

# Boosting MDBs' investing capacity

Independent Review of MDBs' Capital Adequacy Frameworks

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- Introduction and Background
- Benchmarking MDB Capital Adequacy Frameworks
- Recommendations on the Capital Adequacy Frameworks
- Conclusions

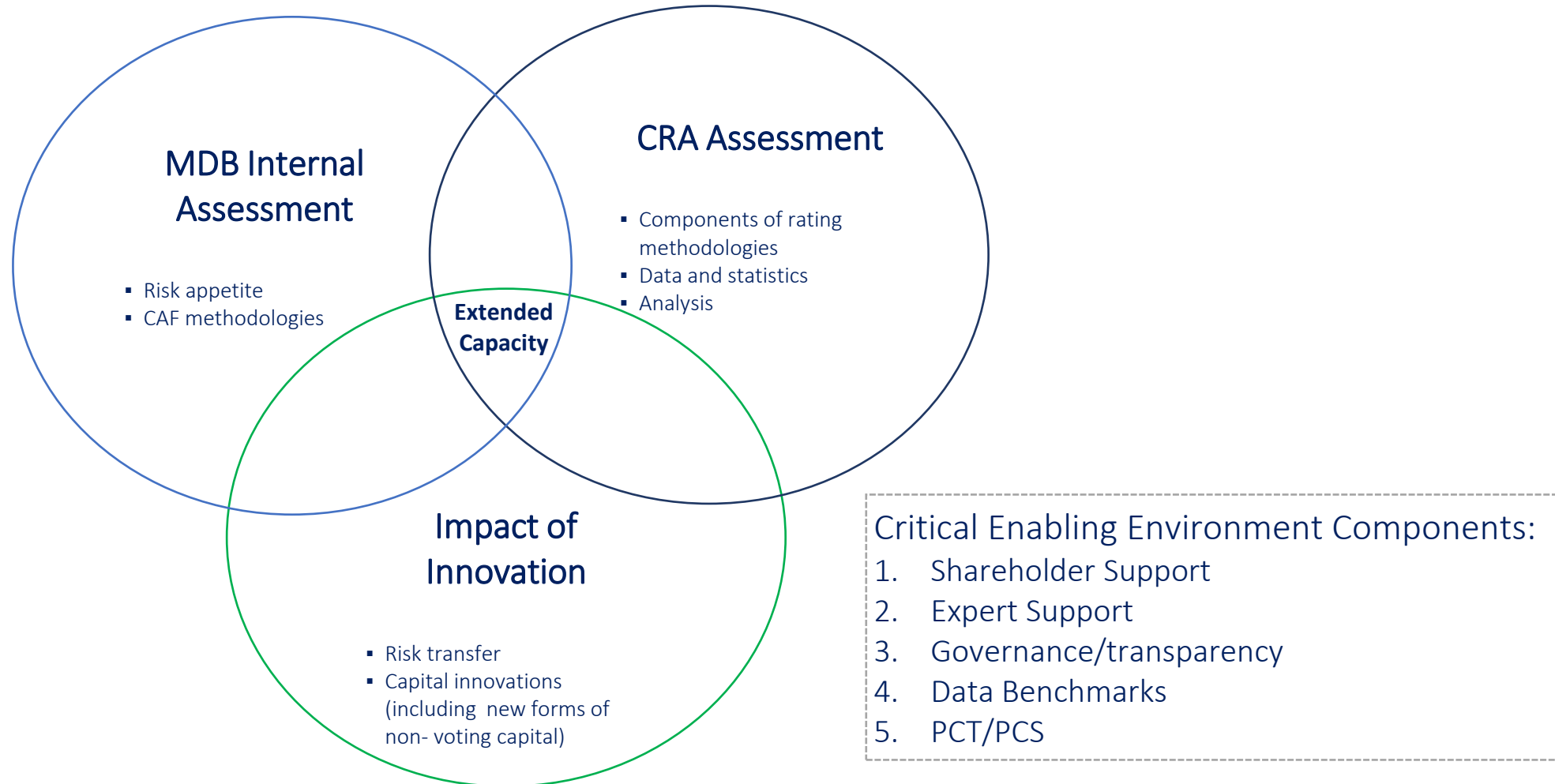
# Timeline



- **July 2021** - G20 Finance Ministers and Central Bank Governors agree to launch the Independent Review of MDBs' Capital Adequacy Frameworks, with three objectives:
  - i. Provide credible and transparent benchmarks on how to evaluate MDB CAFs;
  - ii. Enable shareholders, MDBs and CRAs to develop a consistent understanding of MDBs capital adequacy frameworks;
  - iii. Enable shareholders to consider potential adaptations to the current frameworks in order to maximise the MDBs' financing capacity.
- **September 2021** - IFA WG appoints 14 members of the Expert Panel, including Dr. Frannie Léautier as **Expert Chair**.
- **July 2022** – G20 Finance Ministers and Central Bank Governors welcome the [Report](#).

# Panel's Conceptual Approach

The Panel examined the critical factors behind MDB capital adequacy and how they underpin lending headroom



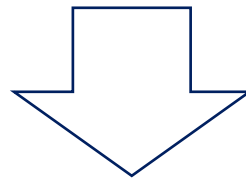
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# An Approach to Support Comparability and Benchmarking

Core Challenge: MDB CAFs utilize similar core concepts, but take divergent approaches

- Policy
- Capital
- Financial Management and Liquidity



Thus making benchmarking challenging as the exercise is only as valuable as the comparability of the data

# An Approach to Support Comparability and Benchmarking

A clear and well-specified MDB CAF should:

- Define **risk tolerance**.
- Comprehensively quantify **sources of risk**.
- Identify all **risk-bearing capital** and the **income strategy**.
- Clarify the trajectory of **nominal leverage ratios**.
- Implement a **high-quality governance** and **risk management framework**.
- Set out **liquidity and funding targets**.

# Benchmarking Overview

The emerging picture:

- MDBs generally aim for AAA ratings while avoiding the need for a call on callable capital.
- MDBs tend to target and monitor a bespoke risk capital utilization ratio, while some rely on the standard Basel or S&P methodologies.
- The way these indicators are constructed differ in their impact.
- Available risk capital is more uniformly defined.
- Financial management practices vary significantly across MDBs.



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# Recommendations

The Panel recommends strategic shifts in five areas to maximize the impact of MDB capital:

- 1 - Adopt a more efficient management of MDB capital and risk**, including by further reflecting on the approach to defining risk tolerance.
- 2 - Give appropriate recognition 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** by adopting a more strategic, cooperative, and proactive approach to innovations that can improve the use of existing capital and free additional financing.

# Recommendations

In particular, the Panel proposes the following innovations:

- **Freeing up space on the balance sheet:**
  - Risk transfers to the private sector
  - Donor guarantees
  - MIGA-MDB partnerships
- **Offering new forms of capital:**
  - Hybrid capital
- **Boosting countercyclical capacity:**
  - Pool commitments of callable capital for crisis response

# Recommendations

**4 - Enhance dialogue with credit rating agencies (CRAs) to improve mutual understanding.**

**5 - Create an enabling environment for reform through greater transparency and information.**

More accessible and comparable data and analysis, as well as regular capital reviews, will support all the stakeholders in their assessment of MDB strength and demystify their financial model.

These actions would allow MDBs to substantially increase available funding, while protecting the MDBs' AAA credit ratings that underpin their business models, through clear communication from shareholders and more dynamic risk management.

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# Strategic Considerations

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1. Capital adequacy reforms and innovations would be most effective as part of a structured program of MDB actions.

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  2. Shareholders have a critical role in MDB capital adequacy.

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  3. These reforms can reinforce one another when enacted as part of a coherent reform package.

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  4. Coordinated implementation and communication by a substantial number of MDBs would be beneficial to market perceptions.

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  5. If reforms increase lending capacity, G20 shareholders need to ensure adequate budgets and resources to support and sustain high quality operations.

# Next Steps –

The G20 is working on developing a roadmap for the implementation of the recommendations.

Individual MDB Boards are beginning to discuss the report and how it may apply to their institutions.

*I believe this initiative has come at a most appropriate time. The needs are great, with both the economic recovery and achievement of the Sustainable Development Goals at risk. Implementation of the Report's recommendations would allow MDBs to increase their firepower, playing a greater role in addressing the challenges of today and tomorrow. Implementation will not be easy, and some recommendations will require very careful decisions about trade-offs. However, this is an opportunity that cannot be missed"*

Dr Frannie Léautier  
Expert Chair of the Independent Review  
of MDBs' Capital Adequacy Frameworks

# Annex – Panel Members



**Frannie Léautier**  
- Chair



Ahmed Al-Mohsen



Paulina Beato



Chris Humphrey



René Karsenti



Ekrem Keskin



Hans-Peter Lankes



Nancy Lee



Mike Muldoon



Hiroshi Naka



Betsy Nelson



Arunma Oteh



Jens Ulrich



Jinkang Wu



# Annex - Terms of Reference

## Objectives of the Independent Review:

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 recognizes 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.

# Annex – Supporting evidence

The Panel relied on five sources of information:

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

# Annex - Redefine the Approach to Risk Appetite for MDB Capital Adequacy Frameworks

	Recommendation	Addressed to	Complexity of Execution	Time Frame
1a	Define MDB risk appetites prioritizing shareholder-specified limits rather than external criteria.	MDBs, Shareholders	Med.	1-2 years
1b	Ensure that MDB capital adequacy frameworks account adequately for preferred creditor treatment and the concentrated nature of MDB portfolios.	MDBs	Low/Med.	1-2 years
1c	Relocate specific numeric leveraging targets from MDB statutes to MDB capital adequacy frameworks.	MDBs, Shareholders	High	>2 years

# Annex - Incorporate Uplift from Callable Capital into MDB Capital Adequacy Frameworks

	Recommendation	Addressed to	Complexity of Execution	Time Frame
2a	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, CRAs Shareholders	Low/Med.	1-2 years

# Annex - Implement Innovations to Strengthen MDB Capital Adequacy and Lending Headroom

	Recommendation	Addressed to	Complexity of Execution	Time Frame
3a	Endorse MDB consideration of non-voting capital classes (paid-in equity or hybrid) to contribute to available capital.	MDBs, CRAs Shareholder	Med./High	1-2 years
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.	MDBs, Shareholders	Med./High	1-2 years
3c	Encourage shareholder guarantees of sovereign repayments on loans related to cross-cutting priorities.	MDBs, Shareholders	Low	1-2 years

# Annex - Implement Innovations to Strengthen MDB Capital Adequacy and Lending Headroom

	Recommendation	Addressed to	Complexity of Execution	Time Frame
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.	Shareholders	Low	1 year
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, Shareholders	Low/Med.	1-2 years
3f	Explore ways of providing MDBs with access to central bank liquidity, including pooled agreements under the supervisory umbrella of one central bank.	Shareholders	High	> 2 years

# Annex - Improve Credit Rating Agency Assessment of MDB Financial Strength

	<b>Recommendation</b>	<b>Addressed to</b>	<b>Complexity of Execution</b>	<b>Time Frame</b>
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.	MDBs, Shareholders	Low	< 1 year
4b	Rating agencies can take steps to strengthen their MDB evaluation methodologies.	CRAs	Low/Med.	1-2 years
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.	CRAs	Low	> 2 years

# Annex - Improve the Enabling Environment for Capital Adequacy Governance

	<b>Recommendation</b>	<b>Addressed to</b>	<b>Complexity of Execution</b>	<b>Time Frame</b>
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.	MDBs, Shareholders	Low	< 1 year
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.	MDBs, Shareholders	Low	< 1 year



# Annex - Improve the Enabling Environment for Capital Adequacy Governance

	<b>Recommendation</b>	<b>Addressed to</b>	<b>Complexity of Execution</b>	<b>Time Frame</b>
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.	MDBs, Shareholders	Low	< 1 year
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.	MDBs, Shareholders	Med.	1-2 years