

JCR Solicits Public Comments on Revisions to “Rating Methodology for Multilateral Development Banks”

Japan Credit Rating Agency, Ltd. (JCR) is considering revisions to “Rating Methodology for Multilateral Development Banks” as described below and solicits opinions on the proposed rating methodology.

1. Outline

JCR is considering revising “Rating Methodology for Multilateral Development Banks” as described in the attachment. The purpose of these revisions is to further enhance the transparency of the rating by reviewing the descriptions in light of changes in the roles, financial practices and risk environment of multilateral development banks while providing greater clarity on the key rating considerations.

2. Future Plans

JCR solicits public comments on this matter. Comments will be accepted by e-mail to “Contact Us” on JCR website until November 4. JCR plans to finalize this rating methodology in about one or two months. There will be no existing individual ratings that need to be reviewed.

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Draft for Public Opinions

Rating Methodology for Multilateral Development Banks

This rating methodology applies to multilateral development banks (MDBs), which are established by multiple sovereign states (member countries) and provide loans, technical assistance, grants and other forms of support to borrowing countries (borrowers). The creditworthiness of MDBs is assessed comprehensively based on the strength of support from member countries, as well as capital, asset quality, liquidity and funding, financial management and risk management frameworks, and earnings capacity, which together form the basis of MDBs' financial strength.

1. Outline of MDBs

An MDB is an international financial institution created by member countries for the purpose of promoting socioeconomic development and regional integration in the regions it serves. It provides loans, technical assistance, grants and other forms of support to borrowers, using contributions from member countries and funds raised in capital markets.

MDBs characteristically differ from ordinary commercial banks in the following respects:

- Shareholders' equity consists of contributions from member countries, with limited exceptions where private commercial banks are permitted to hold equity stakes.
- MDBs have no specific nationality and are not subject to banking regulations of any countries. At the same time, they conduct conservative financial management in accordance with the constitutive agreements endorsed by member countries.
- MDBs are not profit-oriented and, in principle, make no dividend payout.

MDBs also have a characteristic different from bilateral aid agencies. Whereas official bilateral claims are subject to debt restructuring under the framework of the Paris Club¹, the official claims of MDBs are generally excluded from such restructuring and MDBs enjoy Preferred Creditor Status (PCS), an established practice under which borrowing countries give priority to repayments owed to MDBs.

In relation to MDBs except the World Bank Group, member countries are generally divided into regional members and non-regional members. Usually, regional members are borrowers, and non-regional members support MDBs by making contributions as non-borrowers. However, in the case of regional development banks, regional members may include non-borrowers.

Both borrowers and non-borrowers have strong policy-related incentives to sustain their MDBs. Borrowers can obtain long-term and stable funding on more favorable terms than they could secure on their own, as MDBs

¹ The Paris Club is an informal forum of major bilateral official creditor countries that discusses measures to ease the burden of servicing official bilateral debt owed by debtor countries facing difficulties in servicing their external debt.

leverage their high creditworthiness to raise funds in capital markets. Non-borrowers on the other hand can support the development of borrowers through capital contributions to MDBs, without directly assuming the credit risks of borrowers.

MDBs are not profit-oriented organizations; they carry out their operations with the aim of achieving policy objectives shared by member countries, including socioeconomic development and regional integration. Accordingly, the policy importance of an MDB depends on the extent to which it contributes to the achievement of policy objectives expected by member countries.

The roles expected of MDBs in recent years have expanded beyond their traditional functions of providing development funds and supporting infrastructure development. MDBs play a crucial role in addressing challenges involving global public goods, including climate actions, biodiversity conservation, pandemic response, food security, energy security, and support for fragile and conflict-affected countries. They are also expected to help bridge development financing gaps through the promotion of private capital mobilization (PCM).

MDBs may provide guarantees covering all or part of the principal and interest on loans, bonds and other financial instruments to facilitate the provision of financing to borrowing countries and the mobilization of private capital. By assuming credit risks for the guaranteed portion to a certain extent, they seek to improve financing terms and encourage private investment.

In order to continue fulfilling these roles, MDBs require both continuous support from member countries and sound financial strength. If they fail to maintain such financial strength, it will be difficult for them to respond to the funding needs of borrowers in a timely and appropriate manner and to continue fulfilling the policy role expected by member countries.

2. Assessment of creditworthiness

When assessing the creditworthiness of an MDB, JCR evaluates the strength of support from member countries and the components of the MDB's financial strength: capital, asset quality, liquidity and funding, financial management and risk management frameworks, and earnings capacity. The following sections outline JCR's fundamental approach to each of the evaluation items.

(1) Support from member countries

Member countries of an MDB consist of borrowers and non-borrowers. They are also categorized into regional member countries and non-regional member countries, except for the World Bank Group. The strength of support from member countries is analyzed separately for borrowers and non-borrowers.

<Borrowers' support>

- Track record of repayments to MDBs during periods of funding difficulties in borrowing countries
- Track record of participation in paid-in capital increases

<Non-borrowers' support>

- The proportion of total paid-in capital contributed by non-borrowing member countries and their participation in capital increases
- Track record of contributions to special financial resources (resources separate from ordinary resources, used primarily to provide loans to low-income countries and other eligible borrowers on more concessional terms), special funds (funds that provide concessional loans, grants and other forms of assistance for technical cooperation and specific development priorities), etc.
- Status of dispatch of officers, employees, etc. from non-borrowing governments

When assessing the strength of support from member countries, JCR places significant emphasis on the track record of support. MDBs that have received support over a long period and have expanded their operations are judged to have relatively strong support from member countries. When evaluating the sustainability and likelihood of support, JCR takes into consideration not only the track record of support but also the role an MDB plays in helping member countries achieve their policy objectives and address the priority issues of the international community, the degree to which policy objectives are shared among member countries, the engagement of major shareholder countries, and the effectiveness of decision-making bodies. JCR also examines the impact of changes in the international situation and in relationships among member countries on the MDB's operations and capital policies. The MDB's high policy importance constitutes an important factor in securing continued support from member countries.

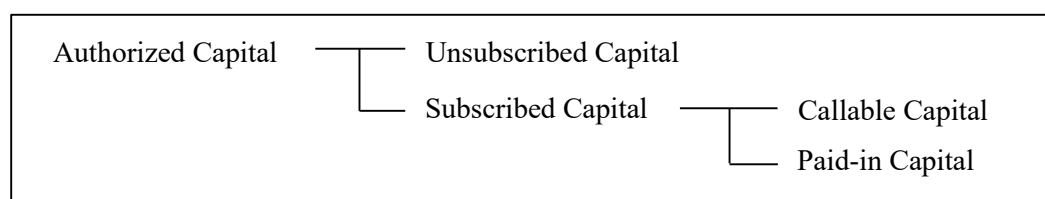
(2) Financial strength

(i) Capital

(a) Capital structure and capital adequacy

JCR places emphasis, in its assessment of capital, on the composition and quality of capital, as well as the adequacy of capital relative to risks.

The capital of an MDB is usually structured as shown below.



In an MDB's balance sheet, paid-in capital is the core element of shareholders' equity. Callable capital is capital that member countries have committed to provide but have not yet paid in. An MDB may call on member countries—shareholders—to pay in capital up to the amount already approved (committed), only when necessary to fulfill its financial obligations. In assessing capital, JCR places the greatest emphasis on the size of paid-in capital. Because callable capital is commitment-based, its creditworthiness depends on the payment capacity of member countries. Accordingly, JCR considers callable capital

subscribed by member countries with low creditworthiness to have limited effectiveness when such countries are in financial difficulties. By contrast, callable capital provided by member countries with high creditworthiness constitutes an important source of support that underpins an MDB's debt-servicing capacity even under extremely adverse circumstances. JCR comprehensively evaluates the size of the portion of callable capital subscribed by highly creditworthy member countries, the creditworthiness of individual shareholder countries, legal enforceability of payment obligations, clarity of call procedures, and the available support capacity and effectiveness of callable capital.

JCR assesses capital adequacy relative to risk by examining the coverage of outstanding loans and equity investments by (i) shareholders' equity, comprising paid-in capital, surplus, reserves and other equity components, and (ii) a broader measure that also includes callable capital subscribed by highly creditworthy member countries.

(b) Capital optimization

In addition to capital increases, MDBs are seeking to enhance their lending capacity through a more efficient utilization of existing capital. Against the backdrop of international discussions on their capital optimization, they have been undertaking initiatives to that end in recent years, including the use of guarantees provided by member countries and other counterparties, credit risk transfer transactions, exposure exchange transactions and hybrid capital instruments.

JCR examines the extent to which these capital optimization measures are utilized. In addition to their effectiveness in expanding lending capacity, JCR comprehensively evaluates their impact on capital quality and financial soundness, taking into account the effectiveness of risk transfer, creditworthiness of counterparties, the complexity of transaction structures, changes in the financial structure, and the effectiveness of these measures under severe financial and economic conditions.

(ii) Asset quality

JCR, in its assessment of asset quality, places particular emphasis on such factors as the credit risks of the loan and equity participation portfolio, degree of risk concentration, and occurrence of arrears. JCR also examines the impact of climate change-related physical risks and transition risks on the loan and equity participation portfolio. In particular, the impact of concentration in specific regions or industries on asset quality over the medium to long term, as well as the adequacy of the MDB's climate-related risk management system, is evaluated.

MDBs have a Preferred Creditor Status with respect to their claims against borrowers. Preferred Creditor Status refers to an established practice whereby principal and interest payments on debt owed to MDBs are given priority over payments on other external debt. This preferential treatment is not based on an explicit legal payment ranking established in the articles of agreement or other governing documents. Rather, it has developed and been maintained through borrowers' repayment track records, the treatment of MDB claims in sovereign debt restructuring, and support from the international community, including member countries.

Preferred Creditor Status has been maintained because MDBs play the role of continuously providing funds to borrowers even in times of crisis and because borrowers have an incentive to continue repaying debts to MDBs from the perspective of maintaining access to future financing opportunities and support during crises. Moreover, in sovereign debt restructuring, debts to MDBs have generally been excluded from restructuring arrangements to maintain MDBs' financial soundness and their future capacity to provide financing.

Nevertheless, the Preferred Creditor Status is not a legally established right and therefore does not entirely eliminate the possibility of payment arrears or defaults by borrowers. Therefore, JCR examines borrowers' repayment track records, the frequency and duration of payment arrears, status of the resolution of arrears, treatment of obligations owed to MDBs during periods of crisis, and track record of excluding MDB claims from sovereign debt restructuring. JCR also evaluates the effectiveness and sustainability of the Preferred Creditor Status in light of the policy role played by MDBs for borrowers, their capacity to provide financing during crises, and support extended by member countries and other official creditors.

JCR examines potential credit risks as well, including those associated with private-sector claims. Private-sector claims without sovereign guarantees held by some MDBs carry relatively high credit risk because they generally cannot be expected to receive the same preferential treatment as sovereign claims. Nevertheless, MDBs aim to reduce risks through such measures as increasing loan-loss provisions, limiting loan balances, applying stricter lending terms and underwriting standards than commercial banks, restricting the scope of eligible projects, and modifying repayment terms to enhance recoverability. JCR evaluates lending policies and risk management frameworks for private-sector exposures.

(iii) Liquidity and funding

Given that MDBs often provide loans for and invest in long-term projects and that the amount per transaction is large, maintaining sufficient liquidity is crucial. Liquid assets primarily consist of deposits and highly rated short-term securities. Moreover, there are cases where credit lines are established with highly creditworthy international commercial banks to supplement liquidity. JCR reviews the coverage ratio of liquid assets to net cash requirements over the next 12 months, along with other indicators, and assesses the adequacy of liquidity.

As for funding, JCR looks at access to capital markets, diversification across funding instruments, currencies, maturities and investors, financing costs, etc. and evaluates MDBs' ability to secure stable financing.

JCR also reviews whether MDBs can maintain sufficient liquidity and the capacity to provide financing even in the event of a sudden increase in loan demand, accelerated loan disbursements, relaxation of repayment terms for borrowers, etc. due to financial market turmoil, natural disasters, the spread of infectious diseases, geopolitical tensions, or other crises. At the same time, JCR reviews the impact of an increase in lending and guarantees associated with crisis response and changes in repayment cash flows on capital, liquidity and earnings capacity and evaluates MDBs' ability to rebuild their financial buffers after a crisis subsides.

(iv) Financial management and risk management frameworks

MDBs engage in conservative financial management in accordance with their strict internal guidelines. JCR

considers such financial management to be a key factor that underpins MDBs' creditworthiness. Major internal regulatory indicators include gearing ratio (ratio of outstanding loans, guarantees and equity investments combined to shareholders' equity), leverage ratio (ratio of outstanding financial debt to shareholders' equity), liquidity metrics, including ratios of liquid assets to undisbursed commitments and to projected debt repayments and loan disbursements over the next 12 months, restrictions on eligible investments, upper limits on total equity investments, and upper limits on outstanding credit guarantees relative to shareholders' equity. JCR reviews the content of these internal regulations and compliance with them. With respect to guarantee operations for loans, bonds, etc., JCR looks at such factors as the credit risks of debts subject to guarantee, scope and terms of guarantees, amount of guarantees outstanding and financial impact of guarantee calls and evaluates the adequacy of the relevant management system. Furthermore, JCR assesses the adequacy of the comprehensive risk management system, including asset-liability management (ALM), market risk management, liquidity risk management, operational risk management, climate-related risk management and business continuity management in the event of large-scale disasters, infectious disease outbreaks and other crises.

(v) Profitability

Not being profit-oriented, MDBs do not give top priority to profit expansion. Yet, they need to secure stable earnings capacity to maintain a sound financial position and continue their business operations. JCR reviews the earnings targets established by each MDB, the extent to which those targets are achieved, stability of earnings and accumulation of retained earnings to assess whether sound financial management is maintained. JCR also examines the capacity to rebuild capital through the accumulation of retained earnings when financial buffers have been reduced by crisis-response measures or other factors.

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