T20 Policy Brief

Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

One Size Does Not Fit All – Analyzing the Applicability of Options for Expanding Lending Capacity Across MDBs

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Abstract

The G20 International Financial Architecture Working Group places great emphasis on improving the efficacy of MDBs' operations to support economic development and to help achieve the UN's Sustainable Development Goals (SDGs). A number of valuable recommendations have been put forward by the G20 Independent Review of MDBs' Capital Adequacy Frameworks. It is estimated that MDBs should provide US$260 billion in additional annual official financing to achieve the SDGs by 2030. This requires both more capital and a more efficient use of MDBs' available resources and instruments.

This paper has a particular focus on regional and sub-regional MDBs, because the specifics of how they raise shareholders' capital differ significantly from those of global MDBs. Regional/sub-regional MDBs are more flexible than global MDBs, have a better understanding of the conditions of member countries and home regions, and therefore can be more efficient. At the same time, they urgently need additional capital to expand their operations.

The G20 should encourage and incentivize regional/sub-regional MDBs to embrace a lending capacity expansion strategy consistent with their specific strengths and weaknesses. The authors discuss available options for capital increase for regional/sub-regional MDBs. These include increasing existing shareholders' capital; membership expansion by attracting regional and non-regional countries, institutional investors, and other MDBs; as well as non-conventional methods (e.g., rechanneling the IMF's special drawing rights to MDBs).

Keywords: Multilateral Development Bank; International Financial Architecture; International Financial Institution; Infrastructure Investment; Development Financing

Diagnosis of the Issue

To achieve the Sustainable Development Goals by 2030, developing countries face an annual financial gap of around US$4 trillion – up from US$2.5 trillion in 2015 (UNCTAD, 2023). Multilateral Development Banks (MDBs) could provide up to an additional US$260 billion annually towards achieving the SDGs by 2030 (G20, 2023a). Emerging markets account for approximately 63% of infrastructure investment needs.

MDBs have been playing a distinctive role in providing sovereign financing, which is why it has been proposed to include them conceptually in an "enlarged Global Financial Safety Net (GFSN)" (Vinokurov et al., 2021, 2022).

Stronger action by regional/sub-regional MDBs will make it possible to contribute more to developing economies, finance more regional projects focused on connectivity, and contribute more to the SDGs in a global context. Needs for financing are growing every year. The growing gap means that to avoid lagging behind the development needs of their countries, regional/sub-regional MDBs need to adopt fit-for-purpose solutions. An important aspect is enhancement of MDB capital.

Despite the G20 action plan to optimize MDB's balance sheets, their lending has not increased significantly since 2016, when aggregate disbursements across MDBs stood at US$147 billion (S&P, 2023). After 2016, lending only gradually increased by around 2.5% annually on average, until the pandemic year 2020, when total disbursements temporarily jumped. During the period 2019–2022, MDBs' annual disbursements averaged US$190 billion.

Strengthening the role and boosting the investment capacity of MDBs is at the top of the G20 agenda. The G20 International Financial Architecture Working Group (IFAWG) is working on this and in 2023 it was called upon to "suggest a way forward for better, bigger, and more effective MDBs". As a result, it is committed to further the implementation of the recommendations of the G20 Independent Review of MDBs' Capital Adequacy Frameworks (CAF) (G20, 2023c). The applicability of the recommendations varies across MDBs due to their individual distinctive features.

The authors believe that the present study will add to the body of research regarding both the second pillar of the G20 Roadmap for a better, bigger, and more effective MDB system (a bigger MDB system, with increased financing capacity) and the 50th article of the New Delhi Declaration (G20, 2023b). Features such as the scale of the balance sheet, the region of operation, and rating affect the viability and efficacy of solutions suggested by the CAF recommendations across MDBs.

Additionally, the CAF review was aimed at a certain MDB ecosystem – specifically, a few large MDBs. While all MDBs seek to expand their lending capacity, AAA-rated MDBs seek to preserve their rating and, in turn, other MDBs try to improve their rating towards an AAA rating.

This study draws attention to regional/sub-regional MDBs, which are rarely taken into account in the international development agenda. By addressing the enablers of the CAF review recommendations, the study facilitates assessing their applicability across MDBs according to their distinctive features. This provides a roadmap for boosting regional/sub-regional MDBs' lending capacity, thereby helping the entire MDB system to actualize its much-needed potential for additional funding towards the SDGs.

Recommendations

The pursuit of better, bigger, and more effective MDBs would benefit from a tailored approach to non-legacy MDBs. There is untapped potential in this segment of the MDBs ecosystem. The G20 should encourage and incentivize regional/sub-regional MDBs to embrace a lending capacity expansion strategy consistent with their specific strengths and weaknesses.

The CAF recommendations were aimed at the largest institutions – legacy and global MDBs – and so has been the tracking of their implementation (G20, 2023c). **The G20 should extend its attention to regional and sub-regional MDBs, tracking their progress, and in doing so identifying opportunities for generating greater efficiency and amplifying the overall financial capacity of the MDB community**.

To that effect, **the G20 should stimulate legacy and global MDBs – which are in general at the forefront of developing innovations and implementing the CAF recommendations – to coordinate and collaborate with regional and sub-regional MDBs to support them in incorporating innovations that boost their lending capacity**. This includes both participating in solutions and sharing knowledge from their experiences.

Regional/sub-regional MDBs need a stepwise expansion and optimization of capital to meet the investment needs to reach the SDGs. This can be accomplished both by increasing MDBs' capital and by optimizing its use.

Options to increase MDBs' lending capacity through capital expansion

The sources of new capital may include recapitalization from shareholders, expansion of membership to new regional and non-regional members, opening shareholding to institutional investors and global MDBs, and using non-conventional approaches such as a hybrid capital-based option for rechanneling SDRs to MDBs (Table 1).

TABLE 1. Options to increase lending capacity through capital expansion

	Financial impact	Political support	Enablers
Recapitalization from shareholders	High	Medium to high	Fiscal space Policy importance
Attracting new regional members	Medium to high	Medium	Fiscal space Policy importance Credit rating
Attracting new non-regional members	High	Medium	Policy importance Vision affinity
Opening shareholding to institutional investors	High	Medium	Trade-off profit vs. development results
MDBs' participation in capital	Medium to high	Medium to high	Vision affinity Policy importance
A hybrid capital-based option for rechanneling SDRs to MDBs	Medium	Medium	Highly rated members with fiscal space Policy importance

Source: authors' assessment.

Recapitalization from shareholders. A capital injection from existing shareholders is the most direct way to increase an MDB's lending capacity. It makes it possible to strengthen the MDB's financial position without the need for existing shareholders to relinquish control and voting power. Capital increase by shareholders demonstrates their willingness to support an MDB over the long term. However, developing countries typically have limited fiscal space to increase paid-in capital.

Expand MDBs' membership with new regional states. New regional members increase overall lending capacity both because of the additional capital they bring in and the freeing-up of capital that results from the portfolio diversification, while at the same time keeping overall governance authority in the hands of regional members.

Engage non-regional members in MDBs' capital to strengthen positions among investors. This is particularly attractive for MDBs seeking to improve their credit ratings in order to access cheaper funding from bond markets. It is a promising option for MDBs to introduce various classes of shares to new members with different degrees of participation in the decision-making process.

Engage institutional investors in MDB capital via non-voting shares. Institutional investors could improve the quality of governance and accountability of MDBs. To make this possible, MDBs' statutes should allow investors to take a non-voting shareholding stake. MDBs should also be commercially attractive to private investors.

Involve global MDBs in capital of regional/sub-regional MDBs. As shareholders with AAA-rated capital, global MDBs are extremely valuable for regional/sub-regional MDBs. This option of capital expansion would have a positive direct impact on the indicators that Credit Rating Agencies (CRAs) use to assess the creditworthiness of MDBs, as well as their access to low-cost credit lines. Global MDBs can also play an important role by speeding up the capacity-building processes by contributing to operational policy and administration, loan standards, and the financial policy of regional/sub-regional MDBs.

Unlock the potential of rechanneling SDRs to MDBs. SDRs can be used only with prior settling of technical and political details. In particular, the African Development

Bank (AfDB) suggests lending SDRs held by developed countries to MDBs to boost the latter's capital (AfDB, 2022). The approval by the IMF of hybrid capital as an eligible instrument for channeling SDR opens up a promising avenue for expanding MDBs' lending. However, SDR rechanneling is likely to be helpful only to the group of leading MDBs that the IMF has authorized to hold SDRs. As of now, it only includes a small number of MDBs. While regional/sub-regional MDBs may become prescribed holders of SDRs, the extent to which they may be able to make use of them is still to be determined, given that such rechanneling even by legacy and global MDBs is still in an exploratory stage.

Options to increase MDBs' lending capacity through optimization of the use of capital

Optimization of the use of capital (Table 2), which is complementary to capital expansion, has a well-paved path reflected in the CAF recommendations. Moreover, as by definition they concern making better use of capital, which is valuable in itself, they may constitute instrumental ways for effecting greater lending in the short term, while MDBs negotiate capital injections with shareholders.

TABLE 2. Options to increase lending capacity through optimization of the use of capital

	Financial impact	Enablers
Risk appetite adjustment	Medium to high	Technical capacity
Risk transfer options to the private sector	Medium	Cost vs. additional income Technical capacity
Risk transfer options among peers	Medium to high	Portfolio compatibility Technical capacity
Integrating a prudent share of callable capital into capital adequacy metrics	Medium to high	Coordinated MDB outreach to CRAs Members' credit rating

Source: authors' assessment.

Risk appetite adjustment. Recalibrating MDBs' risk appetite within sound banking principles may allow prudently extending capital utilization ratios while retaining high ratings. Extensive dialogue with CRAs can ascertain the right calibration relative to an MDB's capital position. For instance, the Asian Development Bank, by optimizing its prudential level of capitalization, was able to unlock US$100 billion in additional lending capacity over the next decade.

Risk transfer options to the private sector. By contracting guarantees to cover part of its portfolio, an MDB may free up capital to expand its operations. The viability of this option is contingent upon the capacity to generate enough additional operations in a timely manner, to compensate for the cost of the guarantee. An alternative to make this option more cost-efficient is to bring in a development partner whose participation enables reducing the risk to the private guarantor, as illustrated by the arrangement between the AfDB and the United Kingdom's Foreign Commonwealth and Development Office to enable additional lending for climate resilience and renewable energy projects.

Risk transfer options among MDBs. The ability to exchange exposures between MDBs via exposure exchange agreements (EEA) allows MDBs to reduce concentration risk and correspondingly free up capital for additional lending. The first EEA transactions among MDBs, signed in 2015 by the AfDB, the Inter-American Development Bank, and the World Bank, introduced a risk management instrument capable of producing a significant impact on the optimization of capital utilization.

Integrating a prudent share of callable capital into capital adequacy metrics. Still under consideration to determine the methodology for its implementation and define the impact it might have, this depends upon MDBs' collaboration and joint outreach to CRAs. Its potential impact is related to the creditworthiness of shareholders' callable capital.

Scenario of Outcomes

Given the scale of operations and the level of sophistication and capabilities of legacy and global MDBs, it made sense to first focus on applying the CAF recommendations to them. The natural next step is to leverage the lessons learned from the legacy and global MDBs' experience and to support a strategy to expand regional and sub-regional MDBs' lending capacity that is consistent with their specific strengths and weaknesses.

It is important to keep in mind the growing relevance of this segment of the MDB ecosystem. Its participation in MDB financial flows (disbursements) to developing countries climbed from 20% during the 2010s to slightly above 25% in 2020–2022 (World Bank, 2023). With G20 support, regional and sub-regional MDBs may further increase their financial capacity and amplify the development impacts generated by the MDB community towards achieving the SDGs.

The growing relevance of regional and sub-regional MDBs has been achieved through successful strategies to replenish shareholder capital and improve institutional effectiveness.

Each of the options discussed above to strengthen the capital base and optimize the use of capital of MDBs has its own features, limitations, and positive and negative outcomes. The options can be complementary, with the possibility of combining several approaches, and the choice about which ones to prioritize should be based on the most convenient strategy at the moment according to how each MDB's features may support or hinder their implementation.

A distinctive example of strong support from shareholders is the Arab Bank for Economic Development in Africa (BADEA). Since its inception, BADEA has been fully funded by shareholders' equity. Its capital increased from US$231 million in 1975 to US$5.4 billion as of June 2023, as a result of several rounds of capital increases – all paid-in.

The Central American Bank for Economic Integration (CABEI), which has attracted non-regional countries through issuance of new series of shares, provides an example of the impact of the incorporation of non-regional members. The participation of Taiwan in CABEI's capital structure strengthened its equity base and allowed it to issue and place bonds for the first time in the international market in 1997.

In turn, the Development Bank of Latin America is a successful example of expanding regional membership. Its membership expansion has allowed it to reduce the concentration of its loan portfolio and increase its paid-in capital base and lending capacity.

The foremost example of attraction of institutional investors is the Eastern and Southern African Trade and Development Bank. The TDB was able to bring in additional capital for greater operational capacity, while leaving overall governance authority in the hands of initial members.

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Incorporating legacy and global MDBs in the shareholder structure of regional/sub-regional MDBs would normally involve relatively small equity participation. For example, the European Investment Bank (EIB) supported the capital increase of the West African Development Bank (BOAD) by increasing its shareholding from 0.4% to almost 1%, enabling the BOAD to expand its lending capacity and improve its credit rating. It is anticipated that the EIB will also have a positive influence on the policy and integrity standards of the BOAD (EIB, 2022).

In contrast with the MDBs' capital expansion options, the alternatives reviewed to optimize the use of capital are not affected by fiscal constraints or political hurdles. Instead, they depend mainly on internal technical capacity and external coordinated efforts from MDBs with CRAs.

G20 encouragement to legacy and global MDBs to share their experiences in implementing these options and strengthening technical capacities, as well as to collaborate to structuring solutions in which they participate together with regional/sub-regional MDBs, would support expanding the implementation of the highlighted options, thereby amplifying the development impacts from the MDB system.

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