17 May 2024

UNLOCKING SPECIAL DRAWING RIGHTS (SDRs) FOR HYBRID CAPITAL

This week marked a significant milestone in the realm of development finance as the International Monetary Fund (IMF) greenlit the use of Special Drawing Rights (SDRs) for Hybrid Capital. In this note, we highlight the key takeaways and implications of this authorisation. We commence by providing a comprehensive understanding of SDRs, proceed to outline the specifics of the approval, and subsequently delve into the core implications arising from this decision.

1 SDRs - A Brief Introduction

SDRs are an international reserve asset issued by the IMF, created to supplement and bolster its member countries' official reserves. SDRs are not a currency in the conventional sense; rather, they are a potential claim on the freely usable currencies of IMF member countries, with an exchange rate of SDR 1 to USD 1.32 as of May 2024.

The IMF has allocated a total of USD 865.5 billion equivalent in SDRs since its creation in 1969, with the biggest allocation being in 2021 worth USD 650 billion at the time of issuance. Once SDRs are issued, the IMF allocates to member countries in proportion to their IMF quota shares.

Although *issuing* SDRs is "cost-free" (that is, it does not require contributions from countries' budgets and does not add to any country's public debt burden), *using* one's SDR allocation comes at a cost. This is because countries pay interest on the amount their holdings fall short of their allocation. As of May 2024, the SDR interest rate (SDRi) was 4.1%.

Holding SDRs is restricted to: IMF member countries, the IMF itself, and certain prescribed holders (with prescribed holders being subject to IMF approval). Although both participating member countries and prescribed holders can engage in SDR transactions (for example exchanging SDRs for hard currency), only IMF member countries receive SDR allocations. Prescribed holders must be granted, loaned, or sold SDRs from an IMF member country or from another prescribed holder, and do not receive allocations directly from the IMF.

The list of prescribed holders includes institutions that perform central bank functions for one or more IMF member countries (e.g., ECB, BEAC, BCEAO), and Multilateral Development Banks (MDBs) (e.g., AfDB, IDB, IBRD) (see Table 1 below).

Table 1: List of Prescribed Holders of SDRs[1]

African Development Bank (AfDB)
African Development Fund (ADF)
Arab Monetary Fund (AMF)
Asian Development Bank (ADB)
Bank for International Settlements (BIS)
Bank of Central African States (BEAC)
Caribbean Development Bank (CDB)
Central Bank of West African States (BCEAO)
Development Bank of Latin America (CAF)
Eastern Caribbean Central Bank (ECCB)
European Central Bank (ECB)
European Bank for Reconstruction and Development (EBRD)
European Investment Bank (EIB)
Inter-American Development Bank (IADB)
International Bank for Reconstruction and Development (IBRD)
International Development Association (IDA)
International Fund for Agricultural Development (IFAD)
Islamic Development Bank (IsDB)
Latin American Reserve Fund (FLAR)
Nordic Investment Bank (NIB)

Prescribed holders may exchange SDRs for currency and use SDRs in certain operations, including loans, settlement of financial obligations, swaps, pledges, transfer as security for the performance of financial obligations, forwards, and donations.

As of May 2024, SDRs may also be used to invest in Hybrid Capital instruments. The new SDR use will be subject to:

1. A cumulative limit of SDR 15 billion, and
2. The expectation that IMF members channeling SDRs to prescribed holders under such capital contributions have Voluntary Trading Arrangements (VTAs) in place to help ensure sufficient liquidity and an equitable distribution of potential SDR exchanges into currencies in the VTA market.

The assessment from the board serves to authorise the use of SDRs to invest in Hybrid Capital, but the decision to invest or not in Hybrid Capital instruments will remain a decision of each member.

[1] Applications to Become Holders of SDRs

2 The AfDB and IDB proposal on SDRs for Hybrid Capital

Since the 2021 allocation, the AfDB and the IADB have been developing a proposal that envisages the issuance of an SDR-denominated and settled Hybrid Capital instrument.

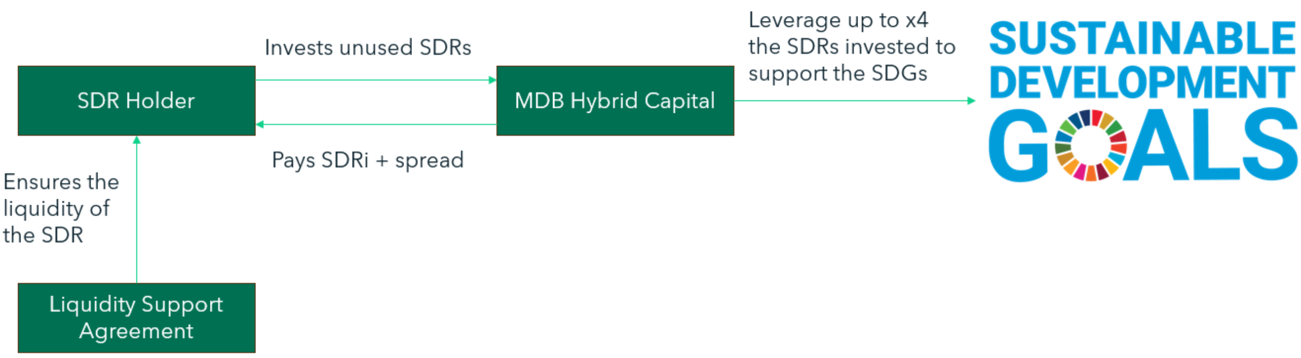
This instrument, acting as subordinated debt, would be accounted for as equity based on accounting standards and credit rating agencies' methodologies. It would initially be a perpetual SDR-denominated loan from the participating IMF member countries with strong external positions to the participating MDB(s), held in the IMF's SDR Department. Instead of SDRs, the IMF member country has on the asset side of its balance sheet an SDR-denominated loan.

The instrument would be callable under certain conditions, with interest potentially cancelled in tail scenarios of portfolio losses. It would rank junior to certain debts but senior to shareholder capital. The recycling proposal would pay the SDR interest rate plus potentially a spread to compensate contributions for incurred SDR interest charges on their allocation. The MDBs would have discretionary rights regarding interest payments and mandatory rights in severe financial distress scenarios.

A Liquidity Support Agreement (LSA) modelled after existing regimes would ensure liquidity, allowing the MDBs to expand lending by leveraging additional capital through international borrowing. The proposed instrument aims to meet reserve asset quality requirements of the SDR, with reimbursement expected from contributors in balance of payments need scenarios. Figure 1 below shows a high-level structure of the Hybrid Capital instrument.

Assuming a leverage ratio of 3 to 4-times, similar to MDB shareholder capital, and that the IMF introduced a cap of SDR 15 billion for Hybrid Capital, the IMF's announcement means that MDB lending capacity could grow by USD 60 to 80 billion.

Figure 1: High Level Structure of the Hybrid Capital Instrument



3 Key Implications of the Approval

The recent IMF authorisation extends the application of SDRs to Hybrid Capital instruments, marking a departure from conventional usage. This strategic decision broadens the scope of financial instruments eligible for SDR utilisation, with significant implications for the role of SDRs in development finance:

1. Countries that expressed some preliminary interest in using SDRs for Hybrid Capital (for example Japan[2]), finally have the green light from the IMF to use SDRs to purchase Hybrid Capital instruments.

2. This approval would not impact the European Central Bank (ECB) constraints to rechannel SDRs to MDBs[3] as the IMF highlights that the decision whether to use SDRs to acquire Hybrid Capital instruments rests solely with each member country. The same approval paper points out that some member countries are impeded to engage in this type of operations due to domestic constraints, in the case of the ECB is the prohibition on monetary financing: *"The fact that under Union law SDR channelling by European Union (EU) national central banks to MDBs is incompatible with the prohibition of monetary financing significantly reduces the pool of potentially available contributions among MDB shareholders"*. Moreover, this restriction is not only limited to countries under the ECB, but also extends to EU member states that retain their own currencies, such as Denmark and Norway. Although these countries are not governed by the ECB, they are still subject to the Treaty of Functioning of the European Union (TFUE), which is cited to be preventing the recycling of SDRs outside the IMF.

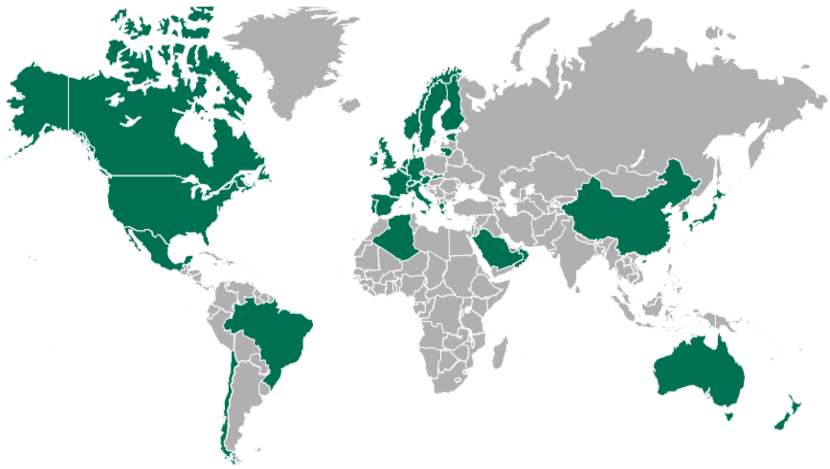
3. The cumulative limit of SDR 15 billion could potentially lead to a race for MDBs to issue before such cap is fulfilled, which is also rightly pointed out in the paper: *"A number of Directors expressed even-handedness concerns from the "first come, first served" basis implicit in the limit of any prescribed holder wishing to channel SDRs into Hybrid Capital instruments."* However, this could be solved under current guidelines as the IMF suggests a review of the new SDR use would be expected to be conducted when cumulative Hybrid Capital contribution surpass SDR 10 billion, leaving the door open to augmenting the amount if needed.

4. The IMF expects only VTA members would be allowed to participate. This restricts the operation to the 39 countries in figure 2. Despite this appearing to be a significant limitation, it's important to note that these countries hold the majority of the SDRs issued, holding more than USD 650 billion worth of SDRs.

[2] https://www.reuters.com/sustainability/cop28-france-japan-support-african-development-bank-push-leverage-sdrs-2023-12-04/

[3] https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp211014~0ebead6ce2.en.html

Figure 2: VTA members



Africa: Mauritius
Asia and Pacific: Australia, China, Japan, South Korea, Singapore, and New Zealand
Europe: Austria, Belgium, Cyprus, Denmark, ECB, Estonia, Finland, France, Germany, Greece, Ireland, Israel, Italy, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom
Middle East and Central Asia: Algeria, Oman, and Saudi Arabia
Western Hemisphere: Brazil, Canada, Chile, Mexico and the United States

5. The IMF also highlights that countries purchasing such instruments should be prepared to participate more frequently in transactions and hold more SDR-denominated assets. However, research by Bernat Camps Adrogue and Mark Plant suggest that this should not be a concern for the Central Banks of the donor country (Camps Adrogue, Plant, 2023) as SDR recycling does not change the amount of foreign reserves but change the composition of those.

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