



Converting speculative-grade exposure into investment-grade exposure¹

Nick K. Kolev
Independent Consultant

Summary

The article outlines the essential elements of a methodology to convert speculative-grade (SG) exposure into investment-grade (IG) exposure. Since some developed market investors prefer IG exposure to SG exposure, the methodology can help emerging market (EM) asset holders optimize their balance sheets and financial operations.

The methodology involves debt issuance by triple-A rated development finance institutions (DFIs) and multilateral development banks (MDBs). Requiring capital markets, portfolio optimization, and structured finance expertise, it supports Group of Twenty (G20) priorities related to MDBs.

G20 and MDBs

In 2015, the international community adopted the Sustainable Development Goals (SDGs). The MDBs, which are supposed to provide countercyclical financial resources, play crucial roles in the endeavor to achieve the SDGs.² As vital pieces in the international financial architecture, they were major contributors to the Millennium Development Goals.

Each year, MDBs borrow through public issues and private placements.³ They have relatively large annual borrowing programs and high credit ratings. Because high credit ratings are particularly relevant to MDBs' sovereign guaranteed operations—lending to member countries that are both clients and shareholders, MDBs have striven to maintain their high credit ratings. With credit rating targets imposing binding constraints on financing operations, in 2013, the G20 asked finance ministers and central bank governors to “explore the ways in which private financing and capital markets can be better mobilized” and called on MDBs to “develop new

approaches in order to optimize the use of existing resources.”⁴ In 2015, the G20 endorsed the Antalya Action Plan, which contained five objectives: improve capital efficiency, deploy exposure exchanges, utilize the concessional windows, engage in risk sharing and transfer, and discuss net income measures with shareholders.⁵ In 2023, the G20 committed to increase substantially the financing capacities of MDBs, endorsed a review of MDB capital adequacy frameworks (CAFs), and called on MDBs to leverage private capital through innovative financing models.⁶ In 2024, G20 finance ministers and central bank governors issued a series of recommendations, including the following: strengthen countries through capacity building, boost private capital and domestic resource mobilization, continue the implementation of CAF reviews, and develop and promote innovative financial instruments.⁷

During the last decade, MDBs have executed creative transactions and made framework changes.⁸ Still, numerous opportunities with high development impact—especially in the areas of capital market development, local currency lending, and bankable project pipelines—exist.⁹

A liabilities approach based on guarantees

The specific guarantee-based liabilities approach to MDB balance sheet optimization presented in A Liabilities Approach to MDB Balance Sheet Optimization was intended to convince policymakers that the entire balance sheet warrants attention. The simple approach highlighted that, just as assets can be managed through insurance, liabilities can be managed through guarantees.¹⁰

An MDB that engages in sovereign guaranteed operations and non-sovereign guaranteed operations from the same balance sheet, such as AfDB, was con-

sidered.¹¹ Wishing to increase its volume of borrowing without an adverse effect on its credit ratings, since sovereign guaranteed lending is on a pass-through basis and non-sovereign guaranteed financing is on market terms, the MDB separates capital market operations associated with sovereign guaranteed lending from capital market operations associated with non-sovereign guaranteed financing¹² by creating Capital at Risk Notes (CaRNs) within its Global Debt Issuance Facility (GDIF).¹³ CaRNs are speculative instruments designed for sophisticated investors: they may contain numerous contingent claims; they do not have the credit ratings of GDIF; they need not be rated; and they are not required to be registered under the United States (US) Securities Act of 1933.¹⁴

With CaRNs, the MDB funds non-sovereign guaranteed operations from capital markets on the basis of non-sovereign guaranteed portfolios and third-party partial guarantees.¹⁵ The basic mechanics of a funding operation are as follows:

1. The MDB issues CaRNs backed by a) the flows from a non-sovereign guaranteed portfolio and b) the protection of a third-party partial guarantee;
2. The full amount of proceeds is invested in the non-sovereign guaranteed portfolio; and
3. The CaRNs are repaid from the income generated by the non-sovereign guaranteed portfolio, with any shortfalls covered, in part or in full, by the third-party partial guarantee.

The partial guarantee is obtained through a competitive process, and the non-sovereign guaranteed portfolio is originated in line with the MDB's regular standards.

Converting SG Exposure into IG Exposure

In the liabilities approach described above, the MDB can use partial guarantees to convert SG non-sovereign guaranteed portfolios into IG exposures. The credit rating of the guarantor and the coverage terms of the guarantee are determinative. Moreover, in principle, any EM asset holder with a reliable origination function can employ the approach. However, in practice, MDBs tend to have better access to guarantees than private-sector institutions. Therefore, a novel methodology, with the following basic mechanics, is proposed:

- a) A special purpose vehicle (SPV) purchases the flows from an SG portfolio;
- b) The SPV purchases triple-A rated notes from a DFI/MDB that bring its credit rating to the desired IG level; and
- c) The SPV issues IG notes that fund the purchases in a) and b).

In a), there are two reasons for the focus on flows. First, whenever the SG portfolio is originated by a DFI/MDB, the DFI/MDB should remain lender of record. DFIs and MDBs have lower rates of default than commercial lenders, and they are ideally positioned to manage borrower issues. Second, in order to align interests, the originator should retain some exposure to the SG portfolio. With flows, it is trivial to split the SG exposure between the originator and the SPV.

In b), the SPV could purchase US Treasuries to achieve a similar outcome. However, doing so would maximize neither development impact nor portfolio return. The borrowing programs of DFIs and MDBs should resolve challenges, and the US offers lower returns than triple-A rated DFIs and MDBs.¹⁶

As usual, the SPV may issue different tranches of IG notes.

Footnotes

1. This version of 22 April 2025 is partially based on the document A Liabilities Approach to MDB Balance Sheet Optimization (13 November 2023), which can be obtained from the author upon request.
2. MDBs are supranational institutions established by treaties. Examples of triple-A rated MDBs are African Development Bank (AfDB), Asian Development Bank, European Bank for Recon-

struction and Development, Inter-American Development Bank (IDB), International Bank for Reconstruction and Development (IBRD), and International Finance Corporation. MDBs' shareholders—the sovereign investors in Ordinary Capital Resources—are usually known as member countries. DFIs are bilateral institutions. DFIs are owned by individual countries, and they are assumed to serve the national interests of their countries. Examples of bilaterals with borrowing programs are Kreditanstalt für Wiederaufbau (known as KfW) and Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (known as FMO).

3. MDBs borrow both from the private sector and the public sector. Public-sector investors are usually identified as central banks and official institutions.
4. https://g20.org/wp-content/uploads/2024/10/G20_Russia_2013_communique-1.pdf
5. <https://www.g20.utoronto.ca/2015/Multilateral-Development-Banks-Action-Plan-to-Optimize-Balance-Sheets.pdf>
6. <https://www.mea.gov.in/Images/CPV/G20-New-Delhi-Leaders-Declaration.pdf>. The reviews of CAFs are to be implemented “within MDBs’ own governance frameworks while safeguarding their long-term financial sustainability, robust credit ratings and preferred creditor status.” The document Aligning MDB Shareholders’ Interests: Callable Capital, Preferred Creditor Status, and Sustainable Creditor Status (8 August 2022) can be obtained from the author upon request.
7. https://coebank.org/documents/1577/G20_Roadmap_towards_better_bigger_and_more_effective_MDBs.pdf
8. <https://publications.iadb.org/publications/english/document/Risk-Transfer-for-Multilateral-Development-Banks-Obstacles-and-Potential.pdf>. In 2024, AfDB launched the inaugural MDB hybrid capital transaction: <https://www.afdb.org/en/news-and-events/press-releases/african-development-bank-launches-historic-perpetual-non-call-perpnc-105-year-inaugural-usd-global-sustainable-hybrid-capital-transaction-68374>
9. For example, see Facilitating Local Capital Market Development Through Swap Counterparty Support (17 October 2024). Rational Pricing in Local Currency Non-Sovereign Lending (3 April 2025) and An LDC Market and Project Develop-

ment Hub (11 August 2023) can be obtained from the author upon request.

10. A guarantee is an instrument that is associated with a liability and represents a secondary claim. Insurance is an instrument that is associated with an asset and represents a primary claim. Hence, protection associated with a debt obligation is called a guarantee, and protection associated with a loan portfolio is called insurance. For instance, see https://www.sidley.com/%7E/media/files/publications/2010/12/credit-default-swaps-guarantees-and-insurance-po_/files/view-article/fileattachment/jnl-of-intl-banking-and-finance-law-jibfl-l-ng-a_.pdf.
11. Another term for “non-sovereign guaranteed operations” is “private sector operations.”
12. In this context, “pass-through basis” means that 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. This separation is realized without dividing the MDB into different institutions, as is the case at the IDB Group and the World Bank Group (WBG), with distinct balance sheets and shareholder compositions.
13. AfDB has a GDIF. IBRD, which is a member of the WBG, has both a GDIF and CaRNs.
14. The performance of the CaRNs is independent of the creditworthiness of the MDB.
15. Thematic portfolios—Financial Institutions, Infrastructure, etc.—can be constructed. Of course, another way to lower risk is to obtain insurance on the non-sovereign guaranteed portfolio.
16. The US has a split rating: it is rated AA+ (stable) by Fitch and S&P, and Aaa (negative) by Moody’s. Yet, triple-A rated DFIs and MDBs borrow US dollars at interest rates higher than the rates paid by the US.