

Working paper 1

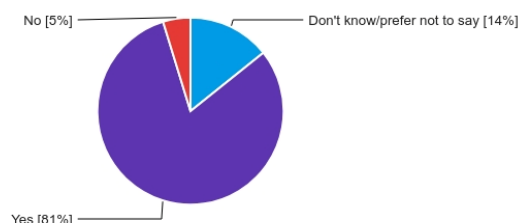
Overview of local currency financing practices by MDBs

1. Introduction

Local currency (LC) financing offers significant benefits, particularly in mitigating exchange rate risk for borrowers in low- and middle-income countries (LMICs). This conclusion is supported by our survey responses, which overwhelmingly affirm the advantages of LC financing, with many respondents indicating that their institutions should increase their provision of such financing. Notably, 81% of respondents identified a gap in LC financing that requires attention.

Figure 1 The need for further local currency financing, according to respondents

Q3.1 - Do you think your organisation should provide (more) financing in local currency to developing countries?



Source: Authors' survey responses.

The primary reason cited by respondents is the need to reduce currency risk and financial uncertainty for borrowers, particularly those in countries with poorly developed domestic financial markets and limited hedging opportunities. Respondents noted that LC financing would not only reduce credit risk and increase the sustainability of lending but also lead to a higher development impact. Some respondents also emphasised the need to respond to client demand for more LC borrowing. Despite these advantages, there is a significant gap in the systematic analysis and understanding of LC financing by multilateral development banks (MDBs), and its use remains relatively limited within MDB portfolios.

This paper aims to provide a comprehensive overview of current LC financing practices by MDBs. Drawing on policy and legal documents, survey responses, and syndicated loan data, the paper analyses the forms of LC financing, its scale within MDB portfolios, and the key risks and

challenges involved. A key focus of this discussion is currency risk management, which significantly influences the feasibility and pricing of LC loans.

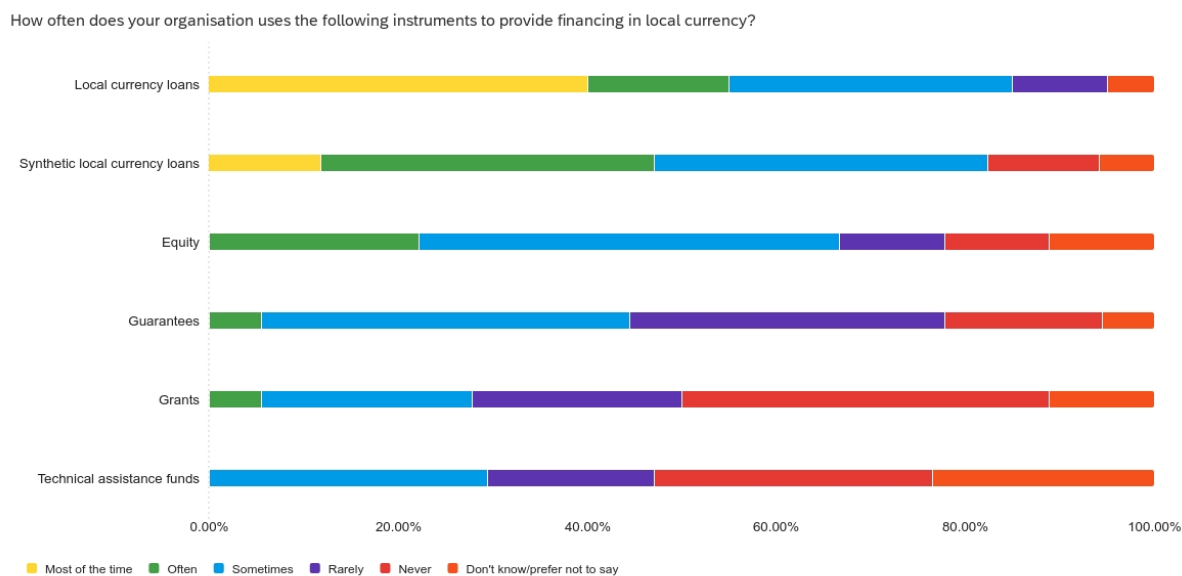
The paper is structured as follows: Section 2 identifies the various forms of LC financing provided by MDBs, including grants, technical assistance, loans, guarantees, and equity investments. Section 3 analyses the scale of these financing activities using syndicated loan data and survey responses, revealing patterns based on currency, region, sector, and borrower type. Drawing on survey data, Section 4 examines the barriers to expanding LC financing, focusing on three key areas: the availability and cost of risk management tools, the challenges associated with mitigating currency risk, and the implications of these factors for MDBs' capacity to offer affordable LC financing. Finally, Section 5 explores instances where MDBs have taken on currency risk, such as through off-balance sheet structures and initiatives involving external guarantors, allowing for some degree of currency exposure in specific projects.

2. Forms of local currency financing

This section provides a comprehensive overview of the various forms of LC financing arrangements offered by MDBs, including grants, loans, guarantees, and equity investments, with a focus on their legal structures. The current practices of selected MDBs in providing LC financing are summarised in Table 1. It is important to note that this table does not indicate the frequency of these arrangements, as some are offered only occasionally.

While most MDBs offer LC arrangements to some extent (Table 1), the frequency of these arrangements varies significantly (Figure 2). Furthermore, Figure 2 does not account for disparities across various MDBs, which may be substantial, with some MDBs being much more active than others in the LC financing landscape.

Figure 2 MDBs local currency financing instruments by frequency of use



Source: Authors' survey respondents.

Table 1 Overview of Selected MDBs' Local Currency Financing Arrangements

	Grants and technical assistance funds	Loans	Guarantees	Equity
African Development Bank (AfDB)	✓	✓	✓	✓
Asian Development Bank (ADB)	✓	✓	✓	✓
Asian Infrastructure Investment Bank (AIIB)	✓	✓	✓	✓
Council of Europe Development Bank (CEB)	✓	✓	✓	✓
Development Bank of Latin America (CAF)	✓	✓	✓	✓
European Bank for Reconstruction and Development (EBRD)	✓	✓	✓	✓
European Investment Bank (EIB)	✓	✓	✓	✓
Inter-American Development Bank (IDB)	✓	✓	✓	✗
Inter-American Development Bank (IDB) Invest	✗	✓	✓	✓
International Bank for Reconstruction and Development (IBRD)	✓	✓	✓	✗
International Development Association (IDA)	✓	✓	✓	✗
International Finance Corporation (IFC)	✓	✓	✓	✓

New Development Bank (NDB)	✓	✓	✓	✓
----------------------------	---	---	---	---

Source: Author’s review of MDBs’ legal documents, official websites, and/or responses provided by survey participants. The MDBs selected for this overview are those for which either public official information or survey responses were available.

2.1. Grants and technical assistance funds

Grants are non-repayable funds typically, though not necessarily, provided to countries eligible for concessional financing due to fragile debt sustainability, such as those at high risk or already in debt distress. **Technical assistance funds**, in turn, are non-repayable resources or in-kind contributions generally targeted at socially vulnerable and disadvantaged areas or sectors in member countries. These funds support training, feasibility studies, project preparation, and other developmental activities, including capacity-building across various sectors to enhance the capabilities of public and private institutions.¹ For example, they can cover consultant fees, travel expenses, and costs related to publishing project outcomes.² These funds may be provided through various trust funds, special funds, and co-financing arrangements, with MDBs acting as implementation agents for donor-provided resources.³

While our survey responses indicate that grants and technical assistance are not as prominent in MDBs’ LC financing operations compared to other instruments, these resources are crucial for enabling access to concessional LC financing for the most vulnerable members, including low-income countries (LICs) and strategic sectors of LMIC economies that may lack access to affordable financing.

MDBs’ policies on LC grants and technical assistance vary, with those serving more LICs being the most active. For example, the *General Conditions* governing the disbursement of grants by the African Development Bank Group stipulate that grants should be made in the currencies in which costs have been paid or in other currencies determined by the African Development Fund, the concessional window of the African Development Bank Group (Section 3.02). The

¹ Asian Development Bank, ‘ADB’s Microfinance Program’ <https://www.adb.org/what-we-do/microfinance-program/overview> accessed 26 July 2024.

² Development Bank of Latin America, ‘Technical Cooperation’ <https://www.caf.com/en/about-caf/what-we-do/products-and-services/technical-cooperation> accessed 26 July 2024.

³ African Development Bank, *Financial Products Handbook 2022-2023* (African Development Bank Group 2022) 59-61 <https://www.afdb.org/en/documents/financial-products-handbook-2022-2023> accessed 26 July 2024; Asian Development Bank, ‘Overview: Asian Development Fund (ADF)’ <https://www.adb.org/what-we-do/funds/adf/overview> accessed 26 July 2024; Development Bank of Latin America (n 2).

value of disbursed funds in one or more currencies is to be reasonably determined by the Fund as of the date of each disbursement (Section 3.03).⁴

In their operations with LMICs, MDBs may provide financing on concessional terms, effectively blending grants with loans or guarantees. Notably, the International Development Association (IDA) is the World Bank's arm that provides financing to LICs or otherwise eligible countries based on relative poverty, defined as GNI per capita below an established threshold, which is updated annually.⁵ Typically, the IDA offers financing to eligible countries on highly concessional terms. However, for LC financing, borrowers under IDA concessional financing must bear the market cost of currency conversion. IDA concessional credits are offered either in Special Drawing Rights (SDRs), or as single currency credits. For SDR-denominated credits, repayments must be made in one of five currencies — US dollars, pounds sterling, yen, euros, or Chinese yuan — with the borrower assuming the foreign exchange risk between the repayment currency and the SDR.⁶ Single currency concessional credits are available in US dollars, pounds sterling, yen, or euros.⁷ Borrower requests for currency conversions are subject to the maximum maturity available in the swap or capital markets for the respective currency or currencies. Conversions into local or authorised currencies at the time of credit disbursement are permitted, provided that the IDA can hedge such conversions through a currency swap or a back-to-back IDA bond issuance. Importantly, pricing for currency conversions is determined at market rates, and conversions are subject to transaction fees periodically set by management.⁸ In summary, under IDA concessional financing, repayment is always in hard currency, with no concessionality regarding exchange rate risk.

Another relevant aspect in the discussion on concessionality and LC financing relates to specific MDB programmes that use donor funds to support high-impact projects in countries where LC solutions are either underdeveloped or unaffordable for local borrowers. Examples include the IDA-IFC-MIGA Private Sector Window (PSW)'s Local Currency Facility (LCF), and the Asian Development Fund (ADF) PSW's Local Currency Solution (LCS), which are further discussed in Section 5.

⁴ African Development Bank (n 3).

⁵ The terms and conditions of IDA grants are given particular emphasis in this report because, although other MDBs also have concessional lending arms, the IDA is the most prominent. The need for specific policy reforms in its financing terms to enhance LC financing capacity emerged more clearly during the semi-structured interviews we conducted.

⁶ Section III(2)(a)(ii)(A) of the International Bank for Reconstruction and Development and International Development Association's *Bank Policy: Financial Terms and Conditions of Bank Financing*, OPS5.09-POL.178 (7 July 2023) <https://treasury.worldbank.org/en/about/unit/treasury/ibrd-financial-products/guidelines-and-forms> accessed 27 August 2024.

⁷ *ibid*, Section III(2)(a)(ii)(B).

⁸ *ibid*.

2.2. Loans

Loans, also referred to as credit facilities or loan agreements, are financial arrangements in which a lender—typically a bank or financial institution—stipulates the terms and conditions for providing funds to a borrower. These terms often include conditions precedent, repayment schedules, interest rates, and other financial covenants.⁹ When multiple lenders provide funds to a borrower (or a group of associated borrowers) under a single facility agreement, these arrangements are known as syndicated loans or facilities.¹⁰

As our survey responses indicate, loans are the most common form of financing provided by MDBs in their LC operations, with 55% of participants reporting that their institutions offer LC loans either frequently or most of the time. Notably, 47% of respondents specified that these are typically structured as synthetic loans—the mechanics of which are discussed in Section 2.2.2 below. Importantly, the survey did not explore specific loan types or terms, so the responses encompass all categories of loans mentioned in this section.

MDB loans can be categorised into two types: sovereign-guaranteed loans and non-sovereign-guaranteed loans. Sovereign-guaranteed loans are extended to state governments or entities backed by a sovereign guarantee, ensuring repayment through the central government’s full faith and credit. These loans primarily support public sector projects that foster economic development and stability, such as infrastructure for transportation, telecommunications, power generation, and water supply. In contrast, non-sovereign-guaranteed loans are provided to public or private sector entities without a sovereign guarantee and are typically used for corporate or project financing. Both types of loans can be offered on concessional or non-concessional terms, depending on the country eligibility policies of individual MDBs.

2.2.1. Standalone loans and co-financing

Within these categories, MDBs offer various financial arrangements, either as **standalone loans** or through **co-financing structures** involving multiple lenders.

a. Standalone loans

⁹ Thompson Reuters Practical Law, ‘Glossary: Facility Agreement’ (Thompson Reuters 2024) <https://uk.practicallaw.thomsonreuters.com/8-200-1386> accessed 29 July 2024.

¹⁰ *ibid.*

Standalone loans involve the MDB acting as the sole lender. MDBs generally prefer the entity responsible for implementing and operating the project to be the loan recipient. Direct lending enables MDBs to monitor the project's implementation more effectively and recommend corrective measures when necessary. If direct lending is not feasible due to legal considerations, MDBs may lend to another entity, provided the project can still be efficiently implemented and operated.¹¹

For each loan, MDBs enter into a loan agreement with the recipient, outlining the loan amount and the terms and conditions.¹² In sovereign-backed financing, the member state provides a guarantee for each loan made to a recipient that is not the member. This guarantee covers the payment of principal, interest, and other charges, generally as the principal debtor and not merely as a surety. This arrangement allows the MDB to call directly on the member for payment without first exhausting its remedies against the recipient.¹³ In non-sovereign-backed financing, the MDB may lend with the support of a third party—such as recourse to designated assets, the sponsor's balance sheet, or a bank guarantee—or on a limited recourse basis.¹⁴ The latter, known as 'structured financing', is backed only by the project's cash flows and assets.¹⁵ In the former, the lender conducts an in-depth analysis of income statement dynamics and evaluates the sponsor's balance sheet. In the latter, the lender assesses the adequacy of capitalisation in the special purpose vehicle and the debt service coverage ratio.

Loan agreements are generally based on general conditions periodically approved by MDB boards, setting forth terms applicable to all loans and those specifically applicable to sovereign or non-sovereign-backed lending arrangements.¹⁶ Typically, the loan agreement, member guarantee agreement, and project implementation agreement incorporate these general conditions by reference.¹⁷

¹¹ See, e.g., Article 8.1.1 of the Asian Infrastructure Investment Bank, 'Operational Policy on Financing' (26 June 2024) https://www.aiib.org/en/policies-strategies/_download/operation-policy/AIIB-Operational-Policy-on-Financing_OPF.pdf accessed 29 July 2024.

¹² *ibid*, Article 8.1.2.

¹³ *ibid*, Article 8.1.4.

¹⁴ *ibid*, Article 4.4 of the Asian Infrastructure Investment Bank's *Operational Policy on Financing* (26 June 2024).

¹⁵ Latin American Development Bank, 'Structured Financing' <https://www.caf.com/en/about-caf/what-we-do/products-and-services/structured-financing/> accessed 30 July 2024.

¹⁶ Asian Infrastructure Investment Bank (n 11) Articles 3.4 and 5.1 (non-sovereign-backed financing).

¹⁷ Asian Infrastructure Investment Bank (n 11) Article 8.1.9. See also African Development Bank, *General Conditions applicable to Loan, Guarantee and Grant Agreements* (African Development Bank Group, February 2009) <https://www.afdb.org/fileadmin/uploads/afdb/Documents/Legal-Documents/General%20Conditions%202009.pdf> accessed 26 July 2024; Inter-American Investment Bank, *General Conditions for the Sovereign Guaranteed Loan Contracts* <https://www.iadb.org/en/who-we-are/how-we-are-organized/legal-department/legal-resource-center> accessed 26 July 2024.

MDBs typically do not require specific security in sovereign-guaranteed loans, although they may require guarantees or security in non-sovereign-guaranteed financing.¹⁸ Non-sovereign-backed loans may be required to be extended as senior loans.¹⁹ If a co-financier of the loan requires security, the MDB typically follows suit.²⁰ Common clauses include negative pledge provisions, and remedies may include the suspension or cancellation of disbursements, acceleration of payments due under the loan, enforcement of security, and the exercise of rights vis-à-vis sponsors or other third parties, such as guarantors.²¹

In addition to direct loans, MDBs may provide lines of credit to financial institutions for on-lending to their customers based on an indicative pipeline of transactions. This product targets various end beneficiaries, such as SMEs and underserved communities struggling to access local credit. While the MDB bears the credit risk of the intermediary financial institution, the local institution assumes the end beneficiaries' credit risk. These are generally senior unsecured loans, extended only to financial institutions with satisfactory credit standing and the ability to manage the on-lending business. In some cases, the MDB may require additional security to guarantee reimbursement of the line of credit.²²

To better serve SMEs, especially in frontier credit markets, MDBs may assume the end beneficiaries' credit risk through agency line arrangements, with financial institutions or other partners acting as their agents. This approach is relevant where the MDB lacks confidence in the credit capacity of local partner institutions. The selection of projects for MDB support is largely delegated to these intermediaries, who use MDB resources to make loans for their account, ensuring that projects meet pre-agreed criteria. The intermediary acts solely as an agent for the MDB, assuming no credit operation risk and receiving an agency fee.²³

b. Co-financing

Co-financing involves multiple lenders funding a project, whether sovereign-guaranteed or purely private sector-based. This approach often includes partnerships with other development

¹⁸ Asian Infrastructure Investment Bank (n 11) Articles 4.5 and 8.1.5.

¹⁹ Asian Infrastructure Investment Bank (n 11) Article 4.5.

²⁰ Asian Infrastructure Investment Bank (n 11) Article 8.1.5.

²¹ Asian Infrastructure Investment Bank (n 11) Articles 8.1.3 (sovereign-backed financing) and 6.2.3 (non-sovereign backed financing). See also African Development Bank, *General Conditions applicable to Loan, Guarantee and Grant Agreements* (African Development Bank Group, February 2009) Article VII.

²² African Development Bank (n 3) 23.

²³ *ibid* 24.

finance institutions and private sector participants, commonly used in large-scale infrastructure projects where financial requirements exceed the capacity of a single lender.

A novel initiative in this area is the Global Collaborative Co-financing Platform, launched during the 2024 IMF and World Bank Spring Meetings. This digital marketplace—comprising the AIIB, the World Bank (WB), AfDB, ADB, CEB, EBRD, EIB, IDB, IsDB, and NDB—aims to streamline co-financing by providing a centralised hub for project information, enhancing collaboration across MDBs.²⁴

Co-financing can take several forms, including:

- **A/B loans:** In this structure, the MDB acts as the lender-of-record, splitting the loan into an A-Loan (retained on the MDB's balance sheet) and a B-Loan (syndicated to participating financial institutions that take full exposure to the project's credit risk).²⁵ B-Loan participants benefit from the MDB's immunities and exemptions, including preferred creditor status (PCS),²⁶ encouraging eligible lenders to finance under the MDB's 'umbrella'.²⁷ Eligible participants are usually robust, investment-grade banks. Ineligible participants include project sponsors, export credit agencies (ECAs), governmental agencies, and local banks.²⁸ The IFC also arranges B-Loans for development finance institutions without supporting A-Loans, though this operation remains small and not widely replicated by other MDBs.²⁹
- **Parallel loans:** Under this structure, the MDB, mandated by the borrower, seeks eligible financial institutions to participate on a best-efforts basis. Typically, MDBs partner with institutions not eligible for A/B loans, such as development finance institutions and local commercial banks.³⁰ The MDB acts as the lead arranger and coordinator, with agreements governed by a Common Terms Agreement (CTA) that allows each lender to refer to its policy requirements.³¹ This allows each lender to explicitly refer to their policy requirements. For large and complex transactions, the MDB may appoint a co-

²⁴ World Bank Group, 'The Global Collaborative Co-Financing Platform' (19 April 2024) <https://www.worldbank.org/en/programs/trust-funds-and-programs/brief/global-collaborative-co-financing-platform> accessed 27 July 2024.

²⁵ Asian Infrastructure Investment Bank (n 11) Article 4.8.

²⁶ African Development Bank (n 3) 27.

²⁷ European Bank for Reconstruction and Development, *EBRD Mobilisation of Private Finance* (April 2020) 21 <https://www.ebrd.com/documents/evaluation/2020-ebrd-mobilisation-of-private-finance.pdf> accessed 27 July 2024.

²⁸ African Development Bank (n 3) 29.

²⁹ European Bank for Reconstruction and Development (n 27) 21.

³⁰ African Development Bank (n 3) 30.

³¹ *ibid.*

mandated lead arranger or distribute aspects of the due diligence among financiers in the syndicate.

- **Classic syndicated loans:** This involves a group of financial institutions providing a large loan to a borrower. One or more MDBs act as lead arrangers, providing a portion of the loan and managing the negotiation process. These loans follow standard commercial loan syndication principles, with all lenders operating under a single facility document. The eligibility criteria and terms are similar to those of parallel loan structures.³²

2.2.2. Structuring of local currency loans

The standalone and co-financing arrangements discussed earlier can be structured as either deliverable or non-deliverable in LC. Deliverable loans are denominated, disbursed, and serviced in LC. In contrast, non-deliverable loans, also known as synthetic loans, are denominated in LC but involve disbursements and debt service in hard currency at the prevailing exchange rate. This structure combines a hard currency loan with a non-deliverable foreign exchange hedge and is particularly used when physical delivery of LC is not required or where settlement in LC is constrained by legal or market factors.³³ Under this arrangement, the borrower bears both conversion and transfer risks, as well as basis risk between the agreed spot exchange rate and the actual rate at the time of conversion.

Repayment structures for LC loans can be tailored to the cash flow profile of the financed project. Repayments may take the form of bullet payments—a single lump-sum payment at the end of the term—or amortising payments, distributed over the loan duration and aligned with the project’s revenue generation patterns. The choice of structure depends on the capacity of the LC market to support the loan’s size, tenor, and repayment profile, as well as the demand from investors and financial intermediaries.³⁴

2.3. Guarantees

Guarantees are widely employed in both domestic and international commercial contracts as safeguards against non-performance or financial default. The issuer of a guarantee assumes responsibility for fulfilling a contractual or legal obligation owed by one party to another in the

³² *ibid* 31.

³³ Asian Infrastructure Investment Bank, ‘Local Currency Financing’ (15 April 2024) https://www.aiib.org/en/treasury/_common/_download/AIIB_Local-Currency-Financing-FactSheet.pdf accessed 29 July 2024.

³⁴ *ibid*.

event of a default by the first party.³⁵ These instruments are provided by MDBs to guarantee sovereign or non-sovereign-backed payment obligations, such as debt and interest payments, including those denominated in LC.

As with loans, guarantees can be either sovereign-backed or non-sovereign-backed. Sovereign-backed guarantees protect against debt service defaults under a loan, whether arising from a government's failure to meet specific project-related obligations or the borrower's failure to make loan payments. These guarantees usually entitle the guarantor, through subrogation rights or a counter-guarantee and indemnity agreement, to reclaim any amounts paid to the beneficiary. In contrast, non-sovereign-backed guarantees support financing for private enterprises or sub-sovereign entities—such as political subdivisions or public sector bodies—without relying on a sovereign counter-guarantee. Like loans, guarantees can be offered on either concessional or non-concessional terms, depending on the country eligibility criteria set by individual MDBs.

While the specific nature of the payment undertaking by the MDB varies across institutions, it is generally understood to be a form of surety.³⁶ This means that the guarantee is payable upon the beneficiary's first demand, provided there is a complying presentation. It does not require the beneficiary to exhaust its remedies against the obligor under the underlying contract or obligation.³⁷ This practice is common in international trade and project financing and extends beyond MDBs.³⁸ The tenor of MDB guarantees is influenced by risk considerations and market conditions, though it usually corresponds to that of the underlying guaranteed obligations or does not exceed the maximum tenor for ordinary capital resources lending operations applicable to the borrower.³⁹

Our survey responses indicate a relatively low prevalence of guarantees in supporting MDBs' LC financing operations, with only about 6% of respondents reporting that their institutions frequently use such instruments. This result may reflect a distortion in the sample, as the type of borrower to whom financing is provided could significantly influence the use of guarantees.

³⁵ K Spencer, S Sabin, R White, and H Howarth, 'Bonds, Guarantees and Standby Credits: Overview' (Thompson Reuters Practical Law) <https://uk.practicallaw.thomsonreuters.com/4-107-3649> accessed 1 August 2024.

³⁶ See, e.g., Asian Infrastructure Investment Bank (n 11) Article 8.1.4(a), which explicitly refers to such an undertaking as not being a surety yet provides a definition that aligns with the common law understanding of a surety, namely, a primary payment obligation.

³⁷ See, e.g., African Development Bank, 'Bank Policy on Guarantees' (African Development Bank Group 2000) 23.

³⁸ G Wynne, *A Practitioner's Guide to Trade and Commodity Finance* (Sweet & Maxwell 2021) Ch 5.

³⁹ African Development Bank (n 3) 45; Asian Development Bank, *Financial Report 2023* (Asian Development Bank, March 2024) 87 <https://www.adb.org/sites/default/files/institutional-document/959761/adb-financial-report-2023.pdf> accessed 21 August 2024.

Despite the low reported rate of use, guarantees hold significant potential to enhance MDBs' capacity to expand access to financing for strategic projects in domestic markets. By providing guarantees, MDBs leverage their PCS to help eligible borrowers secure financing from third-party lenders, including those in capital markets.

Currently, as discussed in the context of loans and elaborated further in Section 4, MDBs operate under 'perfect hedging' requirements when offering LC guarantees. However, guarantees offer unique potential to scale up LC financing through alternative approaches to currency risk management.

While the terms of guarantees vary across MDBs, they can generally be categorised based on the type of risk covered, the structure of the guarantee, their applicability to LC lending, and the type of beneficiaries. The survey responses do not distinguish between these categories, all of which are addressed in the discussion below.

2.3.1. Credit guarantees

Credit guarantees protect lenders from the risk of default on scheduled payments by the borrower. These guarantees enhance the creditworthiness of the borrower, enabling them to obtain financing on more favourable terms by improving credit profiles, extending debt tenors, and lowering spreads. While typically used to cover public sector borrowers' debt obligations to private sector investors,⁴⁰ they can also be extended to private entities such as companies and financial institutions.⁴¹

Credit guarantees can cover most types of debt, including commercial bank loans, shareholder-guaranteed loans, capital market debt instruments, financial leases, letters of credit, promissory notes, and bills of exchange.⁴² The multiplier effect of credit guarantees can be significant, leveraging overall mobilisation of external resources for a project.

⁴⁰ Asian Development Bank, 'Private Sector Financing: Guarantees' <https://www.adb.org/what-we-do/private-sector-financing/guarantees> accessed 21 August 2024; Development Bank of Latin America and the Caribbean, 'Partial Guarantees' <https://www.caf.com/en/about-caf/what-we-do/products-and-services/partial-guarantees/> accessed 21 August 2024; African Development Bank (n 3) 40-44; World Bank Group, 'Products: Non-Honoring of Financial Obligations' <https://www.miga.org/product/non-honoring-financial-obligations> accessed 12 August 2024.

⁴¹ African Development Bank (n 3) 43.

⁴² Asian Development Bank (n 40); International Finance Corporation, 'Product: Guarantees for Approved Exposures' <https://www.ifc.org/en/what-we-do/products-and-services/treasury-client-solutions/guarantees-for-approved-exposures> accessed 21 August 2024.

In most cases, only a pre-agreed percentage of the underlying debt is covered, facilitating risk-sharing between the MDB and private investors or lenders. The level and scope of coverage are tailored to each transaction's specific needs. For instance, the guarantee might cover principal repayment of a bullet bond issue, rolling coupon payments, or latter part repayments of amortised loans. The amount of coverage depends on the borrower's objectives and market conditions, though MDBs generally aim to provide the minimum necessary to attract private investors.⁴³ Some institutions, notably the IFC, may offer both partial and full credit guarantees, covering up to 100% of the outstanding principal.⁴⁴

2.3.2. Risk guarantees

Risk guarantees, often referred to as political risk insurance, are key instruments employed by MDBs to mitigate political and sovereign risks in investments in LMICs. These guarantees primarily protect private lenders and investors against a government or government-owned agency's failure to meet obligations towards a private sector project, though they may also cover private parties' obligations. Government obligations may be financial or non-financial in nature, including regulatory approvals crucial to the project's execution.

Risk guarantees differ from credit guarantees in that they do not protect against commercial risks inherent in a project but focus on sovereign and political risks. These guarantees are particularly useful when commercial lenders are willing to assume commercial risks but are unwilling to take on political ones. By covering these specific risks, MDBs foster private sector participation in sectors heavily influenced by government policies, such as infrastructure, energy, telecommunications, and capital markets.

As with credit guarantees, most forms of debt can be covered with risk guarantees, including commercial bank loans, shareholder loans, loans guaranteed by shareholders or third parties, capital market debt instruments, bonds, financial leases, promissory notes, and bills of exchange. Commonly covered risks include non-honouring of contractual obligations, breach of contract, currency inconvertibility and transfer restrictions, political force majeure, and expropriation.

⁴³ World Bank Group, 'Product Note: World Bank Credit Guarantee' <https://pubdocs.worldbank.org/en/948571507314980958/product-note-world-bank-credit-guarantee-2015.pdf> accessed 21 August 2024; Asian Development Bank (n 39) 87.

⁴⁴ World Bank Group, 'Product: Partial/Full Credit Guarantee for Loans' <https://www.miga.org/product/partial-full-credit-guarantee-loans> accessed 21 August 2024.

The extent of coverage under a risk guarantee is negotiated based on project-specific risks, the host country's environment, and the level of protection required by private investors. Although risk guarantees can cover up to 100% in exceptional cases, MDBs generally aim to provide the minimum necessary to mobilise financing.

MDBs often employ syndication arrangements to extend the reach and impact of their guarantees, mobilising additional capacity through partnerships with insurers and other financial institutions. The Africa Co-Guarantee Platform (CGP), for instance, was launched in 2018 to enhance risk mitigation efforts and increase capital mobilisation for trade and investment in Africa. The CGP aims to centralise trade and investment-related guarantees and insurance, streamline application processes, and improve risk mitigation instruments to attract private investment more effectively.

2.3.3. Use of guarantees in local currency financing

MDB guarantees in LC financing usually take the form of LC guarantees or risk-sharing facilities. LC guarantees can be issued in any of the MDB's lending currencies, including designated local currencies,⁴⁵ and may be provided on concessional or non-concessional terms.⁴⁶ If a guarantee is called, the MDB may raise LC from the market or convert hard currency to fulfil its obligations. To support this, MDBs may establish medium-term note (MTN) programmes, standby LC lines, commercial paper programmes, and other funding options. They may also borrow directly from local commercial banks.⁴⁷ Should the MDB be unable to procure LC, it may convert hard currency into LC and record the transaction in its equity book.⁴⁸

Risk-sharing facilities, on the other hand, are employed in credit guarantee transactions to address the challenges posed by the MDB's back-to-back funding requirements for LC transactions, which are further discussed in Section 5.⁴⁹ In these transactions, a local lender, typically a bank, extends the loan and partially assumes the risk on its balance sheet, benefiting from an irrevocable, first-demand guarantee for the MDB's share.⁵⁰ Risk-sharing credit guarantees can be applied to any project or line of credit where a lender provides full LC funding

⁴⁵ See, e.g., Article 5.15.1 of the African Development Bank's *Revised Bank Group Policy on Guarantees* (Revised Version, July 2020) <https://www.afdb.org/en/documents/revised-bank-group-policy-guarantees> accessed 21 August 2024.

⁴⁶ World Bank Group (n 43).

⁴⁷ African Development Bank (n 45) I.

⁴⁸ *ibid* 17.

⁴⁹ World Bank Group, 'Product: Risk-Sharing Facility' <https://www.miga.org/product/risk-sharing-facility> accessed 21 August 2024.

⁵⁰ African Development Bank (n 45) Article 5.15.1.

to the borrower.⁵¹ This approach is particularly useful when a local lender has a funding advantage in LC but is constrained in its capacity to manage the credit exposure of the borrower, allowing MDBs to provide LC loans at competitive rates.

For instance, the ADB's Microfinance Risk Participation and Guarantee Programme (MFP) collaborates with lenders to enhance microfinance institutions to enhance their access to LC funding, addressing the financial needs of those at the base of the economic pyramid.⁵² The MFP shares the default risk—up to 50%—on wholesale loans to microfinance institutions provided by its Partner Financial Institutions (PFIs), including commercial banks and others. The programme aims to encourage new funding towards financial inclusion initiatives, including loans to SMEs in the informal sector, micro-housing, and related activities.

Another example of a risk-sharing facility used to promote LC financing is the IFC's Synthetic Risk Transfer (SRT).⁵³ This is a partial guarantee on credit losses extended by the IFC to commercial banks, allowing them to use the freed regulatory capital for increased lending to local borrowers. Unlike traditional securitisation, where assets are sold to a special purpose vehicle (SPV), SRTs keep assets on the bank's balance sheet, with third-party investors, such as the IFC, assuming some of the risk.

In terms of eligibility, risk-sharing credit guarantees are accessible to a wide range of lenders, including commercial banks, development finance institutions (DFIs), other MDBs, and ECAs.⁵⁴ Eligible lenders must comply with the MDB's due diligence processes, including know-your-customer (KYC) and environmental and asset-liability management (ALM) policies.⁵⁵

2.4. Equity

Equity investments, also referred to as equity interests, represent a form of investment in an entity, such as capital stock, partnership interests, or limited liability company interests. These investments entitle the investor to a share of the entity's profits and enterprise value, following

⁵¹ *ibid.*

⁵² Asian Development Bank (n 1).

⁵³ See, e.g., International Finance Corporation, 'IFC and BNP Paribas Launch Landmark SRT Transaction to Support Trade Finance in Emerging Markets' <https://www.ifc.org/en/pressroom/2023/ifc-bnp-paribas-launch-landmark-srt-transaction-to-support-trade-finance-in-emerging-markets> accessed 26 July 2024; Multilateral Investment Guarantee Agency, 'Significant Risk Transfer' <https://www.miga.org/product/significant-risk-transfer> accessed 26 July 2024.

⁵⁴ See, e.g., African Development Bank (n 45) Article 5.15.3.

⁵⁵ *ibid.*

the satisfaction of creditors' claims.⁵⁶ In the context of MDBs, equity investments are a prominent type of non-sovereign-guaranteed financing.⁵⁷ Since equity investments are typically made in the currency in which the investee company's shares are denominated—often the LC—they hold particular importance within the LC financing landscape of MDBs.⁵⁸ According to the survey responses, 22% of respondents reported that their institutions frequently make equity investments, while only 11% stated that they never do so.

MDBs engage in equity investments to fulfil several strategic objectives, such as supporting key sectors like SMEs, infrastructure, and clean energy, thereby stimulating growth, job creation, and competitiveness.⁵⁹ Additionally, equity investments enable MDBs to pursue their dual mandate of development impact and financial returns, allowing for reinvestment in future initiatives.⁶⁰ By holding equity positions, MDBs can influence corporate governance, provide technical expertise, and ensure alignment with broader development goals, often securing board representation or facilitating strategic decisions.⁶¹

MDBs use both direct and indirect channels for equity investments. Direct investments involve direct stakes in companies, such as ordinary shares, preference shares, or loans convertible into equity, and are used when MDBs seek close monitoring and influence over company operations.⁶² Indirect investments, made through financial intermediaries like private equity funds, allow MDBs to diversify their investments and leverage fund managers' expertise while still influencing strategic direction in line with development objectives.⁶³

To manage risk and ensure alignment with strategic goals, MDBs set specific limits on their equity investments. For instance, the ADB caps its equity investments at 10% of the aggregate amount of its unimpaired paid-in capital stock, along with reserves and surplus included in its

⁵⁶ Thompson Reuters Practical Law, 'Glossary: Equity' <https://uk.practicallaw.thomsonreuters.com/5-382-3436> accessed 21 August 2024.

⁵⁷ Asian Infrastructure Investment Bank (n 11) Article 3.1.

⁵⁸ Asian Infrastructure Investment Bank (n 11) Article 4.7.2.

⁵⁹ Office of Evaluation and Oversight, *Comparative Study of Equity Investing in Development Finance Institutions* (Inter-American Development Bank, March 2017) 13-14 <https://publications.iadb.org/en/publications/english/viewer/Comparative-Study-of-Equity-Investing-in-Development-Finance-Institutions.pdf> accessed 21 August 2024.

⁶⁰ International Finance Corporation, 'Equity Investments' <https://www.ifc.org/en/what-we-do/products-and-services/equity-investments> accessed 21 August 2024.

⁶¹ Asian Infrastructure Investment Bank (n 11) Article 4.9.4.

⁶² Office of Evaluation and Oversight (n 59) 14.

⁶³ *ibid* 15.

ordinary capital resources.⁶⁴ Additionally, it stipulates that the amount of any equity investment shall not exceed a certain percentage of the entity's equity capital, as determined by the Board of Directors.⁶⁵ The ADB also mandates that it shall not seek a controlling interest in the entity unless necessary to safeguard its investment.⁶⁶

Similarly, the AIIB limits its equity investments to 30% of a company's ownership, except in exceptional circumstances,⁶⁷ to maintain diversification in its investments.⁶⁸ The AfDB mandates that its equity investment shall not exceed the lesser of 25% of the investee's total share capital or a lower percentage representing a non-controlling interest.⁶⁹ These provisions are designed to prevent situations where the MDB might need to directly manage the entity, imposing restrictions on assuming a controlling interest unless required to safeguard its own investment.⁷⁰

MDBs engage in equity investments only when there is a clear prospect of financial returns.⁷¹ Each investment is expected to achieve a return that reflects its risks, typically benchmarked against the interest rate the MDB would charge for a comparable loan, with an added risk premium.⁷² For instance, the AIIB's expected returns on investments generally range from 8% to 20%, depending on the type of investment.⁷³

Although MDBs usually invest with a medium-term perspective, they may retain investments for the long term in exceptional cases. To manage these investments effectively, MDBs incorporate exit strategies in their agreements, aiming to exit when a reasonable price can be achieved and their developmental role is deemed complete.⁷⁴ Valuations at exit are based on audited accounts, market practices, and relevant data, considering ongoing risks and market maturity.

⁶⁴ Asian Development Bank, 'Articles of Agreement' (ADB Charter) Article 12 s(3).

⁶⁵ *ibid*, Article 12 s(4).

⁶⁶ *ibid*.

⁶⁷ Asian Infrastructure Investment Bank, 'Articles of Agreement' Article 14 s(3); Asian Infrastructure Investment Bank (n 11) Article 4.9.2.

⁶⁸ Asian Infrastructure Investment Bank (n 11) Article 3.1.3(j).

⁶⁹ African Development Bank (n 3) 38.

⁷⁰ Asian Infrastructure Investment Bank (n 11) Articles 3.1.3(k) and 4.9.2.

⁷¹ African Development Bank (n 3) 39.

⁷² *ibid*.

⁷³ Asian Infrastructure Investment Bank (n 11) Article 4.9.3.

⁷⁴ See, e.g., Asian Infrastructure Investment Bank (n 11) Articles 4.9.6 and 4.10.

Achieving a minimum return is not a prerequisite for exit—in some instances, MDBs may choose to exit to minimise anticipated losses if the investment is assessed as non-performing.⁷⁵

In sum, this section has outlined the main ways MDBs provide LC financing. The survey results have given us some insight into the relative importance of these instruments. However, we know very little about the relative share of LC versus FC financing, the different sectors these funds are directed to, and the terms at which they are provided. A comprehensive assessment of LC financing across all MDBs remains challenging due to the lack of an integrated database encompassing the variety of financing arrangements discussed in Section 2. The next section attempts to bridge this information gap by combining evidence from syndicated loan data—a quantifiable subset of MDB lending activities—with our survey responses to provide a comprehensive overview of the LC financing landscape by MDBs today.

3. Representation of local currency financing in MDB portfolios

3.1. Evidence from the syndicated loan market

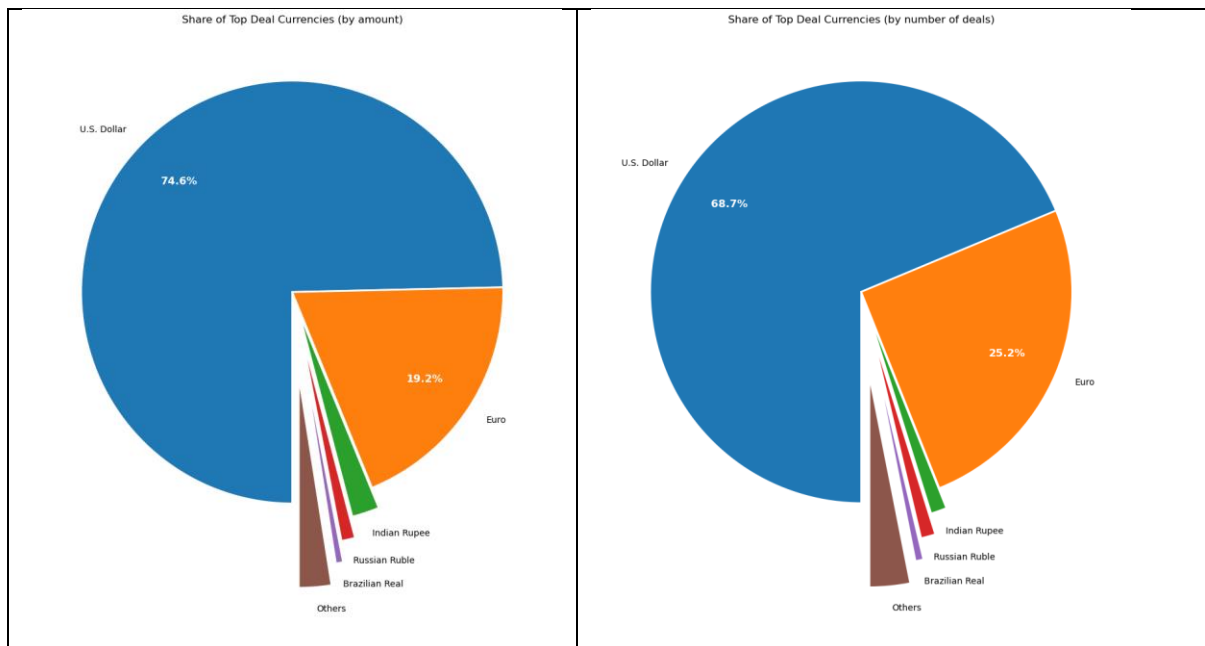
We obtained syndicated loan data from the WRDS-Reuters DealScan Database. This dataset covers 1,354 loans made by the 23 institutions in our sample that have offered loans on a syndicated basis, totalling USD 556 million, and includes loans issued to entities in LMICs between April 2000 and June 2023 (Table 1). While this represents only a subset of total loans—around 27% of total assets—since it only includes loans issued in the syndicated loan market, it nonetheless provides a useful disaggregated picture of these loans.

We begin by examining the currency composition of these loans. As shown in Figure 3, loans in currencies other than the US dollar or euro account for just under 6%, whether measured by the total amount or the number of loans. This figure aligns with Kapoor and others’ finding that development finance institution (DFI) loans in hard currency—primarily the US dollar—account for 80-90% of the total.⁷⁶

⁷⁵ African Development Bank (n 3) 39; Asian Infrastructure Investment Bank (n 11) Article 4.1.

⁷⁶ S Kapoor, H Hirschhofer, D Kapoor, and N Klieterp, ‘A Multilateral Solution to Hedging Currency Risk in Developing Country Finance’ (Nordic Institute for Finance, Technology and Sustainability, 2021).

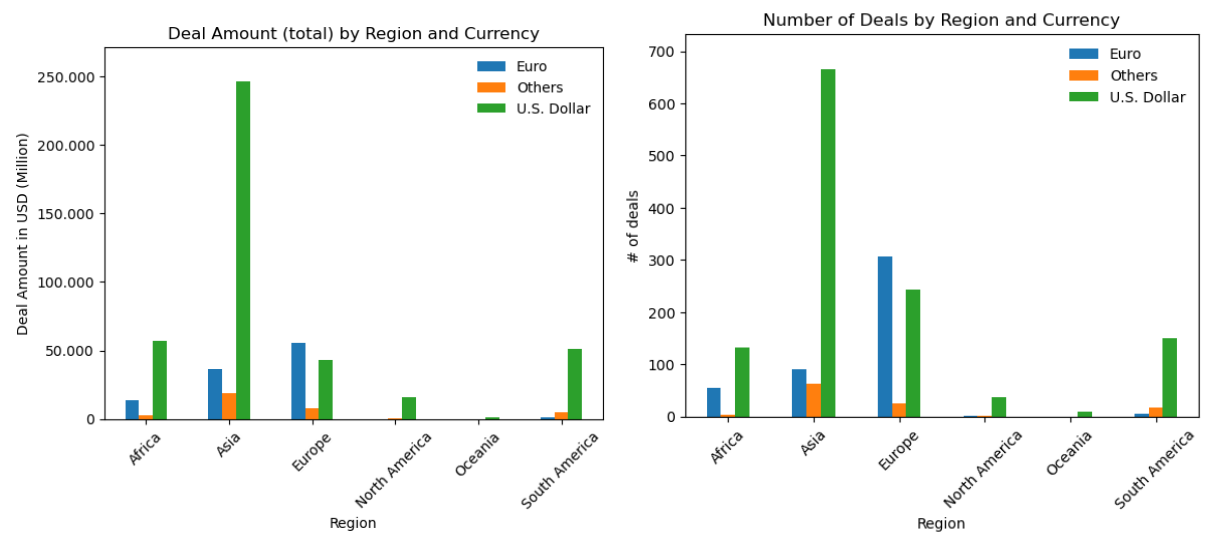
Figure 3 Currency denomination of MDB loans



Source: Dealscan.

Figure 4 shows the distribution of MDB loans by region. The euro, unsurprisingly, holds a significant share in Europe and Asia, while loans in other currencies—predominantly LC—are more common in Europe and Asia compared to Africa and the Americas. Additionally, Europe has a larger number of deals but smaller loan amounts compared to other regions, indicating a higher proportion of smaller loans in Europe.

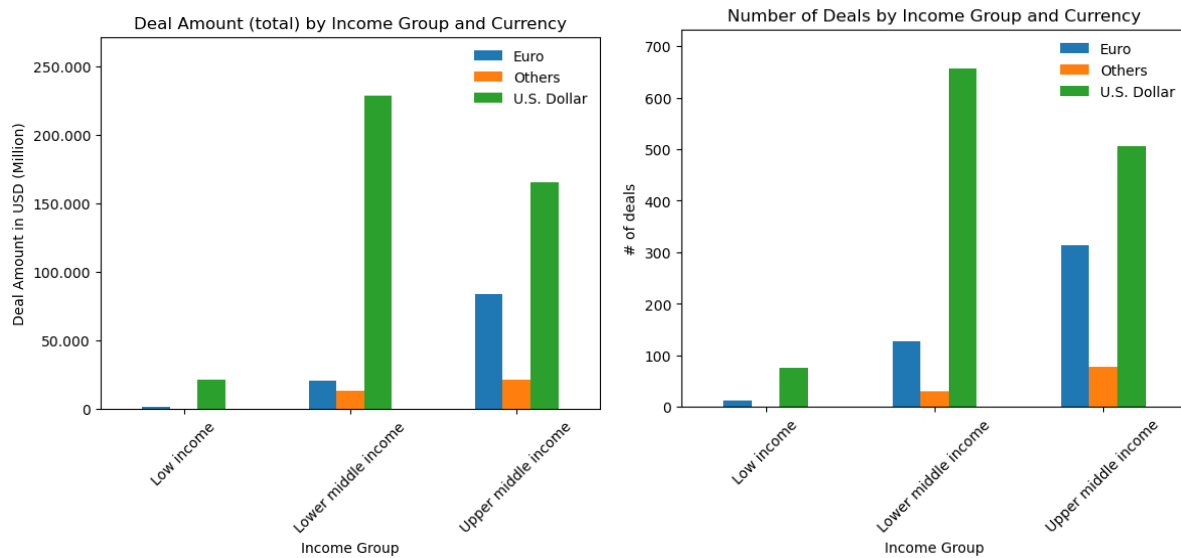
Figure 4 MDB loans by currency and region



Source: Dealscan

Figure 5 illustrates the currency breakdown by income group. LICs receive fewer and smaller loans, all in hard currency. Lower-middle-income countries receive some LC loans, though the amounts remain modest. Only in upper-middle-income countries do LC loans become slightly more prevalent.

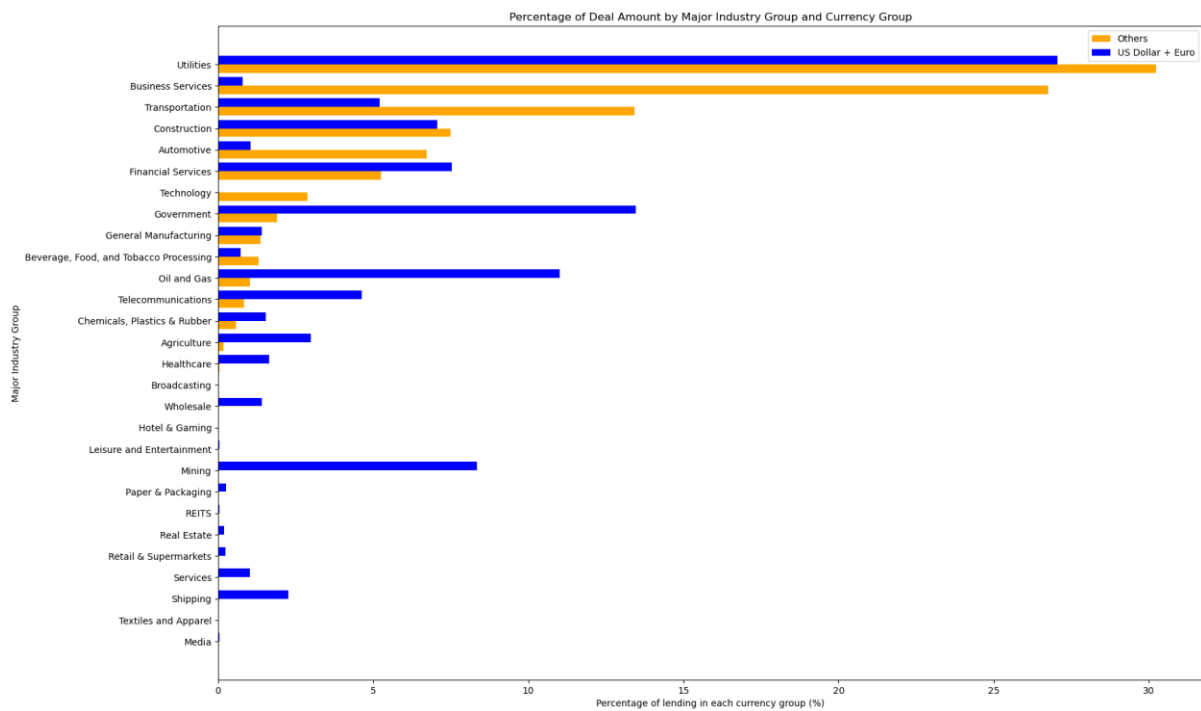
Figure 5 MDB loans by currency and income group



Source: Dealscan

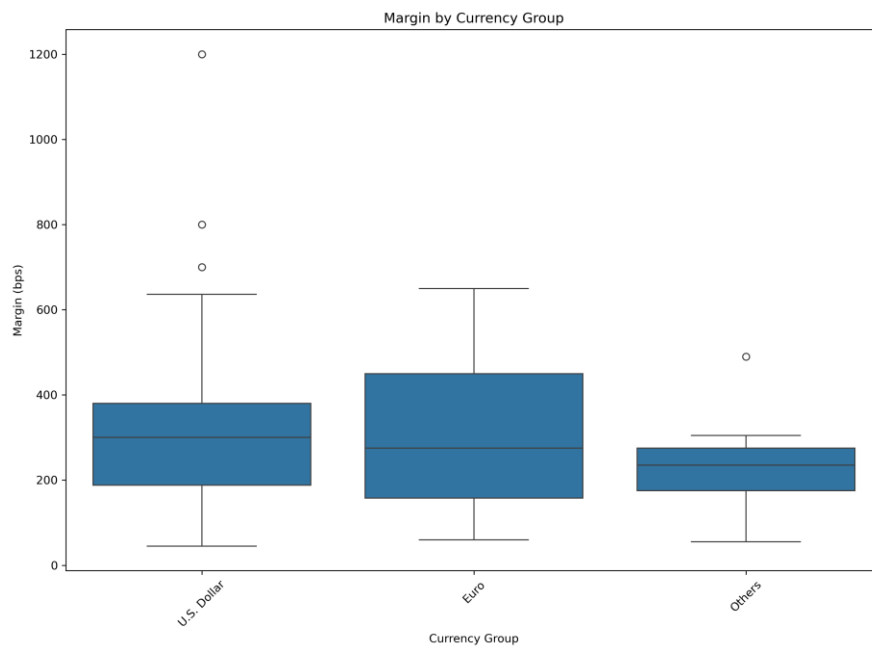
LC loans tend to focus on a narrower range of industries compared to hard currency loans. As shown in Figure 6, the top four sectors are utilities, business services, transportation, and construction. Except for the automotive sector, these industries are generally oriented towards domestic markets and generate LC revenue. While utilities are also significant recipients of hard currency loans, the other top sectors that receive hard currency loans—such as oil and gas, and mining—receive very little LC lending and either focus on export sectors or have access to other sources of LC financing, such as government funding or financial services.

Figure 6 Local currency loans by industry



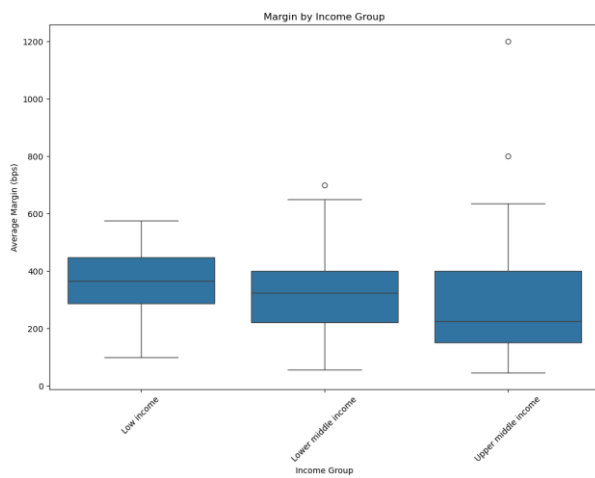
Interestingly, as shown in Figure 7, LC loans—except those in Chinese RMB—tend to have lower margins than euro or US dollar loans. Margins, which reflect the extra interest rate charged by banks to compensate for the lending risk, indicate that the risk premium on LC borrowers is generally lower than that on hard currency loans. This could signal lower perceived credit risk on LC debt or the higher concentration of LC loans in middle-income countries, where margins are typically lower (Figure 8). Importantly, as discussed in section 5, the interest rate on LC loans is still likely to be higher, but this is because the benchmark for those loans is more likely to be a local or fixed-rate benchmark rather than LIBOR, not due to higher margin levels (Figure 9).

Figure 7 Interest rate margins by currency



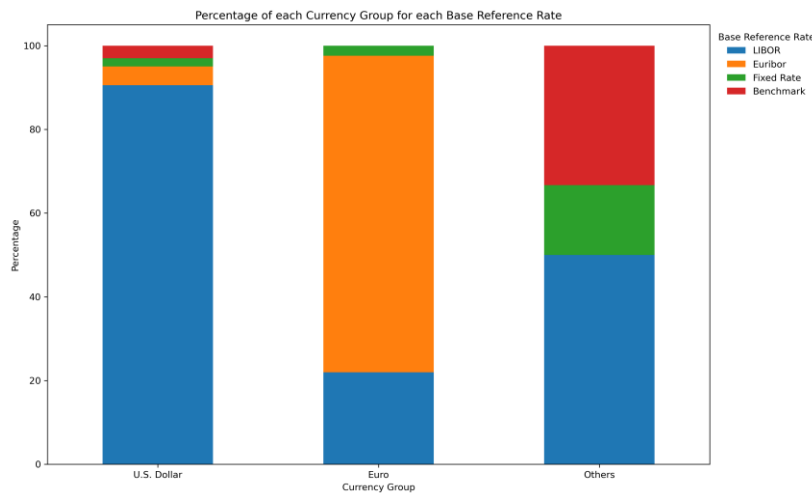
Source: Dealscan.

Figure 8 Interest rate margin by income group



Source: Dealscan

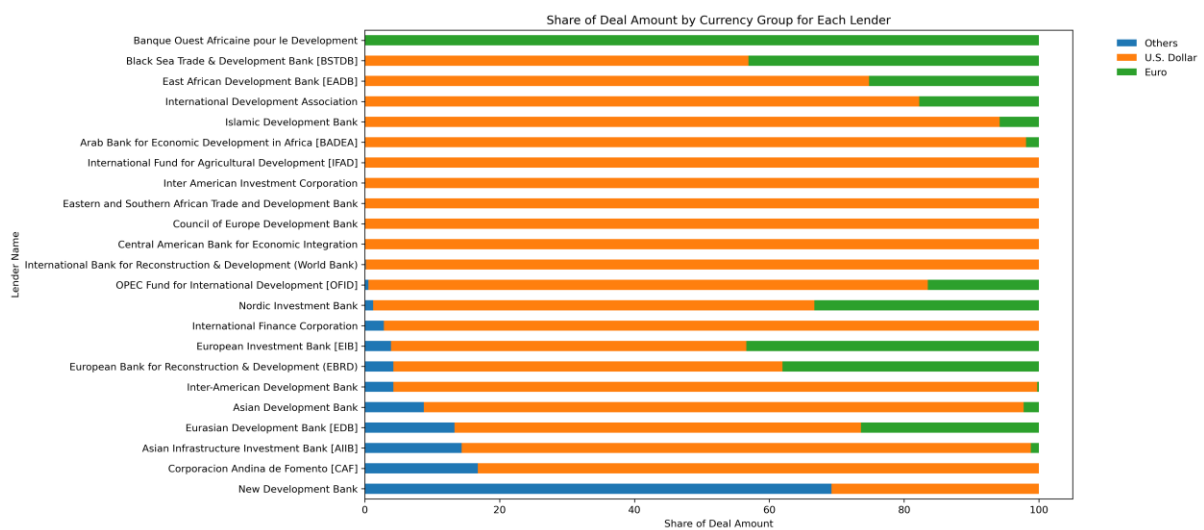
Figure 9 Base reference rate by currency



Source: Dealscan

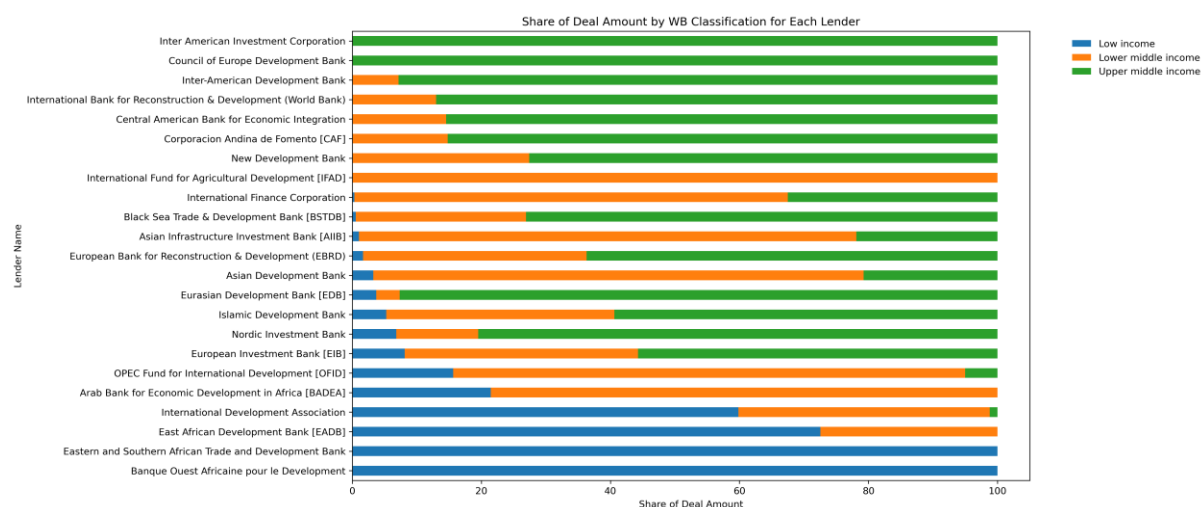
Regarding the issuing institutions, Figure 10 shows that loans in currencies other than US dollars or euros are concentrated among a small number of MDBs. Only half of the institutions in our sample have any loans in other currencies, and only a small group provide such loans in significant amounts. Relative to their syndicated loan issuance, only four institutions (CAF, AIIB, EDB, and NDB) have LC loans exceeding 10%, with the NDB being a noticeable outlier, as nearly two-thirds of its issuance is denominated in LC. These institutions primarily focus on upper-middle-income countries, except for AIIB, where lower-middle-income countries account for almost 80%. In terms of amounts, only eight MDBs have syndicated loans exceeding USD 1 billion in other currencies, and the top three institutions (ADB, AIIB, and EBRD) account for over 60% of the total (Figure 11).

Figure 10 Loans by different MDBs, currency shares



Source: Dealscan

Figure 11 Loans by different MDBs, income group shares



Source: Dealscan

Table 2 Loans by institutions and currency in US dollars

Lender Name	U.S. Dollar	Euro	Others	Total
Arab Bank for Economic Development in Africa [BADEA]	5,694	111.35	0	5,805
Asian Development Bank	103,842	2,645	10,219	116,706
Asian Infrastructure Investment Bank [AIIB]	35,528	507.82	6,048	42,084
Banque Ouest Africaine pour le Development	0	217.21	0	217
Black Sea Trade & Development Bank [BSTDB]	10,200	7,724	0	17,923
Central American Bank for Economic Integration	2,478	0	0	2,478
Corporacion Andina de Fomento [CAF]	12,878	0	2,593	15,471
Council of Europe Development Bank	140	0	0	140
East African Development Bank [EADB]	1,965	661.49	0	2,626
Eastern and Southern African Trade and Development Bank	600	0	0	600
Eurasian Development Bank [EDB]	5,290	2,315	1,168	8,773
European Bank for Reconstruction & Development (EBRD)	88,093	58,012	6,447	152,552
European Investment Bank [EIB]	27,837	22,920	2,048	52,805
Inter American Investment Corporation	1,647	0	0	1,647
Inter-American Development Bank	30,389	82.5	1,345	31,817

International Bank for Reconstruction & Development (World Bank)	3,971	0	5.9	3,977
International Development Association	2,040	440.62	0	2,481
International Finance Corporation	30,971	0	897.49	31,869
International Fund for Agricultural Development [IFAD]	963	0	0	963
Islamic Development Bank	15,863	982.17	0	16,845
New Development Bank	1438.67	0	3236.28	4,675
Nordic Investment Bank	11,175	5,687	214.67	17,076
OPEC Fund for International Development [OFID]	22,303	4,433	147.58	26,884
Total	415,307	106,738	34,370	602,022

Source: Dealscan

In sum, MDB syndicated loan data suggest that lending in currencies other than hard currency remains limited, with most lending occurring overwhelmingly in hard currency. Other-currency loans are primarily concentrated in upper-middle-income countries, mainly in Europe, Asia, and, to a lesser extent, Latin America. Lending margins are generally lower, but they are based on higher benchmark rates. The bulk of these loans originate from a small group of institutions, indicating that a closer examination of their operations could provide valuable insights into scaling up LC lending.

3.2. Evidence from survey responses

While syndicated loan data provide a clear picture of LC financing by MDBs, they only cover a subset of MDBs' total activities. We therefore complement this secondary data with our primary survey data.

Table 3 shows the average amount of LC financing according to our survey respondents. There is a wide range of responses, but on average, the share of LC financing (15%) tends to be higher than what the syndicated loan markets indicate, with some respondents reporting up to 30% of their organisation's financing in LC. Despite potential sample self-selection bias, this suggests that more LC financing occurs outside the syndicated loan market or through instruments such as equity, guarantees, and other forms discussed in Section 2.

Table 3 Proportion of local currency financing

Field	Min	Max	Mean	Median	Responses
Percentage of financing in local currency	2.00	30.00	14.25	11.00	16

Percentage of local currency financing to public-sector borrowers	0.00	100.00	32.92	27.00	13
Percentage of local currency financing made on concessional terms	0.00	40.00	6.20	3.00	10

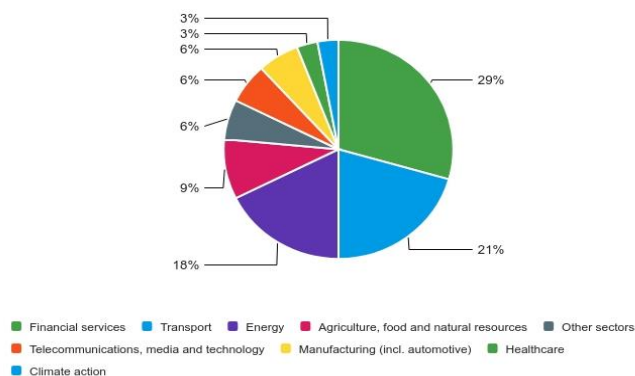
Source: Authors' survey responses.

Table 3 further indicates that most LC financing tends to go to private-sector borrowers, which aligns with the pricing of LC loans, as we will explore later in this paper. The high proportion of LC lending to the private sector also explains the relatively low share of concessional lending denominated in LC.

Regarding the key recipient sectors, there is significant overlap with the syndicated loan data. Transportation and utilities (energy, telecommunications) rank among the top three sectors, according to our respondents. Financial services, which ranked sixth in the syndicated loan market, are also important recipients of LC financing. Construction and automotive sectors do not appear as prominently in the survey, which may indicate that syndicated lending is prioritised for these industries.

Figure 12 Top local currency recipient sectors, according to respondents

In the private sector, what are the top three sectors your organisation provides local currency financing to in developing countries?



Source: Authors' survey responses. Excludes don't know/prefer not to say

Finally, in terms of the lending terms for LC (interest rates, maturity, collateral requirements, and deal size), the survey indicates that these terms are either similar to or less favourable than those for FC loans (Table 4). Forty percent of our respondents noted that interest rates on LC loans are generally higher, while another 40% indicated that they are similar. This finding is not inconsistent with the margin figures discussed earlier. As mentioned in Section 5, LC financing may have higher interest rates due to the cost of hedging, which is factored into the final financing costs. Additionally, a significant minority of respondents indicated that LC loans tend to have shorter maturities (22%) and smaller sizes (33%) compared to FC loans. Collateral requirements were generally the same or lower. Lastly, while average deal sizes are reportedly

similar, a significant minority of respondents noted smaller deal sizes, a detail not revealed in the syndicated loan market data.

Table 4 Characteristics of local currency financing

Interest rate	Higher: 45%	Similar: 35%	Lower: 10%
Maturity	Shorter: 25%	Similar: 55%	Longer: 5%
Collateral requirements	Higher: 5%	Similar: 65%	Lower: 5%
Average deal size	Smaller: 35%	Similar: 50%	Larger: 5%

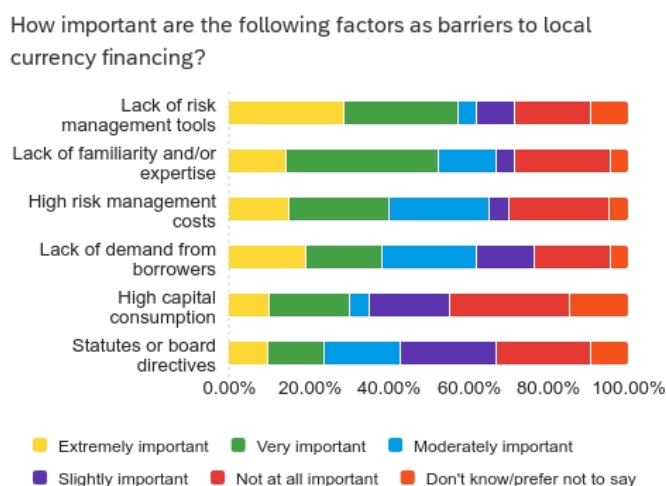
Source: Authors' survey responses. Excludes don't knows/prefer not to say

Overall, the survey results broadly confirm the picture described in the previous subsection: MDBs are active in LC financing, likely more so than indicated by syndicated loan market data, with a focus on the private, non-tradable sector. The financial terms of LC lending are generally similar to or less favourable than those for hard currency financing. LC financing is largely a comparative option for smaller, specific private-sector deals. This reflects the different types of borrowers involved, as well as the barriers and risks associated with LC financing, which hinder its further development.

4. Barriers to local currency financing

The small proportion of LC financing indicates the presence of barriers that prevent its expansion. This section explores those barriers. Several key barriers were identified by our respondents (Figure 13)

Figure 13 Barriers to local currency financing



Source: Authors' survey responses.

According to our survey responses, the lack of risk management tools is the most critical factor, with over half of the respondents indicating it as extremely or very important, and a further 40% citing high risk management costs. These responses highlight the centrality of risk and risk management as the key barriers to expanding LC financing. Additionally, around 40% of respondents identified a lack of borrower demand as a significant barrier. This, too, may be related to the high cost of providing LC loans, as the pricing of such loans often reflects the elevated costs of managing risks, which can make them less attractive to potential borrowers (as further discussed in Section 4.3).

About half of the respondents also identified a lack of familiarity and expertise as a significant barrier. These responses reveal the difficulties MDBs face in providing financing in currencies for which financial markets are underdeveloped, or where there is insufficient expertise. In some countries, for example, the lack of domestic financial development constrains MDBs' ability to price LC loans. More broadly, as indicated in the literature review, MDBs may lack familiarity with local regulations and institutions, complicating their capacity to provide LC financing. Existing statutes or board directives were only an extremely or very important barrier in 20% of our respondents.

4.1. The role of currency risk

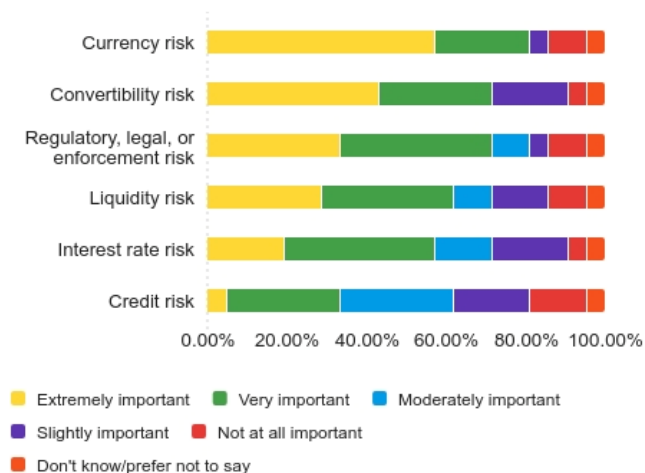
The significance of risk as a key barrier was confirmed when respondents were asked to assess the importance of various risk categories in the context of LC financing (see Table 5 for a brief summary of the different risk categories).

Table 5 Risks of local currency lending

Type of risk	Description
Currency risks	The risk of local currency depreciation when there is a mismatch between assets and liabilities, and cash inflows and outflows
Convertibility risk	The risk of converting local currency receipts into hard currency (e.g. due to lack of counterparties or foreign exchange restrictions)
Credit risk	The default risk of local currency borrowers
Interest rate risk	The risk originating from local currency interest rate volatility, which can negatively impact the assets
Liquidity risk	The risk of being unable to service liabilities due to a mismatch between assets and liabilities
Regulatory, legal or enforcement risk	The risk originating from differences in domestic regulations, laws, and enforcement

Figure 14 Risks of local currency lending

Thinking of local currency compared to hard currency financing, how important are these risks?



Source: Authors' survey respondents

Unsurprisingly, currency risk was regarded as the most critical risk of LC financing by MDBs, with over 80% of respondents considering it very or extremely important. MDBs' liabilities are largely denominated in hard currency, primarily US dollars and euros. As a result, by providing LC financing, MDBs potentially expose themselves to a balance sheet mismatch between LC assets and hard currency liabilities. A depreciation of the LC, for example, could result in a reduction in asset value when measured in hard currency, leading to a decline in the MDB's capital. This balance sheet structure makes MDBs highly sensitive to exchange rate changes.

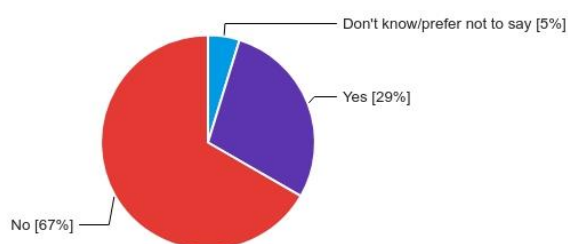
The second and third most important risk categories for MDBs in the context of LC lending are convertibility risk and regulatory, legal, or enforcement risk, with around 70% of respondents considering them extremely or very important. These risks stem from underdeveloped financial markets and the broader macro-financial and regulatory context. Interestingly, while liquidity risk—the risk of being unable to service liabilities as they come due—is important, it is considered somewhat less critical by MDBs. In LC operations, liquidity risk can arise from mismatches between short-term liabilities and long-term assets. Of similar importance is interest rate risk, where fluctuations in local interest rates can negatively impact asset values, potentially generating losses for MDBs.

Interestingly, respondents found credit risk—the risk of borrower default—less important in LC lending compared to FC lending. This may reflect the fact that LC financing generally carries lower risk for borrowers, as it eliminates the currency mismatch that would otherwise affect borrowers' balance sheets, reducing the likelihood of default. This is especially true for sovereign borrowers, who have more direct control over their currency. It may also be related to the fact that MDBs are partially protected from credit risk through their preferred creditor status, which gives them priority for repayment in the event of a default.

The fact that currency risk is the most significant risk in LC lending is unsurprising. More analytically important, however, is that very few MDBs assume any currency risk at all. In other words, even if MDBs extend LC loans, they do not take on the potential risks associated with adverse exchange rate movements. Instead, MDBs hedge all the currency risk arising from their LC loans, which explains why the high cost of risk management tools is a major barrier to extending LC loans.

Figure 15 Limited exposure to currency risk

Does your organisation take on currency risk when providing financing to developing countries?

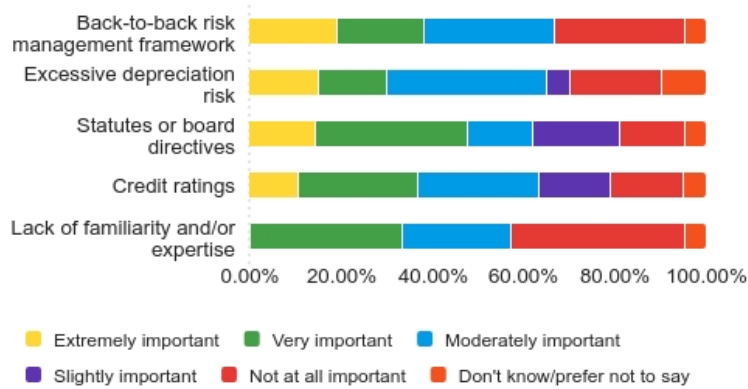


Source: Authors' survey respondents.

The lack of exposure to currency risk has several causes (Figure 16). Several respondents indicated that internal institutional frameworks play a key role. Currency risk exposure may be restricted by MDBs' own statutes or back-to-back risk management frameworks. As Interviewee 1 noted: 'The exposure is zero by a risk management framework. We cannot take on any exposure to LC'. As Interviewee 12 said, 'I don't want our treasury to be currency traders'. The volatility of LMIC currencies, which are subject to significant annual depreciations, is also a key factor, as noted by Interviewee 15. As a result, MDBs generally do not take currency risk and lack the familiarity or expertise to manage it effectively.

Figure 16 Barriers to currency risk exposure

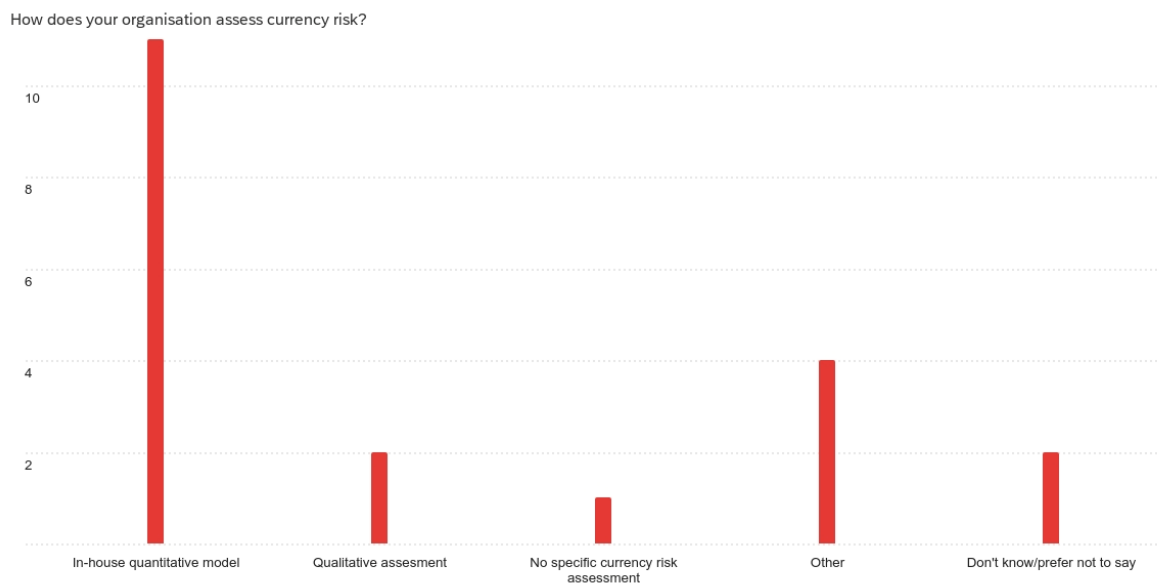
How important are these factors in preventing your organisation to allow (greater) currency risk exposure to developing countries?



Source: Authors' survey respondents

Despite limited exposure to currency risk, the majority of respondents indicated that their organisations explicitly evaluate currency risk (see Figure 17). Over 50% of respondents stated that their organisations use some form of quantitative model for this purpose. This suggests that there is available expertise and experience that could enable MDBs to take a more active role in exchange rate modelling and pricing currency risk.

Figure 17 Currency risk calculation



Source: Authors' survey respondents

4.2. Currency risk mitigation

As discussed in the previous section, given that MDBs cannot or do not want to take on any currency risk, the lack of risk management tools and their high cost are key barriers to expanding LC lending. While there are various ways to mitigate this risk, MDBs primarily adopt two strategies: borrowing in LC and utilising foreign exchange derivatives. This section examines these two approaches using our survey results, highlighting both the primary methods and their associated limitations.

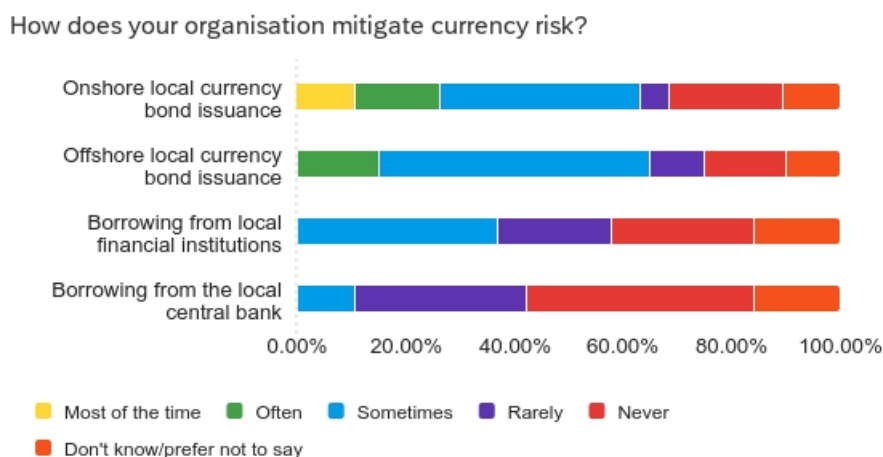
In general, derivatives are used more frequently than LC borrowing. Compared to LC borrowing, FX derivatives offer significant flexibility with limited risk for MDBs. Swaps, for example, can be tailored to specific maturities and payment schedules, whereas bonds tend to have a more standardised structure. Swaps are also preferred due to their greater liquidity (Interviewee 1). Furthermore, LC borrowing usually requires MDBs to operate onshore, which can generate significant regulatory and legal hurdles.

4.2.1. Borrowing in local currency

One way to avoid currency mismatches is to align liabilities with assets by borrowing in the same currency as the assets. MDBs can and do borrow in local currencies, matching these liabilities with their LC assets, thereby removing currency risk. Additionally, borrowing in LC allows MDBs to directly source LC liquidity, which can be used to disburse LC loans.

MDBs can borrow LC in various ways. They may issue bonds, either onshore in the domestic market or offshore in global markets. MDBs can also borrow directly from local private institutions or central banks. Figure 18 summarises the survey responses on the frequency of different borrowing methods.

Figure 18 Hedging currency risk I: borrowing local currency



Source: Authors' survey respondents

Our results show that issuing bonds in the onshore market is the most common method for raising LC liabilities, followed by offshore LC bond issuance. Onshore bonds are issued under the local legal and regulatory framework, where the currency of denomination is legal tender. For instance, the ADB has made several issuances in the Panda bond market—the market for Chinese Renminbi bonds issued by foreign institutions. The IFC has been active in domestic bond markets across many countries. For example, in fiscal year 2024, the IFC issued bonds totalling USD 70 million, denominated in Kazakhstani tenge, Bangladeshi taka, Mexican peso, and Zambian kwacha⁷⁷—a notable development given Zambia’s ongoing sovereign debt restructuring.

Alternatively, LC bonds can be issued in offshore markets. Although less common, 15% of our respondents indicated that their organisation uses this method often, with 50% stating that they use it sometimes. Bonds issued outside the domestic market in the currency of denomination are typically called Eurobonds. Eurobonds are usually underwritten by an international syndicate, free from national regulations, and cleared through a pan-European clearing system. Alternatively, MDBs can issue global bonds, which can be offered in several markets simultaneously.

For example, the EBRD has issued Eurobonds denominated in 24 local currencies of its member countries, compared to five bonds issued in domestic markets. Many MDBs operate Global Medium-Term Note (GMTN) programmes, which allow them to issue bonds in local currencies. For instance, the AIIB’s ongoing GMTN programme specifies that notes can be issued in any

⁷⁷ International Finance Corporation, *Spring Investor Newsletter* (June 2024) <https://www.ifc.org/content/dam/ifc/doc/2024/IFC-Spring24-Newsletter-Final.pdf>.

currency.⁷⁸ As of March 2024, the Turkish lira and Indonesian rupiah are among the largest currencies of denomination in AIIB's borrowings under its GMTN programme.⁷⁹ Most IBRD bonds are issued under its Global Debt Facility, which has included issuances in seven LMIC currencies.⁸⁰

Offshore and onshore bond issuances differ in several important respects. The first is the regulatory and legal framework. Onshore bonds are subject to domestic capital market regulations, which may require authorisation from local authorities. These regulations can be onerous and may limit the ability to issue onshore bonds. Offshore bonds, on the other hand, are subject to more standard international regulations. For example, bonds issued under MDBs' GMTN programmes typically use a standardised prospectus, requiring only specific pricing supplements for each issuance.⁸¹

The second key difference is market characteristics. Onshore bonds tend to attract domestic investors seeking to diversify their portfolios away from other local issuers, such as the government. However, onshore bond markets may be narrow in terms of maturity and volume, necessitating the management of domestic currency cash flows, which can increase issuance costs. At the same time, MDBs can contribute to the development of domestic capital markets. Offshore bonds, by contrast, generally attract foreign investors, in part because these bonds are often 'linked bonds':

'sold off to international investors, who are usually seeking exposure to the local market because they like the high yield, but without having to go all the trouble of opening an account there and having an account in local currency... all of the payments, even though they take place [and] they are settled in US dollar, they are indexed to the performance of the local-currency, hence why they get the performance in local currency without having any credit risk because the issuer is [name of the MDB]. Or one of the MDB.'⁸²

⁷⁸ Asian Infrastructure Investment Bank, *Global Medium Term Note Programme, Base Prospectus* (March 2023) https://www.aiib.org/en/treasury/_common/_download/AIIB-GMTN-Base-Prospectus-March-2023.pdf.

⁷⁹ Asian Infrastructure Investment Bank, *Condensed Financial Statements* (31 March 2024) <https://www.aiib.org/en/about-aiib/financial-statements/.content/index/pdf/AIIB-Q1-2024-Financial-Statements-clean.pdf>.

⁸⁰ Chinese Renminbi, Uruguayan Peso, Indian Rupee, Brazilian Real, South African Rand, Kazakhstani Tenge and Mexican Peso. Data as of 25/09/2024 <https://financesone.worldbank.org/world-bank-ibrd-bonds-1947-present/DS00052>.

⁸¹ Interview 2.

⁸² Interview 2.

Offshore bond markets can be less active, however, with investor interest often being volatile. For example, Interviewee 2 noted the ‘masala market’ (offshore bond market of India), which disappeared during the COVID-19 pandemic and only recently returned. Offshore markets are therefore more flexible to access, but can be less reliable and do not directly contribute to local market development.

Another method of raising local currency is to borrow from local financial institutions. According to our respondents this method is used sometimes in a bit less than 40% of cases. As the AfDB states, ‘this is the most straightforward method of obtaining LC and involves the MDB simply receiving a loan or line of credit facility from a local banking institution in the desired currency’.⁸³ Other MDBs also engage in these practices. The EBRD, for instance, negotiates credit facilities with local commercial banks.⁸⁴ These facilities enable the EBRD to borrow LC on a revolving basis. In January 2024, for example, the EBRD signed a USD 100 million credit facility with Citi Ukraine to source Ukrainian hryvnia for its LC operations.⁸⁵ These revolving lines of credit are drawn only on demand, which reduces the cost of managing local liquidity. However, maturity mismatches can arise, as these credit lines are often on a 1-year revolving basis, while EBRD’s LC loans tend to be long-term.⁸⁶

Borrowing from central banks, by contrast, is quite uncommon due to regulatory and political complexities. As Interviewee 9 explained:

‘In general, no, because they [central banks] have charter issues and the IMF will say it’s not allowed. A prime example for us was [anonymised country], where at some point we were totally reliant on the central bank... but with each new governor, things changed. We learned a lesson. We want to be independent of political winds. Therefore, we prefer dealing with the private sector rather than being held hostage to political fortune.’⁸⁷

4.2.2. Using FX derivatives markets

⁸³ African Development Bank (n 3) 25.

⁸⁴ European Bank for Reconstruction and Development, *Local Currency Operations of the EBRD: Considerations on Country and Client Selection* (EBRD) 4 <https://www.ebrd.com/downloads/capital/select.pdf> accessed 14 October 2024.

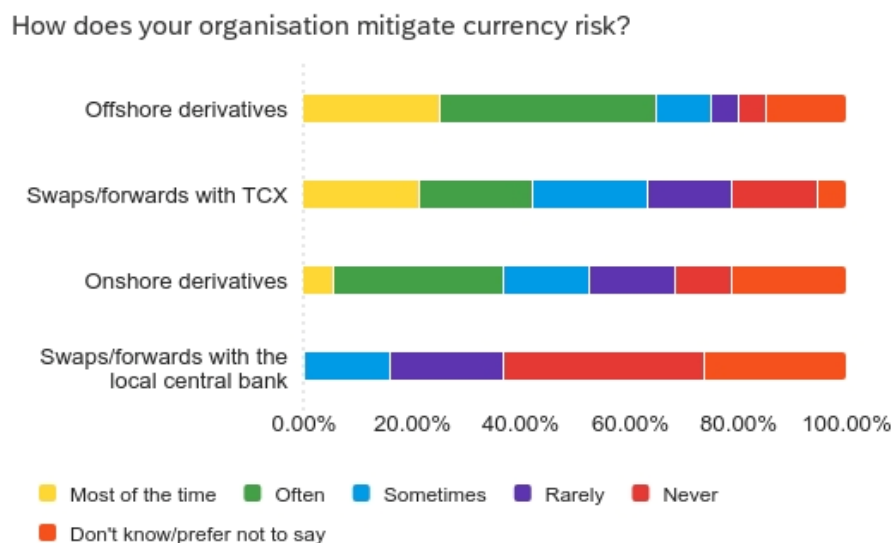
⁸⁵ European Bank for Reconstruction and Development, ‘EBRD and Citi Ukraine sign a UAH revolving credit facility to support Ukrainian clients’, Nigina Mirbabaeva, 31 January 2024 <https://www.ebrd.com/news/2024/ebrd-and-citi-ukraine-sign-a-uah-revolving-credit-facility-to-support-ukrainian-clients.html>.

⁸⁶ European Bank for Reconstruction and Development, ‘Local currency financing: Treasury’ (May 2024) <https://www.ebrd.com/local-currency-financing-presentation.pdf>.

⁸⁷ Interview 9.

Rather than borrowing directly from institutions or bond markets, MDBs can also hedge the currency risk of their LC operations using FX derivatives. The main instruments used by MDBs are cross-currency swaps and forward contracts. These instruments protect MDBs by locking in exchange rates between the local and base currencies of the MDB, allowing them to mitigate the risk of LC depreciation. Figure 19 shows our survey results concerning the use of FX derivatives.

Figure 19 Hedging currency risk II: derivatives



Just like bonds, cross-currency swaps and forwards can be used in both offshore and onshore markets. Offshore derivatives, typically executed with international banks, are the most common, with 65% of our respondents indicating that they use them often or most of the time. Onshore derivatives, where the counterparty is a local financial institution, are less common but still utilised.

Another source of hedging for MDBs—particularly in countries with shallow and underdeveloped financial markets—is the Currency Exchange Fund (TCX). TCX was founded in 2007 by a group of DFIs, specialised microfinance investment vehicles (MIVs), and donors to provide a solution for managing LMIC currency risk. TCX acts as a market-maker in currencies and maturities not covered by private financial institutions, particularly in those currencies where there are no offshore hedge markets, no long-term hedging products, or no hedging markets at all. The broader goal is to progressively develop an offshore FX risk market in these currencies, with risks subsequently sold to investors. Given this role, TCX cannot hedge its currency risk with counterparties and relies purely on diversification across different currencies to manage exchange rate risk. Forty percent of our respondents indicated that they use TCX most of the time or often.

In offshore markets—and in the case of TCX—these instruments are typically non-deliverable. This means that principal amounts are not exchanged, and transactions are ‘cash-settled’; i.e., at maturity, the difference between the prevailing exchange rate and the agreed exchange rate is exchanged. For example, in the case of LC depreciation, the MDB would receive a payment from the counterparty equivalent to the difference between the lower value of the LC and the exchange rate agreed upon in the swap contract. All payments are generally made in hard currency. These non-deliverable contracts are the typical instruments supporting synthetic LC loans, as described in the previous section.

This mechanism allows MDBs to reduce borrowers’ currency risk, as payments are indexed to LC. At the same time, this solution does not require any exchange of LC by the MDBs, as all payments are made in hard currency, reducing operational costs such as maintaining a LC treasury. However, some risks remain. For instance, the borrower will still need to convert LC into FC and transfer it to the MDB. Derivative contracts can also be expensive—a topic we will discuss in more detail in the next section.

An alternative to commercial swaps and forwards—whether offshore or onshore—are currency swaps with the monetary authority issuing the LC. These are rarer, as indicated by our survey respondents, but they do occur. The IFC, for example, can enter into swap agreements with local central banks for the purpose of making LC loans where commercial swaps are unavailable.⁸⁸ This includes low- and lower-middle-income countries such as Rwanda,⁸⁹ Paraguay,⁹⁰ and the Democratic Republic of Congo.⁹¹ Such agreements can also be particularly important during times of economic and financial stress, as demonstrated by the EBRD’s

⁸⁸ International Finance Corporation, *Annual Report Financials 2023*
<https://www.ifc.org/content/dam/ifc/doc/2023/ifc-annual-report-2023-financials.pdf>.

⁸⁹ International Finance Corporation, ‘IFC Signs Agreement with Rwanda’s Central Bank to Provide Local Currency Loans’, Press Release, 8 December 2010
<https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=23857>.

⁹⁰ International Finance Corporation, ‘IFC Signs Swap Agreement with Paraguayan Central Bank to Provide Local Currency Loans’, Press Release, 25 July 2011
<https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=23688>.

⁹¹ International Finance Corporation, ‘IFC, Central Bank of the Congo Launch Swap Facility for Private Sector Local Currency Financing’, Press Release, 1 June 2015
<https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=16521>.

agreements with the central banks of Azerbaijan⁹² and Georgia⁹³ in spring 2020 during the COVID-19 crisis.

4.2.3. Currency hedging and funding models

As indicated by our respondents, while these risk mitigation tools protect MDBs from currency risk, they also pose challenges due to their high cost and limited availability. To fully appreciate the issue, it is important to relate these tools to MDBs' underlying funding and risk management models. While MDBs generally seek to limit currency risks as much as possible, there are still variations in how this is operationalised.

The most common approach is a back-to-back funding structure, which is ingrained in MDB's institutional and legal structures. Financially, back-to-back funding requires MDBs to perfectly match assets and liabilities. As Interviewee 15 explained, 'it basically means you can only lend what you can find'.⁹⁴ This implies that LC loans must be perfectly covered by liabilities of equal size, maturity, and structure. For example, the IBRD loan in Uruguayan pesos mentioned earlier follows a back-to-back structure, so 'the terms of the loan exactly replicated the bond (i.e. bullet maturity, payment dates, etc.). A 30 basis point contractual spread was added'.⁹⁵ Similarly, the AfDB explicitly states that its LC loan process works in the same way, with funding raised first and the terms of the loan, including its cost, dictated by the funding costs plus a spread.⁹⁶ This perfect asset-liability matching model means that MDBs are not exposed to any risk except credit risk, with each project funded by its own dedicated liability. However, this model significantly limits MDBs' ability to extend LC financing to operations where a perfect match for the LC loan can be found.

As an alternative to back-to-back funding models, some MDBs are experimenting with more flexible structures that allow for a separation between LC financing and liabilities. For instance, some MDBs have shifted to a risk management approach that sets maximum risk limits in terms of value-at-risk and expected shortfall across the overall portfolio, rather than matching

⁹² European Bank for Reconstruction and Development, 'EBRD and Azerbaijan's Central Bank Promote Manat Lending to Coronavirus-Hit Firms' (19 May 2020) <https://www.ebrd.com/news/2020/ebrd-and-azerbaijans-central-bank-promote-manat-lending-to-coronavirushit-firms.html> accessed 14 October 2024.

⁹³ European Bank for Reconstruction and Development, 'EBRD and NBG Join Forces to Support Coronavirus-Hit Firms in Georgia' (27 April 2020) <https://www.ebrd.com/news/2020/ebrd-and-nbg-join-forces-to-support-coronavirushit-firms-in-georgia.html> accessed 14 October 2024.

⁹⁴ Interview 15.

⁹⁵ World Bank, 'Case Study: Local Currency Financing in Uruguay' (2015) <https://documents1.worldbank.org/curated/es/278031468126557301/pdf/81177-REVISED-WP-Uruguay-LocalCurrency-2015.pdf> accessed 14 October 2024.

⁹⁶ African Development Bank (n 3) 24.

individual loans ‘back-to-back’.⁹⁷ This approach allows MDBs to disconnect specific LC loans from liabilities and to keep liquid assets in domestic currencies. These liquid assets can then be used to disburse loans on demand without necessarily finding a matching funding source first. Similarly, these liquid resources can help manage rollover risks arising from possible mismatches between short-term liabilities or hedging instruments and long-term assets. However, this strategy can result in negative carry, as liquid assets held in LC typically yield low interest rates.⁹⁸

While the currency risk mitigation and risk management approaches discussed here are the most common, it is also important to remember that exceptions to these conventional operations exist. One such exception involves MDBs’ equity capital, which comes from paid-in capital and retained earnings denominated in specific local currencies. This equity can provide a more flexible source of funding for LC operations, as it does not entail specific payment schedules.⁹⁹

Notwithstanding these exceptions, full hedging remains the norm. While full hedging protects MDBs from currency risk, it can also act as a barrier to expanding LC financing. First, the lack of available instruments to hedge currency risk—especially when coupled with a back-to-back model—limits MDBs’ flexibility. Moreover, even when mitigation tools are available, their high cost can still make LC financing unattractive to borrowers. The next section will explore this issue through an example.

4.3. Currency risk mitigation: the pricing problem

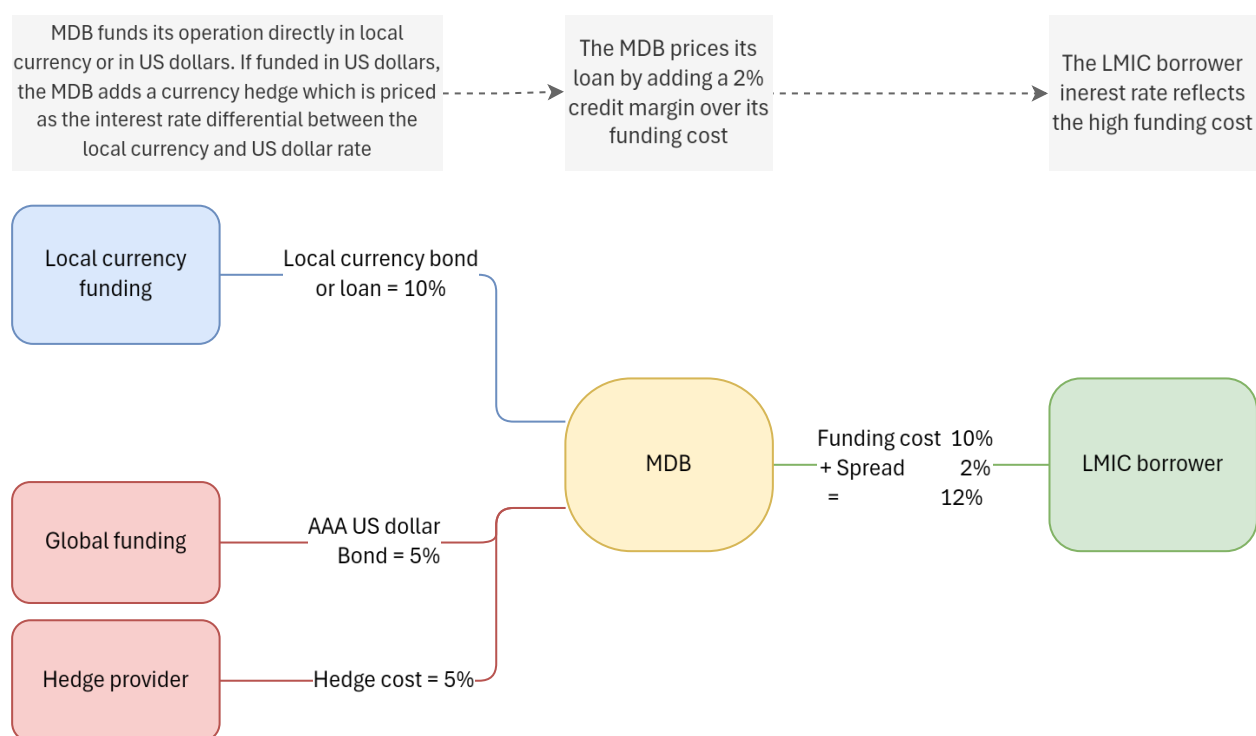
This section explores the issue of pricing LC loans in the context of the risk mitigation strategies discussed in the previous section. Figure 20 provides a stylised summary of how MDBs extend a LC loan.

⁹⁷ Interview 12.

⁹⁸ Interview 15.

⁹⁹ Interview 2.

Figure 20 The pricing of MDB local currency loans



Source: Authors' elaboration

Suppose an MDB needs to price a five-year LC loan for a borrower in a LMIC. The interest rate charged will reflect the cost of funding, plus a margin to cover the specific credit risk of the borrower. The funding cost for the MDB is based on its cost of borrowing. One option is for the MDB to fund itself directly in LC markets. For instance, in a back-to-back funding arrangement, the MDB could issue an LC bond or borrow from a local bank and pay an LC rate with a five-year maturity. This rate can vary depending on local regulation and macroeconomic conditions, but it will generally be based on local base or government borrowing rates, which are typically higher than global interest rates on hard currencies such as the US dollar. For simplicity, let us assume that the MDB, thanks to its AAA rating, is able to pay the same rate as the government, making the MDB's cost of funding, for example, 10%.

Alternatively, the MDB could fund itself on global markets in US dollars and combine this with a financial instrument (e.g. a currency swap) to hedge the currency risk. In this case, the MDB would pay a much lower rate on its liability (e.g. 5%)¹⁰⁰, similar to sovereign borrowers, thanks to its AAA rating. The hedge cost would be based on the interest rate differential between the local and US dollar interest rates. Assuming, for simplicity, that the differential is based on

¹⁰⁰ For instance, the IDA issued a 5-year US dollar bond on 24 October 2023 with a yield of 4.98%, 18.38 basis points over the US Treasury. World Bank Group, 'IDA Prices New USD 2.5 Billion 5-Year Sustainable Development Bond' (24 October 2023) <https://treasury.worldbank.org/en/about/unit/treasury/ida/ida-press-releases-19> accessed 14 October 2024.

government bond rates,¹⁰¹ the MDB would pay 5% on its hedge cost. This would again make the cost of funding for the MDB 10%.

As a result, in the absence of any concessionality, the MDB can at best offer a 10% lending rate in this example, plus a margin to compensate for credit risks. In practice, the rate would likely be higher, as margins are also applied to the hedges purchased by MDBs, or LC bonds may carry higher interest rates than the central government. Such additional costs can be substantial, particularly when involving currencies with underdeveloped markets. However, it is important to note that even without these considerations, the cost of LC loans offered by MDBs remains high, and often comparable to prevailing LC government borrowing rates, because these reflect the high-interest rate differentials that underpin the currency hedging.

These high-interest rate differentials represent the significant compensation required for the exposure to LC and the local economy:

‘Interest rates in other currencies are generally higher because they reflect the local economic conditions. There’s nothing we can do about it.’¹⁰²

In part, this is due to high inflation:

‘One of the biggest issues is around pricing interest rates in those local markets—because you cannot have negative interest rates. Many people come to us and say local banks are way too expensive. They are lending to us at 27%. Why do not you come in and lend at 9%? I say to them, what is the inflation in your country? Is it 20-22%? And you want me to come in and lend at 9%—so who pays for the difference? You know, because someone has to take on the difference.’¹⁰³

Whatever their cause, these high-interest rates are incorporated into MDBs’ LC lending rates. This means that LC lending rates are often not attractive for sovereign borrowers.

‘Usually, it does not make sense because the sovereign can issue itself or generate local currency at a cheaper cost than we can offer.’¹⁰⁴

¹⁰¹ Normally, interest rate differentials are based on risk-free reference rates, such as SOFR or EONIA. However, for LMIC currencies, such rates are sometimes unavailable and need to be calculated from existing government bond rates (Interviewee 3).

¹⁰² Interview 11.

¹⁰³ Interview 5.

¹⁰⁴ Interview 1.

‘When it is the sovereign, they usually want hard currency from us. And they have the cheapest funding costs in local currency anyway, because they are not supposed to default on their local currency obligations’¹⁰⁵

LC loans for sovereigns are particularly unattractive when offered by MDBs, as they can offer FC loans at significantly lower rates than prevailing market rates:

‘When [country’s name] considers taking a loan from [MDB’s name] or any multilateral, the difference is not just 8% in dollars versus 11% in [local currency], as it would be in the market. With a multilateral, it could drop to 5% in dollars. So, the gap they are looking at is not between 8% and 11% anymore; it is between 5% and 11%. This substantial difference makes it appealing to manage currency risk through multilaterals where they get the most comparative advantage.’¹⁰⁶

This explains why LC financing by MDBs focuses mostly on the private sector, where, despite the hedging costs, MDBs can still offer competitive rates and/or beneficial terms (e.g. longer maturities) to potential borrowers compared to what they can find in domestic markets.

In sum, the cost of hedging currency risk is a key factor constraining MDBs’ LC financing. While MDBs have an advantage over other lenders in providing loans in hard currency, thanks to their lower funding costs, these advantages are lost when lending in LC and fully hedging currency exposure. To avoid this, MDBs could reduce hedging and take on some currency risk. While rare, there are instances where MDBs have—within specific and well-defined frameworks—taken on such risk, which we explore in the next section.

5. Taking on currency risk

While the majority of MDBs LC operations are fully hedged, some specific initiatives allow a degree of currency exposure outside of their main operations, often with the involvement of external funds acting as guarantors. Most of the existing examples take the form of off-balance sheet separate fund structures, where the losses are not absorbed by the MDBs’ capital but by the contributors to the fund’s equity (which could include the MDBs themselves if they are shareholders). Below are some of the most prominent examples.

¹⁰⁵ Interview 5.

¹⁰⁶ Interview 11.

5.1. Asian Development Fund (ADF)'s Private Sector Window (PSW) Local Currency Solution (LCS)

The ADB provides grants to its poorest and most vulnerable developing member countries through the Asian Development Fund (ADF). ADF resources primarily come from contributions by ADB member countries, which are mobilised under periodic replenishments and net income transfers from ordinary capital resources. Eligibility for ADF grant assistance is determined based on a three-tier classification system grounded in gross national income per capita and creditworthiness. Developing member countries are classified into Group A (concessional assistance only), Group B (ordinary capital resources blend), and Group C (ordinary capital resources only). ADF grants support under-invested areas, including regional cooperation, disaster risk reduction, and climate adaptation, particularly in Group A countries.¹⁰⁷

Of relevance in ADF's LC grants is the Private Sector Window (PSW), which is currently deployed on a pilot basis to promote private sector growth, expand investment, and mobilise private finance in Group A countries. A key part of the PSW is the Local Currency Solution (LCS), which mitigates and protects potential losses of commercial lenders due to LC exposure, addressing the lack of currency hedging solutions in lower-income economies.¹⁰⁸ ADB-PSW resources backstop the LCS to enable commercial lenders to lend to a project or borrower on terms not available in the market—namely, with proceeds in LC and longer tenors. LCS support includes credit lines and facilities to local commercial lenders and financial institutions, including local development banks, to support LC lending to SMEs and other projects.¹⁰⁹

Transactions typically follow this sequence: (1) lenders issue a USD-denominated loan that is converted to LC at the financial close of a project; (2) the borrower assumes the liability and services the debt from LC revenue generated by the project. Should the LC depreciate against the USD and a loss is realised during loan repayment, (3) the lenders issue a reimbursement request to ADB, as administrator of the LCS, to recover the loss due to foreign exchange movements; and (4) upon approval of the reimbursement request, LCS resources, funded by ADB-PSW, are disbursed to the lenders to cover the foreign exchange loss. Should the LC appreciate against the USD, the borrower will continue to make LC payments, and the lender

¹⁰⁷ Asian Development Bank, 'Overview: Asian Development Fund (ADF)' <https://www.adb.org/what-we-do/funds/adf/overview> accessed 26 July 2024.

¹⁰⁸ Asian Development Bank, 'Concessional Assistance Policy for the ADF 13 Period' (October 2020) <https://www.adb.org/sites/default/files/institutional-document/649536/concessional-assistance-policy-adf13.pdf> accessed 26 July 2024.

¹⁰⁹ Asian Development Bank, 'ADB Private Sector Window to Promote Private Sector Operations in Group A Countries' (ADF 13 Replenishment Meeting, 5-7 November 2019, Manila, Philippines) <https://www.adb.org/sites/default/files/page/561776/psw-pso-group-a-countries-discussion-paper.pdf> accessed 26 July 2024.

will keep and accrue the gain to offset future depreciation. If a lender's loss exceeds its accrued gains, it would issue a reimbursement request.¹¹⁰

5.2. IDA-IFC-MIGA Private Sector Window (PSW)'s Local Currency Facility (LCF)

The IDA-IFC-MIGA Private Sector Window (PSW) aims to derisk and boost investments in IDA and IDA-eligible fragile and conflict-affected states by addressing fundamental constraints, including the limited availability of LC loans.¹¹¹ The Local Currency Facility (LCF) specifically addresses this by providing long-term LC investments in countries with undeveloped capital markets and insufficient market solutions. Backed by IDA resources, the LCF enables IFC to support various operations in LC. The facility acts as a risk transfer vehicle for operations in PSW-eligible countries, up to the designated allocation of PSW's resources.¹¹²

While IFC retains the credit risk of the underlying loans and investments, the LCF undertakes several operations to source LC funding for PSW projects:¹¹³

- Counterparty credit risk: When IFC enters into an LC transaction, it hedges the currency risk with an offshore or onshore market counterparty. LCF resources absorb counterparty credit losses if the counterparty's credit quality does not meet IFC's standard criteria or if they are non-traditional counterparties.
- Market and credit risk: IFC may issue bonds in a local market to obtain the necessary currency for its loans and invest in the local fixed income market until the funds are disbursed to the client. The client covers expected negative changes in value, while the PSW covers unexpected changes in the value of the local investments.
- Transfer/convertibility risk: When using local counterparties, IFC may offer a deliverable swap but hedge the market risk with an undeliverable swap offshore. LCF resources cover the inability to convert/transfer the currency without loss when the underlying hedged loan matures.
- Open currency/interest rate risk: If market-based solutions are unavailable, IFC hedges its currency and interest rate risk with the LCF, which covers any losses (or gains) related to changes in market rates over the term of the hedged investment. The LCF is actively managed by IDA-IFC-MIGA on a portfolio basis, employing strategies to hedge open

¹¹⁰ *ibid.*

¹¹¹ International Development Association, 'What is the IDA Private Sector Window?' <https://ida.worldbank.org/en/financing/ida-private-sector-window/what-is-ida-private-sector-window> accessed 27 July 2024.

¹¹² International Development Association, 'Operationalizing the IDA18 IFC-MIGA Private Sector Window' (11 April 2017) 26 <https://documents1.worldbank.org/curated/en/928011520447801610/pdf/123995-BR-PUBLIC-IDA-R2017-0347-1.pdf> accessed 26 July 2024.

¹¹³ *ibid* 27.

risks. Should they incur realised losses on LC investments made with the LCF, they can submit a payout request to IDA for reimbursement. Losses under certain LCF operations could exceed the initial investment on a transaction-specific basis, but aggregate claims on IDA under the LCF are capped, with any losses exceeding this cap borne by IFC-MIGA.¹¹⁴ In this sense, the LCF acts as a last-resort currency risk absorber.

5.3. ACP Investment Facility

The EIB's ACP Investment Facility, established under the Cotonou Agreement, operates as a revolving fund, reinvesting income and repayments into new projects. The Investment Facility receives capital from the 9th, 10th, and 11th European Development Funds. Capital contributions are made by Member States to the EIB.¹¹⁵ The Facility provides a diversified mix of financing options, including equity, infrastructure project financing, and credit lines to financial intermediaries. The unhedged LC tranche currently stands at around EUR 900 million, representing 20% of the total capital raised and diversified across 15 currencies.¹¹⁶ Their LC financing is limited to countries with macroeconomic stability and strong financial regulation and supervision, as well as firms, primarily SMEs, with LC revenues.¹¹⁷ Interest rates are set using prevailing market rates, plus administrative and risk-related mark-ups.¹¹⁸ This fund structure allows the EIB to manage FX risk effectively by leveraging a diverse portfolio across currencies, geographies, clients, and sectors. The Facility's sustainability is evidenced by its performance, which has not only been sustainable but has also generated positive returns.¹¹⁹

5.4. MASSIF Fund

¹¹⁴ *ibid.*

¹¹⁵ European Court of Auditors, *The ACP Investment Facility: Does It Provide Added Value?* (Special Report No 14, European Union 2015).

¹¹⁶ C Fink, HP Lankes, and C Sacchetto, *Mitigating Foreign Exchange Risk in Local Currency Lending in Fragile States: Review and Options* (International Growth Centre, June 2023).

¹¹⁷ European Investment Bank, 'Financing Conditions and Instruments in the ACP Countries' (EIB) https://www.eib.org/attachments/country/eib_in_acp_financing_conditions_and_instruments_en.pdf accessed 14 October 2024.

¹¹⁸ *ibid.*

¹¹⁹ S Andreasen, W Bartz, C Clubb, J Durland, A Efiog, Y Ehlert, P Horrocks, J Sedemund, H Hirschhofer, and K Parplies, 'The Need to Reduce FX Risk in Development Countries by Scaling Blended Finance Solutions' (FX Risk in Development Workshop, Convergence, EDFI, European Commission, OECD, TCX, 2017) https://assets.ctfassets.net/4cgqlwde6qy0/3UYrVvpyqckCsw802wWoOi/7abfe71c3b60ff521635f713865cad16/FX_Risk_in_Development_Primer.pdf accessed 11 October 2024.

FMO's MASSIF Fund, established in 2006 and managed by FMO on behalf of the Dutch government, is another example of an MDB using a fund structure to bear FX risk. The fund's capital base (over EUR 463 million by 2023) allows it to absorb FX risk effectively while maintaining financial sustainability. MASSIF's financing includes LC seed capital, loans, mezzanine structures, and grants. The fund maintains broad diversification in terms of geographies, clients, and sectors. While their maximum portfolio exposure to LC is capped at 20%, most of the portfolio is denominated in US dollars and euros, with only 10% in unhedged LC financing by 2023. However, since the fund has 43% of its assets categorized as hard currency equity investments, even when these instruments do not imply hard currency commitments, the actual currency risk of its clients is smaller.

MASSIF's pricing strategy builds on the reference prices provided by TCX, with deviations allowed on a case-by-case basis. Similar to the ACP Investment Facility, MASSIF has remained financially sustainable, fulfilling its revolving target of 100%. MASSIF's net profits over capital between 2014–2019 fluctuated between -0.8% and 11.6%, mainly due to fluctuations in the EUR-USD exchange rate, since 57% of its assets are denominated in US dollars, while the euro is their accounting currency.¹²⁰

5.5. UNCDF's BRIDGE facility

Launched in 2017, the BRIDGE facility is an 'on-balance sheet' investment vehicle of the United Nations Capital Development Fund (UNCDF), capitalised by grants from donors, including member states, foundations, and philanthropies.¹²¹ Although it is not an MDB-led initiative, the structure provided by this facility offers valuable insights for the analysis conducted in this report. The facility provides concessional loans, guarantees, and quasi-equity to SMEs, municipalities, and project developers with primarily LC revenues in sectors such as food, financial inclusion, the green economy, and public infrastructure. The initial capitalisation of the fund was USD 50 million, with future replenishments planned. BRIDGE's LC financing represents 90% of its portfolio, with unhedged exposures to currency risk.¹²² Its portfolio comprises fewer than 40 companies, with loan sizes mostly between USD 100,000 and USD 1 million USD equivalent. While the lending rate is set based on an internal scoring model, TCX

¹²⁰ N Oomes and others, *Evaluation of the FMO-MASSIF Fund (2015-2019): Final Report* (SEO Amsterdam Economics, Report No 2020-83, Commissioned by the Dutch Ministry of Foreign Affairs, 19 November 2020) <https://www.government.nl/binaries/government/documenten/reports/2020/11/19/evaluation-of-the-fmo-massif-fund-2015-2019/EvaluationoftheFMO-MASSIFFund2015-2019.pdf> accessed 14 October 2024.

¹²¹ United Nations, *Midterm Review of the UNCDF Strategic Framework, 2022-2025, and Report on Results Achieved by UNCDF in 2023* (UN 2024) <https://coilink.org/20.500.12592/6wwq4wz> accessed 14 October 2024.

¹²² Fink, Lankes, and Sacchetto (n 116).

provides reference swap rates for the currency risk. By 2023, the facility had only one write-off and a few instances of restructuring.¹²³

In conclusion, these funds' performance shows that MDBs can successfully provide LC financing by taking on FX risk in a sustainable manner.

¹²³ *ibid.*

Bibliography

African Development Bank, *Financial Products Handbook 2022-2023* (African Development Bank Group 2022).

Andreasen S, Bartz W, Clubb C, Durland J, Efiang A, Ehlert Y, Horrocks P, Sedemund J, Hirschhofer H, and Parplies K, 'The Need to Reduce FX Risk in Development Countries by Scaling Blended Finance Solutions' (FX Risk in Development Workshop, Convergence, EDFI, European Commission, OECD, TCX, 2017)
https://assets.ctfassets.net/4cgqlwde6qy0/3UYrVVpyqckCsw802wWoOi/7abfe71c3b60ff521635f713865cad16/FX_Risk_in_Development_Primer.pdf accessed 11 October 2024.

Asian Development Bank, 'ADB Private Sector Window to Promote Private Sector Operations in Group A Countries' (ADF 13 Replenishment Meeting, 5-7 November 2019, Manila, Philippines) <https://www.adb.org/sites/default/files/page/561776/psw-pso-group-a-countries-discussion-paper.pdf> accessed 26 July 2024.

Asian Development Bank, 'Concessional Assistance Policy for the ADF 13 Period' (October 2020) <https://www.adb.org/sites/default/files/institutional-document/649536/concessional-assistance-policy-adf13.pdf> accessed 26 July 2024.

Asian Development Bank, 'Overview: Asian Development Fund (ADF)' <https://www.adb.org/what-we-do/funds/adf/overview> accessed 26 July 2024.

Asian Infrastructure Investment Bank, *Condensed Financial Statements* (31 March 2024) <https://www.aiib.org/en/about-aiib/financial-statements/.content/index/pdf/AIIB-Q1-2024-Financial-Statements-clean.pdf>.

Asian Infrastructure Investment Bank, *Global Medium Term Note Programme, Base Prospectus* (March 2023) https://www.aiib.org/en/treasury/_common/_download/AIIB-GMTN-Base-Prospectus-March-2023.pdf.

Asian Infrastructure Investment Bank, 'Operational Policy on Financing' (26 June 2024) https://www.aiib.org/en/policies-strategies/_download/operation-policy/AIIB-Operational-Policy-on-Financing_OPF.pdf accessed 29 July 2024.

Development Bank of Latin America, 'Structured Financing' <https://www.caf.com/en/about-caf/what-we-do/products-and-services/structured-financing/> accessed 30 July 2024.

Development Bank of Latin America, 'Technical Cooperation' <https://www.caf.com/en/about-caf/what-we-do/products-and-services/technical-cooperation> accessed 26 July 2024.

European Bank for Reconstruction and Development, *EBRD Mobilisation of Private Finance* (April 2020) 21 <https://www.ebrd.com/documents/evaluation/2020-ebrd-mobilisation-of-private-finance.pdf> accessed 27 July 2024.

European Bank for Reconstruction and Development, *Local Currency Operations of the EBRD: Considerations on Country and Client Selection* (EBRD) 4 <https://www.ebrd.com/downloads/capital/select.pdf> accessed 14 October 2024.

European Bank for Reconstruction and Development, 'EBRD and Azerbaijan's Central Bank Promote Manat Lending to Coronavirus-Hit Firms' (19 May 2020) <https://www.ebrd.com/news/2020/ebrd-and-azerbaijans-central-bank-promote-manat-lending-to-coronavirushit-firms.html> accessed 14 October 2024.

European Bank for Reconstruction and Development, 'EBRD and Citi Ukraine sign a UAH revolving credit facility to support Ukrainian clients', Nigina Mirbabaeva, 31 January 2024 <https://www.ebrd.com/news/2024/ebrd-and-citi-ukraine-sign-a-uah-revolving-credit-facility-to-support-ukrainian-clients.html>.

European Bank for Reconstruction and Development, 'EBRD and NBG Join Forces to Support Coronavirus-Hit Firms in Georgia' (27 April 2020) <https://www.ebrd.com/news/2020/ebrd-and-nbg-join-forces-to-support-coronavirushit-firms-in-georgia.html> accessed 14 October 2024.

European Bank for Reconstruction and Development, 'Local currency financing: Treasury' (May 2024) <https://www.ebrd.com/local-currency-financing-presentation.pdf>.

European Court of Auditors, *The ACP Investment Facility: Does It Provide Added Value?* (Special Report No 14, European Union 2015).

European Investment Bank, 'Financing Conditions and Instruments in the ACP Countries' (EIB) https://www.eib.org/attachments/country/eib_in_acp_financing_conditions_and_instruments_en.pdf accessed 14 October 2024.

Fink C, Lankes HP, and Sacchetto C, *Mitigating Foreign Exchange Risk in Local Currency Lending in Fragile States: Review and Options* (International Growth Centre, June 2023).

International Bank for Reconstruction and Development and International Development Association, *Bank Policy: Financial Terms and Conditions of Bank Financing*, OPS5.09-POL.178 (7 July 2023) <https://shorturl.at/KyhNw> accessed 9 September 2024.

International Development Association, 'Operationalizing the IDA18 IFC-MIGA Private Sector Window' (11 April 2017) 26 <https://documents1.worldbank.org/curated/en/928011520447801610/pdf/123995-BR-PUBLIC-IDA-R2017-0347-1.pdf> accessed 26 July 2024.

International Development Association, 'What is the IDA Private Sector Window?' <https://ida.worldbank.org/en/financing/ida-private-sector-window/what-is-ida-private-sector-window> accessed 27 July 2024.

International Finance Corporation, *Annual Report Financials 2023*
<https://www.ifc.org/content/dam/ifc/doc/2023/ifc-annual-report-2023-financials.pdf>.

International Finance Corporation, 'IFC, Central Bank of the Congo Launch Swap Facility for Private Sector Local Currency Financing', Press Release, 1 June 2015
<https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=16521>.

International Finance Corporation, 'IFC Signs Agreement with Rwanda's Central Bank to Provide Local Currency Loans', Press Release, 8 December 2010
<https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=23857>.

International Finance Corporation, 'IFC Signs Swap Agreement with Paraguayan Central Bank to Provide Local Currency Loans', Press Release, 25 July 2011
<https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=23688>.

Oomes N and others, *Evaluation of the FMO-MASSIF Fund (2015-2019): Final Report* (SEO Amsterdam Economics, Report No 2020-83, Commissioned by the Dutch Ministry of Foreign Affairs, 19 November 2020)
<https://www.government.nl/binaries/government/documenten/reports/2020/11/19/evaluation-of-the-fmo-massif-fund-2015-2019/EvaluationoftheFMO-MASSIFFund2015-2019.pdf> accessed 14 October 2024.

Thompson Reuters Practical Law, 'Glossary: Equity'
<https://uk.practicallaw.thomsonreuters.com/5-382-3436> accessed 21 August 2024.

Thompson Reuters Practical Law, 'Glossary: Facility Agreement' (Thompson Reuters 2024) <https://uk.practicallaw.thomsonreuters.com/8-200-1386> accessed 29 July 2024.

United Nations, *Midterm Review of the UNCDF Strategic Framework, 2022-2025, and Report on Results Achieved by UNCDF in 2023* (UN 2024)
<https://coillink.org/20.500.12592/6wwq4wz> accessed 14 October 2024.

World Bank, 'Case Study: Local Currency Financing in Uruguay' (2015)
<https://documents1.worldbank.org/curated/es/278031468126557301/pdf/81177-REVISED-WP-Uruguay-LocalCurrency-2015.pdf> accessed 14 October 2024.

World Bank Group, 'IDA Prices New USD 2.5 Billion 5-Year Sustainable Development Bond' (24 October 2023) <https://treasury.worldbank.org/en/about/unit/treasury/ida/ida-press-releases-19> accessed 14 October 2024.

World Bank Group, 'The Global Collaborative Co-Financing Platform' (19 April 2024)
<https://www.worldbank.org/en/programs/trust-funds-and-programs/brief/global-collaborative-co-financing-platform> accessed 27 July 2024.