Emerging analysis

Making sense of hybrid capital for multilateral banks

Chris Humphrey, Chris McHugh and Eamonn White

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Key messages

Hybrid capital is a useful tool to modernise multilateral development bank capital structures, build resilience to financial stress and increase lending capacity.

Two types of investor are being sought: i) commercial investors; and ii) government shareholders and non-profits.

A clear definition of the triggers that would lead investors to lose their investment is critical to viable hybrids.

Hybrid capital has financial and governance trade-offs that need to be evaluated in relation to other capital adequacy reforms to increase lending capacity.

Hybrid capital is not a substitute for the core shareholder capital MDBs need to retain market confidence and sustainably pursue public policy goals.

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About the authors

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, and is a recognised expert on the MDB financial model. He was a member of the G20 Independent Panel on Multilateral Development Banks' Capital Adequacy Frameworks.

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 with 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 of London's School of Economics and Finance.

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Acronyms

AfDB	African Development Bank
MDB	multilateral development bank
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OMFIF	Official Monetary and Financial Institutions Forum
SDRs	Special Drawing Rights

1 Introduction

After decades of a slowly evolving financial model, multilateral development banks (MDBs) have in recent years dramatically accelerated their balance sheet innovations. This is a welcome and necessary shift: development needs are daunting, aid budgets are restricted and MDBs have considerable potential for greater efficiency.

Spurred in part by the recommendations of the G20 Independent Panel on MDBs' Capital Adequacy Frameworks (2021), MDBs are reviewing their capital structures and considering what mix of balance sheet efficiency, paid-in and callable capital and new tools is optimal to support their development policy purpose. This has included exploring hybrid capital instruments.

Furthest along is the African Development Bank (AfDB), which has issued a prospectus (AfDB, 2023a) and staged a roadshow (AfDB, 2023b) with potential investors on 15 September. The World Bank's main lending wing is developing a version to be offered to shareholder governments in an initial phase and has Board approval for a pilot hybrid for commercial investors (World Bank, 2023a). The European Bank for Reconstruction and Development appears likely to follow suit (Global Capital, 2023a), although only after it completes its paid-in capital increase negotiations now under way.

Hybrid capital can be useful to expand MDB loss-absorbing capital resources and reinforce capital adequacy, and are part of a much-needed modernisation of the way MDBs ensure resilience to financial stress.

However, they are not a magic bullet. Hybrid capital comes with financial, developmental and governance trade-offs that need to be thoroughly understood and evaluated. They need to be compared with alternative options to ensure MDBs increase lending capacity and resilience in an economically efficient manner.

Most importantly, hybrids and other innovations should not be viewed as easy substitutes for traditional paid-in capital from member government shareholders, which is the foundation on which MDB financial strength and access to capital markets is based.

2 What is hybrid capital?

An MDB's capital is the difference between its assets (mostly development loans and other investments) and liabilities (mostly bonds the MDB has issued on capital markets).

All capital is junior to senior liabilities like bonds. In other words, should an MDB face severe financial stress, the bank's capital absorbs the losses first before its bond investors. That is why investing in share capital is riskier than making a loan: shareholders can face losses even while creditors still get repaid.

Up to now, almost all MDB equity capital has consisted solely of shares issued to member governments, plus accumulated reserves. Hybrids would represent a new type of capital.

Hybrid capital falls between senior debt and share capital, and shares characteristics from both (hence the term 'hybrid'). Hybrids pay a fixed interest rate return ('coupon') and can usually be bought and sold on a secondary market, which means they look a lot like a bond. But hybrids are junior to normal bonds and can absorb losses like equity capital, and thus are given 'equity content' by rating agencies and regulators (see ECB, 2006 for more). Hybrids are therefore not just another way to borrow money; they also help to strengthen an MDB's capital resources.

According to the AfDB's prospectus, the entire face value of their proposed hybrid will be treated as core capital by rating agencies and by International Financial Reporting Standards because of how the hybrid is structured. This means that whatever amount of hybrid resources is raised from investors will be effectively just as good as regular AfDB share capital. Hybrids from other MDBs would very likely be treated the same. As per rating agency requirements, hybrids cannot amount to more than a third of an MDB's total equity capital.

Unlike commercial banks, MDBs also possess another type of capital instrument: callable capital. Exactly where callable capital fits into this capital structure is not entirely clear (and is the topic of an ongoing research project by the authors: see Humphrey et al., 2023), but it would appear to be only usable to repay bondholders in an extreme shock scenario. Callable capital has never been tested and its triggers need to be better understood to ensure that it can play a useful role in the MDB capital structure.

As MDBs look to enhance the sophistication of their capital structure, a number of key hybrid design features must be clearly defined:

- Convertible vs. write-down. Some hybrids convert into regular capital shares in a stress scenario (to strengthen the quality of an institution's capital), while others have their value written down in a stress scenario (to reduce the institution's obligations). Both types reinforce an institution's financial resilience and ability to deal with financial stress without needing to go into liquidation. MDB hybrids are being designed as write-downs, as existing member government shareholders would not want to have their shareholding diluted in response to a shock.
- Write-down triggers. For a hybrid to be classified as core capital, it needs to absorb losses well before an MDB would be at risk of defaulting on senior bondholders. The exact timing at which this write-down is triggered relative to when paid-in and callable capital will be exposed to losses must be clearly specified and understood by investors (government or commercial). If the trigger is too discretionary or ambiguous, it can undermine market confidence in a stress scenario, lead rating agencies to weaken the hybrid's classification as core capital and increase pricing.
- Market treatment. As hybrids are 'perpetual' (i.e. there is no contractual obligation to repay the principal), a key issue for investors will be market liquidity – whether they can easily sell their hybrid to another investor. Further considerations will include whether the instruments are eligible as collateral and what risk weighting they are deemed to have. These issues will be less of a concern (or none at all) for government investors since they will almost certainly not trade or use them as collateral.

3 Financial trade-offs of commercial hybrids

Boosting MDB capacity by leveraging new investors and avoiding the difficulties of a normal MDB capital increase (the latter of which requires lengthy and contentious negotiations among shareholder governments) sounds appealing – but nothing comes for free.

Commercial investors expect to be compensated for the fact that the hybrid instruments they hold are designed to absorb losses and help the institution recover from stress, compared to senior debt, which only faces losses in a liquidation scenario (and not even then in the case of an MDB, as all debt is guaranteed by callable capital). As a result of these capital features, hybrids cost more than a senior bond issued by the same institution.

According to a recent article by the Official Monetary and Financial Institutions Forum (OMFIF), investors are asking for a 150–200 basis point mark-up over senior bonds. Calling this spread 'astonishing', the OMFIF asked: 'If the AfDB and other MDBs end up paying that much for hybrid issuance, is it worth it? Some would say it isn't' (OMFIF, 2023).

The high spreads are in part due to current interest rate volatility in global markets, and the AfDB intends to wait until later this year or early 2024 before issuing on the expectation that markets will settle. It also likely reflects the fact that markets are unclear on how to price this new kind of MDB instrument (as explored in Global Capital, 2023b). The lack of secondary market liquidity for the hybrid could be a further factor. Pricing may improve as more MDB hybrids are issued, but that is not certain.

The AfDB's hybrid has received an AA- rating from Standard & Poor's, three notches below the AAA rating of the bank's normal bonds. While this is logical because of the greater risk attached to hybrids, it means that the AfDB will have to pay a mark-up over its regular funding costs, as would any other MDB issuing to commercial investors.

Pricing may also reflect the hybrid's terms. The most important trigger for a hybrid is when the instrument is written down to zero and the investor's asset is wiped out. MDB hybrids are likely to link the write-down trigger to a call on callable capital. However, the conditions for a capital call are not well understood, as our research

project is exploring. This weakens the clarity of this important trigger – an issue in the news recently with the write-down of AT1 hybrids during the Credit Suisse meltdown (see Global Capital, 2023c).

The other main trigger is when the MDB is allowed to stop making coupon payments on the hybrid when it faces moderate financial stress. Deciding when to trigger a coupon payment halt on an MDB hybrid could also impact pricing, as could the question of whether the MDB can still allocate net income to concessional lending windows even as it stops paying the hybrid coupon.

A mark-up over senior debt costs might make sense for a commercial bank, since hybrids offer additional support to the firm's capital base without diluting existing shareholders or having to pay the return that an increase in shareholder equity would require. Hybrids can also target a different set of investors than normal shareholders.

But for an MDB, the cost of capital is zero. This is a core part of the MDB financial model and allows the banks to offer loans at very low cost to achieve public policy purposes, rather than to earn a profit. Therefore, any cost at all for a hybrid implies an overall increase in MDB funding costs, which in turn would be reflected in the interest rates charged to borrowers on their loans. AfDB management has said that this additional cost would be marginal, likely in low single-digit basis points depending on hybrid pricing and size.

The impact on MDB loan charges – however marginal – was reportedly a key reason why borrower country shareholders expressed misgivings when the World Bank commercial hybrid instrument came up for discussion at the Board level, although the Board did eventually approve a $1 billion pilot.

4 Governance trade-offs of official hybrids

Another proposal under implementation at the World Bank is to market $1 billion in hybrids to government shareholders rather than commercial investors. At the 2023 World Bank/International Monetary Fund Annual Meetings, Germany confirmed that it would invest €305 million in the World Bank hybrid (Reuters, 2023), while other shareholders are apparently considering joining in too. The AfDB also intends to issue a similar hybrid, but likely after it goes ahead with its commercial market version.

The main advantage of this option is pricing. Although the trigger terms of the hybrid are the same as those for commercial investors, shareholder governments might request a return more in line with MDB senior bond funding costs, thus reducing (although not eliminating) the pressure on MDB loan costs to development borrowers.

Sources within the German government indicate that it is trying to have the investment formally qualify as part of the country's official development assistance (ODA), although this hinges on approval from the Organisation for Economic Co-operation and Development (OECD). If so, Germany might forgo any interest payments at all. The AfDB led initial discussions on this point with OECD starting as far back as 2021, and the World Bank is now also involved.

The catch is that shareholders seeking below-market returns for a hybrid investment, or no return at all, will want a say in deciding how the resulting lending resources will be deployed (what the World Bank calls 'preferencing'). This has implications for the governance of the MDBs. It would give these government investors a stronger voice in promoting their policy priorities on a portion of MDB lending outside of the MDB's normal decision-making procedures.

Although one might consider this a worthwhile price to pay to increase lending capacity, not everyone will necessarily agree with the preferencing priorities of hybrid investors. German Minister for Economic Cooperation and Development Svenja Schulze noted in a September speech that the country would request that new World Bank resources be used for environmental and climate protection and vaccines (BMZ, 2023). Some borrower countries might prefer increased lending resources to be oriented towards economic growth

and job creation. While one might argue that these are not mutually exclusive, some borrowers might see them as such.

This kind of 'preferencing' increases the fragmentation of an MDB's operational strategy in much the same way that the proliferation of trust funds has done. The World Bank itself highlighted this risk in a recent board paper (paragraph 40), noting that '[m]any shareholders representing the Bank's client countries have expressed concern with the potential financial, operational, and governance implications of preferencing' (World Bank, 2023b).

World Bank sources say they are aware of the concerns and are working to design guardrails to ensure that preferencing remains in line with the Bank's overall lending strategies agreed on by all shareholders. One proposal under discussion is that only a portion of additional resources created by the hybrid investment could be preferenced, while the bulk of it would go into general Bank resources.

A much better option for a major shareholder not seeking a financial return and wanting to support greater lending by an MDB, in line with its existing shareholder-agreed strategic priorities, would be to simply contribute additional paid-in capital without voting rights. This would eliminate both the financial and governance downsides of hybrids and would be counted as ODA.

The World Bank's offer, however, seems to give wealthy shareholders the best of both worlds. It accepts (despite the misgivings voiced in the board paper) that the resources can be partly preferenced. Yet in the event of a future capital increase, investments in hybrids could be redeemed in order to pay for normal paid-in shares with voting rights. Government investors therefore get a say in lending allocation as well as later voting rights (although preferencing would cease if hybrids are redeemed).

The World Bank and the AfDB are both considering extending this type of hybrid investment option – including partial preferencing – to non-shareholder investors focusing on development impact rather than financial return. This might include philanthropic organisations, foundations, sovereign wealth funds, high-net-worth individuals or even, eventually, smaller-scale investors through fund vehicles. These proposals remain only at the discussion stage, and the current focus is on government shareholder investors, but the governance implications of non-shareholder investor preferencing would need to be carefully considered.

Preferencing would give investors a voice in lending allocation, but the write-down triggers embedded in the hybrid would not be linked to specific sections of the portfolio and hybrid resources would be available to absorb losses emerging anywhere on the balance sheet. Otherwise, this would raise a host of other problems (as highlighted

by Fitch (2020) in relation to green hybrids issued by commercial banks).

Another option under consideration at several MDBs, most actively the AfDB, is for shareholder governments to use ‘extra’ Special Drawing Rights (SDRs) issued by the International Monetary Fund to purchase MDB hybrids. Doing so would require overcoming a number of obstacles, notably currency convertibility and the need for a country to maintain the reserve asset status of its SDRs (see Plant, 2023 for more). It remains unclear if governments would be willing to commit foreign exchange reserves to an instrument with contractual write-down features issued by an MDB.

5 Hybrids are useful but no substitute for MDB core capital

Exploring the option of hybrid capital for MDBs makes a lot of sense. AfDB management has led the way, working intensively for over two years to develop this new instrument, and more recently the World Bank and other MDBs have joined forces in a collective effort to engage investors and credit rating agencies.

Hybrids can form a useful addition to the MDB capital structure, adding a new layer of resilience to potential financial stress and thereby safely increasing lending capacity.

Investigating new forms of capital support, including from new types of investor beyond government shareholders, is a logical part of broader efforts to standardise and modernise MDB capital adequacy, in line with the recommendations of the G20 Independent Panel on MDBs' Capital Adequacy Frameworks.

It is imperative, however, that all stakeholders be clear that hybrid instruments are not a replacement for normal paid-in capital from shareholders.

As with all financial innovations, hybrid capital comes with trade-offs. Additional financial capacity never comes for free, and shareholders, MDB management and external stakeholders need to closely examine the terms of hybrids to understand the costs and compare them to other options that may be more financially efficient or have fewer governance trade-offs.

If shareholder governments want MDBs to accomplish public policy goals, they need to supply the required capital. An institution appropriately capitalised for its mission is what gives markets confidence, and that confidence is the foundation of the MDB financial model.

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