

Pricing in Sovereign Guaranteed Operations: Methodology and Fairness

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This article examines the methodology and fairness of multilateral development bank (MDB) pricing in sovereign guaranteed operations (SGOs). Cognizant of the complex nature of the concept of "fairness," a novel methodology based on proportionality is proposed.

MDB Pricing in SGOs

In SGOs, MDB **pricing tends to be based on MDB borrowing cost**. For example, the Flexible Financing Facility (FFF) of Inter-American Development Bank (IADB) has three components: the Secured Overnight Financing Rate (SOFR), the funding margin, and the Ordinary Capital lending spread.^[1] Similar to IADB's FFF, the Fully Flexible Loans (FFL) of African Development Bank (AfDB) in United States (US) dollars (USD) have four components: SOFR, funding cost margin, lending margin, and maturity premium.^[2] In particular, **neither IADB's FFF nor AfDB's FFL takes credit risk into account**.

Unlike AfDB and IADB, **the European Investment Bank (EIB) claims to take credit risk into account**.^[3]

The EIB's attractive pricing is the result of the trust investors have in us, which translates into advantageous funding costs on the financial markets. EIB adds a margin on top of its funding interest rate to cover the risks and administrative costs associated with each operation. The interest rate or guarantee fee of our product therefore reflects the credit risk profile of the individual project.

However, EIB still uses its funding cost as a base rate. In fact, EIB's funding cost is a pricing component across operations.^[4] **If pricing were truly risk-based, EIB's funding cost would be immaterial because the required return for a project would depend exclusively on the risk of the project.** To illustrate, in order to determine the required return for a five-year risk-free project in USD, one only needs to look up the return on the five-year US Treasury.

Focusing on an MDB's net interest margin, in the absence of risk-based pricing of purpose-related investments, can be misleading. The approach is analogous to risk-neutral pricing. A supporter might point to an MDB's triple-A ratings (on the liabilities side) and Preferred Creditor Treatment (on the assets side), with the latter partially explaining the significant differences between average default rates on SGOs and average default rates on non-SGOs. Nevertheless, although some may be comparable to those of investment-grade portfolios, average default rates on SGOs are not comparable to triple-A portfolios.^[5]

Fairness of MDB Pricing in SGOs

In effect, **pricing in SGOs tends to follow a “club deal” mindset**: although they may have different credit qualities, countries within the same group get the same pricing. Of course, **this pricing methodology, while commendable for its spirit of solidarity, is unfair.**^[6] Despite the fact that all borrowing countries benefit from heavily subsidized pricing based on the triple-A funding costs of MDBs, **some countries benefit more than others.**

AfDB and IADB are different from EIB. AfDB and IADB have regional member countries (also known as borrowing member countries) and non-regional member countries (also known as non-borrowing member countries).^[7] This means that, **even though it is the second-largest shareholder in AfDB and the largest shareholder in IADB, the US cannot borrow from AfDB or IADB.** EIB does not divide its member states into regional/borrowing member countries and non-regional/non-borrowing member countries. All EU countries can borrow from EIB. Basically, because non-regional/non-borrowing member countries provide equity but do not borrow, **AfDB and IADB can afford to ignore credit risk completely. EIB cannot do so.**

The cost of capital associated with an investment depends mainly on the riskiness of the investment: it is the use of the money, not its sources, that matters.^[8] **While MDBs do not pay dividends to their sovereign shareholders, the weighted average cost of capital for an MDB can still be interpreted as the required return on the MDB’s assets.** This required return depends on the riskiness of the assets: it does not change due to changes in the MDB’s capital structure or dividend policy.^[9]

Ability, Desire, and Diversification

If it might borrow USD from AfDB or IADB, the US would not choose to do so. Both AfDB’s USD bonds and IADB’s USD bonds have positive spreads over US Treasuries. **This is despite the fact that the US is rated one notch below AfDB and IADB:** AA+ (stable) by Fitch^[10], Aa1 (stable) by Moody’s^[11], and AA+ (stable) by S&P^[12]. For the same reason, **although it can, the Federal Government of Germany (Germany) does not borrow euro (EUR) from EIB.** Both EIB and Germany are triple-A rated, but EIB’s EUR bonds have positive spreads over German securities.

Naturally, in their liquidity portfolios, AfDB holds US Treasuries and EIB holds German securities. While this is equivalent to lending to the US and Germany, respectively, this is not the salient point: SGOs are vastly different from capital market transactions. For their liquidity portfolios, AfDB does not purchase USD bonds issued by, say, the Government of Ghana, and EIB does not purchase EUR bonds issued by, say, the Government of Romania.

The examples of AfDB/US and EIB/Germany demonstrate two fundamental principles of diversification: **if you are uniquely the best, diversification can only hurt you; and, if you are uniquely the worst, diversification can only help you.** Hence, **diversification is not a sufficient condition for productive collaboration.**

Fair MDB Pricing in SGOs

Fairness tends to foster productive collaboration, and, when every member country may borrow from an MDB, **access and pricing are two crucial elements by which fairness is judged.** If every member country has a financial incentive to borrow, then pricing should not be a de facto access barrier. If every member country has an equal—by some measure—financial incentive to borrow, then pricing should be fair.

A proportional discount is an equal financial incentive to borrow: every member country obtains the same pricing discount relative to its commercial market—or, fair, according to commercial markets—pricing. For example, **if the discount is 20% and a country borrows in markets at 10%, then the country can obtain an MDB loan at 8%.** Specifically, **if the MDB and the US both borrow at 5%, then the US can borrow from the MDB at 4%.**^[13]

The proportional discount pricing methodology is transparent: it is easy for any observer to see the credit risks borne by the MDB.^[14] In the above example, with a discount of 20%, the MDB prices 80% of its borrowers’ credit risks. Essentially, **the MDB offers its borrowing countries discounted risk-based pricing.**

Certainly, **the MDB can impute its various margins—funding, lending, maturity, etc.—into the discount.**

A Closer Look

Assume that an MDB with five member countries—A, B, C, D, and E—borrows USD 100 at 5% and that its various margins add up to 1.25%. This means that, to break even, the MDB must lend the USD 100 to its countries at a weighted average interest rate of 6.25%. Suppose that the MDB observes the following:

- Country A needs USD 10 and can borrow in markets at 5%;
- Country B needs USD 20 and can borrow in markets at 7%;
- Country C needs USD 40 and can borrow in markets at 8%;
- Country D needs USD 20 and can borrow in markets at 9%; and
- Country E needs USD 10 and can borrow in markets at 11%.

Consequently, the MDB sets the discount at 21.88%:

Country	Loan	Market Rate	MDB Rate	MDB Interest
A	10	5.00%	3.91%	0.39
B	20	7.00%	5.47%	1.09
C	40	8.00%	6.25%	2.50
D	20	9.00%	7.03%	1.41
E	10	11.00%	8.59%	0.86
TOTAL	100			6.25

Footnotes

1. <https://www.iadb.org/en/how-we-can-work-together/public-sector/financing-solutions/interest-rates-and-charges>

2. https://www.afdb.org/sites/default/files/documents/financial-information/adb_applicable_lending_rates_for_sovereign_and_sovereign_guaranteed_loans_-_feb_-_aug_2025.pdf There is also a “spread adjustment rate,” which may be added to the lending margin as a “strategic control measure.”

3. <https://www.eib.org/en/products/pricing-and-other-terms>

4. <https://www.eib.org/en/products/loans/public-sector/index> and <https://www.eib.org/en/products/loans/private-sector/index> state “Attractive pricing, reflecting the EIB’s advantageous funding conditions on the market.”
5. For the period 1990-2023, Asian Development Bank (ADB) has an average annual default rate of 0.54%: <https://www.adb.org/sites/default/files/institutional-document/1002581/adb-sovereign-default-and-loss-rates.pdf> Significantly different from ADB, for the period 1984-2023, the Global Emerging Markets Risk Database, known as GEMs, has an average annual default rate of 1.06%: https://www.eib.org/attachments/lucalli/20240218_sovereign_and_sovereign_guaranteed_lending_1984_2023_en.pdf
6. The unfair treatment does not incentivize borrowing countries to improve debt management, fiscal policies, or political environments.
7. <https://www.iadb.org/en/who-we-are/how-we-are-organized> and <https://www.afdb.org/en/about-us/corporate-information/members>
8. MDBs do not pay taxes. In addition, because their sovereign shareholders are extremely averse to reputational risks, they face immaterial costs of financial distress.
9. Concentrating exclusively on notional amounts, as in the cases of holding debt to maturity or relying on historical cost accounting, does not change this fact.
10. <https://www.fitchratings.com/entity/united-states-of-america-80442210#ratings>
11. <https://www.moodys.com/web/en/us/about-us/usrating.html>
12. <https://www.spglobal.com/ratings/en/regulatory/article/-/view/sourceid/101641039>
13. The examples use fixed rates and annual interest payments for the sake of simplicity.
14. Because every member country obtains the same pricing discount, the use of “credit risks” here is loose: credit risk is one component of an interest rate. To illustrate, under the assumption that the US has no credit risk, the MDB cannot possibly offer the US a positive pricing discount on the basis of credit risk alone.