MDBs: could callable capital help boost lending?

Leveraging MDB resources to address G-20 priorities

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Clarifying the process by which multilateral development banks (MDBs) can make capital calls on their shareholder governments – and how they in turn account for them from a budgetary perspective – could raise the loss-absorbing capacity of MDB balance sheets.

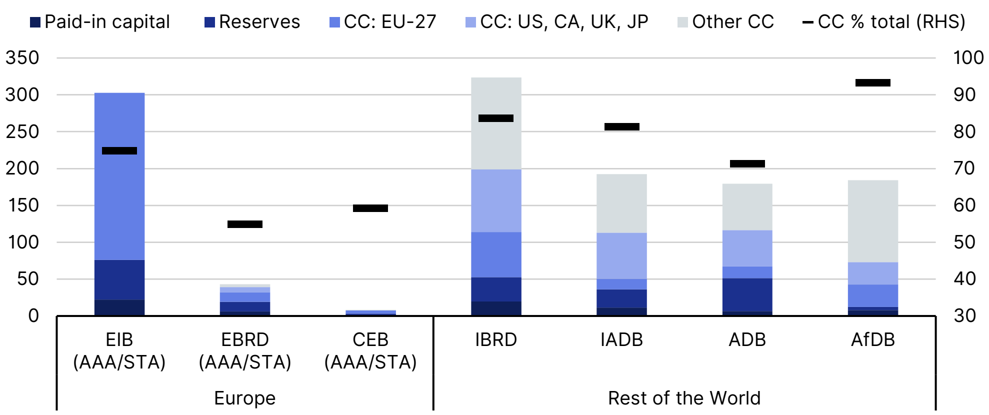
Western-led multilateral lenders have callable capital close to EUR 1trn of which 60% is held by the G-7 and EU-27 shareholders, and 50% is concentrated at the EIB (AAA/Stable) and World Bank (IBRD). By contrast, for the select MDBs analysed, paid-in capital is just over EUR 74bn and accumulated reserves around EUR 177bn[1].

Callable capital, which constitutes an obligation for or promise by shareholder governments to provide capital if ever needed, thus accounts for about 60-90% of each MDB's capital. Its potential use as a loss-absorbing instrument thus matters as MDBs seek to leverage their resources to finance G-20 policy priorities while preserving their high credit ratings. Over the coming years, significant resources will be needed for the reconstruction of Ukraine, the green transition, helping countries achieve the SDGs or facilitate debt-relief, among other priorities.

MDBs aim to leverage their resources by optimising balance sheets, increasing lending capacity, and crowding-in private-sector resources. In this context, clarifying how and under which circumstances callable capital could be deployed could give this instrument greater value as a financial backstop when assessing MDB capital adequacy.

Figure 1: Paid-in capital, accumulated reserves and callable capital of select MDBs

EUR bn; % of total capital (paid-in, reserves, callable)



NB. CC = callable capital. European Investment Bank (EIB), European Bank for Reconstruction and Development (EBRD), Council of Europe Development Bank (CEB), International Bank for Reconstruction and Development (World Bank), Inter-American Development Bank (IADB), Asian Development Bank (ADB), African Development Bank (AfDB).
Source: Respective MDBs, Scope Ratings

[1] These figures exclude the European Stability Mechanism (ESM), which has callable capital of EUR 628bn, paid-in capital of EUR 81bn, and reserves of EUR 3.3bn.

'Gone concern' treatment and procedural uncertainty limit current value

No history of capital calls among major MDBs

To date however, callable capital is untested as there has never been a capital call by any major MDB for two main reasons.

First, MDBs generally state that callable capital would only be used in a so-called 'gone concern' scenario, that is, when all other MDB resources have been used up to repay its creditors before permanently shutting down. MDBs are thus managed such that a capital call is not expected to occur.

Secondly, few international rules or sanctions oblige a sovereign to comply with a call. While failure to honour a call may result in suspension of MDB operations or even shareholder voting rights in some instances, compliance may still require budgetary approval from a national parliament. Callable capital is therefore usually not appropriated or provisioned for by shareholder governments.

Consequently, in past stressed scenarios that could have risked the AAA-status of MDBs, shareholders agreed to implement a pre-cautionary general capital increase, demonstrating their commitment to the institution, building its capital buffers while at the same time increasing its lending capacity.

Would shareholders honour a capital call, and if so, how quickly would the capital be paid?

As capital calls have never been tested, there remains significant uncertainty regarding the process by which shareholders would meet their obligation to respond to a capital call. Moreover, it is also unclear whether all shareholders would be able to honour their commitments and how much time it would take for the MDB to receive the capital should a call ever be made.

This is also because the position of callable capital in the waterfall against losses (usually after provisions, net income, reserves, and paid-in capital) implies that there would have been a significant loss in the portfolio. For MDBs that lend mostly to the sovereign sector, there is the additional risk that the NPLs driving the need to call callable capital could prevent the affected shareholder from honouring the call at that specific point in time.

At the same time, it is also likely that if a capital call were to be made by governments for an institution they established, it would be honoured given the reputational risks of not honouring such a call, provided shareholders can pay.

For this reason, we currently account only for the callable capital of highly rated shareholders for our credit rating assessment. With no record of its use, callable capital provides limited uplift to our MDB ratings of at most 2-notches in case the amount of callable capital of investment-grade rated shareholders exceeds outstanding loans and guarantees. Nonetheless, we do not incorporate callable capital into the stand-alone or intrinsic financial profile assessment of the MDB.

Could callable capital become a 'going concern' instrument?

This could change should callable capital be treated by MDBs as a 'going concern' instrument, which MDBs can access to recover from a temporary crisis that weakens their balance sheets.

Shareholders need to be prepared to increase the probability of a call on callable capital to increase its value as a loss-absorbing instrument

This treatment would require important clarifications and likely treaty or statutory changes, including how callable capital relates to other loss-absorbing instruments, the circumstances that can lead to a capital call, the process of a call, and the purposes for which the resources can be used.

This implies that shareholders would need to be prepared to increase the probability of a call on callable capital. For this, specified non-viability triggers would be needed to allow MDBs to manage their operations to avoid such conditions, and in turn, to provide clear guidance to shareholders and investors on the likelihood of such a call.

Hybrid instruments could provide guidance on these issues. For example, the AfDB's forthcoming hybrid debt issuance references a mandatory coupon cancellation should the ratio of Total Assets / [Paid-In Capital + Reserves] exceed 7.5x, implying a capital depletion of approximately 50% based on 2022 figures.

Moreover, the AfDB states that investors would lose the principal upon a call on its callable capital, which can only be made if the MDB is unable to meet its borrowing and guarantee obligations. Still, even in this case, it is unclear how quickly shareholders would honour such a call.

The ESM (AAA/Stable) has the strongest capital call mechanism and the largest outstanding callable capital (EUR 628bn), reflecting its crisis-driven mandate and the fact that it is among the most recently established institutions. Capital calls are permitted in several specified instances, including emergencies and losses. The ESM's Managing Director, rather than the Board of Directors or Governors as is the case at most MDBs, can make an emergency capital call to avoid default on any ESM payment obligation, which is to be paid within seven days of receipt by member states.

More flexibility for use of capital calls at ESM

The ESM Board of Directors can also make a capital call to restore the level of paid-in capital if it were reduced due to loss absorption below the threshold of 15% of the maximum lending volume of the ESM. Contrary to the emergency capital call, which can only be made to meet 'liabilities', that is, ESM obligations to creditors, one can interpret a capital call to restore the level of paid-in capital to the maximum lending volume as a backstop to lending activities, raising the value of callable capital to equity risk capital.

Budgetary treatment of shareholders' callable capital

Vital to clarify government procedures, budget provisions

But even in the case of the ESM, which has defined the circumstances under which a capital call could be made, including for non-emergencies, it is unclear how its shareholders have prepared and accounted for the possibility of such a potential call. More clarity on government procedures and budgetary accounting could raise the value of callable capital as a financial backstop.

We understand that callable capital is usually defined as a 'remote' contingent liability, based on the very low probability of a call. International Financial Reporting Standards, International Public Sector Accounting Standards and Eurostat guidance recommend provisioning for a contingent liability only if the likelihood of a call is deemed greater than 50–70%. Given the very low likelihood of a capital call, no government currently faces any requirement to provision for callable capital in their budgets.

The timeline for meeting a capital call would likely depend on whether potentially called funds are already appropriated, emergency expenditure powers are in place or whether legislative approval would still be required to honour a call. Here, the credit quality of the government making such a commitment also matters for determining ex ante the credibility of the callable capital, unless funds are already specifically appropriated for such a situation.

Figure 2: Assessing the value of shareholder callable capital

<table>
<tr><th colspan="2" rowspan="2">Value of callable capital to strengthen MDB capital adequacy</th><th rowspan="2">Shareholder creditworthiness</th><th colspan="2">Use of callable capital</th></tr>
<tr><th><u>'Going concern': Assets & liabilities</u>
To compensate for loan/equity losses and honour MDB obligations</th><th><u>'Gone concern': Liabilities</u>
For emergencies only
(e.g. to pay MDB creditors)</th></tr>
<tr><td rowspan="5">Timing: willingness and ability of shareholders to honour capital call</td><td>Funds readily available/ already appropriated</td><td>Investment and non-investment grade</td><td>Very High</td><td>Moderate</td></tr>
<tr><td rowspan="2">Emergency expenditure powers in place</td><td>Investment-grade</td><td>High</td><td>Low</td></tr>
<tr><td>Non-investment grade</td><td>Moderate</td><td>Low</td></tr>
<tr><td rowspan="2">Legislative approval still needed</td><td>Investment-grade</td><td>Moderate</td><td>Very Low</td></tr>
<tr><td>Non-investment grade</td><td>Low</td><td>Very Low</td></tr>
</table>

Source: Scope Ratings

Wider use and short timelines to receive capital would increase value of callable capital

The value of callable capital would increase if it could be used widely (not just for honouring liabilities in emergencies) and the timeline for MDBs receiving it from their shareholders were known in advance, short, and broadly aligned across all shareholders, implying a similar budgetary treatment of callable capital among EU and/or G-7 member states.

Since a capital call is unlikely to come as a surprise or unexpected event but instead is likely to be preceded by severe macro-economic disruptions and intense political negotiations among shareholders, addressing some of these questions could raise the value of this unique capital instrument, strengthen MDBs' capital adequacy frameworks, and thus help boost their lending capacity in line with current efforts.

Latest developments among key MDBs

Leading MDBs are revising their capital frameworks

In response to the G-20 review of MDB capital adequacy frameworks and the U.S. Treasury's push for MDBs to complete work on new rules for leveraging shareholder capital commitments by 2024, the World Bank (IBRD), Asian Development Bank (ADB) and African Development Bank (AfDB) have set out to revise their capital frameworks, operations and funding practices to enhance financial resilience and increase their lending capacity.

The World Bank's efforts, including a portfolio guarantee programme from shareholders and hybrid capital, are aimed to increase lending by USD 100-125bn over the next decade, mobilising USD 6 for every new USD 1 guaranteed or raised. Similarly, the ADB will adjust its risk appetite and reduce its minimum level of capitalisation, adjusting downward unexpected loss estimates to increase lending by USD 100bn over the next decade while the AfDB expects additional lending of USD 2 for every USD 1 raised via its forthcoming hybrid debt issuance.

The European Bank for Reconstruction and Development (EBRD, AAA/Stable) is also modernising its capital framework, shifting its statutory capital limit from the statutes to a board level policy, which should enhance its flexibility in capital management and widen sources of mobilisation. The bank's lending capacity will be boosted by the forthcoming decision to increase its paid-in capital by about EUR 3-5bn, which could result in additional lending of about EUR 12-15bn, or 35-45% of total loans outstanding (EUR 32bn) and provide important resources for reconstruction efforts in Ukraine.

Similarly, the Council of Europe Development Bank (CEB, AAA/Stable) approved a capital increase of EUR 4.25bn in December 2022, of which up to EUR 1.2bn will be paid in, increasing its lending capacity. For the European Investment Bank (EIB, AAA/Stable) we are not aware of proposals to change the bank's capital adequacy framework and/or issue hybrid capital to date, reflecting the bank's sophisticated balance sheet optimisation and risk management as well as its significant available lending headroom, which we estimate at around EUR 185bn.

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