RESEARCH INSIGHTS

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Risk Transfer for Multilateral Development Banks: Obstacles and Potential

Risk transfer refers to a set of techniques which allow Multilateral Development Banks (MDBs) to transfer risk off their balance sheet freeing up space for greater lending to developing countries at low interest rates.

There is potential for the wider use of risk transfer, complementing further increases of MDB capital from shareholders.

But a set of obstacles limit risk transfer possibilities. We thus provide specific recommendations to international policymakers to unlock the potential of these techniques.

CONTEXT

On the strength of their high creditworthiness, MDBs issue bonds bought by investors seeking very low risk assets and provide long-term development finance to developing countries at low interest rates. MDBs can further increase their impact through co-lending with the private sector and by transferring risk off their balance sheet, creating space to lend more with current capital levels.

While co-lending has received considerable attention and has worked well in countries with more developed institutions, the transfer of risk off MDB balance sheets to allow for greater lending to all countries has received less attention.

PROJECT

In this project, we describe alternative risk transfer techniques, including: i) exposure agreements (swapping assets with others to reduce concentration risk); ii) purchasing insurance, obtaining guarantees (particularly where there is a large volume of lending and therefore a high concentration risk); and iii) securitizations (taking existing assets, repackaging them, and selling some of the risk to other investors) (see Table 1). We quantify the potential impact of these transactions through the medium of development multipliers to determine the extent to which MDBs could boost their lending capacity. Finally, we discuss the obstacles to scaling-up such transactions for both MDB loans to sovereigns and loans to the private sector.

RESULTS

We argue that risk transfer has been "hiding in plain sight." In particular, the European Fund for Strategic Investment is backed by a guarantee of some €16 billion from the European Union budget and has allowed the European Investment Bank to originate considerably larger lending volumes. We suggest that MDBs and donor governments alike can learn from the European experience.

Furthermore, we suggest there is considerable potential for the wider use of risk transfer transactions. For example, we employ a widely utilized tool to analyze securitizations and find that they could result in multipliers of 1.5 and 1.7 for specific sub-portfolios of sovereign lending and for private lending, respectively. That implies boosting the lending power of an MDB by between 50% and 70% of the value of those asset portfolios suitable for risk transfer. The total amount of additional lending would depend on the creditworthiness of the assets securitized and the share of securitizable assets on the balance sheet.

Key concept

RISK TRANSFER

Techniques used by banks to shift certain risks of their balance sheets to free up space to then lend more.

POLICY IMPLICATIONS

MDBs could lend more if they were able to make wider use of risk transfer to complement their own capital resources. However, there are several serious obstacles in that path.

First, MDB sovereign loans are considered as preferred meaning that in the context of a debt restructuring, while commercial lenders often suffer losses, MDBs expect to be repaid in full. But there is potential confusion regarding MDB loans that are insured or guaranteed by third parties or that are securitized and in part sold. In our view, international policymakers, including the *Paris Club* of official creditors, should make clear that all MDB-originated and serviced loans should be considered preferred, irrespective of any risk transfer transaction.

Second, investors and rating agencies do give MDBs some allowance for the preferred status of MDBs, and this enables the main MDBs to maintain the highest credit rating (AAA) at lower levels of capital than otherwise possible. But the impact of being a preferred creditor tends to be underestimated and is not accounted for when evaluating risk transfer. MDB loans have low default probabilities and extremely low losses given default. In fact, MDBs generally talk about *arrears* and not *default*. This should be recognized in the context of evaluating potential MDB transactions.

Third, to assist rating agencies and investors in evaluating MDB loan performance, MDBs should be transparent and share and publish their loan credit performance data in a standardized and granular fashion. There is an ongoing project in this regard known as Global Emerging Markets Risk Database Consortium (GEMs), which could be strengthened and deepened to assist in evaluating risk transfer transactions and widening the range of investors that might purchase, guarantee, or insure risks currently on MDB balance sheets.

Key concept

PREFERRED CREDITOR STATUS

The expectation of official lenders such as the IMF and MDBs to be repaid in full in the event of a sovereign default.

Table 1. Examples of Risk Transfer Transactions by Selected MDBs

Exposure exchange arrangements	Securitization transactions	Structured reinsurance	Single-name guarantees
Inter-American Development Bank	African Development Bank	African Development Bank	Inter-American Development Bank
African Development Bank	European Investment Bank	Multilateral Investment Guarantee Agency	Asian Development Bank
Asian Development Bank	European Investment Fund	African Trade Insurance Agency	IDB Invest
	International Finance Corporation	Islamic Corporation for Insurance of Investments and Export Credit	

FULL STUDY

Galizia, Federico, William Perraudin, Andrew Powell, and Timothy Turner. 2021. "Risk Transfer for Multilateral Development Banks: Obstacles and Potential."

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

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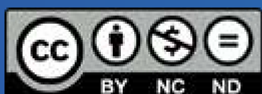

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