New Development Bank

Rebooting development finance

July 2021

Leslie Maasdorp

Vice President and CFO

Structure

1. Current trends
2. MDB business model
3. Proposals on changes to existing business model
4. Summary

Most relevant macro trends impacting on MDB’s

1. Stretched sovereign balance sheets
2. COVID-19 and its economic impact
3. Surplus liquidity & near zero rates
4. New era of Net zero commitments & growth in ESG capital
5. Increased role of sub national economic actors especially cities
6. Technological changes leading to disruptions

Current MDB business model

- Co-operative banking principle
- Low leverage + high liquidity + high capital adequacy = AAA rating
- Borrow cheap & lend cheap USD funds to sovereigns
- Need for capital injection to increase lending capacity
- Loan processing time closer to ~12 months
- Mode of lending is nation/sovereign centric
- Counter-cyclical by design

What is the scale of the MDB system

- Lending outstanding ~ USD 1.5 trillion[1]
- Equity capital ~USD 620 billion[1]
- Total assets ~USD 2 trillion[1]
- COVID-19 response package ~USD 300 billion[2]
- MDB balance sheet size close to 2.5% of world GDP
    - 4 major central bank balance sheet size close to USD 30 trillion

1. Source: S&P report on Supranational, data as at end 2019
2. Source: S&P report on Supranational

MDB Business model to be reconfigured for

- Scale and enhanced development impact, agility and speed
- Flexibility to adapt to client needs
- Shift from culture of lending to Risk Mitigation aimed at mobilizing private capital
- Greater focus on market outcomes (creating markets) rather than individual MDB specific institutional targets
- Convergence around core standards including ESG, procurement policies, contracts and processes.

Proposals on changes to business model of MDB's

A. Revisit Prudential norms specifically capital adequacy metrics

B. Fundamental shifts in core aspects of lending operations

C. Institutional changes within & outside MDBs

Is AAA the optimum credit rating for MDBs ?

Key financial matrix of AAA rated MDBs

Total capital : ~**USD 567 billion**

Average leverage : ~**3**

Liquid assets as % of total assets : **~35%**

Difference between AAA & AA

Bond yield : **~10-12 bps**

Probability of Default : **Negligible**

1: AAA rated MDBs include: IBRD, IFC, IDA, AfDB, ADB, AIIB, ESM, IADB, ISDB,CEB, EIB,NIB,EIF, data as of 2019
2. AA rated MDBs considered include: IDBINVST, IFFIM, NDB,, bond yield data is as of July 2021& tenor considered is 5y
3. Source: S&P report on Supranational & bond yield from bond arrangers

Is AAA the optimum credit rating for MDBs ?

- Re-evaluate trade-off between ratings
  - Two-point increase in leverage translates to USD 1 trillion of additional lending
- Should MDBs have access to lender of last resort
  - IMF or central banks of developed countries potential option
  - Reduces requirement for higher liquidity

Alternative sources of capital / capital optimization

1. Hybrid capital
    - Preference shares, perpetual debt etc.
    - Standard product for commercial banks, insurance companies
2. Asset sell down/ securitization to recycle capital
    - Capital market has appetite for shorter tenor EM assets
    - Issues like pricing, PCS impediments
    - Explore IMF, central banks as potential partners

Alternative sources of capital / capital optimization

3. Callable capital
    - Sovereigns have subscribed to callable capital
    - Callable capital not leveraged for lending
    - S&P in its report in 2016, highlighted MDBs could accommodate about USD 1 trillion increase in their aggregate credit exposure based on 2016 position without additional capital & by leveraging callable capital
    - Eligible callable capital as of end 2019 ~USD 400 billion

Lending operations : Mobilization

- No shortage of long-term low-cost capital, however it is sensitive to:
  a) Credit ratings, investment grade threshold, most EM sub-investment grade
  b) Averse to **construction risk** of infrastructure projects
  c) Needs **transparency**
  d) Home country **investment bias**
- These act as impediments for channeling this capital to EM
- On balance sheet model has limited capacity

Lending operations : Mobilization

- **Solution** : Credit enhancement products
  - Credit enhance risk profile of EM issuers to better match target risk profile required by capital providers
- **Option 1**: New sovereign backed entity focused on providing credit enhancement solutions
- **Option 2**: Existing MDBs focus on off balance sheet mobilization & syndication platforms

Lending operations : Driving ESG in EM

- Lead role in driving ESG investment in EM
  - Simplification and standardization of ESG standards
  - Driving consensus amongst institutional investors on issues concerning ESG related aspects in EM
  - Narrative towards impact investments in EM from a defensive ESG play
- Support EM sovereigns & SOEs for green bond frameworks

Lending operations : Driving ESG in EM

- Lending geared for helping countries meet net zero commitments
  - Demonstration effect
- Issuance of labelled bonds in local bond markets
  - Apart from China, labelled bond issuance in EM local markets almost negligible
  - EM can't raise capital needed to address climate risk only from abroad
  - MDBs, local banks & investors need to address this market gap

Lending operations : Local currency lending

- Focus on increasing share of local currency lending
  - Increased EM access to global capital markets
  - Effective cost of USD lending usually higher than the expected cost at initiation
  - Improved projected credit worthiness
  - Increasing importance of cities as development actors
  - Development of local capital markets
- Local currency lending not without its own set of challenges

Lending operations : Portfolio characteristics

- Lending to sub-nationals
  - Decentralization & devolving of development responsibilities to sub-nationals
  - Local authorities lead actors to implement majority of SDG
  - 80% of global GDP generated in cities & 68% of population to live in cities by 2050
- Impact of technology changes
  - Paradigm shift away from traditional infrastructure
  - Changes to types & features of projects funded

Institutional changes within and outside MDBs

- Basel Committee on Banking Supervision to regulate MDBs?
  - Risk matrix defined by rating agencies for MDBs restrictive
  - Regulator defines risk matrix & agencies evaluate risk profiles against those defined by regulator viz. for banks, insurance companies
- Internal efficiency measures
  - Impact of technology on cost structures
  - Improving speed & efficiency of delivery
  - Benchmarking parameters & processes with entities outside the MDB space

Summary

- Is AAA the optimum credit rating for MDBs ?
- Should MDBs start issuing hybrid capital?
- Need for new entity focused on providing credit enhancement solutions?
- How best can IMF or central bank balance sheet be used by MDBs?
- What role MDBs should play in channeling ESG capital to EM?
- Should Basel Committee on Banking Supervision regulate MDBs ?

Thank you