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Reform of World Bank Could Unlock Billions Of Additional Financing for Developing Countries

- *Developing countries could access at least $162 billion of additional finance for climate and development if reforms recommended by G20 Independent Panel are implemented.*
- *Comes ahead of the World Bank and International Monetary Fund Annual Meetings in October, where next steps on reform will be discussed.*

LONDON | 27-September 2023 — A new study by international finance analytics firm Risk Control has identified significant headroom that could be unlocked through reform of the world's largest development-focused institutions. This would enable increased spending on prosperity and climate resilience. The report sets out how recommended reforms could, in current market conditions, unlock up to **$162 billion for IBRD, without affecting its AAA credit rating. The scope identified for additional lending by IDA is smaller at $21-27 billion but still significant.**

The study, *Implications of the CAF Panel Report for IBRD and IDA,* commissioned by The Rockefeller Foundation, will inform discussions on reform at the Annual Meetings. It provides a data-based foundation for how the World Bank could boost its lending by implementing the recommendations of the 2022 G20 Independent Review of MDBs' Capital Adequacy Frameworks (CAF).

Risk Control's analysis shows that the International Bank for Reconstruction and Development (IBRD), the World Bank's main lending window, could add new lending of $162 billion to its balance sheet before it experiences a rating downgrade from any of the global Credit Rating Agencies (CRAs). Yet more lending would be possible if credit ratings agencies were to change their processes to better reflect the unique status of the development institutions.

The MDB rating approaches of Moody's and Fitch are less mechanistically risk sensitive than that of the third global rating agency, Standard & Poor's. Since IBRD has a relatively high-quality loan book, it is much more constrained by the Moody's and Fitch ratings than that of Standard & Poor's.

For the International Development Association (IDA), the part of the World Bank that helps the world's poorest countries, access to donor funding is the primary limiting factor on the growth of its zero or extremely low interest rate loans. The Risk Control analysis shows that even if IDA sticks to low or zero-rate lending, **it can still accomplish a small but meaningful increase ($21-27 billion) in the amount it can lend to low-income countries**.

The study proceeds to examine how adoption of another of the CAF Panel's five recommendations would permit greater expansion. Specifically, the study finds that **innovations often used in commercial banking, such as** hybrid capital, risk transfer, and shareholder guarantees could boost IBRD lending. **Forms of hybrid capital and securitisation of MDB loan portfolios, whereby MDBs share the risk of portions of their loan portfolios with other investors, is particularly noteworthy.**

"Our study highlights the constraints faced by IBRD and IDA and their significant scope to boost lending by adopting the CAF Panel recommendations," said **William Perraudin, Director of Risk Control Limited**. "IBRD and IDA lending represents 42 percent of total lending by development focussed MDBs. If these institutions provide leadership, others will be influenced to accelerate implementation of the reforms recommended by experts."

“This is the most authoritative study to date on World Bank lending capacity, and the results highlight the need to establish basic capital adequacy standards for MDBs in a way that accurately reflects their tremendous financial strength," said **Chris Humphrey, a member of the G20 CAF panel and a senior scientist at ODI**.

“This analysis provides a credible quantification of the CAF panel’s core recommendations,” **says Nancy Lee of CGD.** “These are timely benchmarks for shareholders and management as they scope out an urgent increase in lending for climate and development,” **adds Hans Peter Lankes of LSE. Lee and Lankes were members of the G20 Panel on MDB capital adequacy.**

To meet the global climate challenges, investment in the green transition in developing and emerging economies needs to reach $2.4 trillion per year by 2030, yet this feels far away. Developing countries urgently need access to increased finance to invest in their future economic growth and climate resilience.

"Given the urgent need for expanded development and climate finance, this detailed, in-depth analysis of how to implement the CAF recommendation is vital, offers striking results, and arrives just in time to inform next steps in the evolution process at the World Bank and other multilateral development banks,” said **Eric Pelofsky, Vice President at The Rockefeller Foundation**. "What’s truly exciting about this Risk Control study is that these recommendations deliver new lending now, as the evolution process continues to be negotiated.”

Key Findings

- **Credit ratings-based lending headroom**
  Risk Control replicated the annual rating assessments of the three global CRAs for IBRD and IDA. The study found that IBRD could **increase non-concessional lending by** a cumulative amount of **$162 billion – 71% of net outstanding loans – before a credit downgrade by one of the three CRAs is triggered.** IBRD would naturally wish to lend less than the amount required to generate a downgrade, but this would still permit a substantial expansion in its loan book. IDA, with its substantial capital base, faces no realistic possibility of a downgrade from AAA if it expands its debt issuance. **The key constraint to IDA growth, however, is not its capital adequacy but rather the availability of concessionary capital from donors.**

- **Economic Capital (EC)-based lending headroom**
  Like all major MDBs, IBRD and IDA have implemented internal capital adequacy frameworks that evaluate risk and determine appropriate operating policies. In this context, MDBs typically set a **Capital Adequacy Ratio (CAR) equal to Capital Resources divided by Economic Capital**. Risk Control found even under conservative assumptions, the CAR for IBRD and IDA is much less constraining than obtaining a triple-A rating from the global ratings agencies. This means there is significant fiscal space within the existing frameworks. Risk Control concluded that IBRD could **increase lending by $393 billion** without jeopardizing its capital resources. IDA is even further from a CAR constraint although the sustainable concessional lending constraint limits scope to exploit this headroom. In evaluating IDA’s CAR constraint full allowance was made for the concessional nature of the loan book.

- **Callable capital uplift**
  The G20 expert report recommended that Multilateral Development Banks recognize the financial value of ‘callable capital’, an international treaty commitment by government shareholders to supply additional resources if an MDB faces severe financial problems. Capital pledged by member governments, many of which have high credit ratings, increases the resilience of MDBs substantially. Risk Control found that if callable capital of AAA-rated shareholders were incorporated into capital adequacy calculations, IBRD could further increase lending from $393 billion (based on Economic Capital

above) to **$894 billion**. Growth on such a scale would clearly require that global ratings agencies modify the allowance they make for callable capital in their evaluations of MDBs.

- **Innovations to strengthen lending headroom**
  The CAF study also recommends that MDBs adopt innovations to optimize their balance sheets and permit greater lending. Many of these innovations are already in use in the private sector. Such innovations could include the use of hybrid capital, securitization for risk transfer, and shareholder guarantees. The impact of hybrid capital and securitisation of MDB loan portfolios is particularly noteworthy.
  - Hybrid capital could boost lending capacity substantially, especially if it were provided by holders of IMF Special Drawing Rights (SDRs) as recently proposed by the African Development Bank and Inter-American Development Bank.
  - Risk Control results show that IBRD and IDA could achieve meaningful reductions in their capital needs as measured by improvements in S&P's Risk-Adjusted Capital ratio. Securitisation of 10% of their portfolios of sovereign loans could, by this measure, generate additional lending headroom of $6-13 billion for IBRD and $23-28 billion for IDA. The gain is greater for IDA because it lends to lower rated countries. Securitization would likewise reduce required capital as measured by EC.
  - Risk transfers, including securitisation, can relax lending constraints that IBRD and IDA face. Tapping the full potential of risk transfer transactions would require some changes in rating agency methodologies.

- **Balance sheet optimisation across the two institutions**
  The fact that the two institutions face differing constraints implies that lending constraints on IBRD could potentially be substantially relaxed if the balance sheets were combined or if risk capacity were shared through cross-booking of loans or internal risk transfers.

About Risk Control Limited
Risk Control is an independent firm of risk specialists assisting major international institutions in developing and implementing effective and rigorous risk management. Based in the UK, Risk Control aims to increase the transparency of the business environment its clients face and to assist them in reducing the likelihood and costs of potential adverse events. Its analyses of financial risk and liquidity have shaped the thinking of regulators and industry participants. Visit www.riskcontrollimited.com for more information.

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