World Bank Group Evolution: Technical fixes or urgently needed reform?

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At Issue

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Twenty-five years after its last major reform, the World Bank is embarking on a wide review of its mission, operational procedures and financial mechanisms. However, the current proposal runs the risk of failing to deliver the structural changes needed to support borrowing countries amidst global crises, and relies on general technical measures that function as patches favouring the 'logic' of the market. In light of the 'crises of development', retrogression on global development goals, and threats to the multilateral order, the Roadmap seems an inadequate response.

The Global South is facing deep, overlapping crises which jeopardise the achievement of the Sustainable Development Goals (SDGs). Since 2020, poverty and inequality between and within countries have increased, and global growth has slowed. The United Nations *Sustainable Development Goals 2022 Report* noted a profound setback in the elimination of poverty, an increase in the number of conflicts with a rising number of displaced persons, and the increasingly negative impacts of climate change, all of which have triggered alerts among development stakeholders.

Among others, in October 2022, a group of ten World Bank major shareholders – including the US, Germany, the United Kingdom and Japan – called for a revision of the institution's approach to these challenges. Responding to this and other calls, such as the G20 multilateral development banks' (MDBs) capital adequacy framework (CAF) review (see *Observer* Winter 2022), the World Bank Group (WBG) – the most important source of official multilateral financing for middle- and low-income countries – began a reform called the Evolution Roadmap. The Bank's executive board emphasised the need for it to be ambitious. But is it? If so, in what ways?

This 'Evolution' process – which was formalised with a first draft of the Roadmap published in January 2023, followed by a more advanced and granular *Development Committee Paper* in March 2023 – purports to focus on the triggers of current challenges, but mainly highlights emerging global events such as the Covid-19 pandemic and the climate crisis. Although these have undoubtedly been serious and unprecedented, the analysis fails to engage with their root causes – including the World Bank's own role in the current 'crisis of development', while referring to itself as world's main development lending and 'knowledge' institution (see *Observer* Summer 2019).

While maintaining the Bank's twin objectives – eradicating extreme poverty and boosting shared prosperity – the Evolution Roadmap reviews their interrelationship and links with global challenges. It also recognises

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that middle-income countries (MICs) face particular challenges and require dedicated support and lending instruments, a consideration explicitly omitted from the last 2018 capital increase. Hence, the WBG proposes setting a certain focus on the problem of inequality – one of the main challenges faced by MICs – and achieving a minimum level of well-being for all, with a "sustainable, resilient and inclusive" approach. Regarding global challenges, the WBG proposes to focus on three priorities: climate change, pandemic preparedness, and fragility. It also repeatedly references the debt problem now faced by many borrowing countries (see *Observer* Spring 2023), which is indeed a central challenge of the current development agenda – especially given the development and human rights implications of the projected wave of austerity – but without making concrete proposals to deal with these issues.

The Roadmap seems more focused on carving out a leading role for the Bank in emergencies and crises, as it calls to increase both blended – concessional and non-concessional – financing, especially, but not only, for MICs. All of this could be positive to the extent that the proposals also favour a more agile and dynamic operating model that reduces transaction costs for countries.

Private sector engagement: A continuation of the (so far) limited "Billions to Trillions" agenda

The Evolution Roadmap proposes working towards a greater coordination of the whole Group as "a single WBG", re-emphasising the priority of the private sector's role in development. The new operating model maintains and reinforces the Bank's current 'way of doing business' (e.g., through its – more positive – "country-based" and – more questionable – "Cascade" approaches), redoubling the Bank's efforts to encourage private sector engagement.

The WBG intends to draw on the so-called Cascade approach – adopted in 2017 and promoted by the G7 (see *Observer* Summer 2023) – to scale developmental impact while engaging "both public and private sectors given their critical roles in development". The Cascade aims to "maximise finance for development" in light of scarce public resources, first seeking to mobilise unofficial funds, enabling upstream sector reforms, and applying guarantees and risk mitigation instruments (see *Observer* Summer 2017) with debatable inclusive developmental impact.

[T]he Roadmap does little to empower states to regulate the [private sector] or to address considerable power imbalances.

Despite the fact that some within the Bank have acknowledged tensions between crowding in profit-driven private investment and optimising financing for development, the approach is nonetheless permeated with the neoliberal idea of 'lean' public funding: The government must only finance what the market cannot, or will not. However, the prospect of failing to meet the SDGs has made clear that the role of developing states will need to go beyond merely 'de-risking' private sector investments if development and green transformation goals are to be met. In this sense, de-risking allows the private sector to reap even more benefits from the state, for example by using blended finance, which, in turn, "adds fuel to the fire", by exposing states to contingent liabilities.

Therefore, the Roadmap could be an opportunity for the Bank to revise its operational work linking the government and the private sector based on state capacity and public-minded innovation policy. The Roadmap intends to give more space on this joint (Bank-government) agenda to the private sector within the country level strategies. However, bearing in mind firms' commercial strategies, and in order to really act as "one WBG", the preparation and approval processes of non-sovereign projects would in fact require an increase in government involvement (i.e. surpassing the currently used "no objection" criteria). This would for example entail the definition of which sectors and types of companies to finance in each country.

Second, a substantial part of the WBG's Evolution is based on the need to foster private – international and domestic – capital mobilisation. The initial years (late 1950s) of the International Financial Corporation (IFC), the Bank's private investment arm, were marked by the same limitations – insufficient capital and market distrust – faced by its main sovereign window, the International Bank for Reconstruction and Development (IBRD, now the Bank's middle-income country lending arm). More recently, the IFC acquired greater relevance and incorporated various instruments, achieving a historical capital increase in 2018, which expanded IFC's work with the International Development Association, the World Bank's low-income country arm (see *Observer* Summer 2019).

While acknowledging the – worryingly – weak domestic private sector investment levels and financial markets for development, the Roadmap calls for their development, particularly in MICs. Some of the proposed changes in the WBG's operational model include critical intermediation by MDBs through private capital-enabling reforms, individual project structuring and active fundraising from private and institutional investors, together with strengthening domestic capital markets "to crowd in local private sectors". While it would be desirable to count on the participation of private stakeholders to complement public multilateral banks' financing, governments have

responsibilities and common goals that differ from those of the private sector, and the Roadmap does little to empower states to regulate the latter or to address considerable power imbalances.

For example, a 2020 research paper from the World Bank shows the effects of 'elite capture' dynamics on development funds, something previously pointed out by many. In this sense, it is also vital to pay attention to the potentially damaging governance consequences that such a process may bring. It is likely that the ultimate responsibility or final cost of the projects will fall on the states' purse when making use of some of the instruments proposed – e.g. guarantees and public-private partnerships. On the other hand, the picture on private capital mobilisation is not very encouraging. The limits of the Roadmap have become visible not only in the meagre mobilisation levels observed - $0.7 of private sector finance for each dollar of public investment by development finance institutions in the most optimistic scenario - but also in its own financial model proposal, where a new capitalisation would be the most relevant way of increasing lending capacity (see below). Even the IMF's *2022 Global Financial Stability Report* admitted that MDBs could do better, having for example attracted, on average, only 1.2 times the amount of private climate finance relative to commitments of their own resources in 2020.

Facing an economic slowdown and given the low capacity for domestic and external resource mobilisation so far, the Evolution Roadmap seems rather lean and potentially tied to increasing conditionalities. Will this time be different from the past and succeed in maximising the Bank's developmental impact? And even in the best-case-scenario of a successful increase in private resources, would the Bank's current development model enable the expected developmental impact (see *Observer* Autumn 2022)?

Moreover, given the strong reliance on resource mobilisation, and despite the evident increase in the number of local currencies covered in WBG's loans, which now reaches over 74, the Roadmap does not propose innovative ideas about developing domestic capital markets through financing in local currency (e.g., by placing bonds in developing countries). In this line, prioritising the private sector should also be consistent with further efforts to develop and strengthen domestic capital markets through local currency financing – see for example JP Morgan's call – helping countries somewhat reinforce their monetary autonomy, as BRICS New Development Bank's short experience is showing.

Finally, on a more positive note, the proposed operating model reform of MICs' lending policy does envisage adding interesting and potentially relevant instruments for emerging economies. This would involve taking a resilience approach, with a strong anticipatory capacity, and expanding the WBG's crisis response toolkit – for example, through a more efficient reuse of undisbursed funds in countries' portfolios for immediate disaster response, as occurred in the context of the Covid-19 crisis.

Reinvigorating the WBG's financial model: At what cost?

The discussions about MDBs' capital adequacy are not new. As public entities, MDBs have diverse ways of financing their operations, mainly capital contributions, leverage in private capital markets and their credit function. The preponderance of callable capital – 91 per cent on average in 2020 with the remainder in cash – together with the AAA rating mandate and the credit rating agencies' methodologies trigger a trade-off between prioritising market over borrower dependence, greatly constraining MDBs' counter-cyclical, or at least non-cyclical, development mandate.

The Evolution Roadmap basically contemplates two significant proposals to deal with capital adequacy issues and expand lending: A (traditional and direct) general capital increase (GCI), or increasing loan pricing; and (rather more indirect) financial engineering – so-called "balance sheet optimisation" (BSO) – measures to free part of the WBG's capital used as prudential buffer.

The existence of the CAF group of experts to study and make recommendations to MDBs in general is a clear contribution towards a somewhat more consensual and

President Joe Biden meets with newly appointed World Bank President, Ajay Banga, whose first big test will be leading the Bank's Evolution Roadmap process. Credit: Adam Schultz, Official White House Photo

country-owned agenda for these banks. The Roadmap took on board many of the group's recommendations, proposing revisiting part of its financial model to make it a little less conservative. But all these measures have varying levels of impact in terms of improving the WBG's lending capacity and institutional framework.

The Roadmap recognises the IBRD as the WBG's most powerful financing source, and a GCI to be its most valuable tool. As such, a GCI would send a strong signal of shareholder support for the relevance of the WBG's "evolution". In any of the proposed scenarios, the GCI would be the most effective way to expand IBRD's lending capacity: The least ambitious GCI ($5 billion in cash) would increase the loanable capacity of the IBRD by 50 per cent.

In terms of BSO measures, the WBG aims to enhance IBRD's financing capacity (adding up to $50 billion over 10 years), always protecting its AAA rating and long-term financial sustainability, through lowering the minimum equity-to-loan (E/L) ratio by 1 percentage point. This would follow a higher shareholder risk appetite for integrating callable capital and a greater reliance on the 'uplift' for such capital provided by risk rating agencies. It also proposes using two kinds of hybrid capital (i.e., subordinated debt instruments like equity but without voting rights) for shareholders and/or private capital market investors, together with increasing risk transfers through the expansion of shareholder and MDBs guarantees and/or exposure exchange.

Although some of these BSO innovations would allow for the WBG to support the proposed changes related to a MIC-oriented operational model, relative to a GCI they pose more institutional risks to the Bank (such as a potentially negative impact of subordinate instruments on loans' property rights, or private investors' influence on the decision making). Also, given that issuing hybrid capital to private investors is estimated to be more expensive than that to shareholders, this could generate further opposition from borrowing countries.

Moreover, it is likely that such complicated financial engineering would result in deepening MDBs' dependence on the 'view of the market' given by credit rating agencies. Increasing lending room does not necessarily imply that the WBG will have a better and larger developmental impact, if it maintains its current development model (see *Observer* Autumn 2022). In this sense, the proposed financial re-engineering puts new stakeholders in play, but key questions remain: Would this have an impact on countries' property rights? Who would be left with the ultimate responsibility of an extended use of guarantees? Will the use of counter-cyclical capital rely on a more conservative approach in 'good times'? And were a potential GCI to be insufficient, will it result in higher loan pricing in the medium-term? Will this all imply a "flight to quality" of the Bank's financing?

A more 'rooted solution' would be to also revise credit rating agencies' risk measurement methodologies – which, among other things, overvalue portfolio concentration and undervalue preferred creditor treatment. Once again, the Evolution Roadmap highlights the increased reliance of most MDBs on more market-based financial innovations to offset the reluctance of shareholders to increase sovereign support. Such financial drought is inconsistent with calls by borrowers for additional development finance and with wealthy countries' past commitments to increase Official Development Assistance.

All in all, the WBG's Evolution Roadmap proposes some interesting potential features, such as expanding concessional financing for MICs and increasing the institution's lending capacity through a GCI, but they are not the core of this reform. The reform rests on a neoliberal paradigm that has been brewing at the macro level of a private-driven development model, as embodied by the Cascade approach. Overall, the Bank runs the risk of failing to deliver the structural change needed to support borrowing countries amidst global crises, with measures that function as patches favouring the 'logic' of the market. It is never too late to demand that these multilateral finance institutions recover their foundational spirit: Attracting resources under their more constituent multilateral 'cooperative logic', and leaving development leadership to developing countries' governments.

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