Principles for Responsible Investment

POLICY BRIEFING

REFORMING THE MULTILATERAL FINANCIAL ARCHITECTURE: WHY, HOW AND THE CASE FOR ACTING NOW

June 2023

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United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. More information: www.unpri.org

ABOUT THIS BRIEFING

This briefing focuses on reforming the multilateral financial architecture. It presents a diagnosis of the current multilateral financial architecture and notes its incompatibility to meet present economic and sustainability challenges. It also highlights the changes necessary to unlock the potential of private finance and presents a suite of mutually reinforcing reform priorities to align public and private finance with the goals of the Paris Agreement, Kunming-Montreal Global Biodiversity Framework and broader sustainability goals.

The requisite capital for tackling today's interconnected crises is beyond the capacity of the public or private sector alone. As such, the stability and fit-for-purpose of the global financial system are highly relevant to responsible investors, not only in the case of mobilising and aligning financial flows to emerging economies and areas most in need but also in strengthening the broader global finance policy agenda.

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GLOSSARY AND DEFINITION OF KEY TERMS

Blended Finance	Blended finance is a structuring approach that leverages the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development. *(Source: Convergence)*
Callable Capital	Callable capital covers the extreme tail risk that an MDB could face and acts as an *absolute last-stop* guarantee in the event of a catastrophe (such as financial collapse) when an MDB cannot repay its bondholders.
Country Climate Development Reports (CCDR)	The World Bank Group's CCDRs are core diagnostic reports that integrate climate change and development considerations. They help countries prioritise climate actions while delivering broader development goals. *(Source: World Bank)*
Financial Intermediary Funds (FIFs)	FIFs are financial arrangements that typically leverage a variety of public and private resources in support of targeted thematic international initiatives, such as responding to climate change. *(Source: World Bank)*
Global Emerging Markets Risk Database (GEMs)	The GEMs Consortium is one of the largest credit risk databases for the emerging market operations of its member institutions, which are MDBs and DFIs. It was established in 2009 between the European Investment Bank (EIB) and the International Finance Corporation (IFC). *(Source: GEMs)*
Guarantees	Guarantees are financial catalysts that attract private financing by mitigating government-related risks to enable financial viability and bankability. Guarantee products can be either project-based or policy-based. *(Source: World Bank)*
International Bank of Reconstruction and Development (IBRD)	Part of the World Bank Group, the IBRD is a development cooperative owned by 189 member countries, providing loans, guarantees, risk management products and advisory services to mostly middle-income countries. *(Source: World Bank)*
International Development Association (IDA)	Part of the World Bank Group, the IDA is one of the largest platforms for fighting poverty in the lowest-income countries. It works in 74 countries and has provided US$458 billion for investments. IDA resources are replenished every three years. *(Source: World Bank)*
International Finance Corporation (IFC)	A member of the World Bank Group, the IFC focuses on the private sector in developing countries by creating new markets, mobilising investors and sharing expertise. *(Source: World Bank)*
Multilateral Development Banks (MDBs)	MDBs dispense concessional and non-concessional funding for the development of low- and middle-income countries. MDBs include the World Bank and regional institutions like the Asian Development Bank, African Development Bank, Inter-American Development Bank, European Investment Bank and European Bank for Reconstruction and Development.
Multilateral Investment Guarantee Agency (MIGA)	A member of the World Bank Group, the MIGA provides guarantees (political risk insurance and credit enhancement) to investors and lenders to promote cross-border investment in developing countries. *(Source: MIGA)*

OVERVIEW

The 21st-century polycrisis[1] – climate and biodiversity crises, international armed conflict, macroeconomic imbalances, growing inequality, public health risks, etc – is challenging governments and institutions to develop ambitious, globally coordinated responses. Financing sits at the heart of meaningful responses to these crises. The multilateral financial architecture is comprised of collective governance arrangements for safeguarding the effective functioning of global monetary and financial systems. Part of this system is multilateral development banks (MDBs), whose financial power, global reach, on-the-ground capacity and specialist knowledge put them in a critical position to address and finance solutions to these challenges.

There is sufficient global capital and liquidity to close financing gaps, but the existing multilateral financial architecture has been unable to deliver financing at the scale and speed needed. On the issue of climate change alone, emerging markets and developing economies (EMDEs) will need to invest around US$1 trillion per year by 2025 and around US$2.4 trillion per year from 2030. Feasible, low-cost and effective options for mitigation and adaptation are already available, but 'barriers to redirect capital to climate action both within and outside the global financial sector and in the context of economic vulnerabilities' remain.[2] Public and private climate finance almost doubled between 2011 and 2020. However, achieving climate objectives will require climate investment to increase at least seven times by the end of this decade as well as the alignment of all other financial flows with Paris Agreement objectives. Together, MDBs hold about US$500 billion in shareholder equity, which can be strategically used to leverage additional public and private financing many times over.

Reforms are needed across the multilateral financial system to enable institutions to play a bigger and more effective role in helping the world face today's challenges. The resource mobilisation plan from the recently adopted Kunming-Montreal Global Biodiversity Framework (2022) also acknowledges the need for a fundamental transformation of the global financial architecture and the reform of MDBs to support the halt and reversal of biodiversity loss by 2030.[3] Inequalities within and across countries have been exacerbated by the Covid-19 pandemic and escalating geopolitical tensions. Left unchecked, they will only compound other crises. The World Bank and the International Monetary Fund (IMF) are in the most visible positions to lead and drive this progress. The World Bank recognises the need for change as it works on its evolution roadmap.[4]

Achieving the transition to a sustainable and equitable economy that supports natural and social systems is not possible without meeting the financing needs of EMDEs. Some research estimates that EMDEs accounted for 95% of the increase in greenhouse gas (GHG) emissions during the past decade, and their share will rise because EMDEs are expected to account for 98% of global population growth and over 90% of new middle-class households in this decade, which will drive energy demand.[5]

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[1] World Economic Forum, 'We're on the brink of a "polycrisis" - how worried should we be?' (13 January 2023): https://www.weforum.org/agenda/2023/01/polycrisis-global-risks-report-cost-of-living/.
[2] Intergovernmental Panel on Climate Change, *AR6 Synthesis Report, Summary for Policymakers* (March 2023): https://report.ipcc.ch/ar6syr/pdf/IPCC_AR6_SYR_SPM.pdf.
[3] Convention on Biological Diversity. *Resource mobilization.* (18 December 2022): https://www.cbd.int/doc/c/22fb/be2c/02e31154c4d4429de03caefe/cop-15-l-29-en.pdf
[4] World Bank, *Evolving the World Bank Group's Mission, Operations, and Resources: A Roadmap* (18 December 2022): https://documents1.worldbank.org/curated/en/099845101112322078/pdf/SECBOS0f51975e0e809b7605d7b690ebd20.pdf.
[5] World Economic Forum, *Three actions to accelerate emerging market climate transition* (14 June 2022): https://www.weforum.org/agenda/2022/06/3-actions-to-accelerate-emerging-market-climate-transition/.

There is great potential and a need to increase private investment and finance. The private sector can bring dynamism and alleviate existing fiscal space constraints in financing the transition. The investments required to achieve the net zero transition in EMDEs also represent a tremendous opportunity for private finance. Investors are increasingly committing to and implementing their net zero goals. However, private finance mobilisation to date is far too little and requires systemic changes to public-private partnerships to unlock them systemically.

This briefing note presents a diagnosis of the current multilateral financial architecture that is incompatible with meeting present economic and sustainability challenges. It highlights the changes needed to unlock the potential of private investment and finance and presents a suite of mutually reinforcing reform priorities to align public and private finance with the goals of the Paris Agreement, Kunming-Montreal Global Biodiversity Framework and broader sustainability goals.

Key recommendations include:

- **Review and revise organisational mandates, operating models and expected outcomes to align with current global challenges.** MDBs need to evolve to tackle the polycrisis of today and deliver outcomes at the local and national levels. This task entails promoting sustainable economic growth and social equity and tackling the planetary crisis of climate change and biodiversity loss as interconnected crises. Revising existing mandates to encompass today's crises will cascade down to the banks' operations, governance and financing mechanisms.
- **Enhance catalytic financial instruments for global sustainability outcomes by reforming capital adequacy frameworks and exploring new financial structures.** There is a great propensity for MDBs to expand their combined lending and financing efficiency while maintaining current institutional ratings. Doing so requires the banks to reform their approach to defining risks and evolve into first-risk takers with catalytic capital.
- **Scale and aggregate concessional finance to increase financial efficiency and leverage greater lending.** To bridge the gap between high investment risk among EMDEs and investors' fiduciary obligations to earn a risk-adjusted return, governments, foundations and other donors should enhance sizeable and flexible pools of concessional capital to de-risk investments, bringing them within investors' risk limits.
- **Prioritise the mobilisation and alignment of private finance at scale with strong incentives, risk sharing and mission clarity.** Changes in the private finance windows of MDBs are needed to maximise the volume of private finance that MDB capital can leverage. This process includes scaling catalytic products like guarantees, transforming to an 'originate-and-transfer model of financing' and improving transparency on MDB credit performance to build private sector interest.

MULTILATERAL DEVELOPMENT BANKS: A BRIEF OVERVIEW

Multilateral development banks (MDBs) are supranational institutions set up by sovereign states, which are their shareholders. While the specific remit of each bank reflects the development of finance and cooperation policies established by shareholders, they have the common task of fostering social and economic progress globally by financing projects, supporting investments and generating capital for the benefit of all people.

Founded in 1944, the World Bank (now with 189 sovereign shareholders) and the International Monetary Fund (IMF) are twin pillars supporting the world's economic and financial order. Given their reach, financial power and expertise, they are particularly well-positioned to drive significant progress in addressing global challenges.

MDBs use various direct and indirect levers to channel finance towards developing countries. These tools include leveraging the paid-in capital from shareholders, directly advising client governments in public finance management or attracting private investment to areas of high profitability and risks through the offer of de-risking instruments.

The requisite finance for tackling today's polycrisis is beyond the capacity of the public or private sector alone. As such, the 'fit-for-purpose' of the global financial system is highly relevant to responsible investors, not only in the case of mobilising and aligning finance to emerging economies and areas most in need but also in strengthening the broader global finance policy agenda.

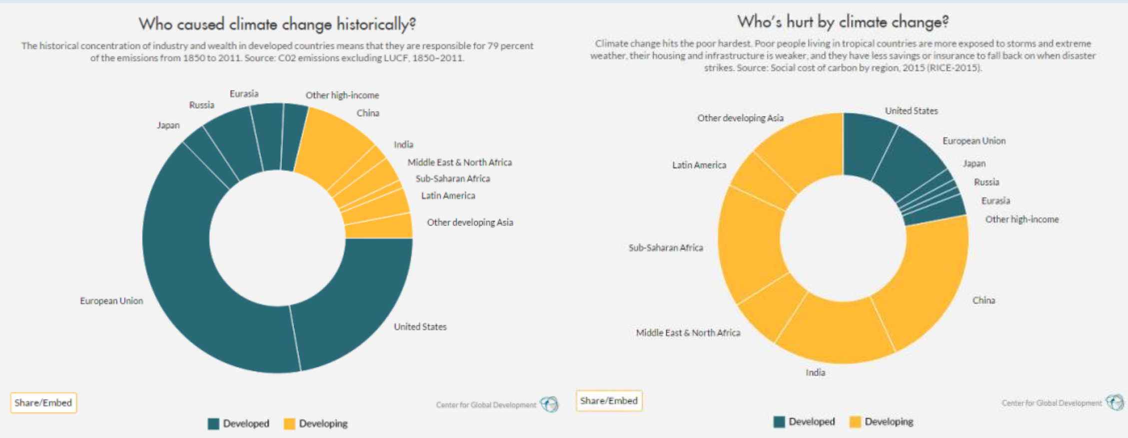

Figure 1 Historically, developed countries are most responsible for climate change. Today, developing countries are most hurt by the impacts of climate change. (Source: Center for Global Development, 2015)

THE LIMITS OF THE INTERNATIONAL FINANCIAL ARCHITECTURE IN THE NEW GLOBAL CONTEXT

Multilateral development banks underpin the multilateral financial architecture as supranational institutions set up by sovereign state shareholders. They have a fundamental role in building greener, smarter and more inclusive economies through directing investments and aligning finance policies towards sustainability goals.

For MDBs to play a meaningful role in scaling collective action to meet 21st-century challenges, they should resolve existing barriers related to their institutional purpose, financial frameworks and impact, capital adequacy frameworks and private sector engagement mechanisms.

Against the *planetary crisis* – encompassing climate, biodiversity and pollution – we need investment in greener capital stock and stronger and more consistent policies that enable investments, innovation and implementation. The investment needs are markedly acute in low-income countries (LICs), with the World Bank's own analysis showing that investing an average of 1.4% of GDP annually could reduce emissions in developing countries by as much as 70% by 2050 and boost resilience.[6]

MDBs need to evolve with long-term objectives and strategies that will enable anticipation, facilitate collective response and forge global resilience. Current bottlenecks exist, preventing them from fully realising their potential.

Diagnostic 1: Lack of a clear institutional priority to tackle the planetary crisis – climate change, pollution and biodiversity loss.

The World Bank's institutional priorities have not evolved to address the crises of today, and shareholders should reach a new consensus on the mission and purpose of MDBs against the planetary crisis. The twin goals of 'poverty alleviation' and 'shared prosperity' were established at the founding of the World Bank in 1944. Yet, today's challenges are much more complex and interlinked. The absence of tackling climate change and biodiversity loss as a core institutional priority can lead to operational silos when financing is needed to unlock developmental, climate and environmental concerns. Such a renewed global financial architecture should be guided by the new 'apex target' for finance, represented by Article 2.1c of the Paris Agreement: '*Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*'.[7]

Given its close institutional ties with central banks, the IMF can play a more decisive role in facilitating global monetary policy cooperation and safeguarding the stability of the international monetary and financial system. With its global reach and near-universal membership, the IMF thus has a critical role to play and can intensify its efforts in addressing the policy challenges and opportunities posed by climate change. Doing so aligns with the tasks assigned to the IMF, such as macro-criticality, debt sustainability, global financial stability and balance of payment needs.

Overall, the capacity of the MDB system hinges on its shareholder structure, policy advice and the investment and capacity-building banks can provide. There exists a disjunction between

[6] World Bank, *Country Climate and Development Reports (CCDRs)* (November 2022): https://www.worldbank.org/en/publication/country-climate-development-reports.
[7] The Paris Agreement: https://unfccc.int/sites/default/files/english_paris_agreement.pdf.

development goals that shareholders set for the banks, the capital budgetary resource they provide and the degree of acceptable risk (explained further below). Shareholders should call on the World Bank to adopt addressing the planetary crisis as a core institutional priority alongside existing priorities, systemically shifting the governance, operations, policy advice and capacity-building programmes the bank provides.

In addition, MDBs should scale up operations across the full spectrum of client countries and evolve operations in national contexts to respond to global challenges alongside national priorities. MDBs' global reach, financing capacity and localised expertise mean that they are well-positioned to address the implications of spiralling global crises on specific countries' financing needs. These abilities include enhancing the Country Climate and Development Report (CCDR) model and facilitating the mobilisation of requisite finance from the public and private sectors.

The interconnection between poverty eradication, social and economic development and climate resilience and mitigation

The impacts of unabated climate change could undermine global efforts to eradicate poverty. One of the lingering misconceptions in addressing global challenges is that climate action entails a trade-off with economic development. However, considering that negative economic impacts from increased temperatures would affect countries in the Global South more severely, which leads to deepened global inequality, inaction on climate change undermines the fight against poverty. Poverty is both a driver and consequence of disasters, and processes such as climate change and biodiversity loss that exacerbate disaster risk-related poverty are steeped in inequality.[8] Within any given country, poorer households and marginalised groups are also more vulnerable to climate impacts.

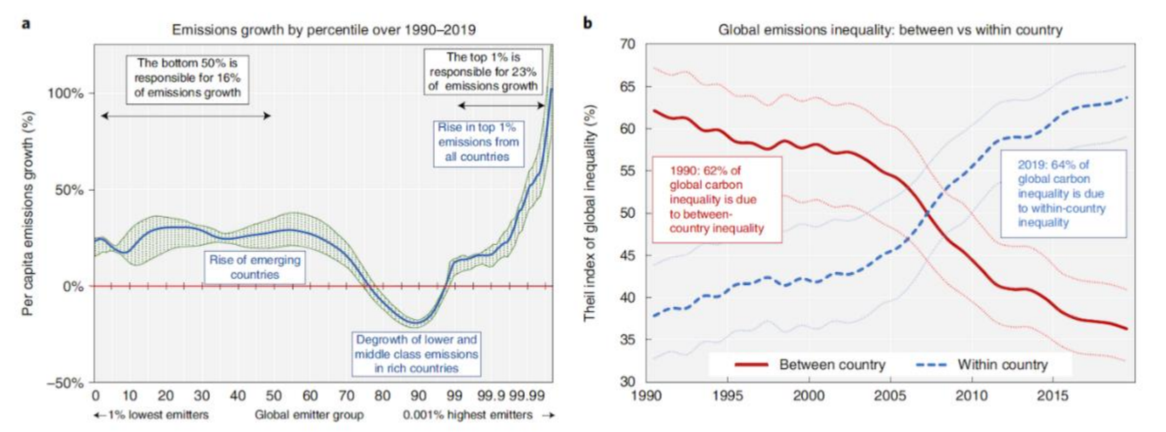

Figure 2 Percentage change in per capita emissions for different emitter groups over 1990–2019 (left) and changes in emissions inequality between and within countries, based on an 'index of inequality' (right). Source: Chance et al. (2022).

Tackling the climate crisis helps tackle poverty, and shared prosperity can only be created in a sustainable and resilient world. Today's compounded crises are much more complex, and their

[8] PreventionWeb, *Poverty is both a driver and consequence of disasters, and the processes that further disaster risk-related poverty are permeated with inequality*: https://www.preventionweb.net/understanding-disaster-risk/risk-drivers/poverty-inequality.

reverberations are more forceful. At the current juncture, the World Bank's nearly 80-year-old mandate needs to evolve in light of how the world has changed around us.

The co-benefits of addressing climate change in ways that simultaneously improve human well-being often have been overlooked. International financial institutions (IFIs) need a new, clear mandate to tackle the climate crisis that renews and reinvigorates their purpose, commitment, political vision, prioritisation of issues and financing mechanisms.

Therefore, alongside updating the mandates, it is equally vital for the World Bank to apply a meaningful climate lens to the existing poverty alleviation priority to tackle economic development, the climate and the environment at their intersection.

Diagnostic 2: The persistently high cost of capital for developing countries leads to unfunded commitments.

The cost of capital and perceived risks in EMDEs are persistent challenges to mobilising capital at the scale and speed needed to address global challenges and national needs, especially in attracting mainstream investment. Today, countries that issue international reserve currency borrow 10-year money at 1–4% per year while developing countries borrow at an average of 14%. This statistic, coupled with a risk premium from the private sector and country rating ceiling, renders many projects commercially unviable in EMDEs. The growing intensity and frequency of crises affect countries' – particularly developing countries – capacities to pursue development objectives while adapting to the impacts of future shocks. Climate vulnerability has further raised the average cost of debt, with many countries (including those most at risk from climate change) facing significant debt overhang, exacerbated by an unfavourable international trade and monetary system.

Scaling financially viable investments requires actors to re-assess, reduce, manage and share risks. Transferring or managing risks, including currency/exchange rate risks, can help bring down the cost of capital significantly. This process can be done through using blended finance solutions whereby MDBs and donor agencies use guarantees, insurance and hedging to mitigate risks and improve the overall credit rating of a project. To scale up blended finance, attract private finance and unlock institutional capital at scale, MDBs need to be the first-move risk taker.

While risk mitigation can partially address this challenge, no amount of mitigation will sufficiently lower the rate differential and solve this systemic challenge at a whole-of-finance scale. As such, scaling up blended finance should be coupled with other mechanisms that reform existing pillars of the financial structure, such as recognising the financial value of 'callable capital' and re-evaluating the use of guarantees (more below). Doing so requires a fundamental shift in the underlying assumptions and perceptions around risk and in redefining the role of MDBs in originating projects with catalytic capital and transferring them to other financial actors.

Without targeted action to reduce the cost of capital and address real and perceived risks (geographical, technological and project-specific), countries are left committing to unfunded commitments. This situation is exemplified by the number of conditional contributions submitted in countries' nationally determined contributions (NDCs) under the Paris Agreement: about 78% of the

NDCs in the first submission round in 2015 included conditional contributions, over 80% of which were attached to international financial and technical support.[9]

Using blended finance to shift and reduce systemic currency risks in EMDEs

Prevailing practices where the most vulnerable borrowers bear the foreign exchange risk is one of the most damaging practices in development and climate finance. Over 90% of cross-border debt to low- and lower-middle-income countries is denominated in hard currency, which exposes unhedged borrowers to a currency mismatch between local currency revenues and foreign currency debt. While currency hedging and other options exist, they can be expensive for many EMDE currencies, particularly with respect to the low cost and large scale required to support the needed transition. Research has shown that depreciations as low as 4% per annum can effectively undermine the ability of a project company to service its debt, leading to payment default and a non-performing loan.[10] There is a need to ensure that currency risk is managed correctly and not transferred to the most vulnerable borrowers.

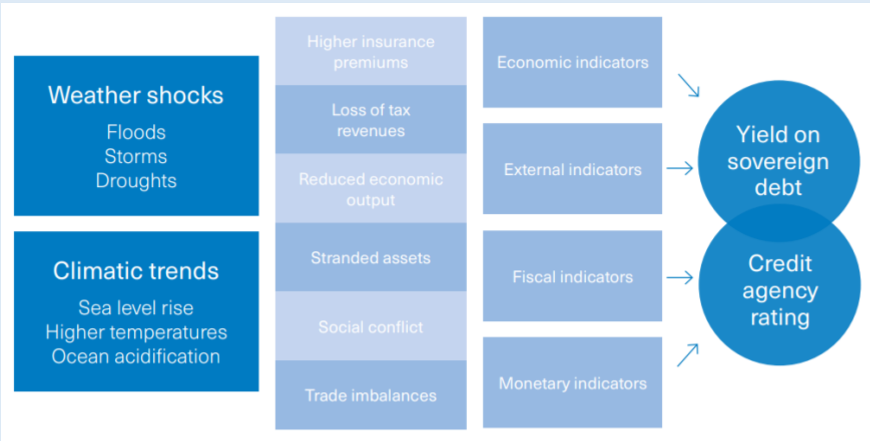

Figure 3 Research highlights the relationship between physical climate impacts and country-specific financial indicators, confirming that countries with higher vulnerability to climate change risk bear an incremental cost on government-issued debt. (Source: Imperial College Business School)

Vulnerable countries face not just economic losses from climate and environmental impacts but also a heightened fiscal burden.[11] The planetary crisis impacts public budgets on both the expenditure and the revenue side. Investments that enhance the resilience of climate-vulnerable countries can not only boost their social preparedness against climate impacts but also lower their cost of borrowing.

Stepping up in this financing requires partnership, given that the financing gap exceeds the capacity of the public or the private sector alone. Linking public and private initiatives in a joint

[9] International Partnership of Mitigation and MRV, *Conditionality of Intended Nationally Determined Contributions (INDCs)* (February 2016): https://transparency-partnership.net/sites/default/files/indc-conditionality_0.pdf.
[10] European Union, OECD, EDFI, Convergence, TCX, *The need to reduce FX risk in developing countries by scaling blended finance solutions:* https://assets.ctfassets.net/4cgqlwde6qy0/3UYrVVpyqckCsw802wWoOi/7abfe71c3b60ff521635f713865cad16/FX_Risk_in_Development_Primer.pdf.
[11] International Monetary Fund (IMF), *The Fiscal Implications of Climate Change* (March 2008): https://www.imf.org/external/np/pp/eng/2008/022208.pdf.

manner through solutions like blended finance can not only ensure the fulfilment of the financing gap but also mitigate foreign exchange risks.

Institutional investors must integrate credit risk evaluations into their portfolio steering. The relatively lower sovereign risk rating of low- and middle-income countries means that investment risks in these countries are often beyond the risk tolerances of asset owners and institutional investors. However, blended finance shifts risk from the most vulnerable parties to well-capitalised organisations that can best bear and manage it. These structures have the potential to create a ‘win-win’ situation for the public and private sectors, whereby the private sector benefits from the improved risk-return profile that meets their requirements, and the public sector achieves an intended multiplier effect of their capital that ‘makes the money go further’.

MDBs are in the perfect position to facilitate private capital by evolving their balance sheets towards an ‘originate-and-transfer’ model and absorbing the first loss. They could focus on higher-risk and earlier-stage funding and transfer assets with stabilised cash flows to the private sector. MDBs can leverage their guarantees to crowd private capital into riskier regulatory environments, making more use of intermediary vehicles that allows the aggregation and diversification of exposures and expand offers to mitigate private sector currency risks. This strategy will look different for LICs and middle-income countries (MICs).

Diagnostic 3: Limited use of shareholder guarantees and weaker-than-necessary financial framework and impact.

MDBs can be a powerful force to catalyse, mobilise and align all financial flows with sustainability goals. They are in a position to do so given (1) their shareholding structure and preferred creditor treatment (PCT) and (2) their strong levels of capitalisation, generally much higher than commercial leaders, which allow them to raise cheaper finance on capital markets. With a small amount of shareholder capital and a solid financial track record, MDBs can borrow substantial medium- and long-term resources from investors at excellent financial terms.[12] Research using MDBs’ own data finds that expected credit losses on public sector loans from 1991 to 2020 were 15 times lower than losses faced by commercial lenders to the same borrowers.

However, MDBs’ valuable financial frameworks and instruments are currently underutilised to catalyse the requisite finance. Guarantees – an MDB financial tool used to target and transfer specific risks – currently represent a small share of MDB portfolios. From 2001 to 2013, project (non-trade) guarantees for both public and private entities totalled only 4.2% of MDB lending. Excluding the Multilateral Investment Guarantee Agency (MIGA), this figure decreased to 1.7% in 2013. When they are utilised following a financial crisis (in the case of the International Finance Corporation), it has almost entirely been in short-term finance guarantees where the risks are low and the impact more limited.

All MDBs currently have a highly conservative approach to capital adequacy, which may clash with the need to provide counter-cyclical and large-scale financing during overlapping global crises. A review of the MDBs’ capital adequacy frameworks – whether shareholder capital is used efficiently – reveals that MDBs can unlock additional lending headroom without threatening their

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[12] Overseas Development Institute (Humphrey, Prizzon), *Guarantees for development: A review of multilateral development bank operations* (December 2014): https://cdn.odi.org/media/documents/9398.pdf.

financial stability or AAA credit rating. Ultimately, MDBs are not subject to a profit maximisation goal; instead, their missions are to be financially sustainable while taking risks to maximise impact. This reality raises important questions about capital management in MDBs, which has settled into an inefficient and suboptimal equilibrium.

Furthermore, providing finance in the context of the looming debt crisis is an additional challenge. An estimated 60% of low-income countries are already in or near debt distress,[13] including 13 climate-vulnerable countries.[14] World Bank stakeholders have continuously called for concessional terms (i.e. grants, below-market interest rates or longer tenures) for MDB lending that yields positive externalities on a global scale. Concessional finance is critical in managing risks and uncertainties related to nascent technologies and emerging markets. In 2020, concessional finance was 16% of total climate finance, while debt consistently remained the main instrument for climate finance. While, by the same year, grant financing has almost tripled to 2011 volumes, their relative share in total climate finance remains less than 5%.[15]

Financial intermediary funds (FIFs) are one of the largest sources of multilateral grant and concessional finance, especially for MIC financing related to the climate and biodiversity. The World Bank serves as a trustee for 12 climate FIFs with combined cumulative funding from donors of more than US$50 billion. FIFs are issue-focused, such as on climate and biodiversity (i.e. the Global Environment Facility, the Climate Investment Funds, and the Green Climate Fund). They are the main financing mechanisms for delivering the Global Biodiversity Framework and for countries attempting to fulfil their NDCs. For these ringfenced budgets to continue delivering consistent results and impacts, shareholder governments can and should engage with MDBs to explore how the efficiency and operational impact of concessional funds can be maximised.

MDB capital adequacy frameworks and the possibilities of prudently unlocking more financial resources.

With the realisation that capital management in MDBs has settled into a suboptimal equilibrium, with underutilised capital and constraints on lending, in 2022, the G20 commissioned an expert review of the capital adequacy of MDBs.

The review finds that MDBs can more efficiently manage shareholder capital and expand lending capacity without jeopardising their AAA credit ratings. They can take on calculated new risks but currently face barriers related to capital structure, financial and operational policies and internal technical capacity.

Two central issues underpinning the report's findings are *callable capital* and the banks' *preferred creditor treatment*, both of which are significant financial strengths unique to MDBs, which are currently underleveraged in their capital adequacy.

'Callable capital' is one of two forms of shareholder capital subscription to MDBs, with the other being 'paid-in capital'. 'Callable capital' is a unique guarantee commitment by shareholders that can be 'called' in the case of imminent default on borrowing or guarantee payment. Callable capital constitutes

[13] IMF, *Helping People Bounce Back* (October 2022): https://www.imf.org/en/Publications/FM/Issues/2022/10/09/fiscal-monitor-october-22.
[14] V2, *An account of debt in the Vulnerable Group of Twenty*: https://www.v-20.org/resources/publications/v20-debt-review.
[15] Climate Policy Initiative, *Global Landscape of Climate Finance: A Decade of Data* (October 2022) https://www.climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-a-decade-of-data/.

a significant portion of the MDB's total capital – to the figure of US$1.2 trillion across 15 MDBs – and has, in practice, rarely been called.

While credit rating agencies see callable capital as additional financial security that, in turn, boosts MDB ratings, most MDBs do not include callable capital when calibrating their capital adequacy frameworks. MDBs should be encouraged to recognise the financial security provided by callable capital and adjust the risk appetite and parameters of their capital adequacy frameworks accordingly.

Preferred creditor treatment (PCT) provides MDBs with a strong loan payment record as it requires borrowers to prioritise MDB repayment over other commercial lenders. Moreover, unlike commercial banks, MDBs are public institutions that do not seek to maximise profit as a priority but rather to enhance longer-term relationships with shareholder borrowers and provide sizeable developmental support. However, the MDB capital adequacy framework and credit rating agencies do not sufficiently reflect PCT in MDB risk parameters modelling. Adjusting such parameters to reflect the lending and repayment history of MDBs is thus needed to enhance the lending headroom across all MDBs.

The more productive use of existing capital helps strengthen the case for more capital. The current environment of escalating crises compounded by the cyclical risk of global economic downturns means that general capital increases are ultimately needed. The reality remains that de facto competition for MDB funds could leave low-income countries at a disadvantage if both MICs and LICs are considered equally, as it could potentially crowd out International Development Association (IDA) allocations to LICs. Capital adequacy is central to the banks' ability to respond to short-term crises and longer-term challenges, including poverty eradication and addressing the planetary crisis. Optimising the efficiency of existing capital will help strengthen the efforts for general capital increases.[16]

Diagnostic 4: Private capital mobilisation is yet to hit 'billions to trillions'

EMDEs will not be able to finance the scale of long-term investment programmes without mobilising at least US$1 trillion a year in private capital by 2030.[17] The role of MDBs therein is not simply filling gaps in development financing, as their direct financing (even if augmented with capital stretching) is insufficient to fill the financing gaps. The purpose and performance of MDBs lie not only in the impact of their own disbursement but in the magnitude of resources they mobilise.

Beyond the immediate optimisation of their own balance sheets, MDBs should continue to advance their engagement with the private sector to support the alignment of all capital flows and intervene where these are effectively directed. Institutional investors have trillions to bring to the table, but a mismatch exists between the supply of finance seeking market rates of risk-adjusted return and the risk-and-return characteristics of investments with climate and broader sustainability impact.

'Billions to trillions' is almost synonymous with the mobilisation of private finance for development. The operational reality, however, has been 'billions to billions' at best.[18] Blended finance could 'provide one of the best solutions to turn billions of development aid into trillions of

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[16] World Bank Group, *Evolving the World Bank Group's Mission, Operations, and Resources: A Roadmap* (December 2022): https://documents1.worldbank.org/curated/en/099845101112322078/pdf/SECBOS0f51975e0e809b7605d7b690ebd20.pdf.
[17] Finance for Climate Action, *Scaling up investments for climate and development: Report of the Independent High-Level Expert Group on Climate Finance* (November 2022): https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/11/IHLEG-Finance-for-Climate-Action-1.pdf.
[18] Convergence, *The State of Blended Finance 2021* (October 2021): https://www.convergence.finance/resource/the-state-of-blended-finance-2021/view.

investment capital for the SDGs'.[19] A recent study by Convergence finds that the average leverage ratio for blended finance transactions has remained stagnant over the past five years. On average, blended finance funds have leveraged US$4 of commercial capital for every dollar of concessional capital, with only a fraction of this commercial capital (US$1.10) coming from private sector investors.[20] Private finance channelled through MDBs for biodiversity amounted to less than US$1 billion in 2022.[21] This figure indicates the lack of prioritisation and budgeting of private sector mobilisation as a necessity to narrow the global financing gap.

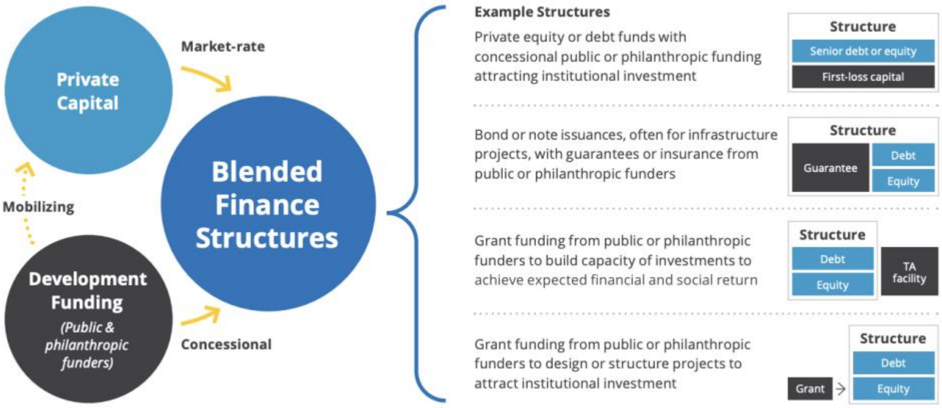

Figure 4 Typical Blended Finance Mechanics and Structures. (Source: The State of Blended Finance 2021, Convergence)

Reforming MDB capital adequacy frameworks goes hand-in-hand with private sector mobilisation, and transparency is key for both. To ensure more coordinated and evidence-based risk assessments, MDBs have collectively constructed a transaction-level database, the Global Emerging Markets (GEMs) database, for assessing credit performance and risks from the banks to public and private sector recipients. The GEMs database has great potential for market-making, educating investors and encouraging private-sector investments alongside MDBs. However, the database remains inaccessible and underutilised. The wider availability of the GEMs database can enable the accurate pricing of risk, which could – in the event of lower net losses and risk levels – allow for projects to be financed at lower and more accurate levels of return.[22]

[19] Blended Finance Taskforce, *Better finance, better world* (2018): https://www.blendedfinance.earth/better-finance-better-world.
[20] Convergence, *How much does a dollar of concessional capital mobilize?* (February 2023): https://www.convergence.finance/news-and-events/news/4cC8kVJXvOFZDVxGQ6HLNH/view.
[21] UNEP, *State of Finance for Nature 2022*: https://wedocs.unep.org/bitstream/handle/20.500.11822/41333/state_finance_nature.pdf?sequence=3.
[22] UN-convened Net Zero Asset Owner Alliance, *Scaling Blended Finance* (November 2021): https://www.unepfi.org/themes/climate-change/scaling-blended-finance/.

STRENGTHENING THE GLOBAL FINANCIAL ARCHITECTURE: AREAS FOR POLICY REFORM

The World Bank/IMF meetings in 2023, the G20 Indian Presidency and Paris Agreement mechanisms such as the Global Stocktake and New Collective Quantified Goals provide special opportunities to scale up MDB support to finance solutions and combat the world's polycrisis. If the world can accomplish this, it would be the most significant transformation of the multilateral finance system since its foundation.

Repurposing, renewing and better deploying the multilateral finance machinery requires transparent, committed and accountable management leadership and shareholder support, as well as incorporating private sector leadership to shift and align all financial flows with sustainability outcomes. MDBs anchor this framework, and the World Bank and IMF need to lead this change.

The PRI recommends the following key steps to create a resilient architecture of cooperation amongst private and public financial systems globally.

1. **Review and revise organisational mandates, operating models and expected outcomes to align with current global challenges.[23]**

During the last century, MDBs focused on capital allocation based on distinct national needs. MDBs of the new century will need to evolve to tackle global existential challenges and deliver outcomes at the local and national levels. Beyond ensuring the prosperity of current and future generations, MDBs have a responsibility to help ensure the habitability of the planet. Doing so does not mean abandoning existing mandates such as poverty reduction or ensuring future prosperity, but instead promoting sustainable economic growth, social equity and climate mitigation and adaptation as interlinked issues.

For the World Bank specifically, shareholders should call for its adoption of tackling the planetary crisis as a core institutional priority, sitting alongside poverty reduction and shared prosperity. Doing so will enable the review and revision of existing operating models to best address these interlinked mandates and allow for the optimisation of existing and new sets of instruments and incentives that can make a measurable difference in shared outcomes such as the Paris Agreement, the Global Biodiversity Framework and wider sustainability goals.

Similarly, the IMF can strengthen its collaboration with financial regulators and international standard setters such as the International Organisation of Securities Commissions (IOSCO) and the International Platform on Sustainable Finance (IPSF) to support the global alignment on sustainable finance. Moreover, the IMF and the World Bank Group of organisations can and should ensure the timely and regular exchange of information and coordination, both at the technical staff level and in terms of grants and financing mechanisms to ensure complementarity.[24]

[23] MDBs can update their charter documents through a special resolution. For the International Bank for Reconstruction Development, any member country can propose such special resolution to the chairman. Once approved by majority of the board, the resolution will be adopted if agreed to by at least 60% of the members with at least 85% of the votes.
[24] European Central Bank, *The role of IMF in addressing climate change risks* (November 2022): https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op309~4a449b41bc.en.pdf.

2. **Enhance catalytic financial instruments for global sustainability outcomes through reforming capital adequacy frameworks and exploring new financial structures.**

There is a great propensity for MDBs to expand their combined lending while maintaining their current institutional ratings. This process includes leveraging donor portfolio guarantee funds that reduce risks and free up capital space for more lending, thereby multiplying the power of donor funds.

Shareholders should review key capital adequacy metrics and concepts that are clearly and consistently defined across MDBs. Regular and standardised capital adequacy benchmarking should also be conducted across MDBs.

The World Bank, IMF and other MDBs should continue exploring auxiliary financial structures and leveraging the strengths and complementarities of pools and financing vehicles that reduce the capital costs for borrowers. Activities could include exploring financial structures that use special drawing rights (SDRs) to expand lending, as the IMF is one of the most available channels for SDR reallocation. This goal can be accomplished through lending schemes, whereby developed countries lend SDRs to MDBs to increase available loan funds, as is done through the Poverty Reduction and Growth Trust and the Resilience and Sustainability Trust. It can also be achieved through capital injections, where SDRs are lent as capital contributions to mobilise more loanable funds.

3. **Scale and aggregate concessional finance to increase financial efficiency and leverage greater lending.**

To bridge the gap between high investment risk in EMDEs and investors' fiduciary obligations to earn a risk-adjusted return, governments, foundations and other donors should create sizeable and flexible pools of concessional capital to de-risk investments to bring them within investors' risk limits.

Shareholders should continue to engage with MDBs on better utilising and leveraging existing financial intermediary funds that are mutually supportive and target distinct outcomes. More can be done to maximise the impact and mobilisation of FIFs by developing a uniform reporting standard across FIFs on a common set of core impact indicators to assess value for money. Strengthening FIF performance, efficiency and impact will make a case for donor contribution growth. Currently, the annual commitments of climate FIF concessional finance total about US$4 billion, which is a fraction of the World Bank Group climate-related finance to LICs and MICs of US$28 billion in 2021 and combined MDB climate-related finance of US$50 billion.

In evolving the multilateral financial architecture in a way that is genuinely fit for purpose, the bank-hosted FIF secretariat should work – under a revised mandate – to build a secure and adequate financial base that can channel and disburse funding through thematic facilities with rapid response.

4. **Prioritise the mobilisation and alignment of private finance at scale with strong incentives, risk sharing and mission clarity.**

Catalysing a much larger volume of private finance for investments towards sustainable outcomes remains the only viable avenue to achieve the financing scale and speed required, particularly in EMDEs. For responsible investors, allocating capital with positive real-world outcomes is central to reducing global risks to crises and capturing sustainable returns.

While, ultimately, more capital injection or concessional contributions are viable options to expand the private windows of MDBs, what is needed first is to reform the business and financial models of these private windows. Increasing the available amounts of concessional finance for blending would not lead to more viable transactions or greater leverage ratios.

Specifically, shareholders should support the following changes in MDBs in order to turn the 'billions to trillions' action plan into a reality:

- **Transform from an originate-and-hold model to an originate-and-transfer model** for transactions at a later stage or with demonstrable profitability while retaining the wider sustainability and impact focus.[25] Such an approach allows MDBs to leverage their PCT, take the first loss and bring projects down to suitable risk-return profiles for investors, ultimately freeing up MDB capital for more operations.[26]
- **Focus on critical gaps in capital markets and on developing relevant instruments while establishing systemic collaboration between the public and private arms of MDBs.** This approach includes early-stage finance, such as first loss guarantees and equity, for projects and firms, local currency finance and especially finance for sectors with positive social and environmental externalities that private finance is not in a position to fully capture. Enabling systemic collaboration is essential to streamline the project procurement, appraisal, approval and support processes.
- **Deploy more concessional finance for risk management**, including for MDBs to take on more risks, reduce risks and bear the first-mover costs of making projects more bankable. Scaling the concessional finance available to MDB private finance arms is one way of incentivising this process.
- **Fulfil revised mandate by delivering on financial returns adjusted for impact**, including impact around social development, emissions reductions and ecosystem resilience. Achieving this goal may mean accepting positive but below-market financial returns at the portfolio level.
- **Increase data transparency on risk to avoid unnecessary costs on capital and incentivise risk sharing.** MDB shareholders can advocate for the Global Emerging Markets Risk Database to be expanded to include more holistic historical loss and recovery data from MDBs, with responsible access to GEMs provided to relevant risk-takers and credit rating agencies. Confidentiality should be ensured through data aggregation as needed. Doing so can address issues related to risk misconception and further crowd-in private capital.
- **Scale up technical assistance at the local level.** MDBs can leverage their existing presence and expertise on market-specific challenges and provide technical assistance such as building governmental capacity on regulation, equitable taxation or phasing out harmful subsidies. Doing so would help cultivate a sustainable financial ecosystem and strengthen the financial architecture from local to global levels.

[25] Center for Global Development, *What Multilateral Development Banks Can Do to Mobilize Private Capital At Scale* (23 November 2021): https://www.cgdev.org/blog/what-multilateral-development-banks-can-do-mobilize-private-capital-scale.
[26] An example is the African Development Bank's Room2Run, a US$1 billion synthetic securitisation instrument between the MDB and the private sector for credit risk transfer, which frees up space for the AfDB to make US$650 million more in loans without requiring further capital from shareholders. The bank reinvests this freed-up capital into new African infrastructure lending in fragile and low-income areas. See https://www.afdb.org/en/news-and-events/african-development-bank-and-partners-innovative-room2run-securitization-will-be-a-model-for-global-lenders-18571.