

Impact Investing through Development Banks

UBS ETF **On Track Research**



↗ Multilateral Development Banks (MDBs) are dedicated to providing financial support and technical assistance to developing countries.

↗ MDB bonds can be classified as a form of Impact Investing because capital acquired from issuance of these bonds is channelled to finance social and economic development projects.

↗ Bonds of MDBs are highly rated, while generally offering slightly higher yields compared to US Treasuries. As such, they can be seen as a “sustainable alternative” to high-grade government debt.

Multilateral Development Banks

MDBs are supranational financial institutions dedicated to providing financial support and know-how for economic and social development projects. They were founded by sovereign states which contribute capital and provide guarantees allowing MDBs to raise funds in international capital markets at attractive rates. Given that MDBs are non-profit organizations, they are then able to provide loans to less developed countries at discounted rates compared to market conditions.¹

The case of IBRD

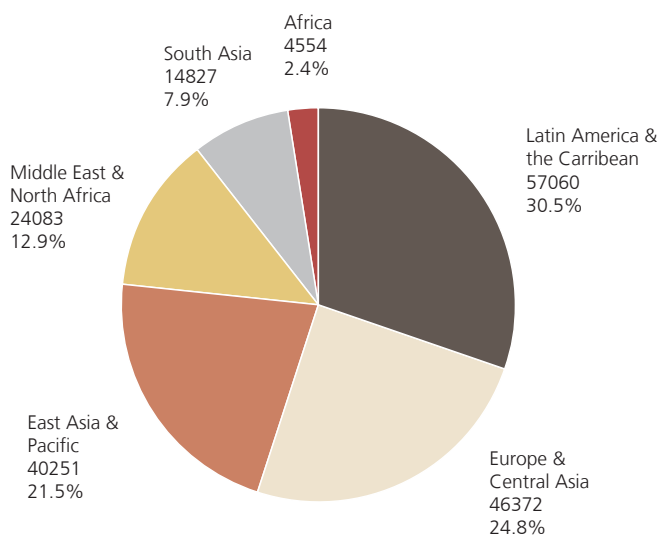
The International Bank for Reconstruction and Development (IBRD), which is part of the World Bank Group, is the oldest multilateral development bank. It was created in 1944 to finance reconstruction of Europe after World War II. Over time, its mandate was expanded to help promote

¹ The net interest margin (revenue less associated funding costs) for fiscal Q1 2019 is estimated to be \$311mn, which translates into an annualized spread of c. 66 bps (IBRD 2018).

economic development and help to eradicate poverty globally. Eligible borrowers include creditworthy low- and middle-income countries with a gross national income per person of at least USD 1145 as of July 2018 (IBRD and IDA, 2018).

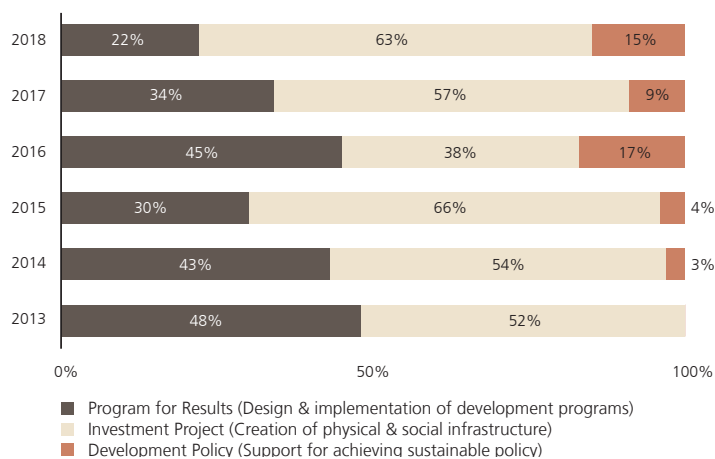
Currently, the IBRD has loans outstanding and commitments totaling USD 187.1 bn with the largest concentration being in Latin America and the Caribbean at 30.5% followed by Europe and Central Asia at 24.8%, see **Figure 1** (IBRD 2018). The projects vary by type with “Creation of Physical and Social Infrastructure” being the largest category standing at 63% of allocated resources (**Figure 2**). These projects involve creating physical infrastructure such as roads, railways, bridges, telecommunication, water-management etc., as well as projects focused on social infrastructure such as schools, hospitals etc. (see **Figure 3** for several examples). Overall, the IBRD is committed to supporting the realization of the UN’s Sustainable Development Goals (SDGs).

Figure 1: Geographic concentration of IBRD commitments (in USD millions and percentage)



Source: Solactive, UBS Asset Management, data as of 30 September 2018.

Figure 2: Distribution of funding between main types of IBRD projects



Source: IBRD, UBS Asset Management, data as of 30 September 2018.

The case for passive investing

One way to invest in bonds issued by MDBs is through passive solutions. With its ongoing commitment to sustainability, UBS Asset Management has partnered with Solactive to develop a family of indices covering the MDB bond market, which includes the *Solactive UBS Global Multilateral Development Bank Bond USD 25% Issuer Capped Index*. The index is designed to capture a representation of bonds issued by the largest MDBs that have all G7 countries as members. It is to also ensure that these are the most robust organizations that enjoy broad support.

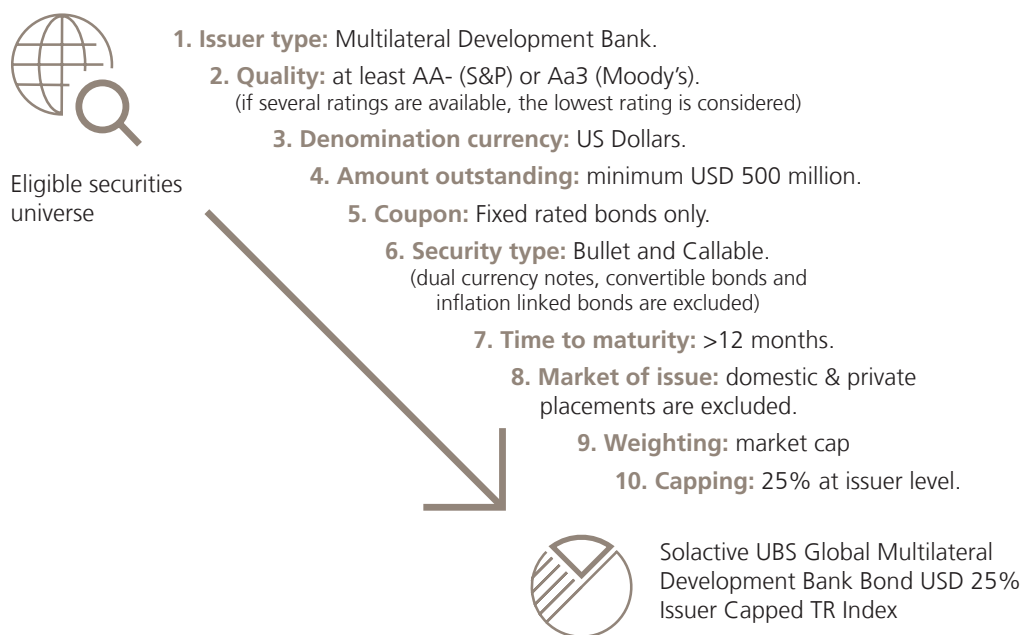
The index has four key features summarized in **Figure 4**. First, only high credit papers are eligible. Second, it includes only USD denominated fixed-rate securities with a time to maturity no less than 12 months. Third, to ensure good liquidity, only large bond issues are eligible (min USD 500 m). Finally, the index is market cap weighted, but there is an issuer capping of 25% to enhance diversification.

Figure 3: Examples of projects financed by IBRD

Country	Project	Description	Commitment
South Africa	Eskom Investment Support Project	Enhancement of power supply and energy security.	USD 3 750 m
Kazakhstan	Western Europe – Western China International Transit Corridor	Increasing transport efficiency along the road sections between Aktobe/Kyzylorda Oblast border and Shymkent and improving road management and traffic safety in Kazakhstan.	USD 2 125 m
Ukraine	Serving People, Improving Health Project	Improve the quality of health services in selected Oblasts, with special focus on primary and secondary prevention of cardiovascular diseases and cancer, and to enhance efficiency of the health care system.	USD 214 m

Source: IBRD, UBS Asset Management, data as of 31 December 2018.

Figure 4: Index rules of the “Solactive UBS Global Multilateral Development Bank Bond USD 25% Issuer Capped Index (hereafter referred to as “the MDB index”)



Source: Solactive, UBS Asset Management, data as of 31 December 2018.

Breaking down the index

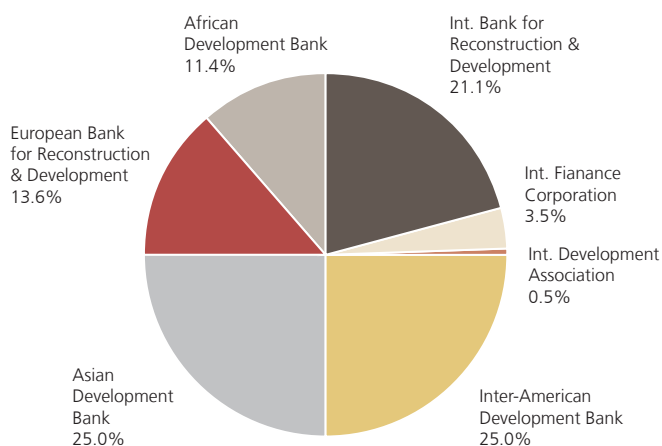
The index constituents include bonds from five different organizations as of December 2018:

- World Bank Group comprising of International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC) and International Development Association (IDA)
- Inter-American Development Bank
- Asian Development Bank
- European Bank for Reconstruction & Development
- African Development Bank

Each of the included multilateral banks have a track record of robust performance, solid reputation, and play an important role in their respective regions. The weights of bonds issued by the World Bank, Asian Development Bank and Inter-American Bank are all at the maximum level of 25% (Figure 5). Overall, the index holds nearly 100 different bonds with their individual weights ranging from 0.15% to 2.34% (December 2018).

This information should not be considered a recommendation to purchase or sell any particular security.

Figure 5: Weightings per MDB institutions within the MDB index



Source: Solactive, UBS Asset Management, data as of 30 November 2018.

Investment rationale

All constituents of the *Solactive UBS Global Multilateral Development Bank Bond USD 25% Issuer Capped Index* are rated triple-A by S&P, Moody's and Fitch (as of December 2018). Hence this exposure can be seen as a "sustainable alternative" to high grade USD denominated sovereign debt. This is also because MDBs have strong guarantees by G7 countries and other highly-rated sovereigns. In terms of risk assessment, it is noteworthy that no major MDB has ever defaulted in their history (Solactive 2018).

The index offers higher returns compared to duration-matched US Treasuries with an option adjusted spread of 14 basis points (bps) (December 18). Provided no defaults are incurred on this triple-A portfolio going forward, the mentioned 14 bps is suggestive of expected outperformance of similar magnitude. Historically, the option adjusted spread over the past seven years ranged between 10 bps and 45 bps (Figure 6). The index duration is just

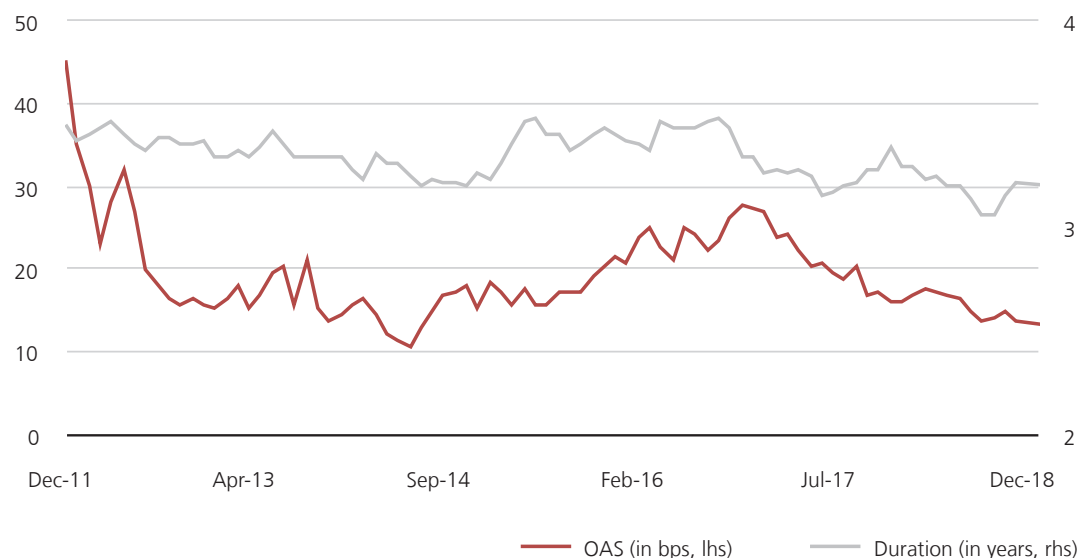
above 3 years (Figure 6), while yield-to-maturity has increased in the recent period to exceed 3% (Figure 7). The constituent bonds are also liquid with an average roundtrip bid-ask spread of 5.5 bps (December 2018).

The investment rationale for MDBs can be summarized as follows:

- Easy access to impact investing
- High grade, triple-A rating
- Good liquidity
- Yield enhancement.

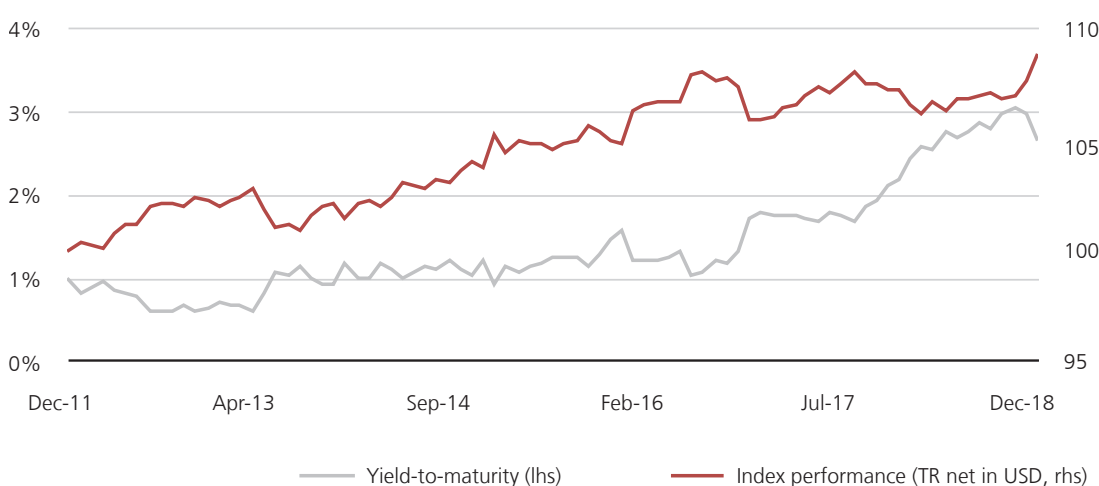
Past performance is not an indicator of future results. Results include back-tested data.

Figure 6: Option-adjusted spread and duration of the MDB index



Source: Solactive, UBS Asset Management, data as of 31 December 2018.

Figure 7: Performance and yield-to-maturity of the MDB index



Source: Solactive, UBS Asset Management, data as of 31 December 2018.

The rationale behind triple-A rating

Multilateral Development Banks provide loans to less developed countries at very low rates of interest, so they enjoy minimal margins compared to their rate of financing. An important aspect making it possible is the so-called "preferred creditor" status of MDBs, which gives them priority over all other creditors. Borrowing members promise² to prioritize payments to MDBs over bilateral sovereign creditors and over loans taken from the markets.

In addition, MDBs have strong fundamental credit positions. For example Moody's points out that IBRD credit strength is due to: "1) very high capital adequacy supported by a strong risk management framework, 2) ample liquidity buffers and conservative asset/liability management policies; and 3) a large cushion of callable capital combined with a very strong willingness and ability of global members to provide extraordinary support" (Moody's 2018).

The MDBs also have a low percentage of non-performing loans (NPL). For example, the IBRD had an NPL of just around 0.3% in 2017 (Moody's 2018). This is to a large extent thanks to its preferred credit status since otherwise the 6.4% exposure to loans provided to countries rated Caa1 or lower would likely result in a higher NPL (Moody's 2018). Moreover, the IBRD has more than full coverage (107%) of its debt outstanding from callable member capital which are predominantly highly rated sovereigns (Moody's 2018).

Conclusion

Bonds of multilateral development banks represent a sustainable investment opportunity in high-grade USD denominated debt. With triple-A ratings from all three major rating agencies, they can be considered a liquid and low-risk form of impact investing. MDB bonds also offer true global diversification given the unique reach, breadth and variety of MDB activities across most of developing countries.

² While sovereigns ultimately decide on their own regarding repayment of their debts, the postwar experience has been that borrowing countries, other members of the MDBs, and well as various creditor's organizations such as the Paris club universally recognize the preferred creditor status of MDBs, see S&P (2000).

Literature

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S&P (2000) "How Preferred Creditor Support Enhances Ratings". Standard and Poor's Structured Finance: Securitization in Latin America.

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Relevant ETF Exposure

The Multilateral Development Banks bonds

Fund name (SF = Synthetically replicated Fund)	Fee	AuM (GBPm)	NAV ccy	Repli- cation	Distri- bution	ISIN	Bloom- berg	Sedol
UBS ETF (LU) Sustainable Development Bank Bonds UCITS ETF	0.18%	18	USD	Physical	Yes	LU1852212965	MDBU LN	BD05YQ9
UBS ETF (LU) Sustainable Development Bank Bonds UCITS ETF	0.18%		USD	Physical	No	LU1852211215	MDBUA SW	BD0BPJ7

Source: Solactive, UBS Asset Management, data as of 28 December 2018.

Find all product details here:

[> UBS ETF Product Overview](#)

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