Emerging analysis

New shareholders for multilateral banks

A viable approach to increase development finance?

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Key messages

Multilateral development banks do not have the financial capacity to respond at scale to the Covid crisis or the climate emergency.

Prospects for fresh MDB capital are limited and private finance can only do so much.

One option to boost MDB capital is to create a new class of non-voting shares open to investors.

Every dollar of investor share capital could support four to five dollars of MDB lending – a major boost to MDB capacity.

Governance and financial obstacles to a new share class are not negligible, but they are surmountable as part of a broader strategy to ramp up MDB capacity.

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Acronyms

ADB	Asian Development Bank
AfDB	African Development Bank
EBRD	European Bank for Reconstruction and Development
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IFC	International Finance Corporation
MDB	multilateral development bank
ROE	return on equity
SDGs	Sustainable Development Goals
SWF	sovereign wealth fund
TDB	Trade and Development Bank

1 Introduction

How can multilateral development banks (MDBs) do more? In the wake of the Covid crisis, and as momentum builds behind a climate agenda aimed at enabling the investments at scale essential to keeping our planet on a sustainable trajectory, the question is on the minds of many. MDBs are only one set of the many public and private actors needed to achieve international goals, but they are unique in combining global reach, practical expertise and an ability to steer large amounts of investment towards development. However, the response of the World Bank and major regional MDBs to the current crisis has been limited at best (Humphrey and Prizzon, 2020; Morris et al., 2021).

To do the job, MDBs need greater financial firepower. They unquestionably require other reforms as well, including reducing bureaucracy and becoming more innovative, ambitious and cooperative, but more lending capacity is essential. This is particularly true for MDBs that lend mainly to governments, since much of the investment needed to build back from Covid and meet global development targets will come from the public sector. While many initiatives are under way to ramp up MDB financial capacity, most are limited, for a variety of reasons explored below. Fresh thinking is needed.

One innovation that could have a major impact would be to **open MDB shareholding to institutional investors**. Allowing investors to take a non-voting shareholding stake in MDBs has the potential to substantially boost development finance resources. Because MDBs leverage their capital, one dollar of new capital translates into four or five dollars in development lending. And unlike many current mobilisation techniques, new capital would allow MDBs to continue prioritising projects that generate long-term global public goods, rather than short-term financial returns.

Bringing in new investor shareholders into the capital structure of the World Bank and major regional MDBs may sound like an outlandish proposal, but it is already happening at some smaller MDBs. This paper explores several of the key issues involved to make a preliminary assessment of the viability of such a reform. Given what is at stake – the ability of MDBs to support recovery from the Covid crisis and help put our planet on a sustainable social and environmental trajectory – all options should be on the table.

2 Why existing approaches to MDB capacity are insufficient

If MDBs need more resources, why not ask existing shareholders to put in more capital? Fresh shareholder capital is highly efficient and imposes the least restriction on the ability of MDBs to focus on developmental rather than financial considerations. With just $18 billion shareholder capital paid in since 1944, the World Bank's main International Bank for Reconstruction and Development (IBRD) lending window had by 2020 lent over $750 billion and generated $55 billion in retained earnings. The total capital paid in by the largest IBRD shareholder since 1944, the US, amounts to only $3 billion – less than 20% of USAID's *annual* budget.

The problem is political will. Major shareholders are happy to pile mandates onto MDBs, but reluctant to ask their legislatures for more capital. Some countries – notably China – are willing to put up more capital, but are blocked from doing so by existing large shareholders who do not want to relinquish voting control. And even when capital increases do go ahead, they involve time-consuming, acrimonious battles over MDB policy that result in little usable paid-in capital, not nearly enough to significantly increase MDB lending.

Shareholders have pushed MDBs to use balance sheet optimisation techniques that squeeze more lending out of existing capital, but results are limited. Loan portfolio exposure exchanges among MDBs have led to small headroom gains (see World Bank, 2015; IDB, 2020), while more ambitious moves such as merging concessional windows are one-time wins.[1] Modifying capital adequacy rules could have a substantial impact (Humphrey, 2020), but MDB finance teams – supported by a few key shareholders – are highly conservative and have long resisted meaningful change.

Initiatives to mobilise external investor resources, such as loan syndication programmes like the International Finance Corporation (IFC)'s Managed Co-Lending Portfolio Program (IFC, 2018) or IDB Invest's facility with a private investment fund (IIC, 2017), are positive

[1] The concessional lending windows of the Asian Development Bank (ADB) and Inter-American Development Bank (IDB) were 'merged' into the main lending window in 2016, resulting in a huge boost to ADB capital and a modest but still substantial boost for IDB. Mergers have been deemed unfeasible for the World Bank and African Development Bank (AfDB) for technical and political reasons.

but have two important limitations. First, they are useful only for projects that generate an immediate financial profit to repay private investors, like toll roads or energy generation. The majority of investments needed to achieve development goals – such as social protection programmes, rural roads, maternal health or primary education – generate long-term developmental benefits but not short-term financial profit. Trying to leverage private investors for projects without short-term financial returns would require so much subsidy that it makes more financial sense for an MDB to do it on its own balance sheet.

Second, the financial scale of private sector mobilisation by MDBs has been relatively modest (IFC, 2021), in part because it is unleveraged. Loan syndication and loan guarantee facilities mobilise investor resources 1:1 – every dollar of financing from an investor results in a dollar of extra financing for a given development project. MDB capital, by contrast, is leveraged several times – one dollar of capital translates into four or five dollars of financing for development projects. And MDB capital keeps on generating more loans, whereas private sector mobilisations are one-time arrangements with a defined expiration, and are often time-consuming and complex to structure.

3 One path forward: open MDB capital to new investors

In light of the above difficulties and limitations, MDBs could consider bringing investors into their capital structure via a new class of shares.

Mobilising investor resources into MDB capital would have three major advantages over the mobilisation approaches currently being pursued by MDBs. First, it would be far more financially efficient, generating four or five dollars of low-cost loans for each additional dollar of capital. Second, share capital could attract institutional investors looking for an aggregate investment platform that does not require analysing individual projects. Third, MDBs could continue their traditional focus on long-term developmental impact, not short-term financial returns to investors. The reason for this is that MDBs enjoy a AAA rating and strong access to bond markets due to their superlative track record of being repaid by borrowers. As a result, they have for decades been able to channel huge sums of bond investor resources to development projects with long-term social returns.

Capital is the binding constraint to doing more with this highly effective development finance model. For example, the European Investment Bank (EIB) had a loan portfolio of $470 billion in 2019, compared to about $200 billion for the World Bank's IBRD, mainly because its shareholders believe EIB useful enough in pursuing policy goals to contribute more share capital. If current shareholders will not contribute more to the World Bank and major regional MDBs, it is worth considering ways to seek share capital from investors instead.

The volume of resources generated by a new share class for investors would depend mainly on how much new capital is brought in, and on how much MDBs are willing to leverage it based on their capital adequacy policies. To give a sense of scale, if the World Bank's two main non-concessional windows (IBRD for public sector borrowers and IFC for the private sector) and the four major regional MDBs were to attract 50% additional paid-in capital from investors, this could result in an immediate boost of $140 billion in available loan portfolio headroom (Table 1).[2] If new loans are directed towards less risky

[2] This is based on an equity-to-loans ratio of 25%, above the 20% policy floor of the IBRD, but below that of the other MDBs. The capital adequacy policies of the MDBs – which the equity-to-loans ratio proxies – is another area where MDBs could create more financial headroom (Humphrey, 2020).

projects – such as smart grid infrastructure or urban mass transport systems in middle-income countries – even more would be possible.[3]

Table 1 Immediate additional lending headroom with 50% new share capital

	$ billions		
Multilateral development bank	**Total paid-in shareholder capital (2019)**	**Additional investor capital (50% of total)**	**Additional loan headroom**
ADB	7.2	4.8	19.2
AfDB	6.3	4.2	16.8
EBRD	7.1	4.8	19.2
IBRD	17.1	11.4	45.6
IDB	11.9	8.0	32.0
IFC	2.6	1.8	7.2
Total	**52.2**	**35.0**	**140.0**

Note: ABD, Asian Development Bank; AfDB, African Development Bank; EBRD, European Bank for Reconstruction and Development; IBRD, International Bank for Reconstruction and Development; IDB, Inter-American Development Bank; IFC, International Finance Corporation.

Source: Author calculations based on 2019 MDB financial statements, using an equity-to-loans ratio of 25%.

Beyond the immediate impact on lending headroom, additional share capital could build even greater financial capacity over time. MDBs retain most net income as financial reserves, which is functionally equivalent to shareholder capital. In most MDBs, reserves are much higher than capital – $29 billion reserves versus $17 billion capital at IBRD, for example. By ensuring that a portion of the income generated by the new capital is dedicated to reserves, a new share class would also further strengthen MDB capacity going forward. Additional reserve equity would increase the sale value of individual shares, thus benefiting the shareholder as well.

[3] This is because loans to borrowers that are perceived by ratings agencies as less risky use up less MDB lending headroom.

4 Investor share classes already work for some MDBs

The idea of bringing institutional investors into the capital structure of MDBs might sound far-fetched, but it is already being done. Several smaller, borrower-led MDBs have for decades used different types of share classes as a way to include non-sovereign and/or non-regional shareholders, although the shares did not pay dividends. More recently, Africa's Trade and Development Bank (TDB) has created new dividend-paying share classes open to certain non-sovereign investors. Afreximbank – more of a public trade finance institution than an MDB – also has a mix of dividend-eligible sovereign and non-sovereign shareholders.

This more creative shareholding structure makes sense. These MDBs are majority-owned by developing countries, most of which have limited fiscal capacity and cannot easily contribute substantial share capital to an international organisation. By creating separate share classes, these MDBs can bring in additional capital to give them greater operational capacity, while at the same time leaving overall governance authority in the hands of sovereign members.

TDB created dividend-paying B shares in 2013, and now has 14 institutional investors, including several regional pension and insurance funds as well as development agencies such as Denmark's Investment Fund for Developing Countries.[4] B shareholders are required to hold their shares for five years, after which point they can sell to another institution, with TDB helping to arrange the transaction. Thus far, none have sold. TDB dedicates 75% of yearly net income to retained earnings, and distributes the rest as dividends equally to all shareholders. A shareholders must take their dividend as additional shares, while B shareholders can take cash dividend or shares.

On the back of the successful B share programme and excellent financial performance in recent years, TDB is launching a new C share designed for international impact investment firms. This would be a listed 'preferred' share (i.e. with financial seniority over the other shares in the event of bankruptcy), but would have no voting rights.

[4] TDB's B shareholders only contribute paid-in capital, while A shareholders contribute paid-in as well as callable capital.

New resources are to be steered towards TDB's growing portfolio of climate-oriented project investments, and as a result the shares will be marketed as 'green' – an equity version of green bonds, with external auditing to provide credibility to investors.

In conceptual terms, TDB shows that an MDB founded and controlled by sovereign member countries can successfully bring external non-sovereign investors into its capital structure. However, TDB differs from the major MDBs in at least two important ways. First, it generates relatively high annual net income, with return-on-equity of 12–14%. This is because it finances mainly private sector projects for which it can charge a higher interest rate, and it has very low administrative costs due to its lack of expensive research and technical assistance services. Second, the country shareholders have relatively uniform views on bank policies, and including new shareholders is not perceived as a threat to their governance control. In fact, according to its president[5] TDB values the participation of investor shareholders at board meetings due to their focus on financial efficiency and project quality.

Because of these differences, it is not self-evident that the same model of separate share classes for non-sovereign investors used by TDB could be applicable to the major MDBs. A number of important political and financial challenges would need to be overcome to apply a similar shareholding model to the World Bank and regional MDBs.

[5] Interview with TDB President Admassu Tadesse and TDB senior management, 24 February 2021.

5 Challenges to reforming shareholding at the major MDBs

Opening up the capital structure of the World Bank and major regional MDBs to bring in non-sovereign shareholders would require addressing concerns related to governance and operational effectiveness. A shareholding reform would require modifying MDB statutes, which in turns requires the support of 75–85% of voting power at the major MDBs.[6] As such, it would be essential to build political support among different shareholders. This chapter outlines key challenges and potential solutions in conceptual terms. Substantial further work would be required before such a proposal could be operationalised.

5.1 Implications for MDB governance

The political implications of MDB capital reform were the first concern voiced by several officials from major shareholder governments consulted for this report.[7] The two most pressing questions raised were that: i) a new class of MDB shares could dilute effective governance control of the MDBs by existing shareholders; and ii) such a move could increase the influence of certain nations with currently low shareholding at the MDBs, notably China. While these are valid points, it does seem possible to structure a new shareholder class for investors in such a way to mitigate governance concerns.

First, the share class would be non-voting. The trade-off is that the new shares would formally be 'preferred' in financial terms – i.e. first in line to be repaid in the (practically inconceivable) event of an MDB bankruptcy. Non-voting preferred shares are well known in the financial world, and are the model proposed by TDB for its new C share class. This would reduce any concerns that investors would influence an MDB's policies and steer it away from the priorities of government shareholders.

Would investors accept non-voting status? That would depend on the entire package being offered, including financial terms as well as less

[6] Reforming the statutes requires 85% voting power at IBRD and IFC, 80% at EBRD and 75% at ADB, AfDB and IDB.

[7] Based on interviews with nine anonymous government officials from five non-borrower shareholder countries (three of which are G7 members).

tangible attributes like the recognition of positive social impact from their investment. As well, investors would in all likelihood be mainly focused on financial rather than developmental issues, and in these areas MDBs already perform extremely well. In light of MDBs' track record, oversight mechanisms and rigorous project vetting, investor shareholders would likely feel confident that MDBs are being managed in a highly prudent fashion, thus reducing the need for voting power.

Second, shares could be open only to certain types of investors perceived as less problematic for MDB governance, for example investors partly or majority owned by member governments such as sovereign wealth funds (SWFs), government-run pension funds and central banks. This class of investor already purchase MDB bonds, and hence have a high degree of trust in and familiarity with MDBs. Their links to existing member shareholders would mean they would align with the views of their 'parent' governments, and mitigate the need to push their own independent views as shareholders.

At the same time, incorporating institutional investors linked to governments could pose challenges. Some countries may not have government-run pension funds or SWFs. Others – such as Japan's government pension fund, SWFs controlled by Norway or the Gulf states or the central banks of Switzerland and China – have massive financial power. Restricting new shares to government-linked investors could thus be perceived as unbalancing MDB shareholding (even though new shares would be non-voting). To alleviate that concern, new shares could be offered to investors in proportion to existing share percentages of the countries in which the investors are based.

Opening to institutional investors *not* linked to governments is another option. This would broaden the pool of potential investors to include impact investment firms and philanthropic foundations committed to social and development goals that might be interested in investing in MDB shares. These investors may also face fewer regulatory hurdles compared to government-linked investors. The trade-off is that these investors may be perceived as having agendas less aligned with existing government shareholders (although, once again, the shares would be non-voting).

5.2 Implications for MDB operations

One concern expressed by several shareholder government officials is that a new class of investor shareholders could **shift MDBs away from prioritising development and turn them into profit-driven institutions**. This danger seems remote. The process to approve and fund projects is well-established and rigorously followed at all the major MDBs, with strict criteria related to development impact, technical feasibility and borrower debt sustainability. Member country shareholders would retain complete control over these criteria and processes, and are very unlikely to change them in response to pressure from a non-voting investor shareholder. Similarly, existing frameworks around setting MDB loan prices and allocating net income would be maintained. Investors would be eligible solely to annual net income in proportion to their shareholding, and in years when net income declines for whatever reason, so too would investor returns. These stipulations should be clearly spelled out to investors prior to share sale.

Another consideration is that incorporating new shareholders could **weaken the desire of government shareholders to contribute share capital themselves**. From a political economy perspective, if governments know that the MDBs can get share capital from investors, they may be less inclined themselves to increase MDB capital.[8] This could, over time, weaken the capital structure of the MDBs as well as their official standing, thus undermining their effectiveness. Related to this is the issue of **how investor shareholders would be perceived by credit rating agencies**. If government shareholders are unwilling to sufficiently capitalise an MDB and create a new share class to relieve their capital burden, this could be interpreted by the ratings agencies as a lack of support, which would be a rating negative.

To address these risks, it would be best to bring in investor share capital as part of a broader package of scaling up MDB capacity, combined with capital contributions from government shareholders. The creation of a new share class as part of a well thought-out and comprehensive programme of ramping up MDB activity to achieve certain policy goals would alleviate this risk in the eyes of the international community, as well as ratings agencies and bond buyers.

5.3 Ability of MDB shares to attract investors

Would a new share class from the major MDBs be of interest to institutional investors? In current market conditions, top-rated government bonds – which make up a large share of many institutional investor portfolios – are paying very low or even negative real interest rates, while the valuations of equity markets are perceived by many to be highly risky. Consequently, many institutional investors are looking for alternative assets that are not strongly correlated to existing investments, match their risk-return needs and can be purchased at scale with minimal need to examine underlying assets. MDB shares could meet that need, although investor appetite could shift in different market conditions.

The *financial risk* of MDB shares would be very low. The World Bank and major regional MDBs are all AAA-rated institutions – a rare breed in today's world.[9] MDBs have a spotless record of servicing their financial obligations and decades of generating steady annual net income, closely overseeing their projects and never writing off loans to

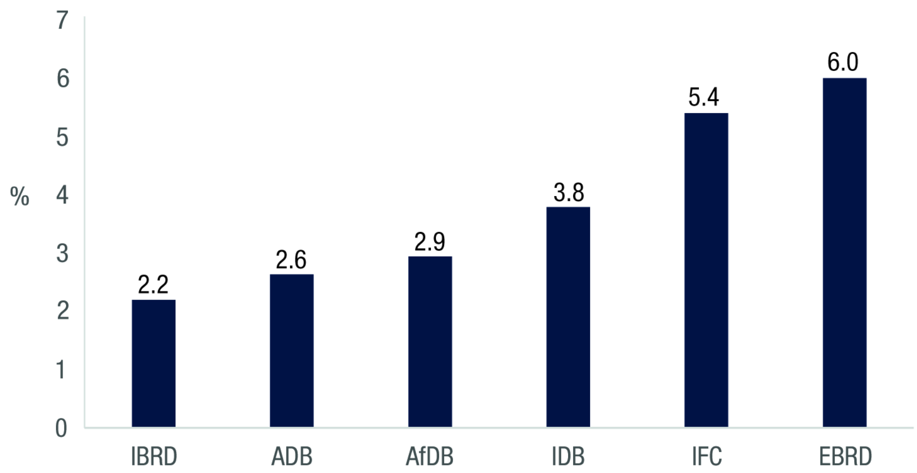
[8] This is similar to the risks discussed by Landers (2021) in relation to permitting the World Bank's concessional window to issue more market debt to offset insufficient donor contributions.

[9] Currently 11 sovereigns have a AAA rating with S&P and Fitch, and 13 with Moody's. Only two corporates – Microsoft and Johnson & Johnson – are rated AAA.

public sector borrowers. On top of that, all the major MDBs have 'callable' capital of between $85 billion (AfDB) and $270 billion (IBRD) committed by shareholders under international treaty in case of financial emergency (which has never come about). The new 'preferred' shares would have seniority over regular shareholders in the extraordinarily unlikely event of an MDB bankruptcy. In short, it is difficult to imagine any equity investment less risky than a preferred share from the major MDBs.

The *return* – both in terms of annual dividend and share value appreciation – is less clear. The ROE of the major public sector-oriented MDBs has historically been very steady but low, averaging between 2.2% and 3.8% over the past decade, or 5.4–6% for those focused on private sector lending (see Figure 1). By comparison, TDB has had an REO of 12–14% annually in recent years, making it much easier to generate returns for its shareholders through dividend payouts and share value appreciation.

Figure 1 Return on equity, 2009–2019 average



Note: These MDBs use slightly different methods to calculate annual net operating income, meaning the numbers are not precisely comparable. IBRD, International Bank for Reconstruction and Development; ABD, Asian Development Bank; AfDB, African Development Bank; IDB, Inter-American Development Bank; IFC, International Finance Corporation; EBRD, European Bank for Reconstruction and Development.

Source: Author's calculations, based on annual financial statements.

The majority of net income from the major MDBs would be retained as reserves, while a portion could be distributed as dividends. Dividend distribution is already permitted in the statutes of all the major MDBs, although it has never been done in practice. The value of new shares would increase in proportion to the growth of reserves, and the share contract could stipulate share sale only after a certain period of time, and only if a suitable new investor is found (as is the case with TDB's

B shares). Share repurchase by MDBs is not an option, as it would defeat the purpose of building greater lending capacity. Hence, the shares would be relatively illiquid and appropriate mainly as a buy-and-hold investment.

In light of the low ROE of the major MDBs, the financial return under this model would be modest, and well below what most investors would look for in a normal equity investment. However, due to the very low risk, AAA rating and steady rates of return, such an investment could be marketed not to the equity portfolio of an investment fund, but rather the bond side as an alternative to highly rated government bonds, which are currently paying very low or negative real returns.

One investment strategist for a European government pension fund consulted for this study considered this type of asset to be in principle viable. ‘It is absolutely conceivable. Everyone is looking for alternative assets to listed equity and bonds. We get more money coming in every year and we struggle to allocate it. If we could find smart deals like this that are chunky, instead of a deal here, a deal there, we would find it interesting.’ The strategist said the risk-return profile of MDB shares would be similar to existing bond portfolios. ‘The difference is that bonds are liquid, and this asset would not be. But you could compare it to green bonds, which are totally illiquid. No one is buying to trade, it’s a buy-and-hold.’

This is just one anecdotal interview, and an extensive and systematic survey of potential investors would be essential before moving ahead with the creation of new MDB shares, but it does suggest that there could be appetite for a low-risk, low-return share.

A new MDB share class would have the added advantage of extremely high positive social impact for the growing number of investors mandated to seek impact investments. MDB equity could easily demonstrate high impact already rigorously documented (unlike many existing impact investments) in annual development effectiveness reports. As the investor community moves toward more systematic evaluation of impact (see for example Cohen, 2020), such well-documented impact will become an increasingly valuable asset characteristic.

6 Conclusions

Could the major MDBs create a new class of non-voting shares for investors, as a means to increase their financial capacity? The short answer is yes, at least in technical terms. Africa's TDB has shown that it is possible. Even with the different financial and political realities of the major MDBs, it is clear that a new share class could work.

The main obstacles repeatedly cited in interviews with government officials consulted for this paper revolve around governance. Considering that new shares would be non-voting, this should not be an insurmountable problem. Nonetheless, it is evident that some of the most important non-borrowing shareholders would perceive a new share class as a threat to their influence.

Although less often cited by government officials, financial considerations are also an obstacle, due to the relatively low ROE of the major MDBs and the need to build reserves through annual net income. This limits potential share dividends, and combined with the relatively illiquid nature of the shares makes their appeal to investors uncertain. Nonetheless, it does seem viable if marketed to the right class of investor as a low risk, low return bond-like instrument with very high social and environmental impact.

A final important concern is that a new share class for investors would reduce the appetite of government shareholders to adequately capitalise MDBs themselves. This point gets to the core of whether the major MDBs should actually consider reforming their share structure to bring in investor capital.

There can be little doubt that creating a new investor share class is not the first-best option. A far better strategy to increase MDB capacity – with no risk to current governance or operational practices – is to obtain further share capital from existing shareholders, combined with optimising balance sheets through reformed capital adequacy policies or other techniques.

However, there are increasing calls for MDBs to set much more ambitious operational targets over the medium term to address the huge investment gap for smart infrastructure needed to shift the world economy onto a more socially and environmentally sustainable growth path. Should MDB member governments agree on such a strategy, creating a new investor share class could be combined with new capital from government shareholders and balance sheet optimisation as a broader package of reforms to increase MDB lending capacity.

As the global community begins to shift its attention from addressing the short-term impacts of the Covid-19 crisis and starts thinking about reconstruction and investment in the near future, creative ways to capitalise MDBs need to be explored. A new investor share class is a logical option that aligns well with the investor mobilisation agenda in development finance, and merits being put on the table for consideration.

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