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WILL MULTILATERAL DEVELOPMENT BANKS WEATHER THE COVID-19 CRISIS?

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This note assesses the impact of the Covid-19 crisis on the financing capacity of four major multilateral development banks (MDBs) specialized in non-concessional sovereign lending, based on the available capital buffers and while maintaining triple-A ratings. The capacity of these MDBs to expand development exposures (spare lending capacity) is on aggregate estimated at around US$ 1 trillion, considering also the benefits arising from the full implementation of the recently approved capital increases. Simultaneously, a number of potential factors – such as the foreseeable increase in exposures in line with MDBs' countercyclical role, the deterioration of the ratings of borrowing and non-borrowing member countries, and the possible weakening of 'preferred creditor treatment' (PCT) – could substantially erode the spare lending capacity, reducing it to US$ 116-227 billion. In the post-pandemic period, it will therefore be crucial to preserve the PCT of MDBs, also in the hypothetical case of debt restructuring episodes involving developing countries. Other policy suggestions point to a revival of balance sheet optimization efforts, a further harmonization of MDBs' risk management and operational procedures, and an expansion of risk sharing mechanisms with highly rated third party investors, to relieve capital constraints and stretch lending capacity.

1. Covid-19 and the potential repercussions on MDBs' lending capacity

The Covid-19 pandemic has induced a global economic shock of unprecedented magnitude, leading to deep recessions in many countries. The impact is likely to affect emerging market and developing economies (EMDEs) disproportionally, given their higher vulnerability. The GDP of these economies is projected to fall by 3.3 percent in 2020 (IMF WEO, October 2020), the only decline recorded in the last 70 years. As happened in the immediate aftermath of the Global Financial Crisis (GFC), the role of Multilateral Development Banks (MDBs) will be key in order to mitigate the consequences of the current crisis, protect the vulnerable, and improve governments' capacity to prevent and cope with similar events in the future.

Using two alternative rating methodologies – developed by S&P and the Bank of Canada (BoC)[2] respectively - this note assesses how much balance sheet expansion can MDBs' capital buffers support, while maintaining triple-A ratings and taking into account the potential impact of the Covid-19 crisis on lending capacity. The focus is on 4 major institutions: the International Bank for

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[2] The Multilateral Lending Institutions Rating Methodology applied by Standard & Poor's (S&P 2018) and the Multilateral Development Bank Credit Rating Methodology developed by the Bank of Canada (Bank of Canada, 2017).

Reconstruction and Development (IBRD, the non-concessional lending arm of the World Bank Group); the Inter-American Development Bank (IADB); the Asian Development Bank (ADB); and the African Development Bank (AfDB). These institutions are among the biggest players in the MDBs' category: at end-2019, they held an aggregate level of assets of almost US$ 700 billion (of which US$ 450 billion in development exposures) and a cumulative equity of around US$ 140 billion. While having a different geographical focus (global or regional), they share a very similar business model, centred on providing, exclusively or predominantly, sovereign lending to emerging and developing countries.

These 4 MDBs entered the Covid-19 crisis holding an amount of capital substantially above their triple-A threshold requirements, which implies the existence of a sizeable aggregate additional lending capacity (the so-called spare lending capacity). At the same time, however, as the effects of the crisis unfold, MDBs' spare lending capacity is likely to erode quickly because of two parallel developments. On the one hand, MDBs will expand their development related exposures, in line with their counter-cyclical role. On the other, the worsening outlook for EMDEs could cause a deterioration of borrowing countries' creditworthiness, leading to credit rating downgrades, higher risk capital requirements and further impairment of lending headroom. Moreover, the Covid-19 crisis may further reduce MDBs' spare lending capacity through two additional channels, i.e. the weakening of two traditional elements of strength of such institutions: the de-facto Preferred Creditor Treatment (PCT) and the Exceptional Shareholder Support (ESS).

PCT is a key characteristic of MDBs that has enabled them to operate with very low or no arrears/losses throughout their history. Indeed, these institutions are not just 'banks' that provide low-cost finance for development-related projects; they also provide their borrowing (member) countries with technical assistance, an external anchor to push through development policies and a voice in the international arena. Moreover, as sovereigns expect that supranational institutions make additional financing available in times of financial stress (when funding from markets and commercial banks usually dry up), they are likely to continue servicing debt owed to MDBs even when defaulting on private debt. As a result, NPLs or arrears on sovereign loans have been historically very low[3]. Given the extreme stress provoked by the Covid-19 crisis and the severe legacies it will likely have on future economic activity, there are concrete chances that arrears/losses may start to materialize. Such an occurrence would induce rating agencies to remove the benefits from PCT in MDBs' credit rating assessments. The result would be a reduced lending headroom for a given rating target (AAA).

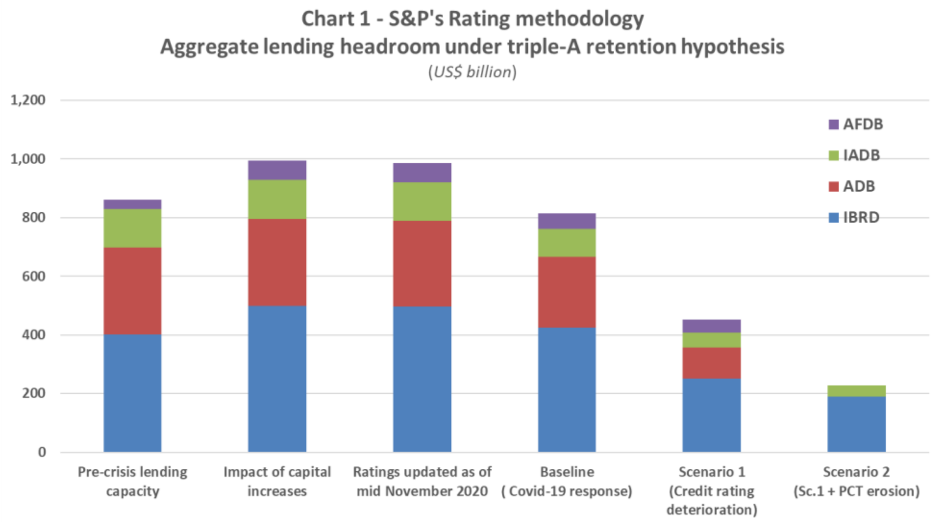
Extraordinary shareholder support (ESS) refers to callable capital, i.e. to the portion of capital subscriptions at MDBs that is not 'paid-in' but committed by each shareholder, jointly and severally with the others, only when this is required to prevent a default on an MDB's obligation. Since shareholders are not always willing to increase paid-in capital, due to budget constraints, callable capital normally dwarfs paid-in capital, ranging from around 80% (AfDB) to over 96% (IADB) of total subscribed capital. According to the algorithms embedded into rating methodologies, the role of callable capital in expanding MDBs' lending capacity is directly related to the creditworthiness of their shareholders, and especially of their strongest non-borrowing member countries. Should a generalized sovereign rating downgrade, ignited by the Covid-19 crisis, affect also the better rated shareholders, this would impact MDBs' spare lending capacity in a negative way.

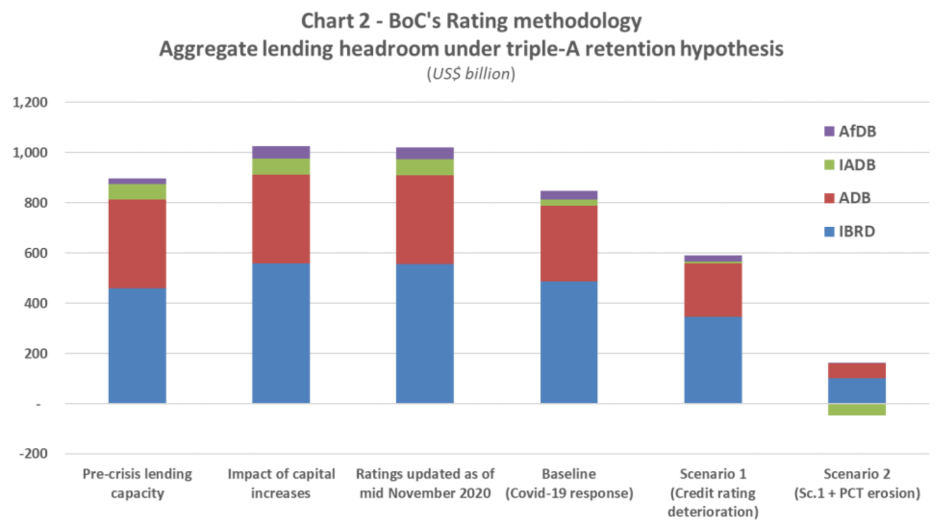
[3] While having no legal foundation, PCT has been demonstrated empirically not only by the behavior of borrowers in distress, but also by the Paris Club, that has regularly exempted International Financial Institutions from its restructuring operations.

2. The estimated impact on lending capacity

According to our analysis, the pre-crisis spare lending capacity of MDBs was in the range of $860-896 billion, depending on the methodology applied (first bar in Charts 1 and 2). We then performed two adjustments to this estimation. First, we incorporated the expected benefits arising from the full implementation of the last capital increases approved by the IBRD and the AfDB. Second, we applied to each MDBs' stock of exposures at end-2019 the ratings (and the corresponding risk weights) as of mid-November 2020, in order to take into account the impact of the changes already occurred in the credit quality of sovereign borrowers, as reflected in the rating actions taken by Standard and Poor's since the onset of the crisis.

In this way, we come up with an estimated spare lending capacity of US$ 985-1.020 billion (third bar in Charts 1 and 2). These favourable financial conditions therefore put MDBs in a position to ramp-up quickly development lending in response to the crisis, without endangering triple-A ratings or having to ask for new contributions from shareholders.





Source: authors' calculations based on MDBs' financial statements and S&P/BOC rating methodologies.

These estimated levels of current lending capacity are the reference points on which we apply 3 scenarios, which are intended to illustrate the previously described channels through which the Covid-19 crisis can potentially impact MDBs' spare lending capacity[4].

In the baseline scenario, the stock of lending exposures at fiscal year-end 2023 grow by an aggregated amount of US$ 171 billion, as a result of the countercyclical response to the crisis. We obtain this number by assuming that the increase in the stock of loans as a share of EMDEs' GDP is similar to what was recorded by these institutions in the aftermath of the GFC[5]. Sovereign ratings are left unchanged, at their mid-November 2020 levels, in order to isolate the effect of the planned lending increases ("exposures' growth channel").

In our stress scenario 1, we try to capture the erosion of lending capacity that would be brought about by a deterioration in the quality of loan portfolios (and associated increase in risk weights) and a weakening of the ESS, coupled with the projected growth in exposures embedded in the baseline. In this scenario, which is not directly linked to any specific macroeconomic scenario or forecast, we assume a one-notch downgrade for all sovereigns with investment grade rating (BBB- or higher), and a two-notch downgrade for weaker sovereigns (BB+ or lower).

While the projected expansion in exposures envisaged in the baseline scenario would have a relatively limited impact, reducing the aggregate spare lending capacity by around 15 per cent (fourth bar in Charts 1 and 2), the widespread deterioration in sovereign ratings assumed in scenario 1 would instead have more substantial implications. The increase in risk-weighted assets brought about by the combination of larger stocks of loans and riskier individual exposures pushes down the aggregate spare lending capacity by around 50 per cent, to US$ 450-590 billion (fifth bar in Charts 1 and 2). Due to higher risk weights and a greater responsiveness to credit rating changes, the erosion in lending capacity estimated through the S&P's methodology is somewhat larger than the one obtained through the Bank of Canada's methodology,

In scenario 2 we add a further channel through which MDBs' capital buffers and lending capacity could be affected. We assume a weakening of the preferred creditor treatment, due to the emergence of payment arrears leading a sizeable portion of sovereign exposures into non-accrual status[6] ("PCT channel"). In this scenario, the PCT channel is not isolated, but operates on top of the assumptions already captured in scenario 1.

Under scenario 2, the aggregate spare lending capacity would be drastically reduced, to a range of US$ 116-227 billion (last bar in Charts 1 and 2). Our calculations thus indicate a large overall impact, which seems to justify MDBs' opposition towards their participation to G20 debt relief initiatives. The impact would be quite heterogeneous at the level of each individual MDB, reflecting also their respective composition of loan portfolios. According to the S&P's methodology, in some cases the assumed increase in arrears would lead to a radical reassessment of the PCT (to the lowest PCT category: "weak"), which by itself would be enough to rule out the possibility of maintaining a triple-A rating, regardless of the size of capital buffers.

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[4] More details on the methodology applied in our analysis, including results disaggregated by individual MDB, will be available in a forthcoming paper.

[5] In nominal terms, the envisaged expansion in the stock of loans is slightly more than two times the increase observed post-GFC (US$ 83 billion, from end-2007 to end-2011), reflecting the doubling of EMDEs' GDP during the period.

[6] Both rating methodologies recognize substantial benefits linked to PCT, whose size is inversely related to the level of arrears. However, they differ on how they specifically quantify these expected benefits. For the S&P methodology, we calibrate scenario 2 by assuming that all countries eligible for the G20 Debt Service Suspension Initiative (DSSI) would enter into non-accrual status following the accumulation of arrears towards the MDBs. This scenario is largely consistent with the assumption of a NPLs ratio rising above 3 per cent made in the context of the BoC methodology.

3. Conclusions and policy suggestions

According to our estimates, MDBs entered the Covid-19 crisis with a large aggregate lending headroom that can be deployed to support borrowing countries. However, as MDBs expand their credit exposures in line with their counter-cyclical role, and as the effects of the crisis unfold putting pressure on sovereign ratings, this spare lending capacity could be eaten away rather quickly.

Moreover, a few factors are likely to limit the potential growth of capital resources in the next years. On the one hand, given the current circumstances, global interest rates are expected to stay very low for very long, which in turn will squeeze MDBs' margins and returns on their liquidity investments, weakening their capacity to generate equity internally. On the other hand, while initiating discussions around the adequacy of MDBs' capital resources in the post Covid-19 world would be advisable in principle[7], a significant new injection of fresh resources by shareholders is unlikely to be feasible in the immediate future, given: (i) the recent approval of capital increases at ADB, IBRD and AfDB; ii) the increasing tide of inward-looking policy stances in both advanced and emerging market economies; (iii) mounting pressures on public budgets.

Therefore, alternative actions need to be taken in order to preserve MDBs' ability to deliver on their development mission through the Covid-19 crisis.

One first crucial accomplishment for the next few months will be to ensure that borrowers stay current and avoid the emergence of non-accruals, in order to ward off the possibility that rating assessments discontinue the inclusion of PCT, a key pillar of MDBs' financial strength. To this end, it will be important to act pre-emptively together with the international community (for instance within the G20) in order to monitor sovereign debt dynamics, implement in a timely manner all measures needed to ensure debt sustainability and preserve the PCT of MDBs also in the context of possible future debt restructuring decisions.

On a more general level, additional efficiency gains could be obtained through the enhancement of cooperation and harmonization among MDBs' risk management and operational procedures, leading these institutions to work progressively more as a system.

At the same time, it would be advisable to revive the spirit of the Action Plan to Optimize Balance Sheets, endorsed by the G20 Leaders at the Summit in Antalya in 2015, with the objective of increasing these institutions' development exposures for given capital resources and whilst preserving triple-A ratings.

Possible options in this direction include the intensification of exposure exchange agreements among MDBs in order to improve asset diversification, especially for the regional institutions whose lending portfolios are more concentrated. In December 2015, AfDB, IADB and IBRD executed 3 bilateral exposure exchanges for a total of US$ 6.5 billion, leading to a material improvement in capital adequacy, especially for the AfDB; additional transactions could be explored, as the ADB has recently approved a new policy allowing the use of this instrument.

One further avenue is a more widespread use of risk sharing mechanisms with third party investors to relieve capital constraints and stretch lending capacity. This could be achieved through credit risk guarantees from non-borrowing, higher rated member countries or national development agencies. Similar effects could be delivered through other instruments such as subordinated debt and credit linked notes, as well as the securitization of MDBs' loan portfolios[8].

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[7] Some preliminary reflections on this front have just been put forward by the new President of the IADB.

[8] A synthetic securitization transaction was carried out in 2018 by the AfDB on an underlying portfolio of US$ 1 billion of private sector exposures. For sovereign loans, an important obstacle is represented by their typical pricing structure, as the interest rates applied to them are usually lower than market rates. In this context, some form of credit enhancement,

Given the heterogeneity among MDBs and the limited margins of manoeuvre characterizing most policy options, it is likely that no option by itself will be sufficient. Rather, it will be necessary to act in a parallel manner on all possible policy fronts, both internally at MDBs and externally through the engagement of the development community as a whole. Equally crucial will be to act in close coordination with other key partners – such as the IMF, UN agencies and national development institutions – in order to combine all available operational instruments and innovative approaches to reinforce MDBs' lending capacity through the Covid-19 crisis.

by a highly rated public institution, would be required in order to close the gap between market and book value of the loans securitized, thus attracting private investors and avoiding a balance sheet loss for the MDB.