Boosting MDBs' investing capacity

Takeaways from the G20 independent Review

Management Solutions
Making things happen

1 Executive summary
Multilateral Development Banks' Capital Adequacy Frameworks

Five broad challenges to improve the capital adequacy of multilateral development banks that would enable a more efficient deployment of shareholder resources

Context

- In 2022, the G20 convened a, Expert Panel to provide **credible and transparent benchmarks on how to evaluate MDB Capital Adequacy Frameworks (CAF)**, enable shareholders, MDBs and Credit Rating Agencies (CRAs) to develop a consistent understanding and enable shareholders to consider potential adaptions to maximise the MDBs' financing capacity.
- As a result, the Expert Panel has produced a report[1] where outlines **five broad areas** where they see opportunities **to improve MDB capital adequacy** and related policies to allow them to most efficient use of the scarce public resources.

Objectives of the report

- **A** Provide credible and transparent **benchmarks** on how to evaluate MDB CAF
- **B** Enable shareholders, MDBs and CRAs to develop a **consistent understanding** of MDBs CAF
- **C** Enable shareholders to consider **potential adaptations** to the current frameworks in order to maximise the MDBs' financing capacity

Challenges

1. Redefine the approach to **Risk Appetite** in CAF
2. Incorporate uplift from **Callable Capital** into MDB CAF
3. Implement **innovations** to strengthen MDB Capital Adequacy and Lending Headroom
4. Assess **CRA Methodologies** and engagement
5. Improve the enabling environment for Capital Adequacy **Governance**

Risks & Mitigations

1. Boosting MDBs' investing capacity. (2022). An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks

2 Distinctive features of MDB capital adequacy frameworks

Main characteristics

MDB CAFs have broadly the same objectives and same fundamental components as those of other financial institutions. However, there are also differences between MDB CAFs and commercial banks that add to MDB capital strength

Distinctive features of MDB capital adequacy frameworks	
Self regulation	• MDBs are not subject to regulation or supervision. • MDBs develop their own **technical variants of the Basel framework** when calculating their minimum capital requirements, and their CAFs are governed by their Boards.
Policy relevance	• MDBs play a significant role as policy tools, enabling shareholders to **leverage scarce fiscal resources** for development, tacking **climate** and **other public goods** and responding to crisis. • As a result, shareholders are likely to **support** the MDBs **in stress situations**.
Preferred creditor status	• Due to the unique nature of MDBs, borrower governments have generally granted MDBs preferred creditor treatment (PCT); this means that they will continue to repay MDBs even if they go into **default or delay** repayment to other creditors • Private sector MDBs are also expected to benefit from **PCT in convertibility and transferability preference**
Callable capital	• Callable capital shares **vary** enormously by **institution.** • **Valuing** callable capital is **fraught** in part because it has never been utilized by the main MDBs;10 it only comes into play during MDB insolvency scenarios, for which there is no precedent
Exposure concentration	• MDBs lending mainly or entirely to governments have loan portfolios that are structurally concentrated in a **small number of borrowers.** Valuating how much penalty risk capital an MDB should carry as a result of this concentration is unclear.
Centrality of ratings	• **AAA credit ratings** from all the major CRAs **are the explicit goal** of most MDB CAFs. These ratings **anchor** the • **risk tolerance**. As a result, the design and clarity **of rating agency frameworks** are **unusually important** factors when considering how MDBs manage their capital adequacy
Business model	• **MDBs** default approach is to **fully fund and hold loans to maturity**. • In recent decades, MDBs have also experimented with **co-financing alongside private capital** and innovations such as risk transfers and new classes of capital, **but these efforts remain a relatively small percentage** of aggregate project funding by MDBs and are mainly conducted by their private-sector arms.

3 Challenges and Policy Options for MDB Capital Adequacy

Redefine the approach to Risk Appetite in CAF

1

Shareholders want MDBs to have ready **access to low-cost funding**. They also want MDBs to **maximize development impact.** Nearly all MDBs have **policies binding** them to a **top bond rating with the major rating agencies** which can lead them to build excessive buffers to cope with uncertainty and widely divergent criteria in the three rating agency methodologies

	Recommendations	Approach & Tools	Benefits	Addressed to	Complexity	Time frame
1A	Define MDB risk appetites **prioritizing shareholder-specified limits**	• **Alignment** with shareholders' guidance on **operational priorities** and **strategies**. • **Anchor capital adequacy in internal frameworks** and shareholder-defined risk appetite. • **External rating agency assessment taken into account in calibrating MDB policy**	• Help **modernize and rationalize analysis** and debates around risk, capital and lending capacity • More **realistic decision-making** on MDBs' ability to implement shareholder mandates	MDBs shareholder		1-2 years
1B	Ensure that MDB capital adequacy frameworks account adequately for **PCT and the concentrated nature** of MDB portfolios	• Methodologies used by credit rating agencies underestimate the benefits of PCT and overestimate risks posed by concentration risk. • MDB **capital adequacy** approaches as well as **credit rating methodologies would benefit** from a **more uniform approach** to understanding the portfolio risk implications of PCT and concentration risk.		MDBs		1-2 years
1C	**Relocate specific numeric leveraging targets** from MDB statutes to MDB capital adequacy framework	• The **simplistic approach** of **MDB statutory limits**, set decades ago**, is not an appropriate hard limit** on the capital adequacy of MDBs today. • **Updating** of MDB statutes in light of modern financial practices and a streamlining of the framework around MDB capital adequacy.		MDBs shareholder		> 2 years

(1) PCT: Preferred Creditor Treatment

Incorporate Uplift from Callable Capital into MDB CAF

Most MDBs have very large amounts of callable capital in their capital structure. The Expert Panel recommends MDBs to consider callable capital as a specialized type of shareholder guarantee that creates a certain amount of capital headroom

Credit rating agencies incorporate a portion of callable capital in evaluations of MDBs such that it can raise an MDB's 'issuer rating' above its 'intrinsic' or 'standalone' rating. B contrast, MDBs generally do not include callable capital in their capital adequacy frameworks.

	Recommendations	Approach & Tools	Benefits	Addressed to	Complexity	Time frame
2A	**Incorporate a prudent share of callable capital into MDBs' own calculation of capital adequacy**, following the approach validated by all three credit rating agencies	• **Consider callable capital** as a specialized type of shareholder guarantee that creates a certain amount of capital headroom. • **Incorporate callable capital financial value into CAFs** in a consistent, rational and prudent way.	• **Take advantage** in a prudent manner of the callable capital	MDBs CRAs Shareholders		1-2 years

3 Challenges and Policy Options for MDB Capital Adequacy (1/2)

Implement Innovation to Strengthen MDB Capital Adequacy and Lending Headroom

The Expert Panel has explored innovations that MDBs could use to expand lending capacity without modifying MDB capital adequacy frameworks themselves

	Recommendations	Approach & Tools	Benefits	Addressed to	Complexity	Time frame
3A	Endorse MDB consideration of **non-voting capital classes** (paid-in equity or hybrid) to contribute to available capital	• **G20** could develop **guidelines** with the specific requirements that these instruments should met. • MDBs should **report** to the G20 by 2023 on the results of their considerations of non-voting capital and provide actions plans to Boards and shareholders.	• **Non-voting shares** is a scalable technique to build a useful capital cushion and crowds in capital from private sector	MDBs CRAs Shareholder		1-2 years
3B	**Scale up the transfer of risks** embedded in MDB loan **portfolios to private sector** counterparties by accelerating the development of funded and unfunded instruments	• **G20** should develop **guidelines** supporting risk transfers.	• **Portfolio risk transfer mechanisms** with commercial counterparties can be implemented flexibly on very different scales (e.g. country/sector level, originate and distribute model)	MDBs shareholder		1-2 years
3C	**Encourage shareholder guarantees** of sovereign repayments to cross-cutting priorities	• **Contract provisions** defining the terms would be more predictable than callable capital, enhancing the value of the guarantee. • **Highly rated non-shareholders** could also deploy **similar** portfolio **guarantees** for **activities of interest**.	• **A guarantee facility** for MDB loans could substantially reduce risk capital usage, free headroom and bolster credit ratings with little paid-in capital	MDBs shareholder		1-2 years

3 Challenges and Policy Options for MDB Capital Adequacy (2/2)

Implement Innovation to Strengthen MDB Capital Adequacy and Lending Headroom

The Panel has explored innovations that MDBs could use to expand lending capacity without modifying MDB capital adequacy frameworks themselves

	Recommendations	Approach & Tools	Benefits	Addressed to	Complexity	Time frame
3D	Support collective shareholder commitments of **temporary pools of callable capital** to help MDBs mount strong countercyclical responses in periods of global or regional crisis	• The G20 should call on shareholders to **make or pool commitments** to create temporary callable capital buffers for countercyclical purpose. • MDBs' Managers should develop actions plans to **set up buffers by 2023**.	• **Temporary callable capital** can offer a useful boost to surge capacity during regional or global crises or to support general lending when MDB ratings are under pressure.	Shareholder	■□□□□□	1 year
3E	Call on MIGA and MDBs to collaborate on transferring portfolio risk from MDB balance sheets through **MIGA´s insurance** products and reinsurance capability	• MDBs and MIGA[1] should proactively **pursue partnership opportunities** for mutual benefit.	• MIGA can help MDBs **address concentrations limits** and make more projects bankable.	MDBs shareholder	■■□□□□	1-2 years
3F	Explore ways of providing MDBs with **access to central bank liquidity**	• **Pooled agreements,** under the **supervisory umbrella** of one central bank.	• **Liquidity lines** are useful in helping MDBs manage specific target metrics and provide comfort that liquidity will be available during market stress.	Shareholder	■■■■■□	> 2 years

(1) MIGA: Multilateral Investment- Guarantee Agency

Assess CRA Methodologies and engagement

The Panel has developed recommendations that can play a useful role in improving communication and understanding between ratings agencies, MDBs and shareholders

	Recommendations	Approach & Tools	Benefits	Addressed to	Complexity	Time frame
4A	**Strengthen communication** of G20 members and other shareholders **to inform rating agency views** of MDBs with respect to the importance of MDBs and shareholder support	• G20 governments and top MDB management should consider **regular, ongoing engagement** with upper-level management of ratings agencies.	• **Modifications to specific metrics** used in rating agency methodologies, notably PCT and concentration risk, could potentially **boost lending space substantially**, particularly for MDB sovereign lending.	MDBs Shareholders	1 of 6	<1 years
4B	**Rating agencies** can take steps to **strengthen** their MDB **evaluation methodologies**	• **Reduce the thresholds** (particularly of leverage and liquidity ratios) to achieve top ratings. • **Review the weighting** of non-risk- based metrics (leverage ratios) , structural concentration and inherent MDB strengths like PCT. • **Better factor** in the countercyclical mandate of the MDBs • **Reconsidering the portion of callable capital factored into** rating methodol. • **Increasing transparency** of professional judgement.		CRAs	2 of 6	1-2 years
4C	Rating agencies and MDBs should work together to **develop common standards for evaluating** the risk weights of **ESG-related assets** on MDB balance sheets.	• **Developing common standards** for MDB ESG assets in close dialogue with rating agencies.		CRAs	1 of 6	> 2 years

3 Challenges and Policy Options for MDB Capital Adequacy

Improve the Enabling Environment for Capital Adequacy Governance

5

The Panel has identified several ways to strengthen channels of responsibility and communication coupled with more systematic exchange of data and information

<table>
<tr><th></th><th>Recommendations</th><th>Approach & Tools</th><th>Benefits</th><th>Addressed to</th><th>Complexity</th><th>Time frame</th></tr>
<tr><td>5A</td><td>Consider implementing measures to strengthen shareholders´ ability in setting parameter of risk appetite and capital adequacy policies and overseeing their implementation</td><td>• Inclusion of independent, non-executive and non-voting board members with expertise in risk and audit functions.
• Better separating the roles and responsibilities of executive management and the shareholder board.</td><td rowspan="4">• Improve the quality of discussions and decision-making on capital adequacy, lending capacity and financial risk
• Help MDBs make better use of data to refine internal models
• Engage more effectively with ratings agencies
• Improve MDBs ability to mobilize private sector resources for development goals</td><td>MDBs shareholder</td><td></td><td>< 1 years</td></tr>
<tr><td>5B</td><td>Prepare regular capital benchmarking reports employing harmonized definitions and support regular reviews of capital resources</td><td>• Regular capital benchmarking report in a standardized format, that might be combined with balance sheet optimization.
• Instituting regular capital resources reviews, which would allow to consider capital situation and set it against strategy in a deliberate manner</td><td>MDBs shareholder</td><td></td><td>< 1 years</td></tr>
<tr><td>5C</td><td>Establish enhanced arrangements to promote benchmarking, share best practices and facilitate discussion among MDBs and shareholders</td><td>• Create enhanced arrangements (e.g. MDB Forum on Financial Best Practices) to collect and curate the benchmarking information and prepare joint. reports, train new executive directors, promote dialogue and exchange of views between MDBs and rating agencies,…</td><td>MDBs shareholder</td><td></td><td>< 1 years</td></tr>
<tr><td>5D</td><td>Endorse and support ongoing efforts to transform GEMs[1] into a stand-alone entity to curate and disseminate regularly-supplied MDB statistics on emerging market risks for MDBs, private investors and rating agencies</td><td>• Transforming GEM into a stand-alone entity with strong governance, management and sustainable funding, including an independent chief operating officer supported by MDB contributing members.
• MDBs need to commit to contributions of data with appropriate protections for transaction anonymity.</td><td>MDBs shareholder</td><td></td><td>1-2 years</td></tr>
</table>

(1) GEM: Global Emerging Markets Risk Database

Risks and Measures to Mitigate these risks

The Panel identified several risk linked to the proposed challenges and defined related mitigation actions

Challenges	Risks	Mitigation actions
1 & 2	• **Potential downward pressure** on the rating of MDB bonds by one or more credit rating agencies.	• **Statements by the G20 and other shareholders** that changes are fully supported and that they stand behind their callable capital. • **Prudent approach** to recognizing the benefit of callable capital in recalibrating risk appetite and capital adequacy models. • **Undertake reforms** in a coordinated fashion across multiple MDBs. • **Publicly releasing analysis** of MDB portfolio performance to demonstrate impacts of preferred creditor status and concentration risk.
3	• Innovations can **dilute shareholder focus on reforms** to core risk appetite and capitalization. • Potential **impacts on MDB net income** and project origination • Scaling up innovations substantially could **weaken how MDBs are perceived**.	• **Undertaking innovations** as part of a broader set of reforms including a thorough examination of risk appetite and capital needs. • **Instituting strong internal controls** on project origination to ensure consistency with their strategies and shareholder priorities, as well as a careful evaluation of financial implications for MDBs and borrowers. • Limiting the scale of innovation on sovereign lending, maintaining a substantial financial stake in each transaction and maintaining the focus on country ownership of MDB lending programs.
4	• Enhanced dialogue with rating agencies may create **confusion with the bilateral engagement** taking place as part of the rating process.	• **Phased rollouts** and ongoing revision..
5	• An excessive push to standardization could result in **misleading comparisons** across MDBs.	• **Working together** on a like-for-like basis is outweighed by the many benefits of better informing shareholders on capital adequacy issues.

Why Management Solutions?

MS has extensive experience with supervisory bodies and financial institutions (with a focus on commercial banks but also MDBs) in the fields of risk and capital management

1. **Experience with supervisory bodies.** MS is a "highly rated external service provider" in internal capital models by different European and American Supervisors.
2. **Regulatory modelling.** MS has extensive experience in modelling: (i) credit risk (IRB, IFRS 9 & CECL, stress testing, others), (ii) market risk, CCR and IRRBB (VaR, pensions, xVA); (iii) ALM and liquidity; (iv) residual value; and (v) economic capital, among others.
3. **Independent validation**. MS collaborates with different institutions as an independent supervisor of internal models, verifying compliance with regulatory requirements to obtain approval from regulators.
4. **Experience in the design and implementation of capital calculation engines.** MS has extensive experience in supporting institutions in the design and implementation of capital calculation and reporting solutions (including our proprietary MIR and SIRO tools, already adapted to BIS IV), as well as in the execution of capital impact analysis exercises, optimisation...
5. Other relevant fields of knowledge: **Risk governance, Risk framework (including Risk Appetite Framework), Risk Reporting and Capital Optimization**.
6. **Specialised team.** MS has a team of more than 1,000 experts in the field of risk and capital management (modelling, regulation, impacts, information systems, reporting...), combining quantitative and technical expertise with strong regulatory knowledge.
7. **R&D**. MS also has a Research and Development area that provides support to the entire Firm and regularly publishes white papers on multiple domains, regulatory notes as well as macroeconomic outlook reports of the main countries where MS develops its activity.
8. Member of the **Social Impact Chair** and the **Hydrogen Chair** of internationally renowned universities to promote training, development of social impact measurement methodologies as well as new business models based no hydrogen.

Annex. List of abbreviations

Abbreviation	Meaning
CAF	Capital Adequacy Frameworks
CRA	Credit Rating Agencies
ESG	Environmental, Social and Governance
EBA	European Banking Authority
ECB	European Central Bank
IRRBB	Interest rate risk in the banking book
IFRS	International Financial Reporting Standards
IRB	Internal ratings-based
MIGA	Multilateral Investment Guarantee Agency
MDB	Multilateral Development Banks
PCT	Preferred Creditor Treatment

International
One Firm

Multiscope
Team

Best Practice
Know-How

Proven
Experience

Maximum
Commitment

ManagementSolutions
Making things happen

José Luis Carazo
Socio
jose.luis.carazo@managementsolutions.com

Marta Hierro
Director
marta.hierro@managementsolutions.com