T20 Commentary

Implementation Challenges to MDB Reform: Enhancing Local Currency Lending

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The G-20 will gather in Brazil next November to coordinate the actions of the heads of state of the world's most powerful nations. Reforming the Multilateral Development Banks (MDBs) will be one of the main issues on their agenda. This subject is not new to them, but expectations are high that this year's suggestions will open a new pathway for these agencies to have a more significant role in sustainable investments, debt relief, and other vital goals. The Brazilian G-20 presidency has made the development of a roadmap for “better, bigger, and more effective MDBs” a central plank of its priorities for 2024. The T-20 debated relevant topics concerning MDB reforms, including issues such as more empowerment of African countries on the boards of these agencies, more funds for climate change, and promoting balance sheet enlargement and optimization.

One of the main difficulties in changing MDBs’ behavior is their need to follow the prudential requirements that apply to private institutions. These rules limit their capacity to bear more risks on their balance sheets. Initially, these regulations aimed to avoid systemic crises, such as the one in 2008. However, MDBs differ from private banks and are not Systemically Important Financial Institutions. They are not profit maximizers and have as shareholders the treasuries of the most influential nations, including the United States. These “financial cushions” should be sufficient to balance the higher risks involved in funding projects related to their mission: long-term funding, capital development, structural change, and debt distress. Unfortunately, private markets regard them as insufficient.

MDBs are not legally subject to the international prudential rules of the Basel Agreement. However, they usually follow them in their by-laws and internal policies. They adopt these standards because they must comply with them to maintain their AAA

credit ratings with risk agencies and continue accessing the cheapest funds available in the international markets.

However, despite abiding by market-based prudential rules, MDBs' financial indicators suggest that their policies are much more conservative than the ceilings established by international conventions. Figures from the balance sheets for 2023 of four different MDBs illuminate this singularity for the World Bank (WB), the Inter-American Development Bank (IADB), the American Development Bank (CAF), and the Asian Infrastructure Investment Bank (AIIB). All of them are AAA-rated institutions.

The figures listed in the Table show three relevant characteristics of these MDBs. First, they are low-levered institutions. In the sample, this indicator (total assets to equity) varied from 2.5 in the Chinese-led AIIB to 5.6 in the US-led WB. Despite their vast difference, MDBs' ratios are, on average, much lower than the ceiling of 12 times fixed by modern regulators.

TABLE 1. Financial Indicators for Selected MDBs in 2023

Indicator/MDB	WB	IADB	CAF	AIIB
Leverage	5.6	3.9	3.6	2.5
Liquidity (%)	30	30	43	51
Liquid Assets/ Equity (%)	95	129	112	84

Second, they have a high liquidity ratio (the percentage of liquid assets to total borrowing). Around a third of their total assets are short-term and easy to sell in the market. This percentage is higher on the two MDBs that the US Treasury does not back.

Those levels are very high for an institution that should focus on development projects and long-term finance. The third characteristic is the relation close to one between equity and liquid assets. These last figures mean they use the money of their shareholder´s equity as a liquidity buffer to access 2.5 to 5.6 times borrowing at the lowest cost at the international capital markets. From a financial point of view, this arrangement is a "straitjacket" that limits the flexibility of MDBs to introduce innovations that the market believes are risky, even if they are development-friendly.

This very conservative financial policy is a consequence of their dependence on private funding. This characteristic was not present in the institutional design of the original MDBs. The US administration made the first attempt to create one in 1940 to counteract German/Nazi influence in Latin America, particularly in Brazil and Argentina. The Roosevelt new dealers suggested the creation of an Inter-American Bank (IAB) with a development purpose (infrastructure and industry). However, the US Senate never voted on this initiative. The World Bank was the first successful attempt to create an MDB in 1944. For many years, their liabilities mainly depended on public funding.

This strategy changed after the 1980s, as borrowing from private funds became the "new normal" because of the financial globalization process. Borrowing costs decreased at the same time as maturities rose. However, rating agencies still analyze MDBs' balance sheets from a private sector perspective. In particular, they usually overvalue their portfolio concentration risk, undervalue the preferred creditor treatment granted them by borrowing countries, and undervalue the callable capital committed by shareholders.

Against this backdrop, which reforms are less controversial and should be included in the Brazilian roadmap for "better, bigger, and more effective" MDBs? The first is the focus on climate finance and energy transition. It is an almost universally agreed upon

goal, and its implementation does not necessarily require changing their financial strategy too much. A second low-impact strategy is to mobilize more private capital flows to EMDCs and help their government structure new development projects. The third one is the optimization of MDB balance sheets with innovative financial products that do not increase the average risk they already carry in their asset portfolio.

Within this third option, an exciting initiative suggested by the Task Force is for MDBs to increase funding and lending in local currencies. Loans denominated in foreign currencies carry a high exchange risk to private and public local debtors, particularly those whose cash flows are exclusively in local currency. These debts can have a severe negative impact on the balance sheets of EMDC companies in times of crisis, even triggering instability. The financial development in some emerging markets economies after the 2000s opened the possibility of issuing long-term bonds in local currency. MDBs, as international AAA institutions, can easily borrow and lend in these markets at low cost without increasing the exchange risk exposure of local investors.

However, nowadays, MDB´s exposure to local currencies is still negligible. The experience of multilateral banks already focused on this type of lending shows they face relevant obstacles. The New Development Bank - the Bank of the BRICs - is a pertinent example. In 2024, 80% of its loans were denominated in dollars (two-thirds), euros, and Swiss Francs, and 17% in Chinese yuan. Only 3% were loans in other EMDC currencies, most in the South African Rand, an Emerging country currency easily exchanged in the international markets.

At first glance, using local currency in MDB´s contracts should not be a difficult option. Nevertheless, this suggestion usually faces criticism from important local issuers such as the National Treasury and banks. Their concerns range from instability to unfair

competition. Therefore, any successful strategy to implement the issuance of bonds on these markets in local currency must first address these political constraints.

MDBs are essential for the G-20 to promote a "better, more inclusive, and less socially unequal" future for the world. However, changing the behavior of these large financial institutions is far from easy. There are constraints imposed by private investors and the need to build an agreement among the most critical stakeholders. Therefore, the decision-making process will be very time-consuming and will depend on the sensitivity of unexpected political and economic issues that may arise over time.

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