Annex

Project description: Generating evidence to inform the better utilisation of MDB callable capital

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Disclaimer – this Annex contains background information on the following insight piece: [Maximising the developmental value of MDB callable capital: a new research agenda]

In April 2023, the MDB Challenge Fund awarded an ODI team funding for a research project looking into MDB callable capital.

The MDB Challenge Fund is administered by New Venture Fund and supported by grants from the Bill & Melinda Gates Foundation, Open Society Foundations and the Rockefeller Foundation. The Fund's goal is to accelerate MDB financing for the United Nations' Sustainable Development Goals (SDGs) and the Paris Climate Agreement, in line with the report of the G20 Independent Review of Multilateral Development Bank Capital Adequacy Frameworks. The project will generate evidence and analysis to provide guidance for how Recommendation 2 of the report might be implemented.

The G20 Independent Review recommends that MDBs 'Incorporate a prudent share of callable capital into [their] own calculation of capital adequacy' (p. 32). Callable capital is characterized not as equity capital, but rather as a specialised type of shareholder guarantee that can only be activated in extreme circumstances. By acknowledging its ability to cover extreme 'tail' risk, an MDB can then adjust the risk parameters of its capital adequacy framework accordingly, safely and prudently creating more lending headroom.

The report's proposal is conceptual and does not explain in detail how it might be implemented across different MDBs. Government shareholders are also understandably concerned that any moves to recognise the value of callable capital would entail provisioning for callable capital in national budgets (as a contingent liability) or, in the worst case, actually leading to a capital call. Shareholders and MDBs also want to ensure that such a move would not put pressure on MDB bond ratings, particularly by Moody's and Fitch.

Our team has tailored a research agenda specifically to address these questions and concerns. We identify three key gaps in understanding callable capital:

1. What callable capital is and how it is understood and treated inside MDBs and in shareholders' public finances.
2. What circumstances could in practice lead to callable capital being triggered.
3. How callable capital fits into the array of tools and procedures for MDBs to manage a stress scenario.

The aim of the research is to provide useful inputs for a discussion among policy-makers and market actors on how this unique financial instrument, created nearly 80 years ago, might be best utilised to support MDB lending to face current and future development challenges. We will generate evidence that can clarify the nature of callable capital, evaluate the risks, potential and trade-offs it poses and propose concrete approaches to better make use of it as one of several tools to reinforce the financial stability and long-term sustainability of these critical institutions.

We hope that MDBs and shareholders will engage with this work, as they will need to 'own' any conclusions if they are to inform policy change. Our intention is to engage with a broad spectrum of stakeholders, including MDB management, shareholder governments, credit rating agencies, MDB bond investors, financial market regulatory authorities, academic experts and civil society actors.

Detailed research agenda

The project has three complementary components, each designed to address key questions surrounding the likelihood of needing callable capital; the capacity and sequencing of MDB tools (including callable capital) for preserving financial stability; and how callable capital would be used in the most extreme stress scenario.

Component 1: What is the nature and value of callable capital?

The over-arching goal of Component 1 is to better understand the characteristics of MDB callable capital, its potential financial value, the process of a capital call and its implications for shareholders, as well as how it might be incorporated into MDB capital adequacy frameworks. Research will proceed along four tracks:

- *Characteristics of callable capital* including scale and shareholder breakdown, MDB statutory provisions and historical background.
- *Process for making a capital call* including nature of trigger(s), MDB timing and procedures, range of potential call size based on MDB liability profile and domestic processes for key shareholders (along the lines of a recent Fitch report, although in a more systematic manner).
- *Options for incorporating callable capital into MDB capital adequacy frameworks* building on how rating agencies evaluate callable capital, risk parameters in MDB capital adequacy models and legal and financial stipulations on callable capital.
- *Options for strengthening callable capital to increase benefits* such as evaluating experiences of the European Stability Mechanism, proposals in the World Bank Evolution Roadmap and relevant commercial sector instruments and other options, as well as potential procedural changes among major shareholders.

Component 2: What circumstances would lead MDBs to a capital call?

This component will analyse the circumstances that might lead an MDB to make a capital call, and the probabilities that those circumstances could materialize, through an industry-standard reverse stress test, adapted to the specific realities of MDBs and based on actual MDB balance sheet data. Results will be refined to reflect the geographic distribution of assets and the funding strategies/maturities of different MDBs. Stress test scenarios can be calibrated to actual market data for credit, funding and interest rate risks. The specific output would be i) reverse stress tests for credit/liquidity risk specific to each selected MDB; and ii) an assessment of the risk of a capital call (using the Monte Carlo-Poisson process). The analysis will include interaction between credit and funding risk, graduated scenarios of the risk of a capital call over time relative to credit rating, and potential impacts of proposals from Components 1 and 3.

Component 3: Developing MDBs' crisis management and recovery capacity

This component aims to improve market and shareholder understanding of the crisis continuum for MDBs (business as usual, early stress, recovery actions, non-viability) and the tools, processes and policies MDBs have at their disposal to manage and recover from financial stress. This component will apply international recovery and crisis management best practices in the commercial financial sector to MDBs. It will propose options to strengthen MDB crisis management and recovery capacity, and will discuss the monitoring and governance arrangements MDBs need to identify stress and act to address it. Establishing a crisis management framework within MDBs will improve their capacity to prepare for and respond to financial stress. The report will articulate MDB capacity to respond to differing levels of stress and define ex-ante MDB financial recovery capacity, including the role of callable capital. This will support MDBs' objective to maintain credit growth and better leverage existing capital resources without undermining their risk profile. Strengthened MDB crisis management capabilities, contextualised in a clear crisis continuum, could improve rating agency and shareholder understanding of how different financial resilience tools can be deployed for different levels of stress. This would help increase MDB lending capacity.

The research will focus on a set of MDBs selected for their relevance to the research topics, to global development and to the Sustainable Development Goals (SDGs). They are:

- African Development Bank (AfDB)
- Asian Infrastructure Investment Bank (AIIB)
- Asian Development Bank (AsDB)
- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank (IDB)
- International Bank for Reconstruction and Development (IBRD)
- Development Bank of Latin America (CAF)

Only institutions with callable capital were considered, although the International Finance Corporation and IDB Invest will be used as comparator organisations where relevant. The European Investment Bank was excluded due to its focus on EU countries and its unique lender-of-last-resort arrangements with the European Central Bank.

The project is to be completed by the World Bank and IMF Spring Meetings in April 2024 with delivery of a final report, including policy options. We also will produce a shorter briefing paper to disseminate findings more widely among the development policy and financial communities. Our intention is to present preliminary research findings at the World Bank and IMF Annual Meetings in October 2023.

The research team is organised with the institutional support of ODI, a UK-based international development think tank. The team has four members:

Chris McHugh is a senior advisor to the International Association of Credit Portfolio Managers, is director of Cantium Limited providing consulting services on sustainable finance markets, and is affiliated to the University of Southampton as a researcher focusing on private sector mobilisation by MDBs. He has over 20 years of investment banking experience, structuring and trading derivatives across a wide range of asset classes.

Eamonn White is the director of Ardhill Advisory, an independent consultancy specialising in supporting international organisations, central banks and financial institutions prepare for and respond to financial crises. He has over 16 years' experience in government and central banking in the US, the UK and Asia, and is a visiting lecturer at Queen Mary University, School of Economics and Finance.

Chris Humphrey is a senior research associate at ODI and a senior scientist at the ETH Zurich Center for Development and Cooperation. He has written extensively on MDBs and development finance more broadly, and is a recognised expert on the MDB financial model. He was a member of the G20's Independent Review of Multilateral Development Bank Capital Adequacy Frameworks.

Bianca Getzel is a research officer in the Development and Public Finance Programme at ODI focusing on MDBs and development finance institutions. Ms. Getzel has previously worked at the International Finance Corporation, the Asian Development Bank, The Currency Exchange Fund (TCX), the US Agency for International Development, and the UN Office for South-South Cooperation.