AADFI and TCX response to the “Finance in Common” calls for collaboration and the importance of reducing currency risk in the development sector by financing local PDBs in their own currency to support resilient and sustainable recovery

At the Finance in Common spring meeting sponsored by AfDB , IDFC and AADFI, preceding the Financing African Economies summit, in May 2021, Public and National development banks (PBDs or NDBs) joined forces to make a bold declaration:

“We the undersigned African Public Development Banks gathered today for the Spring meetings of the Finance in Common Summit, commit to supporting African heads of state and international organizations to finance the needed transitions and transformation of African economies. In the context of the Covid-19 crisis recovery, our efforts will center on achieving sustainable, resilient and equitable development.”

As active players in the development finance sector, TCX welcomes this timely declaration and the approach to use PDBs as a catalytic vector for resilient and sustainable growth.

A collective and uniform strategy from the development stakeholders worldwide is crucial when trying to achieve a systemic impact. This entails both Multilaterals , bilateral DFIs (e.g. KfW, Proparco, FMO, CDC Group etc.) as well as the National Development Banks from recipient countries.

To meet the 2030 SDGs Agenda in Africa, there are tremendous additional investments still required, especially in the short term to compensate for the Covid crisis. African PDBs have an important role to play to help bridging and allocating the US$2.5 trillion financing gap for development as well as the US$100 billion (cfr. IMF) per annum additional external funding to help tackle and recover from the crisis as :

(i) They have unrivalled local market knowledge that can serve as a ‘gateway’ to international DFIs’ activities whereas the continent’s sector fragmentation further constrains development impact;

(ii) They can redirect private investments, especially by reducing the perceived risks inherent to banking in Africa;

(iii) They can bring in domestic institutional investors, especially pension funds, to finance infrastructure projects in local-currency.

Currency mismatch as a driver of unsustainable financing

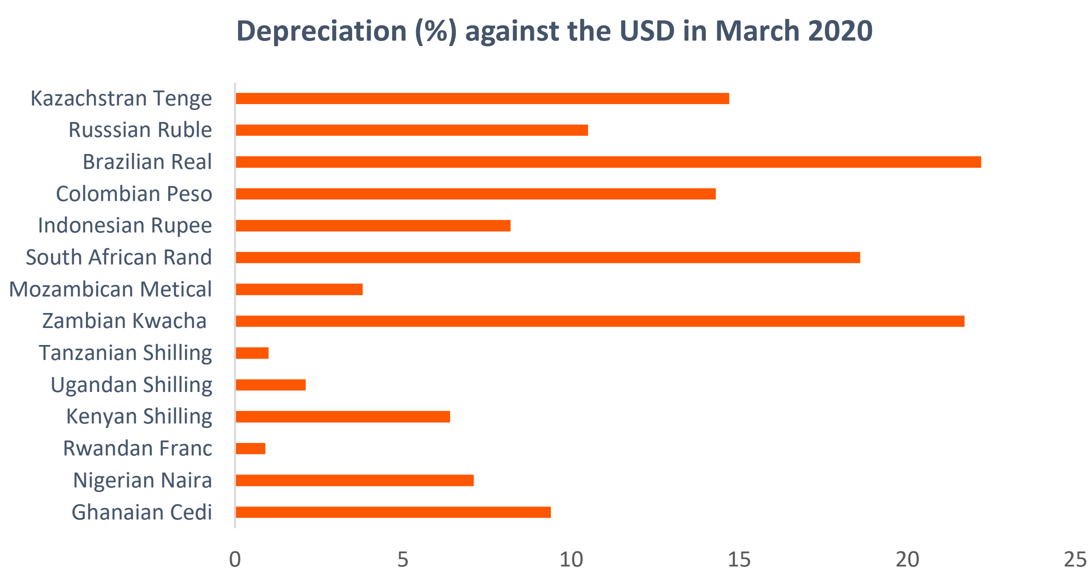
However, most PDBs in Africa have a majority of their assets in local currency because they are enabler of their local economies whereas most of their funding, if not underwritten through local markets, will be in hard currency, such as USD or EUR, as these are the currencies of MDBs, international concessional loan providers and

DFIs. This currency mismatch on the balance sheets of PDBs increases the risk of financial strain and jeopardizes their resilience, contradicting the commitment to a sustainable way of financing.

Unfortunately, volatile exchange rates are still a reality in many emerging and frontier markets. A Financial Times article from 2019 stated that about one in eight ‘developing country currencies falls 20% or more against dollar in any given year’ and about one in twenty crash by 50% or more against the dollar in any given year’.The volatility due to the Covid-19 pandemic has likely even exacerbated this phenomenon. At the recent Fitch Ratings webinar about African PDBs, Vincent Martin, Director Financial Institutions Africa at Fitch Ratings' mentioned that mitigating the exposure to currency risk is a key aspect of financial sustainability for African PDBs, requiring partnerships or more collaboration with international development lenders that offer hedging instruments . As currency risk is one of the key drivers of their losses in the recent year.

If development stakeholders want to build a better and more sustainable response, we must strengthen these PDBs’ resilience by providing them with the right type of financing (at a competitive rate, in synthetic local currency- bringing the much needed USD inflow in the country while protecting against volatility- and with the right tenor).

AADFI and TCX are committed to supporting PDBs in finding local currency financing as we know too well the devastating effect of currency volatility in times of crisis. Any unhedged currency exposure eats away lending capacity and profitability from PDBs, at the moment when it is needed most, and therefore makes them procyclical instead of anti-cyclical.



As part of the development community, we have a responsibility to ensure sustainability in our actions to safeguard lasting impacts. Therefore, we believe some of the funding that will go through these PDBs should be in (synthetic) local currency to avoid, said currency mismatch , stabilize the bank’s asset & liability management and build price transparency that will reinforce financial systems.

So in line with the declaration of the first Finance in Common Summit , was a call to action:

"We, PDBs, also invite all stakeholders to increase cooperation and partnership with us to "finance in common", to better support, collectively and in each and every country, the SDGs and the objectives of the Paris agreement, while reinforcing local financial systems. We stand ready to enhance our dialogue with private actors, including all categories of financial institutions (commercial banks, asset owners, insurance companies, investors, etc.), private sector firms, civil society organizations, philanthropists, academia and think tanks, to reinforce collaboration, as well as with international organizations and local authorities, in the framework of their respective mandate and capacities."

AADFI and TCX are ready to work together to provide solutions to improve the way development finance is provided by allowing the borrowers to take out their loans in their own local currency.

Background information
The Association of African Development Finance Institutions (AADFI) is an umbrella organization for development finance institutions in Africa, created under the auspices of the African Development Bank in 1975. The objectives of the Association are to stimulate co-operation for the promotion and financing of sustainable development in Africa and to encourage the process of economic integration in the African region. AADFI has over 80-member institutions made up of National, Regional, and Multilateral development finance institutions in Africa, and from other continents engaged in development finance activities in Africa.

TCX is a global development finance initiative that offers long-term currency protection in 100+ financial markets where such products are not available or poorly accessible. The Fund started operations in 2007 and has since then provided hedging instruments with a total volume of USD 8.5 billion, spread over 3500+ transactions. Today the fund has an exposure of over USD 5 billion in 60 frontier and emerging market currencies. By selling parts of this exposure to private investors, TCX creates markets and gives these countries access to the international capital markets.

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