THE NEED TO REDUCE FX RISK IN DEVELOPMENT COUNTRIES BY SCALING BLENDED FINANCE SOLUTIONS

INTRODUCTION

Foreign exchange (FX) risk is a significant barrier to sustainable development in emerging and frontier countries. FX risk contributes to a bottleneck in the supply of sustainable financing for agriculture, SMEs, infrastructure, energy and other sectors critical to achieving the Sustainable Development Goals (SDGs).

The development community and private sector have developed promising solutions to reduce FX risk, but these innovations have not had a material impact. Over 90% of cross-border debt to low- and lower middle-income countries is denominated in foreign currency, exposing unhedged borrowers to currency mismatch between local currency revenues and foreign currency debt. When local currencies depreciate, the consequences range from bad to disastrous; including insolvency, job losses, recession, increases in non-performing loans, decreases in investment flows and economic crisis.

What can we do to reduce systemic FX risk in developing countries? While regulatory reforms to deepen and broaden domestic financial intermediation in local currency can solve the problem, this has proven to be a long-term journey in most developing countries. In the meantime, there is a need to ensure FX risk is properly managed and not transferred to the most vulnerable borrowers. Modest amounts of concessional funds can go a long way to improve sustainable investment and economic development by (i) increasing the amount of cross-border financing from the private sector to developing countries and (ii) decreasing the level of FX risk in developing countries, especially for the most vulnerable such as farmers, microenterprises, SMEs, and consumers.

In order to maximise the impact of the USD 132B of annual Official Development Assistance (ODA) from OECD Development Assistance Committee members and the USD 30B of annual funding from philanthropic sources, development funders would be best served to deploy resources to support innovative solutions for mitigating FX risk in developing countries. The impact on sustainable development and the SDGs could be immense.

WORKING DEFINITION OF BLENDED FINANCE

Although there are multiple ways to define blended finance, the authors see three signature markings:

1. FINANCIAL RETURNS: Whether a project, company, fund, or structured offering, the transaction is intended to yield a return.
2. DEVELOPMENT IMPACT: The transaction is in a developing country and contributes to the SDGs, but not all investors need to be socially motivated.
3. LEVERAGE: The development parties are catalytic and additional; the private investment would not have been mobilised without the blended finance intervention.

Figure 1: Working definition of blended finance

MOUNTING RISKS FOR VULNERABLE BORROWERS

THE NEED FOR CROSS-BORDER FINANCING

The domestic financial sector in most developing countries is not able to provide the sustainable financing required to achieve the SDGs, with cross-border financing required to overcome the three major impediments to domestic sustainable financing in developing countries:

- Financing needs are too large for the domestic financial sector. The United Nations estimates USD 2.5T of incremental annual financing is required to achieve the SDGs, with the greatest potential in high-impact sectors such as infrastructure, energy, water and sanitation, and telecommunications, which together have an estimated annual shortfall of USD 1.6T.[1]

- Domestic intermediation is limited and dollarized. Too much of financial sector assets and liabilities is denominated in foreign currency. Domestic savings rates are low and confidence in local currencies is unstable.

[1] UNCTAD 2014 op cit., Sachs et al 2014 op cit

- Mismatched risk-return profiles. The limited amount of domestic institutional capital tends to invest in low-risk investments in developed countries or domestic government bonds. Developers of economically important projects cannot obtain the necessary long-term financing in local currency. This is particularly true for capital-intensive projects that depend on debt, such as renewable energy.

However, macro risks and exchange rate volatility impede the flow and impact of cross-border finance. When cross-border flows are denominated in foreign currencies, the recipient bears the currency risk—the prevailing current practice.[2] When cross-border flows are offered in local currency (rarely), borrowers perceive the nominal interest rates as excessively high. For a variety of reasons, including very low foreign currency interest rates, the interest rate differential between foreign currency debt and local currency debt in most emerging and frontier countries ranges from 4 to 14% per annum. This leads to a large cross-border FX loan market and a small local currency (or FX-hedged) loan market.

This FX risk is prevalent whether the lender is the private sector of public sector. Multilateral development banks, international financial institutions and development finance institutions (collectively DFIs) are unwilling or unable to provide financing with open currency risk, even at a premium. As a result, DFIs almost always provide debt in FX and far too often the most vulnerable borrowers bear the FX risk.[3]

THE IMPACT OF FX RISK ON DEVELOPMENT

Unhedged FX risk can have significant, negative consequences on progress towards the SDGs, particularly at the borrower level. Most borrowers earn revenue in local currency, but hold debt obligations in a foreign currency. While these parties should borrow in local currency, local currency loans may not be available or available only at very high interest rates at the required volume and tenor. Short of an alternative, the local parties are forced to bear the risk on an unhedged basis.

Take a standard renewable energy project as an example. The [International Renewable Energy Association (IRENA)] estimates debt service costs typically account for around 40-70% of a solar project. To qualify for financing from a conventional project financier, projects often require a minimum debt service coverage ratio around 120-125%. A solar project company that earns revenues in local currency and borrows in foreign currency for a ten-year tenor at a market interest rate of around 5% fixed is vulnerable to currency movements. Even small currency depreciations can impact the capacity of the project company to generate sufficient cashflows to service the FX debt.

The authors have performed several sensitivity analyses to ascertain the level of depreciation that jeopardises the ability to service debt. Depreciations as low as 4% per annum can effectively undermine the ability of the project company to service its debt, leading to payment default and a non-performing loan. This applies to all unhedged borrowers, from large infrastructure project loans to small SME loans. Unwittingly or unwillingly, these borrowers are forced into currency speculation.

Research indicates that annual depreciation rates have averaged over 4% for developing countries over the past 25-40 years.[4] Further, depreciations of greater than 15% over a 12-month period are quite common in developing countries. It is these significant depreciations that have the most devastating impact on a borrower and systemic ramifications for the country. Figure 2 is reproduced from "This Time is Different" by Reinhart and Rogoff (2009) and depicts the incidence of depreciations greater than 15% between 1800 and 2000. It is no coincidence the region with the highest rates of FX denominated assets and liabilities in the financial sector experiences the highest non-performing loan ratios: Central and Eastern Europe.

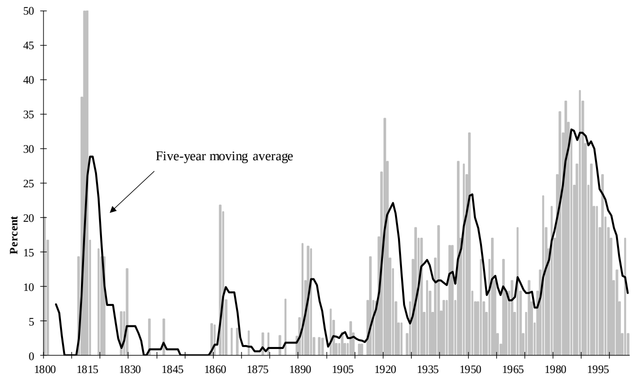

Figure 2: Share of countries with annual depreciation rates greater than 15 percent, 1800-2000

But the project-specific impacts of currency fluctuations vary and are difficult to predict. The same project company could successfully service a local currency loan at a similar tenor with nominal interest rates at a 3-4% premium to the USD loan.

[2] In principle, FX risk adversely affects the cost of financing even in USD as a factor that heightens default risk on the recipient side.

[3] The DFIs could consider taking, pricing, and managing currency risk, especially in the most critical countries and sectors to achieve the SDGs, but that subject is beyond this paper's remit.

[4] This is simply an average, with actual deprecations being lumpy. Rogoff (2009) research informs the above sentiment.

PROMOTING SOLUTIONS THAT LEVERAGE BLENDED FINANCE

Blended finance emerges as one high-potential path towards the SDG objectives, specifically to "*mobilize additional financial resources for developing countries from multiple sources*" (17.3) and "*assist developing countries in attaining long-term debt sustainability*" (17.4). At the International Conference on Financing for Development in Addis Ababa in June 2015, UN member countries reached consensus on the importance of deploying public funds to attract private sector investment in blended finance:

> *"An important use of international public finance, including Official Development Assistance, is to catalyse additional resource mobilization from other sources. Blended finance instruments serve to lower investment-specific risks and incentivize additional private sector finance across key development sectors led by regional, national and subnational government policies and priorities for sustainable development."*

The SDGs and Addis Ababa Action Agenda point towards deploying blended finance to reduce FX risk in developing countries to achieve long-term sustainability, including reducing the percentage of cross-border flows where the borrower bears FX risk on an unhedged basis and increasing the amount of domestic financial intermediation in the financial and capital markets in local currency.

THE IMPORTANCE OF BEST PRACTICE

There have been numerous solutions to address FX risk and increase the supply of sustainable finance over the past decade. Yet over 90% of cross-border debt financing to low- and lower-middle-income countries is denominated in foreign currency and almost 100% of equity flows are exposed to FX risk. Numerous good solutions exist but reducing FX risk at scale will require concentrating on several of the best practice solutions that provide good leverage of public and philanthropic funds.

Relevant solutions depend on the region and, specifically, the level of capital markets development. In Sub-Saharan Africa, the market for investment is private equity focused, whereas in Asia, capital markets are deeper and debt is more important. Regardless, solutions have not achieved scale across all regions. High levels of FX risk remain the norm in developing countries, threatening the achievement of the SDGs.

In an effort to address FX risk and discuss blended finance as a potential solution, the European Commission, the OECD, the European Development Finance Institutions, TCX and Convergence convened more than 130 people from over 60 private, public, and philanthropic organisations in February 2017 for the largest-ever workshop of experts and practitioners dedicated to FX risk reduction in developing countries and development finance. The participants investigated existing innovative solutions to reduce FX risk, identified best practices, and discussed how these solutions can be scaled up to achieve the SDGs.

The workshop concluded that there is a critical need for regulatory and institutional reforms to improve domestic financial intermediation in the long-term - it is important to improve the ability of domestic financial and capital markets to intermediate larger amounts of local currency finance. Public sector donors and DFIs are working with national authorities (e.g., central banks) in developing countries to improve domestic financial and capital markets regularly, including technical assistance to fund reforms to deepen and broaden domestic financial intermediation in local currency.[5]

In the short- to medium-term, there are four high-impact uses of blended finance to reduce FX risk and increase sustainability.

1. Credit enhancement and risk-sharing instruments to facilitate domestic capital being invested in domestic projects. Organisations like GuarantCo and the Credit Guarantee and Investment Facility (CGIF) have proven instruments, issuing guarantees that allow borrowers to gain access to local currency capital at sustainable terms. Meanwhile, domestic investors achieve their local risk-return requirements. With growing wealth and investable capital in developing countries, these instruments should be scaled up.

2. Credit enhancement and risk sharing instruments to facilitate cross-border debt and equity investment. Vehicles like the Sida Guarantee Instrument and the IFC–Sida Managed Co-lending Portfolio Program allow investors and lenders to benefit from a full or partial guarantee from an investment grade guarantor. With the growing supply of institutional capital in developed countries out-stripping investment opportunities, these instruments hold great promise to crowd-in debt investors from developed countries.

[5] Depending on the definition, technical assistance to support policy reforms and capacity development may or may not be included in the field of blended finance.

3. Currency risk hedging instruments to improve the management and allocation of FX risk. TCX has underwritten around USD 5B of currency risk in more than 50 developing countries over the past decade, allowing around 3-5M SMEs to access local currency financing at viable rates. TCX has earned a positive return – albeit with the high volatility expected from its business model. The MIGA Guarantee Instrument cross-currency swap arrangement allows borrowers to swap out of FX debt obligations into local currency obligations. These instruments represent best-practice innovations to manage currency risk in developing countries.

4. Financing and guarantee instruments that bear FX risk. The European Investment Bank–European Union ACP Facility is the best-known sizable program within the DFIs where the lender takes open currency risk and charges a premium to cover FX losses. After 10 years of financing around EUR 600M in loans, the cumulative FX premium has been around five times greater than FX losses. The ACP Facility has demonstrated that a DFI can bear open currency risk, price the risk and earn a positive return.

HEIGHTENED CONCERNS IN FRAGILE STATES

Security problems, social conflict, and weak financial policies and institutions are all root causes of high FX risk. High levels of interest rate risk increase domestic interest rates and, therefore, the cost of currency hedging, discouraging local currency lending and investment.

Businesses operating under fragile market conditions cannot generate enough revenues to afford paying risk-reflective financing or the hedging costs. These businesses are forced to seek financing in foreign currencies at much lower rates, but a much higher exposure to exchange rate risk. Unwittingly or unwillingly, they are forced into currency speculation.

Blended instruments will be especially needed in high-risk, fragile markets to ensure that local currency instruments can be made available at accessible prices. This can be achieved by providing risk-capital or grants to entities that extend funding or hedging instruments at viable but below risk-reflective prices.

BENEFITS OF BLENDED FINANCE	PREVAILING CHALLENGES
Best-practice blended finance solutions may be sustainable in the medium-term, but experience significant short-term volatility of returns (i.e. too volatile for pure market solutions).	The returns on capital have been too low to crowd-in private sector investors as the only providers of capital
Blended finance instruments have high "additionality", crowding in financing that either would not have occurred or would have occurred in foreign currency with the resulting high risk of default	Existing vehicles have not reduced the scale of the FX risk problem. FX risk in developing countries and development finance has remained similarly pervasive as before the Latin American debt crisis of 1980s
The best blended finance instruments have been scalable, replicable, and, in most cases, ever-green facilities. Best practice solutions are market-supporting and adhere to the DFI guidance (e.g., blended finance principles).	Existing instruments remain too fragmented and too small – there are likely more than 30 instruments that reduce FX risk in developing countries and development finance, but only two have capital of more that USD 500M – TCX and CGIF. To achieve scale, more capital and FX risk needs to be concentrated in the best instruments
Public and philanthropic sector contributions to blended finance solutions have often linked the risk reduction need to a sectoral need, such as infrastructure and renewable energy	Despite a stated ambition and increased efforts to reduce FX risk, DFIs continue to extend most loans in hard currency. This practice generates strong profitability for the institutions, often more than USD 2.5B of net earnings each year. If a percentage of this income could be directed to blended finance instruments to deliver local currency loans, the capacity of the development community to reduce FX risk would be significantly increased.
The frequency and size of capital loss for public and philanthropic funders in the best-practice instruments in the medium-term has been low.	Some instruments have no transparent, risk-based pricing. Thus, they cannot re-distribute risks with private markets and take full advantage of off-setting risk profiles of other players.

Table 1: Observations from review of blended finance instruments

ACHIEVING SCALE IN REDUCING FX RISK GOING FORWARD

So long as domestic financial intermediation is insufficient to finance the SDGs and cross-border financing is required, FX risk is inevitable. The question is how to best manage, properly price, and fairly allocate this risk.

Prevailing practices too often cause the most exposed parties to bear that risk, including farmers, micro-enterprises, SMEs, the customers of unhedged utilities, and, in many cases, taxpayers. The innovative solutions described above shift FX risk to parties best able to bear and manage the risk, such as professional financiers, DFIs, and developed country public and philanthropic sector parties.

CHALLENGE	EXAMPLE BLENDED FINANCE SOLUTIONS
Domestic financial and capital markets are immature, shallow, and narrow.	• Memoranda of Understanding to pursue coordinated technical assistance to improve, deepen and broaden financial intermediation in local currency
Domestic financial markets are heavily dollarized. When local currency is available, is not intermediated into domestic projects.	• Reforms to improve domestic intermediation • Blended finance instruments to incentivise investors to invest their local currency capital domestically, such as GuarantCo and CGIF
Public aid agencies, philanthropic investors, and DFIs often pursue "development project" where FX risk is shifted to the beneficiary without fully understanding the implications at the project- and systemic-levels.	• FX risk principles agreed by public and philanthropic sectors and development finance institutions to govern cross-border FX financing and local currency financing Baseline approach to provide local currency financing to borrowers and projects that do not have sufficient FX earning
Although mandated to achieve impact, DFIs are often motivated by volumes. Foreign denominated debt is often the quickest and easiest to complete.	• Adherence to FX principles • Scorecard objectives at DFIs should include targets to increase the percent of financing in local currency or hedged foreign currency
With hard-currency interest rates low due to monetary policies in developed countries, the interest rate differential is very high. Hard-currency loans appear cheaper initially, but their cost advantage disappears with FX depreciation.	• In the long-term, reforms to improve domestic intermediation • In the short-term, blended finance instruments to decrease the cost of local currency or hedged foreign currency financing, to reduce currency risk, and/or credit risk
Incentives are shaped by short-term considerations. Developers prefer to show high-returns with high FX risk, corporate managers seek short-term profit maximization, and sovereign borrowers are subject to political cycles.	• Life-time cost assessment of loan products under market based assumptions and cost-comparison between local currency and FX products should become standard procedure. • Lenders should not support speculative behaviour and stop offering FX finance to borrowers without FX income.
Cross-border financing from DFIs and through blended finance vehicles should not distort domestic market development.	• All cross-border financing provided by DFIS and through blended finance should be provided with a view to enable, not distort, market competition (e.g., at market prices for short-term loans and market-norm premium for medium and long term loans), whether denominated in FX or local currency. • Pursue blended finance instruments that can readily deploy at scale local currency or FX-hedged solutions at domestic market- or risk-reflective prices.
Macro-risks in developing countries are very high due to structural weaknesses in financial policies. Very few companies, projects, and ultimately customers can afford risk-reflective prices.	• Donors can support explicit or implicit subsidy regimes, possibly conditioned on signing and implementing MoUs. Distortion concerns are less relevant due to typical absence of existing markets and mitigating measures include fair and transparent allocation and impact reporting.
Development community should endeavour to achieve scale to reduce systemic FX risk	• New public and philanthropic funding to FX risk mitigation should first consider the myriad of existing FX-risk reducing blended finance instruments.

Table 2: Examples of blended finance approaches to reduce FX risk in developing countries

Overall, there are many promising blended finance solutions for reducing FX risk in developing countries, but cost and scale are still key problems. The nature of the issues means that FX risk is most acute for those countries least able to mobilise finance domestically. This factor is relevant because FX risk is extraneous to the fundamental economics of a project but a double penalty for countries already most in need.

Unless the solutions outlined above and other new solutions become less costly and more viable, they will remain unaffordable given significant constraints on public development finance. Looking ahead, there is a very strong case for focusing on identifying solutions that drive down the cost of local currency borrowing, including currency hedging. This will have to involve grant resources, but there is a limit to the extent that such scarce resources can be deployed for improving the terms of other transactions, without ramifications for other funding needs.

Organisations at the workshop agreed that the prevailing practices—practices where the most vulnerable borrowers bear the foreign exchange risk—is one of the most damaging practices in development finance. Recipients of development finance should not be forced into currency speculation. There is also agreement that blended finance has the potential to play a significant role in transferring the foreign exchange risk to those most equipped to manage and mitigate them. Table 2 above includes the best practices identified by the workshop participants and authors to reduce FX risk at scale.

The World Bank Group and the International Development Association (IDA) donors are taking an innovative and leading role in addressing FX risk. The current IDA replenishment includes a new Private Sector Window, which is expected to provide approximately USD 500M to assist IFC provide local currency financing. Similarly, the new European Fund for Sustainable Development is expected to allocate European Union aid to reducing FX risk in developing countries. These new sources should contribute to shifting FX risk back to the most equipped.

Further, we have seen significant impact and catalytic leverage of public and philanthropic funds across the 10 instruments profiled at the workshop. A simple review of the instruments indicates less than USD 1B of public and philanthropic funds have been committed to support around USD 10B of local currency financing. The best news is that donor losses have been infrequent and minimal; almost all donor funds are still available to continue to support the SDG implementation period. Indeed, a small percentage of annual ODA resources combined with redirecting some existing public sector funds in the system (e.g., DFI retained earnings) could drive one of the most systemic, permanent, and impactful transformations during the SDGs. Further, the sectors that benefit the most from FX risk reduction—including agriculture, SMEs financing, infrastructure, energy, and climate change—are those most critical to the SDGs.

Increased public sector investment in blended finance instruments would likely have a positive impact on reducing the incidence of sovereign debt defaults and restructurings. In the long run these blended finance instruments could reduce official creditor losses in debt restructurings. Official creditors bear the losses of Paris Club sovereign debt restructurings. Since 1956, 90 countries have restructured around USD 600B of sovereign debt with official creditors experiencing significant losses. One of the leading causes of these restructurings—and official creditor losses generally—has been high FX debt followed by local currency depreciations.

THIS DOCUMENT WAS CO-AUTHORED BY:

- European Commission: Kay Parplies, Yves Ehlert, and Asari Efiong
- OECD: Paul Horrocks, Jens Sedemund, and Wiebke Bartz
- Association For European DFIs (EDFI): Soren Andreasen
- Convergence: Christopher Clubb and Justice Durland
- The Currency Exchange Fund (TCX): Harald Hirschhofer

For more information on the FX Risk in Development Workshop on 1 February 2017, please visit www.convergence.finance.