessional finance as both complicated and slow, with high transaction costs. That certainly appears to be the case for the countries most vulnerable to climate change. They currently receive a tiny fraction of adaptation finance.

The world already has a major success story in allocation of concessional finance at scale: the International Development Association (IDA) in the World Bank Group. IDA deploys a performance-based allocation system for country finance envelopes. We need something similar to consolidate the highly fragmented and inefficient architecture for concessional climate finance that now spans more than 50 climate trust funds and 12 climate financial intermediary funds in the World Bank Group alone. More and better-allocated concessional climate finance is warranted both for low-income countries and for middle-income countries to incentivize larger investments where such investments generate significant regional and global benefits.

The new model must in no way divert donor contributions from the IDA window. Rather there should be an analogous country-level allocation system, purpose-built for concessional climate finance, for both low- and middle-income countries. This recent CGD paper proposes a set of common criteria for allocating concessional climate finance in a consolidated system: climate-related impact; impact per dollar of concessional finance commitments; the scale of impact in relation to country needs/challenges; for mitigation finance, the contribution to global emissions reduction; and for adaptation and loss and damage finance, the country ranking in global climate vulnerability indices. Project allocation within the country envelope could deploy the same criteria.[27]

Using concessional climate finance for portfolio guarantees. One consolidation option is to take some of the concessional finance and put it in a portfolio guarantee fund to take risk off MDB balance sheets for climate lending to countries with agreed climate and development strategies. The guarantees would free up MDB capital for more lending, thereby leveraging donor funds. If highly rated donors contribute, the amount of paid in capital could be relatively small, bolstered by contingent commitments to supply more capital if necessitated by borrower arrears. The Asian Development Bank's Innovative Finance Facility for Climate in Asia and the Pacific, IF-CAP, uses this model.[28] Over an initial 5-year period, the AsDB hopes to raise $3 billion in guarantee funding, which could enable as much as $15 billion for climate projects across the region.

27 Nancy Lee, Clemence Landers, and Samuel Matthews, "Concessional Climate Finance: Is the MDB Architecture Working?" (Center for Global Development, March 2023), https://www.cgdev.org/sites/default/files/concessional-climate-finance-mdb-architecture-working.pdf.

28 "IF-CAP: Innovative Finance Facility for Climate in Asia and the Pacific," text, Asian Development Bank (Asian Development Bank, May 2, 2023), https://www.adb.org/what-we-do/funds/ifcap.

Private foundations and philanthropic investors might also contribute to such a guarantee fund and play a role in its governance. In doing so, they would multiply their contributions in two ways—through partnering with public donors and through harnessing MDB leverage.

The fund would have no independent project origination capacity, streamlining its deployment. Country eligibility for access to the guarantee funding could be commensurate with the ambition of that country's program, using standardized criteria for judging domestic and external impact. Such a fund could be a very useful tool to offer expanded support on favorable terms to the country-led climate and development strategies referred to above.

Using MIGA for portfolio guarantees. The World Bank has a powerful guarantee arm, the Multilateral Insurance Guarantee Agency, MIGA, that could partner with MDBs at the portfolio level. MIGA has a diversified global portfolio, insurance for political risk and failure to honor contracts, good access to reinsurance, the ability to take both sovereign and non-sovereign exposure, and authority to work with multiple MDBs. It could take some country exposure risk off MDB balance sheets and thus free up MDB capital for more climate and SDG lending, especially for countries that are bumping up against country exposure ceilings.

Finance to the Private Sector and Mobilization

Benefits

A complete toolkit. The private finance arms of MDBs have a unique array of tools for expanding finance to individual firms and for supporting private capital market development. Because they serve both governments and private actors, they have the opportunity to combine policy and institutional support to improve the investment climate with their private finance tools. They have been particularly active in lending to banks and other financial intermediaries, close to 40 percent of their commitments in 2018, with infrastructure the next largest sector, according to an ODI report.[29] Lending to the financial sector has often aimed to improve finance access for excluded firms, especially MSMEs and women-owned firms.

The spillover or sustained impact beyond the lending directly related to MDB programs is difficult to determine. But one study looks at the effects of MDB syndicated lending[30] for a large sample of developing countries from 1993 to 2017, controlling for other factors.[31] Its results show evidence of

29 Samantha Attridge and Matthew Gouett, "Development Finance Institutions: The Need for Bold Action to Invest Better" (London: ODI, April 2021), https://cdn.odi.org/media/documents/DPF_Blended_finance_report_tuMbRjW.pdf.

30 MDB syndicated loans are generally offered in an A/B structure, in which the MDB funds the A portion of the loan from its own resources and partners with other institutions to provide the B loan. The MDB is the lender of record for the transaction and acts as lead lender and administrative agent for the entire loan.

31 Chiara Broccolini et al., "Mobilization Effects of Multilateral Development Banks," *The World Bank Economic Review* 35, no. 2 (May 1, 2021): 521–43, https://doi.org/10.1093/wber/lhz049.

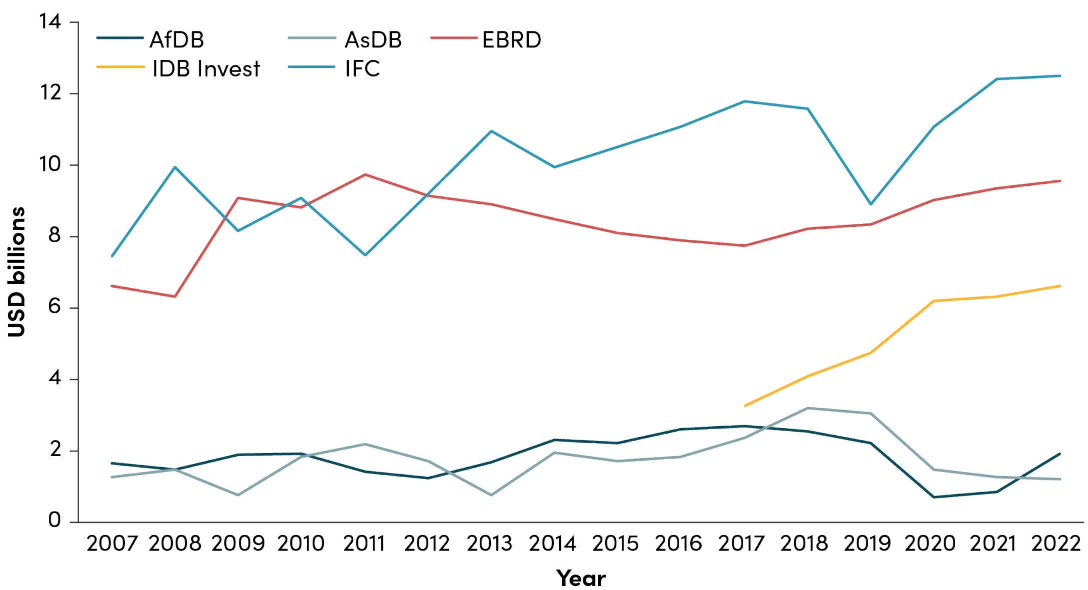
positive and significant effects on the number of syndicated loans, the amount of syndicated lending, the average number of banks participating in syndicated loans, and average loan maturity. These effects are sizable and last for at least three years, suggesting that MDBs do indeed have important demonstration effects and promote capital market development.

By instrument, the ODI report finds that loans account for the largest share. Equity, guarantees, and insurance make up a small share of MDB/DFI private finance commitments, with the exception of MIGA, the insurance arm of the World Bank group.

Mixed growth in MDB private finance. Growth in MDB private finance has been more rapid in institutions which separate public and private finance balance sheets or which specialize in private finance like the EBRD.

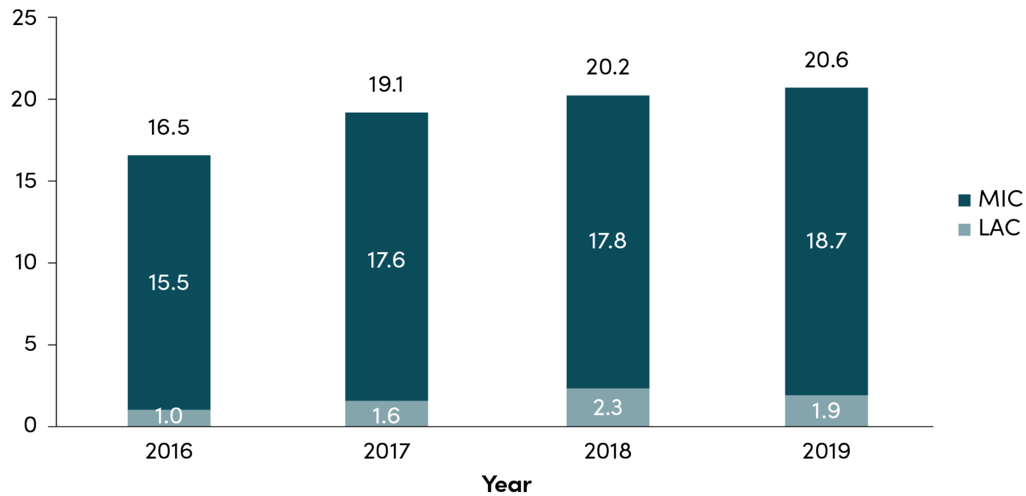
We see some evidence of countercyclicality for EBRD during the global financial crisis, for IDB Invest in the 2020 pandemic year, and for IFC beginning in 2019 (Figure 7). But for the MDBs where sovereign and non-sovereign finance share balance sheets we see little increase from relatively low levels. In fact, finance to the private sector from AsDB and AfDB fell in 2020, as the institutions shifted their focus more toward financing governments.

Figure 7. Total non-sovereign commitments, 2007–2022 (USD billions)



Note: Non-sovereign commitments include both short-term trade finance and long-term finance commitments.
Source: AfDB, 2023; AsDB,2023; EBRD, 2023; IDB Invest, 2023; IFC, 2023.

Figure 8. Direct MDB mobilization of private finance by income group, 2016 to 2019 (USD billions)



Source: MDB Joint Report, 2016; MDB Joint Report, 2017; MDB Joint Report, 2018; MDB Joint Report, 2019.

Mobilization challenges. The last MDB joint report on private finance mobilization published was for 2019, so we lack data for the pandemic and poly crisis periods. The report indicates a total direct mobilization volume of $21 billion for LICs and MICs for 2019 and not much evidence of a significant upward trend (Figure 8).

Interestingly, the same ODI report finds that mobilization ratios—the ratio of private finance mobilized per dollar of MDB/DFI commitments—are highest for low-income countries.[32] While the volume of private finance mobilization is higher in middle income countries (MICs) because they have a greater number of transactions and transactions of a larger size, the mobilization ratio is not higher in MICs. MDBs have difficulty finding or developing bankable projects in LICs (a key rationale behind the IDA Private Sector Window), but the analysis suggests that MDBs could be catalytic in poorer countries if they could generate more projects.

Constraints

Evolving MDB role in the private sector. When the first private finance arms of MDBs were created (IFC was founded in 1956), capital market development in EMDEs was limited, including banking sectors. In many countries, private banks lent mostly to a few very large corporations and to the government. Banks were generally large holders of local sovereign debt. The formal banking system lent little to SMEs, farmers, or individuals.

32 Attridge and Gouett, "Development Finance Institutions: The Need for Bold Action to Invest Better."

In that environment, maximizing the volume of MDB private finance made sense. It helped directly drive private sector development, growth, and job creation, and could, in theory, influence local financial institutions to lend more themselves.

Now many more countries have functioning private capital markets. Local banking sectors play a more important role in intermediating savings: private credit/GDP ratios now average 69 percent in 2021 for EMDEs.[33] Equity, bond, and insurance markets are more developed. Local pension and other institutional investment funds have grown. Challenges related to better allocation of private finance are now more important than increasing the overall size of the local financial sector.

These changes should drive changes in MDB private finance roles. They are no longer needed mostly for their own finance volumes. Rather their most important role is to mobilize private finance in ways that channel funding toward development/SDG and climate-related purposes. This is the "billions to trillions" vision.

Which instruments mobilize? But to achieve that vision their instruments need to evolve to play more catalytic roles. A banking model heavily dependent on spreads limits the spectrum and composition of financial instruments offered. Private banks in particular complain that the dominant role of senior lending in MDB commitments limits the space available for others and fails to address the gaps in capital markets that are blocking the flow of private capital. Lending still accounted for an average of 69 percent of the long-term commitments of the AsDB, AIIB, EBRD, IDB Invest, and IFC in 2022.

Relatively small amounts of equity and first loss guarantees can unlock much larger amounts of private finance. The AsDB and IDB Invest, for example, report that guarantees represent an average of 1.5% of long-term non-sovereign commitments and account for 22.3% of direct private finance mobilization.

Such instruments are more catalytic, but they also change the financial model significantly and staff skills needed. And they have implications for risk tolerance and institutional ratings. In a recent study of a sample of bilateral DFIs, Attridge and Novak find room for more risk tolerance in all of the institutions studied, rated and unrated, and in fact raise questions about whether AAA ratings are appropriate and consistent with their development mission.[34]

Few institutions set targets for private finance mobilized per dollar of commitments. The AsDB is an exception, setting a relatively modest target of a 3-year average of $2 of mobilization per commitment dollar. IDB Invest, which has moved mobilization center stage in its institutional

33 IMF, "Private Debt, Loans and Debt Securities," IMF Datamapper, accessed June 14, 2023, https://www.imf.org/external/datamapper/PVD_LS@GDD/CHN/RUS.

34 Samantha Attridge and Christian Novak, "An Exploration of Bilateral Development Finance Institutions' Business Models" (London: ODI, December 2022), https://cdn.odi.org/media/documents/ODI_Working_paper_An_exploration_of_bilateral_development_finance_institutions_x0AEs0S.pdf.

strategy and is seeking a capital increase, mobilizes roughly a dollar of private finance per dollar of its own long-term (i.e., not trade finance) commitments. Actual mobilization ratios across MDBs fall well short of 2:1, averaging 0.77:1 for AsDB, EBRD, IDB Invest, IFC, and MIGA in 2022, with large variation across institutions.

Blended finance has not come to the rescue. Blended (concessional plus market-driven) finance has been advanced as a solution to help manage risks and increase the number of bankable projects. But its volume remains tiny, its catalytic performance limited, and its transaction-by-transaction approach hard to scale. For 2021, the latest report from the MDB/DFI working group on blended finance notes that the total volume of MDB/DFI own-account investments in blended finance transactions was $5.3 billion, and the (donor-funded) concessional finance total was $1.9 billion. About $4.6 billion in private finance was catalyzed by those MDB commitments, so less than a dollar of mobilization per dollar of MDB commitment.[35]

Dissatisfaction with mobilization. EMDE clients are not satisfied. The ODI survey reports that only 42 percent of respondents rank MDB performance in catalyzing private finance as very good or good. Major shareholders are also not satisfied and are calling for better mobilization performance as part of the MDB evolution agenda, as noted by Treasury Secretary Yellen in a February 2023 speech.[36]

Changes needed to strengthen performance are perhaps more fundamental for MDB private finance operations than in any other area. MDBs have to find a way to take more risk and build a broader array of financial products into their model. In that regard, they face a threshold question: should they build that capacity on their balance sheets or off-balance sheet. The former would be the more ambitious fix, but it would likely be expensive in terms of additional capital required. And it would require a very different set of staff skills to deploy first loss, early-stage equity, and guarantee instruments.

An off-balance sheet approach to managing higher risk? An off-balance sheet option is worth exploring, especially an option that has global reach and can be accessed by multiple MDBs. This would be an entity that does most of its business in the form of equity and other subordinated products. A CGD paper proposes such an entity in the form of the Stretch Fund.[37] Its distinguishing features are its instrument mix, its modest overall financial target—preserving capital rather than

35 "DFI Working Group on Blended Concessional Finance for Private Sector Projects Joint Report 2022," March 2023, https://www.aiib.org/en/about-aiib/who-we-are/partnership/_download/2022-DFI-Working-Group-Joint-Report-on-Blended-Concessional-Finance-for-Private-Sector-Projects.pdf?mkt_tok=Njg1LUtCTC03NjUAAAGLe_bVuwuveJRKpDwAabzp449O9o40XI0o5Yzh-LvpkREVsxZqrrIxK8zh-qbG4NTHgJkniYGD13gCpHe9VWd_fHHNm9EulmMsRq02KpRdw4Gq7H8.

36 "Remarks by Secretary of the Treasury Janet L. Yellen at the Center for Strategic and International Studies," U.S. Department of the Treasury, June 9, 2023, https://home.treasury.gov/news/press-releases/jy1258.

37 Nancy Lee and Dan Preston, "The Stretch Fund: Bridging the Gap in the Development Finance Architecture" (Washington, DC: Center for Global Development, December 2019), https://www.cgdev.org/sites/default/files/Lee-Preston-Stretch-Fund-Full.pdf.

market returns, its higher risk tolerance, higher mobilization ratios, smaller project sizes, and focus on early-stage finance.

Early-stage finance is the most pervasive finance gap blocking the flow of private finance where it is needed most: for infrastructure and for innovative firms with rapid growth potential and high development impact. Some of these firms offer new products and services, new technologies, and new business models (e.g., off-grid infrastructure services, and new efficient ways to assess creditworthiness for small firms) that can scale in low-income environments.

Risks are high and exceed MDB tolerance. The Stretch Fund would operate as a partner with MDBs, taking subordinated positions to make a broader range of investments bankable and to help build a pipeline for later MDB loans when Stretch Fund resources are no longer needed. The Stretch Fund proposal is based on modeling that uses data from the closest comparable funds to estimate returns for different instruments. The relatively high costs of operating such a fund are also built into the model. Model results show that mobilization ratios of 4 to 5 dollars of private finance to 1 dollar of Stretch Fund investment are achievable and financially sustainable with an instrument mix of two-thirds equity and guarantees and one-third loans.

It would be more efficient and better for diversifying risk if there were one such fund deployed across the MDB system, rather than having many small Stretch Funds in different MDBs. Offering access to such scarce and valuable risk-tolerant finance to multiple MDBs could encourage a race to the top for impact. And it might serve as a means of encouraging MDBs to collaborate on joint investment proposals for scale.

Goals, Impact Measurement, and Reporting

Measuring and demonstrating impact—what positive change is triggered by MDB interventions—is complex and difficult. It takes years to build credible development impact frameworks. The challenge now is to integrate climate-related impact into these.

Benefits of the MDB model

MDB's goals are spelled out in their respective strategic priorities.[38] MDBs propose financing instruments and other support (e.g., technical assistance) to address the development challenges that countries face. Often building upon theories of change that logically dissect what it takes to make projects effective and impactful on the ground, strategic priorities are translated into designing projects that result in outputs and outcomes.

38 Examples include, for the WBG, "ending extreme poverty and promoting shared prosperity"; for AfDB, "strengthening institutional capacity, building resilient societies and catalyzing private investment."

Impact is central to an MDB's mission. There are many ways to track how effective interventions are. Existing approaches range from scorecards with reporting indicators, to mapping projects to sustainability goals, and can involve modeling, frameworks by sector, mechanisms for ex ante and ex post impact assessment. Reporting on institutional impact using outputs and outcomes is central to evaluating results, supporting learning through feedback, identifying gaps and adjusting future finance decisions to address remaining challenges. Reporting is usually done by project, aggregated at the portfolio (institutional) level, and can be used for internal or external purposes depending on the disclosure policies of each institution.

MDBs have partnered on harmonized approaches to measure and report on their goals, which improves consistency and comparability. This provides increasingly reliable data, helps set standards, is a signal for other institutions' practices, notably for other development partners and private sector counterparts, and facilitates experience-sharing and knowledge sharing.

MDBs undertake assessments of their operations, such as the environmental and social impact assessments. Development finance institutions traditionally apply 'safeguards', to identify and then avoid or mitigate adverse environmental and social impacts from their operations. To track positive contributions, the so-called climate finance co-benefits accounts for the portion of a project that specifically addresses climate-related challenges.[39] Methodologies are still being harmonized jointly, for instance following the 2015 Paris Agreement to mainstream climate considerations into the MDBs' operations.[40] Other examples include the set of harmonized indicators for MDBs' private sector operations, joint guidance, to map indicators with the SDG targets, and the guidance to measure the contribution to an SDG target.[41]

Aligning with the 2015 Paris Agreement. The goal of MDB "Paris alignment" emerged in 2017 as MDBs jointly committed to 6 interrelated objectives, and to establish and publicize methodologies by July 1, 2023.[42] Paris alignment is broader than just providing climate finance and is not about one objective more than another. In practice, this translates into aligning MDB project pipelines with Paris temperature goal, incorporating adaptation into projects, supporting investment in climate action, strengthening country's contributions to support long-term decarbonization and transition plans, and increasing reporting and transparency.

39 "Climate Co-Benefits," World Bank, October 2022, https://www.worldbank.org/en/news/factsheet/2022/10/31/a-closer-look-at-world-bank-group-climate-finance.

40 https://www.eib.org/attachments/documents/cop26-mdb-paris-alignment-note-en.pdf

41 Inter alia, the Global Impact Investing Network's IRIS metrics catalogue, the Harmonized Indicators for Private Sector Operations (HIPSO) and the OECD Social Impact Investment (SII) initiative.

42 "The MDBs' Alignment Approach to the Objectives of the Paris Agreement: Working Together to Catalyse Low-Emissions and Climate-Resilient Development," 2017, https://thedocs.worldbank.org/en/doc/784141543806348331-0020022018/original/JointDeclarationMDBsAlignmentApproachtoParisAgreementCOP24Final.pdf.

Aiming for the 2030 Agenda. This global agenda, which integrates economic, social, environmental, and governance dimensions grouped under 17 Sustainable Development Goals and 169 targets to be achieved by 2030 and maintained thereafter.[43] The 2030 Agenda serves as an overarching guidepost, since its implementation presupposes building synergies and coherence, seeking to address potential trade-offs encountered and striving for equitable outcomes.[44]

Engaging with the private sector. In 2012 MDBs adopted common principles of engagement with the private sector;[45] in 2017 the G20 endorsed the Hamburg principles,[46] and in 2018 some MDBs agreed to harmonize their approaches to additionality for private sector operations,[47] by which MDBs intend to avoid that their interventions are not crowding out what the private sector can provide. Harmonized approaches help allay concerns across shareholders about using scarce resources in a catalytic manner and directed to where they are needed most.

Constraints

A number of constraints apply to any impact measurement. Aggregating results from the project- or transaction-level into outcomes does not necessarily add up to the necessary impact and scale. Even if individual projects are effective, they fall short of what is desirable at the national level. Impact delivery may undershoot targets, and capturing accurately and fully the 'impact' appears challenging, even conceptually.

Project results are hard to predict. Underlying trends in the economy, changes in a country's policies or in the leadership of companies, may change the outcomes of a given intervention. The impact on different stakeholders could also take much more time than foreseen to materialize, even beyond the intervention-span of the MDB. For example, initial job destruction may bounce back later on; or impact communities only in the longer term after innovation or new activities have been established. Simply assessing results at the project- or transaction-level can be misleading.[48]

Impact measurement and monitoring can be perceived as an add-on that delay approvals, rather than as an integral part of an MDBs' value proposition. Translating indicators into outcomes is complex and requires contextual information to determine the contribution of a project to an outcome. Monitoring

43 "Transforming Our World: The 2030 Agenda for Sustainable Development," United Nations General Assembly § 70/1 (2015), https://sdgs.un.org/2030agenda.

44 "Interlinked Nature of the Sustainable Development Goals — SDG Indicators," United Nations, 2018, https://unstats.un.org/sdgs/report/2018/interlinkages/.

45 "Multilateral Development Bank Principles to Support Sustainable Private Sector Operations," 2012, https://www.ebrd.com/downloads/news/mdb.pdf.

46 G20, "G20 Hamburg Action Plan," July 8, 2017, https://www.consilium.europa.eu/media/23546/2017-g20-hamburg-action-plan-en.pdf.

47 ADB, "Multilateral Development Banks' Harmonized Framework for Additionality in Private Sector Operations" (October 9, 2018), https://www.adb.org/documents/mdbs-framework-additionality-private-sector-operations.

48 This has been one of the main criticisms of theories of change, because they assume simple one-way causal linkages between two variables.

and reporting processes can be perceived as cumbersome. SDGs and climate goals are intertwined, such that assessing every project's SDG- or climate-contribution adds steps in the project cycle.[49] The broad range of DFIs, or other funds, use different systems to track development results. This implies multiple data collection exercises from the client's perspective.

Harmonizing definitions and reporting is challenging, notably for climate finance. All the MDBs have set clear institutional climate finance targets, following the joint MDB climate finance methodology for tracking and reporting purposes.[50] Some have adopted targets as a share of overall financing dedicated to climate mitigation and adaptation, while AsDB has a finance volume goal. Target years vary, from 2024 (AsDB) to 2030 (AIIB).[51]

For climate mitigation and the Paris temperature goals, in 2018 MDBs committed to consistency of operations with each country's low-emissions development pathways. Individual targets or climate risk screening (at project-level, including safeguards) and various tools and reporting methods coexist (GHG accounting, exclusion lists, shadow carbon pricing, etc.).[52] There is variability across MDBs to account for portfolio-wide emissions targets, set emissions intensity targets, or incentives and instruments for investments into clean energy.

For climate adaptation, high-level commitments have been made, MDBs have tools to identify risks, encourage investment in adaptation solutions and a have a joint methodology for tracking climate adaptation finance.[53] But integrating resilience into monitoring, performance metrics is often lacking, tracking is difficult and often requires expertise. There is persistent uncertainty about how to account for adaptation finance in public[54] and especially private sector investments.[55]

Transition finance rarely features in the top strategic priorities. Finance for the transition, e.g., for the energy transition, is usually not explicit—although in the case of NDB, transition is mentioned in the strategy alongside mitigation and adaptation, and reporting is an even greater challenge.

49 Eliza Northrop et al., "Examining the Alignment Between the Intended Nationally Determined Contributions and Sustainable Development Goals," Working Paper (World Resources Institute, September 26, 2016), https://doi.org/10.1163/9789004322714_cclc_2016-0020-009.

50 Carolyn Neunuebel, Joe Thwaites, and Esther Choi, "The Good, the Bad and the Urgent: MDB Climate Finance in 2021," November 11, 2022, https://www.wri.org/insights/good-bad-and-urgent-mdb-climate-finance-2021.

51 Pre-2020 targets were much easier to compare, since almost all banks aimed for a share of annual commitments, only AsDB opted for a specific amount (which was still simple to compare to the other banks).

52 "Updates to Towards Paris Alignment (2018): Following Up on MDB Climate Tools in 2021," World Resources Institute, October 29, 2021, https://www.wri.org/data/updates-towards-paris-alignment-2018-following-mdb-climate-tools-2021.

53 "Joint Methodology for Tracking Climate Change Adaptation Finance" (EIB, 2021), https://www.eib.org/attachments/lucalli/20220242_mdbs_joint_methodology_climate_finance_en.pdf.

54 Gaia Larsen, Carter Brandon, and Rebecca Carter, "Adaptation Finance: 11 Key Questions, Answered," World Resources Institute, October 25, 2022, https://www.wri.org/insights/adaptation-finance-explained.

55 Timothy Randall, Jens Sedemund, and Wiebke Bartz-Zuccala, "Private Investment for Climate Change Adaptation—Difficult to Finance or Difficult to See the Finance?," Grantham Research Institute on climate change and the environment, March 16, 2023, https://www.lse.ac.uk/granthaminstitute/news/private-investment-for-climate-change-adaptation-difficult-to-finance-or-difficult-to-see-the-finance/.

Harmonized approaches to Paris Alignment across MDBs are yet to be finalized and implemented. Joint principles for Paris Alignment were published on June 19, 2023.[56] MDBs are still developing and evolving the implementation tools (e.g. the World Bank Group has recently published guidance by instrument[57] and by sector),[58] guidance frameworks or mechanisms to steer their financing in a Paris-aligned way, building evidence on the basis of concrete cases going through this type of methodology will take time. Guidance for aligning direct financing is more established,[59] other guidance by instrument and by sector are in pilot phase but lack detail and concrete project examples, especially for investments through financial intermediaries,[60] and for policy-based lending.[61] The latter may have indirect, cross-sector, or policy-related effects, that remain underreported or are not accounted for ex ante, but can present either risks or instead missed opportunities to support development trajectories and Paris goals.[62]

Both for Paris goals and for SDGs, there is a lack of guidance from MDBs to their partner financial institutions (private corporates and public counterparties) or the counterparties lack implementation capacity, which limit the allocation of resources, commitment to and achievement of targets. Some banks, notably EIB,[63] EBRD,[64] are laying out approaches for their 'counterparties' in a more systematic way, such that the counterparty itself becomes aligned with the Paris goals—but this rests upon capacity and willingness to do so.[65]

SDG reporting also varies across MDBs, depending on definitions of sustainable development, and how these get translated into mechanisms that influence project design. This leads to bank-specific approaches. Project by project assessments may rely on quantitative and qualitative assessments to assess the coherence of each project with the countries' own development and climate strategies. Some banks rely on sector guidelines to assess a project against quantitative benchmarks, others map projects to SDG outcomes.

56 EBRD, "MDBs announce common principles for Paris alignment," June 19, 2023, https://www.ebrd.com/news/2023/mdbs-announce-common-principles-for-paris-alignment.html
57 World Bank, "Instrument Methods," https://www.worldbank.org/en/publication/paris-alignment/instrument-methods.
58 World Bank, "Sector Notes,"https://www.worldbank.org/en/publication/paris-alignment/world-bank-group-sector-notes.
59 "Joint MDB Assessment Framework for Paris Alignment for Direct Investment Operations," BB1 and BB2 Technical Note (EIB, November 2021), https://www.eib.org/attachments/documents/cop26-mdb-paris-alignment-note-en.pdf.
60 Neunuebel et al., "Aligning Policy-Based Finance with the Paris Agreement."
61 World Bank, "World Bank Paris Alignment Method for Development Policy Financing" (Washington, DC, March 7, 2023), https://documents1.worldbank.org/curated/en/099704503162315996/pdf/IDU0e3b4f7df040b204cee0865e05dc7f1fe687d.pdf.
62 Carolyn Neunuebel, Valerie Laxton, and Hayden Higgins, "How Multilateral Development Banks Can Use Policy-Based Financing to Support Climate-Resilient Economies," February 17, 2023, https://www.wri.org/technical-perspectives/multilateral-development-banks-policy-based-financing.
63 EIB, https://www.eib.org/en/publications/the-eib-group-path-framework
64 EBRD, https://www.ebrd.com/ebrd-activities-paris-alignment
65 Alice Pauthier and Aki Kachi, "Supporting Financial Institutions in Developing Countries in Their Alignment Journey with Climate Goals" (Paris: I4CE, March 1, 2023), https://www.i4ce.org/en/publication/supporting-financial-institutions-developing-countries-in-their-alignment-journey-with-climate-goals/.

In practice, attributing MDB's added benefits remains a challenge, the 'additionality' principle is difficult to implement. The stocktaking carried out by IEG in 2022 could not validate with certainty that MDBs actually provide financing terms that are not offered by the market (financial additionality).[66] However, it did find that MDBs are increasingly providing political risk mitigation, knowledge transfer, capacity building, for instance (non-financial additionality). The latter is especially valuable in mobilizing the private sector.

Purpose-driven assessments to maximize impact. Common metrics and frameworks for results, impact assessment and evaluation require cross-cutting approaches, and call for overcoming siloes within and between institutions. Conceptually, assessment and allocation mechanisms need to effectively channel finance to countries, with a view to maximizing progress towards achieving the following (lists are indicative):

- Development and poverty impact: improving economic outcomes compared to the common country diagnostic used as benchmark; and reducing multidimensional inequality and poverty; increased use of performance-linked assessments,[67] funding and financing instruments;
- Climate impact: reducing GHG emissions in line with the 1.5 C pathways using NDCs and the best-available scientific assessments by country; adaptation outcomes based on climate vulnerability index and relative to a country's national adaptation plan needs and targets; increased biodiversity protection; and account for energy access and transition scenarios based on country-specific transition pathways and cost of capital for different technologies;
- Equity and shared prosperity impact: increasing flows to the most vulnerable countries and populations, where gaps in climate and development financing are large and the cost of capital is high; interventions that target excluded and vulnerable populations with outcomes measuring economic, social and financial inclusion, and equity.

Systematic inclusion of these three dimensions should be based on a harmonized range of indicators. Scientific consensus and methodologies would help project the trajectory pursued by the country. For example, assessment matrices and toolkits can inform the risk screening (e.g., financial, climate, social risk), numerical benchmarks and targets, complemented by qualitative measures, can inform progress towards a target. They can involve modeling, notably to capture indirect effects across different sectors. Using adaptive targets to ratchet up the ambition over time can support course-corrections and foster alignment in country-based plans. A coherent set of environmental impact, development impact, and equity impact principles, outputs and outcomes and a toolkit that integrates these for staff use is crucial for implementation.

66 Carmen Nonay and Ana Belen Barbeito, "What next for Additionality: Promoting Better Understanding of Its Role in Development," World Bank Group, June 27, 2022, https://ieg.worldbankgroup.org/blog/what-next-additionality-promoting-better-understanding-its-role-development.

67 Reference the latest evaluation RAP 2022—which was done at country level for the first time, published Dec 2022.

Reporting, transparency, and accountability. MDBs should report transparently at the institutional, country, and project levels on results, track, evidence out the remaining gaps, adapt, course correct to make sure to achieve targets. MDBs should systematically consult stakeholders and communities on the ex-ante impact assessment, before the operational and financial details of the project are ironed out, and well before Board approval. Early consultation promotes local and national level engagement. Including development, climate and equity indicators from ex-ante to ex-post stages of the project supports evaluation of Paris- and SDG-alignment and integrating learning and increased ambition from one project to the next.

For a successful climate-related guarantee fund or pool of funds, as proposed in the above section, a common climate and development impact assessment framework, using these principles would guide the design of the common concessional fund. An optimized allocation mechanism based on performance would then ensure that scarce concessional finance is allocated where it drives the greatest additionality in terms of impact and need.

The Agenda for Change

Predictable, sustained MDB support for one country climate and development strategy

The foundation of a new approach to MDB policy conditionality and investment lending decisions is the creation of a country strategy that integrates development and climate analysis, sets targets, and identifies supporting actions by both the country and the MDBs (and other development partners). The country strategies should include output and outcome targets for sectoral priorities, and commitments by countries and MDBs to take the actions required to achieve targets.

The strategies would differ from traditional MDB country strategies. (See Box 2) They would not be comprehensive development plans or seek to cover all sectors. Rather, they would focus on achievable targeted outcomes in perhaps two to three sectors that: (1) are on the critical path for, and would make large contributions toward, development and climate challenges; (2) have broader positive spillovers on the economy; (3) are priorities for client government (either central or local); and (4) are areas where external support from MDBs is particularly needed. An illustrative example might be sustainable agricultural production that benefits smallholder farmers. MDBs and other development partners would concentrate forces and bring all their tools to bear to maximize chances for success: support for policy, institutional, regulatory, legal, and governance reforms; technical assistance and knowledge of crops, production techniques, distribution systems, and local and export markets; feasibility studies and project development assistance; support for relevant public infrastructure investments; and risk-sharing tools to crowd in private investors.

Countries must make the strategic decisions on sectoral priorities and outcome targets. But those decisions should be grounded in robust analytical support from MDBs, integrating development and climate challenges and opportunities. MDBs should collaborate on common country diagnostics and cost-benefit analyses to allow informed government decisions on investment choices and policies. Governments should build consensus at the national level, through consultative processes with parliaments, civil society, businesses and communities to underpin the critical elements of the strategy.

The strategy should include government commitments on policy, regulatory and institutional reforms, public investment plans, and other spending. For their part, MDBs should commit to lending envelopes (budget, investment project, and pay-for-results loans), technical, and other assistance for the duration of the program to help achieve the defined outcomes.[68] This common strategy will help break down internal silos within MDBs and enhance the coherence of policy advice. A common strategy will also be a powerful driver of collaboration across MDBs.

The private finance arms of MDBs would be full partners in development of the strategy to ensure that public policy and investment decisions support improved investment climates and more opportunities for private investment in relevant sectors, including public-private infrastructure projects.

The development of such a strategy would take considerable time. But that time would create the basis for well-defined actions and responsibilities leading to well-defined outcomes. And it would save time by obviating the need to negotiate individual loans.

A new approach to MDB budget lending: no more separate policy-based loans

The country strategy (including targets and country and MDB commitments) should provide the entire basis for policy-based lending. There would be no need for additional conditionality or individual policy-based loans. The MDB would disburse the agreed envelope of finance annually as long as the country fulfilled its commitments under the strategy with respect to policy, investment and other spending, and compliance with ESG standards. The country would benefit from predictable, more timely financing, reduced process burdens, and the focus on well specified development and climate priorities. MDBs would benefit from the tighter link between their financing and achievement of important sectoral development and climate outcomes and the reduced administrative burdens on their own staffs.

68 The compacts negotiated by the Millennium Challenge Corporation are one proven model of country ownership with accountability for both the country and the funder. Countries and the MCC undertake compact analysis together to determine the sectors of focus. Compacts are not comprehensive development plans; they cover areas that are priorities for governments and that address critical constraints as demonstrated by credible analysis. Countries manage and implement the compact projects using MCC contracting, procurement, and ESG standards.

A differentiated approach will be needed, depending on borrowing country capacity, needs, and income level. Development partners would need very different approaches to supporting India, Barbados, or South Sudan, where climate-related challenges, technical capacity, and fiscal space are very different. Tailored support could be built in as needed if countries ask for support in formulating their climate strategy: the Fijian authorities, for example, specifically worked on their climate finance strategy.[69] Support was provided in analyzing the country's needs to meet this country's climate goals and in formulating its priorities. This strategy was based on wide stakeholder consultations, aligned with Fiji's Climate Change Act, and provides a detailed financing roadmap for engagement with funders like the Green Climate Fund.

This case demonstrates the value to development partners of having a consultative strategy and country ownership over their climate priorities. Lessons learnt from such country experience in formulating a climate finance strategy are manifold, and include: "(i) tailoring the strategy to complement existing climate plans, existing legislation, strategies or priorities; (ii) tying the high-level strategy to specific actions, projects, and investments that need to be made to achieve these high-level goals; (iii) intentionally including social, equity, health, relocation outcomes alongside, such that climate policies respond to development needs of vulnerable communities." [70] Adopting one strong development and climate strategy and an associated financing roadmap are difficult undertakings that should be shared by the country, MDBs, and other development partners.

Helping countries borrow from markets on better terms

A growing number of developing country governments focus more on their access to global capital markets for climate and social investments, than on borrowing from MDBs. MDBs can play a powerful role in improving borrowing terms through guarantee instruments, through supporting measurement and verification of climate and SDG commitments, and through backing and deploying clauses that permit temporary debt service suspension in the event of major climate and health shocks and natural disasters.

Consolidation of MDB concessional climate finance to support larger country portfolios of climate lending

Concessional finance to support climate-related objectives can be an essential success factor. But as important as more concessional finance is more efficient and catalytic deployment of the finance. The CGD study cited describes a deeply fragmented and inefficient system that operates transaction by transaction across a multitude of trust funds, FIFs, and MDB and UN implementing partners.

69 Caitlin Smith and Prashant Chandra, "What the World Can Learn from Fiji's National Climate Finance Strategy," August 19, 2022, https://www.wri.org/insights/understanding-fiji-national-climate-finance-strategy.

70 Ibid.

Under this strategy-driven approach, concessional finance for climate purposes would be committed at the country level to support the agreed strategy. Concessional finance commitments would be allocated across countries based on consistent criteria: the projected climate-related impact of the strategy; the impact per dollar of concessional finance; the impact in relation to the magnitude of country's mitigation and adaptation challenges; the case for concessionality for that country (its income level and alternative sources of finance); for mitigation projects, the country's global role in emissions reduction; and for adaptation projects, the country's climate vulnerability score. These criteria would be deployed for concessional funding to support investment projects as well as to improve the terms of budget finance.

To harness MDB leverage, concessional finance for climate-related lending could be deployed in a guarantee fund that takes risk off MDB balance sheets, freeing up capital for more climate lending, with allocation of the funds aligned with the level of ambition and performance under country strategies. Some of the concessional finance could also be used to improve the finance terms of climate-related lending that warrants concessionality. And funding could be shared across MDBs[71] in a way that optimizes their specific capabilities on the ground.

Such an allocation rubric or formula would foster more efficient use of scarce concessional resources. It would also promote a fairer distribution of subsidies, whether countries are large or small and whether their challenges are principally adaptation or mitigation.

Putting mobilization first in MDB private finance operations

The first step to better mobilization performance is setting corporate targets for private finance mobilization volumes and mobilization per dollar of MDB commitment, preferably based on a methodology common across MDBs. But success requires more fundamental changes, a very different financial and business model. It requires taking more risk and a systematic focus on subordinated positions in cases where the absence of investors in these positions is blocking the flow of finance. This is especially true for promoting the kinds of innovations in business models and products that work at scale in the developing world.

The mobilizing MDB must be capable of offering products that fill binding gaps in capital markets. Simply creating pools of concessional finance to off-load risk does not in and of itself drive investment at scale. Instead MDBs should build structures at the portfolio level with the first loss and other subordinated finance tools and staff skills necessary to bear the high-risk tranches of investments, especially early-stage investments. CGD modeling shows that it is possible to create a financially sustainable entity that does more equity and guarantees than lending.[72] Returns may be

71 'Transfer out' mechanisms already exist in the context of the Climate Support Facility, such that donors' contributions can transfer from one MDB to the other. Such a mechanism could be scaled and made more widespread to allocate concessional funds.

72 Lee and Preston, "The Stretch Fund: Bridging the Gap in the Development Finance Architecture."

limited but not negative. Whether to offer riskier products on the MDB's core balance sheet or off-balance sheet is a decision requiring analysis and close engagement with shareholders on ratings.

Putting mobilization first also means bringing MDB engagement with governments together with private finance tools. Often cited constraints to mobilization are the supply of bankable projects and the risks perceived. These constraints can only be addressed at scale by improvements in the investment climate, with sector-specific investment constraints among the most important—and by sharing the data on actual risks when it exists (cf. the GEMS database). The mobilizing MDB will prioritize, in the country strategy, critical sectoral policy and public investment decisions that shape private investment opportunities.

To counter criticism that MDBs are too slow, bureaucratically rigid, and opaque, private firms and financiers should be partners in origination. If private actors are partners from an early stage—rather than just as an 'add on' to project development and the country strategy—they can play their essential role as enabler of innovation, bringing expertise, know-how and capacity to introduce new technologies and create new job-creating business models that work in low-income environments. This private sector comparative advantage can be combined with what should be the comparative advantage of MDBs, a broader array of subordinated risk sharing tools—equity, guarantees, insurance (including from MIGA), and subordinated debt—to support the early-stage firms which drive much of the innovation in EMDEs.

In short, the mobilizing MDB will differ from existing MDBs in fundamental ways. It will:

- Set targets at the corporate level for private finance mobilization;
- Focus on binding gaps in local and external capital markets, especially for early- stage infrastructure and finance for scalable innovation with significant development and climate impact;
- Shift to more deployment of subordinated instruments that help fill those gaps;
- Equip and incentivize staff to match instruments to gaps to strengthen additionality;
- Accept below-market returns for such instruments in some cases of high impact, significant positive spillovers, and market-building benefits;
- Deploy off-balance sheet vehicles at the portfolio level to help manage increased MDB risk, including partnerships with risk-tolerant public and private investors and access to concessional climate finance guarantee funds;
- Proactively co-create investment opportunities with the private sector;
- Participate as an equal partner with sovereign MDB departments in helping countries shape their priorities for integrated development and climate strategies; and
- Adopt a deliberate strategy of offloading the risk of portfolios of later-stage, performing assets to the private sector to free up capital for more origination (see next section).

Moving toward an "originate to distribute" MDB model

The MDB comparative advantage is originating SDG investments with governments and the private sector. Origination is costly and risky, but MDBs, uniquely, have all the tools necessary to do so at scale and with real SDG impact.

A shift toward regularly distributing portfolios of performing MDB assets to the private sector to free up capital for new lending is a major change and a major challenge to MDB financial sustainability. But it is perhaps the most direct route to creating credible SDG asset classes at scale, with enough diversification across EMDEs to be attractive to large-scale investors. This would especially be the case if such assets were pooled across MDBs.

Distribution can be accomplished while MDBs remain the lenders of record through offloading risk to private insurers or synthetic securitization, as pioneered by the African Development Bank in two Room2Run transactions, one for non-sovereign portfolios and one for a sovereign portfolio. To be sure, both AfDB transactions involved a public concessional funder to create terms acceptable to private participants.

That experience suggests five critical success factors: (1) access by private investors to granular statistics on MDB credit performance to drive down risk transfer premia; (2) donor willingness to consolidate risk-tolerant finance for use at the portfolio level, rather than transaction-by-transaction; (3) a (downward) adjustment in shareholder expectations for MDB net income; (4) more MDB budget resources devoted to investment pipeline development so that freed up capital can be redeployed rapidly; and (5) country strategies that prioritize key investment climate reforms.

Letting private investors help capitalize MDBs

Most MDBs are currently capitalized only by governments. But there are large institutional and philanthropic investors that are interested in assets that share two characteristics that MDBs can offer: safety with moderate returns and SDG impact credibility. Hybrid capital issuance is common in the commercial world. The time has come for MDBs to deploy these instruments, which can be leveraged by multiples in MDB lending.

Non-voting hybrid capital is no threat to governments, which would retain all shareholding voting rights and control over MDB finance decisions. It is a more expensive source of capital than shareholder equity and does not substitute for general capital increases. But it is a very scalable way to crowd in the private sector (and potentially some governments interested in returns and exits), especially if MDBs collaborate to create a common asset class.

MDBs together: Assessing impact for an integrated climate and development mission

To meet the expectations for climate and development with finance flowing in an equitable way, MDBs should integrate all three purposes (climate, development, and shared prosperity), guided by the global political agenda that the international consensus has reached. Paris Alignment must be achieved while sustaining and strengthening development effectiveness. As the Global Commission on the Economy and Climate has demonstrated, there is scope to develop a 'no trade-offs' approach, because delaying climate action will risk missing opportunities for economic growth and development gains, and because climate action will generate benefits that are shared globally.[73]

MDBs should demonstrate success and impact as assessed against a country's priority needs. The MDB's role is to support filling the gaps to deliver on country strategies. Systematic mainstreaming of overarching purposes in all processes and structures relevant to project design (such as country dialogue and diagnostics) is necessary to identify the gaps, risks and opportunities for financing climate and sustainable development solutions early on and generate demand for financing both Paris- and SDG-aligned activities.

An integrated mission to support country transitions to low-carbon and resilient development paths. Aligning the institutional strategic goals of MDBs would help prevent these considerations being sidelined in implementation. Integration should be pursued at three levels:

1. *Institutional strategic goals that explicitly state how they contribute to the integrated mission.* By making this case clear and explicit, the bank signals there is a shared understanding of these dimensions being mutually reinforcing. This helps to internally to mainstream climate and development considerations into economic and financial thinking, to generate the knowledge, coherent project design—and externally, to communicate that the three dimensions are intertwined in the shareholders' vision, the potential for synergies stand out and guide decision-making. To make this signaling concrete, strategic portfolio targets can be set that focus on cross-cutting themes to support the integrated framework.
2. *Country-level strategies and targets.* Understanding and recognition by recipient countries of how they benefit from this integrated set-up, are a condition for success. Showing the existing gaps, opportunities, costs and benefits from Paris- and SDG-alignment will build support from the demand side. Shared diagnostics between countries and MDBs of sustainable country-level development pathways are needed (NDCs,[74] CCDRs, NAPs, LTSs, when these exist), to ensure consistent support by MDBs and progress by countries towards the longer-term development and climate country goals. Diagnostic tools to inform country priorities and project design should be shared across the MDB system—as a global public

73 "New Climate Economy."

74 Taryn Fransen et al., "The State of Nationally Determined Contributions: 2022" (World Resources Institute, October 19, 2022), https://www.wri.org/research/state-nationally-determined-contributions-2022.

good, to base each MDBs' decisions on a common understanding of the specific country context and challenges at hand.

3. *Measurement consistency throughout the system.* Harmonized Paris- and SDG-alignment and results frameworks should be used across the MDB system. These guide the investment with the external counterpart (public or private partner) throughout the project's cycle. Ex ante assessments allow for early identification of gaps, risks and opportunities to influence the selection and design of projects from early stage on. Expected outcomes are monitored throughout the project cycle, and course-corrected by interlocking with overarching strategies and targets. The ex post assessments are essential to learn from one project or intervention to the next. Sharing data, economic models and impact assessment methodologies across MDBs would alleviate capacity constraints and the additional burden on staff; and technology will increasingly prove useful in gathering the evidence to report on impact.

Adopting MDB-generated shared principles and metrics across public and private finance actors on which investments are Paris-aligned and SDG-aligned would considerably reduce the barriers to investing and the asymmetry of information about the risks and quality of projects. The results and impact using such common principles and metrics[75] would be evaluated by decision makers based on independent and transparent tracking and evaluations with governance and transparency at the institutional level. Paris-alignment will likely require ratcheting up mechanisms that will support specifying the metrics—allowing for getting the direction right at first, and then becoming more specific and targeted within sectors to attain specific goals.

More effective MDB governance, including across the system

MDB governance structures need to be adapted to the integrated mission and approach, particularly the emphasis on collective action to produce outcomes. That means that MDB Executive Boards need to focus more on the performance of individual MDBs in achieving outcomes at the country, regional, and global levels. Individual project approvals now take up most of Board members' time. But Boards do not have the information and analysis necessary, or even a strong mandate from their capitals, to assess whether the individual projects are driving success at the country level and beyond, and whether the interventions are cost effective in the aggregate.

But the integrated mission also clearly points to a missing piece of global architecture: a means of assessing the performance of the system as a whole. This CGD paper proposes the creation of a

75 On this, see the paper on "Aligning financial intermediary investments with the Paris Agreement", by World Resources Institute, GermanWatch, and New Climate Institute, which outlines a guidance for how MDBs could align their Financial Intermediary investments with the Paris Agreement.

collective MDB oversight body to monitor collective action performance.[76] To better fit the financial model proposed in this paper, such a body could:

1. Set and oversee achievement of aggregate MDB targets for climate and development outcomes and finance.
2. Mandate risk-sharing across MDBs and shared access to concessional finance for boosting operations in difficult and vulnerable environments.
3. Promote harmonization of MDB climate investment processes and shared transaction costs to scale the pipeline of investible projects and the size of the investments possible.
4. Drive the pooling of MDB climate-related assets to attract large-scale institutional investors.
5. Assess collective MDB capital adequacy, capital efficiency, and finance capacity for climate-related and development-related finance, to increase the coherence of the MDBs as a whole system.

There are alternatives for the composition of such a body. But one objective must be paramount: better representation of countries, including climate-vulnerable countries, than they now have in the G20. Countries that have a critical role and interest in investing in mitigation, adaptation, and resilience need a meaningful voice in shaping how MDBs support them.

A clear division of responsibilities between the Board of Governors, Executive Directors, management, and staff, and mechanisms designed to associate other development or financial partners and stakeholders to decisions could be envisaged, which would enhance accountability as well as coherence, but go beyond the scope of this paper.

Conclusion

This paper advocates fundamental changes in what MDBs do and how they do it, while seeking to preserve what is most valuable in the MDB model. It advocates an MDB approach driven by outcome targets for selected development and climate priorities, under country strategies that include both country commitments and MDB commitments for finance and other support. The paper de-emphasizes traditional MDB policy conditionality. It defines MDB success in more attainable and demonstrable sectoral outcome terms. It suggests more focus, especially for middle-income countries, on improving market borrowing terms for SDG investments rather than only on maximizing the volume of borrowing from MDBs. And it seeks to refocus private finance activities and instruments on where capital market gaps are most binding and build sustainable investment portfolios and partnerships at scale with a broad range of institutional and more risk-tolerant private investors.

76 Nancy Lee and Mauricio Cardenas Gonzalez, "Forging an MDB System: Strategy and Governance" (Center for Global Development, April 2021), https://www.cgdev.org/sites/default/files/Forging-mdb-system-strategy-and-governance.pdf.

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