Emerging analysis and ideas

All hands on deck

How to scale up multilateral financing to face the Covid-19 crisis

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Key messages

- Multilateral development banks (MDBs) have the financial firepower to help developing countries deal with the impacts of the Covid-19 crisis.
- The major MDBs can expand lending by at least $750 billion (160% above current levels) while maintaining a AAA rating, or as much as $1.3 trillion (nearly triple current levels) if they are willing to risk a rating downgrade to AA+.
- Doing so requires rethinking MDB financial policy in light of the current emergency by taking existing callable capital of shareholders rated AAA and AA+ into account in capital adequacy calculations, and by reforming or abolishing outdated statutory lending limits.
- Scaling up lending quickly does not require any additional resource contributions from shareholders, and it will not endanger the financial stability of MDBs.
- Shifting MDB policy and expanding lending to face the crisis should be done in a coordinated manner among MDBs, with the explicit support of the G20 and shareholders.

About this article

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Facing the global emergency

The worldwide crisis triggered by the Covid-19 pandemic is, as UN Secretary- General Antonio Guterres aptly put it, the greatest global challenge since the Second World War. While many higher-income countries are understandably focused on their own challenges, it is essential to begin preparing the groundwork for stepped-up financial support to developing countries. A recent UN report states that 'It is in everyone's interest to ensure that developing countries have the best chance of managing this crisis, or Covid-19 will risk becoming a long-lasting brake on economic recovery' (UN, 2020).

The major MDBs are well-placed to lead this effort. They have the latent financial firepower to quickly ramp up development financing in response to the crisis. This briefing note argues that the World Bank and the five largest regional MDBs[1] could increase lending by an additional $750 billion (160% above current levels), without threatening their AAA bond rating. This rises to $1.3 trillion (nearly triple current levels) if they are prepared to risk a one-notch downgrade to AA+. Just as important, MDBs have the staff expertise, coordination capacity and implementation systems to direct resources where they can do the most good.

Ramping up MDB lending in response to the Covid-19 crisis does not require any new contributions from shareholder countries. What is needed is for MDBs to push their financing as far as possible within the constraints imposed by bond markets and credit rating agencies. Expanding MDB lending does come with risks. But the downsides are minor – concerns about a bond rating downgrade for an MDB ring hollow in the face of what is happening across the world right now.

MDBs must leverage the financial strength they have built up. There is no point in development finance institutions having spare capacity at a time when all hands are needed on deck to avert a global depression.

Multilateral banks have spare lending capacity – now is the time to use it

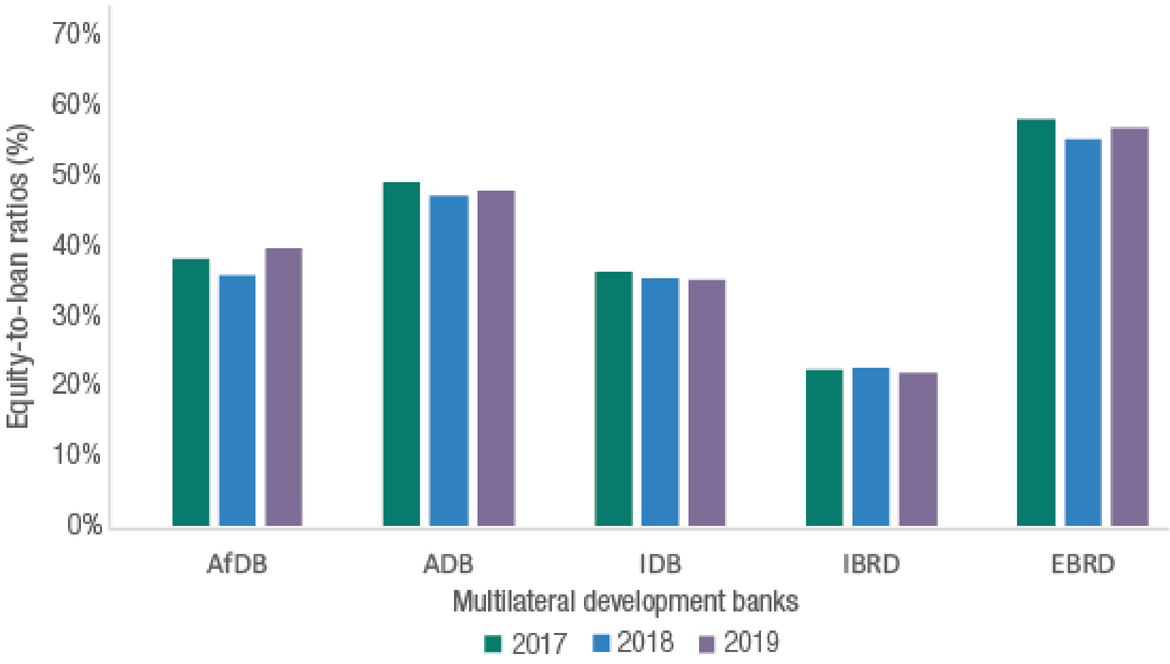
The key to unlocking greater lending by the MDBs is how they evaluate their capital adequacy. Just like commercial banks, MDBs have to have a certain amount of 'own money' – shareholder capital – to back up the loans they make. This gives MDBs a cushion to pay off bondholders even in the event that some borrowers don't repay their loans.

1 African Development Bank (AfDB), Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB), European Bank for Reconstruction and Development (EBRD) and Inter-American Development Bank (IDB). This analysis only includes the 'non-concessional' lending windows of the MDBs, and does not include the donor-funded International Development Association (IDA) of the World Bank or the African Development Fund (ADF) of the African Development Bank.

How does an MDB decide how much capital is 'adequate'? This is not an easy question to answer, as MDBs differ from private banks in many ways. They are international treaty institutions that lend mainly to their own shareholders (governments), and they lend for development purposes rather than to make a profit. MDBs are also not regulated, unlike commercial banks that must follow capital adequacy guidelines established by financial authorities in their countries of operation.

MDBs take an extremely conservative approach to capital adequacy. Their internal models are highly complex and not public, but can be proxied by the equity-to-loans ratio: paid in shareholder capital plus accumulated reserves, in relation to outstanding loans. The major MDBs have an equity-to-loan ratio of between about 20% and 60% (Figure 1), compared to 10–15% for most commercial banks. That means that MDBs hold $2–6 in equity for every $10 in outstanding loans – well above the $1–1.50 held by most commercial banks.

Figure 1 Multilateral development banks' equity-to-loans ratios (2017–2019)



Notes: 'Equity' includes paid-in capital and accumulated reserves. 'Loans' includes loans, guarantees, and equity investments made for development purposes. IBRD is the International Bank of Reconstruction and Development, the World Bank's main lending window.
Source: MDB financial statements. 2019 data is as of December for AfDB, IDB and IBRD; September for ADB and EBRD.

This conservative policy is all the more surprising in light of the superb loan repayment record of MDBs. Non-performing loans made by MDBs to government borrowers are almost non-existent, hovering around 0.1–0.3% for the major MDBs, compared to, for example, 3–4% on average for commercial bank loans in Europe. Borrower countries consider MDBs to be 'preferred creditors' and prioritise repaying them, since they rely on MDBs for much-needed development lending year after year. All the major MDBs also have tens of billions in callable capital, a type of financial guarantee that shareholders have committed to pay in case an MDB ever needs it.

Why are MDBs so conservative, considering their financial strengths? Much is driven by concerns about access to bond markets. MDBs borrow most of their resources from investors, rather than receiving annual budget allocations like the UK Department for International Development (DFID), the US Agency for International Development (USAID) or the UN. Because of their government backing and superlative financial track record, the MDBs considered in this paper are all rated AAA by the bond rating agencies, meaning they can issue bonds at extremely low interest rates. MDBs have an entrenched culture of financial conservatism dating back to their early years of building relations with the bond markets, and encouraged by a few major shareholders.

Bond rating methodologies are not a binding constraint

MDBs argue that expanding their loan book could threaten their AAA bond rating. In fact, this does not appear to be the case. Standard and Poor's (S&P), the world's largest credit rating agency, undertakes its own capital adequacy calculation as one component of its MDB rating methodology. Following S&P's methodology (S&P, 2019) and based on the most recent MDB data, it is possible to extrapolate the amount of outstanding loans each MDB can have while maintaining a AAA rating.2 The major MDBs collectively have 'headroom' on their balance sheets for an additional \$750 billion in loans in the coming years, while comfortably retaining their AAA bond rating (Table 1). These estimates do not include the recently agreed paid-in capital increases for AfDB (2019) and the World Bank (2018), and leave a substantial margin for error,3 meaning that actual lending headroom is likely to be even higher.

Table 1 Maximising multilateral development bank portfolios (US$ billions)

	ADB	AfDB	AIIB	EBRD	IBRD	IBD	Total
Current portfolio (2019)	109.1	26.5	2.1	33.2	195.9	96.5	463.3
Additional headroom for AAA rating	171.6	70.4	13.9	23.2	365.4	100.2	744.7
Additional headroom for AA+ rating	305.9	118.3	22.1	48.8	637.0	191.7	1,323.8

Notes: Current portfolio based on most recent financial data: December 2019 for AfDB, IBRD and IDB; September 2019 for AIIB, ADB and EBRD. Current portfolio includes loans, equity investments and guarantees. Source: Methodology based on Humphrey (2018), using data from 2019 MDB financial statements and S&P (2019).

The key reason why the above estimates are so much higher than what MDBs say they can lend relates to callable capital. This methodology follows S&P by including callable capital from AAA and AA+ shareholders in calculating capital adequacy, whereas the MDBs do not. S&P pointed this out in a briefing note (S&P, 2016), suggesting that MDBs could greatly expand lending with no impact on their rating. It may be hard to believe, but a bond rating agency has more faith in MDB callable capital than the MDBs themselves.

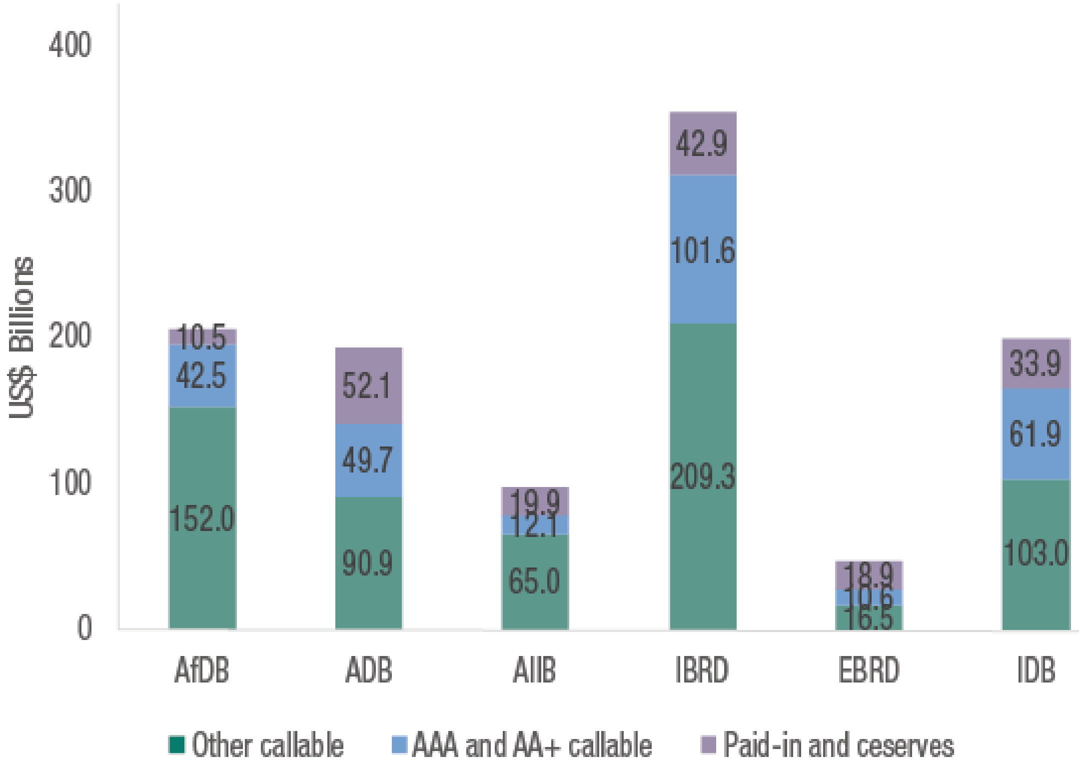
2 See Humphrey (2018) for details on the estimation methodology. The only assumption needed to make these estimates is that future MDB lending is done in roughly the same risk profile as current lending. Should MDBs lend disproportionately to less risky countries or projects, estimates would be higher, and the reverse is also true.

3 The estimates assume 10% above what S&P considers necessary for the highest capital adequacy category, as a safety margin, and the final headroom number is reduced by 25% to conservatively account for increased MDB liquidity requirements to support a larger loan book.

The capital structure of MDBs has three components: paid-in capital, accumulated reserves and callable capital. Paid-in capital and reserves are exactly the same as at any private firm, and are together known as shareholder equity. Callable capital, however, is unique to MDBs. It acts as a guarantee that, should MDBs ever run into financial difficulty, shareholders will contribute additional capital to ensure that bond investors are repaid. Callable capital has never been called in the history of any MDB, and thus shareholders have never had to pay any of it.

Callable capital represents a huge resource, currently over $900 billion at the major MDBs (Figure 2). All MDB shareholders contribute callable capital, but S&P (as well as Moody's and Fitch, the other two main rating agencies) consider only callable capital from the highest-rated shareholder countries to be reliable. Callable capital already committed by shareholders rated AAA and AA+ amounts to $278 billion. This capital is considered financially sound by the ratings agencies, but is effectively ignored by the MDBs.

Figure 2 Structure of multilateral development bank capital (2019)



Notes: Includes callable capital committed as part of recent capital increase for AfDB (2019) and IBRD (2018), but does not include new paid-in capital commitments.
Source: MDB financial statements

Substantially expanding lending means that MDBs would run into the lending limits written into their articles of agreement. Most of the major MDBs have a 1:1 lending limit: outstanding loans cannot exceed total subscribed capital (callable and paid-in) plus reserves. With the exception of EBRD, most MDBs are well within the statutory limits at the moment, but that would quickly change with the expanded lending proposed in this paper.

The statutory limits were originally put in place at Bretton Woods in 1944 to reassure bond markets that didn't trust the newly founded World Bank. Nowadays the 1:1 limit has no relevance to modern financial markets and is simply a vestige of another time, since it includes hundreds of billions of callable capital that no one considers reliable. Ratings agencies and bond investors pay no attention to the statutory limits, and focus instead on capital adequacy. It is high time to relax or even abolish the statutory limits, as they simply confuse debates about MDB headroom and capital adequacy.

Further options to boost MDB financing

In the event that the Covid-19 crisis deepens in the coming months, MDBs should be prepared to expand their balance sheets even further. This would risk a downgrade to AA+, but would allow the major MDBs to collectively lend up to $1.3 trillion above their current portfolios (see Table 1) – a trade-off well worth considering to help avert a global depression. Maintaining a AAA rating is a worthy policy goal for the major MDBs, as it brings down the cost of loans to borrowers and ensures strong access to capital markets in all conditions. But a AAA rating is not an end in itself. The small difference in funding costs at AA+ would mean that the MDBs could still make loans to their borrowers at rates well below what they would have to pay in the markets, especially in times of crisis. If global conditions warrant it, MDBs should be prepared to let their rating slide on a temporary basis, with a view to winding down lending and recovering their AAA status once the crisis has passed.

The above headroom analysis does not include the European Investment Bank (EIB), which is the largest MDB in the world but focuses about 90% of its lending within the European Union. By taking its highly rated callable capital into account, the EIB could increase its loan book ($522 billion in June 2019) by another $190 billion under a AAA scenario. Even if only a portion of that is directed to developing countries, it would be a substantial additional contribution. Targeting a AA+ rating would allow the EIB to expand its loan book by as much as $500 billion above current levels.

Another possibility is to scale up the bond issuances of the World Bank's International Development Association (IDA) window for the poorest countries. Originally a purely donor-funded organisation, IDA received a bond rating in 2016 and now obtains part of its funding from bond issuances, although the bulk still comes from donor countries. IDA is sitting on a massive amount of paid-in shareholder capital – $163 billion in 2018. It could expand its balance sheet by over $250 billion in additional loans with no threat to its AAA rating. However, this should only be considered in a genuine global emergency and on a temporary basis, as doing so would severely restrict the ability of IDA to supply zero interest, long-term loans to the world's poorest countries on a sustainable basis in the years to come.

A last point to mention is the dozen or so smaller MDBs in Latin America, Africa and Central Asia. The AAA-rated Islamic Development Bank (IsDB) has lending space of $15 billion currently, which could be expanded up to $30 billion in a AA+ scenario. The BRICS-led New Development Bank (NDB) is AA+ in international markets, but has a AAA rating in China. With $10 billion in shareholder capital and a still-small loan book, NDB has scope to expand aggressively in response to the Covid-19 crisis. With the support of the Chinese government, NDB would have no difficulty accessing China's capital markets. The smaller regional MDBs have lower bond ratings and cannot grow so easily, but they could contribute their expertise, project management capacity and country relationships to help channel resources from the larger MDBs.

What are the risks?

Pushing MDBs to manage their finances in a less conservative fashion to the benefit of development has made sense for years. Should the Covid-19 crisis lead to the sort of global downturn that is now widely predicted, it is all the more urgent. Nonetheless, expanding MDB balance sheets even under the AAA scenario laid out above does come with risks.

The first is that expanded lending would lead to a downgrade by Moody's or Fitch, which use different rating methodologies than S&P. This risk is highly unlikely to materialise. The methodologies Moody's and Fitch use are less transparent and more difficult to replicate than that of S&P, but give even greater weight to the policy importance of MDBs than S&P, which assesses them more like commercial banks. The best way to mitigate against this risk is for the major MDBs to coordinate their lending expansion, in conjunction with stated support from the G20. Due to the uncertainty among rating agencies around how to evaluate MDBs' official status and policy role, they place great importance on how MDBs compare to one another, and on the support of major shareholders. A coordinated and pre-announced shift in their capital adequacy policy would be less likely to lead to a downgrade.

A second risk is that one or more of the AAA/AA+-rated MDB shareholders are downgraded, which could result in the MDB being downgraded as well. This is a realistic possibility in light of the massive fiscal stimuli already approved or in train in response to the crisis. This risk can be mitigated by easing MDB capital adequacy policy in stages. Only AAA-rated callable capital would be included first, so even if a country were to be downgraded one notch, the capital would still be useful. Should the crisis deepen further, AA+ callable capital should also be counted to allow lending to grow to the level set out in Table 1.

A third risk is that the global crisis escalates so severely that numerous borrowers default and one or more MDBs make a call on callable capital to pay off bond investors. Fear of a capital call is one of the key reasons MDBs manage their finances so conservatively: the largest non-borrower shareholders have committed the most callable capital, and have no desire to ever pay it. In reality, a capital call is extremely unlikely. In the past seven decades, none of the major MDBs has come remotely close to calling on their callable capital. Even in the worst moments – the debt crisis of the 1980s, the emerging market crisis of the 1990s and the global financial crisis of 2007–2008 – no country has ever defaulted on the major MDBs. This demonstrates the strength of MDBs' preferred creditor status. Widespread defaults cannot be ruled out in the event that the crisis leads to the truly doomsday scenario of socio-economic collapse in several countries or regions. But it is very difficult to envision that it would be triggered by the kind of expanded lending proposed in this briefing – and could be averted by it.

A fourth risk is that bond markets would not have the appetite to take on the additional bonds MDBs would need to issue to fund ramped-up lending. This will not be a significant issue for the MDBs. In normal times, MDBs have a steady stream of institutional investors eager for their super-safe bonds. This demand only increases during financial market crises, when investors pull money out of any type of risky investment and put it in the safest, most liquid assets they can find – AAA bonds. While some investors may panic and convert directly to cash, trillions of dollars managed by central banks, pension funds and insurance firms will always have a strong demand for top-rated MDB bonds. Even a downgrade to AA+ would not necessarily have a major impact for trusted issuers, as the downgrade of the US government by S&P in 2011 demonstrated.

Conclusions and policy recommendations

The unprecedented crisis triggered by the Covid-19 outbreak calls for unprecedented measures. All international institutions must contribute in any way possible to help tackle the current emergency and support global recovery.

MDBs are well-positioned to quickly ramp up their lending in response to the crisis. The World Bank and major regional MDBs could collectively increase their loan book by $750 billion without risking their AAA bond rating. Such an increase would not threaten their financial stability, and would not require any additional resources from shareholders. Lending could rise to $1.35 trillion if MDBs are willing to risk a downgrade to AA+ – a small sacrifice that should be considered if the crisis moves into worst-case territory.

Conservative financial policies made sense when MDBs were first created to gain the confidence of investors, but the major MDBs are by now well established and highly respected players in international bond markets. MDBs have built up an extraordinary reserve of financial strength, and now is precisely the time to put it to use to face the challenges posed by this worldwide crisis.

Recommendation 1

Reform MDB financial policy to permit the inclusion of highly-rated callable capital as part of capital adequacy calculations, in line with the methodology used for MDBs by S&P. To minimise downgrade risk and expand MDB lending in line with needs and absorptive capacity, this should be done in three stages:

- Stage 1: Expand lending space by taking existing callable capital from AAA-rated shareholders into account in MDB capital adequacy calculations.
    a. Consistent with AAA MDB rating
    b. Headroom: $350 billion
- Stage 2: Take existing callable capital from both AAA- and AA+-rated shareholders into account in MDB capital adequacy calculations.
    c. Consistent with AAA MDB rating, as long as no shareholders are downgraded to AA or lower
    d. Headroom: at least $750 billion
- Stage 3: Include AAA and AA+ callable capital, and push lending further in response to a deepening global emergency.
    e. Consistent with AA+ MDB rating – a one-notch downgrade – with a view to dial back lending and recover AAA when the crisis passes
    f. Headroom: at least $1.3 trillion

Recommendation 2

Expanding lending as proposed would in the medium term require modifying the statutory lending limits in MDBs' articles of agreement. These are relics of the Bretton Woods era with no bearing on current financial market reality. The statutory limits should either be abolished entirely or modified in line with the AIIB's statutes, which allow shareholders to loosen the limits depending on circumstances.

Recommendation 3

It is essential that this lending expansion take place in a coordinated manner among the major MDBs, with the explicit support of the G20 and other shareholders. This will reassure ratings agencies and bond market investors, and greatly reduce the possibility of a rating downgrade or investor flight from MDB bonds.

Recommendation 4

Further measures are also possible by including other MDBs.

- EIB is mainly focused on Europe, but could on a temporary basis direct a larger portion of its lending to developing countries. Including AAA and AA+ callable capital in its capital adequacy calculations would result in lending headroom of $190 billion while keeping its AAA rating, or $500 billion if it risks a one-notch downgrade to AA+.
- The World Bank's IDA concessional lending window could leverage its stockpile of shareholder capital to expand lending by as much $250 billion beyond current levels without threatening its AAA rating. This would have major implications for concessional lending to the poorest countries and should only be considered in a serious emergency.
- Other MDBs such as IsDB and NDB are more constrained, but each has available lending capacity in the $15–40 billion range. Smaller regional MDBs have limited room to quickly expand their lending, but could use their staff capacity and country presence to help implement loans of other MDBs in their countries of operation.

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