Local currency financing: some considerations for DBSA

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EXECUTIVE SUMMARY

- In the context of deteriorating economic conditions in an increasing number of African countries, the growth of the DBSA portfolio in these countries has been weaker than expected. In addition, an increasing number of African countries are beginning to fall behind in servicing their external debt obligations and are accumulating external payment arrears. To address these problems, the Bank is exploring the possibility of offering Local Currency Financing (LCF) to its clients on the African continent.

- Available international experience shows that the demand for LCF is strong particularly in developing countries where currency risks are high and borrowers lack effective means for managing the risks.

- LCF can be delivered via three core mechanisms. The first approach is the derivative-based approach in which the financier issues LCF and hedges the resulting currency risk using foreign currency derivatives markets. The second approach is to provide LCF that is supported by a matching liability through issuances of local currency bonds. The third approach is through credit enhancements to entities so that they can secure LCF from other better positioned LCF financiers.

- Each approach carries its own advantages and disadvantages. The experience of AfDB, which has been offering LCF on the African continent since 1997, seems to indicate that the local bond issuance approach may be feasible. Nevertheless, the AfDB has been to do this by securing favourable terms for issuances of local currency bonds and by relying on its multilateral status with a diverse range of shareholders.

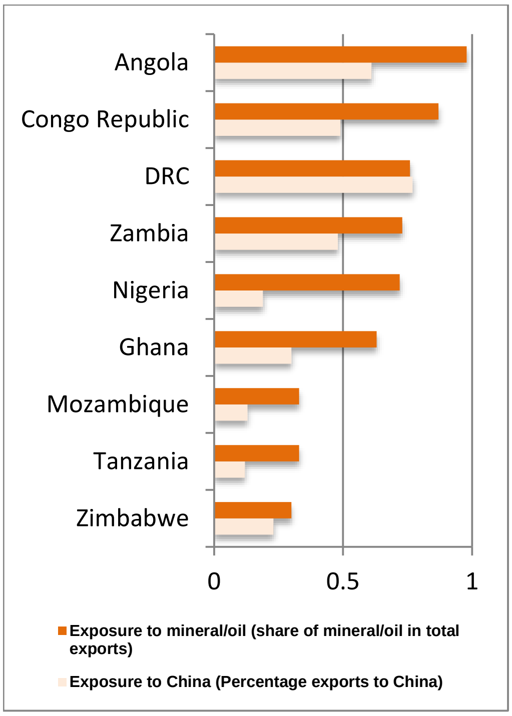
- Several issues need to be considered by the DBSA if it wishes to pursue the goal of offering LCF. These include: the choice of delivery mechanism; whether the Bank will be able to offer competitively priced LCF products; the additionality of LCF; and earning volatility that could arise from offering such a product. These issues require detailed and exhaustive investigations.

- This paper has attempted to highlight these considerations and reviewed the experience of multilateral financiers in this regard.

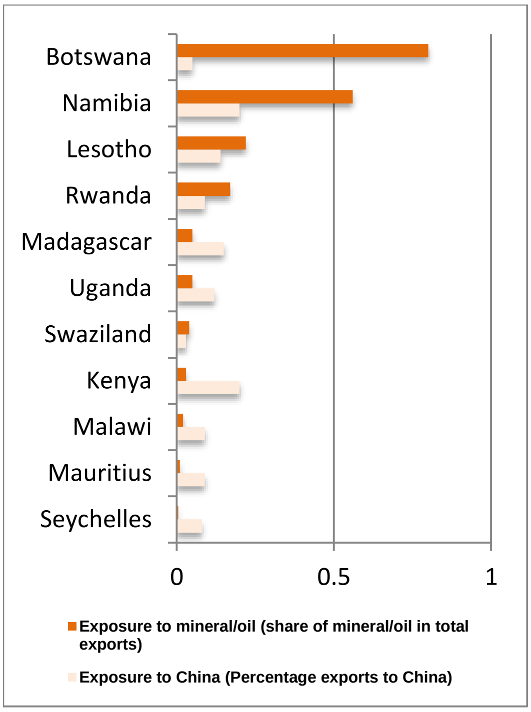
1. The context

Economic conditions in some African countries in which the Bank has investments in have been deteriorating.[1] Countries such as Angola, Mozambique have been experiencing rising balance of payments problems and foreign exchange shortages as well as rapidly depreciating currencies. As a result, the DBSA portfolio, which is denominated largely in United States dollars has been growing at rates that are below expectations as key clients became reluctant to accumulate foreign currency exposures in the context of rapidly deteriorating balance of payments conditions. A further problem, also related to the current economic conditions, has been that many of these countries are starting to accumulate payments arrears on their external debt obligations.

Vulnerable DBSA priority countries



Resilient DBSA priority countries

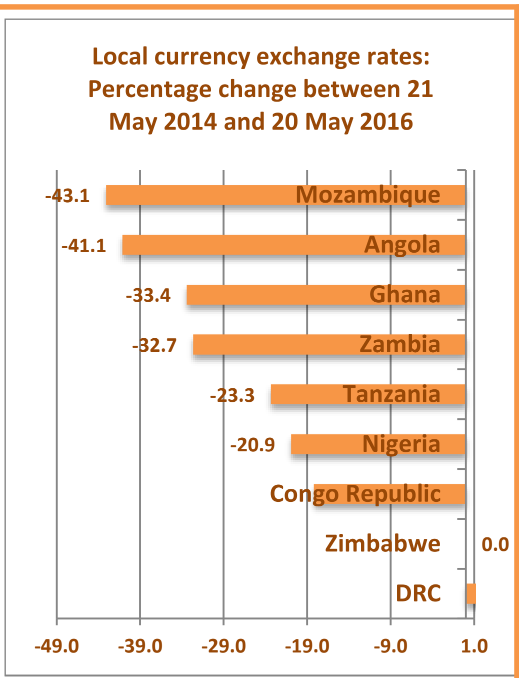


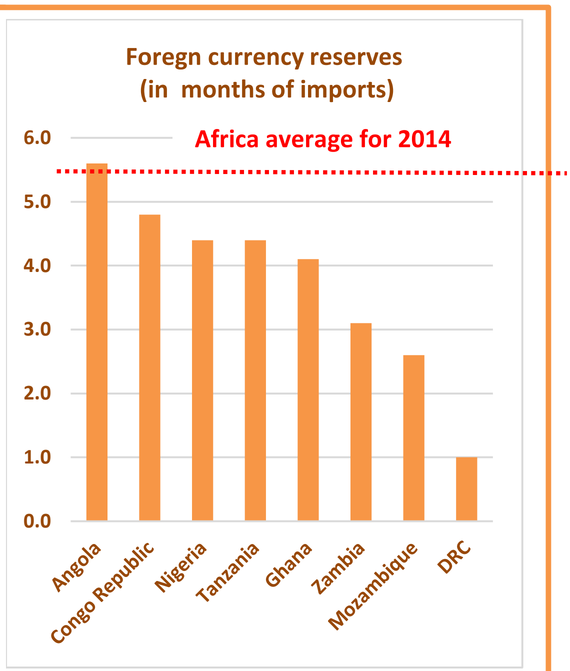
To address these problems, the Bank is considering expanding the Local Currency Financing (LCF) offering to its clients on the African continent. Although the Bank has offered LCF financing in the past, the idea currently is to explore alternative delivery mechanisms beyond the ones it has relied on in the past.

[1] Following the extension of the DBSA mandate to operate beyond the SADC region, the following additional countries were identified as priority countries by the Bank: Congo Republic, Ghana, Kenya, Nigeria, Rwanda and Uganda.

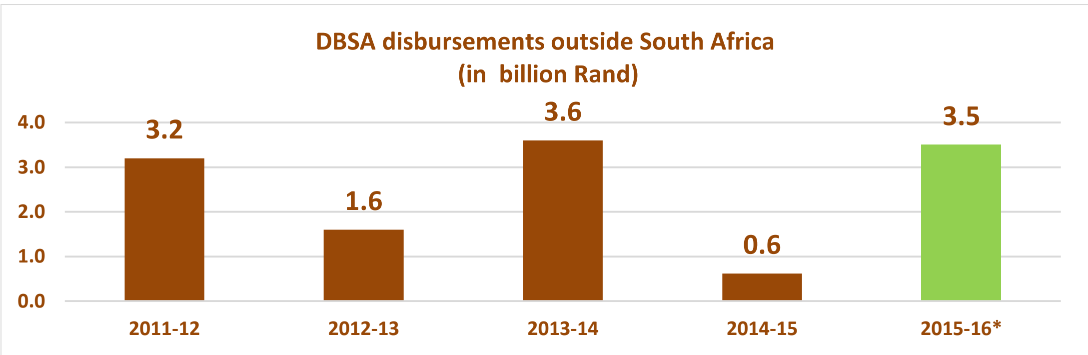
Local currencies of vulnerable countries have depreciated significantly against the US dollar since 2014.

Similarly, foreign exchange reserves in these counties are in decline and are on average some 2 months of imports cover lower than the African average.





The Bank's portfolio on the continent has not grown to expected levels. The reluctance to accumulate foreign-currency exposures by DBSA clients in the context of volatile exchange rate movements could be one of the many reasons for this lacklustre performance.



At present a number of teams within the Bank are working on the feasibility of expanding the LCF product. Given the on-going efforts elsewhere in the Bank, the purpose of this paper is to give an additional perspective on the feasibility of a much wider LCF offering and to identify additional issues that need further investigation by the Bank. The request for an additional perspective came from Finance Division of the Bank and was made to the Strategy Division in May 2016.

2. Local Currency Financing (LCF) and the international experience

2.1 Experiences of multilateral financiers

LCF involves the provision of financing (e.g. loans or equity) in the currency of the recipient as opposed to financing in the currency of the financier or financing in some international currency. LCF offers several advantages to recipients of funds particularly if the recipients' revenue streams are denominated in local currency or the recipient does not have access to cost effective means of hedging against foreign currency risks.

Available evidence suggests that currency risk poses a major risk particularly for infrastructure developers whose income streams are denominated local currencies. In one enterprise survey that targeted developers of renewable energy infrastructure, some 58 percent of the respondents identified currency risk as a "significant" factor in their operations[2].

Yet, there appears to be significant supply-side challenges to offering effective, competitively-priced solutions even for major multilateral financiers and development banks. Table 1 below shows that, with the exception of the World Bank which is prevented by statute from providing local currency financing except in exceptional circumstances, all other major multilateral financiers and development banks provide local currency financing[3]. The table also shows that most MDBs started offering LCF from the late 1990s.

Table 1. Multilateral financiers and local currency financing.

Name of the Institution	First year of offering LCF
African Development Bank (AfDB)	1997
Asian Development Bank (ADB)	2002
European Bank for Reconstruction and Development (EBRD)	1994
European Investment Bank (EIB)	2002
International Finance Corporation (IFC)	2003

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Although major multilateral financiers have been offering local currency financing for over a decade, the total volume of this type of financing has generally remained at less than 15 percent of the total financing[4]. Only in the case of the IFC and the ADB has total financing exceeded 15 percent of total loans.[5] In the latter case, although local currency financing reached a high of 40 percent of the total lending book, this level was only for one year and was not sustained after that.

2.2 Experiences of the Currency Exchange Fund (TCX)

The Currency Exchange Fund (TCX) is a special-purpose fund created to provide currency and interest rates swaps in emerging market countries where such services are not provided by commercial banks or other providers[6]. It acts as a market maker in currencies and maturities that are typically not covered by traditional providers.

The Fund was established in 2007 and the major shareholders are Netherlands

[4] G. Perry, *Growing business or development priority: Multilateral development Banks' direct support for private firms*, Centre for Global Development. 2011. Washington D.C.

[5] Ibid

[6] See TCX website.

FMO, KfW and EBRD each with 15.7 percent shareholding[7]. The DBSA is also a shareholder in TCX with 9 percent shareholding. Other significant shareholders are AfDB, JICA and IFC with 10.1, 9.4 and 5.6 percent shareholdings respectively[8]. As at December 2014, the total assets of TCX amounted to United States $765.9 million.

Given its core function of providing hedging and interest rate swap services, TCX's main risk exposure stems from currency risk and to a lesser extent interest rate risk[9]. TCX enables its shareholder financiers to offer local currency financing by assuming the currency risk underlying the financing in the local currency of the borrower. The Fund manages this risk essentially by diversifying its portfolio across as many currencies as possible (currently 51 different emerging market currencies) and by having adequate capital buffer to absorb any losses that cannot be diversified away.

TCX's basic business model relies on diversification benefits in that out of a given pool of currencies in its portfolio, there is bound to be some negative correlations in the movements of the currencies. This "natural" hedging allows TCX to diversify away the currency risk. In addition to this "natural" hedge, the shareholders of TCX have provided adequate capitalisation to the Fund to enable it to absorb the losses that cannot be diversified away. In its 2015 rating opinion, Standard and Poor notes that one of the key ratings strengths of TCX is the "high likelihood of extraordinary support from main shareholders"[10]. The rating agency notes that this support takes the form of: (i) provision of the Fund with capital as an independent entity; and (ii) strong influence on the Fund's strategic and business plans[11].

[7] See Standards and Poor's Rating service, *Rating opinion on TCX (2015),* available online

[8] Ibid

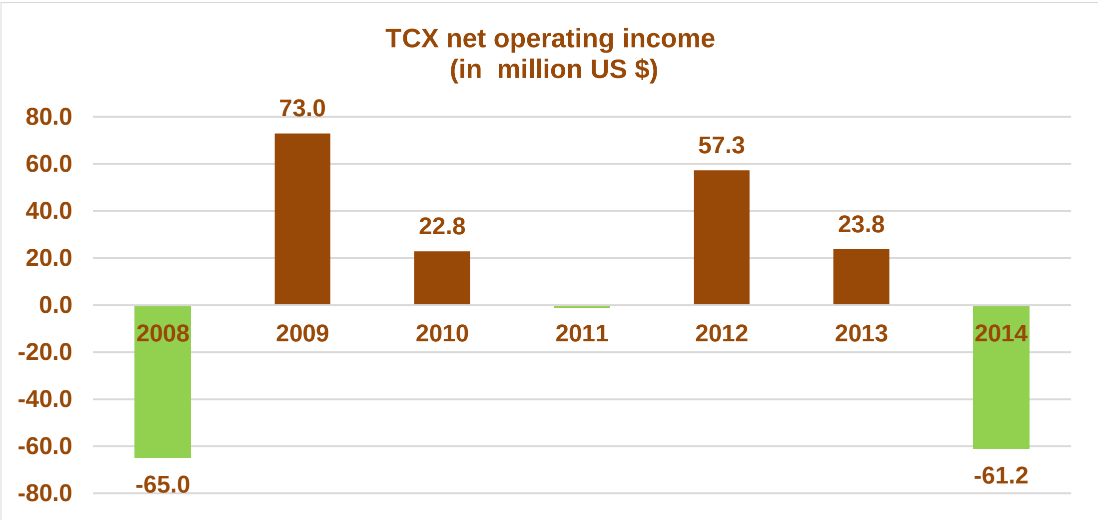
[9] ibid

[10] See Standards and Poor's Rating service, *Rating opinion on TCX (2015),* available online

[11] ibid

Of interest for purposes of this paper is the fact that although the TCX currency portfolio is diversified across 51 different currencies, it continues to experience high volatility in its earnings. This demonstrates the risky nature of local currency financing and the fact that significant capital is required to absorb losses that cannot be diversified away.

TCX, which absorbs currency risks associated with LCF by its shareholders, continues to experience high volatility in its earnings despite the fact that it has diversified its portfolio across 51 different currencies.



Based on the experience of TCX, one can conclude that:

(a) Local currency financing creates significant currency risks for the financier;
(b) To manage the resulting currency risk, scale as measured by that of currencies that move in opposite directions with respect some international currency, is critical; and
(c) Strong, unequivocal on-going, long-term shareholder support is critical as the scale of losses that cannot be diversified away can be significant.

2.2 Experiences of the African Development Bank (AfDB)

The African Development Bank (AfDB) is a multilateral development finance institution. It was established in 1964 to promote sustainable economic growth and to reduce poverty in Africa. The shareholders are 54 African member states and 27 non-African countries. It has a total asset base of slightly over US $10bn in 2015[12]. The AfDB started offering its LCF product in 1997, mostly through issuances of local currency bonds in 10 African countries and or currency areas. The countries and/or currency areas are:

- the CFA central African monetary area;
- the CFA west African monetary area; and
- Egypt, Ghana, Kenya, Nigeria, South Africa, Tanzania, Uganda and Zambia.

Of specific interest for purposes of this paper is the fact that recent bond issuances by the AfDB in local currencies have typically been small and were designed to suit local bond market conditions. The smallest bond issuance was the Ugandan local currency bond issuance which totalled the equivalent of US$5mn. This was issued in 2014 as part of a larger Medium Term Note (MTN) issuance programme with a planned total issuance of US$50mn. The largest issuance was the 2014 Nigerian local currency issuance which totalled the equivalent of US$80mn. This was done as part of the MTN issuance programme with a planned total issuance of US$1bn.

Nevertheless, LCF by the AfDB is still small relative to the total size of lending by the Bank. LCF has not exceeded 10 percent of the total AfDB loan book despite the fact that the institution has been offering the product from as far back as 1997[13].

Recent local currency bond issuances on the African continent by the AfDB have been typically small in size to suit local market conditions. The smallest issuance equaled US$5.0mn with the largest equaling US$80mn . Nevertheless, the total AfDB local currency portfolio is still small and has not exceeded 10% of its total loan book.

[12] See AfDB website

[13] G. Perry, *Growing business or development priority: Multilateral development Banks' direct support for private firms*, Centre for Global Development. 2011. Washington D.C.

Country	Total planned Medium Term Note issuance Programme (in million US$)	Amount actually issued to date (in million US$)	Year of parcel issuance
Nigeria	1000	80	2014
Uganda	50	5	2013
Zambia	951	..	n.a.

3. Mechanisms for delivering local currency financing

There are essentially three ways of delivering LCF. The first approach relies on the existence of a derivatives market and is as such derivative-based[14]. Under this approach the financier provides financing in the local currency of the entity receiving funding and simultaneously hedges the resulting currency risks using the foreign currency derivatives market. The second approach relies on local currency bond issuances by the financier. Under this approach, the financiers raise funds in the currency of the entity receiving funding. Provision of financing in the same currency in which the liability is created thus creates a "matching" asset and thereby significantly reduces currency risk. Although the matching of assets and liabilities significantly reduces currency risk, some (translation) risk still remains as the financier ultimately has to translate the profits made from the transaction into to their own currency. The final approach is to credit-enhance entities so that they can meet the financing criteria of existing local currency financiers.

Each LCF delivery mechanism carries advantages and disadvantages. The best approach has to take into account several factors including: (i) the state of

[14] IFC, *IFC and local currency financing*. Not dated, Washington D.C.

development of the foreign currency derivatives market; (ii) the competitiveness of such derivatives products; and (iii) conditions for issuances of local currency bonds and existence of alternative local currency financiers.

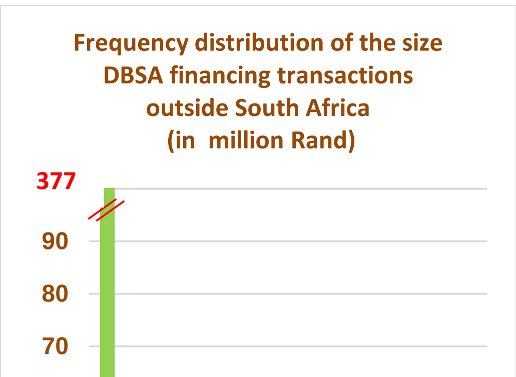
4. Some considerations for DBSA

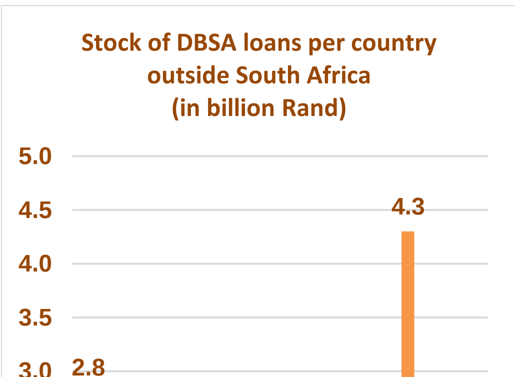
4.1 What is the best delivery mechanism for LCF

A distinctive feature of the financing offered by the DBSA is that a majority of the financing transactions are less than R100.0mn in size. The size of each financing transaction could be a major constraining factor in the choice of a LCF delivery mechanism. For example, in South Africa, the DBSA bond issuances are typically in sizes of over R1bn and this is done to minimise the transaction costs associated with such issuances. Given the small size of the financing transactions that the DBSA has been involved in on the African continent, transaction costs associated with bond issuances in local currency would have to be significantly lowered for this approach to be economically justifiable to the Bank.

Another possible constraining factor for this delivery mechanism is the strong possibility that the Bank may incur “negative carry”. A negative carry arises when the interest rate that the Bank gets for short-term investments of funds (before it makes disbursements) is less than the rate it pays on the bond that it has issued in the local currency. This may occur if bond issuances are not aligned with disbursement dates and there are limited alternative investment opportunities for funds raised from local currency bond issuances.

A majority of DBSA financing transactions outside South Africa are less than R100mn in size. The Bank’s database shows that 377 transactions were less than R100mn





Nevertheless, a review of AfDB experiences seems to indicate that it may be possible for the DBSA to issue bonds in smaller denominations. It appears that the AfDB has been able to secure favourable terms for issuing local currency bonds in various African countries. In the absence of favourable issuance terms, it may not be feasible to deliver LCF through issuances of local currency bonds.

4.2 Can the DBSA offer competitively priced LCF Products

A review of AfDB experiences indicates that the entity has been able to issue local currency bonds at yields that were up to 50 basis points (bps) below a comparable local currency government bond. This favourable pricing could be a result of AfDB multilateral status with 27 non-African governments as shareholders and strong support from such shareholders. The yield that the DBSA would secure if it were to issue local currency bonds in various African countries is not known as the Bank has not carried out such an undertaking. This aspect needs to be investigated further.

4.3 How much additional business can the DBSA generate from an LCF Product

Available evidence indicates that there is a strong demand for LCF products[15]. The constraints for strong growth of the market appear to be on the on the supply side of the LCF market. Financiers face several challenges in designing cost effective solutions that reasonably compensate them for the currency risks that they assume.

However the experience of TCX indicates that once sufficient scale is reached in terms of ability to manage currency risk through diversification over a portfolio of currencies, growth can be quite favourable. The total asset base of TCX grew by average annual compound growth rate of 9 percent between 2008 and 2014.

4.4 Will a LCF introduce volatility to DBSA Earnings?

A review of the experiences of TCX indicates that earning can be highly volatile and significant even with significant diversification across multiple currencies. In the case of TCX, earnings ranged from a negative US$65mn to positive US$73mn between 2008 and 2014. Such high volatility requires a strong capital base.

[1515] The Global Innovations Lab for Climate Finance, Long-term cross-currency swaps: Phase II analysis summary. Nov 2014. Venice, Italy