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Development agencies turn to local currency lending

Switch to frontier currencies aims to reduce FX risk for borrowers

Steve Johnson YESTERDAY

Development finance institutions are increasingly lending to emerging market companies in their domestic currencies, rather than dollars or euros, in an effort to protect borrowers from often painful currency swings.

The government-backed lenders have traditionally offered funding almost exclusively in hard currencies, allowing them to avoid taking on foreign exchange risk.

While this is generally fine for companies with significant dollar or euro earnings, it creates a currency mismatch for many borrowers, a potentially catastrophic risk that they cannot offload because of a lack of hedging instruments for many small, illiquid currencies.

"There is a big push to move from dollarised funding to local currency funding. The French government, for example, is better equipped to hedge their FX risk than a Nigerian company," said Philippos Kassimatis, partner at Maven Global, which designs hedging strategies for DFIs and other organisations.

One-in-8

Developing world currencies fall 20% or more against dollar in any given year

"The practical implication of this is the obvious social gain, ie more projects and funding and ultimately value creation since this protects the local economies from FX fluctuations and risk," he added.

Grant Metcalfe-Smith, head of client risk management at the European Bank for Reconstruction and Development, said: "DFIs are starting to get the bit between their teeth and do more.

One-in-20

Developing world currencies crash by 50% against the dollar in any given year

"The need is there to de-dollarise economies and industries. We have made very good progress since the financial crisis and a good part of our loan portfolio is in local currency but we feel there is a lot more we can do. We would like to move it up as much as we can.

"It's an incredibly important part of our business," Mr Metcalfe-Smith added. "Anybody who is borrowing in dollars and euros and earning local currency is vulnerable, whether that is a corporation or a municipality."

Around 21 per cent of the EBRD's loans in 2018 were denominated in local currency, Mr Metcalfe-Smith said, up from 13 per cent in 2017, taking its stock of such loans to €13bn in a mix of 25 currencies.

FMO, the Dutch DFI, said about 20 per cent of its 2018 loans were in local currencies, the second year running it has been at this level. This will take the local currency share of its overall portfolio to a record high of 12-13 per cent, with a face value of around €600m.

"It's driven by the need of our clients," said Matthijs Pinxteren, director of treasury at FMO. "There is nothing wrong with dollar financing if you lend money to clients who have a dollar business, who operate in global markets and have dollar revenue from sales, but if clients need local currency funding we can provide them with that."

The latter option may, however, only be available if FMO or its peers are able to hedge the resultant long exposure to a potentially little-traded frontier market currency, as DFIs are not keen to hold it on their own balance sheets.

In 2018, for the first time, FMO engineered the necessary short exposure by issuing local currency bonds in a domestic market, when it raised 263m Georgian laris ($98.5m) via two bonds and lent the proceeds to clients, helping to establish a domestic capital market in the process.

Although this leads to higher interest rates for its clients (policy rates in Georgia are 7 per cent, compared with zero in the eurozone), borrowing in local currency "matches their risk profile [so] they are not exposed to foreign currency risk".

In essence, DFIs going down this route are engaging in maturity transformation, said Mr Metcalfe-Smith, issuing one to five-year bonds in the local market but lending for five to 10 years.

"A lot of these countries have tiny capital markets so we may only be able to secure, as a borrower, small amounts of short-term money," he said. "We use a variety of funding instruments to secure local currency including bonds, derivatives and other lines of credit. Investors however feel safe credit wise in EBRD bonds as it is triple-A."

However, this strategy has only become possible in a small frontier market like Georgia because the country's government has led a push to stimulate local currency-based financing in order to reduce the economy's dependence on external dollar funding.

Another route is to hedge via TCX, an Amsterdam-based currency exchange fund set up by FMO and another 21 multilateral and bilateral DFIs and microfinance investment vehicles, alongside the Dutch and German governments in 2007 to pool the risk of currencies for which there are no long-term hedging products, or, in some cases, no market at all.

Offloading the currency risk to the clients they actually want to support is contrary to their mission

Ruurd Brouwer, TCX chief

The growth of TCX illustrates the upsurge in frontier currency loans. Ruurd Brouwer, chief executive, said TCX took $550m worth of paper on to its books in 2016, $1bn in 2017, and around $1.4bn in 2018.

“Growth is tremendous and expected to continue,” Mr Brouwer said. “This growth makes perfect sense, because ultimately the development banks want to create growth and economic stability in developing countries. Offloading the currency risk to the clients they actually want to support is contrary to their mission.

“It is like providing Swiss franc-based mortgages to UK housebuyers. The interest might seem lower, but the lender forces their clients into currency speculation.”

This speculation can prove ruinous. Analysis by TCX and Carnegie Consult, an investment advisory service, of 95 currencies since the end of the Bretton Woods system of fixed exchange rates in 1971 suggests that, on average, one-in-eight developing world currencies fall 20 per cent or more against the dollar in any given year, and one-in-20 crash by 50 per cent.

TCX now has exposure to almost 60 hard to hedge currencies, such as the Sierra Leone, for which there is no local yield curve or interbank market, meaning TCX had to conduct its own macroeconomic modelling in order to price it.

“Together with other DFIs, FMO has created an institution that carries the currency risk. This is important as DFIs have limited appetite to carry that risk on their balance sheet,” said Mr Pinxteren.

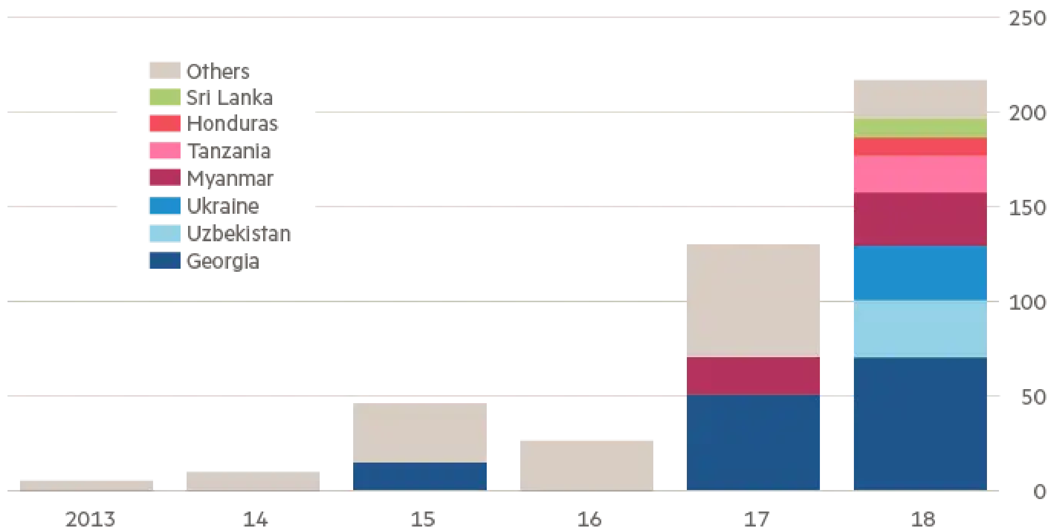
Although TCX is forced to keep the bulk of its exposure on its own balance sheet, Mr Brouwer said it had generated a “modest positive return” since 2007 “despite high frontier currency volatility,” helped by the generally high interest rate on such bonds.

More recently, though, TCX has started hedging the local currency payment obligations (ie coupon and principal payments) deriving from a wave of local currency bonds issued by DFIs.

These bonds have seen explosive growth, with issuance jumping from $4.9m in 2013 to $216m last year, predominantly in Georgian lari, Uzbek som, Ukrainian hryvnia, Myanmar kyat, Tanzanian shilling and Honduran lempira, as the chart shows.

Kings of the wild frontier

Local currency bond issuance hedged by TCX ($m)



Source: TCX

This hedging, which involves TCX paying a return linked to the performance of the frontier currency and receiving hard currency, allows it to offset some of the risk on its own books, as well as helping to support the development of capital markets in frontier currencies.

The downside is "that is not a very big market", said Mr Pinxteren, although ethically minded "impact investors" are increasingly willing to bear the currency risk in order to earn an elevated interest rate from a triple-A rated institution, as are some boutique and specialised investors.

Undeterred, TCX is targeting a fourfold expansion of this offshore local currency bond market by 2022, Mr Brouwer said.

Nevertheless, around 80 per cent of lending by DFIs remains in hard currencies, predominantly the dollar. Even in the microfinance sector, where the vast majority of borrowers lack offsetting dollar revenues, 65-85 per cent of lending is still done in the US currency, according to TCX.

Mr Metcalfe-Smith said one of the challenges to "moving the dial" further in the direction of local currencies was the low level of "financial sophistication of some borrowers, who can overly focus on the increased interest cost of borrowing in local currency rather than on the significant risks that adverse foreign exchange rates can have on the inflation of the size of their liabilities".

Peer group behaviour can also limit demand, he added, while a lack of regulation and legal transparency can hinder the development of local money market and capital market infrastructure. A paucity of international and domestic investor interest in emerging market currencies adds to the barriers.

For its part, TCX is hoping to at least double its capital base to $1.5bn — enough to support a $5bn book — by 2022, via fresh injections from DFIs, governments and, Mr Brouwer hoped, the European Commission, “which has made increasing local currency in development finance a policy objective”.

Reaching this target may not be straightforward, however. “We are an unusual animal and explaining to governments that financial derivatives can have a very positive impact on African enterprises and economies is still somewhat challenging,” Mr Brouwer added.

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