Preferred Creditor Status

Multilateral Development Banks' Comparative Advantage

Special Report

Definition of Preferred Creditor Status: Preferred Creditor Status (PCS) is a widely accepted principle under which multilateral development banks (MDBs) are given priority for repayment of debt in the event of a borrower experiencing financial stress. In its narrow definition, PCS applies only to sovereign loans: in the event of a sovereign default, the servicing of MDBs' debt takes precedence over obligations to other creditors. Under a broader approach, MDBs' sovereign and non-sovereign loans servicing are protected against restrictions on foreign exchange.

No Legal Foundation: PCS was originally devised in the context of Paris Club negotiations between official creditors and sovereign borrowers. All parties agreed that MDBs would not participate in sovereign debt rescheduling. PCS is a *de facto*, not *de jure*, status; ie it has no legal foundation, and is not mentioned in laws or in MDBs' charters. The exception is the European Stability Mechanism (ESM), which has introduced PCS in its charter.

Limited Number of Breaches: Breaches of PCS have historically been low. PCS was recently tested in the Greek crisis between 2011 and 2015, when the sovereign agreed to honour the repayment of loans from the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB) as well as government bonds held by these MDBs, while at the same time writing off a sizeable share of its debt owed to private creditors. PCS also applied in the 2002 Argentina crisis for the debt owed to the Inter-American Development Bank (IaDB).

High Recovery Rates: As a result of PCS, recovery rates for MDBs are generally high. PCS means that MDBs never cancel or reschedule loans, unless they are compensated for this. Overdue loans are, in principle, never written off by MDBs. Nevertheless, most MDBs do not charge interest for the late payment of interest.

Low Sovereign Defaults: The impairment rate on MDB loans is very low overall – it was even nil for three institutions as of end-2017. This performance results from the low sovereign impairment rate on MDBs' loans. It is lower for European and sub-regional MDBs than for regional MDBs as a whole. This indicates that the higher the share of individual countries in the capital of the MDBs, the stronger their incentive not to default; this has recently been illustrated by the selective defaults of Zimbabwe and Côte d'Ivoire on African MDBs' debt.

PCS Strength Differs Across MDBs: To assess the strength of MDBs' PCS, the sovereign impairment rate for each MDB has been compared with default rates for an identical pool of sovereign borrowers to other official and private creditors. The results provide evidence that default rates on sovereign loans are significantly lower for MDBs than for other creditors and that PCS is weaker for the regional MDBs, in particular those operating in the Middle East and Africa (MEA), than for European and sub-regional MDBs.

PCS Transfers to Other Creditors: MDBs' financing often takes the form of project loans involving co-lenders; debt may bear a sovereign guarantee. PCS is not transferred to co-lenders, unless, *de facto*, cross-default clauses are inserted in the loan documentation, or where the MDB remains the lender of record, as is typically the case with A/B loan structures; these are generally granted to private-sector projects, with limited PCS benefit.

However, there are indications that the participation of MDBs is positive for co-lenders, as they benefit from the MDB's due diligence and ability to influence the outcomes of the project.

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Definition of PCS

What is PCS?

Fitch defines PCS as a widely accepted principle under which MDBs are given priority for the repayment of debt in the event of financial stress in a country. In its narrow definition, PCS applies only to sovereign loans: in the event of a sovereign's financial difficulties, the service of an MDB's debt takes precedence over obligations to other creditors. It also means that MDBs do not reschedule or write off sovereign debt, unless they are compensated for this by donors. This was the case for the Highly Indebted Poor Countries (HIPC) Initiative, launched in the late 1990s, where MDBs received funds from donors to offset debt reduction granted to sovereigns.

Under a broader approach, MDBs' sovereign and non-sovereign loan servicing benefits from a number of protections; in particular, MDBs are protected against restrictions on foreign exchange. Thus, in the event of an external debt crisis involving a squeeze on the country's international assets, the central bank would grant priority access to foreign exchange reserves to all entities, including private borrowers, for the service of MDBs' loans.

PCS is a *de facto*, not *de jure*, status; ie it has no legal foundation, and is not mentioned in laws, regulation or even in MDBs' articles of agreement. The exception is the ESM, which has introduced PCS in its charter. Other MDBs mention in their by-laws or charter that they benefit from exemptions, privileges and immunities, without referring specifically to PCS. Also, under the IMF staff rules, full repayment of MDB loans is a condition for the granting of new financing.

PCS was originally devised in the context of Paris Club negotiations between official creditors and sovereign borrowers. All parties agreed that MDBs would not participate in sovereign debt rescheduling. This principle has always been applied. However, there have been cases of MDBs rescheduling or cancelling sovereign loans, either at their own initiative or as part of a coordinated effort to alleviate the debt of some countries.

Breaches of PCS have remained limited overall. In the 2011-2015 Greek debt crisis, the sovereign agreed to honour the repayment of loans from the EIB and CEB as well as government bonds held by these MDBs, while at the same time negotiating a substantial cancellation of its debt owed to private creditors. In 2002, Argentina defaulted on its market debt, but loans from the IaDB were repaid within the six-month limit (in fact, loans were repaid within one month). In the late 1990s, neither the Asian Development Bank (AsDB) nor the European Bank for Reconstruction and Development (EBRD) suffered a sovereign default, although many Asian and Eastern Europe countries were affected by a deep financial crisis. More recently, in 2017, PCS was successfully tested on smaller-scale debt defaults: Belize defaulted on its debt to private creditors while remaining current on debt owed to the IaDB; the Republic of Congo honoured its debt service to African Development Bank (AfDB), although it defaulted on its Eurobonds in 2016. Ukraine defaulted on its market debt in 2015, but remained current on its EBRD debt.

Who Benefits From PCS?

As PCS has no legal foundation, one cannot state under which conditions PCS applies and if it applies with the same strength to all MDBs. However, several principles can be drawn from discussions with creditors and borrowers, and from empirical evidence.

As mentioned above, PCS, in its narrow definition, applies only to sovereign loans. There is a clear incentive for sovereigns experiencing financial difficulties not to default to an MDB, as these institutions generally provide the cheapest source of funds, especially for governments without access to financial markets. Highly rated MDBs can disburse very substantial amounts of loans at the cheapest conditions – their cost of funds plus a flat spread – irrespective of the credit quality of the borrower. In addition, countries in difficulty are aware that MDBs are the only source of financing in times of stress. Links between development institutions are strong; even though there are no formal cross-default clauses, a country that defaults to a regional MDB may have difficulty obtaining new loans from other regional MDBs. PCS is also explained

Related Criteria

Supranationals Rating Criteria (May 2018) by peer pressure, ie countries of the same region interceding to avoid a default from a peer to an MDB.

PCS may vary among MDBs. Sovereign borrowers also own shares in the capital of many MDBs. It will be shown in the next section that the higher the share in the capital of the MDBs, the stronger the incentive not to default.

Sovereign impaired loans are, in principle, never written off by MDBs, and unpaid interest is added to the amount of arrears. If and when an overdue loan is repaid, principal and interest are recovered. Nevertheless, most MDBs do not charge interest on the late payment of interest. Therefore, once arrears are cleared, the loss for the MDB is equal to the 'interest on interest' owed to the MDB.

As a result of PCS, recovery rates for MDBs are generally high. The rate essentially depends on the length of the default episode and the level of interest rates. Based on discussions with MDBs and investors, Fitch estimates the Loss Given Default (LGD, equal to one minus the recovery rate) on MDBs' sovereign loans to range between 1.5% and 12.0%, depending on the level of interest rates. This means that MDBs' recovery rate on sovereign loans, given the current level of interest rates, is higher than 90%, which is well above that of commercial banks overall.

In Fitch's view, however, the LGD should also take into account the contributions made by certain MDBs in funds dedicated to help some HIPC countries clear their arrears, which would bring the LGD to a higher level. Indeed, the HIPC Initiative made it compulsory for eligible countries to clear their arrears before obtaining debt cancellation. This created a strong incentive for countries to clear arrears, as cancelled debt was far higher than accumulated overdue debt. Some MDBs, such as the AfDB and the International Bank for Reconstruction and Development (IBRD), provided substantial financial assistance, in the form of contributions to special funds, to the countries that did not have enough funds to clear their arrears, the largest being the fund created to repay the Democratic Republic of Congo's arrears.

Observing MDBs Impairment Rates

Comparing Impairment Rates on Sovereign and Non-Sovereign Loans

As mentioned above, PCS in its narrow definition applies only to sovereign loans. One way of measuring the effect of PCS is to compare, across MDBs, the impairment rate on sovereign loans (IRSL), which enjoy PCS, with the impairment rate on non-sovereign loans (IRNSL), which benefit only from a protection against FX transfers.

A sovereign loan from an MDB is considered in default (or impaired[1]) by Fitch when it has been overdue (or in arrears) for more than six months; for private sector loans, the threshold is generally set at three months. After this period, interest is recorded only when actually paid and not accrued as for other loans[2]; this is why these loans are also known are as *non-accrual loans*. There is a consensus on this definition of sovereign impairment among MDBs, though the EBRD applies a three-month limit to recognise a sovereign loan impaired.

The table below shows, for each type of MDBs and for the last three years, the impairment rate on total loans (IRTL); the IRSL, defined as impaired sovereign loans (based on the above definition) to gross outstanding loans at year-end; and the IRNSL, defined as impaired non-sovereign loans to gross outstanding loans. Note that these figures do not take into account the MDBs' concessional funds.

[1] A number of MDBs use the term 'non-accrual' rather than 'impaired' for loans in arrears for more than six months. In accordance with its *Supranationals Rating Criteria*, Fitch retains the term 'impaired'.

[2] Under IFRS, interest may be accrued if the loan has predicted future cash flows.

MDBs are presented under the classification adopted by Fitch, which distinguishes four types of institutions: Global and Regional MDBs, European MDBs, Sub-regional MDBs, and MDBs focused on the private sector only[3]. Note that MDBs providing equity participations only (such as Gulf Investment Corporation – GIC) and recently created institutions, such as the Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB), have not been included in this comparative table.

The table shows that MDBs' IRTL is overall very low – it is even nil for three institutions. This performance is triggered by the low default rate on sovereign loans, which is significantly lower than on non-sovereign loans for most MDBs – Islamic Development Bank (IsDB) is the only institution displaying close impairment rates for the two. This clearly demonstrates that sovereign loans benefit from stronger protection than non-sovereign loans, and provides strong evidence of the impact of PCS on MDBs' asset quality.

MDBs' Impairment Rates, 2016-2017

(%)	IRSL		IRNSL		IRTL	
	2017	2016	2017	2016	2017	2016
Global & Regional MDBs						
AfDB	2.2	2.2	4.5	7.5	3.6	2.7
AsDB	0	0	1.4	0.4	0.07	0.03
EBRD	0	0	4.5	6.7	3.7	5.5
IaDB	0	0	8.1	8.3	0.5	0.6
IBRD	0.2	0.3	ns	ns	0.2	0.3
IsDB[a]	3.2	3.5	3.1	4.5	3.2	3.6
European MDBs						
CEB	0	0	0	0	0	0
EIB	0	0	0.4	0.5	0.3	0.3
ESM	0	0	ns	ns	0	0
Sub-regional MDBs						
Afreximbank	0	0	3.6	5.6	2.5	2.4
BOAD	0	0	6.7	11.2	3.4	2.3
CABEI	0	0	0	0.3	0	0.1
CAF	0	0	4.2	3.1	0.6	0.6
CDB	0	0	11.9	17.1	0.5	0.5
EBID	0	0	32.1	56.2	11.4	17.2
TDB	0	0	6.6	6.0	2.4	2.9
Private sector MDBs						
ICD	0	0	13.4	16.0	13.4	16.0
IIB (June 17)	ns	ns	3	3.9	3	3.9
NADB	ns	ns	1.32	0	1.32	0

[a] IsDB only reports the overdue amounts, and not the full amount of impaired exposure; based on this approach, the IRSL was 0.6% in 2017 (0.5% in 2016), the IRNSL was 3.4% (4.5%), and the IRTL was 0.7% (0.9%). The figures in the above table have been restated by Fitch to make IsDB's impairment rate comparable with peers.
Source: Fitch and MDBs' annual reports. See *Annex 1* for acronyms

Comparing IRSL Across MDBs

European MDBs are the best performers in terms of default rate: two out of three have zero impaired loans. This is clearly the group of institutions for which PCS has the strongest impact, with a zero impairment rate on sovereign loans for CEB, the EIB and the ESM, although they had to face the default of Greece, the largest sovereign default in modern times. This is attributable to the generally high credit quality of European states and the strong discipline of government vis-à-vis European institutions. Interestingly, for the EIB, the IRSL on non-European countries is also nil, despite the lower overall credit quality of these borrowers.

Sub-regional MDBs also exhibit strong performance on their sovereign portfolio. Afreximbank, Banque Ouest-Africaine de Developpement (BOAD) and Trade and Development Bank (TDB), which are exposed to high-risk African countries, have zero IRSL. Although the average rating of borrowers to Central American Bank for Economic Integration (CABEI; covering Central America), Corporacion Andina de Fomento (CAF; South-American states and some Central and Caribbean countries), and Caribbean Development Bank (CDB; Caribbean states) is also

[3] The rationale for this classification of MDBs is explained in our Supranationals Rating Criteria (May 2018).

well below investment grade, these institutions enjoy a zero IRSL (and even a zero total impairment rate for CABEI). This provides evidence that repayment performance is higher for MDBs whose borrowers also own a relatively large share of capital and are involved in the governance of the institution, compared with MDBs controlled – or at least supported – by rich countries, whether they are Occidental or Islamic.

There have been several cases of selective defaults to MDBs by sovereigns over the last 20 years. Côte d'Ivoire remained current on BOAD and IsDB debt between 2001 and 2008, while defaulting to AfDB and IBRD; Zimbabwe has honoured its guarantee on defaulted bank loans extended by TDB, while remaining in arrears to AfDB and the IBRD since 2000. Guinea Bissau has been in arrears to IsDB for several years, while remaining current to BOAD.

In contrast, PCS for some regional MDBs, which have capital that is partly owned by rich countries, appears overall weaker than for sub-regional MDBs, although they are exposed to a similar group of countries. IsDB and AfDB exhibit the highest impairment rate on sovereign loans, followed by the IBRD. IaDB had zero IRSL in 2017, but will probably record a positive IRSL at the end of the year due to the Venezuela default. Political considerations also weigh on sovereign repayment priority choices. MDBs that are perceived as pro-occidental have been treated, in some instances, less favourably than sub-regional MDBs and Islamic MDBs: IsDB had no arrears to Sudan until 2016, while this country has been in default to AfDB for a long period. Venezuela defaulted to Washington-based IaDB, but has not yet been declared in arrears by Caracas-based CAF – although this may occur in December 2018 when its overdues reach the six-month deadline.

Sovereign Selective Defaults to MDBs, 1998-2018

	AfDB	IBRD	IsDB	IaDB	TDB	BOAD	CAF
Côte d'Ivoire	2001-2008	2001-2007*	n.s.	n.s.	n.s.	No default	n.s.
Guinea Bissau	1998-2000	n.s.	2001-2016	n.s.	n.s.	No default	n.s.
Niger	n.s.	n.s.	2001	n.s.	n.s.	2001	n.s.
Sudan	2001 -	1997-2000**	2016-17	n.s.	No default	n.a.	n.s.
Mali	n.s.	n.s.	2017	n.s.	n.s.	No default	n.s.
Venezuela	n.s.	n.s.	n.s.	2018	n.s.	n.s.	No default
Zimbabwe	2000-	2001-	n.s.	n.s.	No default	n.s.	n.s.

* Arrears were cleared in 2002, but, in 2004, the country defaulted again and cleared arrears in 2007.
** Sudan was in non-accrual status since 1994, but the period of observation starts in 1998.
This table lists the sovereigns which defaulted to certain MDBs, with the year of the default, while not defaulting to others.
n.s. indicates that no loan was due by the sovereign to the MDB.
Source: Fitch

Overall, MDBs operating in MEA are more exposed to sovereign defaults than other institutions. Based on IRSL, the PCS of MDBs lending to African countries seems to be weaker than regional MDBs operating in other regions. However, this is largely due to the weak credit quality of African borrowers, and not necessarily to deliberate choice made by borrowers to give priority to a given creditor. To obtain a full measure of PCS, one needs to compare repayment performance across creditors, for a given pool of borrowers, for a period encompassing episodes of global sovereign debt crisis.

Measuring MDBs' Track Records on PCS

To measure the strength of PCS, Fitch has studied the number of sovereign loans in arrears observed for the MDBs it rates between 1998 and 2017 and compared this with defaults to other creditors in the same period. Empirical evidence indicates that the strength of PCS varies across MDBs, but also that it has evolved over time. The evidence confirms that, as a whole, sub-regional and European MDBs enjoy stronger PCS than regional MDBs. PCS is weaker for regional MDBs operating in MEA than for others.

The Approach

Fitch has collected the number of sovereign and sovereign-guaranteed loans in default (ie in arrears for more than six months or placed in non-accrual status) at the end of each fiscal year for all the MDBs it rates. Arrears data were obtained from the MDBs' annual reports, information provided by MDBs to Fitch, and default statistics from the Bank of Canada's Credit Rating Assessment Group (CRAG) database. Although the definition of default used in the CRAG database differs somewhat from that used by MDBs, Fitch believes it allows a useful comparison with the default series based on the MDBs' definition.

The CRAG database draws on previously published data sets compiled by various public- and private-sector sources, in particular the IMF, the Paris Club, the World Bank and the World DataBank. It combines elements of these sets, together with new information, to develop estimates of stocks of government obligations in default from 1960 to 2017 on both a country-by-country and a global basis. It considers that a sovereign is in default "*when debt service is not paid on the due date or within a specified grace period, when payments are not made within the time frame specified under a guarantee, or, absent an outright payment default, in any of the following circumstances where creditors incur material economic losses on the sovereign debt they hold*"[4], a definition consistent with Fitch's definition of sovereign default on its debt. Sovereign defaults are broken down by categories of creditors: the IMF, the IBRD, other official creditors, foreign-currency bank loans, foreign-currency bonds, private creditors, and local-currency debt – see *Annex 3*.

Data were difficult to collect for some MDBs, especially sub-regional MDBs that have been rated recently or for which default history was not available for a long period. This was the case for the AIIB, ESM and NDB, which were created very recently, while the International Investment Bank (IIB) and North American Development Bank (NADB) only had limited activity in the early 2000s, and the sovereign default history of Banque d'investissement et de développement de la CEDEAO (BIDC) (ECOWAS Bank for Investment and Development or EBID in English) was not available for the 20-year period covered in this report. Afreximbank and TDB were focused on private-sector lending at the beginning of the period, and both developed their sovereign lending activity fairly recently; we therefore decided not to include them in the study of long-term trends. MDBs that have no sovereign lending activity are obviously not included.

Thus, the study on sovereign default covers six regional MDBs (AfDB, AsDB, EBRD, IaDB, IBRD and IsDB), two European MDBs (CEB and EIB) and four sub-regional MDBs (BOAD, CABEI, CAF and CDB). Fitch computed, for these institutions, the annual default rates, defined as the number of sovereign loans in default to the institution divided by the number of active borrowers at the end of the year.

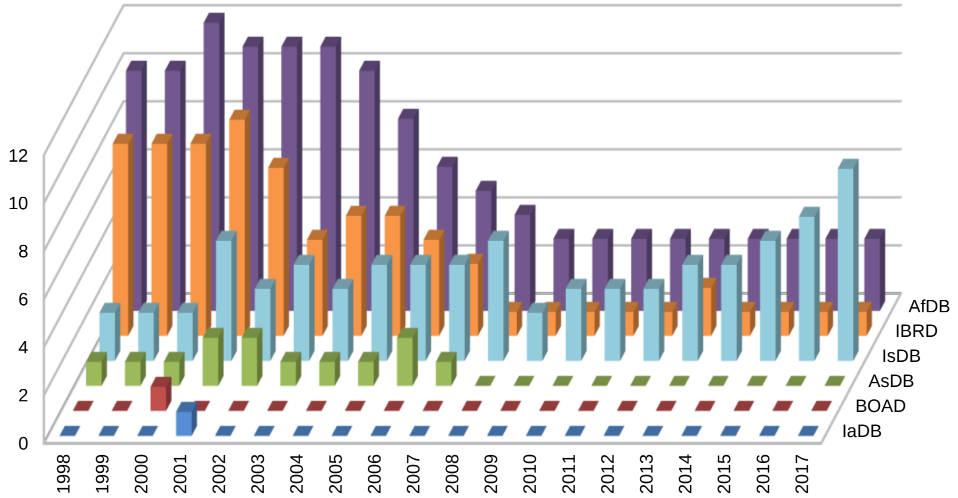
Trends in MDBs' Sovereign Defaults

Default to MDBs peaked in the early 2000s, reaching 28.2% of loans for the AfDB in 2003 and 9.7% for the IBRD. In this period, BOAD and IaDB recorded their unique sovereign defaults in 2000 (Niger) and 2001 (Suriname), respectively; the Venezuela default to IaDB, which occurred in 2018, does not appear here. The default rate has markedly declined since then, in both gross and relative terms: in 2017, default rates for AfDB and IBRD were 10.3% and 1.3%, respectively; however, for IsDB, the rate peaked at 14.3% in 2017. For other MDBs, it was nil. This suggests that PCS has strengthened over the period. However, in Fitch's view, the drop in default rate does not simply reflect an improvement in credit fundamentals. It is largely attributable to the HIPC Initiative, which concerned mostly African countries (of the 36 countries that obtained debt relief under the HIPC Initiative, 30 were African).

[4] Beers, D. and Mavalwalla, J., 2017,"Database of Sovereign Defaults', Technical Report N°101, Bank of Canada.

Defaults to MDBs over the period have been concentrated in MEA (AfDB, BOAD, IsDB and IBRD). MDBs operating in Latin America (CABEI, CAF, CDB and IaDB) and Asia-Pacific (AsDB) have faced an extremely small number of defaults, while European MDBs have experienced no sovereign defaults in the last 20 years. This suggests that the strength of PCS is the highest for European MDBs, and excellent for MDBs operating in Asia and Latin America; it is weaker for MDBs operating in MEA. However, this needs to be verified by comparing MDBs' repayment performance with that of other creditors.

Sovereign Defaults to MDBs, 1998 to 2017



Source: Fitch

No sovereign default was recorded for the European MDBs (EIB and CEB), as well as for the EBRD (which can be viewed as a combination of European and regional MDB as it operates predominantly in Europe and the majority of its shareholders are European). Argentina, in 2003, defaulted on a loan granted by the EIB acting under a mandate from the EU; as the loan was guaranteed by the EU, no arrears were recorded for the EIB. As per Fitch's definition, the EU is not an MDB, but a supranational administrative body (SAB); these institutions are not covered in this study.

Sub-regional MDBs operating exclusively in Latin America and Caribbean – CABEI, CAF and CDB – suffered no sovereign default over this period. The IaDB recorded only one default, which was cured within one year. The Latin American HIPC countries (Bolivia, Honduras, Nicaragua and Guyana) remained current on their MDB loans from the CABEI[5], CAF and IaDB.

MDBs operating in Asia-Pacific were only marginally affected by sovereign defaults. The IBRD recorded no default in this region (which excludes, in the definition retained in this study, the Middle East), while the AsDB had to face loan impairments from two small island states (the Marshall Islands and Nauru), one of which was cleared within one year; its largest and longest default was from Myanmar.

The regional MDBs operating in MEA recorded the worst performance over the period. The IsDB faced the highest sovereign default amount in 2017, followed by AfDB and IBRD[6]. Over the entire period, AfDB had the sovereign highest default rate. After peaking in the early 2000s, the default rate for the AfDB and IBRD has decreased markedly in the last five years. This is largely due, especially for AfDB, to the impact of the HIPC Initiative. The first debt cancellation in Africa was completed in 2000, and then they were spread over 2003 to 2008, which corresponds to the period when sovereign default rates shrunk for the IBRD and AfDB. Since

[5] Note that Nicaragua's loans to CABEI were declared Impaired by the bank in 1997, though there were no overdues of more than six months.

[6] IBRD operates in emerging countries across the world, including MEA.

2009, the number of default has stabilised at three for the AfDB (Somalia, Sudan and Zimbabwe) and one for the IBRD (Zimbabwe).

The low default rate is also explained by the role played by the concessional funds controlled by these institutions, the African Development Fund (ADF) and International Development Association (IDA), which bear the exposure to the poorest and riskiest countries. Being only (or largely for IDA) funded by donors' contributions, these funds can absorb large credit losses. Unlike the AfDB and IBRD, the IsDB has only a modest concessional lending window, which is funded by its ordinary resources; this partly explains its high default rate throughout the period. In addition, the IsDB's sovereign portfolio has been affected by the chronic political instability in the Middle East, which translated into a number of countries being unable to repay their debt.

Comparing MDBs' Default Rates to Other Creditors'

Statistics provided by the Bank of Canada indicates that, in 2017, a total of 79 countries in the world were in default on at least one debtor (commercial, official, local, external), which represents a default rate of 36.9% relative to all sovereign borrowers (assuming a total of 214, ie all countries of the world). This rate, which seems very high, includes in the numerator a large number of small countries in default on relatively limited debt amounts; in fact, only 0.3% of total public debt was in default at end-2017.

Sovereign default rates on MDBs, as measured by the ratio of the numbers of sovereigns in arrears for more than six months to total borrowing countries, are much lower: nine out of 12 MDBs had zero sovereign loan defaults at end-2017, and only two had a default rate higher than 10%. However, as noted before, there are significant differences between MDBs.

Sovereign Default Rate: MDBs vs Other Creditors

	2017			1998/2017
Sovereign defaults to	Number of borrowers	Number of defaults	Default rate (%)	average default rate (%)
All creditors	214	79	36.9	47.9
AfDB	29	3	10.3	18.2
IsDB	56	8	14.3	7.0
IBRD	76	1	1.3	4.1
AsDB	39	0	0.0	3.4
BOAD	8	0	0.0	0.6
IaDB	26	0	0.0	0.2
EBRD	33	0	0.0	0.0
CEB	26	0	0.0	0.0
EIB	36	0	0.0	0.0
CABEI	9	0	0.0	0.0
CAF	17	0	0.0	0.0
CDB	17	0	0.0	0.0

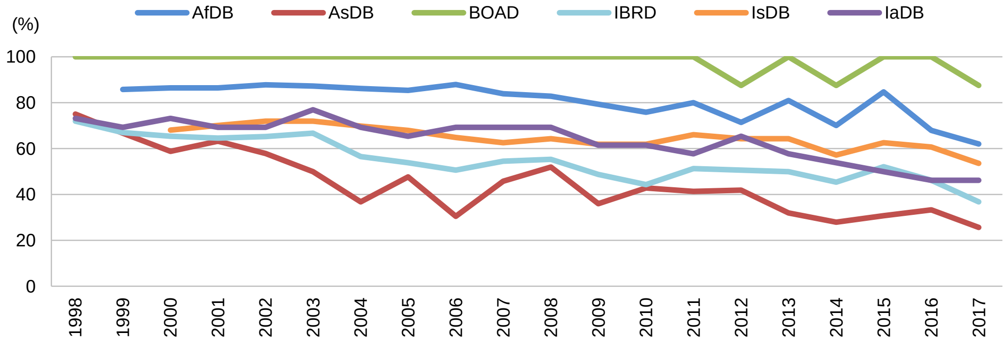
Source: Fitch and MDB's annual reports

The relative strength of PCS can be measured by comparing the sovereign default rate on each MDB with the default rate observed on creditors other than the MDBs.

Special attention needs to be paid to the MDBs that faced non-zero default rates – namely, the IsDB, AfDB, IBRD, AsDB, BOAD and IADB. As mentioned above, MDBs operating in MEA are exposed to higher sovereign risk and exhibit higher default rates; this does not necessarily means that the PCS is weak, as the default rate to other creditors may also be affected. Therefore, the comparison of relative default rates of MDBs versus other creditors must be based on the same pool of borrowers. The pool of borrowing countries differs markedly among MDBs; moreover, it is not stable over time, as some countries may stop borrowing from the MDBs and new states may start borrowing.

For each of the six MDBs, Fitch has identified the borrowing countries that defaulted to at least one official or private creditor other than an MDB in a given year and compared them with sovereigns that defaulted to the MDB that year.

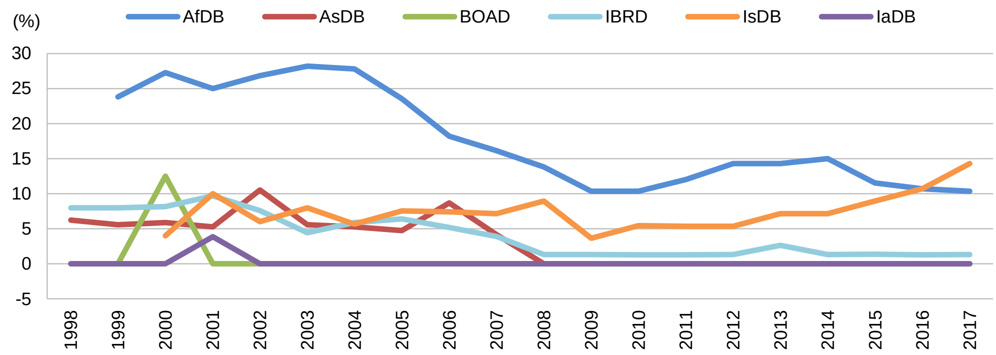
Sovereign Default Rates to Official and Private Creditors other than MDBs, 1998 - 2017



Source: Fitch

The percentage of borrowing countries that defaulted on at least one official or private creditor other than the MDB is shown in the table above. This ratio fluctuates widely, ranging from 21.4% (IsDB's borrowers in 2016) to 100% (BOAD, for the quasi totality of the period). This clearly indicates that BOAD and AfDB's pool of borrowers contains the largest number of defaulting countries, followed by IaDB, IBRD and IsDB; AsDB's borrowers appear, as a whole, less risky than its peers'. The declining trend over the period is also observed, confirming the impact of the HIPC debt reduction initiative.

Sovereign Default Rate to MDBs, 1998-2017



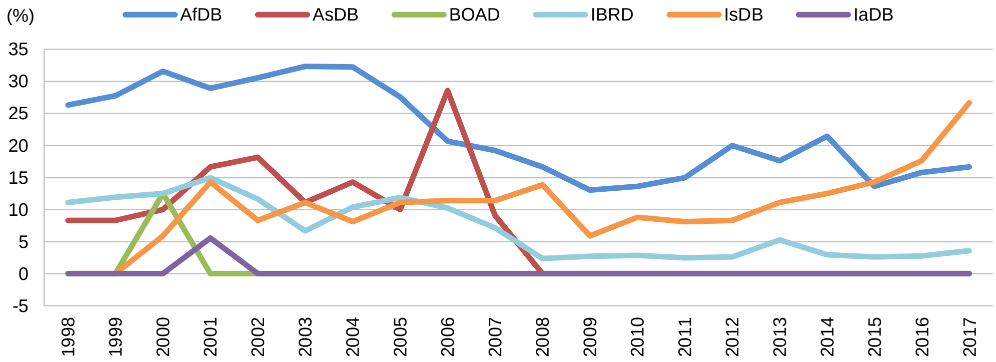
Source: Fitch

As shown in the table above, MDBs have overall experienced a much lower rate of default than other creditors on the same pool of borrowers. Over the period, the AfDB recorded the highest rate: it peaked in 2003 and then significantly decreased, as most African countries completed the HIPC process. Only three countries have been in default since 2009: Somalia, Sudan and Zimbabwe. The default rate to IsDB has remained relatively stable over the period, and has increased in the last three years. At 14.3% in 2017, IsDB has the highest sovereign default rate among MDBs; this largely reflects the political instability in the Middle East, as many countries in default are experiencing severe political troubles (Somalia, Syria, Yemen). The IBRD's default rate followed the same trend as AfDB's, and stood at 1.3% in 2017, with only one borrower (Zimbabwe) in default. AsDB, BOAD and IaDB have had no defaults since the early to mid-2000s.

These indicator rates provide the strongest evidence of the impact of PCS on MDBs' asset quality. There are clear differences between MDBs in terms of repayment performance, with AfDB and IsDB more exposed to sovereign defaults than their peers. This is not entirely due to the higher risk of their borrowers: although IsDB has experienced a relatively large number of sovereign defaults in the period, its borrowers, with a default rate of 53.6% in 2017, tend to be more current than those of AfDB or BOAD on their debt to other creditors (default rates of 62.1% and 87.5% in 2017 respectively). Conversely, although more than 60% of IaDB's borrowers were in default to other creditors between 1998 and 2017, only one of them defaulted to the IaDB in this period, which illustrates the strong PCS of this institution.

Hence, to assess PCS, one can compute the MDBs' sovereign relative default rate, defined as the ratio of sovereign default rates on MDBs to the sovereign default rate on other creditors. The higher the value of this ratio, the weaker the PCS. For MDBs with no sovereign defaults, it is equal to zero. If higher than one, the MDB has faced more defaults than the creditors lending to the same pool of borrowers – but not necessarily to the same borrowers. *Annex 3* provides the value of the sovereign relative default rate for MDBs over the period.

Sovereign Relative Default Rate, MDBs vs other Creditors, 1998 - 2017



Source: Fitch

The sovereign relative default rate for the six MDBs is shown in the graph above. This illustrates the weak PCS of AfDB over the period, and its progressive improvement (17% in 2017). The IBRD followed the same trend (4% in 2017, versus a peak of 12% in 2005). The IsDB's relative default rate was stable over the period, but peaked at 27%, as a result of political tensions that led a number of Middle East countries to default on their debt to all creditors, including MDBs.

Can PCS be Transferred to Other Creditors?

A large share of MDBs' financing to developing countries takes the form of projects loans involving co-lenders. Such loans may bear a guarantee from the government, in which case they are part of the sovereign portfolio. Typically, the project's debt is borne by a company, which borrows from private or official lenders, including MDBs, with the guarantee of the state. Not all projects, however, bear a government guarantee, in which case they are treated as a non-sovereign exposure by the MDBs. Note that if there is no formal government guarantee on the project's debt, but only on the payments to the off-taker, the debt is considered as a non-sovereign guarantee, and part of the non-sovereign portfolio.

When MDBs participate in the pool of creditors or provide a guarantee on a sovereign debt, one frequently asked question is to what extent is PCS transferred to other co-lenders in the event. PCS is not transferred to co-lenders, unless, *de facto*, cross-default clauses are inserted in the loan documentation, or where the MDB remains the lender of record, as is typically the case with A/B loan structures. It is worth noting that A/B loans are typically granted to private-sector projects, and hence represent non-sovereign exposures with limited PCS benefit.

In the absence of cross-default clauses for sovereign exposures, co-lenders are *de facto* treated as subordinated lenders as the MDB will be repaid as a matter of priority, which may at first view be a situation that is worse than having no MDBs in the deal. However, in reality, the participation of an MDB in a pool of creditors is positive for other financiers as they benefit from the MDB's due diligence on the project and from its ability to influence the outcomes of the project; this is especially true when problems arise that are result of adverse government action as this creates an incentive for sovereigns not to default on their guarantee.

There are some indications that the presence of one or several MDBs in a non-sovereign transaction (as lenders or providers of partial guarantees on loans or contractual payment obligations) is incentivising sovereigns to act to avoid a default, as there is downside risk in letting MDBs suffer losses. Fitch is trying to gather information supporting this ‘soft form’ of preferential treatment in order to quantify the potential rating impact of MDB participation in a financing package for such projects.

Rating Implications and Outlook for PCS

PCS is an important criterion in Fitch’s approach to rating MDBs. To capture the effect of PCS, Fitch assigns a credit uplift of up to three notches to the average rating of loans and guarantees of MDBs, one of the key factors in the assessment of an MDB’s risk profile and solvency.

The uplift takes into account the share of the sovereign loan portfolio in the MDB’s total banking exposure and the MDB’s PCS strength. The relative default rate described above provides a useful tool to assess the latter.

Fitch expects PCS to remain a key feature of MDBs, offering them a comparative advantage over other lenders. However, as MDBs tend to increasingly focus on their private-sector operations, there is a risk, over the longer term, that PCS will progressively become less relevant, as it applies chiefly to sovereign loans. New balance-sheet optimisation techniques introduced by MDBs will result in credit risk transfers to third parties, which may not necessarily lead to transfers of PCS.

The strength of PCS may vary over time and may become less efficient in times of sovereign debt crisis. As global sovereign debt continues to rise and some countries experience financial stress in public finance, Fitch expects PCS to be tested again in the coming years.

Annex 1: MDB Coverage

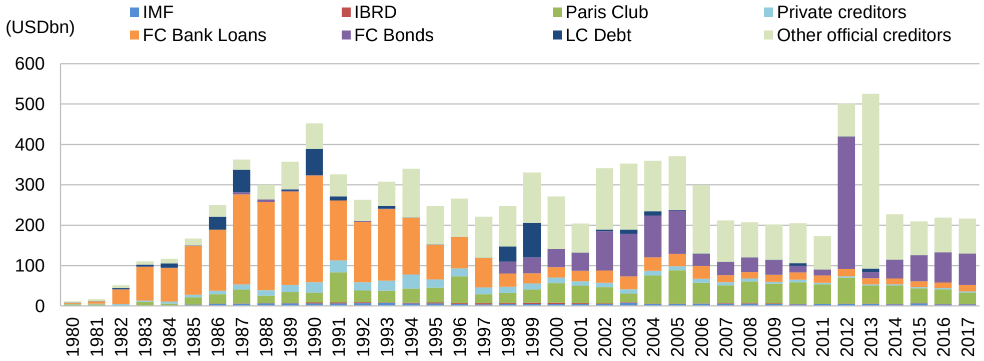
30 Supranational Entities

Entity	Country	LT IDR	Outlook
African Development Bank (AfDB)	Cote d'Ivoire	AAA	Stable
African Export-Import Bank (Afreximbank)	Egypt	BBB-	Stable
Asian Development Bank (AsDB)	Philippines	AAA	Stable
Banque Ouest Africaine de Développement (BOAD)	Togo	BBB	Stable
Asian Infrastructure Investment Bank (AIIB)	China	AAA	Stable
Caribbean Development Bank (CDB)	Barbados	AA+	Stable
Central American Bank for Economic Integration (CABEI)	Honduras	A+	Positive
Corporacion Andina de Fomento (CAF)	Venezuela	AA-	Stable
Council of Europe Development Bank (CEB)	France	AA+	Stable
Ecowas Bank for Investment and Development (EBID)	Togo	B+	Stable
European Atomic Energy Community (Euratom)	Luxembourg	AAA	Stable
European Bank for Reconstruction and Development (EBRD)	United Kingdom	AAA	Stable
European Financial Stability Facility (EFSF)	Luxembourg	AA (issue Rating)	n.a.
European Investment Bank (EIB)	Luxembourg	AAA	Stable
European Investment Fund (EIF)	Luxembourg	AAA	Stable
European Stability Mechanism (ESM)	Luxembourg	AAA	Stable
European Union (EU)	Luxembourg	AAA	Stable
Gulf Investment Corporation (GIC)	Kuwait	A-	Negative
Inter-American Development Bank (IaDB)	United States	AAA	Stable
Inter-American Investment Corporation (IIC)	United States	AAA	Stable
International Bank for Economic Co-operation (IBEC)	Russia	BBB-	Stable
International Bank for Reconstruction and Development (IBRD)	United States	AAA	Stable
International Finance Facility for Immunisation (IFFIm)	United Kingdom	AA	Negative
International Investment Bank (IIB)	Russia	BBB	Positive
Interstate Bank (IB)	Russia	BB	Stable
Islamic Corporation for the Development of the Private Sector (ICD)	Saudi Arabia	AA-	Stable
Islamic Development Bank (IsDB)	Saudi Arabia	AAA	Stable
New Development Bank (NDB)	China	AA+	Stable
North American Development Bank (NADB)	United States	AA	Stable
Trade and Development Bank (TDB)	Burundi-Kenya	BB+	Stable

Source: Fitch

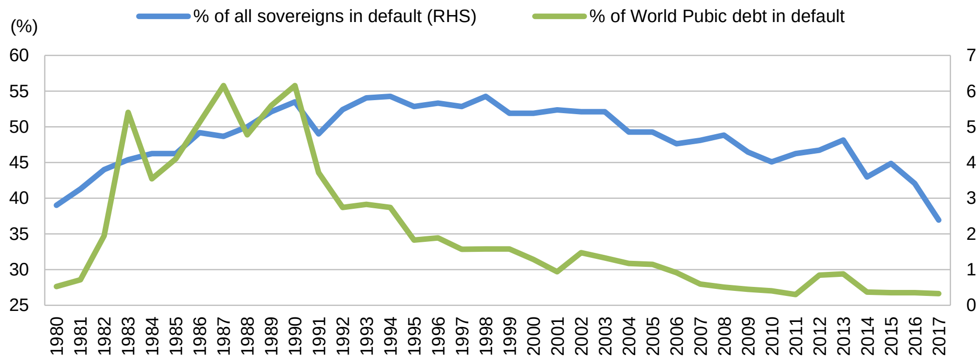
Annex 2: Sovereign Default Statistics, 1980-2017

Sovereign Defaults, 1980 - 2017



Source: Bank of Canada, Fitch

Sovereign Debt in Default, 1980 - 2017



Source: Bank of Canada, Fitch

Annex 3: Sovereign Borrowers Relative Default Rates – MDBs vs Other Creditors

MDBs Sovereign Borrowers Relative Default Rates: MDBs vs Other Official and Private Creditors

(%)	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Average
AfDB's sovereign borrowers																					
Creditors other than AfDB	90.5	85.7	86.4	86.4	87.8	87.2	86.1	85.3	87.9	83.9	82.8	79.3	75.9	80.0	71.4	81.0	70.0	84.6	67.9	62.1	81.1
AfDB	23.8	23.8	27.3	25.0	26.8	28.2	27.8	23.5	18.2	16.1	13.8	10.3	10.3	12.0	14.3	14.3	15.0	11.5	10.7	10.3	18.2
PCS strength (x)	3.8	3.6	3.2	3.5	3.3	3.1	3.1	3.6	4.8	5.2	6.0	7.7	7.3	6.7	5.0	5.7	4.7	7.3	6.3	6.0	4.5
Relative default rate	26.3	27.8	31.6	28.9	30.6	32.4	32.3	27.6	20.7	19.2	16.7	13.0	13.6	15.0	20.0	17.6	21.4	13.6	15.8	16.7	22.4
AsDB's sovereign borrowers																					
Creditors other than AsDB	75.0	66.7	58.8	63.2	57.9	50.0	36.8	47.6	30.4	45.8	52.0	36.0	42.9	41.4	41.9	32.0	28.0	30.8	33.3	25.6	44.8
AsDB	6.3	5.6	5.9	10.5	10.5	5.6	5.3	4.8	8.7	4.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.4
PCS strength (x)	12.0	12.0	10.0	6.0	5.5	9.0	7.0	10.0	3.5	11.0	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	8.6
Relative default rate	8.3	8.3	10.0	16.7	18.2	11.1	14.3	10.0	28.6	9.1	0	0	0	0	0	0	0	0	0	0	6.7
BOAD's sovereign borrowers																					
Creditors other than BOAD	100	100	100	100	100	100	100	100	100	100	100	100	100	100	87.5	100	87.5	100	100	87.5	98.1
BOAD	0	0	12.5	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0.6
PCS Strength (x)	ns	ns	8.0	ns	ns	ns	ns	ns	Ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	157.0
Relative default rate	0	0	12.5	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0.64
IaDB's sovereign borrowers																					
Creditors other than IaDB	73.1	69.2	73.1	69.2	69.2	76.9	69.2	65.4	69.2	69.2	69.2	61.5	61.5	57.7	65.4	57.7	53.8	50.0	46.2	46.2	63.7
IaDB	0.0	0.0	0.0	3.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2
PCS Strength (x)	ns	ns	ns	18.0	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	ns	331.0
Relative default rate	0	0	0	5.6	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0.3
IBRD 's sovereign borrowers																					
Creditors other than IBRD	72.0	67.0	65.3	64.5	65.2	66.7	56.5	53.8	50.6	54.5	55.3	48.7	44.3	51.3	50.7	50.0	45.3	52.1	46.2	36.8	54.8
IBRD	8.0	8.0	8.2	9.7	7.6	4.4	5.9	6.4	5.2	3.9	1.3	1.3	1.3	1.3	1.3	2.6	1.3	1.4	1.3	1.3	4.1
PCS Strength (x)	9.0	8.4	8.0	6.7	8.6	15.0	9.6	8.4	9.8	14.0	42.0	37.0	35.0	40.0	38.0	19.0	34.0	38.0	36.0	28.0	13.4
Relative default rate	11.1	11.9	12.5	15.0	11.7	6.7	10.4	11.9	10.3	7.1	2.4	2.7	2.9	2.5	2.6	5.3	2.9	2.6	2.8	3.6	7.5
IsDB's sovereign borrowers																					
Creditors other than IsDB	ns	ns	68.0	70.0	72.0	72.0	69.8	67.9	64.8	62.5	64.3	61.8	61.8	66.1	64.3	64.3	57.1	62.5	60.7	53.6	64.6
IsDB	4.0	4.0	4.0	10.0	6.0	8.0	5.7	7.5	7.4	7.1	8.9	3.6	5.5	5.4	5.4	7.1	7.1	8.9	10.7	14.3	7.0
PCS strength (x)	ns	ns	17.0	7.0	12.0	9.0	12.3	9.0	8.8	8.8	7.2	17.0	11.3	12.3	12.0	9.0	8.0	7.0	5.7	3.8	9.2
Relative default rate	ns	ns	5.9	14.3	8.3	11.1	8.1	11.1	11.4	11.4	13.9	5.9	8.8	8.1	8.3	11.1	12.5	14.3	17.6	26.7	10.9

Source: Fitch

PCS Strength = default rate to other creditors / Default rate on MDB; relative default rate = default rate to MDB / default rate to other creditors