



Aligning MDB shareholders' interests: callable capital, preferred creditor status, and sustainable creditor status¹

Nick K. Kolev
Independent Consultant

Summary

This article proposes the release of accumulated callable capital (CC) of borrowing member countries (BMCs) of multilateral development banks (MDBs), the formal recognition of preferred creditor status (PCS), and the establishment of sustainable creditor status (SCS).² The three proposals are made because, with COVID-19 behind it, the development community needs to make progress towards Agenda 2030 with a sense of purpose and a sense of urgency. Such progress requires a rational alignment of MDB shareholders' interests. Occurring under resource constraints, the alignment necessitates trade-offs.

The article focuses on MDB shareholders: sovereign states that are either BMCs or non-borrowing member countries. While its proposals can be interpreted as simultaneously advantageous and disadvantageous to each mentioned party, the article should not be read as examining every element necessary for agreement. Similarly, although the importance of mobilizing private-sector resources is recognized, only the need to incentivize participation of institutional investors in offshore sovereign bonds is discussed in a specific context.

The proposals contained in this article are meant to encourage stakeholder debate that produces constructive discourse and collective action.

Introduction

The purpose of this article is to propose three changes that have the potential of aligning the interests of MDB shareholders. The objectives of aligning MDB shareholders' interests are to ensure that MDBs can do more for their member countries and that MDBs' member countries can do more for themselves. MDBs' activities are expected to remain focused on their core missions, and MDBs' shareholders are expected to continue seeking innovative ways of attracting resources. Facilitating their member countries' sustainable development—in line with the Sustainable Development Goals (SDGs) and according to established milestones—is MDBs' core mission.

Two concepts that are common in the MDB space are discussed: CC and preferred creditor treatment (PCT).³ In addition, the concept of SCS is introduced in the context of sovereign bond issues.

The changes proposed are the following:

1. CC accumulated within MDBs that has been provided by BMCs is released without any effect on ownership structure or voting rights;⁴
2. MDB shareholders formally grant PCT to MDBs, converting PCT to PCS; and
3. BMCs, within a formal process, grant institutional investors in their offshore bonds SCS.

Changes 1 and 3 may be considered negative for MDBs, while change 2 may be considered positive for MDBs. However, should crowding institutional investors at scale into sustainable development projects be a policy priority for MDBs' shareholders, change 3 may be neutral—or even positive—for MDBs.

In the interest of readability, with one exception, the definitions employed by S&P are used.⁵ The exception is the term "MDB." S&P uses the term Multilateral Lending Institution (MLI):⁶

"Supranational institutions are those owned or established by governments of two or more countries. They are usually established by international treaties to pursue specified policy objectives and are generally not subject to commercial law. Multilateral lending institutions (MLIs) are a subset of this asset class. MLIs are usually established to promote economic development in their less-developed or regional member countries, facilitate regional integration, or expand cross-border trade."

Since some MDBs can do more than lend—they can invest equity and issue guarantees, this article prefers MDB to MLI.

Callable capital

CC is a standard feature in the MDB world:⁷

"Callable capital is a characteristic of most MLIs. It corresponds to a commitment by each shareholder to make additional capital available, but generally, only to prevent a default on an MLI's debt or a call of a guarantee. The size of capital subscriptions generally varies among members, in proportion to their ownership shares. However, the ratio of paid-in to callable capital is generally the same for each shareholder. An MLI's callable capital is typically a multiple of its paid-in capital and often exceeds not only paid-in capital, but also shareholders' equity. If an MLI were to make a capital call, each shareholder would be responsible for providing the percentage of the capital called to which it has subscribed. Moreover, a shareholder's responsibility for meeting a call on capital, up the amount to which it has subscribed, does not depend on whether other shareholders have paid up."

The relationship between CC and paid-in capital varies both among different MDBs and among a specific MDB's various general capital increases (GCIs). For instance, if a GCI is 100, CC may be 90, and paid-in capital may be 10.

CRAs assign CC limited value:⁸

"To our knowledge, no rated MLI has ever made a call on its callable capital. We only count callable capital as a form of extraordinary support for an MLI if we consider that its shareholders have sufficient ability and willingness to pay in such capital on a reasonably timely basis."

The ability and willingness of a shareholder to pay in the event of a call is linked to the shareholder's credit rating:⁹

"We only include the callable capital from the shareholders rated at or above the SACP of the MLI."

Hence, if an MDB's SACP is aa, the callable capital of shareholders rated below AA cannot contribute to a rating uplift (that is, the ICR is unaffected).

Similarly, if an MDB's SACP is aaa, a rating uplift due to CC is impossible (that is, again, the ICR is unaffected). Finally, a rating uplift cannot exceed three notches:¹⁰

"In our view, calling capital is an uncertain process. We therefore anticipate limiting the maximum support it can provide above the SACP. The maximum uplift due to callable capital is limited to three notches above the SACP."

For the above reasons, given the current economic environment and pressing policy objectives, the CC accumulated by BMCs should be released. These contingent obligations represent unnecessary burdens on developing countries.

From PCT to PCS

MDBs usually have exposures to sovereign states (sometimes, these operations are called sovereign guaranteed) and private-sector entities (sometimes, these operations are called non-sovereign guaranteed). PCT is related to sovereign operations:¹¹

"Preferred creditor treatment (PCT) on exposures to sovereigns. This is a cornerstone of the MLI sector that historically has enabled it to operate with low credit losses."

Specifically,¹²

"PCT status means that:

— MLIs have historically been exempt from participating in sovereign debt rescheduling coordinated by the Paris Club of bilateral creditors, while commercial lenders have generally not been exempt (under the principle of "comparability of treatment"); and
— When sovereigns do default to MLIs, these defaults are usually cured before commercial debt arrears because such clearance is usually a condition of resumed access to funding from the International Monetary Fund (IMF) and other MLIs."

The value of PCT is questioned by the CRAs:¹³

"... there have been a few cases where sovereigns have defaulted on a MLI and cured commercial debt arrears first. In other cases, MLI debt has been included in sovereign debt restructurings. ... Therefore, we assess a MLI's PCT status by considering arrears, typically over the past 10 years, and, based on our forward-looking view, whether a country will likely be in arrears in the near future."

The reason is the following:¹⁴

"PCT—which applies to sovereign exposures—cannot be legally enforced; it is a discretionary status that borrowing member countries afford to each MLI. In our opinion, an MLI gains PCT status through its perceived role and policy importance."

In other words, PCT is not a legal construct. As a result, if it were not a discretionary—but a legal—status, its value would be higher.

Are there ways of shifting to a de jure PCT, meaning PCS, from a de facto PCT? Such a shift can be accomplished either bilaterally or multilaterally. In the former case, an example would be a BMC committing to give priority to its obligations to an MDB. In the latter case, an example would be member countries amending an MDB's charter to include the requirement for each BMC to give priority to its MDB obligations.

Since

- a) each member country has a stake in an MDB's optimal operations,
- b) there is strong empirical evidence that MDBs tend to be prioritized by sovereigns, and
- c) MDBs are countercyclical institutions by design, a shift to PCS from PCT is a good idea.

SCS

Under the auspices of the United Nations (UN), sovereign states committed to Agenda 2030. At the time the commitment was made, it was generally accepted that private-sector participation was a necessary condition for achieving the SDGs. In the wake of COVID-19, crowding private-sector resources in SDG-positive initiatives optimally and at scale has become a matter of urgency. Thus, it is important for the development community to identify and operationalize incentives that generate a major increase in private-sector financing of high-impact projects in developing countries.

Sovereigns borrow from MDBs in hard currencies. Due to PCT, MDBs have historically experienced low credit losses, which is why MDBs' lending terms may not be as deeply concessional as some believe. Many sovereigns that borrow from MDBs are keen on accessing international capital markets in hard currencies. While various innovative modalities for crowding in institutional investors can be explored, a modality with significant development impact is one that supports sovereigns adequately in their nascent international borrowing operations. To be adequate, support should consider a sovereign's debt position, minimize the cost of borrowing, and avoid market distortions.

To encourage private-sector participation, per-

haps once PCS has been established, institutional investors should be granted SCS whenever they invest in offshore sovereign bonds the proceeds of which are dedicated to SDG-positive projects.¹⁵ The meaning of SCS is the following: obligations covered by SCS will be excluded from any sovereign debt restructuring process.¹⁶ In other words, when supporting SDG-positive projects by investing in offshore sovereign bonds, commercial institutions will benefit from the equivalent of PCT enjoyed by the IMF and the MDBs.

The SCS concept needs to be put in perspective. First, according to empirical evidence, commercial institutions are de facto ranked above bilateral institutions.¹⁷ This may be a reason why, between 2008 and 2018, government bilateral debt decreased by 7%, while government commercial debt increased by 8%.¹⁸ Second, within a sovereign restructuring, various obligations are regularly excluded. For instance, because of their importance to continued economic activity, trade credits and treasury bills are usually excluded.¹⁹ Ultimately, all stakeholders must decide how important private-sector participation is to deliver on the SDGs.

As is the case with most novel ideas, implementation will determine success. The IMF and the UN may wish to work jointly with sovereigns to ensure that SCS is used appropriately and optimally, such as in the case of thematic bonds related to the SDGs that do not lead to a significant increase in sovereigns' indebtedness. Appropriate and optimal utilization of SCS should allow MDBs to deploy their capital bases effectively.

Footnotes

1. This article is based on a paper of 8 August 2022.
2. MDBs are assumed to be highly rated by the main credit rating agencies (CRAs), namely, Fitch, Moody's, and Standard & Poor's (S&P). In addition, the shareholders are assumed to be sovereign states. These assumptions are made only to keep the article short: these assumptions can be relaxed on a case-by-case basis. The terms "shareholder" and "member country" are used interchangeably.
3. PCT is occasionally called PCS. For the purposes of this article, the difference between "treatment" and "status" is key: treatment refers to consistent or inconsistent practice, while status refers to legal commitment. PCT is not limited to MDBs; for instance, the International Monetary Fund (IMF) benefits from PCT.
4. This means that, using S&P terminology, ac-

cumulated CC that does not lead to an improvement from the Stand-Alone Credit Profile (SACP) to the Issuer Credit Rating (ICR) is released.

5. Supranationals Special Edition (October 27, 2021). S&P Global Ratings, Available at <https://www.spglobal.com/ratings/en/research/pdf-articles/211027-supranationals-special-edition-2021-100658635>.
6. Ibid., p. 6. S&P's usage is correct in the context of its analysis because MDBs offer their BMCs grants and loans.
7. Ibid., p. 45.
8. Ibid., p. 30.
9. Ibid., p. 45.
10. Ibid., pp. 45-46.
11. Ibid., p. 6.
12. Ibid., p. 33.
13. Ibid., p. 33.
14. Ibid., p. 30.
15. SCS is to have a limited lifespan. A natural cutoff—defined as the date of issuance—for SCS-eligible bonds is the year 2030.
16. The implication is that institutional investors will receive all interest and principal amounts, except that the amounts may not be paid on the originally promised dates.
17. Schlegl, Matthias and Trebesch, Christoph and Wright, Mark L.J., *The Seniority Structure of Sovereign Debt* (2019). CESifo Working Paper No. 7632, Available at SSRN: <https://ssrn.com/abstract=3387668> or <http://dx.doi.org/10.2139/ssrn.3387668>.
18. *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors – Recent Developments, Challenges and Reform Options* (September 23, 2020). International Monetary Fund, Available at IMF: <https://www.imf.org/-/media/Files/Publications/PP/2020/English/PPEA2020043.ashx>, pp. 14-15.
19. Buchheit, Lee C. and Chabert, Guillaume and DeLong, Chanda and Zettelmeyer, Jeromin, *How to Restructure Sovereign Debt: Lessons from Four Decades* (May 13, 2019). Peterson Institute for International Economics Working Paper No. 19-8, Available at SSRN: <https://ssrn.com/abstract=3387455> or <http://dx.doi.org/10.2139/ssrn.3387455>, p.5.