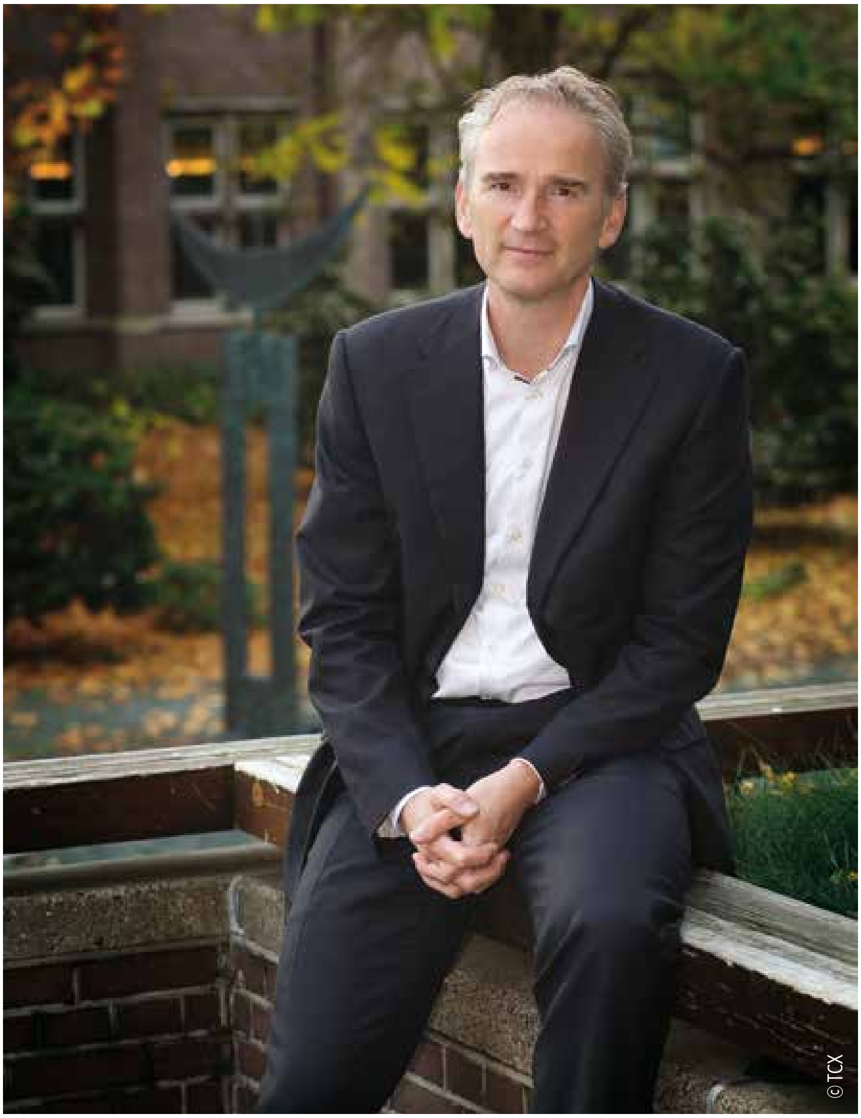
The Currency Exchange Fund (TCX) celebrates 10 years of achievement

Manon Stravens spoke to **Ruurd Brouwer**, CEO of TCX, about how the fund's pioneering work in frontier markets has made local currency borrowing possible and its plans to service more business in the energy and infrastructure sectors



Ruurd Brouwer, CEO of TCX

Entrepreneurs and governments in emerging economies mostly depend on foreign lending institutions for long-term loans. But repaying a dollar loan, while operating in a volatile economic environment with fluctuating local currencies, can be a risky business.

TCX, an initiative of the Dutch FMO and Ministry of Foreign Affairs, derisks crossborder investments by hedging a possible currency mismatch. The fund, the worlds' only so far, as such enables long-term local currency financing and opens up emerging economies for risk-taking investors.

Since 2007 TCX has hedged over US$5 billion in loans, benefitting an estimated 1 million small and medium entrepreneurs in 68 countries worldwide.

The fund has been a game changer in the microfinance sector, explains CEO Ruurd Brouwer in his office in the majestic Royal Tropical Institute in Amsterdam. Backed by a group of shareholders, comprised of development banks, impact investors and micro-finance institutions, the fund is now turning its eye to the infrastructure and energy sector. More investors are welcome to join.

Why do international lenders shy away from local currency lending?
Commercial lenders don't want to burn their fingers on the risks of emerging market currencies that are less resilient to absorb shocks. In the globalised world economy, prices or monetary policies can greatly affect economies that depend on only one or two export commodities. See how oil-dependent Nigeria or Azerbaijan still suffer today from the fall in the oil price. The Zambian kwatcha devaluated 50 percent in 2015 because of a drop in the copper price. This is typical for many frontier market currencies. The currency risk is unacceptable for western investors, so it is pushed to the African borrower, that pushes it to the African individual, who can bear it the least. It is actually quite absurd when you think about it.

How does that affect local entrepreneurs?
By offering US dollars instead of the currency that the borrower earns, the international lender transfers risk to the borrower. The borrower becomes a riskier client who might not be able to repay the loan. Western entrepreneurs have access to loans in the currency they earn, so their business is naturally protected against currency risk. But an African or Asian entrepreneur often does not have that option. He or she either takes the dollar loan and accepts the currency risk, or doesn't accept the loan, meaning he or she can't invest. Governments too often finance energy generating projects in hard currency, ultimately offloading the risk to the energy bill. The local entrepreneur always ends up paying the bill.

How are you relieving that entrepreneur?
A local currency loan gives certainty. It's like an insurance against currency risk. The entrepreneur knows what to pay back, so all the time and energy can be put into growing the business. For example, some years ago we hedged 25 percent of the loans to Kyrgyzstan in a specific year, benefitting an estimated 100,000 entrepreneurs. TCX spared them potential bankruptcy because of the 2014 ruble crisis. At the end of the day it is about responsible banking: offer your client the product they need, not the product the bank wants to sell. The fun of our model is that every dollar TCX loses, isn't lost by the local entrepreneur.

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So how do you protect yourself against the risks you are taking on your shoulders?
Diversification and the use of local interest rates. With a maximum of 10 percent of the fund exposed to one currency we mitigate risk. We currently are invested in more than 50 currencies, a devaluation in one country is counterbalanced by a better performing currency elsewhere.

By using local interest rates, we make up for some of the losses of devaluation as rates tend to rise in an inflationary environment.

However, the best protection are the investors of TCX who understand a long-term view is required and who do not get nervous after a disastrous year. We lost tens of millions of dollars after the Zambian, Nigerian and Azerbaijan crises. EBRD, KfW, FMO, Proparco, JBIC, IFC all know these markets and don't panic easily, and a year later most losses were recovered. Apart from that, the shareholders are protected by a first loss buffer from the German and Dutch governments. After 10 years we have survived four major crises and our day one investors have a small positive return on their investment. That's not a bad result at all.

Is TCX's approach aid or trade?
TCX handles a healthy commercial approach to development finance. If we don't have a positive long-term result, we will cease to exist, but maximising profits has too many negative side effects. Profitability is a means, not an end in itself. We pay for the donor support. It's an innovative approach to development finance.

Aid too could be much more tailored to the needs of the recipient. Today multilateral development banks often provide aid in the form of long-term cheap dollar loans to governments, the so called ‘soft loans’. These soft loans can have hard consequences for the recipients though. After a 50 percent devaluation, the size of the loan in the recipients' currency effectively doubles, that is not soft. It is old donor centric thinking, as these institutions can also decide to offer the loan (partly) in the recipient countries' currency.

Whats your biggest achievement in ten years?
Creating solutions for the most difficult markets. Myanmar, Sierra Leone, Madagascar, Haiti, all countries for which local currency borrowing was impossible prior to TCX. Ten-year lending in Uganda

Ruurd Brouwer

shilling, Vietnamese dong or Azerbaijan manat was unthinkable. Opening these financial markets to the world is a unique and fantastic achievement of the TCX team.

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How are you doing that?
In a country with no reliable economic data, bond market, interest rates, or lending system we build on macro-economic research. Our Czech business partner OGResearch developed individual country models to determine a currency price based on estimated growth, inflation rates, commodity price development and other variables like demographic trends. I like to call it applied creativity (see box 1). These models form the basis of our pricing used to open up these markets.

And what is the biggest criticism?
That TCX is expensive. We have insufficiently been able to convey the message that TCX simply applies market principles. If the Kenyan Treasury bill is at 14 percent, we charge that rate. The difference between this 14 percent and the 1 percent on the US dollar is large, but it reflects expected inflation and depreciation. What has not helped is the fact that the US dollar →

and euro interest rates have been subsidised by their relative central banks on a scale we haven't seen before in economic history.

What could local governments do themselves?
Call upon international lending institutions to provide their economies with loans in their local currency. Through TCX, or with guarantees from Guarantco for example using local liquidity, and of course, develop their own financial sector. For example the Central Bank of Kyrgyzstan and Georgia now limit dollar loans to individuals and companies that don't earn dollars. Also the Rwandan utility explicitly asks for Rwandan franc financed energy projects.

Where will TCX be in ten years' time?
At first TCX almost only serviced the microfinance sector. Nowadays a third of our activities go towards SME's infrastructure and renewable energy, that have a need for more and longer term hedging. In ten years' time we expect 80 percent of our funds to support these sectors. To make that move, we will increase our current portfolio from US$1.5 billion to US$5 billion in 2025. A hydropower plant needs larger volumes, so we will scale up the whole business. For that we need investors with deep pockets.

What's the main obstacle in finding these investors?
For some investors we are still too exotic, a high-risk fund with a relatively short track record. But times are changing. Investors are increasingly interested in sustainable or impact investing opportunities in 'adventurous' destinies. If TCX manages to get bigger investors on board, enabling us to do bigger transactions, that will move others. Our risk profile will gradually lower. Apart from that, we continue to bang the drum to air our message.

Is getting new investors on board the only way to grow?
No. We are in the midst of a fantastic development. TCX created a new market by taking long-term positions in exotic currencies. But now that we are an established name, we are learning that there are investors out there willing to invest in these currencies through TCX. Together with some of our shareholders we issue bonds in Rwandan franc, CFA franc, Costa Rica colon, etc and there is appetite for these bonds. Today we have 'sold' almost 25 percent of our portfolio. In doing so we generate room for more transactions in these currencies, and open up these markets to the world.

What is your ultimate message?
Take it from a reverse angle: imagine the reaction if a European windfarm is financed in Swiss franc. This structure would be unacceptable. But this is exactly what we offer entrepreneurs in emerging economies. It's our mission to curb that weird logic, though we are aware that changing an age-old practice is not done overnight. It requires a change of mindset. But eventually all entrepreneurs should have access to long-term local currency loans. ■

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The hedging innovation

Prior to TCX it was impossible for international investors to offer local currency to clients in most frontier markets. There were simply no data from which a price could be derived. TCX Partnered with OGResearch, a consultancy based in Prague, and successfully applied the so-called Forecasting and Policy Analysis System ('FPAS') to price currency and macroeconomic risks in the most frontier markets. The FPAS was originally created by the IMF and central banks for inflation targeting purposes. OGResearch redesigned the models so these could be used for price setting of hedges, when no market data is available.

Two-hundred transactions have been realised in local currency thanks to this unique innovation. FPAS based pricing is offered in:

- Armenia
- Azerbaijan
- Belarus
- Cambodia
- DRC
- Ethiopia
- Guatemala
- Haiti
- Kazakhstan
- Kenya
- Kyrgyzstan
- Laos
- Liberia
- Madagascar
- Moldova
- Mongolia
- Mozambique
- Myanmar
- Nigeria
- Rwanda
- Sierra Leone
- Tajikistan
- Tanzania
- Uganda
- Uzbekistan
- Zambia

This interview was undertaken in cooperation with TCX.