



Six proposals to strengthen the finances of multilateral development banks

Chris Humphrey

Key messages

- Multilateral development banks (MDBs) are running up against financial limitations that will impede their ability to help achieve the Sustainable Development Goals.
- Shareholder appetite to increase MDB capital is uncertain at best, particularly in the US, despite the fact that MDBs are extremely cost-effective compared to other development assistance providers.
- A capital increase is still a top priority, particularly for the World Bank and the African Development Bank (AfDB), despite the political complexities involved.
- Reforming MDB capital adequacy and pushing ahead with balance sheet mergers at the World Bank and AfDB could reap substantial gains in financial capacity, as can a package of measures to boost MDB net income.
- More creative financial engineering could help at the margins but will not have a substantial impact, while reforms to callable capital face technical and political hurdles.

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Introduction

The arrival of the new US administration has been a harsh reality check for many in the international development community. The US role in global cooperation has been problematic for years, to say the least – think of the tortuous politics of the recent International Monetary Fund (IMF) quota reform. But the new administration’s ‘America First’ mantra and its vocal scepticism about international engagement takes this to another level altogether.

This is a particular concern right now for the World Bank and major regional multilateral development banks (MDBs). In recent years, heeding the calls of the G20 and their country shareholders, MDBs have ramped up lending to address the impacts of the global financial crisis, reach the Sustainable Development Goals (SDGs) and make the sustainable infrastructure investments required to keep pace with economic growth.

Like all financial institutions, though, MDBs can only lend a certain amount based on their capital, and the available ‘headroom’ is narrowing. At least two of the MDBs – the World Bank’s main lending window, the International Bank for Reconstruction and Development

(IBRD), and the African Development Bank (AfDB) – will start to bump up against their capital adequacy limits in 2019 or 2020, and have been preparing the ground to request a new round of capital contributions from shareholder countries. The situation is less urgent at the Inter-American Development Bank (IADB) and the European Bank for Reconstruction and Development (EBRD), although some shareholders and senior management in both (particularly the former) believe a capital increase is necessary to remain relevant.

In light of the new US administration’s attitude toward international engagement, a new round of capital increases for the MDBs looks complicated, to say the least. As a result, MDB shareholders, management and other stakeholders will be thinking hard in the coming months about what can be done to strengthen MDB capital foundations such that these institutions can continue as effective tools to achieve global development goals. This paper evaluates **six options to strengthen MDB capital adequacy**, in order of their potential financial impact as well as their political and technical viability (Table 1).

Table 1. Options to strengthen MDB capital adequacy

	Financial impact	Political support	Technical viability	Realistic time frame
General capital increase	Very high (one-time)	High, apart from US	Very high	2018-2019
Reform capital adequacy	Very high (sustained)	Very high	Medium (depends partly on rating agencies)	2018
Balance sheet merger at World Bank and AfDB	High (one-time)	High	Medium	2018-2019
Net income reform	High (sustained)	Medium to high (depending on reform)	Very high	2017-2018
Balance sheet optimisation	Modest	Very high	Medium	2017 onward
Callable capital reform	Uncertain	Low to medium	Low to medium	2018 earliest, probably later

1. Push ahead with preparations for a general capital increase

Despite political difficulties, convincing shareholders to contribute further capital to the MDBs remains a top priority, particularly for the World Bank and the AfDB. While other measures can build MDB capacity, a general capital increase (GCI) boosts resources in the most direct and emphatic manner possible, which strengthens the perception of MDBs among the investors they depend on for operating resources. As part of GCI negotiations, shareholders should insist on further measures by MDBs to make better use of resources, including balance sheet optimisation and techniques to build their own resources going forward (more on these below).

Unfortunately, the prospects for a general capital increase at any of the major MDBs are uncertain at best in the near term, mainly because of potential US opposition. Barring a sudden sea change in attitude, the new administration is not likely to go to bat in Congress for an increase in its capital shares at the MDBs at a time of substantial proposed cut-backs to US discretionary spending. Although the administration has yet to make a public statement on capital increases at the MDBs, it did call for a \$650 million reduction in annual funding for MDBs (most of which is resources dedicated to the poorest countries) as part of its proposed budget.¹ A further ominous sign came in late March 2017 with the nomination of Adam Lerrick, a long-time critic of the World Bank, to serve as assistant secretary for international finance at the Treasury.²

It would be unfortunate for the US if it backed away from the MDBs, as they are a very cost-effective way of achieving development goals beneficial to US geopolitical interests. MDBs have a powerful financial model that channels private investor resources to development projects that promote social stability and increase economic opportunities, at a very low cost to shareholders. For example, member countries have invested a grand total

of \$15.8 billion of their own capital (\$2.9 billion by the US – just one-tenth the *annual* budget of USAID) in the World Bank's IBRD over the past 70-odd years. With that, IBRD has lent at least \$658 billion,³ plus donated several billion more in profits to help the poorest countries, and at the same time covered the costs of building the most comprehensive body of global development knowledge, data and technical advice in existence. The most recent IBRD GCI in 2010 cost the US only \$173 million a year for five years – remarkably little for IBRD's role in furthering US interests in global stability and economic growth.

If the US is unconvinced and does not contribute to a GCI at the MDBs, is it still possible for a GCI to go ahead? Technically, in most cases the answer is yes. Only at the IADB does the US by itself have sufficient voting power to formally block a change to the capital structure. However, the US has traditionally had no difficulty in assembling a coalition of allies to support its position, such that it effectively can wield veto power over capital changes at all the major MDBs. Moreover, as one G20 official put it in a recent interview, 'If it's clear that there's no appetite from the largest shareholder [the US], there's enough other shareholders unconvinced of the need to stop this going forward.'⁴

The US could allow a GCI to go ahead and simply not contribute itself, but that would mean a decrease in US voting power relative to other shareholders – not something the US has historically been inclined to accept. The capital structure of all the major MDBs has been held hostage by a combination of US unwillingness to either contribute capital or give up voting power. This goes a long way to explaining the eagerness of China and other emerging nations to create the Asian Infrastructure Investment Bank and New Development Bank.

1 See Bloomberg (2017).

2 See Financial Times (2017).

3 Loan commitments in unadjusted US dollar terms.

4 Anonymity requested.

Regardless of US attitudes, other shareholders should continue to build consensus towards GCIs. This will strengthen the case for asking the US to abstain from blocking a GCI, or to consider more creative options like finding ways to maintain US voting power while allowing

some shareholders to contribute capital. Alternatively, in the event that the US turns decisively away from international engagement, it may consider diluting its voting power by allowing a GCI to move ahead even though it does not contribute.

2. Reform MDB capital adequacy metrics

Another way to boost MDB capacity is to loosen rules on how they deploy their capital – that is, lend more based on a given amount of shareholder capital. Access to bond markets underpins the MDB financial model, and having the confidence of bond investors has always been a top priority. MDB management as well as some shareholders have been wary of any move that might threaten their all-important AAA bond rating,⁵ which allows them to raise resources very inexpensively even in times of global crisis, thus strengthening their development impact. Despite this legitimate concern, MDB financial management has been unjustifiably conservative, in light of their superlative loan portfolio performance and bond repayment record. Loosening capital adequacy requirements would open up space for hundreds of billions of dollars in additional loan portfolio size, without threatening the very strong financial stability of MDBs.

The problem is, no one is sure just how much capital is necessary to preserve a AAA rating. This is a difficult question to answer for MDBs, because of their unique characteristics and the fact that, unlike private financial institutions, MDBs have no regulator.⁶ As a result, shareholders, MDB staff and bond rating agencies all have different ideas about MDB capital adequacy. Shareholders would like to see their capital work harder, but because MDB finance and risk departments manage their own interactions with bond markets and credit rating agencies, they tend to favour cautious financial policies.

In former decades, the main metric by which MDBs measured their financial capacity was the statutory requirements written into their articles of agreement. For the World Bank and four regional MDBs, the statutory requirements are the same: the total of outstanding financing (mainly loans) cannot exceed the total of subscribed capital plus reserves. That worked well in years past, but not anymore. The bulk of subscribed capital is actually not real cash, but a type of shareholder guarantee known as callable capital. Nowadays, capital

market players do not consider callable capital to be ‘real’, and instead focus on MDB shareholder equity (paid-in capital plus reserves). The statutory requirements have thus become a vestige of another era, leading shareholders to commit more and more callable capital that is of questionable real value – shareholders assume it will never be actually called (it never has). Statutory capital requirements should be abolished or thoroughly revised as a first step towards making capital adequacy measurement more rational.

The main metric now used by MDBs to judge how much they can lend is the ratio between their shareholder equity and their outstanding loan portfolio – the E/L ratio. The World Bank’s IBRD formally uses the E/L as the key variable underpinning its financial policy, with a floor currently set at 20%. In other words, for every \$1 in shareholder equity, IBRD can currently hold a maximum \$5 in outstanding loans. Comparing E/L ratios for different MDBs, it is striking how well capitalised they appear to be compared to the World Bank (Figure 1), and even more so compared to private financial institutions, which typically have E/Ls in the 10% to 15% range.

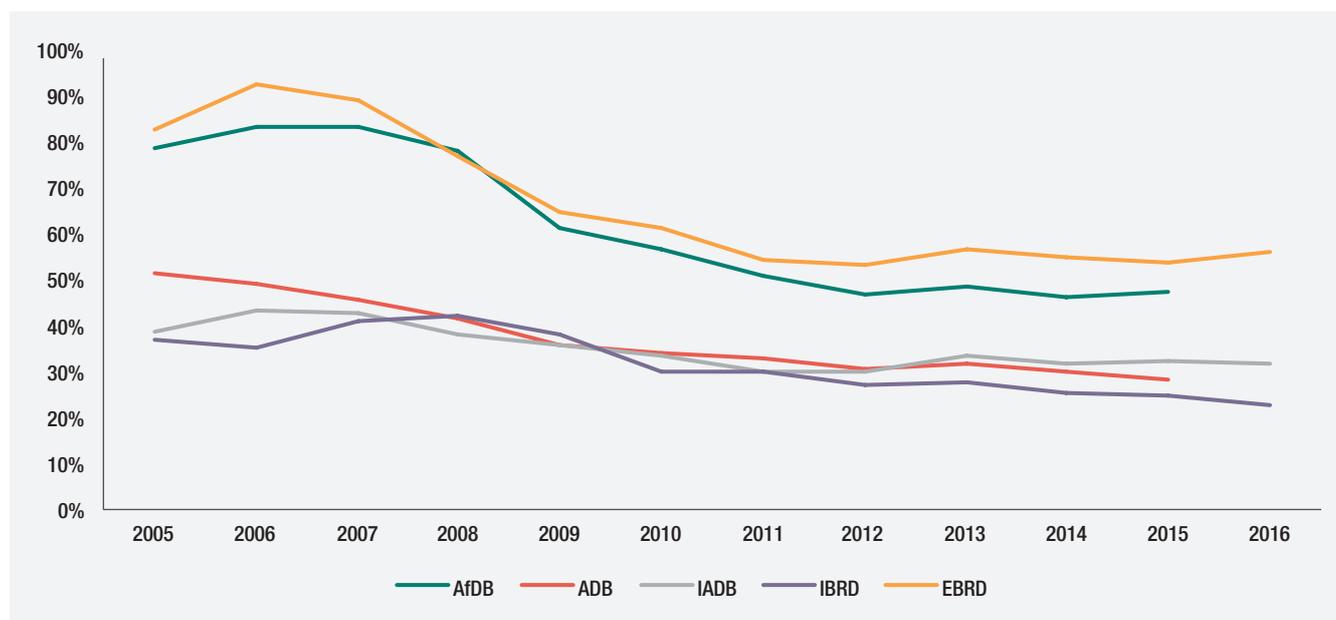
All else being equal, a higher E/L ratio implies that shareholder resources are being leveraged less to support development projects. It should come as no surprise that shareholders have encouraged MDBs to use equity more aggressively, rather than asking for another capital increase. E/L ratios have declined steadily in the past decade, and the World Bank recently lowered its E/L floor level from 23% to 20%. Just bringing the other MDBs down to the level of IBRD’s 20% would open space for an additional \$200 billion in outstanding loans, while bringing all MDBs down to 15% – still quite conservative, particularly in light of the extremely strong repayment record of MDB loans⁷ – would result in an additional \$380 billion. Analysis done within the G20 working group on international financial architecture in late 2016 found that the World Bank and four regional MDBs had ‘headroom’

5 The trade-offs of one of the major MDBs going sub-AAA have never been thoroughly explored outside MDB treasuries, and would be worth investigating. The case of CAF (Development Bank of Latin America) is suggestive: it has an AA– rating and lends as much or sometimes more than either the IADB or World Bank in its countries of operation. Out of 27 currently operating MDBs, eight have a AAA rating.

6 The only exception is the European Investment Bank, which is regulated by (and receives lender of last resort rights from) the European Central Bank.

7 This lower level may be less appropriate for the EBRD and International Finance Corporation (IFC) due to their riskier private sector exposure.

Figure 1. Equity-to-loan ratios, 2005-2016



Source: Own calculations based on MDB annual financial statements. 2016 data not available yet for the AfDB or the Asian Development Bank (ADB). Notes: Includes outstanding loans as well as guarantees and equity investments. The ADB's E/L will increase sharply and the IADB's modestly as of 2017 due to the completion of the concessional window mergers and resulting increase in shareholder equity. The EBRD's E/L ratio is relatively high, in part because it has a higher exposure to riskier private sector borrowers and equity investments compared to the other MDBs.

for an additional \$493 billion based on 2015 data, while still retaining an AAA rating.⁸

Part of the reason behind MDB financial conservatism is the evaluation methodologies used by credit rating agencies. In particular, Standard and Poor's (S&P) has since 2012 used a methodology that severely penalises MDBs for the fact that their loans are concentrated among just a few borrowers, even though that is exactly what MDBs are designed to do and how they have operated for decades. S&P also gives minimal credit for the fact that MDBs have a unique relationship with their borrowers quite unlike a commercial bank, resulting in a very well-performing loan portfolio. In short, S&P evaluates MDBs similarly to commercial banks, despite their substantial operational differences, official government backing and extremely strong financial track record.⁹ S&P has said that it will be reviewing its methodology for MDBs in 2017, but it remains unclear whether revisions, if any, would be more or less restrictive to MDBs.¹⁰

One way to ease fears of a downgrade would be to have an independent, qualified assessment of MDB capital adequacy and portfolio risk. An idea recently mooted by some G20 shareholders of hiring a consulting firm to do this might be useful, but the reality is that the findings would have limited credibility among external stakeholders, most notably bond buyers and credit rating agencies. A much better option would be for shareholders to task the Bank for International Settlements (BIS) to undertake a thorough evaluation of MDB capital adequacy – not in the capacity of a regulator (MDBs are owned by shareholders, who must always have the final say in how they are run), but rather as an objective and respected third party. Due to its role in overseeing the global financial system, BIS is the obvious candidate. The results of such an evaluation would give shareholders another reference point beyond MDB staff and rating agencies, and could influence rating agencies to revise their currently misguided and punitive MDB evaluation methodologies.

8 \$324.6 billion for IBRD, \$90.5 billion for ADB, \$30.8 billion for the EBRD, \$29.2 billion for the AfDB and \$18 billion for IADB.

9 For a detailed analysis, see Humphrey (2015).

10 See Standard and Poor's (2016).

3. Merge balance sheets at the World Bank and the AfDB

One dramatic recent initiative to maximise MDB financial capacity has been via ‘mergers’ of concessional and non-concessional lending windows. Concessional windows, like the World Bank’s International Development Association (IDA), are essentially very large trust funds supported by donations from wealthy countries to give grants or zero interest loans to the poorest countries. These funds do not achieve any financial leverage – donors give \$1, and the fund makes \$1 in grants or loans (or a bit less, after administrative costs). This compares to the main non-concessional windows, where shareholders contribute \$1 in capital and the MDB makes \$4 or \$5 in loans.¹¹ Merging concessional fund resources into the main MDB lending windows means that the donations can make use of financial leverage.

At the start of 2017, ADB completed the first of these operations with its concessional Asian Development Fund (AsDF), taking the AsDF’s outstanding loan portfolio of \$34.6 billion in assets and putting it into ADB’s reserves.¹² As a result, ADB’s equity nearly tripled from \$18.3 billion to \$53 billion, in effect a massive capital increase at no additional cost to shareholders. ADB projects an increase in regular lending by 40% to 50% in the coming years, and an increase in resources to the poorest countries by 70%, due to the ability to leverage AsDF’s equity. The effectiveness of this operation explains why ADB has no need for a GCI for the foreseeable future.

Following on this lead, the IADB has completed a merger of its concessional window, the Fund for Special Operations (FSO), also as of 1 January 2017.¹³ Discussions surrounding the merger were much faster, as ADB had already shown the way and the IADB used essentially

the same procedure. The impact was considerably less, however, as FSO had a much smaller outstanding loan portfolio of \$5.2 billion. Nonetheless, the resulting boost to equity was three times more than the IADB’s most recent GCI in 2010. The IADB is not using the additional equity to increase lending, but rather to relieve existing pressure on capital adequacy and build a buffer to be able to address potential future crises in member countries.

The World Bank’s IDA has the most financial potential from a balance sheet merger, based on its \$154.7 billion in equity (most of it in loans). A merger would boost IBRD equity from \$39.4 billion to \$194.1 billion,¹⁴ resulting in space for several hundred billion dollars more in potential loan portfolio size. However, shareholders instead decided as part of the IDA 18th replenishment round to permit IDA to get a bond rating and issue its own debt in capital markets as a way to raise resources and defray the costs to donors. IDA received an AAA bond rating from S&P and Moody’s in autumn 2016, and is expected to raise a total of \$16 billion in market debt issues over the next three years.¹⁵

Several reasons explain why the World Bank went down this route instead of a merger. The first and most important issue is legal. Unlike the concessional windows at the IADB and ADB, IDA is fully separate from IBRD and constituted based on its own international treaty agreement. Wealthy countries have a much higher ownership stake in IDA equity than at IBRD, due to their donations over the years. Merging the two windows would mean either increasing the voting share of wealthy countries at the new merged bank relative to borrower shareholders, or asking the wealthy countries to give up their ownership stake in IDA – both technically feasible options, but politically difficult.

11 For both concessional and non-concessional windows, this does not take into account further lending based on the initial loans being repaid.

12 See Asian Development Bank (ADB) (2015).

13 See Inter-American Development Bank (IADB) (2017: 3).

14 According to World Bank staff, the resulting equity boost to IBRD would be 25% to 30% less than nominal IDA equity, due to the way IDA loans would be valued in accounting terms, as required because IDA and IBRD are legally separate and would thus have to ‘sell’ the loans – an issue that was not relevant for ADB or IADB.

15 See World Bank (2016a: 59).

Additionally, the financial implications are less clearly beneficial. Most major Asian and Latin American countries had already graduated from the concessional windows of ADB and the IADB, meaning that the loan portfolio is higher quality and the need for continued concessional lending low and declining. The situation at IDA is quite different, as it supports many large low-income countries with continued major development needs, particularly in Africa. A merged IDA–IBRD loan portfolio would have a substantially higher risk profile than is the case at ADB and the IADB, and the financial dynamics of generating loan resources to address continued concessional needs, relative to the size of the non-concessional lending flows, are more complex. IDA loans are well below market rates at which a merged IDA–IBRD could borrow, and the present-value subsidy to cover the difference has to be paid out of the same funding pool.

The AfDB's African Development Fund (ADF) is in a similar situation to the World Bank's IDA, only more so. The legal and shareholding issues are the same, as ADF is formally separate from the AfDB. Furthermore, ADF borrower countries are even more concentrated in poorer countries with continued high borrowing needs compared to IDA, and the AfDB's non-concessional loan window has far fewer countries to lend to (only 17, compared to 37 ADF-eligible countries). The benefits of seeking a bond rating for a standalone ADF are less clear than at IDA, due to the stronger reputation of the World Bank among bond investors and rating agencies compared to the AfDB. ADF deputies opted to delay any decisions on a merger or bond rating at the most recent replenishment round in late 2016, but the two options remain under active consideration.

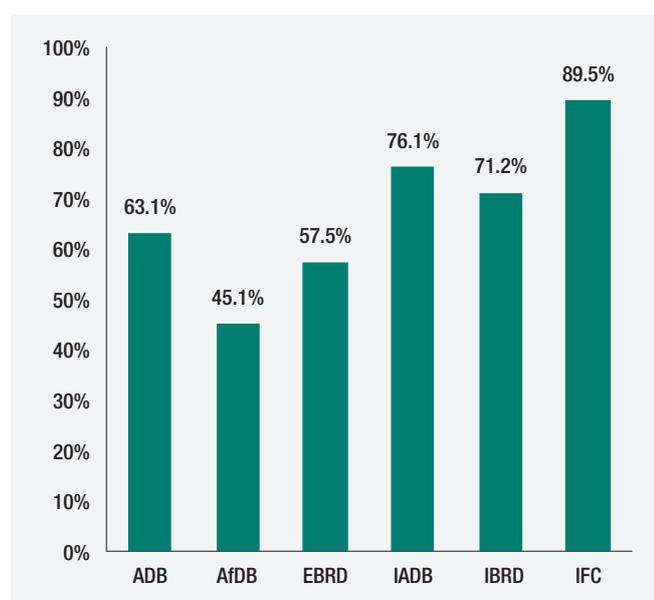
Despite the complexities facing the AfDB and World Bank balance sheet mergers, they are well worth pursuing. Obtaining a bond rating for IDA and ADF is a positive step, but the financial benefits are not as substantial as a merger and the move does nothing to address the capital constraints of the non-concessional windows. Further, if concessional windows depend increasingly on bond markets, they could feel pressured to lend in ways more appealing to investors rather than to achieve development goals. Transferring IDA's \$154 billion in usable equity to IBRD would be a tremendous boost to the merged institution's financial capacity, resulting in several hundred billion dollars in additional outstanding loan potential, even under conservative lending assumptions based on a riskier portfolio and the need to fund continued concessional loans. ADF's \$13 billion in equity would have less of an outsized impact on the AfDB, but would still be very significant.

One option for IDA and ADF would be a partial merger, wherein a portion of loans from the concessional window is shifted to the non-concessional window, while the concessional window continues operating to address the needs of particularly poor countries. Legal and shareholding issues would remain to be addressed, and would require compromises by donor countries for the good of the MDBs. One idea under consideration at the World Bank would be to transfer back all allocations taken from the net income of the non-concessional windows over previous years (see section 4). The financial impact would be relatively small – only \$4 billion in the case of IDA, and much less at ADF – but it would avoid some of the thorniest legal and financial problems of a larger merger.

4. Grow net income and eliminate shareholder allocations

The main financial variable used to assess MDB lending capacity is shareholder equity: paid-in capital from shareholders plus accumulated reserves. Thus, without more shareholder capital, the only way to grow equity is via reserves. MDB reserves already comprise a substantial share of equity, in some cases quite a bit more than paid-in capital (Figure 2). MDBs should grow reserves further by (i) reducing the very significant amounts of net income allocated each year by shareholders to special causes; and (ii) boosting net income through greater revenue generation and budget tightening. A compromise to combine these measures as part of an overall package to strengthen MDB equity could bridge longstanding disagreements between borrower and non-borrower shareholders on these issues.

Figure 2. Reserves as percentage of shareholder equity

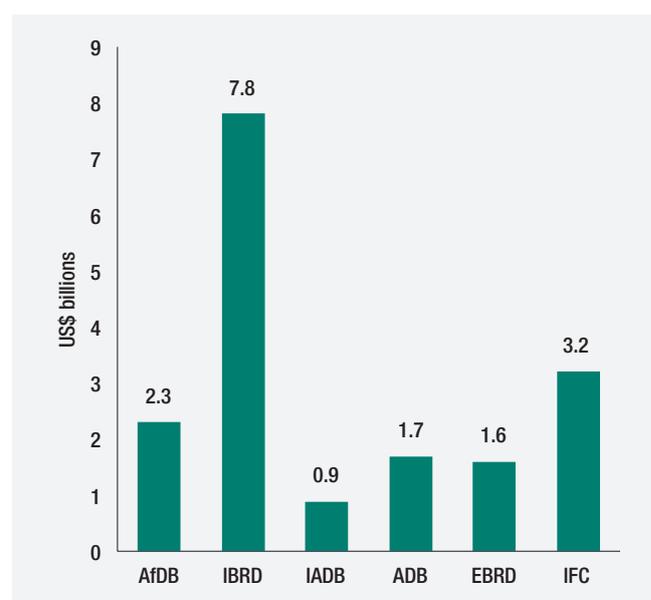


Source: Own calculations based on MDB financial statements, 2015.
 Note: EBRD data does not reflect that \$1 billion was taken from reserves and included in paid-in capital in 2012. Without that transaction, the EBRD's reserves would total 64.1% of equity in 2015.

4.1. Net income allocations by shareholders is a drain on MDB equity

A major reason that MDB equity growth via reserves is limited is because shareholders – particularly non-borrowing countries – have become accustomed to using net income as a convenient piggy bank to fund various causes, rather than paying out of their own government budgets. The sums of money are very significant (Figure 3), and could go a long way to addressing MDB capital constraints if they were put in reserves instead. By far the largest allocations are to support the poorest countries, either as contributions to the concessional window replenishment rounds or to special

Figure 3. Cumulative net income allocations to shareholder causes, 2005-2015



Source: MDB annual financial statements.

funds. This practice represents a transfer from middle-income countries to very poor ones to pay for programmes that were created by, and in former years entirely funded by, wealthy countries. IBRD contributions to IDA have totalled \$14 billion over the World Bank's history – almost the same amount of paid-in capital that shareholders themselves have contributed to IBRD since its creation (\$15 billion). Even more galling for borrowers is the use of IBRD net income to cover programmes linked to the geopolitical interests of the US and Europe, like the West Bank/Gaza or the reconstruction of the former Yugoslavia.

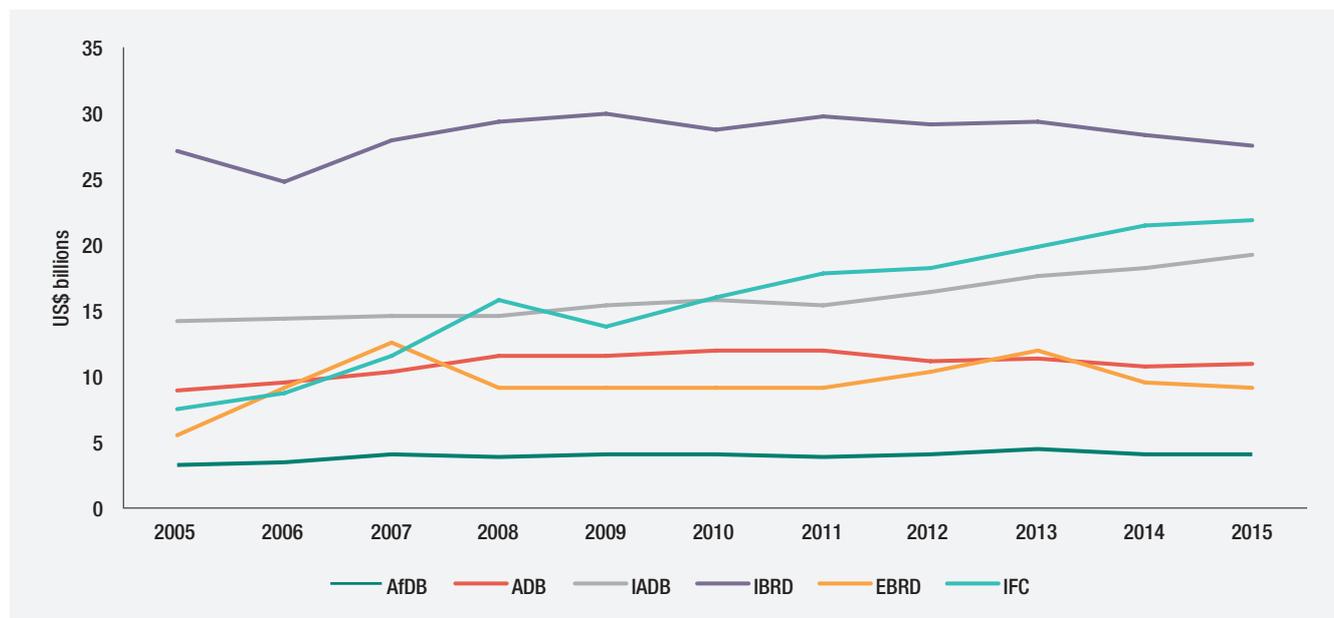
Borrower shareholders as well as some MDB managers argue that while these programmes are worthy causes, they should be funded by willing donors, rather than with resources extracted from MDBs in a manner that clearly goes against the spirit of their articles of agreement. If those resources had instead been put into reserves, MDB lending capacity would be much higher. For example, the \$7.8 billion allocated out of IBRD net income in the past 10 years is well above the \$5.1 billion capital increase agreed in 2010. Net income should be utilised only for purposes benefiting the cooperative itself – either building equity through reserves, or at most used for purposes directly related to the operations of the MDB, such as technical assistance and project preparation.

4.2. Boosting net income through revenue and budget measures

Reserve growth has plateaued at most MDBs, and even declined at a couple (Figure 4) – partly through the allocation issue discussed above, but also because of stagnating or declining net income in recent years. Net income is driven partly by global interest rates, and the current low rate environment has squeezed MDB lending margins, reducing loan income, and also brought down the income generated through investing MDB liquidity – a significant source of revenue for most MDBs.¹⁶ Other drivers of net income, however, are more amenable to influence through policy, and a package of measures should be considered to strengthen net income at the AfDB, ADB, IADB and IBRD. Net income measures are less pressing at the EBRD and IFC, which already generate substantial net income (return on equity 8% to 10% average, 2005-2015, compared to 2.5% to 4% at the other MDBs).¹⁷

Loan price increases is a policy tool favoured by most non-borrowing shareholders, but unsurprisingly opposed by most (but not all) borrowers. Loan pricing was increased at the World Bank in 2014 and the AfDB in late 2016, while the IADB raised prices in 2015 but brought them back down at the start of 2017. Views differ on how

Figure 4. Total financial reserves

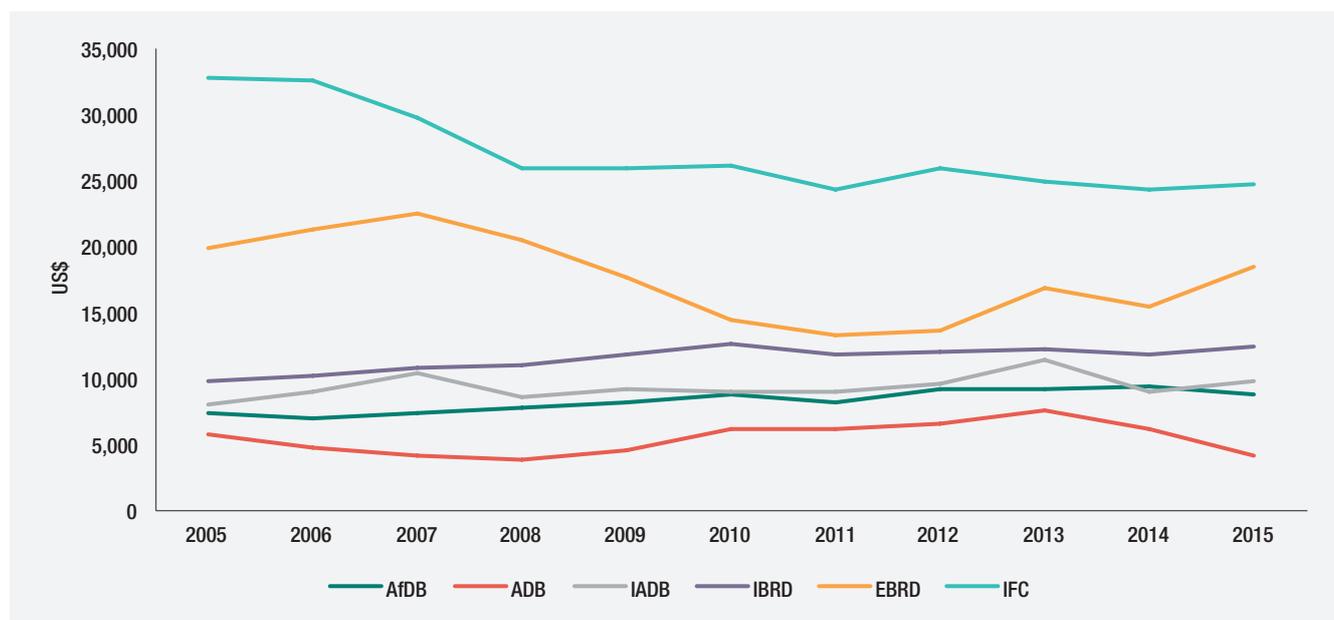


Source: MDB financial statements, 2005-2015.

16 Loan income at non-concessional MDBs is at best a break-even business, while investment income generates the bulk of net income.

17 Because IFC and the EBRD lend entirely and mainly (respectively) to the private sector, they can price risk into their loans more effectively and earn substantial income on equity investments.

Figure 5. MDB administrative costs per \$1 million outstanding portfolio



Source: Own calculations based on annual financial statements.

high loan charges can go without undermining MDBs' development value added, but across-the-board increases may be feasible in some cases. Loan charges could also be raised for certain types of loans, such as like fast-disbursing budget support operations, which use up capital more quickly than investment loans. Higher prices for longer maturity loans or lending volumes above the normal country limit have both been piloted at some MDBs, and should be scaled up. Combining loan price increases with an agreement to reduce allocations to shareholder causes (as discussed above) could build support among borrower shareholders. Another concern of borrowers – that loan price increases and reserve growth function as a 'back door' capital increase that they pay for without receiving the voting shares they would get in a GCI – could be addressed by offering a type of subordinated share to borrowers in recognition of their loan repayments.¹⁸

A further policy lever to boost net income is to lower administrative costs. Despite recent belt-tightening efforts, budgets have continued to creep up in recent years as a

ratio of the outstanding portfolio (Figure 5). Further gains seem feasible, particularly at the World Bank. Shareholders and management should think hard about exactly what the value added is of the myriad programmes and research streams to their core task of promoting development on the ground. At the same time, care must be taken not to undermine MDBs' operational capacity through budget cuts – development expertise and data are fundamental to MDBs' value added.¹⁹ Another obvious place to seek budgetary savings would be in bureaucracy. Many shareholder-imposed instances of oversight and control are redundant or excessive. For example, the developmental benefit of maintaining a board of executive directors to sit in permanent session at the World Bank and regional MDBs – which costs hundreds of millions of dollars in annual budget – is questionable at best. The European Investment Bank operates just fine without a sitting board, and the new Asian Infrastructure Investment Bank is doing the same.

18 Such a technique is used at the Central American Bank for Economic Integration (CABEI). For more on the politics of MDB loan pricing, see Humphrey (2014) and Mohammed (2004).

19 For a detailed discussion, see Center for Global Development (2016).

5. Optimise MDB balance sheets

Shareholders increasingly want to see MDBs squeeze the most development results out of the capital that their taxpayers have contributed. This new push – backed strongly by the G20²⁰ – has led to several initiatives opening additional financing space for some institutions. While these creative efforts are worth pursuing further, their potential to really ‘move the needle’ in terms of capital adequacy is limited, and all come with some risks.

5.1. Exposure exchange agreements

A creative piece of financial engineering recently piloted by three MDBs was to swap portions of their outstanding loan portfolio with one another, in an effort to reduce the high concentration of their loans in some countries. Portfolio concentration has become an increasingly pressing concern for MDBs in the wake of a new methodology implemented by S&P in 2012 that heavily penalises MDB capital adequacy for having concentrated portfolios.

The impact of loan concentration was particularly severe for the AfDB (due to large exposures in North Africa considered more risky in the wake of the Arab Spring) and the IADB (mainly due to its large portfolio to Argentina, which was for several years in default to other creditors). In December 2015, these two MDBs and the World Bank concluded an arrangement whereby the three exchanged loan exposure among themselves in such a way that the total amount of the exposure was equivalent, but it reduced the country concentration at the AfDB and the IADB. The result boosted S&P’s evaluation of capital adequacy for the AfDB and the IADB, allowing for several billion dollars more loan portfolio space in each.²¹

While the exposure exchange was a success, prospects for further gains from similar future operations are limited. Exchanges must occur for legal reasons among

overlapping sets of shareholders, which are not easy to match up in ways that make financial sense. The exchanges also carry some risks. A key aspect of the MDB financial model is preferred creditor treatment (PCT) – the idea that a borrower country puts the MDB first in line to be repaid, even if it faces financial difficulties. When MDBs start swapping loans among each other, even if only on a ‘synthetic’ basis (i.e., technically the loan is still owned by the originating MDB), borrowers may feel less inclined to grant PCT. Moreover, the MDBs are engaging in a legally and financially complex operation essentially to mitigate the impact of the questionable methodology of one private credit rating company. If the methodology changes (as it has in the past), the gains of the operation could be invalidated.

5.2. Portfolio guarantees and loan sales

Portfolio guarantees are a new idea at the MDBs, first piloted by Sweden at ADB in 2016. The arrangement involved Sweden’s development agency SIDA offering a guarantee to cover \$155 million in loans on ADB’s portfolio, which freed up \$500 million in lending space on ADB’s balance sheet.²² The World Bank concluded a similar operation at the end of 2016 covering loans to Iraq, with guarantees from Canada and the UK.²³ Future operations are likely, but limited donor appetite for providing guarantees may act as a ceiling to making a meaningful dent in MDB capital needs.²⁴ In addition, this could lead to donors using guarantees to support their own priorities, which weakens MDB collective governance – similar to what has occurred with the proliferation of trust funds at MDBs.²⁵

Selling loans off the balance sheet to private buyers is another option under consideration, although only for private sector MDB lending. MDBs cannot easily

20 See G20 (2015). This effort was supported again in the most recent G20 meeting on 17-18 March 2017 (see G20, 2017: paragraph 3).

21 The capital impact on IBRD was minimal due to the more diversified nature of its portfolio. For more details, see World Bank FY2016 Financial Statement, p. 23.

22 See Asian Development Bank (ADB) (2016).

23 See World Bank (2016b).

24 A proposal is currently under design by the Education Commission to work with the MDBs using a similar guarantee instrument, and will reportedly be presented at the upcoming 2017 IMF/World Bank spring meetings.

25 See for example Reinsberg et al. (2015).

find private sector buyers for public sector loans, since they are not issued at market-based prices. Furthermore, such an operation could dilute PCT. Private sector loans are more amenable to sale as they are priced on market criteria and do not enjoy the same level of PCT. IFC and the EBRD have ramped up this activity in recent years,²⁶ while the AfDB did its first transaction in 2016. However,

even private sector loan sales have limited appeal. MDBs consider these loans much safer than they are perceived by potential buyers, and hence do not feel that they can get good value on the sale. In addition, the benefit to capital adequacy is limited or non-existent due to the complexities of how the transactions are evaluated by rating agencies – the main advantage is to reduce country concentration.

²⁶ The World Bank Group's insurance provider, MIGA, has used this technique successfully for years, selling off their insurance policies to re-insurance companies.

6. Make callable capital more operationally useful

Callable capital, a type of guarantee offered by shareholders to MDBs, represents a tremendously under-utilised volume of financial resources – \$247.5 billion at IBRD, and another \$420 billion at the four regional MDBs. Because callable capital has never been called, shareholders feel comfortable offering it in ever-greater amounts. It now accounts for well over 90% of subscribed capital at most of the major MDBs.

Unlike most financial guarantees, an MDB capital call is not triggered automatically under defined circumstances, but must be decided on by shareholders – that is, the ones who would have to pay it. Furthermore, the time frame and exact process for paying the call are unclear. As a result of this murky situation, it is no surprise that investors and credit rating agencies are wary of giving much credence to callable capital, despite the fact that it is a legal obligation for all shareholders under international treaty.

To turn callable capital into a more useful instrument to underpin greater MDB financing, shareholders could clearly spell out the procedure under which it can be called, making it a more automatic, transparent process. Because of

the volumes of resources involved, market perceptions and shareholder budget processes, reforming callable capital is likely to be politically and technically complex, and hence is more of a speculative recommendation for the medium term. Despite the complexity, it is well worth pursuing: callable capital is a clear international obligation of substantial financial scale specifically intended to strengthen MDB capacity, that is currently serving minimal purpose.

In the short term, MDBs could find other uses for callable capital from shareholders rated sub-AAA (and hence not very useful to support MDBs' own ratings), but still above investment grade. For example, in the event of another capital increase, MDBs could request shareholders rated between BBB and AA to offer portfolio guarantees rather than callable capital. The impact on shareholders would be the same – it is in both cases a contingent liability – but it would have much more use for MDBs. This might be particularly relevant for the AfDB, which is well under its statutory limits and thus has little need for sub-AAA callable capital.

Conclusion

The World Bank and major regional MDBs have many flaws, and their internal efficiency and development impact can certainly be improved. But they remain powerful tools for channelling resources and expertise to overcome market failures that lead to low economic growth and social inequality, which in turn are causes of reduced opportunities, instability and migration that impact rich and poor countries alike. Not only are MDBs effective, but they are extremely inexpensive due to their powerful financial model of directing mainly private investment towards development projects, with limited need for financial support from governments. However, several major MDBs are now running up against their financial limits.

To address these limitations, the top priority is to push ahead with general capital increases for the World Bank and the AfDB, and consider adding capital to the IADB and the EBRD as well. A GCI is the best way to strengthen the MDBs, not only in strictly financial terms, but also as a signal that shareholders continue to view the MDBs as key tools to achieve the SDGs. The cost of a GCI is extremely cheap compared to how much project financing MDBs can generate by leveraging shareholder capital through their financial model. In the event that the current US administration chooses not to participate in a GCI, other shareholders should move ahead regardless. The US must decide if it will remain a leader in the MDBs it has strongly supported for decades – in recognition of how they further US interests – and, if not, it should step out of the way.

Reforming capital adequacy is the next priority to expand MDB capacity. Shareholders should insist on getting the most development results for their capital contributions, and MDBs

are currently too conservative in managing their finances. The first steps should be (i) enlisting a respected external agency like the Bank for International Settlements (BIS) to review MDB capital adequacy and get an independent point of reference beyond the questionable methodology used by credit rating agencies; and (ii) developing a common approach to capital adequacy by shareholders at the different MDBs, building on the work already underway at the G20. Less urgently, shareholders should revise statutory rules limiting MDB lending capacity, which no longer make sense in the current financial context.

Two further options with potential to significantly boost MDB lending are (i) a partial merger of the concessional and non-concessional balance sheets at the World Bank and the AfDB (a one-time boost) and (ii) a compromise package of revenue and budget measures to boost the ability of MDBs to build shareholder equity via net income (sustainable over the medium term). Both options face technical and political challenges, but are feasible within the next year or two.

Balance sheet optimisation measures being considered or already underway at MDBs can help, but gains are likely to be marginal and several risks exist. Shareholders should be cautious of ramping up the use of creative financial engineering to expand MDB capacity.

In the medium term, callable capital – a type of guarantee committed to MDBs by shareholders under international treaty, but currently undervalued by financial markets – could be converted into a much more useful instrument. MDB shareholders and staff should begin exploring ways to overcome political and technical obstacles, with a view to reforms in two to three years.

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