Working paper

Maximising the developmental impact of MDB callable capital

Project findings and path forward

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Key messages

Callable capital is a central pillar of the multilateral development bank (MDB) model, but stakeholders lack basic standards to understand its value to operational capacity.

The risk of a crisis requiring a capital call is less than 1% in conservative scenarios and the amount needed would be a fraction of the total $891 billion currently subscribed.

The rules and processes for a capital call are ambiguous and need to be clarified at MDBs and in shareholder government fiscal accounts.

MDBs should modernise their approach to prepare for and recover from financial stress, including callable capital in an extreme scenario, to bolster resilience and market confidence.

Callable capital can increase MDB lending capacity, but doing so requires collective action by shareholders across MDBs to establish standards that are credible to capital markets.

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Acronyms

ADB Asian Development Bank

AfDB African Development Bank

AIIB Asian Infrastructure Investment Bank

CAF Development Bank of Latin America and the Caribbean

EBRD European Bank for Reconstruction and Development

IBRD International Bank for Reconstruction and Development

IDB Inter-American Development Bank

IFC International Finance Corporation

MDB multilateral development bank

S&P Standard & Poor's

1 Introduction

Multilateral development banks (MDBs) have an unusual capital structure. A portion of their capital is paid in by government shareholders, and they also have a substantial stock of 'callable capital' available if ever needed to repay MDB creditors. Originating when the World Bank was first created at the Bretton Woods conference in 1944, and replicated at most MDBs created subsequently, callable capital totals $891 billion across the seven major MDBs considered in this study.[1]

Callable capital has never been deployed in the eight decades since Bretton Woods, as the MDB model has proved extremely robust. A combination of prudent financial management, judicious project selection and the unique official relationship between MDBs and their borrowers has led to superlative loan repayment performance (see, for example, Risk Control, 2023). No major MDB has ever come remotely close to triggering a capital call.

At six of the seven MDBs, callable capital plus shareholder equity substantially exceeds the total amount of outstanding market borrowings (Table 1). That means, in principle, bond investors face extremely low repayment risk: the full amount of bond repayments is guaranteed by a combination of paid-up equity and an international treaty commitment of callable capital.

Callable capital protects MDB bondholders, but how does it help the MDB itself? Intuitively, one would expect that if the risk of not being able to repay creditors is guaranteed, MDBs could take on more risks to pursue their development mandates. However, MDBs do not put a value on how callable capital strengthens an MDB's balance sheet or incorporate that value into capital adequacy frameworks. Bond investors and rating agencies take comfort from the existence of callable capital, but are unsure of its real value, as the procedures for making a call are uncertain and MDBs themselves do not provide guidance on its intrinsic value.

[1] The MDBs assessed in this study are: the African Development Bank (AfDB), Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB), the Development Bank of Latin America and the Caribbean (CAF), the Inter-American Development Bank (IDB), the World Bank's International Bank for Reconstruction and Development (IBRD) window, and the European Bank for Reconstruction and Development. The World Bank's private sector window, the International Finance Corporation (IFC), is considered in some aspects of the analysis but does not have callable capital; the same goes for IDB Invest.

Table 1 MDB equity capital, callable capital and market borrowings ($ billion)

	Equity (paid capital plus reserves)	Callable capital	Market borrowing	Callable capital + equity as % of market borrowing
ADB (Sept. 2023)	$54.2	$132.9	$140.4	133.3%
AfDB (June 2023)	$13.8	$188.7	$31.4	644.9%
AIIB (Sept. 2023)	$21.1	$77.6	$29.3	336.9%
CAF (Dec. 2023)	$14.7	$1.8	$35.6*	46.3%
IDB (Dec. 2023)	$38.9	$164.9	$108.3	188.2%
IBRD (Dec. 2023)	$62.5	$300.2	$250.7	144.7%
EBRD (Sept. 2023)	$22.7	$24.9	$46.2	103.0%
TOTAL	**$227.9**	**$891**	**$641.9**	**174.3%**

* Includes $4.1 billion in deposits, mainly from shareholder central banks. None of the other MDBs have deposit liabilities.

Sources: ADB, AIIB and EBRD Q3 information statements; AfDB October 2023 investor presentation; CAF, IDB and IBRD 2023 annual financial statements.

This project seeks to help implement Recommendation 2 of the *G20 Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks*: 'Incorporate uplift from callable capital into MDB capital adequacy frameworks' (G20, 2022: 30). Findings are intended to inform policy discussions among shareholders and management at the MDBs covered in the study, as well as the other roughly two dozen MDBs operating around the world today, and to improve understanding of callable capital among bond investors and other external stakeholders.

Callable capital is not a magic bullet. A full implementation of the proposals laid out below will not by themselves unlock the level of financing needed to address global needs, as described by the G20 Independent Expert Group report (G20, 2023). It forms only one part of broader discussions on MDB capital adequacy, capitalisation and operational policies. But callable capital represents an under-utilised tool to increase MDB lending capacity.

This paper brings together the results of studies undertaken by the authors (see Box 1), each of which contains detailed explorations of

the topics reviewed here in more summary form. The paper begins in Chapter 2 by laying out the potential of callable capital to bolster MDB financial strength. The subsequent chapters describe the different actions needed to make this happen. Chapter 8 summarises policy options for the future.

Box 1 Maximising the developmental value of MDB callable capital

This paper is part of a year-long project investigating MDB callable capital, supported by the MDB Challenge Fund and undertaken by a research team based at ODI. The project concludes in spring 2024 and comprises the following papers:

1 *Making sense of hybrid capital for multilateral banks* (C. Humphrey, E. White and C. McHugh)

2 *The legal underpinnings of MDB callable capital: implications and policy options* (C. Humphrey)

3 *Backstopping multilateral development banks: the fiscal context of callable capital for shareholder governments* (B. Getzel)

4 *How likely are multilateral development banks to need callable capital? Implications for risk frameworks and lending capacity* (C. McHugh)

5 *Enhancing multilateral development bank resilience and lending capacity: Crisis management, recovery planning and improving loss-absorbing capacity* (E. White and C. McHugh)

The project is led by Chris Humphrey (ODI Senior Research Associate) and includes Chris McHugh (Senior Adviser, International Association of Credit Portfolio Managers), Eamonn White (Director, Ardhill Advisory) and Bianca Getzel (ODI Research Officer).

2 Why is it worth evaluating MDB callable capital?

Better use of callable capital can have three important benefits for the ability of MDBs to sustainably increase development lending.

***First*,** incorporating the benefit of callable capital into MDB capital adequacy frameworks has the potential to significantly increase MDB loan portfolio capacity.

The range of potential lending gains depends in part on the method chosen to incorporate callable capital (discussed in Chapter 7). Outcomes will be driven by differences in how the benefits of callable capital are incorporated into MDB capital adequacy frameworks and the level of risk shareholders are willing to accept.

Lending gains also hinge on the willingness of shareholders and MDBs to undertake the reforms related to callable capital discussed throughout this paper. Different combinations of reforms, and the degree to which these reforms are undertaken in a collective fashion across the MDBs, will substantially impact how they are perceived by capital market actors.

The degree to which government shareholders are willing to 'define MDB risk appetites [by] prioritising shareholder-specified limits rather than external criteria', as recommended by the G20 Capital Adequacy Framework report (2022: 27), is another key factor. Little progress is possible without the active engagement of shareholders in making informed decisions on risk thresholds and clearly communicating those to MDB management as the basis for formulating policy.

***Second*,** callable capital can be incorporated into a more refined and systematic approach for MDBs to monitor and plan for financial stress scenarios.

MDBs should build on the lessons learned by the commercial banking sector and regulatory strengthening in the wake of the 2008 global financial crisis to ensure their capacity to maintain service provision even in the face of stress, as is appropriate for their critical policy role.

This would involve, among others: conducting regular reverse stress tests comparable across MDBs; a well-articulated set of indicators

defining the stress continuum between ‘business as usual’ and financial non-viability; and a series of management or ‘recovery’ actions and instruments to be deployed at different points along that continuum, including callable capital in an extreme scenario. Several MDBs have already begun to move in this direction, but more can be done.

Third**,** the above two sets of benefits can, in turn, boost the confidence of bond market actors – and, in particular, credit rating agencies - in the utility of callable capital to contribute to MDB creditworthiness and lending capacity.

Rating agency methodologies related to callable capital are highly varied, in part due to a lack of clarity on the part of MDBs and shareholders about its real value and the reliability of the call process. Addressing key obstacles limiting how callable capital is understood and perceived by market actors, and explaining these reforms in a compelling fashion with explicit shareholder support, can encourage an evolution in the methodologies used to rate MDBs over the medium term.

This will permit greater development lending while maintaining the top ratings that are so crucial to the MDB model.

The remainder of this paper considers a series of policy options for MDBs and shareholders to reap these benefits.

3 Evaluating the likelihood and scope of an MDB capital call[2]

A realistic and rigorous evaluation of the probability that an MDB might end up requiring a capital call, including how that would play out over time and the amount of resources involved, is essential to inform evidence-based policy choices related to callable capital.

These issues are explored by statistical modelling of the dynamics of MDB balance sheets and through scenario analysis using publicly available MDB data. The analysis subjects the MDBs to varying scenarios and assumptions, particularly related to MDB balance sheet growth projections and repayment patterns. The scenarios are wide-ranging, considering cases that are in line with the historical record to increasingly aggressive expansion strategies.

The first step of the modelling assesses the conditions under which an MDB might need to trigger callable capital, to help shareholders understand the risks they face. Scenario analysis is done through reverse stress tests that simulate conditions that cause financial distress from defaults in the lending portfolio.

The analysis confirms that MDBs are very low-risk institutions. The probability of an MDB requiring a call is less than 1% over a three-year time horizon, even in scenarios assuming: i) loan loss rates triple what MDBs have historically experienced; and ii) the MDB continues lending growth regardless of rising financial stress.

Under loan loss rates in line with historical patterns and assuming that the MDB would reduce lending in the face of stress, the risk of a capital call is essentially zero. This should not be a surprise and is consistent with the prudent structure and management of MDB balance sheets, low borrower default rates, and substantial liquidity buffers.

It is possible to build scenarios that generate a higher probability of a capital call over a three-year horizon by assuming very high loan losses coupled with a very high growth of MDB lending each year in spite of financial stress. Even then, the probability remains below 3% in all MDBs. Only by extending to a five-year time horizon would

[2] See McHugh (2024) for more details.

probabilities rise to represent material risk, and then only in scenarios that are hard to imagine in real world terms: extraordinarily high loan losses and very rapid continued expansion of the loan portfolio. Essentially, this would require shareholders and management to simply watch the MDB collapse over a five-year period, while still ramping up lending quickly and opting not to recapitalise the MDB.

Even in extreme scenarios leading to a capital call, the amount of money needed to cover bond obligations would be less than 10% of the outstanding callable capital, as MDBs have substantial liquid assets and other income that would meet most obligations first. Only by modelling loan losses of more than seven times current averages would it be possible to arrive at a high of needing 20% of callable capital stock for the International Bank for Reconstruction and Development (IBRD) and Asian Development Bank (ADB), 14% for the Inter-American Development Bank (IDB), and less for the other MDBs (Box 2).[3]

This highlights that any imaginable capital call could be met even if a number of governments were themselves under duress – only a small fraction of the total would be needed to cover MDB obligations. The exception is the Development Bank of Latin America (CAF), which has a much smaller amount of callable capital compared to the other MDBs (only $1.4 billion, compared to $300 billion at IBRD).

Box 2 Estimating the magnitude of a capital call

	AfDB	ADB	AIIB	CAF	EBRD	IADB	IBRD
Loans ($ bn)	27.6	144.3	22.2	30.4	32.0	112.7	241.0
Equity at CC (50% loss)	6.6	27.1	10.2	6.9	10.4	18.9	30.2
Current CC ($bn)	185.0	134.5	77.6	3.0	25.3	164.9	296.0
Capital Call Magnitude							
50% default, LGD 45%	0.0	5.4	0.0	0.0	0.0	6.4	24.0
50% default, LGD 75%	3.8	27.0	0.0	4.5	1.6	23.3	60.2
Capital Call as a percentage of current CC							
50% default, LGD 45%	0.0%	4.0%	0.0%	0.0%	0.0%	3.9%	8.1%
50% default, LGD 75%	2.0%	20.1%	0.0%	100.0%	6.4%	14.1%	20.3%

Notes:

IBRD using Total Equity rather than ‘Usable Equity’ from the accounts

CAF CC includes callable and capital subscriptions receivable

AIIB/EBRD presented as a call at 50% of equity for comparability with other MDBs

Source: McHugh, 2024.

[3] ‘Equity at CC’ in the second row of the box table refers to the level of equity an MDB would have if it had lost 50% of its current reported equity due to a shock and were to trigger a capital call in response. This is an assumption for illustrative purposes, as MDBs have not clearly defined precisely when a capital call might be triggered, as discussed in Chapters 4 and 6. The calculation is conservative: the 50% equity loss would likely have been triggered by loan losses, but the magnitude of the capital call assumes a further 50% defaults on outstanding loans. Hence this could contain an element of double counting, which would err on the side of conservatism.

Moving beyond callable capital, a second set of models considers how MDB lending capacity might be affected by a more consistent shareholder approach to risk tolerance across the MDBs. The results indicate that additional lending capacity could be released should all MDBs in the study adopt the same risk tolerance levels as IBRD, and that substantial additional headroom could be generated by modest increases in shareholder risk appetite across all MDBs.

These findings have several implications for MDB policy.

First, the extremely low probability of an MDB capital call, even using very conservative assumptions, is a relevant input for governments and MDBs to appropriately plan for extreme crisis scenarios and to consider how callable capital might be included in MDB capital adequacy frameworks. These results are also relevant for how market participants and rating agencies evaluate the creditworthiness of MDBs.

Second, investing time and resources to better understand the risks of MDB stress could unlock significant additional lending while maintaining the highest credit ratings.

Third, enhancing and harmonising MDB risk-appetite frameworks will help both MDBs and shareholders improve their mutual understanding of risk appetite and inform risk-taking decisions by shareholders.

4 Better define callable capital and the process to trigger a call[4]

Despite being an integral part of the MDB financial model since 1944, callable capital is poorly understood. The nature of callable capital and the process of a call are ambiguous, no MDB has ever publicly issued secondary policies or formal statutory interpretations,[5] and the instrument has never been tested. Uncertainty as to its financial value is therefore unsurprising.

What do MDB statutes tell us about callable capital?

A close reading of provisions of MDB founding statutes related to callable capital leads to three broad conclusions.

First, despite its name, callable capital is not 'capital' in the modern, formal sense of the term, because it can legally only be used to repay bondholders.[6] Hence, it does not meet modern regulatory criteria for defining capital.[7] Rather, callable capital as defined legally in the statutes is a specialised guarantee that shareholders commit to repay bondholders should the MDB face difficulties in meeting obligations.

At the same time, the authors of the World Bank statutes on callable capital – which formed the basis for all other MDBs – viewed it in less technical terms. It was a commitment, embedded in the treaty, of shareholders to support the MDB if it faced a shock triggered by large-scale loan defaults. Such contingent capital arrangements for commercial banks were well known at the time, and the modern definitions of what counted as capital did not exist in 1944.

This conception of callable capital as a type of capital is expressed in the name itself, and also by the fact that four of the seven MDBs

[4] See Humphrey (2024) for more details.

[5] The authors were informed just prior to publication that the boards of AfDB (in 1983) and IBRD (in 1947) had issued statutory interpretations related to callable capital, although these have not been made public. To date, we have no evidence that other MDB boards have done so.

[6] Specifically, callable capital can only be used to repay creditors who have lent the MDB resources used to support development financing at six of the seven MDBs. At these MDBs, this means investors in MDB bonds. CAF statutes do not include this limitation (CAF, 2015: Art. 5(2C)). Callable capital is also designated to cover any obligations created when MDBs issue guarantees for development purposes (that is, to help a developing country borrower obtain a commercial loan at better terms). These guarantees are technically booked as a liability on MDB balance sheets, along with MDB bonds.

[7] Callable capital would not qualify as either Tier 1 or Tier 2 capital in Basel III given its current structure (BIS, 2019).

considered here (IBRD, ADB, IDB and CAF) report callable capital in the equity section of their audited balance sheet. The implication would seem to be that if a call were to occur, callable capital would come into the equity section of the balance sheet, meaning that it is a specialised kind of capital.

These two understandings of the nature of callable capital – one as a guarantee and the other as a unique type of capital – form the basis for the two options for incorporating its value into MDB capital adequacy frameworks described in Chapter 7.

Second, at five of the seven MDBs, statutory language would appear to permit a capital call in a 'going concern' scenario, to help an MDB face an extreme crisis and get back on its feet to continue operations. At the European Bank for Reconstruction and Development (EBRD) and the Asian Infrastructure Investment Bank (AIIB), by contrast, the statutes appear to limit a capital call to a 'gone concern' scenario, when the MDB is past the point of non-viability. Bondholders are covered by callable capital in both cases, but these provisions may have implications for when callable capital can be deployed.

The differing wording of EBRD and AIIB statutes does not imply that their shareholders offer them less support than other MDBs. At issue are the mechanics of how and when a capital call can occur, not the support of shareholders to back these MDBs in case of need.

Third, MDB statutes do not spell out which instance of governance has the authority to make a capital call, with the exception of CAF, which specifies the board of directors. Secondary evidence and the logic of a capital call suggest that MDB management should have a role, although realistically one would expect the boards of directors and/or governors to take the final decision.

How can MDB policies be reformed to strengthen callable capital?

Management and shareholders should clarify the circumstances in which a call is permitted and delineate the process of triggering a capital call. Doing so would: 1) strengthen the ability of MDBs to incorporate callable capital into capital adequacy frameworks; 2) give bond investors even more confidence in MDB resilience; and 3) guide credit rating agencies to better account for callable capital in MDB ratings.

First, MDB boards of directors should publicly issue interpretations of callable capital statutes to clarify:

- When it can be called, and in particular if a capital call can help an MDB recover from stress or only be deployed as part of liquidation.
- Who has the authority to trigger a capital call. One approach would be to give management (the guardians of the MDB's

financial integrity) authority to require a discussion of a capital call in a crisis, but require final approval from the board (engaging the political level).

Second, shareholders and management should implement MDB policies on callable capital spelling out:

- A set of indicators of balance sheet stress to define when MDB management and shareholders should i) begin preparations for and ii) actually trigger a capital call. This links to the reforms described in Chapter 6. If a call can be triggered earlier in stress, that makes the probability of a call higher, but also increases the ability of callable capital to maintain continuity of MDB lending services. If a call can only be triggered closer to or at the point of non-viability, the risk of a call is lower but it is also less useful in managing stress without disrupting MDB lending services.
- A transparent set of processes for triggering and implementing a capital call, including determining the amount of callable capital needed; timeframes to meet the call and the consequences of non-compliance; and arrangements to ring-fence resources for use only to repay creditors.

Third, the EBRD and AIIB boards may consider issuing interpretations to clarify whether callable capital is a gone-concern instrument or not. If it is only to be used in liquidation – an inherently uncertain scenario – shareholders may consider board resolutions or policies to give bondholders confidence that they will be repaid in a timely fashion in the event of a major crisis.

None of these recommendations require revising MDB statutes. Shareholders can also consider statutory reform to change the way callable capital can be used. This may require the agreement of every shareholder who has subscribed callable capital in the past, as it would be changing the terms of their past subscription. It could be possible to reach agreements with a subset of willing shareholders.

Shareholders could convert callable capital from a guarantee for bondholders into a type of pre-committed capital accessible in a moderate crisis. This would facilitate the ability of MDBs to deploy a portion of it directly as a special type of MDB contingent capital to support increased lending (as described in Chapter 7, Option 2).

- EBRD and AIIB shareholders may revise their statutes to explicitly permit a capital call to help the MDBs recover from a crisis, rather than only in a gone concern liquidation scenario, as their statutes seem to suggest.
- IBRD shareholder governments can change the terms of past capital increase resolutions to free up a designated portion of callable capital (roughly $41.6 billion) for direct use in operations, as described by Humphrey (2024: 15–16). This is only possible for IBRD, due to the peculiarities of its statutory language.

5 Clarify shareholder fiscal context for callable capital[8]

As with MDB procedures, the process by which shareholders would meet a capital call in the event of an emergency is uncertain. Many shareholder governments have not spelled out how callable capital is accounted for in their fiscal frameworks or what procedures would be needed to meet a call. Credit rating agencies have pointed to this as a factor in limiting the amount of callable capital that they include in their rating methodologies (see, for example, Fitch, 2022).

Improving this situation is an obvious reform that all MDB shareholders should consider. From a domestic perspective, it is a sensible step to better understand a contingent liability they already have, in line with modern budgetary practices and International Monetary Fund (IMF) guidance. For the MDBs, greater clarity on shareholder support can substantially strengthen how callable capital is perceived by ratings agencies and other market actors, and facilitate incorporating callable capital into capital adequacy.

What is the current fiscal panorama of callable capital?

This project obtained information from 21 shareholder governments (including all G7 nations and 15 of the G20), representing 60% of callable capital at the major MDBs ($530 billion).

For every shareholder government of all MDBs considered in this project, subscribed callable capital is an international treaty commitment that has been formally ratified by their legislatures. As such, meeting a capital call is an obligation of every shareholder government that is anchored in their own national legal frameworks. This obligation is valid regardless of whether other members meet the call or not. A 1979 United States (US) Treasury legal counsel finding highlights this fact.

> *Callable capital subscriptions that are authorized by the US Congress are binding commitments backed by the full faith and credit of the United States notwithstanding that a future appropriation might be necessary in order to fund this commitment. To date, no authorizing statute has provided that such subscriptions are not backed by the full faith and credit of*

[8] See Getzel (2024) for more details.

> *the United States. The full faith and credit of the United States is the highest assurance of payment the Government can provide.*

Callable capital is most often treated as a remote, off-balance-sheet contingent liability. 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%, which is much higher than the case for callable capital (see Chapter 3). Consequently, no government currently faces any requirement to provision for callable capital in its budgets.

The timeliness of governments' ability to meet a capital call depends on whether funds are already appropriated, emergency expenditure powers are in place, or whether legislative approval is required.

Callable capital funds substantially exceeding what would be needed in most capital call scenarios (see Box 2 in Chapter 3) could be made available in a matter of weeks without the need to go through a parliamentary process. This expedited process could follow several paths:

- Already-appropriated resources, estimated at $32.27 billion across five shareholder governments, can be disbursed in a matter of weeks and would not require approval from the legislature.
- Emergency expenditure powers allow the ministry overseeing the MDBs to respond to a call in less than a month by using available resources within contingency reserve funds without parliamentary approval. Around $66.3 billion has been appropriated in the most recent budget cycle for contingency reserve funds across 10 countries.
- For several countries, if the size of a call does not breach the government's overall debt or guarantee ceilings or predefined expenditure limits, funds could be disbursed to respond to a call without immediate legislative approval.

In the unlikely event that a call was to exceed the above resources, then parliamentary approvals would be required through either supplementary or regular budgetary appropriation processes:

- A supplementary appropriation for unforeseen and urgent expenditures may be enacted and disbursed by a provisional executive measure, with legislative approval required ex post in several countries. For most countries, special appropriations usually require 2 to 3 months of lead time and can be presented at any point in the year.
- In the few countries where the above processes are not available, supplementary estimates can only be presented during specific periods of the budget cycle. In these cases, the timeline for a call could be as fast as 2 to 3 months, depending on the time of year.

How can shareholders provide greater clarity and confidence around callable capital?

Shareholders providing greater clarity and explicit backing to their callable capital commitment would substantially improve the way in which it is perceived by bond investors and rating agencies. It would also give MDBs greater comfort to include the benefits of callable capital in their capital adequacy frameworks. Doing so would not have an impact on the likelihood of a capital call and could be achieved with minimal effort.

Two sets of reforms would be most useful.

First, MDB shareholders who have not yet clarified their process for responding to a call should do so promptly. This would not only be beneficial to MDBs but also aligns well with broader moves by many governments to better understand fiscal contingent liabilities. The status of callable capital as a remote contingent liability would remain unchanged.

Second, the legal counsels of relevant ministries of MDB shareholder countries should issue opinions explicitly recognising the legal obligation of the government to meet its callable capital commitments, following the example of the US Treasury legal counsel finding of 1979. Such categorical statements, which do not in any way modify existing commitments, would provide a powerful signal to bond investors and ratings agencies.

6 Embed callable capital in a modernised planning framework for MDB stress[9]

Understanding MDB financial resilience arrangements and how they might be enhanced, including the role of callable capital, is an essential part of preparing for lending growth. If MDBs are to expand their balance sheet to meet the development challenges of the future, they need to consider not just how to maintain top bond ratings, but also actions to take should they experience financial stress.

The modelling discussed in Chapter 3 demonstrates that the risk of a capital call is extremely remote. However, the risk that an MDB faces less severe financial stress is higher, and MDBs should plan for that possibility. This requires MDBs to thoroughly evaluate a continuum of stress between 'business as usual' and non-viability.

Planning for financial stress is a part of risk management best practice for all financial institutions, commercial and public. This is relevant not only for their ability to remain financial solvent on their own, but also because many financial institutions have systemic relevance far beyond their own balance sheets. The global financial crisis made this abundantly clear in the case of commercial financial institutions; as a result, monitoring, regulatory and recovery arrangements have been substantially strengthened in the past 15 years.

The need for MDB resilience to financial distress was recognised at the establishment of the World Bank in the 1940s with the creation of callable capital to give confidence to bond markets to lend to what was then a new type of development bank. However, callable capital is not well understood in the context of today's capital market expectations, while other aspects of MDB stress monitoring and recovery planning can be further reinforced. This will strengthen the way markets and credit rating agencies perceive the financial resilience of MDBs, which would benefit the ability of MDBs to access funding at reasonable terms.

[9] See White and McHugh (2024) for more details.

MDBs should develop a broadly similar approach to preparing for and responding to financial stress, while tailoring it to their specific circumstances. MDBs are not regulated and are not subject to any consistent set of standards or expectations. Therefore, close coordination between MDBs and their shareholders is essential to ensure a consistent approach.

Unlocking any additional MDB lending capacity related to callable capital or other types of enhanced financial resilience depends on MDBs implementing a multi-year reform programme to deliver changes that have become mainstream in the commercial banking world since the 2008 global financial crisis. Doing so will reduce the probability that an MDB ever requires a capital call and will strengthen the ability of MDBs to continue providing lending services even in financial stress and to quickly recover.

These reforms should include the following:

- **Define MDB lending as critical financial services.** Shareholders should explicitly recognise that the lending services provided by many MDBs are essential for sustainable economic development in many borrowing countries and must be maintained. The assumption that failure of MDBs can be managed by placing them into liquidation would be inconsistent with this continuity. Recognising the critical nature of many MDB lending services forms the conceptual basis for designing robust capacity to identify and recover from financial stress to avoid entering liquidation.
- **Enhance MDB crisis management capabilities.** As the MDB capital structure begins to evolve to include hybrid capital and other loss-absorbing instruments, MDBs need to develop a well-articulated description of how stress would unfold in the MDB balance sheet, including the point of non-viability, and in-house stress-testing capabilities. This improved description of MDB stress should be accompanied by a new MDB Proactive Intervention Framework to guide MDB management's capacity to identify and respond to financial stress.
- **Implement MDB recovery plans**. MDBs should put in place financial arrangements and recovery plans to enable them to continue their lending services under stress – or even in the extremely unlikely event that non-viability is reached.
- **Strengthen MDB capital structure with alternative capital instruments and strategies**. MDBs should develop and document recovery actions and agree with shareholders on options to recover from extreme solvency stress scenarios, including from the point of non-viability. This should include the conditions for triggering callable capital and for paid-in capital injections, as well as designing hybrid and other instruments to enhance MDB solvency capacity. A Perpetual Bond Facility, as

proposed in a separate paper in this project, may be a useful addition to expand MDB lending capacity.

- **MDB Shareholder Expert Advisory Panel**. Ultimately, the effectiveness of new MDB recovery arrangements will determine the risk to shareholders. To support shareholders in assessing MDB recovery capacity, an expert panel should be established to advise them as part of regular business planning cycles on the effectiveness of the recovery options.

7 Incorporating callable capital into MDB capital adequacy frameworks

This chapter provides two conceptual approaches to incorporating the benefits of callable capital into MDB capital adequacy frameworks.

Both of these options require further evaluation and discussion by MDB management and shareholders. Neither is capable of supporting additional MDB lending today: certain preconditions must be met first, which will require further work over the medium term.

One can conceive of two ways for MDBs to incorporate the benefits of callable capital into capital adequacy and lending capacity: i) viewing callable capital as a bond guarantee that can influence MDB risk thresholds; or ii) considering callable capital as a type of capital instrument unique to MDBs.

This project does not take a position on the relative merits of either approach. They both have advantages and disadvantages that would need to be carefully considered by shareholder governments and MDB management. They would also need to be implemented in a systematic and deliberate fashion, adapted to the particular contexts of each MDB.

For either approach to be successful, it is essential that MDBs work collectively, as a system, to arrive at a common strategy that has the explicit support of shareholders. That is the only way to give confidence to market actors, including credit rating agencies, that MDBs are pursuing a prudent use of callable capital while ensuring financial resilience in the event of future stress.

Option 1: Callable capital as a bond guarantee to improve MDB risk tolerance

A first approach is to understand callable capital as a type of guarantee for bonds issued by the MDB on capital markets,[10] and to consider how that should impact the risk tolerance thresholds that underpin MDB capital adequacy frameworks.

[10] As noted above, callable capital also covers guarantees that the MDB itself issues for development purposes. These guarantees form a small share of the exposure of all the MDBs considered here, and hence are not explored in detail in this paper.

Conceptual basis

Callable capital as a specialised bond guarantee should impact MDB risk appetite because it helps MDBs manage the risk related to bondholders' willingness to fund their operations at sustainable prices. Callable capital makes the point of financial distress that might shut MDBs out of funding markets further away than it would otherwise be, because it gives bond investors greater confidence.

Funding costs are a market reflection of the probability of financial distress: a higher risk of default increases funding costs. Callable capital reduces the risk of default, keeping MDBs' funding costs at sustainable prices for longer than would otherwise be the case. Although callable capital is not the same as paid-in capital, it makes existing paid-in capital more valuable by reducing funding costs. This reduced funding cost allows greater balance sheet leverage by pushing the point of stress further away.

Given the above, callable capital should allow MDBs to run more risk on the balance sheet (for example, reducing their target capital ratio) compared to an identical MDB without access to callable capital. This would allow MDBs to increase their lending capacity without increasing capital resources. In this way, callable capital can play an important role in expanding MDB lending capacity.

All MDB capital adequacy frameworks naturally interact with their liquidity management framework, and an MDB's overall risk appetite is an expression of both. If funding distress is not triggered until MDB capital ratios are lower because bondholders take confidence in the protection provided by callable capital, MDBs should be able to increase leverage with existing capital while not increasing their likelihood of default. Even though MDB capital adequacy frameworks are different,[11] all MDBs should consider the benefit of callable capital when setting capital risk thresholds.

The rationale for linking internal capital targets to callable capital is supported by the Modigliani and Miller theorem,[12] which essentially states that the average cost of capital for a business is independent of its capital structure. That means that if an MDB's cost of debt is reduced, the value of its equity capital must increase – so that existing paid-in capital is worth more. Treating callable capital as a guarantee for senior debt investors that reduces the cost of debt finance should allow MDBs to adjust credit risk and internal capital adequacy ratios based on their understanding of the strength of the callable capital commitment.

[11] MDB capital adequacy frameworks differ in a number of important ways, but one notable difference is that IBRD uses an income-based model while other MDBs in this report use a solvency-based model.

[12] The Modigliani–Miller theorem (Modigliani and Miller, 1958) forms the basis for modern thinking on capital structure. It holds that the average cost of capital to the firm does not depend on its capital structure (the ratio of equity finance to debt finance), because any reduction in capital cost from switching to higher leverage using lower-cost debt is exactly offset by an induced increase in the unit cost of higher-cost equity capital because of the associated rise in risk.

This rationale is strongest when callable capital is available while MDBs are 'going concerns'. Bond investors are highly sensitive to the timing of repayment. If callable capital is available to MDBs on a going concern basis, then senior debt holders will be repaid as per their maturity profile. If the MDB can only access callable capital after it is past the point of cashflow or balance sheet insolvency, this may affect the timing at which senior debt investors are repaid, which could weaken the case for incorporating the benefit of callable capital into capital adequacy frameworks.

Operationalising callable capital as a bond guarantee in MDB capital adequacy frameworks

The risk-based modelling framework developed by McHugh (2024) can be used to estimate how much additional lending capacity callable capital could support. The estimates below are not meant to be precise, but rather to: i) illustrate the causal mechanisms; ii) highlight the impact of different assumptions about key variables; and iii) give a broad sense of the scale of potential lending headroom gains.

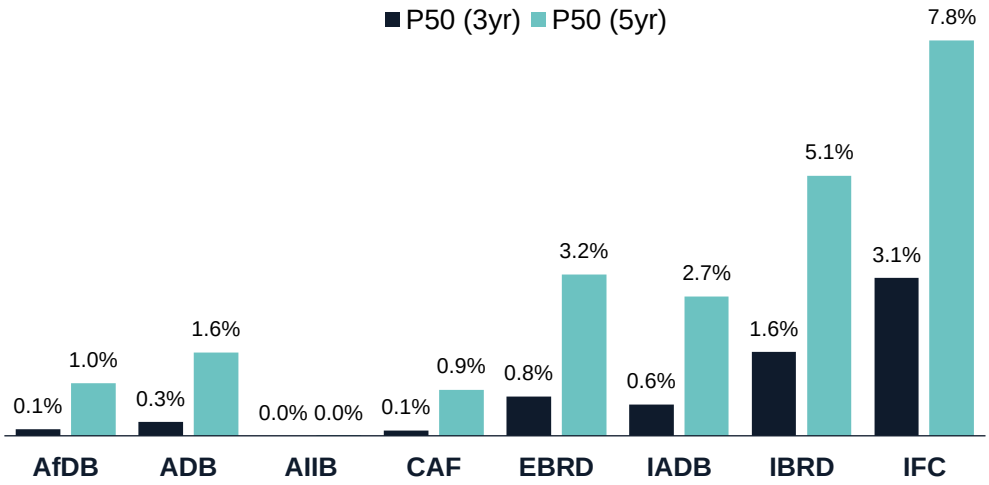
This approach to quantifying the benefit of callable capital is based on assessing the impact of changing the threshold at which MDBs experience stress and/or the risk probability of reaching this threshold (shareholder risk appetite). Different values for either of these two factors based on underlying assumptions would generate different results, as would different modelling approaches from the one used here. The important takeaway for the purposes of this paper is to illustrate the mechanism.

McHugh (2024) estimates the probability that an MDB would lose half of its capital base ('P50') over a three-year timeframe, without any mitigating action by management or shareholders. Defining a specific threshold is subjective, but it is reasonable to consider that if an MDB loses 50% of its capital, it would become significantly stressed or have a higher likelihood of reaching the point of non-viability, both from a capital and liquidity standpoint. One could perform the same calculations below using a different threshold.

The seven MDBs in this study with callable capital vary in the probability of crossing that threshold over a three-year period, from effectively zero for AIIB, the African Development Bank (AfDB), and CAF to 1.6% for IBRD (see Figure 1). This indicates that IBRD is lending more based on its capital compared to the other MDBs. Part of the reason for this is, according to IBRD, that it reduced its risk tolerance ceiling from 99% to 98.5% in 2023 due to the presence of callable capital.[13] This is the basis of the IBRD announcement to reduce its equity-to-loans ratio from 20% to 19%.

[13] The 98.5% target level is effectively almost exactly the obverse of the 1.6% residual risk estimated for IBRD in our modelling.

Figure 1 Probability of MDB losing 50% of capital in 3 or 5 years



Note: The International Finance Corporation (IFC) does not have callable capital, but is included for comparison.

Source: McHugh (2024).

A first step would be to bring the risk threshold of other MDBs in line with that of IBRD. If all MDBs have the same apparent risk as IBRD (that is, a 1.6% probability of losing 50% of their capital base within three years), this would imply a marginal one-off increase in MDB lending capacity by $37.2 billion across the other MDBs over a three-year period.

From this baseline, one could consider further adjustments to increase either the threshold level for capital losses or the probability of hitting that threshold, or both, based on the existence of callable capital. The degree to which one could increase either of these values – and hence the amount of lending headroom generated – would be based on a number of factors, including:

- Putting in place management plans to face financial stress (as per Chapter 6), which were not accounted for in this modelling[14] and could substantially reduce the probability of reaching a given level of financial stress.
- Increasing the confidence of callable capital as a reliable and timely instrument to help MDBs recover from stress (as per Chapters 4 and 5), so that MDB bonds are perceived by the

[14] For example, a different Monte Carlo modelling approach undertaken by McHugh (2024), which does include potential management actions, found much lower probabilities of losing 50% of capital under all scenarios except extraordinarily high continued lending growth and loan losses three times above historical averages. See McHugh (2024): Box 5.

markets as fully covered. This could support MDB access to funding at reasonable terms, even with higher stress levels (for example, losing 60% or 70% of capital).

- The degree to which reforms incorporating callable capital are coordinated across the major MDBs and implemented systematically, with compelling explanations to funding markets and explicit support of major shareholders. If carried out in conjunction with other capital adequacy reforms, as well as injections of fresh capital to achieve agreed development goals, this would further bolster market perceptions of MDB strength and policy importance, which would support access to funding at reasonable terms, even with higher stress levels.

With these considerations in mind, one could estimate a range of potential lending headroom benefits, represented as an increased loan portfolio over three years above normal projected growth. The gains range from a low of a 6.3% increase across the seven MDBs to a high of 26.0%, representing a boost of $43.3 billion to $179.2 billion over the period. This is based on shareholders tolerating a risk of 2%, 4% and 6% probability of crossing a given threshold of capital losses. The threshold of capital losses is set at 50%, 60% and 70% of total capital.

These are not precise estimates, but rather illustrative of the scale of potential gains in broad terms, and to highlight how changing the parameters affects the results.

Different modelling approaches – such as Monte Carlo simulations, which are employed by many MDBs – would significantly impact the results. If credit risk distributions are very skewed to the downside (long-tail risk), then changes in potential lending capacity will be greater than the modelling approach used above would suggest.

Option 2: Callable capital as a specialised MDB capital instrument

Callable capital does not meet modern definitions of a capital instrument, as by MDB statute it can only be used to repay liabilities and cannot directly absorb credit losses. Nonetheless, it can be argued that callable capital can be incorporated into MDB capital adequacy frameworks as a type of contingent capital.

Conceptual basis

Capital adequacy is, in the simplest terms, the ratio between an institution’s available capital and the amount and estimated riskiness of its assets. One approach would be to incorporate a portion of callable capital as a specialised type of capital instrument added to paid-in capital when calculating that ratio so that it can support additional MDB lending.

An immediate objection is that callable capital is not a capital instrument in the modern, Basel III-compliant sense of the term, due to the legal restrictions discussed in Chapter 4. While this is true,

MDBs are unregulated and not subject to the same restrictions on capital instruments as commercial banks. MDBs are non-profit, official agencies central to the international financial system, founded by international treaty among groups of sovereign nation-states. This unique nature impacts how they are perceived by funding markets and underpins several MDB attributes that are different from those of commercial banks, including callable capital, preferred creditor status and the concentrated nature of MDB loan portfolios.

Markets have long recognised the unique status of MDBs and the value of callable capital. The historical record shows that bond markets in early decades of the MDBs relied on callable capital subscribed by the US and other major governments to justify top-notch bond ratings, despite the ambiguities of the instrument. This was a time when unpaid capital shares were not uncommon in the commercial banking world.

Callable capital was – and still is, judging by current rating agency methodologies – perceived to function as capital, a treaty commitment by shareholders to support an MDB if it faces severe financial stress and ensure that MDB creditors do not bear losses. This is exemplified by the fact that four of the seven MDBs considered here (IBRD, ADB, IDB and CAF) formally report callable capital in the equity section of their audited balance sheets.

Before incorporating some share of callable capital directly into the capital adequacy ratio, MDBs and shareholders must undertake reforms such that callable capital would meet some of the key conceptual underpinnings of ‘capital’, even if it does not meet strict modern regulatory definitions. The typical features of regulatory capital are that it is: 1) fully paid in, 2) available to absorb credit losses, 3) perpetual, 4) without mandatory distributions, and 5) subordinated to other unsecured creditors.

Callable capital is, of course, not paid in. Therefore, it is essential to ensure that it is perceived as highly reliable to underpin a portion of MDB lending. Shareholders should explicitly reaffirm their commitment and ensure that budgetary processes are in place to give confidence that a capital call could be met in a timely fashion (see Chapter 5). Reforms to ensure clear lines of authority and a better understanding of the circumstances that could trigger a capital call are also very important (see Chapter 4).

Additionally, callable capital cannot directly absorb credit losses. By statute, MDBs can only use callable capital to repay bondholders. Nevertheless, as shown by the methodologies of both Standard and Poor’s (S&P) and Fitch, some market actors consider (a portion of) callable capital to be de facto capital. Callable capital does indirectly absorb credit losses by making up the lost income stream from non-

performing loans to ensure that the MDB can pay bondholders, such that the bondholders themselves will not bear credit losses.[15]

MDBs and their shareholders may decide to take the same view. A further step that would add greater credibility to this approach would be to modify MDB statutes such that callable capital could absorb losses arising anywhere on the balance sheet.[16]

Callable capital appears to meet the other three criteria for regulatory capital:

- It is effectively perpetual – a shareholder government can withdraw, but MDBs statutes all stipulate that subscribed capital remains with the MDB until all loans backed by that capital have been repaid (see, for example, World Bank, 2012: Art. VI Section 4a).
- Distributions to equity holders are technically permitted at the major MDBs, but never actually happen, and are certainly not mandatory.
- Since callable capital cannot absorb credit losses, it does not formally fit into the subordination waterfall, which refers to the order of credit loss absorption. However, it is specifically designed to ensure that senior bondholders are repaid in the event of loan defaults, and hence serves to protect their investment from absorbing credit losses.

Whether shareholders would consider deploying callable capital as a type of contingent capital will depend critically on how strongly they value their own callable capital commitments to MDBs and how well that strength is communicated to market actors. There can be no doubt in the minds of shareholders, MDBs, credit rating agencies and investors about the nature of callable capital if it is expected to play the role of capital.

By definition, increasing lending in this way (or in any other way, including Option 1 above) increases the probability of a capital call. How much that probability increases would depend on: i) the amount of lending increase; ii) how one defines the threshold of financial stress in the model; and iii) how well an MDB implements other actions to face increasing financial stress, as described in Chapter 6. Depending on the answer to these questions, one can design an approach to incorporating callable capital to ensure that the probability remains well below the threshold of budgetary rules for a remote contingent liability, as discussed in Chapter 5.

[15] All MDB statutes (other than CAF) explicitly state that callable capital is to be called in response to credit losses, and not for any other reason. For example, the text of IBRD statutes spelling out when callable capital is called, is titled 'Methods of Meeting Liabilities of the Bank in Case of Defaults' (World Bank, 2012: Art. IV Section 7). For CAF, callable capital can be called to meet unspecified 'financial obligations' (CAF, 2015: Art. 5(2C)).

[16] The European Stability Mechanism statutes foresees three ways to make a capital call, and two of them (ESM, 2012: Art. 9(1 and 2) are unrestricted.

Operationalising callable capital as a capital instrument

Incorporating a share of callable capital as an MDB-specific capital instrument has the advantage of being aligned with the conceptual approach of S&P, the world's largest rating agency. S&P's methodology (S&P, 2023: 23–59) adds callable capital provided by highly rated shareholders into its capital adequacy formula in the final stage of its rating methodology.

Due to the relatively quantitative nature of S&P's methodology, it is possible to model in broad terms the amount of lending headroom available due to callable capital. For the MDBs in this study, the deployment of callable capital as described by S&P would conservatively result in $517 billion in additional lending capacity, an 88% increase over current levels, while still maintaining an AAA rating with S&P.[17]

Does this mean that MDBs should simply adopt S&P's methodology and lend an additional $517 billion? No, for a number of reasons. The most obvious problem is that doing so would almost certainly lead to a rating downgrade by Moody's and Fitch, which use different methodologies (see Moody's, 2024; Fitch, 2023). But more fundamentally, MDBs and their shareholders need to define for themselves what they believe this instrument is worth, based on evidence, as per the first recommendation of the G20 Capital Adequacy Frameworks report (G20, 2022: 27).

The suggestion here is to follow S&P's methodology conceptually, not mechanically: incorporate a share of callable capital as an MDB-specific type of capital instrument that can support additional lending. How much callable capital might be considered usable, and how much of an MDB's risk capital should be made up of callable capital are questions that shareholders and management of individual MDBs must decide.

A critical point would be to decide how much callable capital can underpin an MDB's loan book. S&P (as well as Fitch, although in different ways) only includes callable capital supplied by the highest-rated shareholder countries. MDBs could consider other criteria instead of – or in addition to – sovereign ratings, including reliability of budgetary process to meet a call, as described in Chapter 4 highlights. For example, an MDB could place more weight on callable capital subscribed by governments that have already appropriated resources or have accelerated processes that do not require legislative approval.

[17] This modelling approach takes into account caveats described by S&P (2017) and (in the case of IBRD) is in line with the results of a separate independent study (Risk Control, 2023). For an explanation of the methodology used to estimate headroom under S&P, see Humphrey (2018).

Option 3: Create a new MDB contingent capital instrument

A further option would be not to try to reform callable capital at all, but rather create new structures that serve the same purpose but are more aligned with regulatory frameworks for commercial banks.

One possibility is a perpetual bond facility that would improve resilience in crises and support credit growth. The facility would be a contractual commitment from a group of highly-rated shareholders to buy perpetual bonds in the event of MDB stress. Perpetual bonds would be designed to qualify as MDB core Tier 1 capital once issued in the event of a crisis scenario. The aim of the facility is to provide contractual certainty to MDBs of shareholder support in a stress scenario. However, it would remain an unfunded commitment unless utilised based on predefined triggers linked to financial distress.

Despite being unfunded, the nominal amount of the facility should qualify as a form of Tier 2 capital if certain conditions are met. To reflect the contingent nature of the Tier 2 capital support, its contribution to MDB capital ratios could be capped – for example, up to 20–30% of the capital required to meet minimum capital ratios. In the case of IBRD, the additional maximum lending capacity generated by the facility would be $50–75 billion. While the marginal risk of the facility being activated might be slightly higher than a call on capital, the absolute risk is significantly below the level at which a contingent liability would be recognised in government accounts.

This facility proposal has benefited from informal feedback and design suggestions from several major capital markets law firms, investment banks with expertise in capital eligibility, and individuals familiar with credit rating agency evaluation processes. However, MDBs will need to leverage their own internal and external legal and capital markets advisers to build a fully operational proposal to consider in detail. It is recommended that an MDB develop a pilot version of the facility with one or more shareholder governments. See the parallel project paper for more details (White and McHugh, 2024).

8 The path forward

The unique capital structure of MDBs first designed at Bretton Woods has proved highly effective, and callable capital is central to that structure. The treaty commitment of sovereign shareholders to support MDBs if needed is a powerful signal to markets of the crucial public policy importance of MDBs.

However, this instrument – with a total nominal amount of $891 billion across seven major MDBs as of 2023 – is not being used as much as it could to support lending capacity, as highlighted by the G20 Independent Review of MDB Capital Adequacy Frameworks (2022). The problem is that shareholders, MDB management or credit rating agencies are entirely sure what callable capital is worth, or even exactly what it is.

Callable capital does not sit easily in modern, Basel III-type banking regulation, something it has in common with many other aspects of MDBs. That is why MDBs do not fall under Basel regulatory approaches – they are very different from commercial banks, and market actors are well aware of that.

It is time for the MDBs and government shareholders to define standards for callable capital, in a way that is backed by evidence and compelling to the funding markets on which they rely. This will clarify the nature and value of this central pillar of the MDB model for the entire sector – which comprises more than 30 MDBs currently in operation (Humphrey, 2023) – and has the potential to release significant additional lending capacity.

Doing so requires work and time. Realising the full potential benefits of callable capital will entail a programme of clarifications and reforms on the part of both shareholder governments and MDB management to generate evidence, agree on standards and incorporate callable capital into their capital adequacy frameworks, and to do so across the MDB system. Proceeding collectively is the most powerful way to ensure credibility with credit rating agencies and continued privileged access to the funding markets on which MDBs depend.

8.1 Step 1: Actions to improve the credibility of callable capital and MDB resilience planning

The first set actions should be taken immediately, regardless of whether shareholders proceed with further actions described subsequently, to improve the understanding of callable capital by all stakeholders and to bolster MDB resilience to financial stress. They

offer clear upside potential to how rating agencies value callable capital, require limited resources and effort, and pose no risk.

- MDB management undertakes reverse stress testing across the major MDBs to provide shareholder governments with the information needed to adequately evaluate risk and ensure appropriate accounting for callable capital in fiscal accounts.
    - Underway or completed at several major MDBs.
- Shareholder governments issue legal opinions by the relevant ministry stating that they stand behind their existing treaty commitment to MDB callable capital. For market and rating agency perceptions, this is most important for G20 governments and other large shareholders. This could be accompanied by a statement from the G20 to increase impact.
    - Can be resolved in weeks or (at most) months by any willing government. The G20 statement could be released in the autumn of 2024.
- Shareholder governments clarify and, where appropriate, strengthen the budgetary processes required to meet a capital call.
    - Some governments are now evaluating their processes with a view to making public statements. Further changes depend on individual country contexts.
- Shareholders and MDBs provide clarity on the circumstances, processes and timing of a hypothetical capital call.
    - Several major MDBs are now collecting information on the existing framework to form the basis for potential reforms. Formal interpretations and policy changes within the framework of existing MDB statutes can be completed by the end of 2024.
- MDB finance management proposes and shareholders approve a refined approach to describing the stress continuum with policy actions and triggers, based on statistical modelling carried out in a conceptually consistent fashion across MDBs. This will further reduce the probability of needing a capital call in response to stress and will help MDBs cope with and recover from stress with minimal disruption to development lending.
    - Initial steps in this direction are already underway as described above, and also in relation to new MDB hybrid capital instruments. The systematic combination of these elements, coupled with other elements of stress management and recovery capacity, should be achieved in the next 12 to18 months.
    - Deciding on the point at which a capital call can be triggered as part of this continuum is a key part of this

work, and involves trade-offs. If a call can be triggered earlier in stress, the probability of a call is higher, but the ability of callable capital to maintain continuity of MDB lending services in a crisis is also higher. If a call can only be triggered closer to or at the point of non-viability, the risk of a call is lower, but it is also less useful in managing stress without disrupting MDB lending services.

8.2 Step 2: Incorporate the value of callable capital into capital adequacy frameworks

These actions must be based on prior work described above. Preparatory work can begin in parallel with a view to modify capital adequacy and liquidity risk management frameworks within 12 months.

- MDB management formulate options for shareholder consideration on incorporating callable capital into capital adequacy calculations, based on the two options described in Chapter 7 and/or other approaches deemed more appropriate. The options should at minimum include:
    - conceptual explanation of causal pathways showing how callable capital can strengthen MDB lending capacity,
    - whether a given option requires revising MDB statutes or whether it can be accomplished at the level of policy,
    - implications such changes might have for the risk of a capital call or other financial indicators of relevance to shareholders, and
    - potential additional lending capacity these options might generate.
- Should shareholders decide to proceed, it would be most effective to institute changes to capital adequacy policies in a conceptually uniform fashion across MDBs as a system. The details of what share of callable capital might be considered and how it would interface with existing capital adequacy and liquidity approaches would be left to individual MDBs and their shareholders, depending on specific circumstances and risk preferences.
- These reforms can be more effective when they are undertaken in conjunction with related capital adequacy measures on preferred creditor treatment and portfolio concentration, as recommended by the G20 Capital Adequacy Frameworks report (G20, 2022).
- Should shareholders opt not proceed, they may consider alternative options to create contingent instruments to support increased lending capacity, such as the perpetual bond facility

outlined in Chapter 7 and described in more detail in White and McHugh (2024).

8.3 Step 3: Encourage evolution in rating agency methodologies

Incorporating callable capital will result in greater lending capacity, but that may conflict with the methodologies of one or more ratings agencies. More action is needed to reap the benefits of additional lending headroom while maintaining top ratings and strong access to funding markets.

- MDBs model and publicly report the divergence in headroom between their internally defined limits and those of rating agencies, to clarify to all stakeholders that additional lending is restrained by the need to maintain an AAA rating, not by MDB internal policies.
- MDBs engage intensively with credit rating agencies to understand key obstacles and supply the necessary evidence to inform the evolution of their methodologies. Involvement of major shareholder groupings such as the G20 and the Inter-Governmental Group of Twenty-Four (G24) can be useful, as the perception of shareholder support is central to how callable capital is perceived by market actors.
- If the methodology of one of the three agencies proves to be particularly problematic, individual MDBs may, on consultation with shareholders, decide to reduce their requirement to maintain AAA ratings to only two of the three major rating agencies. This would only be advisable after thorough consultations with bond market participants to ensure no negative impacts on access to funding markets, especially in adverse market conditions.
- Incorporating callable capital into capital adequacy frameworks is most effective when undertaken from a position of strength. Directly linking the work programme described above with discussions of additional shareholder capital to MDBs (in line with the G20 Independent Expert Group report, 2023) would positively reinforce how it is perceived by credit rating agencies and capital market investors.

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