



Italian G20 Presidency

Third G20 Finance Ministers and Central Bank Governors meeting

Annex I

**An Independent Review of Multilateral
Development Banks' Capital Adequacy
Frameworks
Terms of Reference**

9-10 July 2021



Annex I: An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks Terms of Reference

Context

Developing countries have lost almost 5% of their Gross Domestic Product in 2020 as a result of the COVID-19 crisis. External financing needs for these countries are expected to have increased by up to USD 700 billion a year as a result of the pandemic, with Low Income Countries (LICs) needing around USD 450 billion over the period 2021-2025. This is in addition to the c.USD 2.5 trillion of financing a year needed to support the Sustainable Development Goals (SDGs) and the USD 100 billion committed to climate financing¹.

Multilateral Development Banks (MDBs) have a critical role to play in providing affordable financing to support economic recovery and to help achieving SDGs in a post-pandemic context. MDBs' scope to leverage shareholders' capital contributions to provide such financing is determined by their capital adequacy frameworks (CAFs). The crisis has demonstrated the importance of scaling up MDBs financing, but also highlighted the constraint imposed by their CAFs in permitting them to go further in supporting their clients' recovery.

As part of the *G20 Action Plan on Balance Sheet Optimisation*, the MDBs are exploring measures to enable further leveraging. However, such measures assume that CAFs remain unchanged, potentially missing options to unlock additional MDB financing. External sources, including the Credit Rating Agency (CRA) Standard and Poor's (S&P), have identified opportunities for a substantial boost in MDB investment capacity - in the range of USD 500 billion to USD 1 trillion - by revising their CAF policies, while preserving their current credit ratings².

MDBs' shareholders and management would also benefit from transparent, objective and consistent metrics against which CAFs across the MDBs might be assessed, when taking strategic decisions impacting capital utilisation. Generally, the capital and liquidity standards and rating methodologies applied to MDBs are adapted from those developed for commercial banks and adjusted to MDBs. More systematic and updated information would be desirable to assess whether these adjustments adequately reflect the unique characteristics of MDBs including preferred creditor status, callable capital, counter-cyclical and long-term sustainability objectives, and default experience.

¹ Sources: IMF (October 2020) 'World Economic Outlook'; World Bank (October 2020) Paper to Development Committee; IMF (March 2021) "Macroeconomic Developments and Prospects in Low-Income Countries".

² Standard and Poor's (2017) 'Key Considerations for Supranationals' Lending Capacity And Their Current Capital Endowment'; Settimo (2019), 'Higher multilateral development bank lending, unchanged capital resources and triple-a rating. A possible trinity after all?' Italian Central Bank; Munir and Gallagher (2018) 'Scaling up Lending at



These Terms of Reference form the basis for the G20 International Financial Architecture (IFA) Working Group to commission an independent review of MDB CAFs. This is consistent with G20 Finance Ministers and Central Bank Governors' (FMCBGs) steer to “explore potential new measures to maximize MDBs’ development impact, according to their mandates and while protecting their credit ratings” (G20 Communiqué, April 2021) and the G20 Eminent Persons Group (EPG) on Global Financial Governance (2018). The Review will take into account and build on the existing G20 work on Balance Sheet Optimisation, which will continue separately under the G20 IFA Working Group with MDB participation.

Objectives and Scope of the Review

The G20 IFA Working Group will commission an independent review of MDBs’ CAFs, while maintaining their robust credit ratings (i.e. AAA) and preferred creditor status, respecting their individual mandate, governance arrangements and policies. The Review is intended to help MDBs better serve their clients, without placing undue burden on staff time and resources of the MDBs. Key objectives of the Review are to:

- 1) **Provide credible and transparent benchmarks on how to evaluate MDB CAFs** - including on MDB-specific issues such as callable capital, concentration risk, and preferred creditor treatment - to facilitate a comparable reading of CAFs and of MDB evaluation methodologies used by CRAs across the MDB system.
- 2) **Enable shareholders, MDBs and CRAs to develop a consistent understanding of MDBs capital adequacy frameworks**, as well as potential lending headroom at prevailing credit ratings on a case-by-case basis that recognises the MDBs strong capital position, financial track record, and their central role in providing development and countercyclical finance.
- 3) **Enable shareholders to consider potential adaptations to the current frameworks in order to maximise the MDBs’ financing capacity** (and their ability to respond to crises) while maintaining long-term financial sustainability, credit ratings and preferred creditor status.

The Review will develop the key areas to focus analysis, in consultation with the G20 IFA Working Group. An overview of likely questions for assessment are included in the Annex. The key MDBs to include in the Review are the: African Development Bank (AfDB); Asian Infrastructure Investment Bank (AIIB); Asian Development Bank (AsDB); Caribbean Development Bank (CDB); Development Bank of Latin America (CAF); European Bank for Reconstruction & Development (EBRD); European Investment Bank (EIB); Inter-American Development Bank (IDB); Islamic Development Bank (IsDB); New Development Bank (NDB); and World Bank Group (IBRD, IDA, IFC, MIGA).

The Review will not seek to impose a regulatory framework on MDBs, and will ensure it does not create any perception of doing so. Any output of the Review should be discussed

the Multi-Lateral Development Banks: Benefits and Costs of Expanding and Optimizing MDB Balance Sheets', Boston University.



within MDBs' own governance arrangements and according to each MDBs' risk appetite, in full acknowledgment that MDBs are independent and governed by their shareholders.

While recognising their different mandates, governance, geographical focus, regional dimension and sectoral exposure, the Review will consider the MDBs as a class of institutions, with characteristics that set them apart from commercial banks, investment banks, insurance companies and non-profit organizations.

The Review will also respect the independence of the CRAs, which have autonomy over their ratings methodologies. It will provide an independent perspective to inform shareholder engagement at individual institutions, with a view of safeguarding their preserving credit ratings and their treatment as a preferred creditor. The Review will follow established definitions, frameworks and taxonomies of multilateral institutions.

The recommendations will not pre-empt future capital adequacy measures at individual institutions, but rather provide indication on how MDB CAFs should be assessed in general, considering differential mandates and geographic and sectoral scope. Access to empirical data from individual MDBs will be essential to inform this exercise. The Review will not examine, and is not intended to prompt discussion of, any suggestions of capital increases, but it could provide tools to eventually inform future discussions on MDBs' potential capital needs.

Governance

The Review will report to the G20 IFA Working Group. The recommendations of the Review will be advisory and non-binding on the G20, MDBs or their shareholders. Publication of the Review will be left to the discretion of the G20 International Financial Architecture Working Group.

The Review will be independent from the MDBs and CRAs, but will engage with these stakeholders throughout the process in an open and consultative manner. G20 shareholders will call on MDBs to provide information requested by the Review team. Any institution-specific information shared with the review team by MDBs or CRAs will be treated in confidence as required by the institution, under the control of shareholders.

The Review team will comprise:

- **An Expert Chair** to provide senior leadership, oversee the process and conclusions, and report to the G20 IFA Working Group.
- **An Expert Panel** to meet regularly during the Review process to provide technical analysis, bring in views from expert stakeholders, provide advice to the Expert Chair to inform their recommendations, and ensure the Review outputs are consistent with the mandate and governance of the MDBs. The Panel, composed by a limited group of experts, will be chaired by the Expert Chair. Membership of the Panel will be determined in consultation with the IFA Secretariat, with a balanced composition and will include also the MDBs and CRAs as observers.



As part of its review of the salient features of the MDB Capital Adequacy Frameworks and for any questions related to the Basel regulatory framework, the Expert Panel will benefit from the technical advice of the Basel Committee on Banking Supervision (BCBS) as appropriate. The BCBS will not contribute to making policy recommendations.

The Italian G20 Presidency, in consultation with the IFA Secretariat, will make arrangements for the provision of administrative support as required. The G20 IFA Working Group will select the Expert Chair and Expert Panel members through written procedure, with the aim of formally nominating them after the July FMCBG meeting. Key selection criteria will include independence, technical capacity, as well as a sound understanding of the development landscape and the mandate of MDBs. Composition of the panel, and of the short list of candidates for expert Chair, will seek to take into account the diversity of the G20 membership.

Timeline

An Update on the initial stages of the Review will be discussed at the G20 IFA Working Group in the Fall of 2021. The Review will end in 2022, with exact delivery date of the full report to be determined by the 2021 Annual Meetings.



ANNEX: Potential Areas for the Review to Focus

I. Salient features of MDB Capital Adequacy Frameworks

- How do the MDBs approach capital adequacy? What are the key metrics each MDB uses and what is the basis for them (e.g. income, solvency)? How to assess and optimize statutory capital ratios to maximize MDBs' development impact? How do the MDBs treat credit guarantees vs traditional loan instruments on their balance sheets? Does this reflect the relative credit risk of these instruments?
- To what extent do MDB-specific characteristics (e.g. features of callable capital of all shareholders, access to funding, exposure concentration, preferred creditor status) and characteristics that differ between the MDBs (e.g. share of lending to public / private sector, access to liquidity backstop, regional and geographical dimension) determine the approaches and metrics used across the MDBs?
- How do the current levels of MDB exposure and capital endowments compare across institutions and are linked to specific regional development financial needs?
- How do MDBs incorporate stress testing or otherwise establish buffers in their capital adequacy frameworks and how do they compare? How do MDBs take into account the impact of market risk on their respective buffers, in particular at regional level?
- What are the comparative implied risk appetites of the MDBs? How does this compare to the MDBs experience of loan default / non-accrual and resulting financial losses?

II. Understanding CRA approaches to MDBs' rating assessments

- How do credit ratings agencies (i.e. S&P's, Moody's, Fitch) assess MDBs' capital adequacy? How do they account for the specific characteristics that set MDBs apart from commercial financial institutions? How distinct are the methodologies CRAs use to assess MDBs and commercial financial institutions? What differences exist, especially considering the intrinsic rating? How do CRA's incorporate the 'risk' of the MDB's clients into their assessment?
- How do CRAs assess the interactions between their assessment of capital adequacy and other factors (such as governance, risk management, liquidity, trends) through changes in exposure? How formalised are these interactions?
- How can MDBs' countercyclical policies proceed without being affected by the procyclicality of credit rating assessments?
- Have MDBs' credit ratings changed over time, and on what grounds?

III. MDBs experience: access to capital markets and exposures

- Who are MDBs' bondholders?
- What are the factors determining the terms at which MDBs can borrow from capital markets? How has demand and / or terms for MDBs bonds been varied?
- What are the current and long-term sustainability constraints / limiting factors of MDBs' exposure? How do they relate to institutional capital adequacy frameworks and/or CRA approaches?



IV. Future considerations for framework design

- How should callable capital and its utilisation be considered in MDBs' capital adequacy approaches?
- How to best model/assess concentration risk and any other MDB-specific characteristics, within their sovereign and private investment portfolios?
- Could the assessment of the interaction between quantitative (e.g. capital adequacy) and qualitative (e.g. governance, risk management) aspects of the ratings frameworks be improved?
- Could a suite of benchmarking indicators enable a more consistent assessment of capital adequacy frameworks and help identify best practices across the system, while respecting each individual institution's governance and operational models?