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Multilateral Development Banks

1. Definition of multilateral development banks

A supranational is defined by international law as an institution composed of and founded by a group of countries in accordance with their accord in the form of a treaty. Such institution is endowed with specific purposes (missions, functions and roles) and acts in conformity with them. Multilateral development banks (MDBs) are among the supranationals rated regularly by JCR. An MDB is an international institution created by countries for the purpose of promoting social and economic development in and integration of the region where it operates. It provides loans, technical assistance and grants, using the contributions made by member countries and the funds procured from capital markets. MDBs are broadly divided into the World Bank Group operating globally, regional development banks and sub-regional development banks. This report explains some of the points that characterize their credit assessment and the methodology JCR adopts in rating them.

2. Characteristics of credit assessment for MDBs

Following points make MDBs different from commercial banks in general:

- The equity of MDBs is primarily composed of the contributions made by member countries with some exception (when they accept equity participation from commercial banks).
- MDBs have no specific nationality and are not bound on by banking regulations of any countries. Instead they manage their financial assets in a conservative manner in keeping with the constitutive agreements endorsed by their members.
- MDBs are not profit-oriented and make no dividend payout.

Following points make MDBs different from bilateral aid agencies in general:

- MDBs are not affiliated with the Paris Club [1] and enjoy preferred creditor status that entitles them to get their loans repaid before any lenders (except loans some MDBs make to private-sector borrowers).

Contributors and subscribers to MDBs comprise regional members and non-regional members with the exception of the World Bank Group. Usually only regional members can be borrowers (beneficiaries). Non-regional members take part in their activities as non-borrowers (donors) through their contributions.

[1] The Paris Club is an informal meeting of bilateral donor governments aimed to arrange measures to reduce debt-repayment burdens of the indebted countries unable to repay their external debt (due to balance of payments difficulties). The club is composed of 19 governments whose representatives meet almost every month at the French Ministry of the Economy, Finance, and Industry in Paris. Their meetings include the "Debt Rescheduling" session where they negotiate with indebted countries and agree on debt-relief measures (such as debt rescheduling and debt reduction) and the "General Review" session where they make a general review of the problems facing the indebted countries. In order for an indebted country to be eligible for the club's debt rescheduling, it must agree with the IMF on an economic program involving IMF financial aid.

(In regional development banks, some regional members are at the same time donors.) Both the beneficiaries and donors share high political incentives to sustain their MDB. The beneficiaries can get stable, long-term loans on better terms than procuring funds by themselves in capital markets by ensuring their MDB to retain its relatively higher credit standing and procure funds in capital markets. The donors through their contributions can assist in the development of developing countries without directly bearing the potential credit risks inherent to the beneficiaries. MDBs carry out their activities not to make a profit but to achieve the member countries' common political goals such as social and economic development and regional integration often involving political consideration. As such, their raison d'etre comes down to whether they can contribute to achieving the purposes desired by their members. Therefore, in rating their creditworthiness, JCR puts top priority on whether the MDBs enlist sustained strong support from their member countries. It is needless to say, however, they would be unable to properly meet the requests of borrowers without adequate financial foundation, and consequently lose the members' support. Secondly, therefore, their ratings need to mirror the state of their financial base. JCR attaches importance to their capitalization, quality of assets, liquidity, conservative fiscal management policy and risk control, and profitability to keep their financial base sound.

3. Rating methodology

(1) Support of members (shareholders)

Countries affiliated with an MDB consist of borrowers (beneficiaries) and non-borrowers (donors). MDBs other than the World Bank Group have regional members and non-regional members. Borrowers and non-borrowers need to be considered separately when looking at the extent of their support.

<Borrowers' support>

- Whether they continue their loan repayment even when they are in financial woes.
- Whether they participate in periodical capital increases (particularly if they subscribe to paid-in capital).

<Non-borrowers' support>

- How much they account for the paid-in capital and whether they subscribe to periodical capital increases.
- Whether they contribute to the special financial resources (used to make loans on concessionary terms to heavy indebted poor countries) and special funds (used to finance technical assistance and provide concessionary loans or grants to facilitate specific development projects).
- Whether they have their representation as executives or staffs at their MDBs.

Any of the points mentioned above illustrate that their track records are important to prove the extent of the members' support. It is reasonable to judge that MDBs that have existed and expanded their activities over a long period have strong support from their members. MDBs can also add to their importance and hope for stronger support from the donors when their missions are consistent with global development agendas. (Examples: U.N. millennium development goals, African aid commitments at the G8 summits and emergency aid at the time of the global financial crisis.)

(2) Financial base

(a) Capitalization

Important elements in the assessment of capital are its structure and solidity.
Generally, the capital of an MDB is structured as shown below.

- **Authorized Capital**
  - **Unsubscribed Capital**
  - **Subscribed Capital**
    - **Callable Capital**
    - **Paid-in Capital**

In an MDB's balance sheet, the paid-in capital forms the core element of its shareholders' equity. Callable capital is the part of its committed capital, which has not been actually paid yet. When an MDB runs into some contingent financial trouble caused, for instance, by a borrower's default or other reasons, it can call on a member to pay within the limit of its committed amount. The size of paid-in capital is the key factor in the assessment of capital. As to callable capital which is on a commitment basis, a borrower or a less-creditworthy member in financial trouble may not be able to comply with a call to pay. For this reason, JCR puts greater emphasis on how much of the callable capital is committed by members with higher credit standing. An MDB's loan/equity participation portfolio coverage ratio is assessed either in terms of equity consisting of paid-in capital, retained earnings and other reserves or in terms of equity in a broader sense, that is, equity capital plus a portion of callable capital committed by members of higher credit standing. Generally MDBs have a high capital adequacy ratio while having at the same time a large volume of risky assets. That is one of the sources their creditworthiness stands for.

(b) Quality of assets

Expanding portfolio mainly through loan commitments to sovereign borrowers by an MDB may mean that they are in great need of its financing and that its activities are strongly supported by the donor countries. MDBs have preferred creditor status with regard to the sovereign borrowers in repayment of their debts. However, JCR sees it necessary to get hold of their overall risk status taking into account potential risks inherent in loans to the countries' private-sector borrowers.

The preferred creditor status means that there is de facto understanding between an MDB and a borrower that the former gets its principal and interest repaid by the latter before any other lenders. The countries affiliated with the Paris Club are agreed not to oblige MDBs to reschedule their loans on terms equal to those offered by its members (the principle of equality among creditors). One factor that justifies preferred creditor status is that it would allow an MDB to play the role of a last resort when a borrower defaulted and was shut out of all other loans. If the borrower should continue to repay its MDB loan, it would be able to stay counting on the latter's financial support. The presence of preferred creditor status does not mean that there will be no default by a borrower. In fact, delayed payment by a borrower does happen although rather seldom. Even in such cases, the delay often tends to be short, rarely leading to a loan loss. In addition to the preferred creditor status, following arrangements help MDBs minimize their possible loan losses.

- They remove a borrower in arrears, or a heavy indebted poor country (HIPC) [2], from the list of those eligible for loans from their ordinary capital resources and enlist it for loans from special capital resources (soft loan windows). By so doing, they can prevent further delay in repayment of loans in their ordinary capital resources.
- By applying international debt reduction schemes such as the HIPC initiative, they get assistance from bilateral donors and some other lenders to help an HIPC cut its debt.

Some MDBs make loans to private-sector borrowers without sovereign guarantee. Such loans involve a greater risk than sovereign loans as the MDBs cannot enjoy the Paris Club-based preferred creditor status. Therefore, when they make loans to private-sector borrowers, they try to reduce risks by setting aside more loan-loss provisions, restraining the outstanding of lending, applying stricter loan terms and screening norms than those employed by commercial banks, limiting projects and preparing rescheduling programs aimed to minimize a loan loss. This requires JCR to examine MDBs' lending policy and risk management with regard to their exposure to private-sector borrowers.

In order to have an accurate picture of potential risks, JCR looks into changes of overall risks inherent in the debts owned by sovereign and private borrowers, occurrence of arrears, and risk concentration and diversification.

(c) Liquidity

Keeping their liquidity sufficient is crucial for MDBs which often make loans and equity

[2] As regards the Heavily Indebted Poor Countries (HIPC) in serious debt problems, an HIPC initiative was agreed in 1996 to provide them with comprehensive debt-relief measures that would cover not only their official bilateral debts but also the debts they owed to international organizations such as the World Bank and the IMF. At the G7 Cologne summit in 1999, the ministers agreed to an enhanced HIPC initiative that would "provide faster, deeper and broader" debt relief. As of January 2008, this initiative was applied to 32 countries.

participation to finance long-term projects and execute a large volume of loans each year. Their liquidity assets primarily consist of deposits and highly rated short-term securities they hold. To supplement their liquidity, they sometimes maintain stand-by credit lines with globally active commercial banks with a high credit standing. In rating MDBs, JCR assesses the ratio of liquidity to the volume of loans approved but not yet executed, the coverage ratio of loans disbursed in the upcoming 12 months period and the ratio of liquidity to funds borrowed.

(d) Conservative fiscal management policy and risk control

MDBs engage in a conservative fiscal management in accordance with their strict internal guidelines. JCR considers that such management policy plays an important role in sustaining their credit standing. Their major internal yardsticks include the gearing ratio (ratio of outstanding loans, guarantees and equity participation combined to equity capital), leverage ratio (ratio of financial obligations to equity capital), liquidity (ratio to the balance of loans approved and those not executed, ratio to the sum of the debt redemption cost and loans to be executed in the upcoming 12 months), limiting investment entities, upper limits on equity participation and upper limits on the ratio of credit guarantees to equity. JCR ascertains whether MDBs abide by these guidelines. MDBs used to keep relatively bigger loan-loss reserves for public-sector loans and government-guaranteed loans despite the low possibility of their becoming delinquent. Lately they increasingly tend to reduce their bad loan reserves coverage ratio. However, this may little affect their credit standing as they continue to maintain their relatively higher capital adequacy ratio as well as loan-loss provisions for risk buffers. JCR also makes sure whether MDBs properly manage their risks through various other means including employment of ALM.

(e) Profitability

Not being profit-oriented, MDBs do not give priority to profit expansion. However, they make an effort to retain profitability sufficient to keep themselves financially healthy and ensure continuation of their business operations. In actual rating, JCR ascertains internal profitability targets and if they stick to a sound fiscal management by checking how far they attain the target.