European Commission OECD BETTER POLICIES FOR BETTER LIVES EDFI EUROPEAN DEVELOPMENT FINANCE INSTITUTIONS CONVERGENCE BLENDING GLOBAL FINANCE TCX the currency exchange fund

WORKSHOP SUMMARY

FX RISK IN DEVELOPMENT – MANAGING CURRENCY RISK THROUGH BLENDED FINANCE SOLUTIONS

EXECUTIVE SUMMARY

In February 2017, European Commission, EDFI, the OECD, Convergence, and TCX hosted members of the development community and private sector at the European Commission for one of the largest workshops dedicated to identifying and advancing best-practice foreign exchange (FX) risk solutions. FX risk is one of the most significant barriers to sustainable development in developing countries. More than 90% of debt financing to developing countries is denominated in foreign currency, causing the most vulnerable and least-equipped borrowers to bear the risk of debt crises in times of local currency depreciation.

The morning sessions of the workshop focused on the current state of FX risk in developing countries, how to deepen domestic financial intermediation in local currency, and ways to increase cross-border flows in local currency and hedged currency. Currently, developing countries face significant systemic risk due to large scale currency mismatches in the financial and public sector. Efforts in the development community have tried to deepen domestic financial intermediation in local currency, but there is still a need for systemic change in developing countries, by improving policy frameworks and addressing regulatory barriers.

The afternoon sessions of the workshop focused on barriers to scaling local currency debt and hedged equity investment. Barriers to scaling local currency debt and hedged FX debt include lack of awareness among development practitioners around the importance of the issue, dependence on enabling local macroeconomic frameworks, and the need for creativity in illiquid or otherwise constrained markets. Barriers to scaling hedged international equity investment include the availability of hedging products in the required geographies and tenors, the cost and collateral requirements for these products, and the delivery risk associated with unknown exit timing.

The workshop concluded with a consensus around three necessary actions. First, FX risk needs to shift from the most vulnerable borrowers to well-capitalized organizations that can best bear and manage the risk. Second, blended finance solutions have the potential to reduce the FX risk for developing countries and attract the investment dollars required to achieve the Sustainable Development Goals (SDGs). Third, more work is required to understand how to drive down the cost of covering FX risk and to scale proven solutions that accelerate investment needed during the SDG implementation period.

The workshop participants are committed to advancing best-practice solutions to reduce FX risk in developing countries and development finance. The workshop organizers – European Commission, OECD, EDFI, TCX and Convergence – will be coordinating efforts to maximize the impact of blended finance solutions to this problem.

SYNOPSIS

Sponsors: European Commission (EC), Organisation for Economic Cooperation and Development (OECD), Association of European Development Finance Institutions (EDFI), Convergence, The Currency Exchange (TCX)

Location: Berlaymont Building, European Commission, Brussels

Date: 1 February 2017

Participants: Over 150 participants from development finance institutions, donor organizations, and the private sector

Discussion topics:

- Current state of FX risk in developing countries
- Deepening domestic financial intermediation in local currency
- Increasing cross-border flows in local currency and hedged currency
- Barriers to scaling local currency debt and hedged FX debt
- Barriers to scaling hedged international equity investment
- Best practice blended finance approaches to achieve scale

WORKSHOP SUMMARY

KEYNOTE ADDRESS

The workshop opened with remarks from Katarina Mathernova, Deputy Director-General, European Commission Directorate-General NEAR. Katarina introduced FX risk as an important topic to discuss because of (1) its tangible effects on developing countries (for example, devaluation in the Caucasus and impact on foreign denominated debt repayments) and (2) the role of donors in transferring FX risk. She noted that it is a matter of responsibility for development practitioners to come up with instruments to hedge and otherwise address the unavoidable FX risks of lending in developing countries, which far too often fall on the shoulders of the most vulnerable borrowers that are least able to bear and manage the FX risk (e.g., projects and companies that earn local currency revenues but borrow in foreign currency).

CURRENT STATE OF FX RISK IN DEVELOPING COUNTRIES

This session introduced FX risk in development. One panelist described the evolution of FX risk in emerging markets, including the significant progress that has been made in reducing FX risk in upper-middle-income countries but the worsening of the problem in low and lower-middle-income countries. Significant systemic risk has built up in developing countries because debt denominated in foreign currency is often extended to unhedged borrowers. High levels of FX debt are accumulating due to (i) underdeveloped domestic financial and capital markets, (ii) undersupplied local currency for domestic intermediation, and (iii) dominance of cross-border debt financing in foreign currency (most research estimates more than 90% of debt to low- and lower-middle-income countries is denominated in foreign currency).

Unconventional global monetary policies exacerbate the problem by keeping foreign currency interest rates abnormally low with a resulting high differential to local currency interest rates. At a micro level, this foreign debt burden weighs primarily on those borrowers who are least able to bear and manage the risk (e.g., agriculture; micro, small, and medium enterprises; and key developmental infrastructure projects in areas like renewable energy). Panelists called on the development community, including multilateral development banks and development finance institutions, to pay more attention to this problem because of the role they play in contributing to these levels and the increasing capacity of innovative financing instruments to play an important role consistent with the Addis Ababa Action Agenda.

The nature and size of FX risk varies among countries, particularly based on the stage of their financial and capital market development. Where markets are developed, donors and investors should operate in local currency, accessing liquidity through local bond issuances, local bank market borrowing, and derivative hedging. Where capital markets are underdeveloped, donors and investors should take a two-pronged approach. First, donors and investors should provide technical assistance support to national authorities to deepen and broaden the mobilization and intermediation of domestic funds (e.g., savings), create a government yield curve, establish bond markets, develop an interbank market, and other means. Second, they should maximize efforts to provide cross-border financing that allows the FX risk to be borne and managed by parties best equipped to play that role, thereby sheltering unhedged borrowers and the countries themselves.

During this session, panelists emphasized that while FX risk must be managed, it cannot be eliminated. A primary objective of the development community must be to take measures to transfer the FX risk from those least able to manage the risk (e.g., SMEs and renewable energy projects) to those best able to manage it (e.g., international providers of finance with large balance sheets and a diversified portfolio, as well as FX risk management blended finance vehicles and DFIs). All participants agreed that solutions must be market-supporting, to make the best possible use of scarce public resources, to avoid market distortion, and to support the improvement of nascent and vulnerable local currency markets. Panelists and participants recommended that engagements should contain minimal concessionality, include separate governance, be time bound, and coordinate market development efforts.

DEEPENING DOMESTIC FINANCIAL INTERMEDIATION IN LOCAL CURRENCY

This session focused on the ongoing challenges of deepening and broadening domestic financial intermediation in local currency in emerging markets and explored relevant best-practice solutions. In more developed markets and some middle-income countries, generally, there is a sufficient supply of long-term funding available for development. In less developed markets, markets are too shallow, narrow, and short-term to meet development financing needs.

Presentation highlights included:

- Kyrgyz Investment and Credit Bank (KICB) explained joint efforts with the central bank to decrease the level of dollarization in Kyrgyzstan through a two-pronged approach whereby (1) the central bank provides local currency financing to allow banks to increase the

provision of local currency loans and FX swaps and (2) the commercial banks stimulate the local deposit market and issue local currency bonds.
- Credit Guarantee & Investment Facility (CGIF) described its services, providing guarantees for local currency bonds in the ASEAN region.
- GuarantCo described its business model to credit enhance local currency bonds and loans to facilitate the flow of local currency within developing countries. GuarantCo shared that it is growing its business in Nigeria with InfraCredit, after finding that in countries like Nigeria there are large supplies of local savings and capital.

Despite many best-practice solutions presented during the session, it was clear that there is still a need for systemic change. The demand for local currency funding will always be greater than what the development community can collectively supply, due to balance sheet size and risk appetite. Therefore, interventions also need to focus on improving policies and addressing regulatory barriers. Providing technical assistance to develop the local financial and capital markets and establish the legal system necessary to enable hedging is one key path to improvement.

The participants agreed there is generally a correlation between the size of the economy and the development of the local currency financial and capital markets; it is particularly difficult to arrange local currency loans in small countries with a high degree of dollarization. One panelist disagreed with the assumption that there is a correlation between the size of a country and the level of market development. For example, Mauritius has a capitalization rate of 50 percent (of GDP). Another panelist argued that while size matters, it is not the determining factor for market development. Ultimately, deal flow is more important than size because deal flow drives the market and attracts new actors.

INCREASING CROSS-BORDER FLOWS IN LOCAL CURRENCY & HEDGED CURRENCY

This session focused on efforts to increase cross-border flows without exposing borrowers to FX risk, through either (i) local currency loans or (ii) FX loans with currency hedges. This session included discussion of continued challenges for scaling these solutions. One proposition was that FX risk mitigation instruments, such as guarantees, should be eligible as ODA; another proposition was to implement incentives for staff to leverage these instruments.

Since it is impossible to eliminate FX risk, but rather only possible to redistribute it among parties, two main approaches to promoting local currency activity emerge: (1) hedging currency for individual transactions, transferring risk to those that can bear and manage it, and (2) having those that manage the risk diversify FX risk. The main means of managing risk exposure is through portfolio diversification, which relies on internal expertise and strong governance. One panelist proposed a strategy of identifying correlations across currencies and then structuring the interest rate premium to compensate for devaluations in other markets. Specifically, the participant recommended an internal index and a minimum of 20 countries (for diversification).

Nonetheless, many developing countries tend to move synchronically against hard currencies, notably the USD, making it difficult to fully mitigate the risks. Reinsurance and hedging products, including TCX, can be used to mitigate risks. Unfortunately, there is only a limited market for these risk mitigation instruments and prices are reflectively high, although risk-reflective. TCX and others continue to refine their solutions to balance financial sustainability and market accessibility.

Given the high cost of local currency financing and hedging programs, DFIs should focus on (1) pooling resources and tapping existing solutions and (2) focusing on leverage and impact when selecting priority interventions. One panelist stressed the importance of the “do no harm” principle in development interventions. Scaling solutions must be based on the fundamental principles of engagement, including making smart use of scarce public funds clarifying when to use which mechanism, acting catalytically to crowd in the private sector, avoiding providing false demonstration effects, informing discussion with data and research, and coordinating with other actors.

BARRIERS TO SCALING LOCAL CURRENCY DEBT & HEDGED FX DEBT

Several solutions provide local currency debt (or FX-hedged debt), particularly in relatively more developed markets, like South Africa. This session focused on how to scale these solutions for greater impact and expansion into new markets. FX risk comes from different places and the level of risk is different across various actors – sovereigns, sub-sovereigns, and corporations. Each situation requires a different solution.

Broadly, there is a need to raise awareness of the significance of FX risk in emerging markets among all relevant parties, including borrowers, central banks, DFIs, private sector parties, and donors. This has not been a significant area of focus for the donor community, which is traditionally focused on specific development needs and sectors (e.g., health care and renewable energy). FX risk is prevalent in almost all cross-border debt; therefore, it is a

macro issue of high importance. Participants shared a consensus view on the need to socialize this issue more in the development agenda. FX risk mitigation is not an accessible issue for donors for two main reasons: (1) FX risk and risk mitigation issues are complex, and (2) there is a not a direct relationship between FX risk mitigation and the social impact outcomes many donors want to see.

Scaling local currency debt depends on local macroeconomic frameworks, so developing fiscal policy, monetary policy, and regulatory capacity is critical. Development actors can and should contribute to the solution, with a coordinated and consistent policy agenda. As an example, one panelist described a situation in which an investor wants to lease a piece of land for the lifetime of a 30-year asset but there is a 15-year ceiling on land leases. In this situation, having buy-in from the central bank and the Minister of Finance is key to ensure enabling policies are in place.

Given the barriers discussed, there is a need for innovative and creative solutions to complement the small set of successful solutions that currently exist. Where local currency lending is not available due to liquidity or other constraints, development financiers can offer swaps for more competitive on-lending or hard currency credit lines as a type of guarantee.

BARRIERS TO SCALING HEDGED INTERNATIONAL EQUITY INVESTMENT

Amid possible solutions for providing local currency debt (or FX-hedged debt), participants acknowledged that there is less attention given to scaling hedged international equity investment. This session focused on investigating new ways to mitigate FX risk for private equity (PE) in developing countries.

Sarona Asset Management, in partnership with USAID, EMPEA, Portico Advisors, and Crystalus, is working on a new initiative to address local currency depreciation during the holding period of equity investments. The project is currently surveying market participants, including institutional investors, fund managers, and the development community, to identify the biggest risk exposures for PE investing. Currency volatility a key concern for investors and it is important for investors to hedge their investments during the holding period. Barriers include the availability of hedging products in the required geographies and tenor, the cost and collateral requirements, and the delivery risk associated with unknown exit timing.

A portfolio approach remains the most effective way to manage FX risk. It is the responsibility of investors to understand and unpack the risks of PE investment in emerging markets. These investments are best left to sophisticated investors that can appropriately price and manage risks.

Pricing remains a significant challenge to the introduction and scaling of solutions for PE. There is a need to better understand the impact of FX risk on the cost of projects in emerging markets, but cost data is largely proprietary and therefore opaque. Other ideas for overcoming barriers to scaling hedged PE investment included tranching PE investment to segment risk, establishing early identification metrics for risk events, and financing residual risk.

BEST PRACTICE BLENDED FINANCE APPROACHES TO ACHIEVE SCALE

This session focused on best practice solutions, including focusing on market creation, the de-risking of current constraints, and interventions that are more market-friendly and locally driven. To achieve these objectives, panelists discussed three themes: developing the narrative, developing a diverse toolset, and promoting shared learning.

FX risk should be held and managed by those parties most able to hold and manage it. Participants expressed a need to build the narrative around the vulnerability of poor people holding the burden of FX risk. Local currency solutions must be prioritized for the least developed countries and low-income countries, which are generally the most vulnerable to large local currency depreciations. For instance, in the renewable energy sector, the FX risk burden should not be left with the utilities (e.g., generators, transmission or distribution companies) which are already constrained. Even worse, risks should not be passed on to consumers (e.g., citizens) in the form of increasing tariffs to allow the utilities to service FX debt during depreciation. Similar to the client protection principles established in the microfinance sector, there is a need for consumer protection principles for FX risk more broadly.

Participants also noted a need to leverage a diverse tool-set for market development and the reduction of FX risk in emerging markets. These solutions do exist but there is a greater need to normalize the issuance of local currency debt and to scale or replicate existing models. Portfolio diversification and hedging, as well as guarantees and other blended finance structures, can be used to shift the burden of FX risk away from the most vulnerable.

Given the frequency of learning-by-doing in the field of blended finance, it is important for development actors to learn and share lessons to achieve scale and impact. As one example, the UN is putting together a taskforce to collate innovative financing projects and best practices for capital

market development, including local currency lending and creative risk management.

KEY INSIGHTS

During the wrap-up session and through a post-workshop survey, the workshop sponsors identified the following key insights:

- Prevailing practices in development finance and international finance cause currency risk to be passed on to those who are least equipped to bear and manage the risk – farmers, SMEs, infrastructure projects, and ultimately in many cases, households. This is the essence of the challenge and needs to be at the center of aggressive efforts among donors and investors to ensure the risk is borne and managed by those most able to do so.

- A wide range of initiatives and instruments address high levels of FX risk in emerging markets, but collectively they are neither achieving scale nor making a systemic impact. Donors and investors should consider efforts to scale up the best instruments.

- DFIs and export credit agencies are already financing projects in developing countries and should increase their use of local currency financing and FX-hedging solutions. There is a need to adopt a set of common principles and increased cooperation.

- The regulations governing institutional and other private investors need to be better understood to ensure that the mechanisms that are created to crowd in private investment and respond to their needs and requirements.

- While blended finance solutions can help reduce FX risk, there is a need to establish principles and practices to guide when it is and is not appropriate to deploy blended finance solutions, and what the appropriate sharing of risk and reward among the private, public and philanthropic sectors looks like.

- According to survey results conducted after the workshop, both follow-on workshops and additional research would be beneficial to advancing solutions to the FX risk challenge. Suggested follow-on workshop topics include FX risk for equity investors and the role of export credit agencies. Suggested research topics include the role of blended finance and the effects of FX risk on emerging markets and poor people.

THIS SUMMARY WAS COMPILED BY CONVERGENCE

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