Working paper

The legal underpinnings of MDB callable capital

Implications and policy options

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Key messages

MDB treaties provide the legal underpinning for callable capital, but ambiguous text limits how management, shareholders and credit rating agencies understand it.

Statutes indicate that a capital call is not technically capital, but rather a guarantee for MDB bondholders, with substantial financial value.

A capital call can be triggered to help IBRD, AfDB, ADB and IDB recover from a severe crisis. For EBRD and AIIB it can only be triggered as part of a liquidation scenario.

MDB boards should issue interpretations and secondary policies to clarify how callable capital can be used and give greater confidence in its reliability to markets and credit rating agencies.

Statutory reform could further strengthen the value of callable capital, although that may be a politically complex undertaking.

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About this publication

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Contents

Acronyms

ADB	Asian Development Bank
AfDB	African Development Bank
AIIB	Asian Infrastructure Investment Bank
BIS	Bank for International Settlements
CAF	Development Bank of Latin America
EBRD	European Bank for Reconstruction and Development
ESM	European Stability Mechanism
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IMF	International Monetary Fund
MDB	multilateral development bank

Executive summary

This paper reviews the legal underpinnings of callable capital, a unique component of the financial structure of multilateral development banks (MDBs) with a nominal value in the hundreds of billions of dollars. It forms part of a multi-paper ODI research project on MDB callable capital.

Callable capital has never been called at any major MDB and its character as a financial instrument and the rules surrounding its use are unclear. This limits the ability of MDBs to make the best use of this potentially valuable instrument and makes it more difficult for market participants and ratings agencies to account for the additional security it provides to MDB bonds.

The paper evaluates MDB statutes to better understand the legal underpinnings of callable capital and formulate policy options. The aim is to encourage MDBs and shareholders to clarify the nature, circumstances and processes of callable capital and incorporate it systematically into MDB financial planning, to reinforce confidence in the financial strength of MDBs.

The relevant provisions of the statutes of the World Bank's International Bank for Reconstruction and Development (IBRD), drawn up in 1944, indicate that:

- Callable capital is not capital in the normal sense of the term, but rather a specialised type of guarantee for IBRD creditors (mainly bondholders).
- Callable capital is for use only in extreme circumstances triggered by large-scale defaults on IBRD loans. Statutes appear to give flexibility to trigger a call in a 'going concern' scenario to help IBRD recover from a shock, rather than only in a 'gone concern' to pay creditors as part of liquidation.
- IBRD management, as the guardian of the institution's financial integrity, is intended to play a role in triggering a capital call in an emergency situation.

The statutes of the Asian, African and Inter-American Development Banks were closely modelled on IBRD and have a similar meaning. However, the statutes of European Bank for Reconstruction and Development and Asian Infrastructure Investment Bank limit callable capital's use to a 'gone concern' liquidation scenario.

This paper's interpretations differ in some ways from how MDB management has interpreted callable capital statutes in the past. The key point is not that either interpretation is correct. The language in the statutes is flexible enough to provide room for shareholders to clarify callable capital in a way that is congruent with existing statutes.

Whether callable capital can be triggered to help an MDB recover from a shock or only as part of liquidation, it has considerable financial value. The priority of MDB bondholders is to be sure that callable capital can be triggered in an emergency to ensure that they are repaid in full and on time, regardless of whether an MDB goes into liquidation.

The question of whether a capital call can be triggered in a going versus gone concern context is, however, highly relevant to MDB management, shareholders and other stakeholders. MDBs are modernising their toolkit of management actions and loss-absorbing instruments to recover from shocks. A well-defined continuum between business-as-usual and non-viability, and how callable capital can fit in, is an important part of this modernisation.

Greater clarity on the legal basis of callable capital will help MDBs to determine its value and how it can be incorporated into financial planning, as proposed by the G20 Independent Panel on MDB Capital Adequacy Frameworks.

These considerations are about planning for an extremely unlikely severe shock, such as no major MDB has ever experienced. Understanding callable capital does not change the likelihood of an MDB getting into a severe crisis situation where a call might be contemplated (either as a going or gone concern). That risk is extremely low, as stress test modelling being done as another part of this research project will show.

Shareholders and MDBs should consider two sets of policy reforms to maximise the developmental value of callable capital. The goal is to provide greater clarity on callable capital such that 1) it can be incorporated into MDB financial planning; 2) bond investors have even more confidence in MDB resilience; and 3) credit rating agencies better account for callable capital in MDB ratings.

- MDB boards of directors should issue interpretations of callable capital statutes to clarify:
  - When it can be called, and in particular if a capital call can help an MDB recover from stress or only be deployed as part of liquidation.
  - Who has the authority to trigger a capital call. The most realistic approach would be to give management (the guardians of the MDB's institutional integrity) authority to

require a discussion of a capital call in a crisis, but require final approval by the Board (engaging the political level).

- Design and implement secondary policies on callable capital spelling out:
  - A set of indicators of increasing balance sheet stress to define i) when MDB management and shareholders should begin making arrangements for a potential capital call; and ii) the point at which a capital call would actually be triggered.
  - A clear set of processes for a capital call, including determining the amount of capital needed for a call; the timeframe for shareholders to meet the call and the consequences of non-compliance; and procedures to ring-fence resources for use only repay creditors.

None of the recommendations above requires reforms of the MDB statutes. Shareholders may also wish to consider statutory reform to change how callable capital can be used.

One option would be to 'enhance' callable capital, converting it from a guarantee for bondholders into a type of pre-committed capital accessible in a moderate crisis, for example, if the MDB is facing a potential downgrade from AAA. Depending on the terms, this type of 'enhanced' callable capital might be accounted directly as actual equity capital.

EBRD and AIIB shareholders may wish to align their statutes with other MDBs to permit callable capital to be deployed to recover from a shock, rather than only as part of liquidation as is currently the case.

1 Introduction

Callable capital is an international treaty obligation with a nominal value of $888 billion across six major MDBs.[1] Despite being a central pillar of the MDB financial model since 1944, it is remarkable how little callable capital is understood – what type of instrument it is, under what circumstances it can be called and how resources could be deployed in the very unlikely event of a call.

Much of the uncertainty around callable capital is derived from the ambiguous wording of MDB treaties and the lack of secondary policies providing more detail. Credit rating agencies have highlighted this lack of clarity as limiting their ability to adequately evaluate the instrument's benefit to MDB ratings.[2]

A more precise understanding of callable capital would strengthen the ability of shareholders, MDB management and credit rating agencies to accurately evaluate the resilience of MDBs in the face of financial stress. This would bolster market confidence, benefit MDB credit ratings and help governments more accurately assess the risks they face as MDB shareholders. It would permit MDBs to incorporate the value of callable capital into their financial planning as proposed by the G20 Independent Panel on MDB Capital Adequacy Frameworks (2022).

This paper – part of a broader ODI project on callable capital (see Box 1) – examines the treaty provisions related to callable capital. The conclusions are drawn from a close reading of the treaty texts,[3] supplemented with background documents from treaty negotiations.

After an initial section providing historical context, the paper considers three key aspects of callable capital:

1 The nature of callable capital as a financial instrument.

2 The circumstances in which a capital call can be made.

3 Who has the authority to make a capital call.

[1] This paper examines the World Bank's International Bank of Reconstruction and Development (IBRD), African Development Bank (AfDB), Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB), European Bank for Reconstruction and Development (EBRD) and Inter-American Development Bank (IDB). The World Bank's International Development Association and International Finance Corporation do not have callable capital, nor does IDB Invest. The paper does not consider the Development Bank of Latin America (CAF), which has a much smaller share of callable capital in its capital structure (14% at end-2022) and no longer solicits callable capital during capital increases.

[2] See Standard & Poor's (2022), Moody's (2022) and Fitch (2022).

[3] The paper follows the stipulations on treaty interpretation of Section 3 of the Vienna Convention on the Law of Treaties (United Nations, 2005).

Box 1 Maximising the developmental value of MDB callable capital

This paper is part of a year-long project investigating MDB callable capital, supported by the MDB Challenge Fund and undertaken by a research team based at ODI. The project will finish in spring 2024 and comprises the following papers:

1. Making sense of hybrid capital for multilateral banks.
2. The legal underpinnings of MDB callable capital: implications and policy options.
3. How shareholders account for MDB callable capital in their budgetary frameworks.
4. Reverse stress testing results for seven MDBs.
5. Modernising MDB approaches to managing financial stress.
6. Calculating the financial value of MDB callable capital for capital adequacy.

The project is led by Chris Humphrey (ODI senior research associate) and includes Chris McHugh (senior advisor, International Association of Credit Portfolio Managers), Eamonn White (director, Ardhill Advisory) and Bianca Getzel (ODI research officer).

2 The creation and evolution of MDB callable capital

Callable capital was an integral part of the capital structure of the World Bank from its inception at Bretton Woods and has been replicated in the 30 or so MDBs created since, including the recently founded Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB).

Callable capital was a common part of US commercial bank capital in the late nineteenth century: 'Section 14 of the [US] National Bank Act of 1863 required just half the capital to be paid in before operations could commence. This created the distinction between authorized and paid-up capital. The remaining "uncalled" capital served as an additional buffer in case of losses' (Haubrich, 2020).

Although this usage declined in the early twentieth century in commercial banks, the structure was included in the charter of the Bank of International Settlements (BIS) in 1930 (BIS, 2016, Art. 7 (1)). It was also included in the charter of a proto-MDB designed in the late 1930s called the Inter-American Bank, which was never implemented but which formed the basis for the US proposals for the World Bank (US Senate, 1941: 8).[4] Callable capital at the BIS and the Inter-American Bank seems to have been conceived as a streamlined way to increase capital and hence operational capacity – a sort of pre-agreed capital increase that could be activated when appropriate.

By the time of Bretton Woods in 1944, the purpose of callable capital was clear and explicit: to reassure bond markets. The World Bank in the mid-1940s faced deep suspicion from New York investors, who were disinclined to offer credit to a new type of non-profit international bank owned by governments (World Bank, 2018: 33). As the Bank's first marketing director put it in a 1948 speech to investors: 'It [callable capital] is in the nature of a guarantee designed

[4] US Treasury official Harry Dexter White was in charge of negotiations on the Inter-American Bank, and subsequently led the US delegation at Bretton Woods (Helleiner, 2016). The treaty was not ratified by the US Senate mainly due to opposition by the US financial community and the outbreak of the Second World War. See also Lichtenstein (2018: 102–103) on the early history of MDB callable capital.

to encourage and induce private capital to invest in the Bank's obligations' (World Bank, 2013).

A signal of the importance of callable capital was a 1946 ruling by the US Attorney General confirming that the US was liable for its share of callable capital: 'This opinion was instrumental in convincing investors of the financial integrity and strength of the World Bank's capital structure' (World Bank, 2018: 42). The ruling paved the way for the first World Bank bond issue the following year and its eventual AAA bond rating in 1959. As a result of this successful experience, first the Inter-American Development Bank (1959) and then all later MDBs copied the use of callable capital.

Between the 1960s and the turn of the century, three trends are notable in relation to callable capital. First, the stock of callable capital grew. Callable capital represents 93% to 97% of total subscribed capital in most of the major MDBs, up from 80% when they were founded.[5] All the major MDBs by statute limited the size of their loan book to total subscribed capital (paid-in plus callable). When MDBs approached those statutory limits, shareholders created more headroom largely by committing more callable capital compared to paid-in capital. This was uncontroversial in good measure because callable capital had minimal or no budgetary cost.

Second, credit rating agencies relied heavily on callable capital from wealthy shareholder governments when awarding a AAA rating to MDB bonds. As a former top World Bank finance official noted in 1995, ratings agencies 'appear to be basing their judgment [on MDBs] solely on the strength of usable callable capital' (Mistry, 1995: 73). The backing of G7 shareholders – especially the US – as represented by their callable capital commitments served as a convenient shortcut to provide top ratings to the major MDBs.

Third, the views of large shareholders began to shift from seeing callable capital as a tool to help MDBs towards seeing it as a risk that MDBs need to avoid coming anywhere near activating. This was well expressed by the Canadian director at the World Bank in 1973: 'Management and the Board should think about callable capital as a Christian thinks about heaven, that it is a nice idea but no one wants to go there because the price of admission is death' (in Kapur et al., 1997: 991). Reducing the risk of a capital call 'to the level of insignificance' (Mistry, 1995: 22) became a key driver of MDBs' very conservative financial management.

In recent years, particularly following the 2008 global financial crisis, the context of MDB callable capital has evolved further. Credit rating agencies came under regulatory pressure after 2008 to overhaul their methodologies, leading to a more data-driven approach to evaluating MDBs. The lack of clarity on callable capital resulted in highly

[5] The exceptions are EBRD, which has a roughly 70%–30% ratio following the 2023 capital increase, and the AIIB, which established the 80%–20% ratio at its creation in 2015 and has not had any subsequent capital increases.

divergent approaches to incorporate it into MDB ratings. For Standard & Poor's, callable capital offers a very substantial and easily calculated uplift to MDB ratings, while it plays a smaller and less easily quantifiable role for Moody's and Fitch.

Shareholder views have also changed. Governments remain highly sensitive to any risk of a capital call, but are open to exploring how an already existing treaty commitment might be better leveraged to expand MDB lending capacity. Several donor governments – including the US, Sweden, the UK and Canada – are increasingly deploying guarantee instruments as part of their bilateral cooperation toolkit and are developing sophisticated approaches to evaluating contingent liabilities like callable capital in their budgetary frameworks.

Partly in response to the 2022 G20 CAF report, MDBs and shareholders are reconsidering callable capital along with other options to maximise lending capacity. Several MDBs are moving forward with the recommendation to eliminate statutory lending limits, thus removing an incentive to commit more callable capital. Governments are taking a closer look at the risks they face as MDB shareholders, including extreme tail risks covered by callable capital, to better inform decisions on MDB lending capacity. And triggers embedded in new MDB hybrid capital instruments are legally linked to a capital call, adding further impetus to clarifying this instrument (Humphrey et al., 2023).

These trends have encouraged MDB management, government shareholders and external stakeholders to evaluate callable capital with fresh eyes, as part of modernising MDB financial management. The first step is a close examination of its legal foundations: MDB statutes.

3 The nature of callable capital as a financial instrument

What kind of financial instrument is callable capital? Is it, as the name suggests, a contingent form of capital? Some type of hybrid capital instrument? A liquidity line? A guarantee? The key provisions addressing this question are in the early section of each MDB's charter as part of the description of its capital structure. These provisions are essentially the same in all six MDBs reviewed here.

Callable capital is an unpaid portion of the total amount of capital subscribed by each shareholder government to the MDB.[6] Shareholders have pre-committed callable capital as part of their international treaty obligation to the MDB, an obligation that has been ratified by each government and has the force of national law. The callable portion of subscribed capital is formally part of the shareholding of each member government and is reported in every MDB's financial statement each year, along with paid-in capital.

This point is critical: governments have already formally and legally committed to paying this capital when it is called. One may legitimately question whether all governments would be able or willing to do so (as will be explored in this project's Paper 3, see Box 1). But the obligation exists. This legal fact is the basis for the 1979 opinion of the General Counsel of the US Treasury that the US callable capital commitments to MDBs are 'authorized by United States legislation, binding obligations backed by the full faith and credit of the United States', regardless of whether 'future appropriations might be necessary to meet that obligation' (quoting IDB, 2023: 34).

Second, all statutes specify that the callable portion of subscribed capital can only be deployed to pay off creditors – mainly for bonds that MDBs have issued to investors. This ring-fenced, dedicated use of callable capital highlights the purpose World Bank founders conceived for it in 1944: a 'surety fund' to reassure bond investors that they would be repaid. The only exception is the special case of a portion of IBRD's callable capital (see Box 2).

[6] ADB (undated) Art. 5; AfDB (2016) Art. 6; AIIB (2016) Art. 5; EBRD (2013) Art. 5; IDB (1996) Art. II Section 3; World Bank (2012) Art. II Sections 3 and 5.

An important implication of this ring-fencing is that callable capital is not an unpaid version of core capital according to traditional definitions (see, for example, BIS, 2019). Whether paid-in or contingent, core capital must be able to absorb losses arising anywhere on the balance sheet, without restriction. Although callable capital was created within the logic of an MDB's capital structure and shareholding, and as a result has 'capital' in its name, it is not capital in the formal, financial sense of the term.

Although this might seem like a semantic difference, it has important implications. Sometimes it is suggested that an amount of callable capital (from AAA-rated governments, for example) can be added to regular equity capital when calculating capital adequacy. The fact that callable capital cannot be considered a type of equity capital means this approach is not justified.

Instead, the callable share of subscribed capital is a specialised type of guarantee to repay MDB bond investors, a kind of lender of last resort liquidity facility (but a cost-free version, unlike central bank crisis facilities for commercial banks). Because the risk that an MDB cannot repay creditors is covered by callable capital, MDBs should be able to adjust the risk tolerance levels in their capital adequacy frameworks. This is the essence of the G20 CAF panel recommendation on callable capital, as will be explored in Paper 6 of this project (see Box 1).

Box 2 The special case of IBRD's callable capital

The IBRD charter specifies that 80% of subscribed capital is reserved for a capital call only to pay creditors. The remaining 20% is paid in immediately or can be tapped for any operational purpose (World Bank, 2012, Art. II Section 5 (i)).

In IBRD capital increase agreements over the decades, the ratio of paid-in share capital to callable capital has declined. As of June 2023, 93.1% of total IBRD subscribed capital was on call and 6.9% was paid in (World Bank, 2023: 79). As such, the remaining 13.1% of IBRD's callable capital – $41.6 billion – is according to statutes eligible for direct use in operations, without the restriction that it only be used to repay creditors.

In theory, IBRD could consider that $41.6 billion as a contingent form of equity capital and incorporate it into its capital adequacy planning to directly leverage more development lending. That could result in a very substantial (roughly 80%) increase in the size of IBRD's loan portfolio. No other MDB has provisions that would allow this.

However, each IBRD capital increase resolution when the paid-in portion was below 20% included language stating that any part of the 20% not paid in immediately can be called 'only when required to meet obligations of the Bank for funds borrowed or on loans guaranteed by it and not for use by the Bank in its lending activities or for administrative expenses' (World Bank, 2011: 5 as example).

This proviso means that the 13.1% of callable capital can only be tapped in the same circumstances as all other callable capital. If any individual shareholders agreed that their subscription to this 13.1% could be repurposed, IBRD management could potentially include it in capital adequacy calculations to increase lending capacity. Such a change would likely require the legislative approval of each country in question.

4 The circumstances in which a capital call can be made

The prevailing view among MDB management has long been that callable capital is a 'gone concern' instrument:[7] it can only be triggered when an MDB is on the path to financial collapse and after other equity resources have been used up. In this view, the statutes prohibit an MDB from making a capital call to stabilise its finances in the face of a shock and return to normal operations.

The relevant provisions of IBRD, IDB and ADB statutes – which use very similar language – do not appear to merit this conservative interpretation, while AfDB's statutes are even less restrictive. By contrast, the statutes of EBRD and AIIB appear to permit a capital call only in a gone concern, liquidation scenario.

The distinction between callable capital as a going versus gone concern instrument is not necessarily relevant to its value to bondholders or MDB ratings. What matters for investors is that they are repaid on time and in full. Whether the MDB recovers after a capital call or is liquidated is not material to the bondholders – they recover their investment either way.

However, it is highly relevant to the MDB and its shareholders, who presumably still see the MDB as a useful tool to pursue public policy goals.[8] If a capital call is permissible when the MDB is still viable, this protection can be incorporated into an MDB's planning to manage risk and recover from stress. If not, then callable capital still has a financial value to bondholders but would not form part of MDB recovery planning (as will be explored in Paper 5 of this project; see Box 1).

IBRD, IDB and ADB

Very similar text defines how IBRD, IDB and ADB should meet liabilities in the event of loan defaults. Taking IBRD's statutes as

[7] In the commercial world, going and gone concern refer to instruments with a capital value (paid-in capital or various types of hybrid capital and subordinated debt). Since the callable portion of MDB subscribed capital is not actually capital, this is a slightly confusing usage of the terms going and gone concern. However, it is common practice in MDB policy discussions.

[8] If not, shareholders can suspend operations under the provisions of a different section of the statutes. See for example World Bank (2012) Art. VI Section 5.

representative (World Bank, 2012, Art. IV Section 7),[9] the relevant provision is as follows:

(b) The payments in discharge of the Bank's liabilities on borrowings or guarantees … shall be charged:

(i) first, against the special reserve provided in Section 6 of this Article;[10]

(ii) then, to the extent necessary and at the discretion of the Bank, against the other reserves, surplus and capital available to the Bank.

(c) Whenever necessary to meet contractual payments of interest, other charges or amortization on the Bank's own borrowings, or to meet the Bank's liabilities with respect to similar payments on loans guaranteed by it, the Bank may call an appropriate amount of the unpaid subscriptions of members in accordance with Article II, Sections 5 and 7. Moreover, if it believes that a default may be of long duration, the Bank may call an additional amount of such unpaid subscriptions not to exceed in any one year one percent of the total subscriptions of the members for the following purposes:

(i) To redeem prior to maturity, or otherwise discharge its liability on, all or part of the outstanding principal of any loan guaranteed by it in respect of which the debtor is in default.

(ii) To repurchase, or otherwise discharge its liability on, all or part of its own outstanding borrowings.

MDB management has generally taken the view that this provision defines a strict 'waterfall' that the MDB must follow. This view holds that first the MDB must exhaust all the resources in its special reserve (clause b (i)). Next, the MDB must exhaust all other reserves, surplus and paid-in capital (clause b (ii)). Only after all these resources have been completely depleted can the MDB take the step of making a capital call. With all equity depleted, the MDB would no longer be able to recover, making a capital call part of a liquidation process.

This interpretation does not seem to align with the wording of the provision. The text suggests considerable flexibility to address defaults of varying severity, with access to callable capital as an extreme measure that should not be taken lightly, but deployable to enable the MDB to recover from a shock and resume normal operations.

The stipulation that all equity resources must be drawn down to zero before triggering a capital call is not found in the text. If that was the intention, it would be expected that such an important point would be

[9] The analogous provisions are ADB (undated) Art. 18 and IDB (1996), Art. VII Section 3.
[10] All three MDBs maintain a special reserve as required by their statutes, which is reported in the equity section of their annual balance sheet statements.

explicit.[11] The phrase ‘to the extent necessary and at the discretion of the Bank’ suggests that the Bank can draw on reserves and paid-in capital up to the point where it would threaten the Bank’s viability, and then would be able to make a capital call.

The prevailing view of MDB management is that this phrase is only granting the Bank the ability to choose the order by which it taps surplus, reserves or paid-in capital. That would be a meaningless type of discretion. There is no need for a decision – the Bank would logically first use up its surplus, then tap reserves, and only after reserves are gone start to draw down shareholder capital. Any other order would make no sense.

It would be far more meaningful – and therefore worthy of special language in an MDB’s founding statutes – to have discretion to protect the Bank from liquidation and allow it to recover. The meaning would be exactly as it appears in the text: the discretion to use up equity as far as can be safely done without endangering the viability of the MDB, and then make a capital call.

This would preserve the capacity of the institution to recover and continue pursuing the policy mandate of shareholders, which would likely be just as relevant as before whatever crisis triggered the capital call, if not more so. It would also avoid forcing the MDB into a fire sale of assets and the destruction of an important tool of public policy. The text points to callable capital as a tool to help an MDB survive a shock, not a liquidation instrument.

At the same time, founding governments wanted to ensure that the MDB did everything possible to not access callable capital, short of actually destroying the MDB. Hence, they created a Special Reserve designed for unexpected but relatively modest defaults (World Bank, 2012, Art. IV Section 6). After that has been used up, provision b (ii) encourages the MDB to tap other equity resources, but does not require running them down to zero and ensuring the liquidation of the MDB (see Box 3).

An earlier draft of IBRD’s statutes, agreed between the US and UK governments just prior to the Bretton Woods conference in 1944, supports this interpretation. Art. IV Section 12 states that losses should be met from reserves and surplus, ‘and finally, as the Bank may determine, either from paid-in capital or from a call on the unpaid part of subscriptions on shares’ (US Treasury, 1944). This language gives the Bank even more discretion, and the change to the final version likely reflected the desire of shareholders to emphasise that the callable portion should only be tapped in a severe crisis.

[11] Particularly when one considers the very substantial attention placed on this specific provision in the Bretton Woods negotiations. From the first proposed draft to the final charter, this provision was rewritten at least five times in three weeks and was a main focus of attention of a special committee (‘Committee 2’) of the World Bank charter conference (see US Department of State, 1948).

This also explains the second sentence of clause (c), which states that an additional 1% of callable capital can be called each year if defaults are expected to be especially long. That sentence only makes sense in the context of a going concern. It implies that some portion of callable capital could be tapped if a series of defaults hit, and an additional 1% per year can be accessed if defaults are prolonged. If an MDB can only touch callable capital after it has used up all other resources and is a gone concern, there would be no reason to include that sentence – the MDB would already be non-viable and headed towards liquidation, so whether defaults are of long or short duration would be irrelevant.

Box 3 Going or gone concern for callable capital?

What would drive an MDB to need a capital call? Short of a global Armageddon, the most realistic scenario would be some type of major natural disaster or regional armed conflict leading a group of MDB borrowers to stop repaying their loans.

Assuming that a significant share of the loan portfolio goes into arrears while the rest remains current, the MDB would be able to service its creditor obligations for some time, well over a year, due to its liquidity buffers (as will be modelled in project Paper 4, see Box 1).

If the crisis continues and a large share of borrowers remain in arrears, the MDB's situation would deteriorate. Ratings agencies would begin to downgrade it, driving up its cost of funding, while liquid reserve assets would begin to dwindle.

At this point, a choice would need to be made: should the MDB be permitted to run down all its equity and use callable capital only to finalise any outstanding obligations as part of liquidation (gone concern), or should a capital call be triggered earlier in an effort to save the MDB (going concern)?

Imagine a gone concern approach. When it becomes clear that the MDB is going into liquidation, borrowers who remained current are likely less inclined to continue repaying their loans, worsening the cash flow of the MDB. Combined with selling assets at a discount on their value due to the crisis conditions, this would increase the amount of callable capital needed to repay creditors. Bond markets would shut the MDB out of funding at reasonable terms, worsening the downward spiral. Decades of accumulated relationships, knowledge and international standing would be destroyed.

Imagine a going concern approach. After special reserves and easily liquidated assets are exhausted and the crisis continues, the MDB triggers an emergency capital call (a faster option than a regular capital increase). The MDB uses called resources to repay its creditors rather than running down its own equity. This calms the markets, allowing the MDB to rebuild its bond rating and regain access to low-cost funding. Other borrowers remain current because they have confidence that the MDB will recover, and more space is given to borrowers in arrears to begin repaying their loans. The MDB does not need to sell more assets, and its institutional standing and public policy capacity is retained.

Faced with these alternatives, a going concern usage for callable capital makes the most sense, in line with this paper's understanding of what the founders of the World Bank, ADB, AfDB and IDB envisioned. The public policy function of the MDB is maintained and the callable resources required would be less than in a gone concern scenario.

To be clear, this going concern usage is only for a severe crisis and does not permit triggering a capital call earlier, such as when an MDB faces moderate loan losses and is in danger of losing its AAA rating. That type of use – more like a pre-committed capital increase to preserve a AAA rating – would require modifying MDB statutes. This is addressed at the end of this paper.

AfDB

AfDB's statutory provisions on how callable capital can be deployed are much shorter and broader than in the other three MDBs. The key text is: 'Whenever necessary to meet contractual payments of interest, other charges or amortization on the borrowing of the Bank, or to meet its liabilities with respect to similar payments in respect of loans guaranteed by it and chargeable to its ordinary capital resources, the Bank may call an appropriate amount of the unpaid subscribed callable capital' (AfDB, 2016, Art. 21 (1)).

The text makes no mention of any order of resources to be tapped prior to callable capital. The only phrase open to interpretation is 'whenever necessary'. In line with the discussion above, it would be most logical to understand this as 'whenever necessary to avoid driving AfDB into liquidation'. The subsequent paragraph (ibid., Art. 21 (2)) repeats very similar text to the other MDBs related to an additional 1% of callable capital per year in the event of longer-duration defaults, further suggesting that it was conceived as a 'going concern' instrument.

The proceedings from AfDB's charter negotiations show that the original draft version of Art. 21 was exactly the same as IBRD's charter. Interestingly, the proposal for AfDB's revised and final text came from an unnamed IBRD observer to the negotiations, who commented that IBRD's Art. IV provisions were 'badly drafted', and that the 'right to make calls in order to meet the Bank's obligations should be unconditional' (UNECA, 1964: 132). The observer also notes that the 'waterfall' provision in IBRD's Art. IV Section 7 (b) 'does not serve a very useful purpose and could be omitted' (ibid.). While it is impossible to know the motivations of the IBRD observer, it clarifies that the final text was specifically chosen to offer AfDB even more flexibility than IBRD to tap callable capital.

EBRD and AIIB

Written in 1991 in the aftermath of the collapse of the Soviet Union, the EBRD charter (EBRD, 2013) has markedly different language compared to previous MDBs. Rather than being a tool to be deployed with a degree of flexibility, EBRD's callable capital would seem to be almost automatically triggered only after all other resources have been exhausted. Art. 17 (1) offers some discretion to deal with individual loan losses, but Art. 17 (2) indicates that, once losses have grown to become a serious problem, callable capital can only be used in a gone concern scenario at the end of a clearly delineated waterfall of resources.

Article 17: Methods of meeting the losses of the Bank

1. In the Bank's ordinary operations, in cases of arrears of default on loans made, participated in, or guaranteed by the Bank, and in case of losses on underwriting and in equity investment, the Bank shall take such action as it deems appropriate. The Bank shall maintain appropriate provisions against possible losses.

2. Losses arising in the Bank's ordinary operations shall be charged:

(i) first, to the provisions referred to in paragraph 1 of this Article;

(ii) second, to net income;

(iii) third, against the special reserve provided for in Article 16 of this Agreement;

(iv) fourth, against its general reserve and surpluses;

(v) fifth, against the unimpaired paid-in capital; and

(vi) last, against an appropriate amount of the uncalled subscribed callable capital which shall be called in accordance with the provisions of paragraphs 4 and 5 of Article 6 of this Agreement.

The waterfall is listed in an explicit, numbered order. This strongly implies that each set of resources must be used up before going on to the next. The provision has no language about discretion similar to IBRD's Art. IV Section 7 (bii), nor does it have a paragraph on calling additional callable capital in the event of prolonged defaults. The overall tone is substantially more restrictive than that of older MDBs.

The minutes of the EBRD charter negotiations are unavailable, so we do not have further guidance to understand this difference. One may speculate that it partly reflects changing attitudes among major non-borrower nations in line with the rise in small government, private sector-focused conservatism in the 1980s, as well as the evolving views on callable capital discussed in Chapter 2.

It may also reflect the fact that EBRD was intended to lend mainly for private sector projects, which are inherently more likely to face defaults than loans to government borrowers. Thus, callable capital may have been perceived as more at risk of being called, and founders may have wished to make that as remote as possible by modifying the statutory language. The expectations of some shareholders that EBRD would have a limited lifespan may also have played a role (Kilpatrick and Williams, 2021: 1).

AIIB follows the wording of EBRD very closely in its Art. 20 (AIIB, 2016). AIIB's first legal counsel, who led the work drawing up its charter, explained in a subsequent book that the waterfall of resources was specifically intended: 'Before a call against callable capital could be made, losses arising from AIIB's investment operations would be charged, in order, to provisions, net income, reserves and retained earnings and unimpaired paid-in capital' (Lichtenstein, 2018: 111).

For both EBRD and AIIB, the statutes describe a gone concern use for callable capital, to be triggered only after the MDB has passed the point of non-viability and is headed towards liquidation. As noted previously, this does not detract from the financial value of callable capital as a guarantee for bondholders. However, it does mean that callable capital cannot be deployed to help these MDBs recover from a severe financial shock. This restriction limits the ability of EBRD and AIIB to incorporate the value of callable capital into their risk planning and capital adequacy compared to the other four MDBs.

5 Who has the authority to make a capital call

It is not clear where the authority lies to make a capital call. Most major MDBs have concluded that a capital call would de facto have to be triggered by a vote at the level of the board of directors (BoD), as noted recently in a report by Fitch (Fitch, 2022: 4). However, in the relevant statutory provisions of the IBRD, ADB, AfDB and IDB, the actor is simply ‘the Bank’.

Evidence suggests that the framers did not intend ‘the Bank’ to mean the BoD. In the charters of all four MDBs, board powers are described explicitly. In the IBRD charter, for example, Sections 6 and 8 immediately before and after Section 7 on callable capital spell out specific roles for the BoD, as does ADB’s Art. 17 and Art. 19 on either side of Art. 18 on callable capital. It would be puzzling if the framers did not do the same in this provision of such importance.

The evolution of this provision during the Bretton Woods negotiations in 1944 bears this out. Initial drafts of the IBRD statutes follow the earlier examples of the BIS and the ill-fated Inter-American Bank by stating that ‘directors’ are responsible for a capital call (US Department of State, 1948, drafts from July 15, 16 and 18). However, by the 19 July draft, reference to the directors had been removed, and discretion was given to ‘the Bank’ (US Department of State, 1948: 847). This was the final wording of the IBRD’s charter.

This shift in the actor responsible, from directors to ‘the Bank’, is very unlikely to have been a casual decision. A special commission had been created within the committee leading the IBRD negotiations specifically to address Art. IV (Commission 2 of Committee II), and the language of Section 7 on callable capital was repeatedly revised during Bretton Woods. The only reason why this word would be changed would be to consciously require Bank management to have a role in making a capital call, rather than leaving it up to shareholder representatives on the BoD.

It would make sense that the decision to trigger a capital call would be initiated by MDB management, as the guardians of the institution’s integrity, as distinct from the political considerations of shareholders. Management is best positioned to understand whether a financial shock would imperil the MDB and merit triggering an emergency capital call. Otherwise, creating this instrument, to which shareholders had already subscribed as part of every capital increase, would serve no purpose.

This authority structure makes sense when one considers that the principal audience for callable capital was (and still is) bond markets. As the historical record shows,[12] a key concern of New York bond market investors when the World Bank was created was that it would be managed for political reasons. This was why the early leadership of the Bank came from the Wall Street finance community: to reassure investors that the Bank would be run on rigorous financial principles, rather than for political considerations. It would make sense that professional Bank leadership would be in charge of being able to trigger the callable capital guarantee.[13]

At the same time, shareholders may have been uneasy giving management unfettered authority to trigger a capital call, due to the fiscal implications involved. Hence, on the one hand, the provisions discussed in the previous chapter were intended to ensure that it could not be called unless the MDB faced serious financial difficulties. On the other, giving ‘the Bank’ discretion on callable capital as per Section 7 may have been the founders’ way of leaving the door open for shareholder involvement.

It may be that the framers intended the situation to be worked out between management and the BoD should an emergency situation ever arise. Triggering a capital call would be a loud message from management to shareholders that the institution needs financial support quickly due to a shock. A BoD vote (requiring only a normal majority, not the special majority needed for a capital increase) might form part of the process, even if the statutes do not explicitly require it and even though shareholders have already subscribed the callable capital.

Unlike the other three MDBs, AfDB’s BoD issued a resolution related to callable capital in 1983,[14] stating that the responsibility for calling capital lies with the BoD. It is unlikely to be a coincidence that this resolution was approved right after non-borrower countries first joined AfDB as shareholders, on 30 December 1982: non-borrowers would have wanted to ensure direct influence over a capital call by requiring a BoD vote, rather than leaving it in the hands of AfDB management. This also aligns with the more conservative interpretations around callable capital that became prevalent among major shareholders in the 1980s, as discussed in Chapter 2.

The relevant provisions of the EBRD (1991) are notably different on this point. EBRD’s Art. 17 on callable capital is written entirely in the passive voice – there is no subject involved, neither directors nor ‘the

[12] See among others World Bank (2018: 33); Kapur et al. (1997: Ch 14); Humphrey (2015).

[13] Interestingly, one of the members of Commission 2 of Committee II tasked with writing the provision on callable capital, Daniel Crena de Iongh (previously president of a Dutch bank), was World Bank treasurer from 1946 to 1953.

[14] Text was supplied by email from AfDB management – specific citation not available.

Bank'. The text gives the impression of an almost automatic process, only triggered at the very end of the resource waterfall, although the actual decision would at some point need to be taken by some authority. EBRD's view is that this should be the BoD, even though it is not stated in the articles. The AIIB provisions are almost exactly the same as the EBRD ones.

In the end, the most important conclusion is that the statutes are ambiguous on this point. Greater clarity would improve investor confidence that a call would occur in an orderly and timely fashion. This, in turn, could improve the uplift given to callable capital by credit rating agencies and the ability of MDBs to incorporate callable capital into financial planning.

6 Conclusions and policy options

Summary of findings

A first step to maximising the value of callable capital is to understand its legal basis in MDB treaties. This is an essential input to policy decisions, including modernising MDB crisis recovery frameworks and pursuing the G20 CAF recommendation to incorporate callable capital into MDB capital adequacy frameworks. It will also inform the methodologies used by credit rating agencies to evaluate the financial strength of MDBs.

A close reading of the statutory provisions on callable capital leads to four conclusions. First, despite its name, callable capital is not actually capital but rather a specialised type of guarantee offered by shareholders that can only be used to repay MDB creditors (mainly bond investors). It has substantial value as a guarantee to bondholders committed by shareholder governments as part of their international treaty obligations. But it cannot be considered part of core capital.

Second, the statutory provisions of IBRD, ADB, AfDB and IDB offer flexibility for the MDB to trigger a capital call to help recover from severe stress and continue operations. For EBRD and AIIB, callable capital can only be used when the MDB is no longer a viable concern. Callable capital has value as a guarantee to bondholders in both cases, but the difference has implications for how MDBs manage risks, plan stress recovery and consider how callable capital’s value can be incorporated into capital adequacy frameworks. It may also influence the uplift given for callable capital by credit rating agencies.

Third, the authority to trigger a capital call at IBRD, ADB, AfDB and IDB appears to reside more with the management of the MDB than the boards of directors (shareholders), but the text is ambiguous. By contrast, a capital call at EBRD and AIIB appears designed to be almost automatic, with little discretionary role for either management or the Board on when to trigger a call. This difference should not influence the security it provides to bondholders, but it can impact MDB stress recovery planning as well as rating agency methodologies.

Fourth, none of the statutes explains the process or timing of a capital call, nor has this been spelled out in any secondary policies. This has led to considerable uncertainty about whether a capital call would ensure timely payment of creditors, which in turn has implications for loss given default calculations by credit rating agencies and investors, and therefore for MDB funding terms.

Policy options to maximise the value of callable capital

Despite its imperfections, callable capital is an existing treaty commitment with a face value of nearly a trillion dollars in its current form. It makes sense to first try to leverage that value as much as possible without statutory reform, which can be politically complex.

MDB shareholders can issue secondary policies or formal interpretations that are congruent with the statutes and past capital increase resolutions. This would provide greater precision and clarity to orient market actors, MDB management and shareholders on the nature and value of callable capital. These actions would be most powerful if done in a coordinated fashion across MDBs, to help establish standards on callable capital for all MDBs as a unique class of financial institution. Should that effort reap only limited gains, shareholders may then wish to consider rewriting callable capital provisions within MDB statutes.

Beyond the policy options discussed in this paper, it is also important for shareholders to clarify their own budgetary procedures related to callable capital, which also limit the uplift given by credit rating agencies for callable capital. This will be addressed in a forthcoming paper in this project (see Box 1, Paper 3).

Board resolutions to clarify existing statutory provisions

Shareholders should clarify their interpretation of statutory language on callable capital via BoD resolutions[15] on the authority to trigger a call and the conditions under which a call can be made.

The authority to formally initiate a capital call should be in the hands of MDB management as the custodians of the institution’s financial integrity, and most aware of the risks posed by the loan portfolio, structure of liabilities and capital market conditions. At the same time, political and budgetary realities indicate that the BoD should also play a role.

One solution would be to confirm that MDB management has the authority to initiate a formal BoD discussion on activating callable capital, should the MDB face a crisis. A BoD vote would be required to actually trigger a call, following normal majority voting. Having a capital call triggered by BoD normal majority voting preserves a streamlined approval process appropriate for a crisis to activate

[15] The BoD is the first port of call in resolving any dispute on the interpretation of each MDB’s statutes. In the case of continued disagreement, the board of governors has the final authority. See for example World Bank (2012) Art. IX.

callable capital commitments already subscribed by shareholders, in contrast to the more cumbersome board of governor special majority required for a regular capital increase.

Shareholders should clarify whether callable capital is a going concern instrument available to help an MDB recover from a severe crisis, or a gone concern instrument that can be used only on the path towards liquidation. Statutes indicate that it is a going concern instrument for IBRD, ADB, AfDB and IDB, and a gone concern instrument for EBRD and AIIB. Shareholders should make this explicit via a BoD resolution, coupled with the appropriate policies discussed below.

A going concern usage makes more financial sense, to avoid destroying shareholder and policy value by forcing the MDB into liquidation. It would not materially increase the risk of a call, which would still only occur in extreme shock scenarios well beyond what any MDB has ever experienced.

If shareholders nonetheless do opt for a gone concern usage, the resolution should further spell out the ability of management to trigger a call sufficiently in advance to ensure bondholders are paid in a timely fashion prior to liquidation. As a practical matter, this would have to happen before an MDB depletes all its capital resources.

BoD resolutions will have an important impact on shaping perceptions of MDB financial strength among bond investors and credit rating agencies by removing ambiguities surrounding callable capital. They will also provide the clarity MDBs needs to prudently incorporate callable capital into risk management and capital adequacy frameworks.

A board of governors resolution expressing broad support for BoD resolutions would further bolster external perceptions of shareholder support and a considered, systematic approach by MDBs to maximising the value of callable capital.

Secondary policies to spell out capital call procedures

MDB management and shareholders should define a set of secondary policies spelling out the process and timing by which a capital call would occur, as part of a modernisation of the management actions and instruments MDBs can deploy in the face of financial stress. These policies should include the following.

- A set of key financial indicators to monitor increasing levels of balance sheet stress beyond business as usual and moving towards MDB non-viability. The choice of indicators and their indicative levels should be selected by each MDB based on its operating context and risk appetite. Triggers should be specific enough to provide clarity to relevant stakeholders, but not overly rigid so that MDB management retains enough flexibility to adapt to evolving circumstances. At least two triggers should be defined:[16]

  - When MDB management informs shareholders that a crisis may result in a capital call in the foreseeable future, so shareholders can begin budgetary arrangements and management can prepare a capital call.
  - When a capital call should actually be initiated.
- A definition of the process of a capital call once triggered, including:
  - Criteria for whether an MDB should seek to sell assets (including loans) before utilising equity resources or making a capital call. This should consider whether market conditions would permit a reasonable sale value or whether shareholder interests are better served by holding assets.
  - A method to transparently determine the likely amount of a call needed to cover liabilities.
  - Timeframes for shareholders to meet a capital call, the process for subsequent rounds to raise the required resources in the likely event that not all shareholders meet the initial call and consequences for non-compliance with a call.
  - Predefined processes and channels to ensure that callable capital is ring-fenced to repay MDB bondholders and not used for any other purpose, as per statutory stipulations.

Further options: reforming MDB statutes or capital increase agreements

The proposals above are congruent with the spirit and letter of statutory provisions related to callable capital. Shareholders may nonetheless wish to reform the statutes or capital increase agreements, either to increase clarity or to change the parameters of callable capital. An example often raised are the statutes defining the callable capital of the European Stability Mechanism (ESM), despite important differences in the mandate of ESM compared to MDBs.[17]

Rewrite existing statutory provisions to increase clarity and reliability

- Delineate the order and extent of ‘waterfall’ resources to be tapped prior to callable capital, and explicitly define in the statutes whether it can be done before the MDB reaches the point of non-viability or not.

[16] These triggers would be linked to a modernised approach to managing MDB financial stress taking into account the lessons of the commercial banking sector following the global financial crisis, to be discussed in an upcoming paper (see Paper 5, Box 1). They would also be linked to triggers for the new hybrid capital instruments being considered by MDBs (see Humphrey et al., 2023).

[17] ESM is an emergency fund to assist EU governments facing severe financial/fiscal stress, created in the wake of the Eurozone crisis. Its role is closer to the IMF than to an MDB: to help overcome a macroeconomic crisis, rather than providing long-term development financing like an MDB.

- Explicitly define in the statutes the lines of authority to trigger a call.
- Include a provision requiring shareholders to supply capital following a call within a specified timeframe.
- Include language stating that the callable capital commitment is irrevocable and unconditional (as with ESM, 2012, Art. 9). While not legally different from existing shareholder commitments under existing MDB treaties (see US Treasury cited in IDB, 2023: 34), more categorical language could further strengthen how callable capital is perceived by market actors.

Modify statutory parameters for callable capital

- Following the example of the ESM treaty provisions (2012, Art. 9), revised MDB statutes could make callable capital deployable as a type of fully loss-absorbing equity capital to directly support greater lending. This would be more like a pre-committed capital increase than existing callable capital.
- MDB statutes could allow a capital call substantially earlier in the face of financial difficulties, and not necessarily triggered by loan losses, as is currently the case. For example, shareholders may agree to deploy callable capital to defend a AAA rating, should a downgrade appear imminent for any reason. This reform would imply a higher risk of a capital call compared to existing callable capital, which can only be triggered in an extreme crisis.
- These changes could be done in combination, further enhancing the strength of callable capital.
- EBRD and AIIB shareholders may consider revising statutes to permit a capital call in a going concern recovery scenario, rather than only in a gone concern liquidation scenario as currently. This would allow them to incorporate the value of callable capital into risk management, capital adequacy and recovery planning. It would also align their callable capital with the other major MDBs, helping promote a more uniform approach to this instrument across MDBs as a class of institution and providing greater clarity to markets and credit rating agencies.

Modify MDB capital increase agreements at IBRD

As described in Box 2, roughly 13% of IBRD’s callable capital (equivalent to about $41 billion) can be redeployed by statute to support increased operations, i.e., as core equity capital. This is currently not possible due to the language of IBRD capital increase resolutions over the years. Individual shareholders could agree to modify their commitment to allow such a use. This would not require unanimity or any board vote, although it likely would require approval from the legislatures of willing shareholder governments.

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