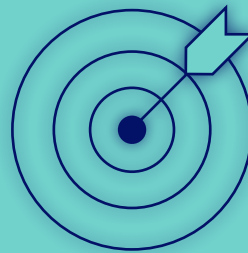
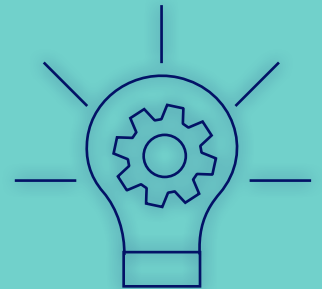


Boosting MDBs' investing capacity

An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks



Disclaimer

This report is the product of the Expert Panel tasked with the Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks and reflects broad agreement among its participants. This does not imply agreement with every specific observation or nuance. Members participated in a personal capacity, and their participation does not imply the support or agreement of their respective institutions. The report does not represent the views of the G20 membership or of the Italian and Indonesian G20 Presidencies. It also does not represent the views of Multilateral Development Banks, Credit Rating Agencies, or any other external party consulted in the course of the Review.

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Abbreviations

ADB Asian Development Bank	EBRD European Bank for Reconstruction & Development	IBRD International Bank for Reconstruction and Development	NDB New Development Bank
AfDB African Development Bank	ECB European Central Bank	IDA International Development Association	OECD Organisation for Economic Co-operation and Development
AIIB Asian Infrastructure Investment Bank	EIB European Investment Bank	IDB Inter-American Development Bank	PCS Preferred Creditor Status
ATI African Trade Insurance Agency	ESG Environmental, Social and Governance	IDB Invest Inter-American Investment Corporation	PCT Preferred Creditor Treatment
BCBS Basel Committee on Banking Supervision	ESM European Stability Mechanism	IFC International Finance Corporation	PPPs Public-Private Partnerships
BSO Balance Sheet Optimization	FSB Financial Stability Board	IFFEd International Finance Facility for Education	RAC Risk Adjusted Capital
CAF Capital Adequacy Frameworks	G20 EPG G20 Eminent Persons Group	IIF Institute of International Finance	S&P Standard and Poor's
CAF-DBLA Corporacion Andina de Fomento – Development Bank of Latin America	G20 FCBD Finance and Central Bank Deputies	IMF International Monetary Fund	SDGs Sustainable Development Goals
CDB Caribbean Development Bank	G20 FMCBG G20 Finance Ministers and Central Bank Governors	IRB Internal Ratings Based	SDRs Special Drawing Rights
CET1 Common Equity Tier 1	G20 IFAWG G20 International Financial Architecture Working Group	IsDB Islamic Development Bank	TDB Trade and Development Bank
CFO Chief Financial Officer	GCI General Capital Increases	IPSAS 19 International Public Sector Accounting Standards	ToRs Terms of Reference
CRA Credit Rating Agencies	GDP Gross Domestic Product	MDBs Multilateral Development Banks	WB Group World Bank Group
CRO Chief Risk Officer	GEMs Global Emerging Markets Risk Database	MIGA Multilateral Investment Guarantee Agency	
CUR Capital Utilization Rate			
DFIs Development Finance Institutions			

Executive Summary

An Action Plan to Reform Multilateral Development Bank Capital Adequacy

Our world is facing turbulent times with a challenging combination of short-term crises and longer-term development needs that is straining the capacity of the international community.

Multilateral development banks (MDBs) are uniquely placed to respond to these challenges. They need to make the most efficient use of the scarce public resources under their stewardship and more effectively attract additional capital from market sources.

The hard realities of the past two years—global pandemic, major international armed conflict, increasingly visible impacts of climate change and rising macroeconomic imbalances—make clear that this is a time to move past discussion to action. Success will require concerted and coordinated efforts from shareholders and MDBs.

This Panel was convened by the G20 to ‘provide credible and transparent benchmarks on how to evaluate MDB Capital Adequacy Frameworks (CAF) [...], enable shareholders, MDBs and Credit Rating Agencies (CRAs) to develop a consistent understanding, [...] and enable shareholders to

consider potential adaptations [...] to maximise the MDBs’ financing capacity’ (see ToRs at Annex D). The Panel recommends strategic shifts in five areas to maximize the impact of MDB capital, which should be seen as a coherent and interdependent package of initiatives to allow MDBs to stretch themselves further while mitigating the associated risks:

1 Adapt approach to defining risk tolerance

Most MDBs and shareholders allow rating agency assessments considerable influence in determining risk tolerance, de facto embedding rating agency methodologies into internal policies. Shareholders and MDBs should further reflect on their approach to defining risk tolerance with evidence-based, realistic assessments of the risks posed by MDB operations, using rating agencies as an external evaluation tool. The Panel recognizes the great importance for the business models of MDBs of maintaining superior financial strength as reflected in AAA ratings, and, to that end, make use of an enhanced dialogue with CRAs and clear public statements of shareholder support. Moreover, specific numeric leveraging targets should be removed from MDB statutes and integrated into capital adequacy frameworks.

2 Give more credit to callable capital

Callable capital is a powerful instrument expressing the commitment of shareholders to stand behind MDBs. MDBs should incorporate its financial benefits in MDB capital adequacy assessments, as is already the practice in some MDBs and in credit rating agency methodologies.

3 Expand uses of financial innovations

Proven innovations to create more usable capital or shift loan risks to willing counterparties should be used more widely and frequently by MDBs, mobilizing financial markets as sources of development finance and potentially freeing billions of dollars in additional financing.

4 Improve credit rating agency assessment of MDB financial strength

Clarity from G20 and shareholders more broadly on their support for MDBs is important for how rating agencies and markets view MDBs. At the same time, there may be scope for rating agencies to refine methodologies to better account for the unique mission, track record and financial strength of MDBs.

5 Increase access to MDB data and analysis

More accessible and comparable data and analysis, as well as regular capital reviews, will support shareholders, rating agencies and market participants in their assessment of MDB strength and demystify their financial model. Ensuring the right access to information and expertise by MDB boards will support shareholder consistency between strategic priorities and financial management. Coordination arrangements across MDBs can be improved, with the

involvement of a greater variety of players, including shareholders. A standalone structure could provide continuity and independence to this work and a space for dialogue for collective and coordinated action.

In the view of this Panel, MDBs and their shareholders can take the necessary decisions and begin implementation on a series of reforms, such that MDBs are able to start increasing their lending capacity over the next 12-24 months. The expected potential scale of the increase is substantial, likely to be several hundreds of billions of dollars over the medium term. The increased lending capacity varies between MDBs and depends on the depth and scale of execution. It is not possible at this stage to provide precise numbers, which would require detailed work at the level of individual MDBs; the estimated benefits provide a sense of magnitude, or scale. Much depends on which combination of reforms are pursued and how they are implemented.

The reforms do have risks associated with them, but the Panel believes that these can be mitigated effectively. The risks are far outweighed by the dangers of not fully deploying the unique strengths of MDBs to help address the daunting development challenges that affect us all.

BOX 0.1

Defining Capital Adequacy for Multilateral Development Banks

Capital adequacy measures a financial institutions' ability to honor its financial obligations if its debtors are unable to pay back what they borrowed. Measures can be risk-based (e.g., using risk-weights) or focus on financial leverage, which considers an MDB's capital and non risk-adjusted assets. In the case of an MDB, the relevant assets are the portfolio of loans it has made for developmental purposes, plus liquid assets held in its treasury portfolio.

An MDB, as any financial institution, should have an "adequate" amount of capital to absorb losses in case borrowers stop repaying loans or if the market value of liquid assets falls. This gives security that the MDB will have sufficient resources to repay bondholders and other creditors. The riskier an MDB's assets are, the more capital is needed to support them.

Unlike other financial institutions, MDBs are not regulated and shareholders have sole authority over MDB capital adequacy policy. In practical terms, MDBs must contend with three different sets of capital adequacy considerations:

- **Internal capital adequacy policies** defined by MDB shareholders and management to manage the risks posed by the specific operational realities and developmental mandates of each institution.
- **Statutory rules** written into the founding agreements of MDBs as a high-level precautionary limit to help ensure long-term financial sustainability.
- **Rating methodologies used by credit rating agencies** to evaluate the creditworthiness of MDB bonds, which are a key factor in shaping access to capital market funding.

A Road Map for Implementation

The reforms proposed by this Panel are aimed at making MDB capital adequacy policy fit to face the challenges of today and tomorrow. The Panel has sought to go back to first principles, question long-held assumptions and historical patterns, and think anew about how to make the best use of shareholder capital to achieve development goals.

The five recommendations are derived from the diverse expertise of the Panel, who carried out extensive consultations with MDB management, shareholders and credit rating agencies; a benchmarking of capital adequacy frameworks and related policies across MDBs; a “deep dive” into the methodologies of credit rating agencies; and the results of four external studies commissioned for this Review.

Implementation will require hard work by all parties, including shareholders, but the potential upside is very high. The turbulence facing the world and the urgency for action present a unique opportunity to engage in reforms that will better position MDBs to play their countercyclical role and also contribute to achieving internationally-agreed development goals.

The applicability of these recommendations varies across the 15 MDBs assessed in this Review, and they cannot be implemented in a uniform fashion or with uniform results. A focus on private sector versus sovereign financing, scale of balance sheet and region of operation, available financing instruments, AAA or sub-AAA bond ratings, shareholder mandated mission and more will all shape how shareholders and MDBs approach these recommendations. They are not one size fits all.

MDB capital adequacy is highly complex: it is the intersection of many factors that interact in ways that are not immediately obvious. This leads to five key strategic considerations:

- 1** Capital adequacy reforms and innovations would be most effective as **part of a structured program of MDB actions** enjoying a degree of consensus among the G20 and other shareholders. Enacting financial reforms as one component of a broader agenda would improve how they are received by external stakeholders, including financial markets.
- 2** **Shareholders have a central role to play in MDB capital adequacy.** Financial capacity issues at MDBs can be portrayed as technical problems requiring technical solutions by MDB management. This is true in some cases. But the root issues are often located at the level of shareholder governance, and in particular the disjunction between the development goals shareholders set for the MDBs, the capital and budgetary resources they provide and the degree of risk they are willing to accept. Shareholders must face that reality if they wish to enact meaningful capital adequacy reforms.
- 3** These reforms are interdependent and indeed can reinforce one another when enacted as part of **a coherent reform package, rather than as individual “menu” options.** They are designed as a medium-term action plan to help MDBs make the most efficient use of scarce share capital. It is critical that they are perceived as such, rather than as an easy fix to boost lending capacity.

4 **Coordinated implementation and communication by a substantial number of MDBs** would be beneficial to market perceptions, as rating agencies use peer comparisons across MDBs as a key part of their evaluations. Such coordinated action should avoid moving to the lowest common denominator with respect to risk management standards and practices.

5 If reforms increase lending capacity, G20 shareholders need to ensure **adequate budgets and resources to support and sustain high quality operations**, including early groundwork by finance, risk and legal departments to prepare for such reforms.

The first two Recommendations (defining shareholder risk tolerance and recognizing the benefit of callable capital) go to the core of MDB capital adequacy. They have the potential to increase lending headroom substantially and can be accomplished mainly, though not exclusively, through board-level policy changes. They require shareholders to consider their own approaches to risk appetite and will be watched closely by market participants, and hence must be done deliberately and be supported by a clear communication strategy.

Recommendation 3 (innovations) includes several options that have been piloted and appear technically viable. Implementation complexity varies, but headroom benefits are potentially substantial, depending on the scale of implementation. By scaling up partnerships with private investors and donors, some innovations carry the risk of influencing MDB missions, although this risk can be mitigated with strong shareholder governance and management oversight.

The final Recommendations (engagement with rating agencies and enabling environment for capital adequacy) can be pursued without delay and irrespective of the G20's view on the other recommendations. They pose relatively low political and technical challenges and require modest resources. Potential gains in lending capacity are indirect, would materialize only over the medium term and are not readily quantifiable. The proposed reforms would improve the way MDBs and shareholders manage capital adequacy and decide capital needs now and in the future. Risks are minimal and are far outweighed by risks of inaction.

Taken together, these recommendations would allow MDBs to materially increase their firepower with very manageable changes to risk tolerance. This is an essential component of a more far-reaching reform agenda to better position MDBs for the coming decades.

1

Introduction

A perfect storm of long-term needs, proliferating crises, rising debt levels and paralyzing fiscal constraints

Currently, the globe is facing an unprecedented need for investment to build a socially, environmentally and economically sustainable path forward—essential to achieve the Sustainable Development Goals (SDGs) and face the increasingly urgent climate emergency. The Covid-19 global pandemic was a once-in-a-century shock costing developing countries an estimated 5% of their Gross Domestic Product (GDP) in 2020, unraveling decades of development achievements and pushing at least 100 million people back into extreme poverty.¹ Before most countries could fully recover, the onset of the Ukraine conflict in February 2022 contributed to further increase food and energy prices accentuating a dangerous inflationary trend with far-reaching economic and social consequences.² Constraints to supply chains have caused real challenges for food security in many countries. Recovery from these multiple crises while

safeguarding the planet from an accelerating climate crisis requires substantial investments, particularly in sustainable infrastructure. The financing needs are daunting.³

Multilateral development banks are central to facing these global challenges

Founded from the ashes of World War II, the World Bank has been joined by a constellation of sister organizations whose multilateral nature, financial strength and technical skills have made them trusted and efficient development partners. MDBs not only provide substantial investment financing themselves—with gross operations in Low and Middle-Income countries of US\$167.5 billion in 2019—but also influence the trajectory of development policies and orient the efforts of many other stakeholders.⁴ MDBs issue bonds on international capital markets to raise most of their resources, which they lend out for development projects at favorable financial terms. Their finance to the private sector supports investments yielding

1. Source: Gerszon Mahler et al. (2021).

2. Source: Kammer et al. (2022).

3. External financing needs for developing countries are projected by the International Monetary Fund (IMF) to have increased by up to US\$700 billion a year through 2025 as a result of the Covid crisis, of which around US\$450 billion is needed in low-income countries, while the investments needed to face the spin-off effects of the Ukraine crisis are at this point still uncertain. This is on top of the roughly US\$2.5 trillion of additional financing a year until 2030 needed to reach the Paris climate goals and achieve the SDGs.

4. Source: AfDB et al. (2021).

both financial returns and development impact. But many public sector projects—including rural electrification, maternal health care and social protection—are unlikely to attract private investors even though they are essential for poverty reduction, climate resilience and inclusive growth. Recent estimates put the need for financing from MDBs to meet the SDGs and the Paris Agreement goals at three times the current level by the middle of the decade.⁵

The power of the MDB financial model

Because of their financial model, MDBs require relatively small amounts of shareholder capital from taxpayers.⁶ Their ability to leverage shareholder

capital contributions through private sector bond issuance is determined, in part, by their capital adequacy frameworks. To safeguard share capital and maintain strong continuous access to capital markets, MDBs have traditionally managed their finances with the main purpose of obtaining a AAA rating from the three main rating agencies. Since 2015, MDBs have explored measures to expand capacity as part of the G20 Action Plan on Balance Sheet Optimization (BSO). External sources have identified potential opportunities for a substantial boost in MDB investment capacity by revising their capital adequacy policies, while preserving their current credit ratings.⁷

Table 1.1 | Selected indicators

	DEVELOPMENT ASSETS	TOTAL ASSETS	SHAREHOLDERS EQUITY	LIQUID ASSETS RATIO*	BONDS OUTSTANDING**
YEAR/UNIT	2020/BN\$	2020/BN\$	2020/BN\$	2020/%	2021/BN\$
AfDB	34	51	11	32	35
ADB	133	272	53	18	134
AIIB	8	32	20	73	19
CAF	29	47	13	31	26
CDB	1	2	1	30	1
EBRD	41	85	22	45	56
EIB	552	678	90	19	565
IDB	106	152	34	26	113
IBRD	211	297	40	29	260
IDA	168	199	168	18	28
IDB Invest	4	6	2	33	2
IFC	47	96	25	48	56
ISDB	25	35	13	30	22
NDB	7	19	10	61	14
	1,366	1,972	503	35	309

Sources: Fitch Connect, Standard & Poor's (S&P) Supranationals 2021

*Liquid assets/adjusted total assets

**Total Long-term funding = senior unsecured debt, subordinated borrowing, covered bonds and other Long-term funding

5. Source: Bhattacharya et al. (2022).

6. For example, 189 shareholder countries contributed a grand total of \$19.2 billion capital to the World Bank's main IBRD lending window over its entire history from 1944 to June 2021. With that capital, IBRD has thus far extended over \$750 billion in loans. IBRD income from loan interest payments as well as treasury revenue has generated nearly \$30 billion in retained earnings, \$23 billion in grants to the poorest countries and covered the costs of the most comprehensive body of global development data and expertise in existence.

7. Sources: S&P (2017); Settimo (2019); Munir and Gallagher (2018).

Capital adequacy constraints

Capital adequacy is a critical driver of MDB financial decision-making. Enhanced clarity surrounding capital needs should support debates among member countries on MDB capacity and the resources they need to pursue their mandates. Shareholders and management of every MDB would benefit from transparent, objective and consistent metrics not necessarily attached to credit rating metrics to assess capital adequacy. Such metrics would be invaluable for strategic decisions impacting capital utilization. Better tailored information and analysis are needed to reflect the unique characteristics of MDBs.

Beyond capital adequacy, a range of challenges

MDBs must strike a difficult balance between setting strong environmental, social, and governance standards and transaction efficiency important to both governments and private sector borrowers. Despite efforts to improve coordination between MDBs and with other development stakeholders, this remains a bottleneck, as pointed out by the G20 Eminent Persons Group (G20 EPG).⁸ Some MDBs have struggled to find their optimal role in a fast-changing development landscape of commercial impact investors, export credit agencies, aid donors, quasi-commercial development finance institutions, philanthropic investors, and more. In short, MDBs must change beyond capital adequacy policies to optimize their efficiency and impact.

8. Source: G20 EPG (2018).

An independent review

Recognizing the important role of capital adequacy, G20 finance ministers and central bank governors launched an independent review of MDB capital adequacy frameworks (G20 Communique, April 2021). The Review builds on existing and ongoing G20 work on balance sheet optimization. In accordance with its Terms of Reference (ToRs—Annex D), the Review was tasked with providing recommendations to optimize MDB capital adequacy methodology while maintaining robust credit ratings (i.e. AAA) and preferred creditor status. The Review aims to help MDBs better serve clients by making the most efficient and effective use of shareholder capital, while respecting each MDB's individual mandate, governance arrangements and policies.

Defining capital adequacy for self-regulated entities

Due to their status as international institutions, MDBs have no regulator or oversight body other than their Board of Governors who delegate the daily routine work to the Board of Executive Directors.

Their unique attributes make capital guidelines developed for commercial banks inadequate. Hence, decisions about when to inject more share capital or whether and how to undertake balance sheet optimization are difficult. The Review does not seek to impose a regulatory framework, but recommends reaching a shared understanding on capital adequacy frameworks to increase lending capacity and improve discussions on capital adequacy. Shared understanding serves shareholders, MDBs, credit rating agencies, private investors and other development finance institutions.

The aim of the panel is twofold

First, to take stock of existing approaches to MDB capital adequacy and benchmark them against one another. Second, to develop proposals that G20 shareholders may consider to improve the consistency and efficiency of MDB approaches to capital adequacy. Proposals include the design and implementation of capital adequacy itself and policies, procedures and instruments that have an impact on capital adequacy and efficiency.

Neutrality on MDB capital needs

The recommendations do not pre-empt future capital adequacy measures at individual institutions but cover how MDB capital adequacy frameworks could be generally assessed and strengthened regardless of differing mandates, geographic or sectoral scope. The Review did not examine, and is not intended to comment on, the question of general capital increases.

MDB project capacity and borrower demand are not addressed.

The key task of the Panel is to consider the relationship between MDB capital stock and headroom to provide development finance. Many other issues must be addressed when considering how MDBs might deploy financial headroom, including project origination, implementation and oversight capacity on the one hand and borrower demand and absorptive capacity on the other. The Panel recognizes the critical importance of those issues, but notes that they fall beyond the Review's terms of reference.

CHAPTER 2

Develops the key elements towards a shared understanding of MDB Capital Adequacy Frameworks. The analysis is based on a variety of evidence as well as the Panel's judgment. The benchmarking exercise in this chapter gathered information provided by individual MDBs across a range of issues related to capital adequacy.

CHAPTER 3

Presents the challenges and recommended policy options for capital adequacy. The Review held intensive discussions with MDB officials on relevant topics and would like to recognize their cooperation and time commitment. The Review held further discussions with the major credit rating agencies about their evaluation of MDBs, and their cooperation and time are gratefully acknowledged. A wealth of secondary sources was consulted to develop the main recommendations, including both academic and policy research on MDB finances. The diverse and complementary expertise of the Panel was an invaluable resource on which to base judgments.

CHAPTER 4

Outlines the path to implementation for the Panel's recommendations, setting out key strategic considerations in introducing the proposed changes as well as highlighting interactions, risks and mitigation strategies.

CHAPTER 5

Concludes, setting the recommendations within the broader context and against the scope of the Review, and also covers limitations and areas not considered by the Review.

2

Understanding MDB Capital Adequacy

Capital adequacy compares the risk capital of a financial institution to its assets. A financial institution should have an “adequate” amount of risk capital on hand to meet financial obligations in the event its assets deteriorate. This Review’s terms of reference request the panel to “provide credible and transparent benchmarks on how to evaluate MDB CAFs” to enable shareholders, MDBs and ratings agencies “to develop a consistent understanding of MDBs capital adequacy frameworks.” MDB CAFs are complex in part because they do not derive from well-understood regulatory guidance, such as the Basel Committee on Banking Supervision (BCBS)’s guidelines for commercial banks.

CAFs have an outsized impact on the strategy of financial institutions and can be likened to an institution’s “engine room.” Capital provides the fuel for operations, and the parameters of the CAF can shift its gears. Small variations in risk tolerance can have large effects on the size of an institution’s balance sheet for any given level of capital. A clear understanding of the concepts, parameters and assumptions that underpin MDB CAFs, including benchmarks that allow putting these features into perspective, is central to MDB governance.

Approaches and core components

Capital adequacy is assessed by different techniques employed by institutions, regulators and rating agencies. Although approaches differ in whom they aim to protect (shareholders, depositors, bond holders) or in their assumptions and methodologies, all answer three basic questions: How much capital is required, how much is available and how good is the management of risks?

Required capital

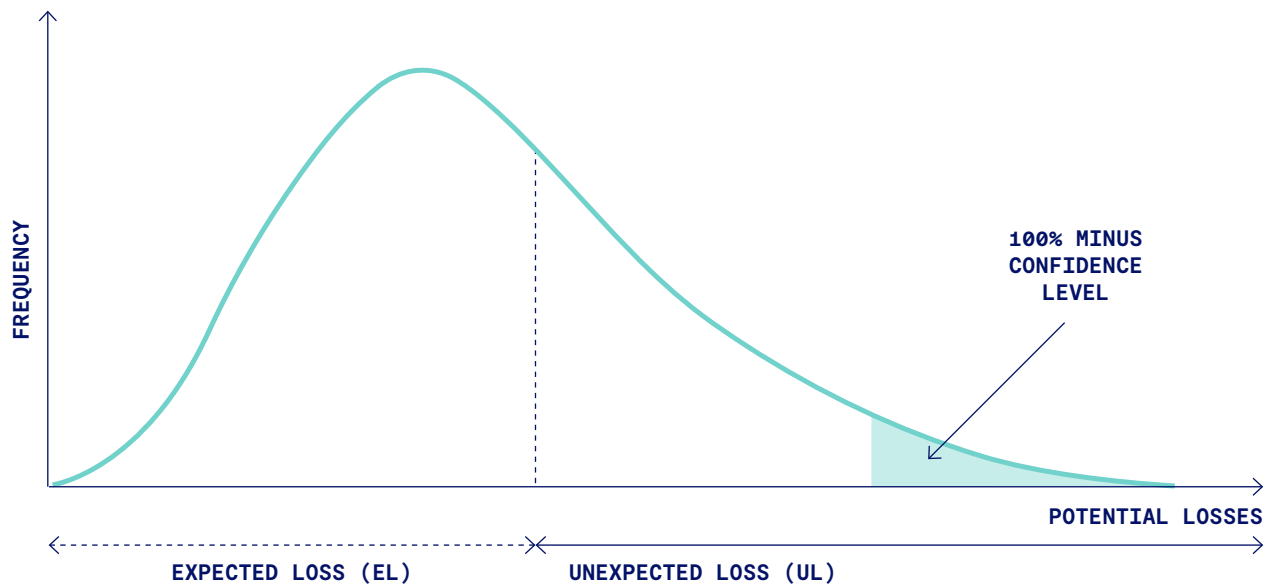
Potential losses can be divided into expected and unexpected losses. Financial institutions **provision** for expected losses, which are losses based on the historical experience of assets with a similar profile; they **hold capital** against unexpected loss, which is when things turn out worse than expected but excluding extreme (tail) risk beyond a specified threshold; and **accept** a certain amount of residual risk—the potential for losses above the risk tolerance threshold. At its core, capital adequacy is about setting risk tolerance levels and calculating the amount of capital to be held against potential unexpected loss in the portfolio, judging from past performance and making assumptions about the distribution of risk (Box 2.1).

BOX 2.1

How much capital should be held against risk?

Risk and risk appetite are quantified through confidence levels around risk distributions. The chart below sets different levels of potential loss on an asset, on the horizontal axis, against the frequency with which empirical (and modelled) evidence suggest such losses might occur. The potential loss that one is willing to buffer through capital and provisions determines the risk tolerance threshold beyond which one essentially accepts default. For instance, Basel Framework risk weights for credit exposures reflect a standard default tail risk of 0.1%, which means they are calibrated for a risk tolerance approximately equivalent to a single A rating on the S&P scale.

These weights are either standardized and given by the regulator, or they can be internal ratings based (IRB) when financial institutions meet certain capacity and risk management quality conditions. MDBs today use IRB approaches to better reflect their specific circumstances. Like commercial banks, most MDBs have embraced so-called “economic capital” models in their internal risk management in order to quantify unexpected loss, generally to a very high level of confidence. MDBs would, for instance, calculate economic capital against a tail risk of 0.03% or less over a three-year horizon, which they expect to be consistent with maintaining a AAA rating.



Capital must be held against various types of risk exposures. These include credit exposures as well as counterparty, market, operational and other risks. For instance, the ADB holds capital against eight types of risk, while others have more or less granularity. Of these, credit risk in the operations portfolio contributes by far the largest share to required capital.

Available capital comes in layers of differing quality reflecting their risk-bearing capacity. Regulators recognize Common Equity Tier 1 (CET1) capital, which consists mostly of common shares, retained earnings and accumulated reserves, and Tier 2 capital, which refers to subordinated instruments that provide loss absorption in a debt work-out scenario. Regulators and rating agencies make adjustments to reported capital to reflect its value under conditions of stress. In the internal risk-based capital adequacy frameworks of the MDBs, available capital comprises paid-in capital and retained earnings and reserves, but excludes callable capital.

Required and available capital are combined in headline **capital adequacy metrics** for purposes of monitoring and targeting. These include Basel risk-based capital metrics, S&P's Risk Adjusted Capital (RAC) ratio and various capital utilization ratios of the MDBs. These ratios reflect different concepts and assumptions and cannot be directly compared. Most MDBs have headline capital utilization ratios in which required capital is divided by available capital.⁹ MDB policy is typically for the capital utilization ratio not to exceed 100% minus various buffers, such as buffers to enable a countercyclical crisis response (as highlighted by the Review's benchmarking exercise, incorporated as an Annex with limited distribution). Most MDBs build AAA-equivalent risk tolerance thresholds into their models for calculating required capital.

The risk-weighted headline metrics are supplemented by nominal, non-risk-based leverage ratios that set capital against overall exposures. The Basel Committee sets a minimum leverage requirement of 3% for CET1 as a share of all on- and off-balance sheet exposures, while some national regulators set higher requirements. MDBs typically have statutory constraints on leverage including a broad concept of capital (paid-in and callable).

Governance and risk management standards are another crucial dimension of capital adequacy. Low standards can undermine confidence in a financial institution's ability to assess and deal successfully with risks when they materialize. Policies and practices such as the internal limits framework to mitigate risk concentration, sophistication of stress testing, level of provisions and reserves as well as internal supervision and controls must also be considered. Capital is not a substitute for inadequate control or risk management.

Funding and liquidity are inseparably linked to capital adequacy frameworks. When markets seize up, such as during the Asian financial crisis, even well capitalized institutions find it difficult to meet their obligations without readily available liquid assets. Regulators set (and CRAs monitor) standards including liquidity coverage ratios and criteria for high-quality liquid assets. As per the Basel Committee, commercial banks are expected to hold sufficient high-quality liquid assets to survive a significant stress scenario and associated net cash outflows for 30 days. Conditions for high credit ratings would tend to be far tighter. Unlike most of the MDBs under review, with the exception of EIB, commercial banks can access liquidity insurance or funding windows at their national central banks for emergency liquidity needs.

9. An important exception is the IBRD, which uses an income- rather than a solvency-based approach to measuring capital adequacy.

Distinctive features of MDB capital adequacy frameworks

MDB CAFs have broadly the same objectives and are designed around the same fundamental components as those of other financial institutions: capital utilization and leverage ratios, methodologies for measuring required and available capital, governance and risk management standards and prudent liquidity and funding policies. However, there are also important differences between MDB CAFs and commercial banks that generally add to MDB capital strength but also to the complexity of assessing it.

Self-regulation

MDBs are not subject to regulation or supervision, either nationally or internationally. Where commercial banks anchor their CAFs on the calculation of minimum regulatory capital under Pillar 1 of the Basel Framework, MDBs develop their own technical variants. Instead of normative guidance under the supervisory review process of Pillar 2, MDB CAFs are governed by their Boards. While many base their economic capital on Basel principles, the absence of a common anchor reduces transparency and can make it hard to read across MDB CAFs.

Policy relevance

MDBs play a significant role as policy tools, enabling shareholders to leverage scarce fiscal resources for development, tackling climate and

other public goods, and responding to crises. As result, shareholders are likely to support the MDBs in stress situations, which is an important factor in assessments by both credit rating agencies and bond investors. But ensuring that MDBs have the capacity to respond in a countercyclical manner to future crises also implies that they must hold more capital than their level of operations would otherwise dictate.

Preferred creditor status

Due to the unique nature of MDBs, borrower governments have generally granted MDBs “preferred creditor treatment” (PCT). This means that sovereign borrowers will continue to repay MDBs even if they go into default or delay repayment to other creditors. In addition, MDBs typically do not reschedule, restructure or write off sovereign loans. PCT is a key factor explaining why the sovereign loan books of MDBs have an extremely low record of loan non-accruals and economic losses. Private sector MDBs are also expected to benefit from PCT in convertibility and transferability preference. PCT is reinforced by lending into arrears and arrears clearance policies relating to IMF and MDB lending and by exclusion of MDB debt from Paris Club restructurings. However, PCT is informal, with no binding statutory or contractual status, making it difficult to quantify in MDB capital adequacy frameworks, or credit rating agency methodologies.

Callable capital

Unique to MDBs, callable capital shares vary enormously by institution. Valuing callable capital is fraught in part because it has never been utilized by the main MDBs;¹⁰ it only comes into play during MDB insolvency scenarios, for which there is no precedent. The processes governing the response to a call differ significantly across shareholders, many of whom would require legislative approval. Ratings agencies acknowledge that some portion of callable capital contributes to MDB capital strength, but MDBs manage their business to reduce the probability of a call and with few exceptions their internal CAFs do not factor in callable capital (see benchmarking tables in confidential annex).

Exposure concentration

MDBs lending mainly or entirely to governments have loan portfolios that are structurally concentrated in a small number of borrowers. As of June 2021, IBRD had only 78 sovereign borrowers, while for the regional MDBs numbers range from 16 to 39. A handful of large borrower governments tend to account for a considerable share of MDB portfolios. A portfolio that is concentrated in just a few borrowers is riskier than one that is not, and hence requires more risk capital to support it. At the same time, this concentration is inherent in the nature and mandate of MDBs and is a characteristic they have all had from their inception.¹¹ Evaluating how much “penalty” risk capital an MDB should carry as a result of this concentration is unclear.

Centrality of ratings

AAA credit ratings from all the major CRAs are the explicit goal of most MDB CAFs. It is worth underlining just how rare such ratings are. No financial institution apart from the MDBs meets this test, with a few state-backed exceptions. Prime ratings allow MDBs to access markets safely and at low cost even during times of stress, to pass on the benefit to borrowers, support liquidity management by minimizing collateral needs and bolster net income from treasury operations. At the same time, the fact that these ratings anchor the risk tolerance of MDB CAFs means that the design and clarity of rating agency frameworks, which vary over time and across agencies, are unusually important factors when considering how MDBs manage their capital adequacy.

Business model

Most MDBs began life when there were few alternative sources of long-term development finance. So their default approach is to fully fund and hold loans to maturity, which is very capital intensive. As private capital moved into direct development financing in recent decades, MDBs experimented with co-financing/syndication and innovations such as risk transfers and new classes of capital, but these efforts remain a relatively small percentage of aggregate project funding by MDBs and are mainly conducted by their private-sector arms or windows where market-oriented spreads facilitate mobilization at scale.¹²

10. Moody's noted to the Panel that the only capital call they were aware of was by the Gulf Investment Corporation that had to call capital in an emergency situation in 2008.

11. This differs radically from the assumptions underlying, for instance, the Basel IRB risk-weight functions, which derive from an asymptotic model where portfolios are finely-grained and individual loans “portfolio-invariant”, i.e., individual exposures do not contribute to or deduct from aggregate portfolio risk.

12. In 2020 the MDBs covered by this review directly mobilised only 14 cents for every dollar of own-account investments, most through their private sector arms (source: MDB Task Force on Mobilization (2021).; excludes CDB, CAF-DBLA and NDB).

In addition to these factors, MDBs operate subject to statutory constraints on their lending that few other institutions face. This includes, in particular, nominal leverage ratios that constrain the overall loan portfolio volume to a multiple of capital (including callable), in most cases 1:1.

Some of the factors that make MDB CAFs distinctive are more relevant for MDBs lending to sovereigns compared to MDBs more focused on private sector operations, in particular EBRD, IDB Invest and IFC. PCT and single-name concentration are less salient, since private sector exposures remain subject to commercial risk and the client base is far larger. IDB Invest and IFC¹³ have no callable capital. Their business models are generally far more geared towards private finance mobilization than those of sovereign-focused MDBs.

In sum, MDBs have unique features that make portfolio risk assessments difficult, creating uncertainty that may contribute to a conservative approach in financial planning and capital assessments.

Benchmarking MDB capital adequacy frameworks

The Panel proposes to describe MDB CAFs by combining regulatory categories, those of the major rating agencies as well as the MDB-specific features discussed above. Benchmarking is useful only to the extent that the information is comparable.

Concepts are generally similar across the MDBs but not strictly the same, due to varying definitions or framing. In some cases, including the key capital utilization metric, MDBs have significantly divergent approaches. A clear and well-specified MDB CAF and associated policies would be expected to:

- **Define risk tolerance**, reflecting risk appetite of the shareholders, and the relevant metrics for monitoring capital adequacy;
- Comprehensively **quantify sources of risk** to be covered by capital, based on best practice modelling standards;
- **Identify all risk-bearing capital** and the income strategy for meeting future capital needs;
- **Clarify the trajectory of nominal leverage ratios in relation to risk capital**, including relevant statutory provisions;
- **Implement a high-quality governance and risk management framework** with the necessary expertise;
- **Set out liquidity and funding targets** that are aligned with high prudential standards.

13. Several other MDBs also have private sector operating assets on their balance sheets. However, their balance sheets are dominated by public sector exposures (e.g., in 2020 these represented 76.5% for AfDB, 93% for ADB, 91% for AIIB, 90% for CAF-DBLA, 94% for CDB etc.; source S&P Supranationals Report 2021).

As part of a transparent approach to support comparability and benchmarking, such a framework and associated policies would explain and / or provide analytical support for:

- The incorporation of **preferred creditor treatment** in the calculation of exposure risk weights, based on the empirical evidence;
- The consideration of **callable capital** as part of the CAF, with reference to procedures and shareholder risk tolerance;
- The treatment of exposure **concentration risk**, including whether and how portfolio concentration and diversification are captured in the risk weights.

The panel has benchmarked these CAF components as well as rating agency views in a confidential annex with limited dissemination. Table 1.2 presents an overview, excluding however the CRA commentary and liquidity and funding, where further work is required.

Large differences in MDB business models are reflected in these CAF profiles. The EBRD, IDB Invest and IFC finance predominantly or exclusively the private sector, IDA is still virtually all equity-funded and MIGAs business model cannot be easily compared with the other MDBs. Nevertheless, the basic CAF building blocks are the same, and some of the benchmarking and conclusions carry across institutions.

The emerging picture is one of similarities in broad architecture of MDB CAFs with variation in the details.

- **The MDBs generally aim for AAA ratings from the credit rating agencies** as well as for avoiding the need for a call on callable capital. However, certain MDBs set a lower bar.

14. The IDB considers callable capital in calibrating its target standalone credit rating, taking into account that highly-rated callable capital is factored into the issuer ratings by the CRAs. The IBRD's income-based capital adequacy framework takes implicit account of callable capital since the underlying rationale is that insolvency is highly unlikely.

- **MDBs tend to target and monitor a bespoke risk capital utilization ratio**, but some rely on the standard Basel or S&P methodologies, one uses an income rather than a solvency measure (expressed through an equity-to-loan ratio) and one has no single headline indicator.

- **The way these indicators are constructed and the modeling assumptions they incorporate differ in their impact.** For instance, preferred creditor treatment of sovereign exposures is sometimes reflected in a granular way in calculations of probabilities of default and loss-given-default in MDB economic capital models; in other cases, it is more judgement-based and categoric, or not reflected at all. The impact of concentration risk and portfolio diversification benefits depends on (economic) model specifications, which are highly technical and can be hard to trace.

- **Available risk capital is more uniformly defined.** Despite huge variation in capital structures, MDBs generally disregard callable capital in their capital adequacy formulae.¹⁴ Statutory lending constraints are also remarkably similar, but some of the more recently-created MDBs offer more flexibility.

- **Financial management practices**, and specifically single or top borrower limits, **vary significantly across MDBs** in a reflection of their mandates.

The benchmarking tables remain partly incomplete and there is scope for further refinement. This is an area of future work covered in more detail in Chapter 3. Nevertheless, the benchmarking helps inform the following sections of this report.

Table 2.1 | MDB Capital Adequacy Frameworks: Summary of results from benchmarking exercise

<p>Policy Targets and Principal Metrics</p>	<p>Policy Target: Generally preserve AAA rating while minimizing the probability of having to draw on callable capital</p> <p>Principal Metric: For most, the Capital Utilization Rate (CUR) = Total required capital/Total available capital</p> <p>Hard Ceiling: CUR ≤ 100% with buffers and triggers at lower thresholds</p>
<p>Required Capital</p>	<p>Required Capital: Typically economic capital modeling of both purpose-related and treasury exposures with confidence level aligned with AAA rating target. <i>Operational risk</i> via Basel II Basic Indicator Approach</p> <p>Lending Activities: Important differences among MDBs with respect to private vs sovereign and sub-sovereign finance as well as country/regional/product concentration of exposures</p>
<p>Available Capital</p>	<p>Available Capital: Paid-in capital, retained earnings and reserves, with minor adjustments for payment schedules etc.</p> <p>Capital Structure: Both paid-in and callable capital, with wide differences in the relative shares but callable capital generally dominant. Share of callable capital from highly-rated shareholders differs significantly across MDBs</p>
<p>Statutory Provisions</p>	<p>Lending Limit: Total nominal exposures < total paid in and callable capital and reserves</p>
<p>Policy Relevance</p>	<p>Institutional Support: Typically demonstrated through track record of capital injections, public statements such as around policy importance in crises, callable capital allocations and other shareholder commitments</p> <p>Preferred Creditor Status (PCS): Approaches include calibrating obligor-specific probabilities of default and setting facility-specific assumptions for loss/time in default</p>
<p>Financial Management</p>	<p>Limit Framework/Concentration: exposure limits (nominal or risk adjusted) for single names, countries, sectors & products, with significant variation in limits across MDBs</p> <p>Stress Testing Framework: MDBs test sensitivity to severe shocks and simulate portfolio against rating agency benchmarks</p> <p>Credit Performance: Very low rate of sovereign default, with some long-duration nonaccruals but typically limited loss-given-default; higher and varying impairment ratios for non-sovereign exposures</p> <p>Income and Pricing Policy: Generally sovereign business has very low margins (passing on low funding costs), with varying degrees of flexibility to use sovereign pricing to support income. Net income split between allocation to reserves and to other purposes, typically with reserves taking priority. Pricing of private sector exposures generally market-oriented and an important source of capital over time</p>

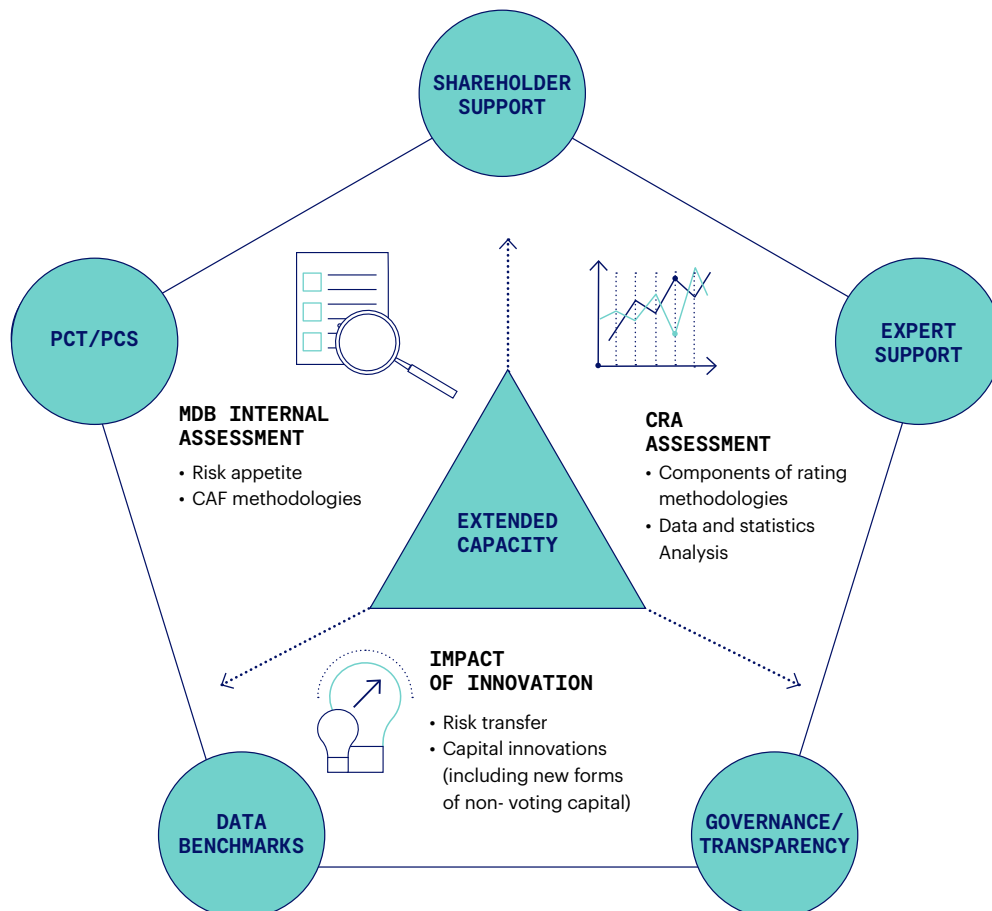
3

Challenges and Policy Options for MDB Capital Adequacy

MDBs and shareholders face important challenges in efforts to maximize available development financing capacity within prudential capital adequacy frameworks. This Review conceives of four overarching areas and a set of enabling factors

(see Figure 3.1) in developing recommendations that can drive increased MDB financing capacity while ensuring their financial strength and stability. Each of these areas includes additional subtopics and related recommendations.

Figure 3.1 | Risk Appetite



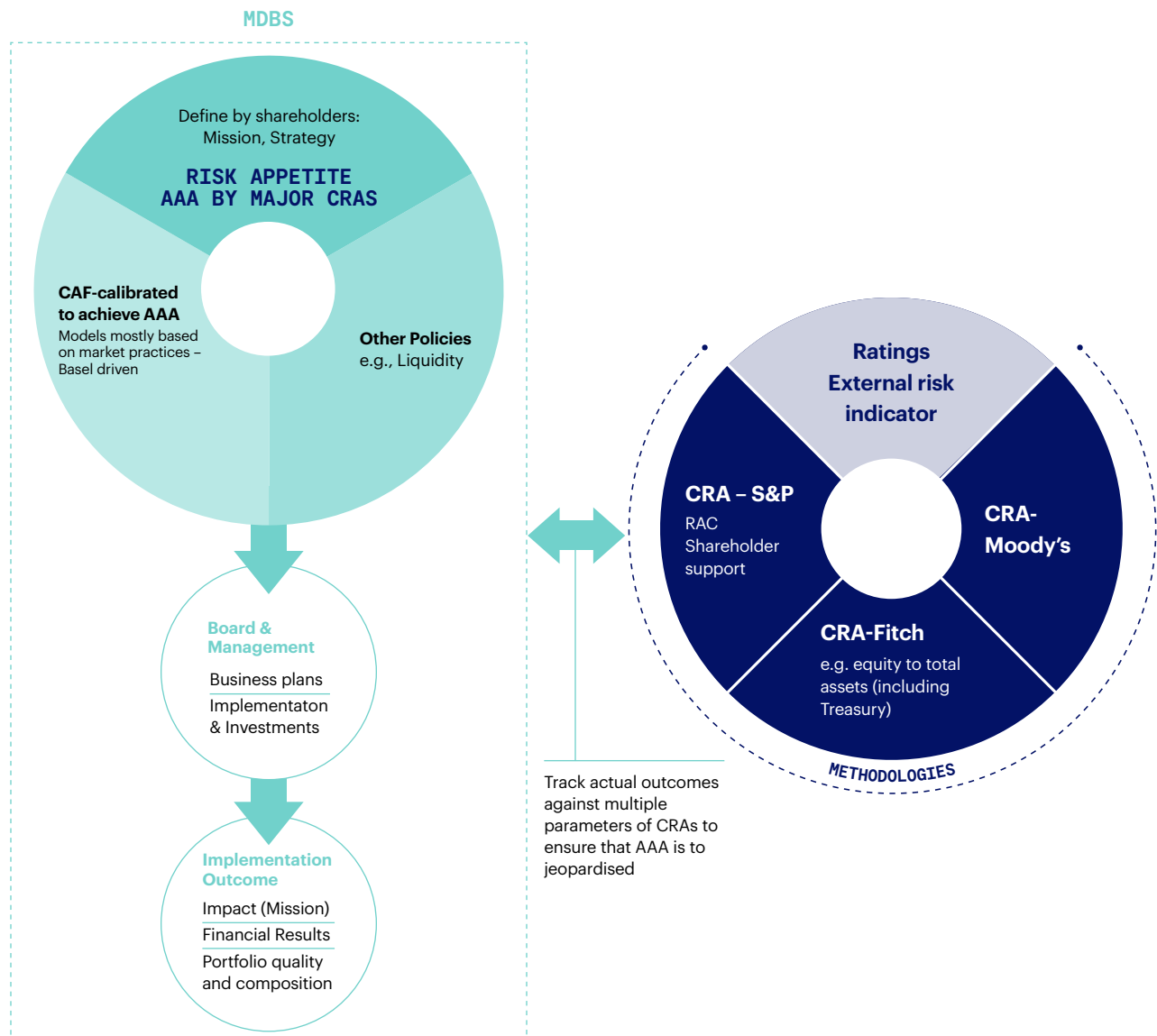
BOX 3.1

Overview of MDB Capital Adequacy Policy Formulation

By defining overall risk appetite for their MDBs, the shareholders set the scene for the development of MDB policies, business plans and investments. The Credit Rating Agencies considers factors and the outcomes of them, in determining their ratings of the MDBs.

Numerous players are involved in defining MDB capital adequacy (Figure 3.2). How they interact with each other and the aspects of capital adequacy they affect in such interactions are key subjects of the analysis and recommendations presented in this chapter.

Figure 3.2 | Risk Appetite



Each MDB has a **mission and strategy**, both defined by shareholder countries. MDB shareholders and management work together to draw up a **business plan**, which is based on this strategy. MDB management then **implements** this plan. The business plan and implementation are modified in response to real-world events. The end objective is to achieve **development impact** in line with the shareholder-defined mission.

Member countries are the owners of MDBs' capital and must specify the risk appetite they have for an MDB's financial operations. This risk appetite statement is an essential input to allow MDB management to design appropriate financial policies.

Based on guidelines and board approval, MDB financial management teams define the **capital adequacy framework**, which is set in response to the risk appetite statement articulated by shareholders. This is the basis on which MDBs define the capital components and assess how much capital they have and what limits or targets are set for an adequate level of capital. The risk appetite statement frequently includes target credit ratings as objectives.

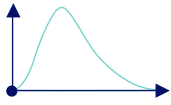
As business plan implementation proceeds, MDB management must **monitor capital adequacy through key risk indicators**, including portfolio quality, leverage ratios, concentrations, capital utilization ratios and more. Management must also regularly undertake stress tests and build in appropriate **capital buffers** to cope with extreme events. These activities ensure that capital adequacy is fit for purpose and aligned with shareholder risk appetite.

Credit rating agencies are key independent indicators of the financial health of the MDBs. Rating methodologies do not define MDB capital adequacy, but rating criteria are factors in helping to define risk appetite and are reflected in financial policies and targets.

The views of rating agencies together with shareholder support are also key in shaping **financial market perceptions** of MDBs as an asset class and as co-financing partners. There is generally a positive predisposition of investors to **participating in development finance** alongside MDBs, including through syndication, Public-Private Partnerships (PPPs), guarantees and risk transfer techniques as a means to improve MDB portfolio structures and diversify sources of financing.

All of this highlights the **fundamental importance of shareholders** in discussions of MDB risk appetite and capital adequacy. Shareholders define MDB objectives, supply share capital and define the limits of risk that they are willing to tolerate. These are the three main levers defining operational capacity.

1



Redefine the Approach to Risk Appetite for MDB Capital Adequacy Frameworks

2



Incorporate Uplift from Callable Capital into MDB Capital Adequacy Frameworks

3



Implement Innovations to Strengthen MDB Capital Adequacy and Lending Headroom

4



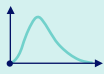
Improve Credit Rating Agency Assessment of MDB Financial Strength

5



Improve the Enabling Environment for Capital Adequacy Governance





RECOMMENDATION

1

Redefine the Approach to Risk Appetite for MDB Capital Adequacy Frameworks

MDBs are not subject to prudential regulation and supervision. They are overseen solely by their shareholders. Shareholders want MDBs to have ready access to low-cost funding from bond markets and avoid the extreme situations which would lead to a call on callable capital. Shareholders also want MDBs to maximize development impact, use their capital more catalytically and efficiently and expand operations in poorer and more fragile countries—all of which have risk management implications.

In the face of these goals and the complexity of estimating the financial risks posed by MDB operations, shareholders have elected to reference MDB bond ratings as a shorthand to express their risk appetite. Nearly all MDBs have policies binding them to a top bond rating with the major rating agencies. Because each rating agency uses a different methodology, the most stringent components of each effectively define the limits of MDB financial policies. This can lead MDBs to build excessive buffers to cope with uncertainty and widely divergent criteria in the three rating agency methodologies. As a result, MDBs manage themselves to a level of risk appetite that can effectively be even lower than that represented by a AAA rating.

One of the key issues highlighted after the 2008/09 global financial crisis is over-reliance on bond ratings at the expense of in-house risk analysis, as noted by the Financial Stability Board (FSB).¹⁵ The goal of the FSB Principles is to provide incentives for firms to develop their own capacity for credit risk assessment and due diligence.

RECOMMENDATION

1A

Define MDB risk appetites prioritizing shareholder-specified limits rather than external criteria

Shareholders and MDB management should define risk appetite more explicitly, based on a sound evidence base, institutional goals and impacts, the specific financial risks posed by MDB operations and shareholder risk tolerance. Guidance on risk appetite by shareholders should align with their guidance on operational priorities and strategies. MDB financial teams can calibrate their capital adequacy frameworks based on this internal definition of risk appetite. The risk appetite level can grow out of the same type of statistical confidence interval associated with a AAA risk, but it would not be dependent on the specific methodologies of the ratings agencies. The goal is to anchor capital adequacy first and foremost in the MDBs' internal frameworks and shareholder-defined risk appetite, managing financial risks as understood by the MDBs and their shareholders and as appropriate to the MDB's particular circumstances. External rating agency

15. Source: FSB (2010).

assessments are crucial and must be fully taken into account in calibrating MDB policy, but consideration of external factors must follow, not lead, the assessment by the MDBs and by shareholders themselves, as noted by the FSB. Such a shift in policy may also be done together with a changing approach to callable capital (Recommendation 2). This new approach should be undertaken in a coordinated fashion across multiple MDBs, thoroughly explained ahead of time to rating agencies and accompanied by clear statements of support by G20 and other shareholders, which would be key for ratings agencies and investors. By defining risk appetite internally while fully taking rating agency methodologies into account, the objective should be to ensure the MDBs maintain bond risk profiles consistent with AAA ratings from the major CRAs. Careful consideration as to how the risk appetite is reflected in policies and model calibrations may allow some adjustments that increase investing capacity.

RECOMMENDATION

1B

Ensure that MDB capital adequacy frameworks account adequately for preferred creditor treatment and the concentrated nature of MDB portfolios.

The research and discussions undertaken as part of this review have highlighted that the ways in which PCT and portfolio concentration risk are reflected in both internal and rating agency methodologies have a very substantial impact on the assessed riskiness of MDB loan portfolios and hence lending headroom (see Chapter 2).

MDB capital adequacy frameworks take PCT and concentration risk into account, although they do so to differing degrees. The Review was not mandated to undertake technical analysis on the inner workings and parameters of individual MDB capital adequacy modeling. Therefore, no attempt was made to arrive at a recommendation on current MDB practices in this regard. The Review commissioned two external studies by technical experts on these two topics. Preliminary empirical results based on aggregated MDB credit performance data indicate that the methodologies used by credit rating agencies underestimate the benefits of PCT and overestimate risks posed by concentration risk, although the implications for internal models of individual MDB could not be evaluated.¹⁶ This work should be done for each MDB to get a sense of scale in addition to the directionality effect the Review was able to establish.

MDB capital adequacy approaches as well as credit rating methodologies would benefit from a more uniform approach to understanding the portfolio risk implications of PCT and concentration risk. More cross-MDB research on these topics, based on detailed and granular data from MDB portfolios over time, would be useful.

16. Using only publicly available data for four MDBs, the preliminary assessment of PCT found that MDBs have a probability of default from borrower countries roughly three times lower than to commercial lenders from the same borrowers (0.37%, compared to 1.13% for bank loans and 1.37% for sovereign bonds), Loss given default was roughly ten times lower (about 5% compared to 50.0%-51.8% to commercial creditors). More granular results are expected in the final study with complete MDB data. The panel also reviewed two relevant external studies evaluating PCT, "Sovereign Default History: Evidence of Supranationals' Preferred Creditor Status" (Fitch Ratings, 16 March 2020) and "Multilateral Development Bank Ratings and Preferred Creditor Status" (Perraudin, Powell and Yang, IDB Working Paper 697, June 2016). The external studies commissioned by the panel on PCT and concentration risk were delayed due to difficulties obtaining MDB data, and as a result it was not possible to compare their results with these other studies or with rating agency methodologies. The panel will submit the results to the G20 when these studies are completed.

Relocate specific numeric leveraging targets from MDB statutes to MDB capital adequacy frameworks

Almost all MDBs by statute cannot exceed a 1:1 ratio between outstanding exposures and total subscribed capital (paid-in and callable) plus reserves. The first statutory limit was put in place at the founding of the IBRD as a means of reassuring bond investors and then replicated at subsequently created MDBs.¹⁷ Statutory limits do not currently constrain most MDBs, but if MDBs undertake other reforms recommended by this panel at a meaningful scale, the statutory limits would become a hard limit.

The statutory limits have no risk weighting, unlike most modern approaches to capital adequacy. Unweighted indicators have their uses (as per Basel guidelines), but the simplistic approach of MDB statutory limits, which were set decades ago when financial markets, tools and practices were very different, is not an appropriate hard limit on the capital adequacy of financial institutions today. When MDBs themselves use unweighted ratios, such as the IBRD's equity-to-loans policy target, they are based on sophisticated financial modeling and updated regularly in response to changing circumstances. The statutory limits confuse shareholder discussion of MDB capital adequacy by introducing an additional factor that must be addressed.

Statutory changes would need to be accompanied by very clear communication that they imply no loosening of financial prudence. Instead, they represent an updating of MDB statutes in light of modern financial practices and a streamlining of the framework around MDB capital adequacy.

17. The recently-established AIIB also has a 1:1 statutory gearing ratio, but the statutes permit the bank to raise those limits to 1:2.5 with approval of a super-majority vote by the Board of Governors (AIIB Articles of Agreement, Art. 12 (1)).



Incorporate Uplift from Callable Capital into MDB Capital Adequacy Frameworks

Most MDBs have very large amounts of callable capital in their capital structure. This is a type of guarantee capital, committed by shareholders as part of their international treaty agreement but only paid in if an MDB were to face a crisis so severe as to prevent it from meeting financial obligations to creditors. As of 2020, the MDBs in this Review had a bit more than US\$1.3 trillion in subscribed capital. Of that, about US\$1.2 trillion (91%) was in the form of callable capital.

No MDB has ever called its callable capital.¹⁸ As a result, it is an untested instrument. The procedures for undertaking a call are not clearly defined in MDB statutes or policies, and the budgetary treatment and legal procedures among shareholders are determined by national arrangements and vary considerably. Credit rating agencies incorporate a portion of callable capital in evaluations of MDBs such that it can raise an MDB's 'issuer rating' above its 'intrinsic' or 'standalone' rating, though the uplift is limited to three notches except for one of the rating agencies.

MDBs themselves generally do not include callable capital in their capital adequacy frameworks, which recognize only paid-in capital and reserves as 'available capital'. Protecting against a capital call is a fundamental goal of MDB financial management and is in many cases stated explicitly in capital adequacy policies. MDBs are also reluctant to expose their own ratings to the risk of shareholder downgrades. These policies are key factors driving the finance risk appetite of MDBs and limiting their operational capacity. Callable capital is considered only useful in the event of a liquidation scenario to meet creditor obligations in a situation in which the institution no longer operates as a going concern.

The one exception among the major MDBs is IDB, which since 2015 has structured its risk appetite framework explicitly around credit rating agency criteria. As a result, IDB incorporates callable capital, to the extent recognized by ratings agencies, into the thresholds the bank's shareholders have defined to guide financial policy decision-making. This approach is consistent with the panel recommendation described below, and highlights that the IDB found it feasible to recognize callable capital in MDB capital adequacy frameworks without requiring a change to statutes, with the explicit backing of MDB shareholders. Shareholders may wish to compare the wording of the statutes of each MDB and the specific details of how callable capital's benefits might be recognized in their capital adequacy frameworks, with reference to IDB's experience, to determine the legal stipulations involved.

18. Moody's noted to the Panel that the Gulf Investment Corporation—also a multilateral institution, although not an MDB—had to call capital in an emergency situation in 2008

BOX 3.1

What is the probability of a call on callable capital?

The likelihood that one of the major MDBs might face circumstances requiring it to make a capital call to shareholders to repay bondholders is extraordinarily remote. This conclusion is based on extensive discussions with MDB finance teams, a close examination of the stipulations for how a capital call would be triggered and an external study commissioned by this panel modeling a reverse stress test for MDBs.

A call on callable capital would be the end point of a cascading series of adverse events. By far the most likely trigger would be a sustained increase in non-performing loans. The first impact would be rating downgrades. Once the bond rating had declined to the point where funding is unavailable at reasonable terms, an MDB would begin selling its assets, starting with its liquidity buffer. Only once marketable assets were exhausted would a capital call be necessary.

Although the reverse stress test conducted was a stylized exercise and cannot be relied upon for detailed results, it shows that the kind of real-world events needed to trigger such a scenario are extraordinarily unlikely. A credit portfolio deterioration of sufficient severity and duration to lead to a capital call scenario would be a more than 10 standard deviation event. Other shock scenarios that could lead to a capital call are similarly so improbable as to be unrealistic. Even if catastrophic shock scenarios were to occur, management and shareholders can deploy multiple policy levers to arrest a deterioration well before a capital call.

The track record of the major MDBs substantiates these findings. Through all national, regional and global crises since World War II, no major MDB has come near a capital call. Only AfDB has experienced even a single notch rating downgrade (between 1995 and 2003 by one rating agency). During that period, AfDB posted annual net profits and remained on solid financial footing. Another example is EBRD, which now faces a sudden portfolio shock due to the Ukraine conflict and sanctions on Russia. Despite this shock, the bank remains within a AAA rating from each of the major rating agencies, a far cry from needing to consider a capital call.

Incorporate a prudent share of callable capital into MDBs' own calculation of capital adequacy, following the approach validated by all three credit rating agencies.

MDBs should consider callable capital as a specialized type of shareholder guarantee that creates a certain amount of capital headroom. The exact parameters of this guarantee are not perfect, including both the processes involved and potential uncertainty over the willingness and ability of some shareholders to pay under stressed scenarios. Hence, treating it as a 1:1 guarantee to the face value amount of total callable capital would not be prudent. Nonetheless, callable capital has considerable financial value that can be incorporated into CAFs. MDBs should do so in a consistent, rational and prudent way to expand the risk-bearing capacity of their internal models and policy limits.

Recognizing the financial backup provided by callable capital would allow MDBs to increase risk-bearing capacity, thus increasing operational headroom either for regular operations or as a crisis buffer. This would not mean callable capital is incorporated into MDB capital adequacy ratios as Tier 1 equity capital, but rather that the existence of this support should impact an MDB's calculation of risk. Callable capital would continue to be designated for use only for MDBs to meet their financial obligations, as per statutory requirements. No new financial instruments nor any change to MDB capital structure would be required. Shareholder commitments to provide callable capital are already as legally binding as paid-in capital commitments.


There are divergent opinions regarding whether implementation of Recommendation 2 would require amending MDB articles of agreement. This will depend both on the drafting of each MDB's governing documents and on the details of the proposed implementation. The view of the Panel is that some form of implementation should be possible in most MDBs without statutory changes, but this is an issue that boards will need to consider carefully in light of each institution's specific circumstances.

Calculating precisely how this benefit could be prudently recognized in capital adequacy frameworks would require great care. It must be performed by each individual MDB based on their circumstances and shareholder composition. Shareholders would need to acknowledge that, while remaining extremely remote, the probability of a call would marginally increase. However, such a marginal change would be unlikely to affect the budgetary and accounting treatment of callable capital from shareholders. Under an accrual-based approach, international public sector accounting standards (IPSAS 19) set the threshold for recognizing a guarantee in the financial statement as a greater than 50 percent probability that it will require future payment. The likelihood of a call on MDB callable capital would remain far below that threshold if this recommendation were enacted.

Recognizing the benefits of callable capital is only relevant for MDBs with callable capital, thus excluding IFC and IDB Invest. The impact would also be dependent on shareholders composition and likely to be less beneficial for CAF-DBLA, IsDB and NDB.

The key risk posed by this recommendation is in the calibration of capital adequacy frameworks, and in further exposing MDBs to the risk of downgrades in the ratings of major shareholders. To mitigate these risks, MDBs should adopt a prudent approach in incorporating the benefits from callable capital. The change should be implemented in a coordinated fashion across the major MDBs, with a clearly explained strategy and strong public support by the G20 and other shareholders to prevent such a move from being misinterpreted.

Ratings agencies highlight that one reason they don't give more benefit to callable capital is that MDBs themselves do not use it. If implemented in a credible manner, taking into account callable capital in capital adequacy frameworks in a prudent fashion could influence the rating agencies to increase this benefit. G20 countries along with other MDB shareholders could also consider reforming MDB statutes to clarify triggers for calls on callable capital.¹⁹ Also, MDBs could, in cooperation with their shareholders, clarify budgetary processes and procedures for callable capital. These reforms would have no impact on the obligations shareholders already have, but can influence rating agency methodologies.

	RECOMMENDATION	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 mainly on capital markets and made long-dated development loans, which they have kept on their balance sheets until repayment. However, that model has slowly begun to evolve. Shareholders are more open to innovations, and commercial and official counterparties increasingly recognize opportunities to work with MDBs.

Innovation has also been encouraged by concerted 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 development projects and portfolios, including through risk transfer techniques. Institutional investors are able to benefit from the high quality of MDB due diligence, Environmental, Social and Governance (ESG) standards and PCT protections in regions (such as Africa) or sectors (such as infrastructure) in which they have difficulty investing on their own. Previous experience with the excellent credit performance track record of MDB assets adds much comfort to expand such transactions.

19. The European Stability Mechanism’s (ESM) unique provisions on callable capital are sometimes cited as an example in this regard, notably the specified timeframe and procedures to making a capital call. The Panel considers ESM to be a useful example, but also notes that it has important differences as an institution with MDBs. It is an emergency fund intended to respond to short-term balance of payment crises among member, not an MDB lending for long-term development projects. As well, all ESM shareholders are EU states who are potential beneficiaries of the ESM.

The review has considered numerous opportunities for MDBs to expand these efforts based on pilots already launched by some MDBs as well as other agencies and by the interest expressed by commercial and official counterparties. This section focuses on six areas:

- **New forms of non-voting capital**
- **Risk transfers to the private sector**
- **Guarantees by shareholders**
- **Temporary callable capital to support MDB countercyclical lending**
- **The use of insurance via MIGA**
- **Contingent liquidity lines**

Mobilizing New Non-Voting Capital

MDBs have safe assets and a demonstrably sustainable business model, credible impact measurement frameworks and project execution capacity. Equity investments in MDBs represent an attractive opportunity for investors seeking to boost the ESG or SDG-related shares of their portfolios. A further option is the offering of hybrid instruments with modest yields that might interest governments as well the private sector. The challenge is to incorporate such equity in ways that are attractive and beneficial to both public and private shareholders.

This approach can attract new forms of capital to MDBs, is scalable in ways not possible through transaction-by-transaction approaches and is applicable to both global and regional MDBs. *Such investments need not upset the existing governance and voting structure if they are in the form of non-voting shares.* Government shareholders are understandably averse to dilution. They are generally and justifiably uncomfortable with the notion that private shareholders should participate in decisions on allocation of public funds.

Several MDBs have developed or are developing variants of non-voting capital. Trade and Development Bank (TDB) already offers non-government voting equity shares (100 percent paid-in) and is developing non-voting capital shares in the form of green equity. Some regional MDBs are also actively considering non-voting capital shares. AfDB is developing an interest-bearing asset for either private or public investors that can function as hybrid capital according to rating agency methodologies. AfDB is exploring how shareholders could use Special drawing rights (SDRs) to purchase such assets through a facility set up at the IMF.

EBRD is exploring concrete options for additional shareholder support for the bank's increased activity in Ukraine and for participation in the reconstruction phase.

For hybrid capital, an important consideration is how much is counted by rating agencies as equity. It will also be important to frame offerings of hybrid capital in ways that signal increased, rather than decreased, shareholder support. And there is the risk that the cost of non-voting capital will be too high. Finally, exit provisions to offer investors liquidity could be problematic if asset valuation at exit is difficult to assess.

Endorse MDB consideration of non-voting capital classes (paid-in equity or hybrid) to contribute to available capital.

Such endorsement could be accompanied by G20 guidelines stipulating that these instruments should: (1) fully align with MDB missions; (2) be limited as a share of overall capital; (3) be subordinated to callable capital; (4) avoid targeting returns above levels prevailing in relevant MDBs; (5) not substitute for general capital increases, and (6) be long-term or in a permanent instrument with a defined exit permitted for liquidity purposes. Non-voting capital could be earmarked for lending of interest to investors in specific areas, such as ESG or wider SDG assets.

MDBs should report to the G20 by 2023 on the results of their consideration of non-voting capital and provide action plans to boards and shareholders wishing to proceed with non-voting capital.

Risk Transfers to the Private Sector

MDBs have a significant comparative advantage in investment origination, including high standards, project preparation skills and technical assistance. However, the developmental benefits of holding loan assets on their balance sheets for long periods are less clear. There is a logic for shifting a part of MDB portfolios from an originate-to-hold model to an originate-and-distribute model. Such a shift can be accomplished through outright sales, or by transferring risk to the private sector through insurance or synthetic securitization. Such transactions can be accomplished at scale for portfolios, not just individual loans, freeing up capital for new lending.

MDBs remain the lender of record and administer the loans even after some part of the risk has been transferred. They remain responsible for overseeing project implementation and ensuring that impact and ESG objectives and standards are met for the entire life of the project.

Risk transfers can be undertaken for both sovereign and non-sovereign assets. For sovereign assets, however, low (below-market) margins would in many cases likely necessitate additional public subsidies to boost returns to levels attractive to private risk off-takers.

An instructive, path-breaking precedent is AfDB's Room2Run, which transferred mezzanine risk on a pool of 47 AfDB loans to the private sector through purchase of private insurance and synthetic securitization, freeing up \$650 million in new lending. There have been zero losses so far on the portfolio, and investor interest in future deals is strong. Despite the deal's success, questions have been raised at the high cost, caused in part by insufficient knowledge of historical credit performance by market actors (see Recommendation 5).

The ADB is also deploying risk transfers at scale. It is now working with 22 non-regional insurance companies providing credit guarantees and insurance on a pro rata basis for 24 percent of the non-sovereign portfolio, increasing non-sovereign lending capacity by about \$2 billion.

Risk transfers at the portfolio level to the insurance industry hold strong potential, as the AfDB transaction and other MDB experiences show. In some ways it can be easier to structure than synthetic securitization, although pricing and capital relief are also important considerations. The credit rating agencies may consider the insurance companies as relatively high-risk counterparts, but experience to date on private sector portfolios has been good as the contractual structure is similar to a guarantee. This risk mitigating approach has not been used on sovereign portfolios, in part because the margins on sovereign loans are not sufficient to cover the cost of the insurance. Thus the usefulness of private sector insurance is still to be tested on MDB sovereign portfolios. As rating agency treatment becomes more refined based on more evidence and track records, the benefits of these transactions can increase.

A number of other issues also need to be considered. MDB net income can be affected, depending on how quickly freed-up capital is used for more lending. A risk transfer strategy could impact investment origination decisions by promoting a bias toward less risky investments in less difficult environments, which are easier to price for later transfer. On sovereign loans, uncertain treatment of risk transfers by borrowing countries, the Paris Club and other official creditors in the eventuality of a sovereign debt restructuring should also be clarified.

RECOMMENDATION

3B

Scale up the transfer of risks embedded in MDB loan portfolios to private sector counterparties by accelerating the development of funded and unfunded instruments

The G20 should develop guidelines supporting risk transfers that: (1) advance the MDB mission, (2) accurately price risk, including through use of relevant granular data for risk weighting (such as from the Global Emerging Markets Risk Database (GEMs) database); (3) are scalable; (4) facilitate the transformation of MDB portfolios toward greener assets and greater development impact; (5) avoid a systematic reduction of risk appetite in investment origination; and (6) develop private markets for MDB asset classes.

Guarantees by Shareholders for Sovereign Loan Portfolios

Guarantees from shareholders and donors have seen increasing use, with Sweden and the UK as notable examples. When targeted at lending to a specific country they can help address concentration risk, and well-specified portfolio guarantees can free up substantial capital for additional MDB lending. For guarantors, guarantees are efficient and because of the extremely low probability of default on MDB sovereign loans, can have limited fiscal impact. Guarantees can be pooled and offered by a subset of interested shareholders, rather than requiring the broad agreement across shareholders necessary for a general capital increase.

Combining guarantees with a grant component can offer additional opportunities for leverage. The International Finance Facility for Education (IFFEd) is an innovative example where donors can contribute to either a grant guarantee window. If countries choose additional borrowing for education, the guarantee would cover any missed repayments. The freed up MDB capital can be leveraged to finance additional lending: \$1 of freed-up capital mobilizes \$4 of additional lending.

IFFEd contributors would only pay in 15% of their guarantee commitment to capitalize the facility, with a contingent commitment covering the remaining 85%. This allows for increased leverage on paid-in capital. If the paid-in capital falls below the 15% threshold because of arrears, IFFEd calls for the contingent capital to restore the required floor within a specified timeframe. IFFEd has received a preliminary AAA rating due to the high ratings of its target contributors. The ADB is proceeding with a similar structure in the energy transition space.

One concern is that a facility targeted at a particular sector creates an incentive that may not align with borrowing country priorities and would give contributing countries disproportionate influence over MDB lending allocation and policies. Guarantees would be better deployed for increases in broadly defined lending capacity in support of the MDB's entire strategy, including proportional growth in areas of interest to both potential donors and most borrowing countries, such as climate mitigation and adaptation finance.

RECOMMENDATION

3C

Encourage shareholder guarantees of sovereign repayments on loans related to cross-cutting priorities.

Given the very low risk of sovereign loan arrears, such guarantees greatly reduce the upfront cost to shareholders. Contract provisions defining the contingent terms would be more predictable and clearer than callable capital, thus enhancing the value of the guarantee. Highly rated non-shareholders, like foundations and philanthropic investors, could also deploy similar portfolio guarantees for activities of interest.

Counter-cyclical and Capital Adequacy

The issue of counter-cyclical is embedded into the very nature of MDBs: providing financing when market actors retreat in a crisis is one of the reasons why MDBs exist. Yet this is inherently in tension with the approach of market actors, including rating agencies. Rating models use capital adequacy weights that are tied to borrowing countries' credit ratings, which may tend to be procyclical, limiting MDBs' ability to respond to crises. In an era of increasing climate change impacts, global macroeconomic volatility and regional geopolitical tensions, the ability of MDBs to respond to crises is ever more important.

Pandemic and climate risks in addition to political instability and wars lead shareholders to put pressure on MDBs to increase their countercyclical role. However, the tension between the MDBs' mandate and market sentiment is not easily addressed. One key approach is to demonstrate to credit rating agencies that the counter-cyclical approach of MDBs can actually help reduce long-term risks (Recommendation 4).

MDBs should consider approaches to build counter-cyclical buffers without locking up excessive amounts of risk capital during "normal" times. One possibility would be an advance commitment to provide temporary subscriptions of callable capital in individual MDBs as a buffer to face global or regional crises. This would give a cushion to MDBs to react without endangering their bond ratings, due to the uplift given by rating agencies for callable capital. The relevance of such an instrument would depend on the circumstances of each MDB and the nature of the shock.

Temporary subscriptions of callable capital have been used by the AfDB toward the end of its general capital increase cycles in order to maintain its rating²⁰ and by EBRD to help maintain lending levels following the global financial crisis. This approach could be institutionalized across multiple MDBs as a standard buffer for counter-cyclical lending. The buffer would help support surges in MDB lending when additional capital needs are temporary and the case for General Capital Increases (GCIs) uncertain.

The benefits are dependent on adequate weighting of callable capital in MDB CAFs and in CRA methodologies (see Recommendations 2 and 4). As a result, they are dependent on shareholder composition and are likely to be sensitive to changes in shareholders' own ratings. To be impactful, the buffer commitments should: (1) be established for sufficient time periods to enable long-term financial planning, (2) clearly define triggers for providing the callable capital in crises, and (3) give all shareholders the opportunity to participate if they wish to avoid dilution of voting power.

RECOMMENDATION

3D

Support collective shareholder commitments of temporary pools of callable capital to help MDBs mount strong countercyclical responses in periods of global or regional crisis.

The G20 should call on willing shareholders to make or pool commitments to create temporary callable capital buffers for countercyclical purposes. Managers of relevant MDBs should develop action plans to set up the buffers by 2023, including discussions with the rating agencies to understand structures needed to be considered as capital cushions. Temporary callable capital buffers do not require charter or governance changes if the opportunity to participate is offered to all shareholders.

Scaling MDB-MIGA collaboration

MIGA's array of insurance products, strong balance sheet, globally diversified portfolio and well-established role in reinsurance markets make it a potentially highly effective MDB partner. Its active use of reinsurance (currently for 60 percent of its portfolio) drives a highly efficient capital model: operating capital of \$1.7 billion supports gross exposure of \$23 billion. The ability of MIGA to reinsure exposures gives it the capacity to help MDBs manage portfolio risk, especially for regional development banks with significant concentration risks.

MIGA could partner with MDBs to reduce political and contract risk at the portfolio level, as noted by the 2018 EPG. MIGA's charter allows it to offer coverage to other MDBs as well as to the World Bank Group, as long as they are making their cross border investments on a commercial basis and meet the criteria set out in the constituent documents, and its non-honoring contract product covers sovereign exposure. Especially for

20. Canada provided temporary callable capital twice to the AfDB (2010 and 2019) to address rating agency pressures as the bank responded to countercyclical demands. Canada waived additional voting rights associated with the capital. When Canada was downgraded and another shareholder placed on negative outlook by Fitch, AfDB had to cut projected lending over the 10-year plan by 23 percent. In response, another temporary subscription from Germany, Denmark, and Sweden has been approved by its Board until 2023, this time with commensurate changes in voting rights.

MDBs with high concentration risk and ratings below AAA, the capital freed up by the risk transfer to MIGA would likely exceed MIGA's capital charge.

This proposed role for MIGA would not substitute for regional public insurance entities such as the African Trade Insurance Agency (ATI) and the TDB's in-house insurance operation. Some regional MDBs offer a partial risk guarantee similar to MIGA's political risk insurance, although on a far smaller scale and without comparable global risk diversification and reinsurance benefits. Comparisons of premium pricing across these different entities will be important. While MIGA's political risk insurance and non-honoring contract insurance products apply to all countries, the World Bank's Independent Evaluation Group notes they are deployed more frequently in middle-income countries.

So far, uptake of MIGA's products by other MDBs has been limited, with the exception of EBRD where they have been used as a risk-enhancement to private sector investors. MDBs are reluctant to add a third party that could complicate and slow loan development and potentially disrupt important MDB relationships with their member countries. There are concerns that MIGA's involvement could reduce rather than support finance opportunities for other MDBs. MIGA's value add is likely to be greatest where concentration risk limits regional MDB lending. For example, MIGA could take on the risk of a portfolio of climate-related lending in middle-income countries bumping up against their exposure ceilings.

RECOMMENDATION

3E

Call on MIGA and MDBs to collaborate on transferring portfolio risk from MDB balance sheets through MIGA's insurance products and reinsurance capability.

MDBs and MIGA should proactively pursue partnership opportunities for mutual benefit. MIGA can help MDBs address concentration limits and make more projects bankable through transfer of political risk and non-honoring of financial obligations by sovereign, sub-sovereign and non-sovereign entities. And MDBs can help MIGA utilize more of its capacity through their project origination advantages.

Liquidity backstop

MDBs hold high liquidity buffers of a year or more to mitigate funding liquidity risks in times of high market stress, when funding costs might increase significantly or funding markets shut down entirely. Considerations around buffers can vary significantly across MDBs. They are driven by factors like balance sheet size and cost of funding. These factors impact the supply of suitable assets, diversification within the liquidity buffer and whether portfolios have positive carry. A subset of MDBs hold larger liquidity portfolios than they otherwise would to maintain AAA ratings.

Some MDBs make use of commercial liquidity arrangements; with three important downsides:

- 1 | Uncommitted facilities cannot be relied upon in times of a market stress.
- 2 | Committed facilities need to be remunerated for the duration of the facility, akin to an insurance premium.
- 3 | Eligible collateral would likely be highly liquid assets that ratings agencies would recognize as part of the liquidity buffer, with limited benefit from a rating perspective.

Cash deposits with MDBs by central banks or other sovereign-related entities in times of market stress could alleviate temporary liquidity pressures and prevent costly liquidation of assets. Temporary funding pressures experienced by MDBs during the global financial crises are a case in point. Such relationships with counterparties who have countercyclical features by the nature of their business model could be particularly beneficial.

Greater benefit would come from the availability of a liquidity backstop for MDBs through access to central bank liquidity against posting as collateral assets from their lending portfolios.²¹ This could mitigate potential leverage constraints, which would provide additional lending capacity. It would also give MDBs additional degrees of freedom in managing their liquidity, which could address possible profitability issues related to negative carry of the liquidity portfolio. And it can alleviate specific rating agency metrics that can be problematic for certain MDBs, for example Fitch's equity-to-total assets ratio.

With very few exceptions – most notably the EIB via the European Central Bank (ECB) - MDBs do not have access to central bank liquidity. The reasons are threefold:

- 1 | In the absence of a central bank whose shareholding is broadly aligned with that of an MDB, negotiating an arrangement of this kind would be difficult.
- 2 | Access to a central bank facility would most likely need to be linked with some form of ongoing regulation/supervision, which would be challenging in a pooled arrangement and even on a voluntary basis could be problematic for MDB governance and autonomy.
- 3 | The respective central banks would need to have access to currencies in which MDBs' obligations are denominated or that can be converted into such currencies even under extreme market stress conditions.

RECOMMENDATION

3F

Explore ways of providing MDBs with access to central bank liquidity, including pooled agreements under the supervisory umbrella of one central bank.

21. A share of EIB's loan book is eligible collateral for ECB. The ECB accepts as collateral some non-marketable assets, including credit claims where the debtor or guarantor is a euro-area public sector entity or non-financial corporation. See: <https://www.ecb.europa.eu/paym/coll/standards/nonmarketable/html/index.en.html>



Improve Credit Rating Agency Assessment of MDB Financial Strength

The three major credit rating agencies of S&P, Moody's and Fitch dominate the market for MDB bond ratings.²² The fact that MDBs are very highly rated provides important advantages in pursuing their development mandates, notably very low funding costs and access to market borrowing even in times of financial crisis. As a result, the way in which each agency evaluates MDB creditworthiness is a key factor in managing the ongoing MDB operational capacity. Target ratings and aspects of rating requirements are part of risk appetite statements as well as financial and risk policies.²³

MDBs pose a challenge to ratings agencies. On the one hand, they are similar to commercial financial institutions as they carry out lending and investing activities. On the other hand, they have very specific features: development and counter-cyclical operational mandates, below-market loan pricing, a structurally concentrated loan portfolio, extraordinarily strong repayment record in part due to preferred creditor treatment and an unusual capital structure, among others. Many of these characteristics are not easily incorporated in bond rating methodologies. In recent years, all three agencies have built increasingly sophisticated and complex methodologies based on the following components:

- **Capital adequacy**
- **Liquidity and funding**
- **Policy importance of the MDB**
- **Internal governance and administration**
- **Extraordinary shareholder support (mainly callable capital)**

Despite these conceptual similarities, the three methodologies vary substantially in actual metrics used, how they are combined and the degree of transparency and subjectivity. Due to policy requirements at most of the major MDBs, they must meet the AAA thresholds of whichever component of the three methodologies is the most binding. The result is that MDBs effectively manage their operations to a composite methodology of the most restrictive metrics of all three agencies and are exposed to any changes in methodology, MDBs build in rating agency model risk buffers. This is an extremely inefficient way to make use of scarce capital.

The Panel commissioned two external studies to examine the issues of PCT and the concentration risk posed by MDB portfolios.²⁴ Definitive results are pending, but preliminary findings indicate that the methodologies

22. U.S. Securities and Exchange Commission (2022) p.24. Other credit rating agencies do exist and are relevant in certain national markets, but none come close to the importance of S&P, Moody's and Fitch as a reference for global bond investors.

23. Of the 15 MDBs included in this review, 10 have the top AAA/Aaa rating from all three agencies, four are in the high investment grade range (CAF-DBLA the lowest at A+), and MIGA is not rated. All MDBs are rated by all three agencies, except for MIGA (unrated) and New Development Bank (not rated by Moody's). The World Bank Group does not pay Fitch for a rating, but Fitch rates IBRD on an unsolicited basis. It does not rate IDA and IFC.

24. The latter was undertaken by a co-author of the original commercial bank methodology on which S&P bases their concentration penalty.

employed by ratings agencies underestimate the benefits of PCT—both in terms of likelihood of repayment delays and loss in the event of arrears—and overestimated the risks posed by concentrated MDB portfolios. Both issues pertain mainly to MDBs’ lending to sovereigns. Rating agencies should build on evidence-based studies such as these to refine their methodologies in these two areas.

MDB finance and risk teams hold regular discussions with rating agency analysts on their institution’s rating and offer feedback to proposed changes in rating agency methodologies. However, the influence of MDBs on rating agencies is inherently limited, as the agencies are private businesses. MDB ratings represent a very small share of rating agency business, which reduces MDB leverage despite the importance of the sector to global development.

This review proposes two sets of recommendations on the methodologies and processes of credit ratings for MDBs. The first relate to the role of G20 members and other MDB shareholder countries in influencing rating agency methodologies. The second highlights a key area where rating agencies may wish to consider reforming their methodologies to address inconsistencies or weaknesses.

RECOMMENDATION

4A

Strengthen communication of G20 members and other shareholders to inform rating agency views of MDBs with respect to the importance of MDBs and shareholder support

Ratings agencies place great value on their perception of shareholder support for the institutions themselves and their mission (policy impact, relevance of MDB and willingness of shareholders to support the MDB). This perception is not only an important rating criterion itself, but also plays a strong role in the subjective assessments that form a major part of all three methodologies. G20 members should not underestimate their own ability to influence how individual MDBs are rated, particularly when launching new initiatives or in response to crises.

Given the importance of public signaling by shareholders, any initiatives deriving from the recommendations of this Review or other shifts in MDB financial policies should be supported by clear and coordinated public statements by the G20 and other shareholders. G20 governments as well as top MDB management should consider regular, ongoing engagement with upper-level management of ratings agencies, who have expressed a clear interest in constructive dialogue. This would not be a substitute for the regular interactions between MDB finance and risk teams and rating agency analysts, but rather an additional layer of engagement to address higher-level issues, particularly in relation to MDB business models and shareholder financing priorities, including the importance of private finance operations, counter-cyclicality and increased climate and ESG-related finance.

Rating agencies can take steps to strengthen their MDB evaluation methodologies.

This review held extensive discussions with rating agency analysts and MDB treasury and risk teams, and closely analyzed the MDB methodologies of all three agencies. The methodologies diverge considerably from one another in important ways, which is not unexpected in a competitive marketplace. More problematic are a number of conceptual and empirical inconsistencies and the use of proxy variables that do not always appear warranted. The Review highlights a few key areas in the subsequent paragraphs where ratings agencies could further reflect on their methodologies.

The thresholds to achieve top ratings in key metrics is in some cases extremely high, to the point where reaching those thresholds would effectively render the MDBs dysfunctional as a financial institution and turn them instead into a type of unleveraged fund or asset-holding trust. Leverage and liquidity ratios are particularly strict. Thresholds could better balance the stringency needed to achieve a AAA rating with the realities of being a going concern.

Leverage ratios not accounting for asset risk have their place (as per the Basel approach), but their weighting seems excessive in some methodologies and can create perverse incentives for MDBs. Metrics related to MDB portfolio risk appear in some cases to under-estimate inherent MDB strength and over-estimate risks derived from their normal operations. In particular:

- Preferred creditor treatment could be better reflected in some rating methodologies. This includes not just the reduced likelihood of a delayed loan repayment event but also the extraordinarily low loss rates in the event of delayed repayment, as illustrated by the preliminary results of an external study commissioned by the Panel.²⁵
- The evaluation of risks posed by structurally concentrated loan portfolios of sovereign-focused MDBs are highly divergent and in some cases extremely punitive to risk-weighted assets.

MDBs are in some cases penalized by the forward-looking approach taken by rating methodologies for acting counter-cyclically in response to crises, even in the absence of a deterioration of financial metrics and with shareholder support. Methodologies should better factor in the counter-cyclical mandate of MDBs and recognize that it i) underpins factors like preferred creditor treatment and ii) can itself play a role in reducing risks by helping countries overcome crises.

The rationale for deciding which portion of callable capital to be factored into rating methodologies appears unclear and insufficiently values the commitment of many major non-borrower countries.

25. Using only publicly available data for four MDBs, the preliminary assessment of PCT found that MDBs have a probability of default from borrower countries roughly three times lower than to commercial lenders from the same borrowers (0.37%, compared to 1.13% for bank loans and 1.37% for sovereign bonds), Loss given default was roughly ten times lower (about 5% compared to 50.0%-51.8% to commercial creditors). More granular results are expected in the final study with complete MDB data.

Rating agency approaches to evaluating MDB innovations (as per Recommendation 3) can leave MDBs and market participants unclear of their benefit until lengthy negotiations with agency analysts are completed. MDBs make up a small portion of CRAs' activity and understanding of MDB-specific issues is not always broad-based within each firm. Rating agency risk weighting approaches, including for risk transfers, would benefit from incorporation of more granular data on actual MDB credit performance. A more systematic consideration involving expertise from across rating agency departments would be beneficial. A significant amount of professional judgement is exercised by rating agencies in interpreting information from MDBs and applying 'notching' to components of rating methodologies. More transparency in how judgement is applied would aid understanding the impact of operational developments on ratings.

RECOMMENDATION

4C

Rating agencies and MDBs should work together to develop common standards for evaluating the risk weights of ESG-related assets on MDB balance sheets.

Rating agencies are increasingly incorporating ESG concerns into their methodologies. MDBs have a leading role in defining and acting on ESG issues and attracting private and philanthropic finance in the ESG sector, as mandated by their shareholders. The bulk of MDB activities are considered as ESG by private sector investors. Rating agencies should reflect this role in their evaluation methodologies. It is important that implications on ratings be properly reflected given growing ESG assets at MDBs, also in the context of evolving regulatory consideration of the potential for reduced risks or improved collateral value through greener portfolios. MDBs should be encouraged to anticipate in their methodologies the benefits of evolving treatment of MDB ESG assets in general and in particular of possible regulatory adjustment of risk weights or collateral value for bank assets associated with high exposure to ESG risks, especially climate ones. MDBs should be encouraged to develop common standards for their ESG assets in close dialogue with rating agencies to ensure early consistency. This would be consistent with the assessment of MDB ESG risks already used by many investors and capital markets actors.

Methodologies vary across rating agencies on the use of MDBs internal risk weighted asset models. However, it is the sub-category by far the most likely to change year-on-year, and hence has an outsized importance in ratings. ESG treatment by rating agencies for MDBs assets should be a priority area. This should provide added incentives for channeling more market savings into MDB ESG portfolios. It will also impact on the treatment of risk transfer transactions as MDBs maintain their ability to protect ESG standards/results and development objectives in administering projects where risks have been transferred.



RECOMMENDATION

5

Improve the Enabling Environment for Capital Adequacy Governance

Information asymmetries, dynamics between shareholder boards and management and the absence of well-understood benchmarks create a challenging environment for capital adequacy governance. Methodologies, indicators and modeling approaches differ between MDBs and the lack of comparability can result in conflicting views about the severity of capital constraints at any one time. This has become particularly problematic in recent years as the demands on MDB to achieve development goals have risen faster than available capital, leading to increasing interest among shareholders for more systematic and comparable information across MDBs.

Full standardization is unlikely and not necessarily desirable. It is, however, possible to gain a better understanding of where capital adequacy frameworks are the same or different and why. Developing a consistent understanding is a process that enables continued clarification and refinement and can support learning and better governance. The key steps would be: establish periodic cross-MDB benchmarking based on consistent metrics, create mechanisms to support MDBs and shareholders in managing information related to capital adequacy and accelerate dissemination of core MDB credit statistics and related analyses through the GEMs.

Addressing these issues can improve the governance environment surrounding MDB capital adequacy, which is essential to enable the other recommendations in this report and, more broadly, to place future discussions around MDB financial capacity and capital needs on a firmer footing. It would support assessments by the credit rating agencies. And it would be positively received by financial markets, which have long been calling for more transparency through data disclosure, harmonization and standardization, in particular in order to assess the risks of investing with or alongside the MDBs.

Capital Adequacy and MDB Board Governance

This Review was not tasked by the G20 with addressing MDB governance issues, which is a broad and complex topic.²⁶ Nonetheless governance must be considered in any serious discussion of capital adequacy. The role of shareholders and board structures is fundamental to financial governance, as is highlighted by all modern good practice recommendations.²⁷ Shareholder representatives on MDB boards and board committees have the responsibility to review financial performance, approve financial policies and specify risk appetite and institutional goals. This gives management a clear set of targets and parameters to implement in MDB operations.

26. For more on this issue, see among others Organisation for Economic Co-operation and Development (OECD) (2015) and Zedillo (Chair) et al. (2009).

27. See for example BCBS (2019).

The boards of most MDBs covered by this Review are very different from those of commercial financial institutions. Between two-thirds and three-quarters of the members on average come from national administration and rotate for a relatively short term of service.²⁸ At many MDBs, board members are involved in approving operations on a weekly basis, whereas at other financial institutions board members focus only on higher-level fiduciary, strategic and policy issues. MDB board members are tasked not just to guide and safeguard the MDB itself, but also to further the economic and foreign policy interests of the countries they represent. While a good relationship between the board and MDB risk teams can help bridge the gap, it does not provide board members the in-depth understanding and information required to provide independent oversight. This set-up is a function of the unusual nature of MDBs—a financial institution, but also an international organization owned by national governments to address issues of public concern.

These governance arrangements create an imbalance in information and expertise between the MDB risk management structures and the relevant board committees. This can impede informed, effective discussion and decision-making on risk appetite and the structure, nuances and implementation of capital adequacy frameworks. They are not well aligned with sound financial governance practice as recommended for example by the Basel Committee, which calls for a clear separation between ongoing management responsibilities and the more strategic role played by boards to provide high-level direction and oversight.

Several MDBs in this Review have experimented with other types of institutional arrangements to find compromise solutions to the dual nature of board member responsibilities. EIB, CAF-DBLA and AIIB all have a sharper differentiation between board and management roles and have mechanisms to involve more technical expertise in financial policy deliberations. AIIB's Accountability Framework is a particularly relevant case study that other MDBs might examine, as noted by an article written by shareholder government representatives.²⁹ AIIB's Board Audit and Risk Committee has external, independent members that are valued by both Board and Management.

Other MDBs not included in this Review, including Trade and Development Bank, include non-executive board members with specialized expertise to strengthen oversight functions on capital adequacy and other financial policies.

RECOMMENDATION

5A

Consider implementing measures to strengthen the ability of shareholder boards at MDBs to effectively undertake their responsibilities in setting the parameters of risk appetite and capital adequacy policies and overseeing their implementation.

28. Executive directors at World Bank, AIIB and ADB have a two-year term with possibility of renewal, compared to three years for AfDB, CAF-DBLA, EBRD, IDB and IsDB, and five years for EIB.

29. See for example Von Müller, Camilo and Elke Baumann (2019).

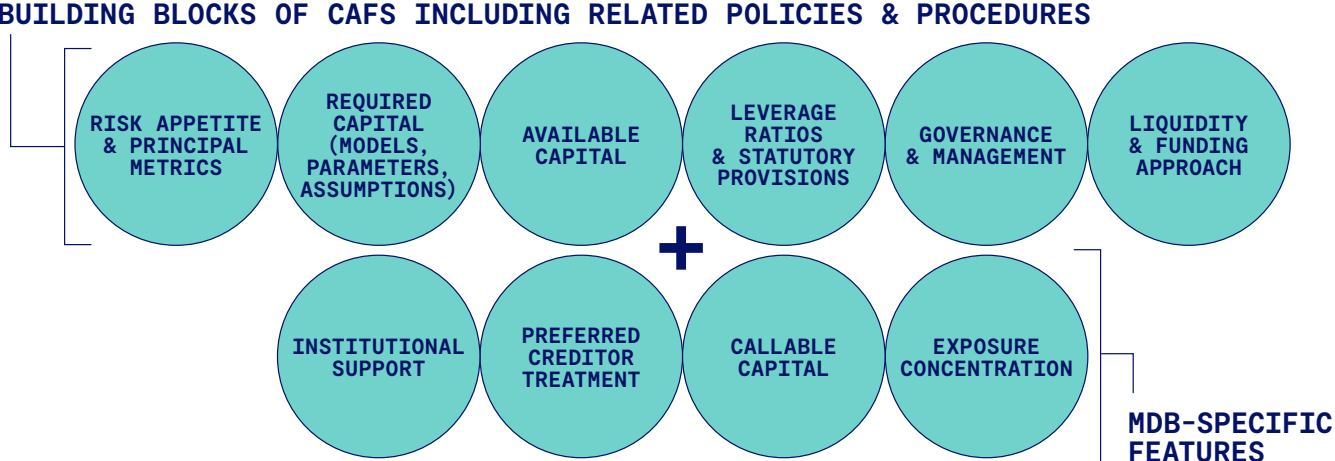
Due to the complexities of the topic and the strictures of the Review’s terms of reference, the Panel does not propose detailed recommendations on board organization or governance. Extensive discussions with stakeholders and a review of the literature and best practices nonetheless make it clear that MDB capital adequacy issues cannot be fully addressed without reference to governance arrangements, and in particular the role of shareholders.

One potential starting point would be for MDBs to consider the inclusion of independent, non-executive and non-voting board members with expertise in risk and audit functions. These could be included as observers tasked with providing support on these issues or given more authority as chairs of audit and risk committees. An alternative would be for shareholders to appoint some board representatives or advisors with technical qualifications on capital adequacy issues, who can contextualize capital adequacy and wider operational considerations. Another measure addressed in Recommendation 5b below would be to create an independent body to collate information, undertake studies and provide expert support to board members on matters related to capital adequacy. More broadly, MDBs may consider refining the current board governance structure by better separating the roles and responsibilities of executive management and the shareholder board.

Regular benchmarking

Well-designed capital adequacy frameworks and related policies and procedures have a number of important components summarized in Table 3.2 below and discussed in Chapter 2 in more detail. Their key elements and drivers should be accessible to shareholders and other stakeholders in a manner that is readily understandable and that allows comparison across institutions. In the Panel’s view, this would be best addressed with a regular capital benchmarking report that presents MDB capital adequacy frameworks in a standardized format and with consistent definitions and metrics. This would address an important gap in MDB’s governance toolkit on financial policy, and support shareholder decision-making at a time when there are considerable expectations for MDBs to scale up and deliver on the SDGs and climate goals. Given the rapid developments in the global economy such a report would best be prepared annually, though the exact frequency would need to be considered by shareholders. Shareholders may wish to consider combining regular capital adequacy reporting with the reporting mandates already in place on MDB balance sheet optimization, due to the close relation of these issues.

Table 3.2. Key Components of MDB Capital Adequacy Frameworks



Such a report could **build on the benchmarking methodology and tables** in the present report but should go a step further by harmonizing nomenclature and concepts and mapping methodologies across the MDBs to flag where they have commonalities and where they differ. In particular, it should provide a comparable risk adjusted capital indicator across MDBs and describe its components and their methodologies. The aim should be to i) better support capital and headroom comparisons for regular operations as well as countercyclical buffers and ii) give comfort to shareholders that these concepts are broadly aligned across institutions (see Recommendation 5c).

The Panel further recommends going beyond an annual benchmarking exercise, with shareholders and each individual MDB **instituting regular capital resources reviews**, as is already the practice of some MDBs (for instance the EBRD has a 5-yearly cycle). Such a review would offer an opportunity for shareholders to consider the MDBs' capital situation and set it against strategy in a deliberate manner, rather than reacting to events.

One challenge is that the standardization inherent in benchmarking might not adequately reflect the specific circumstances of each MDB. The exercise needs to be conducted in a manner that does not undercut MDB management responsibilities, but rather builds on them. Further, care needs to be taken to ensure that data sharing and curation as well as capital reviews are cost efficient and value adding rather than burdensome.

RECOMMENDATION

5B

Prepare regular capital benchmarking reports on each MDB's capital adequacy framework in a comparable format employing harmonized definitions and support regular MDB reviews of capital resources.

Enhanced arrangement for sharing financial management practices

In light of the diversity of MDBs and the complexity of capital adequacy frameworks, shareholders should consider **creating enhanced arrangements** (such as an MDB Forum on Financial Best Practices) to collect and curate the benchmarking information and prepare joint reports, ensuring validation and agreement by each MDB, subject to strict non-disclosure agreements. Arms-length data gathering and curation would provide an added layer of credibility and can support informed judgement among shareholders, rating agencies and investors. Such an arrangement could build on the established chief risk officer networks but should involve other parts of the institutions (finance, strategy) and, crucially, shareholders.

MDBs and shareholders might leverage the knowledge and expertise such an arrangement would provide for other potential benefits. Acting as a resource for MDBs and shareholders, this would allow to:

- Continue the work on benchmarking and comparability of data, and issue an annual report to shareholders;
- Share best practices, including by preparing a 'shareholders guide', and forging best practices on urgent matters such as the treatment of climate risk;
- Train new executive directors and other parties as required;

- Serve as a venue to convene and facilitate informal discussion among shareholders on capital adequacy and financial management;
- Commission analysis on behalf of MDBs as a collective, leading to efficiencies.

In addition, if desired, such an arrangement could play a role in implementing some of the Review’s other recommendations, including promoting dialogue and exchanges of views between MDBs as a group and rating agency senior management, with the dialogue between the Institute of International Finance (IIF) and the Paris Club as a possible model. This would be additional and in no way replace bilateral engagement on specific ratings. Such a forum could also act as a clearinghouse for innovation, giving MDBs a venue in which to share experiences, promoting learning and cross-pollination.

There are many possible set-ups that could fulfil this mandate, including virtual ones, and this may be an arrangement that evolves over time. In the Panel’s view, an academic institution or consortium might be well positioned to support existing MDB risk team networks in this function. Some of its functions may attract fees, while secondments from shareholders and MDBs could minimize costs. Key features should include: (1) a focus on collaboration, (2) independence, (3) strong data confidentiality, (4) core staff promoting continuity, (5) clearly defined relationship with MDBs and shareholders, and (6) inclusiveness, with access available to all MDB shareholders on an even basis.

RECOMMENDATION

5C

Establish enhanced arrangements on issues of capital adequacy and risk management to promote ongoing MDB benchmarking, share best practices and facilitate discussion among MDBs and shareholders.

Data transparency

Since its establishment in 2009, the GEMs Consortium has developed the only emerging market and developing economies credit database of its kind. GEMs membership (twenty-four institutions) and contributing members (eleven) have increased over time. Its data is pooled from many years of contract level data points and include credit defaults on the loans extended by consortium members, the migrations of their clients’ credit rating and the recoveries on defaulted projects. GEMs covers private, sovereign, sub-sovereign and sovereign guaranteed lending, cutting across sector, country and income groups and regions.

GEMs provides asset class information that is valuable to a range of market parties assessing or investing in individual MDB loans or in portfolios of MDB assets. These include, private investors (see, for example, the ILX Fund), credit rating agencies, insurers and securitization agents and investors, as well as sovereigns providing project or portfolio support to MDBs. Wider access to GEMs would build investor understanding and strengthen risk assessment, expanding investor interest and better risk transfer opportunities for MDB assets, improving capital efficiency and scaling capacity for MDBs.

Long-standing challenges have greatly limited GEMs information sharing and publication. The GEMs organization structure is a loose consortium of members with day-to-day management and control sitting within EIB. Data contributions are on a voluntary basis with no formal commitment to provide data in the future. EIB's leadership and contribution have been valuable, and members' efforts to build and improve the data quality for their own use have been successful. But the current structure is not well suited to take GEMs to the next level and reap its wider benefits.

To make GEMs more widely available and sustainable, the organization needs to be transformed into a stand-alone entity with strong governance, management and sustainable funding, including an independent chief operating officer supported by MDB contributing members. MDBs need to commit to ongoing contributions of data with appropriate protections for transaction anonymity. This new, robust structure should be designed and implementation underway before the end of 2022.

Some of this work is already ongoing, with significant efforts from participating MDBs. However, it will be challenging to implement in terms of data governance, management and quality control. It will require more successful collaboration among MDBs and Development Finance Institutions (DFIs) than has occurred to date. It will also require funding on an ongoing basis, attention and support from shareholders and buy-in from rating agencies to use relevant data for risk ratings.

RECOMMENDATION

5D

Endorse and support ongoing efforts to transform GEMs into a stand-alone entity with legal status and secured budget able to curate and disseminate regularly-supplied MDB statistics and analysis to support improved knowledge on emerging market risks for MDBs, private investors and rating agencies.

Under the new structure, GEMs should: (1) transform the GEMs organization into a robust, stand-alone entity with members committed to providing data on an ongoing basis, (2) publish more granular statistics and analysis of the data showing credit performance for sovereign and private sectors by sector, countries or country groups, and regions, (3) share anonymized statistics with private investors and ratings agencies and (4) provide risk analytics, charging fees as needed. In addition, efforts should continue to add more members contributing data as well as to harmonize, anonymize, and ensure the quality of the data, with the aim of publishing more disaggregated annual statistics and data analytics reports in late 2023 or first half of 2024.

Consideration might be given to combining the GEMs organization with the arrangements discussed under the previous recommendation. The Panel has not reviewed the options in this respect but notes that it is important for the enhanced GEMs to have a clear business focus.

4

Action Plan on MDB Capital Adequacy

The challenges of today highlight more than ever the need for MDBs to make the most efficient and effective use of the public resources under their stewardship. In the judgment of this Panel, shareholders can increase MDB's capacity to address global development needs through their approach to risk appetite and capital adequacy. Collectively, the recommendations proposed here could add several hundreds of billions of dollars in additional portfolio room in the MDBs included in this Review over the medium term depending on the depth and scale of implementation, while posing minimal additional risk to their financial stability. The risks of inaction are far greater.

This chapter summarizes the key recommendations articulated in detail in Chapter 3, highlighting interactions and setting them out against the broader context.

- **The first two Recommendations (risk appetite for capital adequacy and recognizing the benefit of callable capital)** go to the core of MDB capital adequacy.³⁰ They have the potential to increase lending headroom substantially. They require shareholders to consider their own approaches to risk appetite and will be watched closely by market participants. They should

be done deliberately and supported by a clear communication strategy. Shareholders should carefully consider associated risks and mitigating actions.

- **Recommendation 3 (innovations)** includes multiple tools that have been used or piloted by MDBs or are used in commercial markets and appear technically viable. Some options not only strengthen MDB capital efficiency options but also offer commercial and philanthropic investors SDG investment opportunities at scale. Implementation complexity varies but headroom benefits are potentially substantial, depending on the scale at which shareholders wish to pursue them and the terms of sharing risks and returns between commercial and official counterparties. Many of the tools have a cost to develop and MDBs could work more cooperatively to build this tool kit to reduce and share these costs. Innovations must be pursued in ways that are consistent with MDB missions and require strong shareholder governance and management oversight.
- **Recommendations 4 and 5 (engagement with rating agencies and enabling environment for capital adequacy)** could be pursued without

30. As noted in the report, applicability to individual MDBs will vary. In particular, Recommendation 2 will not apply to MDBs that have no callable capital, notably IFC and IDB Invest.

delay and irrespective of the G20's view on the other recommendations. They pose relatively low political and technical challenges and require modest resources. Potential gains in terms of lending capacity are indirect, would materialize only over the medium term and are not readily quantifiable. Nonetheless, they would improve the way MDBs and shareholders manage capital adequacy and decide capital needs now and in the future. They would help position MDBs and shareholders to better address the discussions around MDB capacity that will inevitably arise on a regular basis in coming years to face long-term development and climate challenges and respond to short-term crises. Additionally, some could have significant market-making impact through better understanding of MDB credit performance. Risks are minimal.

The table below summarizes key actors in decisions on recommendations and gives broad indications of complexity and time frames for execution. It is important to re-emphasize, however, that the recommendations are interrelated and time frames for implementation are inter-dependent. This means that in some cases the time frames indicated below will be cumulative, with for example two reforms each requiring 1-2 years adding up to a timescale of 2-4 years. Decisions about the treatment of callable capital in capital adequacy frameworks, for example, are related to decisions regarding risk appetites, statutory changes, innovations to increase available capital, evolution in rating agency methodologies, and the availability and use of granular data on MDB credit track records to strengthen risk weighting. In some instances, implementation may need to take place in a sequential manner with one reform, or a set of reforms, necessary to enable others. This will affect implementation timelines, which may also differ significantly between individual institutions depending on their specific arrangements.

Table 4.1. Summary of Recommendations

■ Low ■ Low Med. ■ Med. ■ Med. High ■ High				
RECOMMENDATION	ADDRESSED TO	COMPLEXITY OF EXECUTION	TIME FRAME	
1 Redefine the Approach to Risk Appetite in Capital Adequacy Frameworks				
1A Shift risk appetite definition toward shareholder-defined limits	MDBs Shareholders	Medium	1-2 years	
1B Ensure frameworks account for MDB-specific features	MDBs	Low Med.	1-2 years	
1C Relocate specific numeric leverage targets from MDB statutes	MDBs Shareholders	High	>2 years	
2 Incorporate Uplift from Callable Capital into MDB Capital Adequacy Frameworks				
2A Incorporate Uplift from Callable Capital into MDB Capital Adequacy Frameworks	MDBs CRAs Shareholders	Low Med.	1-2 years	

RECOMMENDATION	ADDRESSED TO	COMPLEXITY OF EXECUTION	TIME FRAME
<h3>3 Implement Innovations to Strengthen MDB Capital Adequacy and Lending Headroom</h3>			
3A	Endorse MDB consideration of non-voting capital classes (paid-in equity or hybrid) to contribute to available capital	MDBs CRAs Shareholders	Med. High 1-2 years
3B	Scale portfolio risk transfers to the private sector of MDB non-sovereign loans to facilitate additional lending	MDBs Shareholders	Med. High 1-2 years
3C	Encourage shareholder guarantees on loans related to cross-cutting priorities	MDBs Shareholders	Low 1-2 years
3D	Support collective shareholders commitments of pools of additional callable capital	Shareholders	Low 1 year
3E	Support adaptation of MIGA's products & reinsurance capability to partially transfer portfolio level risk from MDB portfolios	MDBs Shareholders	Low Med. 1-2 years
3F	Consider ways to provide MDBs access to central bank liquidity	Shareholders	High >2 years

4 Assess CRA Methodologies and engagement

4A	Strengthen communication with credit rating agencies; increasing mutual understanding	MDBs Shareholders	Low <1 years
4B	Encourage steps by rating agencies to strengthen their MDB evaluation methodologies	CRAs	Low Med. 1-2 years
4C	Take proactive approach to incorporation of ESG factors in rating methodologies	CRAs	Low >2 years

5 Improve the Enabling Environment for Capital Adequacy Governance

5A	Strengthen the ability of shareholder boards to effectively set parameters of capital adequacy policies and overseeing their implementation	MDBs Shareholders	Low <1 years
5B	Establish yearly capital benchmarking report presenting key elements & statistics in comparable format harmonizing definitions overtime. Support regular reviews of capital resources in light of MDBs' strategies	MDBs Shareholders	Low <1 years
5C	Establish enhanced dialogue and cooperation on capital adequacy, risk management and risk mitigation tools	MDBs Shareholders	Low <1 years
5D	Transform GEMs into stand-alone entity to support improved understanding of MDBs by private investors and CRAs	MDBs Shareholders	Med. 1-2 years

Strategic Considerations for Action

MDB capital adequacy is highly complex, the intersection of many factors—including development goals, policy frameworks, risk evaluations and balance sheet components, as well as external perceptions, notably from financial market actors—that interact in ways that are not immediately obvious. This leads to five key strategic considerations.

1 First, capital adequacy reforms and innovations would be most effective as part of a **structured and coordinated** program of MDB actions enjoying a degree of consensus among the G20 and other shareholders. Signaling from shareholders is extremely important in shaping how MDB policies and actions are perceived, which impacts their bond ratings and, ultimately, reliable access to low-cost funding. A broader agenda is not a necessary precursor to capital adequacy reforms, but it would be beneficial to how markets perceive them, giving greater clarity on the purpose of reform as well as a sense of how it fits into shareholders' overall strategy.

2 Second, G20 members and other shareholders have a central role to play in MDB capital adequacy. With a few exceptions, financial capacity issues at MDBs can sometimes be portrayed as technical problems requiring technical solutions by MDB management. This is true in some cases. But the root issues are often located at the level of shareholder governance, and in particular the disjunction between the development goals shareholders set for the

MDBs, the capital and budgetary resources they provide and the degree of risk they are willing to accept. Shareholders must address those tensions if they wish to enact meaningful capital adequacy reforms.

3 Third, the reforms proposed in this report can reinforce one another when enacted as part of a **coherent** reform package, rather than as individual “menu” options. These reforms are designed as a short- and medium-term action plan to help MDBs make the most efficient use of scarce share capital. It is critical that they are perceived as such, rather than as an easy fix to boost lending capacity.

4 Fourth, coordinated implementation by a substantial number of MDBs would be beneficial to market perceptions, as rating agencies rely heavily on comparisons across MDBs in their evaluations. At the same time, this does not mean uniformity: the Panel's recommendations vary in their applicability based on each MDB's business model and scale, operating environment, development mandate and other specific features.

5 Fifth, most MDBs' internal resources are constrained. If reforms increase lending capacity and therefore portfolios, G20 shareholders need to ensure that operational risk is managed appropriately, including adequate staff resources to support and sustain high quality operations. This includes front line project teams as well as supporting staff engaged in transactions and portfolio management tasks.

Action Agenda: Boosting MDB Investment Capacity While Maintaining Financial Strength

This report has outlined five broad areas where the Panel sees opportunities to improve MDB capital adequacy and related policies to allow them to more efficiently deploy shareholder resources. The remainder of this chapter considers implementation: how recommendations relate to each other, upside benefit, feasibility, timing, risks and mitigation measures. The aim is to provide guidance to G20 members and other shareholders on how to assess options and trade-offs as they consider whether and in what direction to move ahead.

Market perception of reforms is a critical consideration across all recommendations. Similar actions are likely to face very different receptions if they are pursued as part of a deliberate and coordinated strategy as opposed to a crisis response to unforeseen or uncontrolled events. A clear and robust communication strategy and vocal shareholder support are key to successful implementation.

	RECOMMENDATION	1–2
	Core Reforms to MDB Risk Appetite and Capital Adequacy	

The thrust of Recommendations 1 and 2 is to shift the way MDBs and their shareholders understand, define and implement capital adequacy frameworks. They hinge on the willingness of shareholders to re-think their approach to defining risk appetite and communicating that clearly to MDB management for implementation.

These two sets of recommendations are linked. Recommendation 1 on defining risk appetite with less reference to rating agency methodologies can be implemented on its own. Recognizing the benefits of callable capital within MDB capital adequacy frameworks (Recommendation 2) can instead only be done in conjunction with Recommendation 1, as shareholder risk appetite is an essential part of its implementation.

Most aspects of these two recommendations can be enacted at the level of MDB boards (Governors and Directors), without statutory or governance changes. However, substantial prior work is needed by shareholders (to evaluate risk appetite) and MDB management (to support shareholders considerations and prepare for the implications of these changes), including to manage the expectations of market participants.

Three key inputs would help shareholders properly evaluate risk: i) improved shareholder understanding of downgrade triggers,³¹ ii) evidence-based analysis of the impact of falling below AAA by one out of three

31. The three main CRAs have very different metrics and web of considerations which need to be navigated when reviewing rating downgrade risks, however most MDBs focus on key aspects which represent greatest vulnerability.

rating agencies;³² and iii) stress tests and analysis of the types of shocks that the MDB would need to face before having to call on callable capital.

Greater understanding of how preferred creditor status and portfolio concentration impact MDB portfolio performance (1b) are technical issues. G20 shareholders should commission granular analytical studies (building on those done as part of this Review) and require MDB risk teams to compare results with the parameters used in their capital adequacy models, to avoid excessive conservatism.

Replacing numerical leverage limits in MDB statutes (1c) would require changes to MDB articles of agreement. Despite this political hurdle, the technical content of this reform is much simpler due to wide recognition that MDB statutory limits are outdated and not aligned with modern financial practices.

There are divergent opinions regarding whether implementation of Recommendation 2 would require amending MDBs articles of agreement. This will depend both on the drafting of each MDB's governing documents and on the details of the proposed implementation. The view of the Panel is that some form of implementation should be possible in most MDBs without statutory changes, but this is an issue that boards will need to consider carefully in light of each institution's specific circumstances.

Benefits

Implementation of Recommendation 1 can help modernize and rationalize analysis and debates around risk, capital and lending capacity. Through proactive review among shareholders and between shareholders and management there can be an increased understanding of how risk appetite translates into capital adequacy frameworks, capital requirements and lending capacity of MDBs. This will make medium-term vulnerability of operational planning better understood and less reactive to changing circumstances, and permit more realistic decision-making on MDBs' ability to implement shareholder mandates. Recommendation 2 would take advantage in a prudent manner of the very substantial callable capital that shareholders are already committed to as part of their treaty obligations to MDBs to increase lending capacity in a way that has already been conceptually validated by credit rating agencies.

Combined, these two recommendations have the potential to have the biggest impact on MDB lending headroom, with a very substantial one-off gain. This conclusion is supported by modeling undertaken specifically for this review by an external consultant as well as a review of several external studies on the topic.³³ New headroom would depend on several factors, including the risk appetite of shareholders as well as the risk profile of MDB portfolios and the exact nature of reforms and how they are implemented, and so cannot be specified with precision. But the potential is clearly significant and could be realized in a short time frame.

32. Preliminary work on this issue has been done by Settimo (2019) and Munir and Gallagher (2020), but much more needs to be done to fully understand the trade offs.

33. For example, Chen, Muller and Wagué (2017), Settimo (2019), Munir and Gallagher (2020) and Humphrey (2020).

Challenges, viability and timing

These are medium-term reforms that imply a substantial shift in the way MDBs manage their capital adequacy and in how shareholders understand and express their willingness to tolerate risk. Although the Panel is convinced that risks are very low, the proposed changes would require time to review options, undertake further studies, refine specific conclusions and build consensus. With strong support from shareholders, it is realistic to begin implementing these reforms within 12 months.

The use of bond ratings to define MDB risk appetite is mainly relevant to MDBs with a AAA rating. Ratings are also critical for sub-AAA MDBs, but specific rating targets are not embedded in capital adequacy frameworks. These issues are nonetheless relevant due to the importance of internally-defined risk appetites. Recognizing the benefits of callable capital is only relevant for MDBs with callable capital, thus excluding IFC and IDB Invest. It would have limited benefit for IsDB, NDB and the CAF-DBLA due to their shareholder structure.

The degree to which preferred creditor treatment and concentration risk are valued in MDB capital adequacy calculations mainly pertain to MDBs lending to sovereign borrowers. IDB Invest, IFC and EBRD are less affected, although preferred creditor treatment does have some relevance to non-sovereign exposures.

Risks and Mitigation

The most realistic risk is potential downward pressure on the rating of MDB bonds by one or more credit rating agencies. Measures can be taken to mitigate the risk, including:

■ Shareholder support

Clear statements by the G20 and other shareholders that these changes are fully supported and that they stand behind their callable capital will influence how ratings agencies perceive reforms and reduce downgrade risk.

■ Limited use of callable capital

A prudent approach to recognizing the benefit of callable capital in recalibrating risk appetite and capital adequacy models—with adequate reserve buffers—would reduce the danger that a downgrade of a major shareholder would negatively impact MDB bond ratings.

■ Coordinated roll-out

Undertaking these reforms in a coordinated fashion across multiple MDBs would positively influence how it was perceived by rating agencies and market actors, compared to moving ahead by just one MDB.

■ Data transparency and communication

Publicly releasing analysis of MDB portfolio performance to demonstrate impacts of preferred creditor status and concentration risk could also influence rating agency methodologies.



RECOMMENDATION

3

Innovations to Build Capacity and Boost Ratings Without Modifying Capital Adequacy Frameworks

The Panel has explored innovations that MDBs could use to expand lending capacity without modifying MDB capital adequacy frameworks themselves. These innovations either increase available risk-bearing capital or reduce the risks in MDB loan portfolios, both of which can expand available lending headroom and support MDB credit ratings. All of the recommendations are being or have been piloted in some form, as described in Chapter 3, and several have been discussed in the context of the G20 BSO agenda. Most risk transfer tools apply first and foremost to private sector portfolios.

These innovations pose trade-offs. When done on a relatively modest scale, the benefits in terms of increased headroom are limited, but so are downside financial and developmental risks. If they are scaled up substantially, the headroom and credit rating benefits are much greater but so are the risks of embedding incentives that are not always aligned with collective shareholder goals. To reap the potential benefits, shareholders should ensure that the uses of new forms of capital and of the capital freed up by risk transfers are well aligned with MDB missions. These risks and complexities of implementation must be understood and addressed.

Benefits

Potential lending headroom benefits vary widely depending on how the innovations are implemented and their scale. Innovations may also imply financial costs, the estimates of which are uncertain due to limited experience and information, further complicating the assessment. Nonetheless, the Panel's consultations and existing early experiences suggest that these innovations could generate very considerable lending headroom that is likely to grow over time as markets and MDBs gain greater familiarity with these structures. These gains are certainly significant enough to warrant major efforts to develop these ideas further.

The creation of new, non-voting shares (3a) is a scalable technique to build a useful capital cushion and crowds in capital from private actors looking to expand SDG-related investments. Its ultimate scale is capped by the need to maintain the preeminence of government shareholders in MDB capital. For hybrid capital, scalability is dependent on cost and rating agency treatment. Shareholders could scale new capital significantly if it is dedicated to MDB priorities, such as ESG-friendly infrastructure.

Portfolio risk transfer mechanisms (3b) with commercial counterparties, which are at present relevant mainly for private sector portfolios, can be implemented flexibly on very different scales, from the country or sector level to a major shift to an originate-and-distribute model for MDBs, depending on shareholder preferences. A guarantee facility for MDB loans (3c) could substantially reduce risk capital usage, free headroom and bolster credit ratings with relatively little paid-in capital, depending on size, guarantee terms and creditworthiness of the donors. Such a facility could be applicable to sovereign as well as non-sovereign loans.

Temporary callable capital for counter-cyclical buffers (3d) can offer a useful boost to surge capacity during regional or global crises, or to support general lending when MDB ratings are under pressure. Benefits depend on the specific context of each MDB, particularly in relation to statutory limits, treatment of callable capital and specific rating agency metrics, as well as the precise terms of the temporary commitment. Liquidity lines (3f) would be useful in helping MDBs manage specific target metrics by rating agencies and provide comfort that liquidity will be available during market stress.

Challenges, viability and timing

Key implementation challenges revolve around pricing and other requirements of commercial and official counterparties, as well as treatment by rating agencies. Negotiation can be lengthy due to uncertainties around risks and pricing, as illustrated by AfDB's Room2Run, especially given limited detailed knowledge outside MDBs of non-sovereign credit performance. Having multiple MDBs implement an innovation or repeated use of an innovation could shorten the time and improve the boosting upgrades provided by credit rating agencies. All options come with costs and management time commitments and should be viewed as a tool kit that can be drawn on by MDBs. MDBs will use them when needed to protect ratings or increase capacity to achieve more ambitious plans.

Hybrid capital arrangements (3a) and risk transfer mechanisms (3b) only require board approval to proceed. Creation of new non-voting share classes in the MDB's capital structure (3a) would require reforming MDB statutes and addressing governance concerns, which could be a lengthy process. Some MDBs have been able to guard against dilution of the voting power of existing shareholders relatively easily as illustrated in Chapter 3. A guarantee facility for MDB loans (3c) requires negotiations among potential shareholders to define goals, agree on governance and capitalize a new structure.

Risk transfer transactions are more readily done for private sector portfolios, while sovereign lending may require concessional support. New non-voting share capital is also more viable for private sector-focused MDBs, for financial and governance reasons. Hybrid capital instruments, guarantee facilities, temporary callable capital and liquidity lines are viable for all MDBs.

Stepping up MIGA's efforts to test use its products to transfer risks from other MDBs portfolios (3e) could provide a significant boost. This would entail MDBs and MIGA to proactively pursue partnerships for mutual benefit. MIGA transactions addressing concentration limits could make more projects bankable through transfer of political and non-honoring of financial obligations risks. MDBs can help MIGA utilize more of its capacity through their project origination advantages. These recommendations would require further analysis and refinement.

Liquidity facilities for MDBs (3f) would require time and may present significant legal and technical challenges.

Timing summary

Initial risk transfer and hybrid capital transactions can move ahead quickly (late 2022 or early 2023), contingent on negotiations with investors and ratings agencies.

Non-voting shares in the MDB capital structure and a new guarantee facility would require further preparatory work and could perhaps be offered by 2023 at the earliest.

Temporary callable capital facilities could be created quickly (by end 2022), contingent on willing donors and shareholder agreement on governance impacts.

Adaptation and expanded use of MIGA products by other MDBs would require prototyping before scaling up and is likely viable for 2023.

Liquidity facilities would require considerable preparatory work on technical aspects and governance and supervisory implications.

Risks and Mitigation

Risks can be grouped in three categories, all of which become more relevant as innovations are scaled up.

The first risk is that innovations can **dilute shareholder focus on reforms to core risk appetite and capitalization**. Pursuing financial innovation can be seen as solutions that bypass more thorny discussions on shareholder risk appetite and MDB capital needs, which would be a missed opportunity for long-lasting structural reforms to the core MDB model. Financial markets could also see innovations as a sign of weakened shareholder interest in considering general capital increases. This risk can be mitigated by undertaking innovations as part of a broader set of reforms including a thorough examination of risk appetite and capital needs.

The second risk relates to **potential impacts on MDB net income and project origination**. Non-voting capital and commercial risk transfer operations have implications for MDB income generation, depending on hybrid capital costs and the rate at which freed up capital from risk transfers is re-lent. Some innovations could incentivize MDB project origination toward projects that are perceived as less risky and more profitable (commercial counterparties) or target sectors of donor interest (official counterparties). MDBs can mitigate these risks by instituting strong internal controls on project origination to ensure consistency with their strategies and shareholder priorities, as well as a careful evaluation of financial implications for MDBs and borrowers.

A third risk is that scaling up innovations substantially could **weaken how MDBs are perceived**. Borrowers could see MDBs more as financial intermediaries for external parties, and that could gradually weaken their view of MDBs as a trusted development partner with potential impacts on preferred creditor treatment. This is particularly relevant for MDBs lending mainly to sovereign borrowers. The risk can be mitigated by limiting the scale of innovation on sovereign lending, maintaining a substantial financial stake in each transaction and maintaining the focus on country ownership of MDB lending programs.



RECOMMENDATION

4

Improve Credit Rating Agency Assessment of MDB Financial Strength

Credit rating agencies are private enterprises, and it would not be appropriate for the Panel or the G20 to attempt to dictate changes to the methodologies used to evaluate MDB creditworthiness. The Panel has developed recommendations that can play a useful role in improving communication and understanding between ratings agencies, MDBs and shareholders. The recommendations are based on the perception, formed as part of the work of this Panel with rating agencies and confirmed by them, that they would like to constructively engage with MDBs and shareholders.

Benefits

Rating agency methodologies cut across all aspects of this Review. Their impact is both deep and broad, as well as being difficult to quantify. Much depends on how ratings agencies perceive MDB actions and shareholder support for them. A positive versus negative perception of Recommendations 1-3 by the ratings agencies can make a material difference in the resulting impact on lending capacity. Modifications to specific metrics used in rating agency methodologies, notably preferred creditor treatment and concentration risk, could potentially boost lending space substantially, particularly for MDB sovereign lending, although quantification is not possible due to the uncertainty of how methodology metrics might change and how they would interact with other aspects of methodologies.

Challenges, viability and timing

The proposed changes under Recommendation 4 are fully within the control of shareholders and rating agencies and have very low barriers to implementation. The very constructive engagement of rating agencies in the work of the Review suggest that they will be receptive to the Review's reflections, although some of the identified areas may require additional analytical work.

While some components of this recommendation have the potential to be implemented quickly (e.g. shareholder statements or enhanced dialogue), the impact is unlikely to be felt until the medium term. Credit rating methodologies have an impact across recommendations: it may take time for reforms introduced under Recommendations 1 and 2 to be incorporated into rating agencies methodologies, while the treatment by credit rating agencies is a key consideration when assessing innovations proposed in Recommendation 3.

Risks and Mitigation

Risks to this recommendation are minimal. Enhanced dialogue with rating agencies may create confusion with the bilateral engagement taking place as part of the rating process, which should rightly remain the purview of each MDB. The engagement should not lead to pressures, or the perception of pressures, with regard to individual ratings. This can be addressed by engaging in a structured manner through well-specified arrangements. It is also possible that methodology changes may have unforeseen effects when combined with other aspects of the methodologies. This risk can be mitigated by phased rollouts and ongoing revision.



RECOMMENDATION

5

Enabling Environment for MDB Capital Adequacy

The Panel has identified several ways to strengthen channels of responsibility and communication coupled with more systematic exchange of data and information. Most of the proposed reforms build on initiatives that are already underway, including new approaches to board oversight of financial matters at EIB, AIIB and CAF-DBLA, regular collaboration among MDB risk teams and efforts to reform the GEMs, among others. They align well with recommendations of the G20 EPG (2018).

In the view of the Panel, the G20 should push ahead with this set of recommendations without delay, irrespective of their views on other recommendations. They pose relatively low political and technical challenges, require modest resources and would have far-reaching though not easily quantified benefits to capital adequacy decision-making and lending headroom. Perhaps most importantly, they would help position MDBs and shareholders to better address ongoing and future discussions around long-term MDB capacity and mission. These discussions are particularly pertinent now due to the global context, but they are not going to disappear, and both MDBs and shareholders need to be prepared to address them in a systematic, transparent and ongoing fashion.

Benefits

Reforms to the enabling environment around MDB capital adequacy are critical in and of themselves, as well as for supporting other reforms proposed by this Panel and developing potential future reforms in this area. They can materially improve the quality of discussions and decision-making on MDB capital adequacy, lending capacity and financial risk. Further, they can help MDBs make better use of data to refine internal models, engage more effectively with ratings agencies and improve their ability to mobilize private sector resources for development goals. These reforms would also go a long way to support positive reception of other Panel recommendations.

Challenges, viability and timing

Proposals under Recommendation 5 for the most part pose relatively low political and technical challenges and would require modest resources.

Governance aspects present the most significant challenge, due to the complexity of modifying existing arrangements and processes of boards and board committees. Modest changes, such as including a non-voting technical board observer to support capital adequacy discussions, could be a useful starting point. More far-reaching modifications to align board practices with the good financial governance principles articulated by the Basel Committee for Banking Supervision would be medium-term goals.

Benchmarking, data transparency and harmonization and instituting regular capital adequacy reviews should be pursued immediately with a strong push by shareholders across the MDBs. These activities could be integrated with ongoing G20 work on BSO.

Creating an enhanced consultation mechanism would take time to define specific tasks and responsibilities, organizational structure and a balance between safeguarding confidentiality and promoting transparency. Striking the right balance between involving MDB management and promoting independent views will also be critical. The Panel suggests that shareholders “start small”, with a modest initiative underway in the works by end-2022, with the expectation that the mechanism could grow over time. Due care should be placed to ensure that any new initiatives are sustainable from a resource perspective.

Reforming the GEMs consortium to establish an autonomous legal standing, independent leadership and budgetary arrangements could be accomplished by the middle of 2023, as shareholders and MDBs are already well aware of the issues involved. More granular publication of statistics and sharing of anonymized statistics with private investors and rating agencies could begin in 2023.

Risks and Mitigation

In the Panel’s view, none of the components of this recommendation pose material risks to MDBs or shareholders. An excessive push to standardization could result in misleading comparisons across MDBs, although risk can be mitigated if carefully executed by MDBs working together on a like-for-like basis and is outweighed by the many benefits of better informing shareholders on capital adequacy issues. Data confidentiality issues must remain in place to avoid the risk of inadvertent disclosure, particularly related to MDB loans to private sector borrowers.

Conclusion

The G20 created this Panel to help understand how MDBs can make the most effective and efficient use of the public resources entrusted to them as they face the challenging combination of short-term crises and longer-term development needs.

The global situation became more turbulent following the set up of the Panel, making the recommendations of this Review even more urgent.

The Panel has sought to go back to first principles, question long-held assumptions and historical patterns, and think anew about how to make the best use of shareholder capital to achieve development goals. To this end, the Panel aggregated findings from analytical research, discussions with stakeholders and professional judgment.

It has arrived at the conclusion that material efficiency gains are achievable in MDB capital use. The recommendations made are aimed at further enabling MDB capital adequacy policy to meet the challenges of today and tomorrow.

In part this can be accomplished by changes implemented by MDB management and credit rating agencies. More fundamentally it requires the MDB's shareholders to further strengthen their own risk assessments, to align their risk tolerance with their development priorities, and to articulate their risk tolerance in a way that translates better into effective policies and provides more clarity to bond investors.

In the Panel's view, MDBs and their shareholders can take the necessary decisions and begin implementation on a series of reforms, such that MDBs are able to start increasing their lending capacity over the next 12-24 months. The expected scale of the increase is substantial, likely to be several hundreds of billions of dollars over the medium term. The anticipated increase comes from prudent adjustments in capital adequacy frameworks in line with better defined risk appetite and innovations to recycle existing capital and build new forms of capital. Increased lending capacity varies between MDBs and depends on the depth and scale of execution. It is not possible at this stage to provide precise numbers, which will require detailed work at the level of individual MDBs, but rather a sense of order of magnitude—much depends on how the proposed set of reforms is pursued and how they are implemented.

The reforms do have risks associated with them, but it is the Panel's opinion that these can be mitigated effectively. It is this Panel's opinion that reform related risks are clearly outweighed by the risks associated with not taking action to deploy the unique strengths of the MDBs to help address the daunting development challenges that affect all of us.

Expanding MDB portfolios in line with the recommendations would have material operational implications. To continue to deliver on their mandates, MDBs must remain engaged in all projects with substantial 'skin-in-the-game' and as lender of record (see Recommendation 3). This has resource implications. Expectation of project impact in line with internal policy objectives and restrictions make finding suitable projects challenging, particularly during times of crisis when risks increase, market participants' appetite reduces and expected returns rise. Developing innovations is costly—a fragmented approach makes innovation uptake slower and would negatively impact the requisite tracking and assessment needed for scaling up. Support for project preparation facilities and establishing mechanisms³⁴ to share costs would go a long way to meeting these constraints. As portfolios and challenges grow, shareholders need to address budget issues to ensure that operational risk is managed appropriately, and the developmental value-added and technical support of MDB projects remain strong.

The work of this Panel was accomplished within a constrained time period and with limited human and financial resources to carry out the background work, to study in depth the information gathered, and to perform the requisite analytical work and research. MDB cooperation was critical. They were responsive and generous with their time, particularly under the circumstances which emerged in Q1 with the Russia/Ukraine conflict. Interaction with GEMS was complex and time consuming. This and the eventual inability to access GEMS data contributed to the Panel's conclusion on the need to reform GEMs.

In the course of discussion, the Panel identified areas for future work, which include both continuation or deepening of Review topics or new work not covered in the Review's ToRs within three areas, in addition to those highlighted by individual recommendations in Chapter 3:

- the need for more granular analysis of risk appetite and capital adequacy frameworks, including relating to PCT, issuer vs stand-alone-credit-rating and its inclusion in MDB risk appetite, capital buffers and how they are determined across MDBs;
- assessing the ability to use tools set out in the Review and other management actions to conserve capital in cases of stress; as well as a better understanding of MDB recovery and resolution plans;
- assessing the impact of a variety of factors on income dynamics, including the impact of credit ratings and innovations like risk transfers, hybrid capital and non-voting share capital.

34. That could take the form of the type of French legal entities called « groupement d'intérêt économique » - economic interest grouping - or become the responsibility of the existing Councils of MDB treasurers or chief risk officers, or be included in the arrangements discussed in Recommendation 5

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Annexes

Glossary

A

Addis Ababa Action Agenda (AAAA)

The outcome of the Third International Conference on Financing for Development, held in Addis Ababa from 13 – 16 July 2015, and subsequently endorsed by the UN General Assembly. It provides a new global framework for financing the implementation of the 2030 Agenda for Sustainable Development by aligning all financing flows and policies with economic, social and environmental priorities [UN definition].

B

Balance sheet optimization

One of the policy recommendations included in the AAAA and in the G20 Action Plan on Balance Sheet Optimization to improve MDBs' contribution to the financing of sustainable developments. The AAAA stresses that development banks should make optimal use of their resources and balance sheets, while preserving financial integrity, and encourages them to update and develop their policies in support of the post-2015 development agenda.

Basel Committee on Banking Supervision (BCBS)

The primary global standard setter for the prudential regulation of banks, which provides a forum for regular cooperation on banking supervisory matters. It has 45 members comprising central banks and bank supervisors from 28 jurisdictions.

Basel III

An internationally agreed set of measures developed by the BCBS in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks [BIS definition]. Basel III comprises three pillars, concerning minimum capital requirements (Pillar 1), supervisory review (Pillar 2) and market discipline (Pillar 3). Total available regulatory capital under pillar 1 is the sum of Tier 1 and Tier 2 capital.

Blended finance

A combination of ordinary loans and other financial instruments with accompanying grant (or grant equivalent) components.

Blended terms

Borrowing terms offered by an MDB reflecting both concessional and non-concessional financing components.

C

Callable capital

The portion of an MDB's subscribed capital not paid in by shareholders, and subject to call by an MDB only in the event that they are unable to meet their financial

obligations. Callable capital is not considered as equity or quasi equity in MDB articles of agreement or financial statements. None of the main MDBs has ever had to draw on its callable capital.

Capital adequacy

A measure of a financial institution's ability to meet its obligations relative to its exposure to risk and the base for assessing its financial strength. MDBs have bespoke internal capital adequacy frameworks, some of which are calibrated to support triple-A credit ratings. MDBs also have statutory lending limits in their articles of agreement limiting outstanding loans and participations to a share of subscribed capital and equity, which are also a type of capital adequacy limit.

Capital Adequacy Ratio (CAR)

Used to weigh up an MDB's capital against its risk and calculated as the ratio of the MDB's available capital to its financial risks, most of which are comprised of risk-weighted credit exposures.

Capital efficiency

One of the five balance sheet optimization measures that, according to the G20 Action Plan on Balance Sheet Optimization, could increase MDBs' development lending. The Plan suggests that "MDBs may be able to increase their development lending, while maintaining AAA ratings, if shareholders agreed for MDBs to operate with higher leverage and at a marginally increased level of risk". To this purpose, MDBs were encouraged to engage the credit rating agencies to assess potential capital efficiency gains without putting the AAA rating at risk.

Capital increase

An increase of shareholders capital subscription, usually including both paid-in capital and callable capital, to enable an MDB to increase its lending. A general capital increase (GCI) occurs when all shareholders increase their subscriptions while keeping the same shareholding structure. A selective capital increase (SCI) for a subset of shareholders increases the MDB's available capital while changing shareholders' relative weight in their voting power.

Concentration risk

Potential risk of MDB credit portfolios that could arise from limited diversification due to large (relative to the size of the portfolio) exposures to individual borrowers, sectors or countries. MDBs, particularly regional institutions lending mainly to sovereign borrowers, tend to have large exposures to individual country borrowers, resulting in a portfolio concentrated in far fewer borrowers than most commercial banks. To mitigate portfolio concentration, MDBs implement risk management policies that limit the share that a single

borrower can have as a percentage of the total portfolio. MDBs have also undertaken exposure exchange agreements with other MDBs and made use of risk transfer mechanisms to reduce portfolio concentration.

Concessional

A measure of the ‘softness’ of a loan, reflecting beneficial financial terms to the borrower compared to a loan at market rate. It may derive from the presence in the loan contract of a grant element. Concessional loans are usually offered by MDBs to lower income countries.

Credit rating

Assessment of a borrower’s creditworthiness predicting its ability to pay back the debt, undertaken by a private credit rating agency. It is an implicit forecast of the likelihood of the borrower defaulting.

D

De-risking (or risk mitigation)

The practice of using balance sheet instruments to reduce the risk of the MDBs’ own or third party exposure. When reducing MDBs’ own risk, it results in freeing up capital for additional development lending.

E

Economic capital

The estimated amount of capital needed to support specific risks, regardless of the existence of assets. It is based on a probabilistic assessment of unexpected future losses at a selected confidence level, and is a forward-looking measure of capital adequacy. Institutions’ internal assessment of capital under Basel III (Pillar 2) often rely on economic capital measures.

ESG

An acronym referring to a collection of corporate performance evaluation criteria that assess an MDB’s (or another institution’s) policies and ability to effectively manage the environmental, social and governance impacts of its operations and achieve associated objectives.

European Stability Mechanism (ESM)

An intergovernmental organization established by member states of the euro area in 2012. Its mission is to enable the countries of the euro area to avoid and overcome financial crises and to maintain long-term financial stability and prosperity by providing loans and other types of financial assistance to member states that are experiencing or are threatened by severe financial distress.

F

Financial Stability Board (FSB)

An international body that monitors and makes recommendations about the global financial system. It was established after the G20 London summit in April 2009 as a successor to the Financial Stability Forum (FSF). Hosted and funded by BIS and based

in Basel, Switzerland, the Board includes all G20 major economies, FSF members and the European Commission.

G

G20 Action Plan on Balance Sheet Optimization

Endorsed by G20 leaders at the November 2015 Antalya meeting, the MDB Action Plan on Balance Sheet Optimization is part of the wider global agenda on resource mobilization for supporting SDGs. The Action Plan asks the MDBs to work with their respective shareholders to consider five measures that could increase lending through balance sheet optimization, taking into account increased risk sharing to enable more effective capital usage or increased amounts of third party, private sector financing or investment.

G20 Eminent Persons Group

Established by G20 finance ministers and central bank governors in April 2017, the Group comprises eminent persons with deep knowledge and experience in international finance and governance. It was tasked to recommend reforms to the global financial architecture and governance of the system of IFIs to promote economic stability and sustainable growth in a new global era, and to consider how the G20 could better provide continued leadership and support for these goals. The Group completed a report entitled Making the Global Financial System Work for All in October 2018.

Global Emerging Markets Risk Database Consortium (GEMs)

One of the world’s largest credit risk databases for the emerging markets operations of its member institutions (MDBs and bilateral private-sector oriented Development Finance Institutions, DFIs). It pools data on credit defaults on the loans extended by consortium members, the movements of client credit rating and recoveries on defaulted projects. GEMs was established in 2009 as a joint initiative between the European Investment Bank (EIB) and the International Finance Corporation (IFC – World Bank Group). Since then, the GEMs consortium has grown to include 24 members comprised MDBs and DFIs. Consortium members contribute anonymized data on their projects’ credit events notably in emerging markets and developing economies. In return, members gain access to aggregate GEMs statistics on observed default rates, rating migration matrixes and recovery rates by geography, sector, time-period and various other dimensions. GEMs statistics provide members with insight into geographies that are otherwise relatively poorly served in terms of empirical credit information.

Grants

Funds given by an MDB to a country for the specific purpose of executing a project that will be beneficial to development. Unlike loans, grants are not repayable.

Guarantees

A form of insurance related to a financial transaction that guarantees a debt will be repaid to a lender by another party if the borrower defaults. Essentially, a third party acting as a guarantor promises to assume responsibility for a debt should the borrower be unable to keep up on its payments to the creditor.

International Finance Facility for Education (IFFEd)

An innovative financing mechanism for global education proposed by the Education Commission. IFFEd was specifically designed to tackle the education crisis in lower-middle-income countries. Several MDBs, including the World Bank Group, African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development and Inter-American Development Bank, have committed to working with other partners to explore ways to make such a Facility feasible and ensure that it meets the objective of expanding support to countries committed to invest in and reform their education systems to reach the SDG targets.

Leverage

An indicator of how much debt (as opposed to own capital) a bank is using to finance its lending operations. MDBs can leverage shareholder capital also by mobilizing additional investors, particularly from private sector.

Leverage ratios

A set of indicators that highlight an MDB's financial leverage in terms of its assets, liabilities and equity. The most common leverage ratio is the debt-to-equity ratio.

Liquidity ratio

A financial metric comparing an institution's easily sellable assets (like highly-rated government bonds) to its debt obligations. It measures a debtor's ability to pay off current debt obligations without raising external capital. MDBs have policies governing the amount of liquid assets they hold to cover potential short-term liabilities.

Multilateral Development Bank (MDBs)

Supranational institutions set up by sovereign states, which are their shareholders. Their remits reflect the development aid and cooperation policies established by these states. They have the common task of fostering economic and social progress in developing countries by financing projects, supporting investment and generating capital for the benefit of all global citizens [EIB definition].

Paid-in capital

The portion of the MDB's subscribed capital the shareholders have paid in any convertible currencies and their national currency based on a predetermined percentage.

Paris Agreement

Adopted at the Paris climate conference in December 2015, the Paris Agreement aims to limit global temperature rise to 2 degrees Celsius while making best efforts to keep it to 1.5 degrees Celsius. Set out to improve upon and replace the Kyoto Protocol, the Paris Agreement entered into force on November 4, 2016, and had been signed by 195 countries and ratified by 190 as of January 2021. It contains provisions to hold countries accountable to their commitments and mobilize greater financial resources to assist developing countries in building low-carbon, climate-resilient economies.

Paris Club

An informal group of official creditors the role of which is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries. Club creditors provide debt treatments to debtor countries in the form of rescheduling, which is debt relief by postponement or, in the case of concessional rescheduling, reduction in debt service obligations during a defined period (flow treatment) or as of a set date (stock treatment). The origin of the Paris Club dates back to 1956 when Argentina agreed to meet its public creditors in Paris. Since then, the Paris Club has reached 477 agreements with 101 different debtor countries. Since 1956, the debt treated in the framework of Paris Club agreements amounts to \$612 billion.

Preferred Creditor Status (PCS)

A widely accepted principle under which MDBs have priority for repayment of debt in the event of a borrower experiencing financial stress. PCS is not a legal status, but is granted by the shareholders including borrowers, and embodied in practice. As a result, accounting for and corresponding benefits of PCS differ widely by credit rating agencies.

Preferred Creditor Treatment (PCT)

The practice of conferring PCS.

Recovery and Resolution plan

Risk management plans of MDBs to prepare for possible financial difficulties and restore their viability in a timely manner during periods of financial distress. Recovery plans should be fully aligned with MDBs' risk management framework. In broad lines, MDBs are expected to set up a governance framework that promptly detects a stress situation and operates swiftly and smoothly in a crisis.

Risk transfer

A risk management technique in which the potential loss from an adverse outcome is shifted to a third party. Purchasing insurance is a common example of transferring risk from an individual or entity to an insurance company.

Risk-adjusted Capital (RAC) Ratio

A capital adequacy ratio defined by Standard & Poors (S&P) and employed in their rating methodology. Like other capital adequacy ratios, it gauges a financial institution's ability to continue functioning in the event of an economic downturn. It is calculated by dividing a financial institution's total adjusted capital by its risk-weighted assets (RWA), utilizing S&P-specific definitions and methods.

Risk Appetite

The level of risk that an organization is prepared to accept in pursuit of its objectives, before action is deemed necessary to reduce the risk. It represents a balance between the potential benefits of a (lending) strategy or an innovation and the potential downside. Risk appetite can also be described as an organization's risk capacity, or the maximum amount of residual risk it will accept after controls and other measures have been put in place.

Risk-weighted Asset (RWA)

A measure of a financial institution's assets or off-balance-sheet exposures, weighted according to risk. This sort of asset calculation is used in determining the capital requirement or Capital Adequacy Ratio (CAR) for a financial institution. According to the Basel framework, banks must meet special requirements in terms of RWA for credit risk, market risk and operational risk.

S

Special Drawing Right (SDR)

An international reserve asset, created by the IMF in 1969 to supplement official reserves of its member countries. The value of an SDR is based on a basket of the world's five leading currencies – the US dollar, euro, yuan, yen and the UK pound.

Sustainable Development Goals (SDGs)

A set of 17 goals at the heart of the 2030 Agenda for Sustainable Development adopted by all United Nations member states at the landmark Sustainable Development Summit held from 25 – 27 September 2015 at UN Headquarters in New York. They provide a shared blueprint for peace and prosperity for people and the planet: 1) No poverty; 2) Zero hunger; 3) Good health and well-being; 4) Quality education; 5) Gender equality; 6) Clean water and sanitation; 7) Affordable and clean energy; 8) Decent work and economic growth; 9) Industry, innovation and infrastructure; 10) Reduced inequality; 11) Sustainable cities and communities; 12) Responsible consumption and production; 13) Climate action; 14) Life below water; 15) Life on land; 16) Peace, justice and strong institutions; 17) Partnerships for the goals.

Single name concentration

A form of concentration risk, describing a condition in which credit portfolios have a material share of loans allocated to single borrowers.

Statutory lending limits

Rules set in the articles of agreement establishing MDBs that impose quantitative limitations on their operations. For most MDBs such rules state that the total amount of outstanding loans, equity investment, guarantees and other types of financing provided by said MDBs shall not at any time exceed the total amount of their unimpaired subscribed capital, reserves and retained earnings. For some MDBs, floors on MDB equity to outstanding loans and ceilings on equity investments are also included in their articles of agreement.

Subscribed capital

The amount of capital for which an MDB has received applications from the shareholders. Subscribed capital consists of paid-in capital plus callable capital.

Synthetic securitization

A transaction where a bank buys credit protection on a portfolio of loans from an investor. If a loan in the portfolio defaults, the investor reimburses the bank for the losses incurred on loans in that portfolio up to a certain amount. While traditional ("true sale") securitization realizes this transfer by transferring the actual underlying exposures as well as their ownership to a special purpose entity, synthetic securitization realizes the risk transfer by means of a credit protection contract between the originator (i.e., the MDB) and the investor, leaving the underlying exposures in the ownership of the originator and on its balance sheet.

T

Tier 1 capital

The core measure of a bank's financial strength under the Basel III framework, which includes Common Equity Tier 1 capital (CET1) and Additional Tier 1 capital (AT1). CET1 consists of common shares, retained earnings and other reserves. As the highest quality of regulatory capital, it absorbs losses immediately when they occur. AT1 consists of capital instruments with no fixed maturity. It also provides loss absorption on a going-concern basis, although AT1 instruments do not meet all the criteria for CET1.

Tier 2 capital

The second layer of capital that a bank must keep as part of its required reserves, including subordinated debt and general loan-loss reserves. It is "gone-concern" capital under Basel III. That is, when a bank fails, Tier 2 instruments must absorb losses before depositors and general creditors do.

Transfer and convertibility risk

The likelihood that a sovereign will limit the ability of a non-sovereign to exchange local currency for another currency or gold and to remit it to the receiver abroad.

Governance of the Review

The Review has been governed by the Terms of Reference included at Annex F. The Review reported to the G20 International Financial Architecture Working Group (G20 IFA WG) during its tenure. The recommendations of the Review are intended to be advisory and non-binding on the G20, MDBs or their shareholders. The main output of the Review has been discussed with MDBs and CRAs. The hope is that MDBs will discuss the recommendations within their own governance arrangements and according to each MDB's risk appetite, in full acknowledgment that MDBs are independent and governed by their shareholders. Publication of the Review is left to the discretion of the G20 IFAWG.

The Review is independent from the MDBs and credit rating agencies but has engaged with key stakeholders within these organizations throughout the process in an open and consultative manner. G20 shareholders have supported the Review by calling on MDBs to provide information requested by the Review team. All institution-specific information shared with the review team by MDBs or rating agencies was treated in confidence as required by the institution, under the control of shareholders. The Review follows established definitions, frameworks and taxonomies of multilateral institutions.

The Review team comprised:

- **An Expert Chair, Frannie Léautier**, to provide senior leadership, oversee the process and conclusions, and report to the IFAWG.
- **An Expert Panel** to meet regularly during the Review process to provide technical analysis, bring in views from expert stakeholders, provide advice to the Expert Chair to inform recommendations, draft the Panel Report and ensure the Review outputs are consistent with the mandate and governance of the MDBs. The Panel, composed by a limited group of experts, was chaired by the Expert Chair. The MDBs and CRAs were included in selected meetings as observers.

The IFAWG selected the Expert Chair and Expert Panel members through written procedure. Key selection criteria included independence, technical capacity and a sound understanding of the development landscape and the mandate of MDBs. Composition of the panel and expert Chair took the diversity of the G20 membership into account. The Italian G20 Presidency, in consultation with the IFAWG Secretariat, arranged for a Secretariat to support the work of the Panel.

Following its appointment, the Panel held several meetings to establish areas of interest and expertise and to organize the work. The work was initially arranged into four workstreams, with Frannie Léautier providing overall leadership: (1) MDBs data and information (led by Betsy Nelson); (2) benchmarking (led by Hans Peter Lankes); (3) approaches to capital adequacy frameworks (led by Chris Humphrey and Jens Ulrich); and (4) innovation and experiences (led by Nancy Lee and Mike Muldoon). Workstreams 1 and 2 were

later merged. The full Panel met on a monthly basis, while the four sub-groups met with greater frequency to carry out the detailed work.

The Review developed the key areas of analysis in consultation with the G20 IFAWG. While recognizing their different mandates, governance, geographical focus, regional dimension, public vs. private borrower composition, and sectoral exposure, the Review has considered the MDBs as a class of institutions, with characteristics that set them apart from commercial banks, investment banks, insurance companies and non-profit organizations.

Regular meetings were held with the full complement of observers nominated by the MDBs. The Panel worked more intensely with a smaller group of MDB representatives who attended the Panel workshops as observers. Individual workstreams also engaged with MDB observers as needed and on an ad-hoc basis. Workstream 1 coordinated the overall engagement with MDBs, to ensure interactions with the Review were not an undue burden. Engagement with the MDBs was active and constructive, with regular attendance to both Chief Risk Officer (CRO) and Chief Financial Officer (CFO) coordination meetings, and support of their teams in the working groups.

The Panel held several fruitful conversations with representatives of the three largest credit rating agencies, who participated as observers in relevant meetings. As part of its review of the salient features of the MDB capital adequacy frameworks and for questions related to the Basel regulatory framework, the Expert Panel benefited from the technical advice of the Basel Committee on Banking Supervision's Secretariat. The Basel Committee did not contribute to making policy recommendations.

An update on the initial stages of the Review was discussed at an IFAWG meeting in the Fall of 2021. A further update was provided to the IFAWG on the Panel's work in advance of the G20 Finance and Central Bank Deputies (G20 FCBD) Meeting in Bali. An interim update, which included some draft sections of the final report, was provided in advance of the Spring Meetings of the World Bank and IMF in 2022 and was discussed in the IFAWG June 2022 meeting. The Review delivered its final report at the July G20 Finance Ministers and Central Bank Governors (G20 FMCBG) Meeting.

External Engagement

In undertaking its tasks and forming its recommendations, the Panel relied on five sources of information:

- **Existing academic literature and other relevant studies.**
- **Information provided by MDBs.**
- **Insight from extensive consultations with MDBs, CRAs, shareholders and experts.**
- **Externally commissioned Studies.**
- **The Panel's own knowledge, judgement and expertise.**

The Panel organized numerous workshops with the Multilateral Development Banks (MDBs) included in the scope of the Review: Asian Development Bank (ADB), African Development Bank (AfDB), Asian Infrastructure Investment Bank (AIIB), Development Bank of Latin America (CAF-DBLA), Caribbean Development Bank (CDB), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Inter-American Development Bank Group: Inter-American Development Bank (IDB) and Inter-American Investment Corporation (IDB Invest), Islamic Development Bank (IsDB), New Development Bank (NDB) and World Bank Group: International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA). It also conducted consultations with the three main Credit Rating Agencies: Fitch Ratings, Moody's and Standard and Poor's. It benefited from case studies from some MDBs that were not included in our Terms of Reference, such as the Trade and Development Bank, and consulted external experts. The Review commissioned three pieces of external research:

- 1** Two analytical reports, commissioned from Risk Control Ltd, UK (RCL, William Perraudin). The first evaluating the impact of Preferred Creditor Treatment in MDB lending and outlining options for how MDBs and CRAs could evolve their PCT modelling. The second on the potential impact of the recommendations on headroom, based on a stylized portfolio built from publicly available information.
- 2** A study by Prof. Eva Lutkebohmert-Holtz, Head of the Department of Quantitative Finance at the University of Freiburg (Germany) and co-author of an influential paper on concentration adjustments to risk weights, aiming to apply the conceptual framework to MDBs, to identify whether features of MDB portfolios may warrant adjustments to prevailing approaches.
- 3** A 'reverse stress test' on the stylized balance sheet of a hypothetical sample MDB, conducted by Chris McHugh, Principal Enterprise Fellow at the University of Southampton and a Senior Adviser to the International Association of Credit Portfolio Managers. This had the objective of providing a general indication of the scale of disruption necessary to trigger callable capital.

The Panel's intention was for the first three pieces of research to be based on data provided by MDBs through the GEMs database, and for the fourth to make use of publicly available data. However, due to delays in obtaining the necessary approvals, the report could only make use of preliminary results based on information in the public domain. The Panel will endeavor to bring the projects to their conclusion and make the results available to the IFA Working Group in due course.

Terms of Reference

Context

Developing countries have lost almost 5% of their GDP in 2020 as a result of the COVID-19 crisis. External financing needs for these countries are expected to have increased by up to US\$700bn a year as a result of the pandemic, with Low Income Countries (LICs) needing around US\$450 billion over the period 2021-2025. This is in addition to the c.US\$2.5tn of financing a year needed to support the Sustainable Development Goals (SDGs) and the US\$100bn committed to climate financing¹.

MDBs have a critical role to play in providing affordable financing to support economic recovery and to help achieving SDGs in a post-pandemic context. MDBs' scope to leverage shareholders' capital contributions to provide such financing is determined by their capital adequacy frameworks (CAFs). The crisis has demonstrated the importance of scaling up MDBs financing, but also highlighted the constraint imposed by their CAFs in permitting them to go further in supporting their clients' recovery.

As part of the G20 Action Plan on Balance Sheet Optimisation, the MDBs are exploring measures to enable further leveraging. However, such measures assume that CAFs remain unchanged, potentially missing options to unlock additional MDB financing. External sources, including the Credit Rating Agency (CRA) S&P's, have identified opportunities for a substantial boost in MDB

investment capacity - in the range of \$500 billion to \$1 trillion - by revising their CAF policies, while preserving their current credit ratings².

MDBs' shareholders and management would also benefit from transparent, objective and consistent metrics against which CAF across the MDBs might be assessed, when taking strategic decisions impacting capital utilisation. Generally, the capital and liquidity standards and rating methodologies applied to MDBs are adapted from those developed for commercial banks and adjusted to MDBs. More systematic and updated information would be desirable to assess whether these adjustments adequately reflect the unique characteristics of MDBs including preferred creditor status, callable capital, counter-cyclical and long-term sustainability objectives, and default experience.

These Terms of Reference form the basis for the G20 International Financial Architecture (IFA) Working Group to commission an independent review of MDB CAF. This is consistent with G20 Finance Ministers' steer to "explore potential new measures to maximize [MDBs'] development impact, according to their mandates and while protecting their credit ratings" (G20 Communique, April 2021) and the G20 Eminent Persons Group (EPG) on Global Financial Governance (2018). The Review will take into account and build on the existing G20 work on Balance Sheet Optimisation, which will continue separately under the IFA Working Group with MDB participation.

1. Sources: IMF (October 2020) 'World Economic Outlook'; World Bank (October 2020) Paper to Development Committee; IMF (March 2021) "Macroeconomic Developments and Prospects in Low-Income Countries".
2. Standard and Poor's (2017) 'Key Considerations for Supranationals' Lending Capacity And Their Current Capital Endowment'; Settimo (2019), 'Higher multilateral development bank lending, unchanged capital resources and triple-a rating. A possible trinity after all?' Italian Central Bank; Munir and Gallagher (2018) 'Scaling up Lending at the Multi-Lateral Development Banks: Benefits and Costs of Expanding and Optimizing MDB Balance Sheets', Boston University.

Objectives and Scope of the Review

The G20 IFAWG will commission an independent review of MDBs' Capital adequacy frameworks, while maintaining their robust credit ratings (i.e. AAA) and preferred creditor status, respecting their individual mandate, governance arrangements and policies. The Review is intended to help MDBs better serve their clients, without placing undue burden on staff time and resources of the MDBs. Key objectives of the Review are to:

- 1 Provide credible and transparent benchmarks on how to evaluate MDB CAF** - including on MDB-specific issues such as callable capital, concentration risk, and preferred creditor treatment - to facilitate a comparable reading of CAF and of MDB evaluation methodologies used by CRAs across the MDB system.
- 2 Enable shareholders, MDBs and CRAs to develop a consistent understanding of MDBs capital adequacy frameworks**, as well as potential lending headroom at prevailing credit ratings on a case-by-case basis that recognize the MDBs strong capital position, financial track record, and their central role in providing development and countercyclical finance.
- 3 Enable shareholders to consider potential adaptations to the current frameworks in order to maximise the MDBs' financing capacity** (and their ability to respond to crises) while maintaining long-term financial sustainability, credit ratings and preferred creditor status.

The Review will develop the key areas to focus analysis, in consultation with the IFA WG. An overview of likely questions for assessment are included at Annex I. The key MDBs to include in the Review are the: African Development

Bank (AfDB); Asian Infrastructure Investment Bank (AIIB); Asian Development Bank (AsDB); Caribbean Development Bank (CDB); Development Bank of Latin America (CAF); European Bank for Reconstruction & Development (EBRD); European Investment Bank (EIB); Inter-American Development Bank (IDB); Islamic Development Bank (IsDB); New Development Bank (NDB); and World Bank Group (IBRD, IDA, IFC, MIGA).

The Review will not seek to impose a regulatory framework on MDBs, and will ensure it does not create any perception of doing so. Any output of the Review should be discussed within MDBs' own governance arrangements and according to each MDBs' risk appetite, in full acknowledgment that MDBs are independent and governed by their shareholders.

While recognising their different mandates, governance, geographical focus, regional dimension and sectoral exposure, the Review will consider the MDBs as a class of institutions, with characteristics that set them apart from commercial banks, investment banks, insurance companies and non-profit organizations.

The Review will also respect the independence of the CRAs, which have autonomy over their ratings methodologies. It will provide an independent perspective to inform shareholder engagement at individual institutions, with a view of safeguarding their preserving credit ratings and their treatment as a preferred creditor. The Review will follow established definitions, frameworks and taxonomies of multilateral institutions.

The recommendations will not pre-empt future capital adequacy measures at individual institutions, but rather provide indication on how MDB CAF should be assessed in general, considering differential mandates and geographic and sectoral scope. Access to empirical data from individual MDBs will be essential to inform this

exercise. The Review will not examine, and is not intended to prompt discussion of, any suggestions of capital increases, but it could provide tools to eventually inform future discussions on MDBs' potential capital needs.

Governance

The Review will report to the G20 International Financial Architecture Working Group. The recommendations of the Review will be advisory and non-binding on the G20, MDBs or their shareholders. Publication of the Review will be left to the discretion of the G20 International Financial Architecture Working Group.

The Review will be independent from the MDBs and CRAs, but will engage with these stakeholders throughout the process in an open and consultative manner. G20 shareholders will call on MDBs to provide information requested by the Review team. Any institution-specific information shared with the review team by MDBs or CRAs will be treated in confidence as required by the institution, under the control of shareholders.

The Review team will comprise:

- **An Expert Chair** to provide senior leadership, oversee the process and conclusions, and report to the IFA Working Group.
- **An Expert Panel** to meet regularly during the Review process to provide technical analysis, bring in views from expert stakeholders, provide advice to the Expert Chair to inform their recommendations, and ensure the Review outputs are consistent with the mandate and governance of the MDBs. The Panel, composed by a limited group of experts, will be chaired by the Expert Chair. Membership of the Panel will be determined

in consultation with the IFA Secretariat, with a balanced composition and will include also the MDBs and CRAs as observers.

As part of its review of the salient features of the MDB Capital Adequacy Frameworks and for any questions related to the Basel regulatory framework, the Expert Panel will benefit from the technical advice of the Basel Committee on Banking Supervision (BCBS) as appropriate. The BCBS will not contribute to making policy recommendations.

The Italian G20 Presidency, in consultation with the IFA Secretariat, will make arrangements for the provision of administrative support as required. The IFAWG will select the Expert Chair and Expert Panel members through written procedure, with the aim of formally nominating them after the July Ministerial meeting. Key selection criteria will include independence, technical capacity, as well as a sound understanding of the development landscape and the mandate of MDBs. Composition of the panel, and of the short list of candidates for expert Chair, will seek to take into account the diversity of the G20 membership.

Timeline

An Update on the initial stages of the Review will be discussed at an IFA WG in the Fall of 2021. The Review will end in 2022, with exact delivery date of the full report to be determined by the 2021 Annual Meetings.

Potential Areas for the Review to Focus

I. Salient features of MDB Capital Adequacy Frameworks

- How do the MDBs approach capital adequacy? What are the key metrics each MDB uses and what is the basis for them (e.g. income, solvency)? How to assess and optimize statutory capital ratios to maximize MDBs' development impact? How do the MDBs treat credit guarantees vs traditional loan instruments on their balance sheets? Does this reflect the relative credit risk of these instruments?
- To what extent do MDB-specific characteristics (e.g. features of callable capital of all shareholders, access to funding, exposure concentration, preferred creditor status) and characteristics that differ between the MDBs (e.g. share of lending to public / private sector, access to liquidity backstop, regional and geographical dimension) determine the approaches and metrics used across the MDBs?
- How do the current levels of MDB exposure and capital endowments compare across institutions and are linked to specific regional development financial needs?
- How do MDBs incorporate stress testing or otherwise establish buffers in their capital adequacy frameworks and how do they compare? How do MDBs take into account the impact of market risk on their respective buffers, in particular at regional level?
- What are the comparative implied risk appetites of the MDBs? How does this compare to the MDBs experience of loan default / non-accrual and resulting financial losses?

II. Understanding CRA approaches to MDBs' rating assessments

- How do credit ratings agencies (i.e. S&P's, Moody's, Fitch) assess MDBs' capital adequacy? How do they account for the specific characteristics that set MDBs apart from commercial financial institutions? How distinct are the methodologies CRAs use to assess MDBs and commercial financial institutions? What differences exist, especially considering the intrinsic rating? How do CRA's incorporate the 'risk' of the MDB's clients into their assessment?
- How do CRAs assess the interactions between their assessment of capital adequacy and other factors (such as governance, risk management, liquidity, trends) through changes in exposure? How formalised are these interactions?
- How can MDBs' countercyclical policies proceed without being affected by the procyclicality of credit rating assessments?
- Have MDBs' credit ratings changed over time, and on what grounds?

III. MDBs experience: access to capital markets and exposures

- Who are MDBs' bondholders?
- What are the factors determining the terms at which MDBs can borrow from capital markets? How has demand and / or terms for MDBs bonds been varied?
- What are the current and long-term sustainability constraints / limiting factors of MDBs' exposure? How do they relate to institutional capital adequacy frameworks and/or CRA approaches?

IV. Future considerations for framework design

- How should callable capital and its utilisation be considered in MDBs' capital adequacy approaches?
- How to best model/assess concentration risk and any other MDB-specific characteristics, within their sovereign and private investment portfolios?
- Could the assessment of the interaction between quantitative (e.g. capital adequacy) and qualitative (e.g. governance, risk management) aspects of the ratings frameworks be improved?
- Could a suite of benchmarking indicators enable a more consistent assessment of capital adequacy frameworks and help identify best practices across the system, while respecting each individual institution's governance and operational models?

