Development banks build appetite for local currency finance

Jacopo Dettoni | 12/04/2018 12:00 pm |

New foreign exchange hedging solutions and deeper capital markets are providing multilateral development banks with new ways to derisk financing packages and increase their development multiplier. Jacopo Dettoni reports.

Multilateral development banks (MDBs) are increasing their focus on local currency finance to spare borrowers foreign exchange risks, particularly following the end of the commodity boom, which prompted struggles among dozens of currencies in the emerging market space.

“More and more [the development banks have] come to realise that loans in hard currency are the wrong product, as they force their borrowers to become currency speculators,” says Ruurd Brower, the CEO of the TCX fund, which offers hedging solution for 55 currencies in frontier markets. “Therefore demand for our products is growing and will continue to grow.”

A stronger need

MDBs provide financing at convenient terms to public or private institutions to facilitate a specific development agenda. They have traditionally worked with hard currency, which exposes the borrowers to foreign exchange risk as they generate cash flow in local currency, but then have to repay loans in foreign currency.

However, MDBs have now become more vocal about the need to strengthen local currency finance.

“Strengthening transactions in local currency will reduce risk and volatility and thus create more stable conditions for the real economy, conducive to long-term growth,” the president of the European Bank for Reconstruction and Development (EBRD), Suma Chakrabarti, said in a note announcing a memorandum of understanding between the bank and Albania to boost local currency lending to SMEs.

The volume of local currency transactions in the portfolio of MDBs focusing on private sector financing is already meaningful. Among others, the EBRD had signed 722 loans denominated in 26 local currencies for a total value of €12.4bn as of January 2018. The International Finance Corporation, the private sector arm of the World Bank, has committed nearly $13bn in local currency financing across 60 currencies through loans, swaps, guarantees, risk-sharing facilities and other structured products, according to the bank's website.

TCX formats

Both banks feature among the 22 MDBs and bilateral development banks that established the TCX fund in 2007 to create a market for currency risk hedging in frontier markets. Since then, TCX has largely acted as the only market maker for hedging solutions in currencies and maturities not covered by commercial banks or other providers by offering development banks forward contracts and currency swaps allowing them to offload part of the risk loans in highly volatile currencies.

The total amount of outstanding loans that TCX has hedged amounted to $1.8bn at the end of 2017, and Mr Brower expects it to grow to $5bn by 2023.

MDBs are also betting on the development of domestic capital markets to bolster local currency finance. The Asian Development Bank (ADB) established a $10bn equivalent Asian Currency Note Programme dedicated to the issuance of ADB notes in local currencies in the Asean+3 bloc, whose revenues are used to back the bank's local lending programmes.

In Africa, the German Development Bank established the African Local Currency Bond Fund to facilitate corporate bond issuances in local currencies and give rising African companies access to debt markets. The fund has brought 15 issuers to the market in nine countries so far, and deployed gross capital of more than $50m since inception.

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