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Financing for development to respond and recover in an era of interrelated and global crise

Session 4: Scaling-up development finance II: The role of multilateral development banks and of innovative financing instruments

Paulina Beato
G-20 Independent Review of MDBs' Capital Adequacy Framework

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# Background and Context

# Timeline

- July 2021. G20 Finance Ministers and Central Bank Governors agreed to launch the Independent Review of MDBs' Capital Adequacy Frameworks (CAF) with a central objective:
    - Ways to increase their lending capacity.
- September 2021-July 2022. The expert group worked and meet almost every week  either in plenary sessions or by work streams, and commissioned several external studies
- July 2022.  G20 Finance Ministers and Central Bank Governors welcomed the Report

# The context in 2021-2022

- First, new challenges put at risk the economic recovery and the achievement of the Sustainable Development Goals
  - The war in Ukraine, droughts, rising prices of food and energy, and many others
- Second, the request of “National Determined Contributions” more and more ambitious to address Climate Change

**MDBs are a unique and powerful tool to face these issues**

# The panel approach analyzed three critical factors of CAF underpinning the MDBs lending headroom

**CREDIT RATING AGENCIES ASSESMENT**

- Statistics and Data
- Internal Methodologies

**MDB INTERNAL RISK ASSESMENT**

- Risk appetite
- Internal Methodologies

**INNOVATION**

- Risk transfer
- Capital Innovations

# The emerging picture we found was:

- MDBs aim for AAA ratings while avoiding the call on callable capital
  - Callable capital is a sort of huge guarantee given by shareholders
- Some MDBs  target and monitor a custom-made risk capital ratio, while some others rely on the standard Basel or S&P methodologies
- CRAs and MDBs give a poor value to  Preferred Creditor Treatment (PCT) even the PCT makes the probability of default of MDBs very low
  - PCT is the governments effective preference for paying MDBs debt obligations
- Financial management practices vary significantly across MDBs
  - For example, the capital indicators are  constructed in different ways

# Shareholders are essential actors for a Change

- Shareholders have the power to unleash a substantial increase in available funding
  - Hundreds of USD billions over the medium term
- Shareholders may promote ***five strategic shifts***
  - For enhancing the intersection of the 3 critical factors that would increase lending capacity
- The implementation of such shifts will not be easy and will require careful evaluation of trade-offs.
  - ***They have the potential to have a huge impact on development finance***

# 5 STRATEGIC SHIFTS 5 Recommendations

# Strategic shifts

1. Redefine the Approach to Risk Appetite for Capital Adequacy Frameworks
2. Incorporate Uplift from Callable Capital into Capital Adequacy Frameworks
3. Implement Innovations to Strengthen Capital Adequacy and Lending Headroom
4. Improve Credit Rating Agency Assessment of MDBs Financial Strength
5. Enhance the Governance of the Capital Adequacy Frameworks

# 1. Redefine the Approach to Risk Appetite for MDBs Capital Adequacy Frameworks

- MDBs are not subject to prudential regulation and supervision. They are overseen by shareholders that .
  - Want MDBs to have  access to low-cost funding
  - Avoid  a call on callable capital.
- Most shareholders use MDB ratings as a shorthand to express their risk appetite.
  - Most MDBs have policies binding them to a top bond rating with the major rating agencies.
  - Because each rating agency uses a different methodology, the union of the most stringent components define the limits
- The Financial Stability Board (FSB)  highlighted, after the 2008-09 global financial crisis, the  over-reliance on external  ratings at the expense of in-house risk analysis
  - The goal of the FSB Principles is to provide incentives for firms to develop their own capacity for credit risk assessment

# Specific Guidelines

- Define MDBs risk appetites prioritizing shareholder-specified limits rather than external criteria
- Ensure that MDBs capital adequacy frameworks account adequately for preferred creditor treatment and the concentrated portfolio
- Relocate specific numeric leveraging targets from MDBs statutes to capital adequacy framework

# 2. Incorporate Uplift from Callable Capital into MDB Capital Adequacy Frameworks

- Most MDBs have very large amounts of callable capital in their subscribed capital
  - In 2020, the MDBs had a bit more than 1.3 trillion of US$ in subscribed capital and about 1.2 trillion of US$ (91%) was in the form of callable capital.
- The procedures for undertaking a call are not clearly defined in MDB statutes or policies
  - the budgetary and legal procedures are determined by national arrangements and vary considerably.
- Credit rating agencies incorporate a portion of callable capital in evaluations of MDBs
  - MDBs generally do not include callable capital in their capital adequacy frameworks

# Specific Guidelines

- Incorporate a prudent share of callable capital into MDBs' own calculation of capital adequacy, following the approach validated by all three credit rating agencies
  - The likelihood that one of the major MDBs might face circumstances requiring to make a capital call to shareholders to repay bondholders is extraordinarily remote.
  - This conclusion is based on extensive discussions with MDB finance teams, and an external study commissioned by the  panel

# 3. Implement Innovations to Strengthen MDB Capital Adequacy and Lending Headroom

- MDBs have long followed a relatively “traditional” model of managing their balance sheets.
  - MDBs have borrowed  on capital markets and made long-term development loans, which they have kept on their balance sheets until repayment.
- Shareholders and counterparties increasingly recognize opportunities to work with MDBs through innovations
  - Efforts in recent years for MDBs to leverage greater volumes of private sector finance for development.
  - Insurance firms and other investors have shown significant interest in taking exposures on MDB portfolios,
  - Institutional investors are able to benefit from the high quality of MDB due diligence, Environmental, Social and Governance (ESG) standards and PCT protections

# Panel proposes the following innovations

- Freeing up space on the balance sheet through
  - Risk transfers to the private sector
  - Donor guarantees
  - MIGA-MDB partnerships
- Offering new forms of capital:
  - Hybrid capital
- Boosting countercyclical capacity:
  - Pool commitments of callable capital for crisis responses

***Several MDBs have developed variants of these innovations, for example non-voting capital, transfers to private sector***

# 4. Improve Credit Rating Agency Assessment of MDBs Financial Strength

- The three major credit rating agencies, S&P, Moody’s and Fitch, dominate the market for MDB bond ratings.
  - The fact that MDBs have good rating provides important advantages in pursuing their mandates
- MDBs pose a challenge to ratings agencies.
  - they are similar to commercial financial institutions as they carry out lending and investing activities.
  - they have very specific features as  counter-cyclical operational mandates, below-market loan pricing, a structurally concentrated loan portfolio, preferred creditor treatment and an unusual capital structure, among others
  - Many of these characteristics are not easily incorporated in rating methodologies.
- Studies show that ratings agencies underestimate the benefits of PCT and overestimate the risks posed by concentrated MDB portfolios

# Specific Guidelines

- Strengthen communication of G20 members and other shareholders to inform rating agencies their views
- Rating agencies can take steps to strengthen their MDB evaluation methodologies
- Rating agencies and MDBs should work together to develop common standards for evaluating the risk weights of ESG-related assets

# 5. Improve the Environment for Capital Adequacy Governance

- Governance must be considered in any discussion of capital adequacy.
  - The role of shareholders and board structures is fundamental to financial governance, as is highlighted by modern good practices
- Shareholder representatives on MDB boards and board committees should have the responsibility
  - To approve financial policies, risk appetite, and institutional goals and review the overall financial performance
  - This gives management a clear set of targets and parameters to implement in MDB operations.

# Specific Guidelines

- Measures to strengthen the shareholder boards at MDBs for setting the parameters of CAF and overseeing them
- Regular capital benchmarking reports on each MDB’s capital adequacy framework in a comparable format
- Enhanced arrangements to share best practices and facilitate discussion among MDBs and shareholders.
- Endorse and support ongoing efforts to transform GEMs, **Global Emerging Markets Risk Database Consortium,** into a stand-alone entity with legal status to curate and disseminate MDB statistics

# Next Steps

# Next Steps

- The G20 is working on developing a roadmap for the implementation of the recommendations.
- Individual MDB Boards are beginning to discuss the report and how it may apply to their institutions.
- Chair's Summary of G20 Finance Ministers and Central Bank Governors in the Meeting in Washington DC, 12-13 October 2022
  - Urge MDBs to continue to discuss options for implementing the recommendations
  - Ask MDBs to deliver an update to G-20 in Spring 2023. Too late?
- The Bill & Melinda Gates Foundation, Open Society Foundation, and The Rockefeller Foundation announce the MDB Challenge Fund ( 5,25 US$ millions)
  - For implementing the panel recommendations and increasing the lending to emerging countries

# The panel’s collective view

- Two central issues underpinning the report recommendations are preferred creditor treatment and callable capital.
- Including them  into the CAF would create substantial additional lending headroom at the major MDBs.
- The panel recommends that MDBs and their shareholders work collectively on these critical recommendations

A global leader is needed for pushing urgently toward the two most relevant changes

*Including PCT and Callable Capital into MDBs Capital Adequacy Framework*