



# MDB Viewpoint: Local currency finance and hedging instruments for foreign exchange risk

## Summary on Working Group Discussions<sup>1</sup>

December 19, 2024

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<sup>1</sup> The publication of this Report does not constitute a decision to implement the action items therein by the participating MDBs, but rather aims to guide structuring discussions within the MDB community of the said recommendations. Future consideration of implementation of the recommendations shall be analyzed in light of potential limitations of statutory and regulatory nature, as well as MDBs risk appetite framework.

## **1. Background**

In April 2024, the Heads of Multilateral Development Banks (MDB) agreed on a set of key deliverables to guide their own work and contribute to global fora. One of these deliverables focuses on initiating a voluntary dialogue aimed at identifying scalable solutions to increase private capital mobilization through local currency lending and foreign exchange hedging mechanisms.

Building on the outcomes of a Working Group (WG) composed of MDB treasury and capital market development specialists that was established to respond to this MDB Viewpoint deliverable<sup>2</sup>, this note articulates the problem statement and outlines a future work agenda.

## **2. Problem Statement**

While MDBs have made substantial progress in offering local currency solutions to their borrowers over the last two decades, MDBs aim to further increase capacity to lend in local currency to private sector development projects to mitigate instability risks arising from unhedged foreign currency exposure. Additionally, MDBs aim to further enhance collaboration with governments to strengthen local financial markets and better channel domestic savings into productive investments. As the climate crisis presents an urgent and escalating financing challenge for developing countries, investment needs will exceed locally available savings, requiring substantial foreign direct investment.

## **3. Key principles and action items for consideration**

The joint work identified a series of strategic considerations and actions to enhance private capital mobilization through local currency lending and foreign exchange hedging mechanisms, while advancing the broader mission of financial market development. Regarding the market development principles and actions listed, each institution may find some to be applicable to varying degrees depending upon the needs of their countries of operation, target markets (sovereign versus private sector), and each institution's own financial capabilities. However, the listed items are not suitable for every institution, given very different stages of development of local currency financing solutions in different geographies as well as different legal and policy constraints and the differences for currency exposure needs between a sovereign and a private sector borrower.

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<sup>2</sup> The Working Group was co-led by IFC, EBRD and IDB, who was also the overall facilitator. Participating MDBs include: ADB, AIIB, CEB, EBRD, EIB, IDB, IDB Invest, IFC, WB, and NDB.

We arrange the principles and action items across four categories: (a) the possibility for MDB capital to support greater market risk and related credit risk-taking, (b) capital market development, (c) foreign exchange hedging initiatives, and (d) the importance of resources and member nation support.

#### A. Market Risk: Allocating More MDB Capital

(i) **MDBs may consider expanding their risk-taking mandate to include market and related credit risks in local markets, subject to such measures being compatible with MDBs' existing legal and financial policy constraints.** Many MDBs are focused on managing credit risk and strictly limit the amount and types of market risk, such as interest rate, currency, and refinancing risks, taken on their balance sheets. A consequence of this market risk limitation is that it may constrain some MDBs' ability to offer flexible local currency financing solutions, particularly for longer tenors that may otherwise be unavailable in local markets. As part of this effort, some MDB treasuries may also need to take additional credit risk to engage productively with local market counterparties who may be of lower than usual credit quality. A potential tradeoff of this action is that under certain circumstances diverting equity to FX could lead to overall less lending.

Action item #1: MDB treasuries and risk management teams, especially the private sector lending operations, should continue to share experiences with taking market and credit risk in local markets. Individual MDBs may explore potential balance sheet management and risk control proposals to enhance their ability to take and manage both market risk and related counterparty credit risk.

(ii) **Expanded market risk-bearing capacity may require a reconsideration of the appropriate allocation of MDB risk-bearing capital between the lending activity of the Bank and Treasury activities.** The corporate risk-bearing capital allocated to treasury (market risk) activities has traditionally been very limited compared to that allocated to mission investment operations. For treasuries to be able to facilitate local currency lending, a greater level of risk bearing capacity (both market and related credit risks) may be allocated to it particularly for private sector lending operations.

Action item #2: Private sector lending MDBs may review the allocation of their capital to treasury operations in support of market-building activities and local currency lending. Even a relatively small increase in allocated capital to these operations may meaningfully improve the capacity to provide local currency lending in underdeveloped markets.

#### B. Market Development: Requires MDB Advice & Active Transactional Participation

**Market development advisory efforts and operations may be supported by complementary transactional participation by MDBs in selected local financial markets.** These efforts would allow MDBs to fund themselves in local markets and offer more flexible loan features that meet borrower requirements, particularly by extending the tenor of local currency investment offerings and improving their ability to offer market

risk management products such as interest rate swaps and currency hedges, subject to the development and availability of appropriate hedging solutions in the local or international financial markets. Assisting the development of new instruments in markets where they are unavailable is key for MDBs to take and manage market and refinancing risks. Demonstration projects and long-term engagement enabled by these steps will help to build capacity and market liquidity.

Action item #3: Individual MDBs may consider pilot efforts in their target markets in which expanded risk bearing could be undertaken with the support of proactive assistance to develop market instruments necessary to manage these risks. Effective market building will not be achievable everywhere simultaneously, so MDBs should target markets where such interventions are regarded as most likely to succeed.

#### C. Foreign Exchange Initiatives: Needed To Mobilize Global Capital

**(iii) Mechanisms to improve the affordability and availability of foreign exchange risk hedging solutions are needed to increase the pace and scale of foreign capital mobilization to developing economies.** Developing new FX liquidity tools, and hedging solutions offered by different MDBs, in close cooperation with local and international capital market players can help address the cost and the availability, e.g., longer tenure of FX hedging for private investors. These solutions are complementary to the previous actions in that they enable mobilization of large pools of global capital.

Action item #4: MDBs, in close cooperation with other local and international capital markets players, should further support the development of FX liquidity and other hedging instruments and support their implementation.

#### D. Importance of Resources & Member Nation Support

**Increased resources, capabilities, and complementary actions at the international and national level represent key enablers for the effectiveness of these efforts.** Increasing local currency financing operations as a result of expanded risk-taking mandates and enhanced initiatives that foster long-term market development may require additional capacity in terms of both human and technical assistance resources (within MDBs and among stakeholders), ensuring a balanced approach that addresses both immediate and future needs. The success and viability of these efforts at the country level also depend on the local enabling environment so there is potential for central banks and regulatory authorities to take a more proactive role in pursuing local market reforms.

Action item #5: MDBs should undertake a resource review that would include consideration of the needed technical capabilities to enable the operations outlined above. To realize the benefits of these efforts, the active support of member country legal and

regulatory authorities, including central banks, will be important as many of the impactful steps envisioned above will not otherwise be possible.

#### **4. Potential next steps for future work and the continuation of this initiative**

An agenda for future work has been identified to foster continued progress and impact of this initiative:

- (i) Assess scalability potential of solutions: MDBs could consider conducting a detailed analysis to evaluate the scalability of existing and proposed solutions for local currency lending and FX risk management. This will help determine which approaches can be expanded and adapted to different markets and contexts, ensuring that MDB initiatives remain effective and continue to support local currency financing efforts. More broadly, MDBs could also explore further opportunities to enhance cooperation, such as leveraging Treasury capacity through counterparty swaps, or establishing a network to share local currency liquidity and pursue bilateral ISDAs.
- (ii) Explore potential synergies in MDB market development approaches: This first mapping of MDBs initiatives highlights the value of exploring synergies and complementarities of approaches that could enhance the consistency and efficiency of MDB efforts towards market development.
- (iii) Policy Forum: In addition to the semi-annual Local Currency Forums that take place amongst MDB Treasuries, consider the creation of a “Policy Forum” comprising treasury and capital market development specialists to ensure continuity, deepen discussions on solutions, and examine synergies within and across MDBs.