

Nick K. Kolev¹

United Nations Capital Development Fund (UNCDF)

A sustainable MDB strategy: The crucial importance of financial sector development

Jonathan Stilwell²

Macro and Credit Strategist, FirstRand Bank

Introduction

MDBs are supranational institutions established by sovereign states on the basis of international treaties. Examples of MDBs are African Development Bank (AfDB), Asian Development Bank (AsDB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank Group (IDBG), and the World Bank Group (WBG). MDBs' shareholders—the investors in Ordinary Capital Resources (OCR)—are usually known as member countries and divided into two groups: borrowing member countries and non-borrowing member countries.

Some MDBs have funds with mandates covering the poorest countries, as well as fragile and conflict-affected states, which are replenished regularly. These funds are deeply concessional, and their contributors are Middle-Income Countries (MICs) and High-Income Countries (HICs).

When an MDB is a stand-alone entity (for example, AfDB, AsDB, and EBRD), financing of member countries (usually referred to as sovereign guaranteed lending or public-sector lending) and financing of commercial ventures (usually referred to as non-sovereign guaranteed financing or private-sector financing) are supported by the same balance sheet and credit ratings. However, when an MDB is a group entity (for example, IDBG and WBG), public-sector lending and private-sector financing are supported by different balance sheets and credit ratings. Therefore, the claim that MDBs should intensify their use of first-loss and guarantee products to catalyze private-sector participation is not well-defined. The claim is understandable if, due to similar control of and support for the separate entities, group MDBs are assumed to be institutions with combined public-sector and private-sector operations.

Public-sector operations and private-sector operations are based on distinct pricing methodologies. On the one hand, public-sector lending is on a pass-through basis: an MDB's borrowing cost—for

instance, an MDB's average funding spread to the Secured Overnight Financing Rate—is a factor in the lending rates that the MDB offers borrowing member countries. That is, the credit qualities of MDBs determine MDBs' lending rates to their borrowing member countries. On the other hand, private-sector financing tends to be on market terms. That is, risks are usually priced to estimate the required return (the appropriate discount rate or the cost of capital).

Towards a sustainable MDB strategy

MDBs have a countercyclical function: they increase their financing operations during economic downturns. Naturally, economic downturns affect both the public sector and the private sector. Since sovereigns are MDBs' owners, MDBs tend to prioritize public-sector lending over private-sector financing during tough times. The COVID-19 pandemic is a prime example.

Since positions that are junior in the capital structure are riskier than positions that are senior in the capital structure, if MDBs' de-risking operations are concessional (that is, if risks are intentionally underpriced), *ceteris paribus*, an expansion of MDBs' de-risking operations will constrain MDBs' financing capacities and weaken MDBs' balance sheets. The constraints will adversely impact both public-sector lending and private-sector financing.

MDBs' de-risking operations aim to crowd private-sector investors into SDG-positive projects at scale. Yet, if MDBs' de-risking operations constrain public-sector lending, borrowing member countries are unlikely to be supportive. Similarly, if MDBs' de-risking operations weaken MDBs' balance sheets, leading to higher MDB borrowing costs and higher MDB lending rates, borrowing member countries are unlikely to be supportive. Consequently, the strategy of de-risking operations on concessional terms is unlikely to be sustainable since it is not aligned with owners'—in this case, also clients'—interests.

Alternatively, MDBs can expand their de-risking operations on non-concessional—that is, market—

terms. If MDBs do so, risks will be properly priced, and any reduction in project risk will be accompanied by a corresponding reduction in project expected return. As a result, *ceteris paribus*, an expansion of MDBs' de-risking operations will constrain MDBs' financing capacities without weakening MDBs' balance sheets. However, reducing expected returns is usually not the way to attract interest from global investors—investors who are not known for scouring Emerging Markets (EM) for low expected returns.

If expected returns are reduced to levels prevalent in Upper MICs and HICs, what will incentivize global investors to finance projects in Low-Income Countries and Lower MICs? The very point about risk premia is that these are what is required to entice investors to put their capital at risk in the first place, and, in a well-functioning market the premium paid should be commensurate with the risk. (Marks, H. 2011) To take an extreme example, if the credit risk and market risk of a set of EM loans are reduced to those of US Treasuries, why will a global investor prefer the EM loans to US Treasuries? Since US Treasuries are highly liquid instruments that exist within a regulated market environment and a predictable legal framework, a global investor will probably prefer US Treasuries to the EM loans.

This example suggests that, while MDBs should be engaged in de-risking operations, it may be a more effective strategy for them to focus on structural, rather than project, risks. Being banks, MDBs ought to make significant contributions to FSD, which should be comprised of sufficient financial resources and relevant skill sets (as those of MDBs' Risk and Treasury experts).

In 1997, Ross Levine argued convincingly that there is a first-order relationship between financial development and economic growth. (Levine, 1997) Although Levine suggested that one should be cautious in drawing conclusions about the precise nature of the relationship, one may safely assume that, from a development finance point of view, the financial sector plays an important role in poverty alleviation, economic empowerment, and systemic transformation and is vital to the optimal growth of the real economy. It facilitates savings, and it enables the intertemporal trans-

fer of wealth. It transforms savings into investments, and it supports the optimal allocation of capital. It aggregates private information, and it fosters price discovery. It promotes risk sharing, and it provides risk management tools. It supplies credit and liquidity, and it facilitates payments and transfers. Therefore, building competitive and stable financial systems in Developing Countries is necessary and valuable work that helps reduce systematic risk.

In accordance with calls by the UN Secretary General (among others) for MDBs to mobilise private finance for development impact, it has been established that scaling development impact also requires significant work on achieving economies of scale for the financial architecture that enables development finance. Neil Gregory for example, has argued that economies of scale are required on legal frameworks (laws, regulations, supervisory bodies, etc.), market infrastructure (exchanges, central depositories, interbank rates, government yield curves, cross-border trading, etc.), and financial instruments (stocks, bonds, commodities, futures, derivatives, securitizations, thematic segments, etc.). Implementing the necessary institutional reforms successfully also demands local ownership, sound governance, and transparent accountability. (Gregory, N. 2016) Here the financial sector represents an essential public good for supporting these objectives, and MDBs have a crucial role to play in supporting its development.

Conclusion: A global FSD partnership

While the specific needs of each country should be taken into account, a country's benefits may be maximized when best practices are applied and when regional integration is advocated. In particular, benchmarking, knowledge sharing, and standardization generate long-term development impact. With this in mind, a global FSD partnership will deliver financial and operational efficiency and, with 2030 around the corner, efficiency is key to achieving the SDGs.

References

1. Levine, R. (1997) "Financial Development and Economic Growth: Views and Agenda." *Journal of Economic Literature*. Volume XXXV.
2. Marks, H. (2011) "The most Important Thing: Uncommon Sense for the Thoughtful Investor." Columbia Business School Publishing
3. Gregory, N. (2016): "Untangling Misconceptions about Blended Finance." Medium.

Footnotes

1. The views expressed herein are those of the author and do not necessarily reflect the views of the United Nations Capital Development Fund (UNCDF).
2. Writing in his personal capacity.
3. For the purposes of this document, the IDBG entities of interest are Inter-American Development Bank (IDB) and IDB Invest, and the WBG entities of interest are the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC). The European Investment Bank Group, which is the largest multilateral financial institution, is the bank of the European Union.
4. The raising of OCR is known as a General Capital Increase.
5. There is an almost perfect overlap between the shareholders of the public-sector lending entity and the shareholders of the private-sector financing entity, and the credit ratings of the public-sector lending entity and the private-sector financing entity are either identical or indistinguishable. At IDBG, IDB has 48 shareholders, and IDB Invest has 48 shareholders. (The UK joined IDB Invest on March 1, 2023.) The five largest shareholders of IDB are the United States, Argentina, Brazil, Mexico, and Japan. The five largest shareholders of IDB Invest are the United States, Argentina, Brazil, Mexico, and China. IDB is rated AAA, while IDB Invest has an AAA/AA+ split rating. At WBG, IBRD has 189 shareholders, and IFC had 186 shareholders. The two largest shareholders of IBRD and IFC are the United States and Japan. China, Germany, France, and the United Kingdom round up the top six shareholders at IBRD. Germany, France, and the United Kingdom round up the top five shareholders at IFC. IBRD and IFC are both rated AAA.
6. A notable exception is Blended Concessional Finance.
7. Among the AAA-rated MDBs, only EBRD has private-sector operations that eclipse public-sector operations.
8. The example, as this document, is theoretical. In general, empirical observations, such as the home bias, are not the subject of this document.