

SECOND REPORT TO THE G20 ON THE MDB ACTION PLAN TO OPTIMIZE BALANCE SHEETS

JUNE 2017

The G20 Leaders endorsed the MDB Action Plan to Optimize Balance Sheets at the 2015 November Antalya meeting. The Plan recognizes the “unique value-added of MDBs” as well as the G20 commitment “to using these institutions to their full potential”. It also called “for the MDBs to work through their respective Boards to consider five measures that could increase lending through balance sheet optimization” and further called “on MDBs to work through their respective governance frameworks to evaluate the elements of this Action Plan, and to report back to Finance Ministers by July 2016 on how the institutions intend to move forward on the measures.”

The first MDB report in response to the Plan was issued in July 2016. It comprised seven MDBs: African Development Bank (AfDB), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Inter-American Development Bank Group (IDBG), International Bank for Reconstruction and Development (IBRD) and International Finance Corporation (IFC). The report covered in detail each MDB’s progress in implementing actions under all five headings of “Capital Efficiency”, “Exposure Exchanges”, “Concessional Windows”, “Non-Sovereign Guaranteed Risk Transfer and Mobilization” and “Net Income Measures”. It also identified areas where additional future work was already being planned. G20 Finance Ministers in Chengdu endorsed the report presented by the MDBs, and called for continued action on balance sheet optimization and further updates. Accordingly, in the Annex to this note, each MDB provides a synthesis of work undertaken over the past year.

The individual narratives point to all institutions having established relevant frameworks for Capital Efficiency and Net Income Measures; Concessional Windows having either been merged with ordinary capital or enabled to access capital market resources; and several additional actions in Non-Sovereign Guaranteed Risk Transfer and Mobilization. No further Exposure Exchanges have taken place, though discussions continue to identify opportunities. Beyond the individual and bilateral efforts, MDBs are engaged on a collective basis, and the regular meetings of their Heads have incorporated balance sheet optimization and engagement with rating agencies to their agenda.

One aspect that remains paramount, in both the G20 Action Plan and the MDB response, is balancing the objective to maintain the MDB’s triple-A credit ratings with the ambition to increase lending towards achievement of the Sustainable Development Goals (and at the same time, maintain ability to provide this

financing during cyclical downturns). In this regard, MDBs caution against taking a mechanistic approach to ratings that is based solely on the reductive notion of a minimum solvency ratio.¹ MDBs have actively engaged with Standard & Poor's on their proposed "Bank Capital Methodology and Assumptions", published on July 6, 2016, which constitutes a building block for the methodology applicable to Multilateral Lending Institutions (MLIs). In part, because of MDBs' pro-active and constructive feedback on those proposals, Standard and Poor's announced on December 20, 2016 its intention to undertake a review of its methodology and assumptions used for rating multilateral lending institutions (MLIs) and other supranational institutions. MDBs' Chief Risk Officers and Chief Financial Officers will continue to coordinate and follow-up with relevant analysis and comments once the proposed revisions are published later in 2017. Analogous follow-up is also foreseen with other major rating agencies.

Finally, in their first report, the MDBs also listed key areas where G20 engagement is needed to assist MDBs in maintaining their triple-A ratings and long-term lending capacity. The main areas comprised continued expression of support, revision of frameworks for net income allocation, donor funds for blended finance, recognition of preferred creditor status and addressing unintended consequences of regulation.² Mutual engagement of MDBs and their shareholders is particularly needed at a moment in which the rating agencies look to the intentions and support of MDB shareholders as part of the rating process and the external environment remains challenging with continued downward rating pressure on emerging market sovereigns. In the private sector, loans and investments are also affected by high and uncertain risk environments, weak and volatile foreign exchange rates and equity markets. The foregoing, compounded by exceptionally low to negative interest rates in developed markets, restrict the ability of MDBs to generate capital from their lending activities.

We look forward to continued exchange and engagement on these areas with the G20 as we work to ensure that we are indeed optimizing shareholder capital to effectively fulfill our mandate of inclusive, sustainable development.

¹ Under the "S&P Ratings Methodology for Multilateral Lending Institutions and Other Supranational Institutions", four main building blocks determine the rating: "Policy Importance", "Governance and Management Expertise", "Capital Adequacy" and "Funding and Liquidity". The third of these, representing solvency, is measured primarily through the Risk-Adjusted Capital ratio (RAC), which is also used in the rating methodology for commercial banks.

² More generally rating agencies consider financial, institutional and shareholder support factors when assigning a rating. Balance sheet optimization addresses primarily the financial variables affecting the rating, and is thus a complement rather than a substitute to the measures affecting institutional factors and shareholder support, in particular capital increases.

AFRICAN DEVELOPMENT BANK GROUP (AFDBG)

Concessional Window. In 2016, the African Development Bank Group launched analytical work to assess the costs and benefits of either leveraging the African Development Fund, as done by the World Bank Group, or merging the Fund's loan portfolio into the African Development Bank, as done by the Asian and Inter-American Development Banks. These options are expected to be discussed with shareholders during the 2017 annual meetings.

Capital Efficiency. The AfDB approved its first formal risk appetite statement in 2012. In 2016 a review of the risk appetite statement was undertaken and several areas for improving capital efficiency were identified. A formal proposal will be presented for Board consideration in 2017.

Exposure Exchanges. In 2015, the AfDB participated in the first MDB Exposure Exchange Agreement with the Inter-American Development Bank and the World Bank. In 2016, the rating agencies confirmed the positive impact of the exposure exchange to diversify the Bank's portfolio and Standard & Poor's upgraded the AfDB's stand-alone credit profile by 1 notch to AA+. The Bank is currently undertaking a review of the exposure exchange and will consider new transactions in 2017 where new country concentrations have emerged. The AfDB is also exploring other sovereign risk mitigation options, such as sovereign non-payment insurance.

Risk Transfer and Mobilization. In 2016, the AfDB concluded its first sell-down of a non-sovereign loan. Also during the year, the African Development Fund agreed to more than double its capital investment in the Private Sector Credit Enhancement Facility that absorbs risk from the AfDB's non-sovereign portfolio in low income countries. The Bank has continued to explore the possibility of a synthetic securitization of part of its non-sovereign loan portfolio. In addition, as part of its reorganization, the Bank created a dedicated finance team for syndication, co-financing and balance sheet optimization.

Net Income Measures. In 2016, the Bank increased its sovereign lending spreads and introduced commitment and front-end fees, to strengthen its reserve generation capacity and improve overall financial sustainability.

ASIAN DEVELOPMENT BANK (ADB)

Concessional Window. On 1 January 2017, ADB combined certain assets of the Asian Development Fund (ADF) with its ordinary capital resources (OCR) and thereby tripled its capital base to \$48 billion. The merger is expected to increase ADB's annual operations by over 50% to more than \$20 billion by 2020, which in turn would increase operating income.

Capital Efficiency. In anticipation of this combination, ADB has reviewed its entire financial and risk management framework. The Board of Directors approved a revised Capital Adequacy Framework (CAF) in March 2017. The revised CAF optimizes leverage and lending capacity given a more complex balance sheet, and the introduction of concessional lending into ordinary operations.

Risk Transfer and Mobilization. ADB has continued to be active in promoting risk transfers to highly creditworthy counterparties, which currently cover about 22% of the non-sovereign portfolio. These risk transfers have improved portfolio quality, created new lending headroom, and reduced concentration risk. In addition, ADB executed its first transfer of risk from its sovereign portfolio in a pioneering transaction with the Swedish International Development Cooperation Agency. ADB also continues to leverage third party donor funds, such as \$1.5 billion of funds provided by the Japan International Cooperation Agency, as well as various climate funds to support private investments in infrastructure and climate change.

Net Income Measures. 2017 budget growth for the ADB incorporates several efficiency measures, including additional staff optimization measures, and reforms in procurement, technical assistance, IT, and business travel. Flexible position management and enhanced budget flexibility measures will contribute to the efficient use of existing resources.

EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

Capital Efficiency. EBRD has taken a number of steps to ensure capital resilience and adequacy for delivery of its three-year rolling business plan. The Bank-wide stress testing, a key tool in the Risk Management Framework for definition of the Risk Appetite has been used to confirm the robustness of delivery capacity under the three-year business plan under a stress environment. EBRD has also updated its investment profitability model. As a result, risk adjusted return on capital (RAROC) has now become one of the key parameters explicitly considered in both business planning and at the approval of individual projects, significantly increasing the emphasis on efficient allocation of capital in the decision process.

Risk Transfer and Mobilization. EBRD continues to expand its B-Loan and co-investment efforts as well as IFI cooperation. The use of unfunded risk sharing structures with new insurance company engagements has mobilized new investors in the Bank's portfolio on a secondary basis, freeing up capital for re-investment. EBRD has closed their first Equity Participation Fund, mobilizing new investors as risk sharing in certain equity investments. To attract new private sector bond investors into infrastructure projects, EBRD developed a risk enhanced facility structure that mitigates political and operational cash flow risks. In partnership with MIGA, the structure provides mitigation of political risk and two EBRD backstop facilities providing risk reduction with respect to cash flow certainty for cost overrun and start up cash flow shortfalls.

Net Income Measures. EBRD has a bank-wide Organizational Effectiveness & Efficiency program underway aimed at improving operational efficiency, generating cost savings to enable the Bank to use resources to fund new and increased activities, and to operate with limited budget growth. Alongside the cost containment, EBRD has undertaken a review of income generation ideas seeking innovative ways of increasing the Bank's revenue base. EBRD attracted a record level of donor funds in 2016, amounting to €445 million. As mentioned, the Bank has rolled out and is refining a new RAROC model for pricing and portfolio performance assessment.

EUROPEAN INVESTMENT BANK (EIB)

EIB continues to be one of the highest leveraged MDBs and, as such, has limited additional capacity to increase lending substantially without endangering its AAA rating. Having this constraint in mind, EIB continues to examine and implement concrete proposals that further optimize its balance sheet. EIB does not operate a Concessional Window and already places capital considerations at the heart of its operational strategy, including through risk-sensitive pricing policies that are integrated with the Bank's Net Income objective.

Capital Efficiency. EIB's Board of Directors approves, at least on an annual basis, EIB's Risk Appetite Framework (RAF). The RAF provides a coherent overview of EIB's risk-taking capacity and provides the tools and metrics to allow EIB's governing bodies to deploy the Bank's capital efficiently in pursuit of its operational objectives. In due course, RAF metrics will be cascaded downwards to business lines and activities, ensuring that EIB's capital is being used to its full potential, while safeguarding EIB's AAA credit rating.

Exposure Exchanges. EIB recognises the benefit to the MDB community of exchanging sovereign exposures between themselves as a means of better managing portfolio concentrations and thereby improving risk metrics and, ultimately, lending capacity. EIB's own legal and statutory constraints will be key to determining the extent to which such instruments could work for EIB. In view of these constraints, EIB is actively seeking to identify with its partners the instruments and arrangements that can most effectively catalyse new EIB lending capacity in the future.

Risk Transfer and Mobilization. The deployment of the European Fund for Strategic Investments (EFSI) is well underway and is on-target to deliver the anticipated level of new investment in the European economy. The success of EFSI as a means of sharing risks on a very substantial volume of high-risk operations between EIB and the public sector is evidenced by current proposals to extend the time-horizon and volume of EFSI. In parallel, a new External Investment Plan designed to meet the economic challenges in Europe's neighboring countries is under development in collaboration with the European Commission and a number of partner IFIs.

INTER-AMERICAN DEVELOPMENT BANK GROUP (IDBG)

Concessional Window. Effective January 1, 2017, the IDBG implemented the Governors' decision to transfer all assets and liabilities from its Fund for Special Operations to the Ordinary Capital. The transfer ensures continued access by the Bank's low income countries to concessional resources, which would have otherwise declined after 2017. It strengthens the ordinary capital base by \$5 billion, enabling the IDB to meet the targets set by the Governors for capital buffers.

Capital Efficiency, Exposure Exchanges and Net Income Measures. Relevant actions under these three headings were completed in 2015 and already reported, so that IDBG has now implemented four of the five measures in the G20 Action Plan. The IDB ordinary capital base will continue to be leveraged in accordance with the Capital Adequacy Policy, Regulations and Income Management Model, which are approved by the IDB Governors. These include buffers which are explicitly calibrated to sustain lending capacity during a downturn, and to enable deployment of additional lending in time of specific stress. Having executed the first Exposure Exchange with the AfDBG and the IBRD, IDBG remains interested in agreements bringing further diversification to the portfolio. On the income side, organic equity accumulation has been increased in both 2015 and 2016. Finally, transfers to the Bank's Grant Facility follow a new procedure approved by the Governors in 2016 to optimize equity consumption, while preserving the benefit for the receiving country.

Risk Transfer and Mobilization. Following the merge-out of Non-Sovereign Guaranteed (NSG) activities into a strengthened Inter-American Investment Corporation (IIC) in January 2016, the IDBG has set explicit targets for mobilization of private sector resources, measured in terms of B-loans, trust funds as well as co-investment raised on behalf of its clients. IIC is also participating, together with other private-sector focused MDBs, in the joint effort to standardize and report common measures of mobilization and address possible bottlenecks, including pricing signals. A new rating system and cross-booking of NSG loans enable optimization of the NSG portfolio across the IDB and IIC balance sheets, opening opportunities for active management and mobilization of resources. IDBG is keen to collaborate with other MDBs to achieve larger scale, enhanced risk diversification and attract potential investors.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)/ INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

Capital Efficiency. IBRD continues to implement work in all areas of capital optimization and resource efficiency that were reported in 2016. These include revenue increases, expenditure controls, and carefully managed new lending, as well as increased efforts to cancel projects where appropriate. In addition, in specific cases where country constraints were binding, IBRD has made selective use of guarantees to relieve such exposure constraints. IBRD is also working on ideas to turnover its capital by seeking opportunities to use private sector financing in later stages of projects to enable countries to prepay loans to IBRD. There continue to be active and detailed engagements with the governing bodies on capital, lending and financial sustainability.

Concessional Windows. In addition to continued implementation of the activities reported in July 2016, IDA completed a historic transformation to a AAA rated entity that will enable market funding for the first time in its history. This generated a record commitment capacity for IDA18 of \$75 billion by leveraging donor resources. Furthermore, IDA will deploy \$2.5 billion in capital for support of private sector activity through IFC and MIGA by way of the creation of the Private Sector Window, which will provide guarantees to IFC and MIGA, thus helping stretch their resources as well.

Mobilization and Exposure Exchanges. IDA will be leveraging donor resources through market funding and will be providing significant capital support of \$2.5 billion to IFC and MIGA through the Private Sector Window, which takes partnership and collaboration within the World Bank Group to a new level and is designed to mobilize private capital in areas where it would not otherwise flow. In addition, for some special situations, IBRD has undertaken innovative transactions and increased lending beyond its own capacity through the support of guarantees from official lenders, thus further partnering with other sources of financing. With regard to Exposure Exchanges, if other MDBs have needs and their frameworks permit, IBRD remains open to work with them.

Net Income Measures. IBRD has also made further progress on net income measures including the introduction of an income-based formula for transfers with the objective of balancing solidarity with preserving financial sustainability.

INTERNATIONAL FINANCE CORPORATION (IFC)

Capital Efficiency. IFC has implemented an enhanced credit risk rating system, which will improve the Corporation's ability to measure the risk of potential and current investments, to price new investments and to allocate capital. IFC is also in the process of finalizing an equity strategy. This strategy, which will be presented to the Board for discussion, will include measures to improve the efficiency and performance of IFC's investments in equities, as well as reviewing IFC's current asset allocation across different investment product classes.

Risk Transfer and Mobilization. IFC is collaborating with IDA and MIGA on a proposed US\$ 2.5 billion Private Sector Window (PSW), which will allow IDA to allocate a small portion of its equity to mitigate risks and provide direct support to stimulate private investments in this critical sector. The PSW aims to unlock significant opportunities, mobilize capital and help scale-up the growth of a sustainable private sector in IDA countries. IFC will be implementing the PSW in partnership with IDA and MIGA. The US\$ 2.5 billion initiative is expected to catalyze between US\$ 6-8 billion in private investments in IDA-only and FCS countries.

The following proposed facilities would be implemented by IFC: (i) a Risk Mitigation Facility to crowd in private participation in infrastructure by providing MIGA guarantees to cover non-commercial risks on IFC arranged transactions; (ii) a Local Currency Facility to support provision of long-term local currency investments for high-impact projects, in countries where market solutions are not sufficiently available and where local currency sourcing is limited due to volatile or underdeveloped financial markets; and (iii) a Blended Finance Facility aimed to mitigate the effects of weak investment climates by providing blended finance for pioneering high-impact investment in priority areas (SME, agribusiness, manufacturing, health & education, energy, telecommunications and climate finance).

Net Income Measures. IFC's Board of Directors approved a revised designation framework in November 2016. This framework incorporates a revised sliding-scale formula for designations, introduces minimum capital adequacy thresholds for designations, and sets an order of priority between advisory services and IDA transfers. The approval also includes an indicative undertaking for IDA18 designations that is lower than previous replenishment windows.