Working paper 5
Policy Recommendations

1. Introduction

This paper proposes concrete policy measures aimed at enhancing the capacity of multilateral development banks (MDBs) to enhance local currency (LC) financing in low- and middle-income countries (LMICs). While the recommendations presented are global in scope, we acknowledge the diversity in economic structures, regulatory environments, and capital market development across different countries and regions. Relevant solutions depend on the region, including, the level of financial development, regulatory and institutional structure, and political buy-in. For example, in Sub-Saharan Africa, investment markets are more focused on private equity, whereas in Asia, deeper capital markets allow for a greater reliance on debt instruments.[1] These factors may influence both the relevance and practical implementation of the proposed policies in specific contexts.

The paper is structured as follows: Section 2 reviews the most significant existing proposals aimed at enhancing LC financing, along with our assessment of their key aspects. This is followed by our own recommendations in Section 3, which are informed by the lessons learned from these proposals and the comprehensive study conducted in this report. While our recommendations are designed to offer scalable solutions, they also allow for flexibility in application, taking into account the various realities of different regions. They also acknowledge that there is not one big solution to the issue of LC lending by MDBs, but that addressing the challenge of increasing LC lending will require a set of different initiatives, which complement and leverage onto each other.

2. Review of existing proposals

Efforts to overcome the barriers to increasing the volume of LC lending by MDBs have given rise to various policy proposals. We broadly classify these proposals into four categories. First, proposals that advocate for embedding local currency lending within the core developmental mandate of MDBs, requiring institutional, cultural, and legal changes (Section 2.1). Second, an extended set of proposals aimed at scaling up and enhancing the means of hedging currency

[1] S Andreasen and others, 'The Need to Reduce FX Risk in Development Countries by Scaling Blended Finance Solutions' (FX Risk in Development Workshop, Convergence, EDFI, European Commission, OECD, TCX, 2017) https://assets.ctfassets.net/4cgqlwde6qy0/3UYrVVpyqckCsw802wWoOi/7abfe71c3b60ff521635f713865cad16/FX_Risk_in_Development_Primer.pdf accessed 11 October 2024.

risk to mitigate the challenges of foreign exchange volatility (Section 2.2). Third, proposals that focus on promoting MDBs' onshore local currency operations, which seek to develop domestic financial markets and reduce reliance on offshore mechanisms (Section 2.3). Finally, cross-cutting proposals that recommend donor-backed guarantees or additional equity capital to mitigate risks associated with large-scale LC lending (Section 2.4).

This review focuses primarily on those proposals that directly address the practices of MDBs. Broader macroeconomic, political, and institutional changes in borrower countries will be discussed only insofar as they intersect with MDB-specific recommendations. This focused approach is necessary given the objective of this review: to assess actionable reforms that MDBs can implement to expand LC financing.

2.1. Bring local currency lending to the core of the developmental mandate of MDBs

The first category of proposals advocates for a cultural and organisational shift within MDBs, recognising LC lending as an integral part of their mandate and toolkit. Fink, Lankes, and Sacchetto recommend starting with relatively low-cost initiatives, such as sharing success stories of innovative LC transactions and integrating LC lending considerations early in the transaction cycle. Capacity-building efforts, including establishing cross-functional knowledge groups across MDB departments to provide LC-specific advice, are also suggested, alongside setting key performance indicators (KPIs) and annual targets for LC transactions.[2]

More generally, as noted by TCX, responsible lending practices must be tightened.[3] This includes offering borrowers options for currency indexation and other risk-mitigation clauses as default practices, providing dual currency loan arrangements—allowing borrowers to choose between LC and foreign currency (FC) loans at disbursement—or allowing for a conversion to LC after the loan has been disbursed in FC.[4] Fink, Lankes, and Sacchetto also highlight the need for a review of MDBs' risk management policies that require strict back-to-back hedging against foreign exchange (FX) risk or that restrict onshore operations due to counterparty restrictions.[5] More flexibility in managing FX, maturity, liquidity, and convertibility risks is required for MDBs to balance these trade-offs effectively.

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[2] C Fink, HP Lankes, and C Sacchetto, *Mitigating Foreign Exchange Risk in Local Currency Lending in Fragile States: Review and Options* (International Growth Centre, June 2023).

[3] TCX, *Scaling Up Currency Risk Hedging for Low and Lower Middle-Income Countries: A Proposal to Mitigate Currency Risk at Scale and Mobilize Private Finance for Sustainable Development* (September 2023).

[4] Fink, Lankes, and Sacchetto (n 2).

[5] ibid.

2.2. Scale up and enhance means of hedging currency risk

A second key category of proposals (or indeed existing initiatives) focuses on enabling MDBs to scale up their LC lending by mitigating currency risk through the provision and expansion of hedging instruments. These instruments would be provided by one or more entities, stepping in where private market solutions do not exist or remain too costly. One significant entity in this regard is the Currency Exchange Fund (TCX), which provides hedging where private markets are either insufficient or completely absent, facilitated by diversification across a broad range of currencies. In the 15 years since its inception, TCX has de-risked USD 1.4 billion in loans to developing countries, including USD 53 million in energy projects.[6] TCX has generated modest profits, showing that FX risk mitigation through diversification in LMIC currency markets is feasible, supported by a strong capital base provided by its investors.[7]

However, the cost of hedging through TCX remains relatively high, which can be prohibitive in some markets.[8] Additionally, current hedging products often do not meet the scale required for investments in clean energy, which are essential to addressing the climate crisis.[9] TCX hedges must also be fully collateralised, which increases transaction costs for users. Several policy proposals aim to reduce these costs and expand TCX's hedging capacity, including increasing donor guarantees, engaging specialised insurance and guarantee providers, and adding capital. In response to the Bridgetown Initiative, for example, TCX has proposed expanding its hedging capacity to USD 50 billion and creating a donor-funded trust to offer concessional guarantees, lowering the cost of hedging or providing longer-term products not available in commercial banks.[10] Improved access to and affordability of currency hedging are expected to gradually lead to a supply response and foster the development of private hedging markets.[11] TCX also aims to

[6] P Benoit and others, *Scaling Clean Energy through Climate Finance Innovation: Structure of an Exchange Rate Coverage Facility for Developing Countries* (Columbia Center on Global Energy Policy, Policy Note, October 2022) 13.

[7] Carnegie Consult, *The Development Impact of Local Currency Solutions: An Evaluation of 10 Years TCX* (2017).

[8] ZB Yahmed, C Grant, and N Pinko, *Managing Currency Risk to Catalyze Climate Finance* (Climate Policy Initiative, August 2024) 5-7; European Bank for Reconstruction and Development (EBRD), *Local Currency Financing* (Treasury, August 2023) https://www.ebrd.com/downloads/capital/local.pdf accessed 12 October 2024.

[9] Benoit and others (n 6) 13.

[10] The current proposal is to do this for a swap portfolio of up to USD 10 billion limited to climate mitigation and adaptation projects.

[11] TCX (n 3) 14.

increase its cooperation with MIGA, Frontclear, and other specialised insurance providers to offer deliverable products and substitutes for cash-collateral requirements.[12]

Fink, Lankes, and Sacchetto have made a similar proposal, suggesting a Portfolio Return Guarantee for fragile and conflict-affected settings. In this model, TCX's hedging would be backed by a donor guarantee, ensuring a minimum return for a portfolio of fragile and conflict-affected settings hedges, allowing TCX to lower its hedging costs in these countries.[13] The guarantee would work within a well-defined framework, with limits on how much hedging costs could drop and strict eligibility criteria. Importantly, the performance and cost to donors would be assessed over a longer period, not during short-term crises. Both TCX's own proposal and that of Fink, Lankes, and Sacchetto see expanding TCX and improving its capacity to manage risk as ways to attract institutional investors and private capital in the future.

The need to increase the availability of affordable LMIC currency hedges—particularly during times of global uncertainty—is also reflected in recent proposals calling for the establishment of new international institutions that would act as market makers for these currencies.[14] Persaud's proposal for a partial and countercyclical FX guarantee mechanism, for instance, has gained attention in the context of the Bridgetown Initiative. His idea involves setting up an international entity—formed as a joint agency of MDBs with IMF liquidity support—to offer partial hedges for LMIC currencies when hedging costs exceed the three-year average. The agency would provide hedges at a lower cost than the market but would not fully cover the excess cost (overpayment). Persaud argues that this conservative approach, which avoids full subsidies, is crucial for allowing the mechanism to scale up sustainably. Similar to TCX, currency risk would be reduced through diversification by pooling MDB assets, while IMF support would provide the necessary dollar liquidity. Collaboration between MDBs and the IMF would combine MDBs' project expertise with the IMF's macroeconomic expertise.[15]

Kapoor and others have proposed the creation of an international currency fund to scale up the availability of LMIC currency hedges and to help develop currency risk markets.[16] Unlike Persaud's proposal, this institution would operate independently from MDBs and the IMF,

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[12] ibid 2, 9.

[13] Fink, Lankes, and Sacchetto (n 2) 51.

[14] A Persaud, *Unblocking the Green Transformation in Developing Countries with a Partial Foreign Exchange Guarantee* (2023) https://www.climatepolicyinitiative.org/wp-content/uploads/2023/06/An-FX-Guarantee-Mechanism-for-the-Green-Transformation-in-Developing-Countries.pdf accessed 11 October 2024; Benoit and others (n 6); S Kapoor and others, 'A Multilateral Solution to Hedging Currency Risk in Developing Country Finance' (Nordic Institute for Finance, Technology and Sustainability, 2021). However, it is not always clear how these proposals relate to the existing structure of TCX. Some explicitly rely on TCX's expertise, while others seem to propose entirely new institutions, raising questions about potential overlap.

[15] Persaud (n 14).

[16] Kapoor and others (n 14).

established as a treaty-based international organisation with preferred creditor status, funded by a mix of paid-in and callable capital—similar to the International Bank for Reconstruction and Development (IBRD). Rather than focusing solely on countercyclical actions, the fund would aim to offer affordable currency hedges through greater diversification, relying on a smaller capital base (which could include callable capital). TCX's expertise in currency and modelling would contribute to the institution's operations, but hedging would be offered on a much larger scale—Kapoor and others estimate that up to USD 6 trillion in unhedged currency exposure will be needed by 2030 to meet the Sustainable Development Goals (SDGs) and climate targets. Additionally, the multilateral and preferred creditor status (PCS) of this currency fund would allow it to offer deliverable products onshore, supporting local market development and reducing collateral requirements—improving the efficiency of the TCX model.[17]

Benoit and others have proposed a Clean Energy Exchange Rate Coverage Facility (ERCF) to increase funding for clean energy projects in developing countries. The ERCF, capitalised by carbon credits, international development institutions (including MDBs), and other international capital, would cover the gap between local currency payments for clean energy projects and foreign currency-denominated debt payments when local currency depreciates. The facility would cover all shortfalls, including those from extreme depreciations, making direct payments in FC to the lenders. [18]

Finally, based on a proposal by Shrimali, Farooquee, and Trivedi,[19] the India Innovation Lab for Green Finance developed an innovative hedging facility to manage currency risk for renewable energy projects in India. The facility divides depreciation risk into different tranches. For depreciations between 0% and 4.5%, investors and/or developers would cover the risk at a fixed cost, which is lower than private hedging costs. Gains from favourable exchange rate movements would accrue to the facility and could be distributed to donors or users. For depreciations between 4.5% and 99.7%, the facility would cover the losses from accrued gains. For depreciations above 99.7%, public grants would be used to cover the losses. This proposal is promising and aligns with findings that LMIC currency returns are generally positive, though they carry significant tail risks. Unfortunately, as Yahmed, Grant, and Pinko note, this proposal has not been implemented due to regulatory constraints and market conditions in India, and it would require donor funding for initial capitalisation.[20]

2.3. Promote onshore local currency operations

[17] ibid.

[18] Benoit and others (n 6) 14.

[19] G Shrimali, AA Farooquee, and S Trivedi, *FX Hedging Facility* (Climate Policy Initiative, 25 September 2015) https://www.climatepolicyinitiative.org/fx-hedging-facility/ accessed 13 October 2024.

[20] Yahmed, Grant, and Pinko (n 8).

The third set of proposals focuses on the development of LMICs' domestic financial markets and facilitating the onshore operations of MDBs. These initiatives aim to provide easier and cheaper access to LC liquidity and hedging through a broader array of counterparties, mitigate transfer and convertibility risks, and allow MDBs to benefit from local market knowledge and potentially interact more closely with the central bank.[21] From an LMIC perspective, having MDBs operate onshore could significantly contribute to local market development, which is key to sustainably addressing the illiquidity of domestic financial markets.

However, operating onshore and managing liquidity requires basic infrastructure, such as local cash and custody accounts, and exposes MDBs to legal risks. Institutional and regulatory reform, along with policy dialogue and capacity-building efforts with the local banking system and central bank, are therefore crucial first steps in enabling the onshore presence of development finance institutions (DFIs) and MDBs.[22] According to Fink, Lankes, and Sacchetto, a focus should be placed on capacity building in areas such as local money market development and liquidity management. This includes defining an overnight benchmark rate, establishing a sound monetary policy framework to control inflation, developing an interest rate curve, and undertaking legal, regulatory, tax, and accounting reforms related to derivative instruments.[23]

To support onshore operations, especially in fragile and conflict-affected settings, the authors propose creating an FX platform that would act as an onshore treasury. This platform would source LC from local counterparts, establish the necessary onshore infrastructure, and centralise LC liquidity management across DFIs.[24] The platform would allow DFIs to continue on-balance sheet lending without exposure to FX risk, as the platform would manage the FX risk entirely. This would reduce transfer and liquidity risk and provide flexibility in setting LC lending rates without requiring immediate donor grants.[25] Another recommendation is to invest in and disseminate information on country-specific foreign investment regulations, such as local bank account requirements, interest rate regulation, and fund repatriation.[26]

In line with this proposal, a group of MDBs— including the Asian Infrastructure Investment Bank (AIIB) and the European Bank for Reconstruction and Development (EBRD)— and the financial markets development company Frontclear have put forward a similar proposal for an onshore

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[21] Fink, Lankes, and Sacchetto (n 2); EBRD (n 8); Andreasen and others (n 1)..

[22] Fink, Lankes, and Sacchetto (n 2); EBRD (n 8); Andreasen and others (n 1).

[23] Fink, Lankes, and Sacchetto (n 2) 47.

[24] ibid 52.

[25] ibid.

[26] ibid 18-19.

hedging platform called 'Delta'.[27] This platform would source LC liquidity from various (ideally onshore) sources to support MDBs' LC operations. A portion of the liquidity would be held as a buffer, invested in very short-term assets, to manage the maturity risk that arises from the platform's short-term liabilities and long-term financing to MDBs. This would reduce maturity and refinancing risks for MDBs while allowing them to provide LC loans without abandoning their back-to-back risk management frameworks. The platform would also collaborate with onshore financial institutions and policymakers to support domestic market development. After initial capitalisation by donors or MDBs, the platform is expected to sustain itself through spreads between short-term borrowing and long-term lending.[28] This initiative addresses the core issue of inadequate LC lending due to underdeveloped domestic financial markets. However, its applicability is limited to relatively mature markets with some degree of LC funding, and, as noted by an interviewee, it faces challenges concerning its initial capitalisation. [29]

While developing onshore markets is ultimately the best way to enhance domestic LC financing, it is a long process hindered by structural barriers. LC market development is often a 'chicken and egg' problem: without proper infrastructure, institutions, macroeconomic stability, and capacity, LC markets struggle to develop. Yet, the instability caused by FX exposure or short-term LC borrowing further impedes the creation of these necessary conditions. Thus, transition policies are needed to help MDBs manage risks associated with LC lending and to allow them to play a catalytic role in developing domestic financial markets.

One such transition policy is the establishment or scaling up of hedging entities, as discussed earlier. Another approach is for domestic central banks to play an active role in collaborating with MDBs to develop local financial markets. One possibility—already practiced to a limited extent—is to source LC hedges and liquidity from domestic central banks through foreign exchange swaps. Fink, Lankes, and Sacchetto suggest that such swaps are a 'win-win' solution: MDBs gain access to LC at locally appropriate rates, while the swap can enhance trust in the local financial system by acting as a 'stamp of approval' and providing foreign currency liquidity, which is especially valuable during periods of financial uncertainty.[30] However, the authors also note that while cross-currency swaps might provide more attractive LC funding and may be the only option in underdeveloped financial systems with no local counterparties, they can be complex to implement, particularly in terms of accounting treatment.[31] Moreover, as discussed later, these swaps transfer the currency risk to domestic central banks, which may not be desirable from a development or balance of payments perspective.

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[27] *Viewpoint Note: MDBs Working as a System for Impact and Scale* (endorsed by the Heads of the African Development Bank and others, Washington, DC, 20 April 2024) https://www.aiib.org/en/about-aiib/who-we-are/partnership/_download/Heads-of-MDBs-Viewpoint-Note-20-April-2024.pdf accessed 13 October 2024.

[28] Yahmed, Grant, and Pinko (n 8) 15-16.

[29] Interview 18.

[30] Fink, Lankes, and Sacchetto (n 2) 27.

[31] ibid 47.

Another recent proposal, the FSD Africa MDB Portfolio Transfer Mechanism, aims to involve local market actors in absorbing some of the exchange rate risk faced by MDBs.[32] Under this proposal, MDBs would sell part of their loan portfolios to local institutional investors to free up risk capital and create additional balance sheet capacity. The mechanism is targeted at brownfield investments that generate revenue for debt repayments and would create a relatively safe asset class for domestic institutional investors. However, a key limitation is the currency mismatch that could arise if MDBs sell FC loans to local investors. As noted by Yahmed, Grant, and Pinko, it is converting these loans from FC to LC to avoid a currency mismatch that presents the most significant challenge to the proposal's large-scale implementation.[33] In this sense, and as discussed in more detail in our policy recommendations, the portfolio transfer mechanism could serve as an important complement and facilitator of onshore MDB LC loans by providing a means to remove the associated risks from MDBs' balance sheets.

Finally, it is important to recognise that developing local financial markets carries significant potential but also potential drawbacks and risks. More developed local financial markets can set LMICs on a path towards raising necessary LC financing domestically, reducing their reliance on volatile cross-border financing. However, as MDB liabilities issued to domestic investors do not generate additional foreign exchange revenues, this could be disadvantageous for balance-of-payments-constrained economies. MDBs issuing LC bonds to non-resident investors could attract external financing,[34] but carries risks if these investors are funded in FC and thus subject to currency mismatches.

2.4. Guarantees and additional equity capital

A key theme across the approaches discussed above is the recognition that enabling LC lending and addressing the risk of large currency depreciations may require additional donor or shareholder support, either through capital injections or guarantees. Evidence from a 2017 LC workshop involving several DFIs and MDBs shows that even modest amounts of concessional funds or additional capital can significantly enhance sustainable investment and expand the balance sheet capacity of MDBs.[35] Indeed, many of the proposals mentioned earlier—such as scaling up TCX, the Delta platform, or the CPI Hedging facility—rely on some form of donor funding for initial capitalisation and/or to ensure affordable pricing in the face of large currency

[32] E Osano and others, *A Local Currency Solution for Multilateral Development Bank Portfolio Transfer* (FSD Africa 2024) https://fsdafrica.org/wp-content/uploads/2024/06/Report-Local-Currency-Solution-for-Multilateral-Development-Bank-Portfolio-Transfer-004.pdf accessed 10 October 2024.

[33] Yahmed, Grant, and Pinko (n 8).

[34] See, e.g., TC Hoschka, *Local Currency Financing – The Next Frontier for MDBs?* (Asian Development Bank, ERD Working Paper Series No 68, April 2005).

[35] Andreasen and others (n 1).

risks. As such, the feasibility of these proposals depends on the political willingness of potential donors to commit these resources.

Another proposal which explicitly relies on (additional) donor or shareholder support is an LC donor credit guarantee (focused on fragile and conflict-affected settings) put forward also by Fink, Lankes, and Sacchetto. By mitigating the credit risk faced by LC lenders, the authors argue, this approach would facilitate loan delivery and reduce the overall spread on LC lending. Guarantees are flexible tools that can be tailored in terms of scope, eligibility, pricing, and the percentage of risk covered. A critical aspect in the context of this report is whether the guarantee should be applied to hedged LC loans or unhedged transactions, where the guarantor (donor) also assumes the currency risk. While providing guarantees for unhedged transactions could significantly lower LC lending costs (given the high cost and limitations of existing hedging markets), it would increase the risk of capital loss, at least in the short term, in the event of currency depreciation.

Another proposal to boost MDB LC lending, through increased shareholder participation, is presented by Schclarek and Xu.[36] They suggest a recapitalisation of MDBs using Special Drawing Rights (SDRs) from developed countries that have surplus SDRs. MDBs could use these SDRs to acquire LC from local central banks, which would then be used to provide LC loans for domestic projects. This approach would not only help reduce currency mismatches on MDB balance sheets when lending in LC, but also provide host countries with FC, which could be used to finance imports. However, as discussed in the appendix, the legal feasibility of proposals of this kind under the legal frameworks of certain potential donors remains uncertain.

In summary, this section has discussed existing proposals aimed at initiating or scaling up LC lending by MDBs. Table 1 provides a summary of these proposals, categorised by their broader objectives. In the next section, we will build on the findings of this report to critically reflect on existing proposals (and potentially propose some modifications), and propose new initiatives aimed at increasing LC lending in LMICs. In particular, whereas existing proposals largely shift the currency risk to entities other than MDBs, we interrogate whether there would be some space for MDBs to take on limited, well defined, and fully modelled exchange rate risk to lower the cost of their LC financing and firmly establish LC lending as part of their developmental financing toolkit.

[36] A Schclarek and J Xu, 'Exchange Rate and Balance of Payment Crisis Risks in the Global Development Finance Architecture' (2022) 79 Journal of International Financial Markets, Institutions and Money 1-19.

Table 1 Summary of existing policy proposals[37]

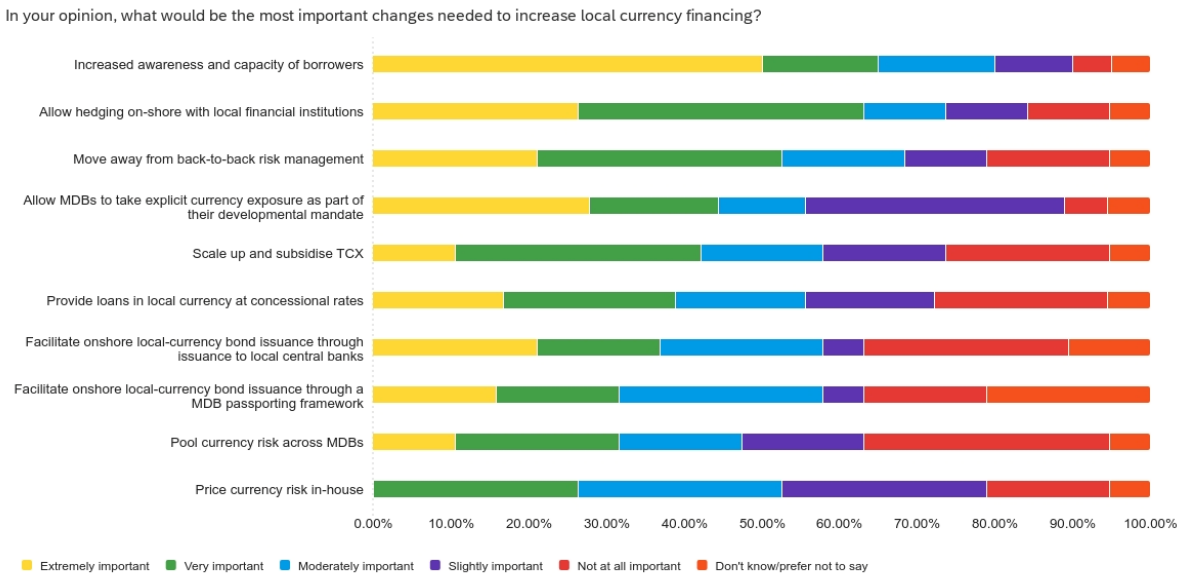
Bring local currency lending to the core of the developmental mandate of MDBs	Scale up and enhance means of hedging currency risk	Promote onshore local currency operations
Information sharing and internal capacity building Tightening of responsible lending practices Moving beyond back-to-back risk management	Scaling up TCX with donor guarantees/portfolio return guarantee (TCX; Fink, Lankes, and Sacchetto) Partial FX Hedging Mechanism (Persaud) International Currency Fund (Kapoor and others) Clean Energy Exchange Rate Coverage Facility (Benoit and others) Climate Policy Initiative Hedging Facility (Yahmed, Grant, and Pinko) India Innovation Lab Hedging Facility (Shrimali, Farooquee, and Trivedi)	Capacity building and technical assistance to develop LMIC financial infrastructure Development of MDB LC liquidity pools (Delta Initiative) Foreign exchange swaps with LMICs central banks to obtain LC
Donor capital or guarantees to mitigate risks		

3. Policy recommendations

[37] Another recent proposal of interest, though not discussed in detail here as it deals with currency risk without promoting the use of LC lending, is the Eco Invest Brazil initiative. Based on Persaud's contribution, this proposal aims to mitigate the risk of large depreciations by providing a hard-currency credit line—intermediated by the Brazilian government—through the IDB to climate-relevant projects, enabling these projects to service their foreign currency debt. Projects receive this dollar financing only if they are deemed capable of raising their prices at or above domestic inflation, ensuring stable dollar returns to the IDB. Additionally, the climate projects are encouraged to seek domestic (short-term) currency hedges or establish a sinking fund (which receives foreign currency during periods of appreciation) to hedge against regular exchange rate fluctuations. This is an interesting proposal as it acknowledges the cyclicality of LMIC exchange rates and the counter-cyclical role MDBs can play in addressing this issue. However, it has not been included in this review because it ultimately does not aim to enhance the availability of LC financing and continues to place the currency risk on borrowers. It also assumes that borrowers will be able to increase their prices above inflation—a condition that may be difficult to achieve in many cases. See further in Persaud (n 14); Yahmed, Grant, and Pinko (n 8).

Survey respondents in the report of Bonizzi and others are asked to share their perspectives on various policy areas they believed would serve to enhance LC financing. The results are presented in Figure 1.

Figure 1 Respondents views on policy areas to enhance local currency financing



Source: Authors' survey responses from B Bonizzi, A Kaltenbrunner, G Klein Martins, K Kohler, K Patrício Ferreira Lima, IW Martínez, 'Enhancing multilateral development banks' capacity through local currency financing' (October 2024), preliminary report https://business.leeds.ac.uk/download/downloads/id/535/enhancing-multilateral-development-banks-capacity-through-local-currency-financing.pdf accessed 15 October 2024.

Informed by the analysis in our report, a review of existing policy initiatives, and the integration of these results, we propose the following eleven recommendations, grouped into four key areas.

3.1. Bring local currency lending to the core of the developmental mandate of MDBs

3.1.1. Develop capacity in local currency borrowing and lending

As discussed above, a key starting point to increase LC lending in MDBs is to create awareness and capacity of LC lending in MDBs across all stages of the lending cycle. As our results show, MDBs already have existing in-house expertise to assess currency risk they can build on. A cultural shift is needed which moves away from seeing hard currency loans as the default option, but makes LC – where possible – part of the normal lending practice. Capacity-building

efforts should also involve sharing expertise and training across the MDB system—particularly between larger and smaller MDBs, which may lack advanced expertise in LC financing.

Finally, MDBs should take an active role in providing technical assistance and building capacity in LMICs. This would enhance borrowers' understanding of the advantages of LC borrowing and increase their awareness of the availability and pricing of such products. Survey results from Bonizzi and others confirm this insight, with 65% of respondents identifying the need to increase the awareness and capacity of borrowers as 'extremely' or 'very important'. While this report primarily focuses on supply-side changes to LC financing for LMIC borrowers, this result underscores the importance of addressing demand-side issues as well.

As part of these capacity-building strategies, it is important, as suggested by TCX, that MDBs develop the contractual structures of their financing arrangements to offer public and private borrowers the option to include features such as currency indexation of debt service, debt service conversion clauses, and suspension and reduction clauses.[38] In particular, it is crucial that sovereign borrowers are offered a synthetic option for their loans as standard practice, as this would significantly reduce the risk of debt distress. Incorporating these options into standard loan products would make LC financing a more central component of MDBs' product offerings.

3.1.2. Enhance the quality and availability of information on MDB local currency financing

To build capacity in LC lending and better understand current practices, successes, and limitations, there is an urgent need for enhanced availability and accessibility of information on MDB LC operations. Assessing the benefits and risks of LC lending requires more comprehensive data on existing LC operations, including both quantitative loan data for modelling and qualitative case studies that provide institutional insights for mutual learning within the MDB community and beyond.

One concrete recommendation is to increase the public availability and scope of the Global Emerging Markets (GEMs) dataset, expanding it to include more detailed information about MDB loans by currency and historical data on credit risk. This would enable thorough evaluations of the state, impact, and outcomes of MDB LC lending, specifically allowing for a more systematic analysis of the relationship between credit and currency risk. Such data would facilitate the formulation of specific policy proposals related to currency risk exposure (as further developed in section 3.4.3).

[38] TCX (n 3) 6.

Another key area of focus is the need for in-depth evaluations of existing LC initiatives—particularly those involving MDBs assuming some currency risk. Presently, limited public information is available on how MDBs address or take on currency risk. Comprehensive evaluations—whether conducted internally or by external consultants—are essential to assess the feasibility of these initiatives, identify best practices, and support broader implementation across other MDBs.

3.1.3. Reassess back-to-back risk management frameworks and stringent counterparty rules

Most MDBs operate within a back-to-back risk management framework, requiring that LC operations are fully matched by corresponding liabilities or currency hedges. This framework constraints MDBs' capacity to lend in LC due to the limited availability of funding and hedging instruments for the currencies of LMICs.

Moving beyond this restrictive framework could offer MDBs greater flexibility in LC financing. The recommendation to reassess and potentially move away from the back-to-back risk management model is strongly supported by the survey results from Bonizzi and others. Over 55% of respondents rated the shift toward more flexible approaches—such as adopting a portfolio-based risk management model—as either 'very important' or 'extremely important'. This underscores the recognition within MDBs of the need for greater flexibility in managing currency risk.

One alternative to the back-back risk management framework is the adoption of a portfolio approach to risk management, already implemented by the EBRD. This approach sets overall risk limits for various categories, such as market risk, allowing MDBs to take on a measured degree of currency risk without leading to excessive portfolio volatility. Such flexibility would significantly expand their capacity to offer LC loans. Additionally, a shift toward more flexible risk management frameworks should include a reassessment of strict counterparty risk rules, which often restrict operations with onshore entities (see also 3.3.1). Nearly 60% of our MDB respondents thought that allowing hedging onshore with domestic financial institutions (which currently often do not fulfil these counterparty restrictions), would be an important measure to facilitate increased LC lending.

Transitioning away from back-to-back financing may require statutory reforms to the Articles of Agreement of certain MDBs—particularly those provisions that require strict hedging against foreign exchange risk in their operations.

3.2. Scale up and enhance means of hedging currency risk

3.2.1. Scale up and subsidise TCX

As discussed above, a core set of current proposals focuses on the need to scale up hedging opportunities in LMIC currencies, either by bolstering the currency exchange fund TCX or by creating a new treaty-based international organisation with preferred creditor status. Risk mitigation would be achieved either through TCX's diversification approach[39] or by pooling MDB assets.[40] Tail risks could be addressed either through a donor guarantee (as proposed by TCX and by Fink, Lankes, and Sacchetto) or through IMF support (Persaud).

Our research strongly endorses the need for an entity that provides hedges where private market solutions are either unavailable or too costly. These proposals could be implemented incrementally, starting with scaling up TCX's capacity by increasing capital from shareholders and/or allowing for higher leverage ratios. Donors could also allocate a portion of their concessional financing to provide capital to TCX, which could then be used to offer portfolio risk guarantees and interest rate subsidies to reduce the costs of the hedges provided by TCX.

The survey results from Bonizzi and others strongly support this recommendation. Over 50% of respondents rated the need to scale up TCX, and to provide subsidies for its hedging products, as either 'very important' or 'extremely important'. This underscores the recognition within MDBs of the critical role TCX plays in filling the hedging gap in LMIC currencies, where private sector solutions are insufficient or unaffordable.

In contrast to the current proposals by TCX and Fink, Lankes, and Sacchetto, our research does not endorse private sector participation in TCX. As outlined in our report, involving private financial actors—who are often funded in foreign currency markets and sensitive to global funding conditions—can introduce new risks and vulnerabilities into local currency assets, which TCX should not be exposed to.

Scaling up TCX would not only enhance its diversification benefits and global presence, but it could also pave the way for its potential transformation into a more robust, treaty-based organisation with preferred creditor status. Capitalised with a mix of paid-in and callable capital, as proposed by Kapoor and others,[41] this entity could operate with a lower capital base. Its preferred creditor status would enable it to operate onshore and offer deliverable products, thus contributing to the development of domestic financial markets.

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[39] Kapoor and others (n 14).

[40] Persaud (n 14).

[41] Kapoor and others (n 14).

3.2.2. Country-specific hedging mechanisms

This international organisation could be complemented by national hedging mechanisms, as proposed by the Climate Policy Initiative Hedging Facility (Yahmed, Grant, and Pinko) and the India Innovation Lab Hedging Facility (Shrimali, Farooquee, and Trivedi). As discussed above, these proposals address the specific exchange rate risks in LMICs and intelligently leverage donor funds to provide effective, sustainable hedging opportunities for LC projects. To address implementation barriers encountered in India, we suggest the need for a further study to identify other potential pilot countries and estimate the specific exchange rate hedging thresholds necessary to ensure the mechanism's sustainability.

3.3. Promote onshore local currency operations

3.3.1. Seek onshore hedging sources, including the local central bank

MDBs primarily source FC hedges from international banks in global financial markets. This practice can increase hedging costs due to the differing balance sheet structures and risk assessments between global and local banks. Expanding the availability of onshore hedging options would enable MDBs to diversify their hedging sources and potentially lower these costs. As indicated above, more than 60% of MDB staff rated the availability of onshore hedging with local financial institutions as either 'very important' or 'extremely important,' underscoring the crucial role of local financial markets in enhancing MDBs' ability to offer LC loans.

Ongoing MDB efforts to establish local onshore platforms—such as the Delta initiative— could offer more cost-effective hedging options by partnering with local financial institutions and sustaining local liquidity pools. These efforts should be further promoted and expanded, with a focus on fostering greater collaboration across MDBs. However, as previously mentioned, this initiative is currently limited to countries with relatively developed financial systems capable of providing short-term LC products.

In countries with less developed financial markets and limited access to local financial institutions, MDBs could engage with local central banks, either individually or through joint onshore platforms. Rather than following the current common practice of engaging in swap operations, we propose that these platforms borrow or issue bonds to be purchased by local central banks. This approach would provide LC funding to MDBs, while allowing central banks to diversify their yield-seeking portfolios into high-credit-rating assets. Unlike central bank swap arrangements, these bonds would not generate foreign exchange liabilities, thereby preventing competing demands on foreign exchange reserves in the event of LC depreciation. Additionally, using a platform model—rather than having individual MDBs issue bonds directly to central banks—may help to mitigate potential political economy barriers.

The policy recommendation of facilitating MDB bond issuance to local central banks is further supported by the survey findings of Bonizzi and others. Almost 60% of respondents rated this mechanism as either 'extremely important,' 'very important,' or 'moderately important' for increasing LC financing.

However, MDBs must exercise caution when engaging with local central banks, particularly in jurisdictions where the legal framework governing derivative transactions is underdeveloped. The absence of clear regulations or comprehensive legal documentation introduces counterparty risks and regulatory uncertainty. These legal factors should be considered when designing onshore platforms to mitigate potential risks.

3.3.2. FDS Africa Portfolio Transfer Mechanism

Another way of mitigating the currency risk for onshore MDB LC financing is FSD Africa's portfolio transfer mechanism. As discussed above, whilst primarily aimed at developing local capital markets and providing safe assets to local institutional investors, this portfolio transfer mechanism could be a useful complement to, and enhance the ability of MDBs to provide LC financing by transferring the LC loans to onshore institutional investors' balance sheets (who are not exposed to the currency risk). Though we are generally critical towards the benefits of securitising MDB assets, if limited to long-term institutional investors in LMICs markets, the FSD mechanism could be an important toolkit in supporting the ecosystem of LC MDB financing.

3.3.3. Promote a harmonised transnational legal and regulatory framework for MDB operations

Operating onshore involves high transaction costs and delays for MDBs, particularly due to complex and diverse legal frameworks across different jurisdictions. To address these challenges, MDBs could collaborate to create a harmonised transnational legal and regulatory framework aimed at simplifying MDBs' onshore fundraising activities, including bond issuance and hedging operations. This framework, championed by MDBs in consultation with national governments, would standardise and align key regulatory elements, offering a streamlined approach to MDB operations across jurisdictions to increase their LC financing capability.

Such harmonisation framework could include elements such as:

a. Securities regulation

MDBs face significant hurdles in issuing LC bonds due to varying disclosure requirements, prospectus approvals, and regulatory oversight. These challenges are particularly acute in smaller or less developed markets, where regulatory structures are often primarily designed for domestic issuers. The proposed harmonised securities framework would establish a consistent approach to disclosure requirements and other criteria for the scrutiny and approval of prospectuses and marketing documentation. This would make the application processes as efficient, simplified, and streamlined as possible within the confines of applicable national laws. The European Union's Prospectus Regulation serves as a useful model, with its passporting mechanism allowing a prospectus approved in one Member State to be recognised across others without additional approvals.[42] While this proposal would preserve state-specific approval processes, it seeks to harmonise the securities regulations governing MDBs across different jurisdictions. Final approval for bond issuances would still rest with local authorities, who would retain the discretionary right to reject applications.

The survey results of Bonizzi and others support the introduction of a harmonised cross-border securities framework for MDBs, with nearly 60% of respondents rating the proposal as 'extremely important', 'very important', or 'moderately important'. This suggests a recognition of the need for streamlined processes to address the regulatory hurdles that currently limit MDBs' ability to issue local currency bonds across multiple jurisdictions.

The framework could establish a shelf registration system specifically tailored for MDBs, allowing the use of short-form prospectuses that incorporate by reference information already filed with the securities regulator. Additionally, it could harmonise the criteria for the credit rating treatment of MDB bonds, enabling the recognition of international ratings for MDB issuers.

An additional benefit of such a ring-fenced harmonised framework for MDB bond issuances is that, in countries with less developed financial markets, the framework could function as a regulatory sandbox. Local authorities could use it to enhance their capacity for developing local debt markets, with the potential to later adapt the rules and practices to other types of issuers.

An accessible first step towards harmonising securities regulations could be the introduction of exemptions specific to MDBs. For instance, under the US Securities Act, non-domestic issuers must comply with registration requirements, and under the Exchange Act, they are subject to reporting obligations.[43] These requirements present a significant regulatory hurdle. However,

[42] Article 25 of Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market [2017] OJ L168/12.

[43] Securities Act of 1933, 17 CFR § 230.77f; Securities Exchange Act of 1934, 17 CFR §§ 240.13a-1, 240.15d-1.

certain US-supported MDBs benefit from exemptions from these requirements, as established in the enabling legislation for each institution.[44]

b. Local derivatives law

Hedging currency risk is essential for MDBs engaged in LC financing, particularly in jurisdictions where local financial markets lack depth. Onshore hedging mechanisms, such as swaps and forwards, play a crucial role in managing exchange rate volatility; however, these instruments are often constrained by legal frameworks or regulatory barriers.

Whilst MDBs have a history of working with local authorities to promote the development of local derivatives markets, a harmonised framework for such efforts could help build capacity across MDBs and local governments, yielding more effective results than if they worked in isolation.

A framework of this type could facilitate legal reforms to ensure the enforceability of key instruments, such as non-deliverable forwards (NDFs) and cross-currency swaps. In cases where concerns about financial stability arise, the framework could restrict eligibility for engaging in derivative transactions to MDBs, excluding other entities from such activities. By authorising MDBs as eligible counterparties for currency hedging onshore, these reforms would enable them to manage currency risk more effectively and provide expanded LC financing options.

c. Capital requirements

MDB bonds often receive unfavourable treatment under local capital requirement regulations, which typically classify them as higher risk than local government bonds. To address this issue, the harmonised regulatory framework should establish clear and consistent guidelines on the risk weightings for locally issued MDB bonds, ensuring that these securities receive treatment that recognises the strong credit ratings of these institutions.

Additionally, the proposed framework could include prudential regulation provisions that allow institutional investors greater flexibility to invest in MDB bonds. By aligning such regulations to support more diversified portfolios, local investors would be able to invest more actively in MDB bonds, which are some of the highest-quality securities in the market.

[44] P Dudek, 'Regulation of Offerings by International Financial Institutions under the U.S. Federal Securities Laws' in C Smith, X Gao, and T Dollmaier (eds), *Funding International Development Organizations* (Brill 2023) 80, 93.

d. Repo eligibility

In order to promote LC bond markets, the framework could include provisions to ensure that MDB-issued bonds qualify as collateral in repurchase (repo) transactions with local central banks. Repo eligibility is a key mechanism for injecting liquidity into financial markets, and the inclusion of MDB bonds as eligible collateral in these transactions would incentivise local banks and other financial institutions to invest in these instruments.

e. Taxation

To enhance the attractiveness of MDB bonds to local investors, the framework could include provisions ensuring the tax neutrality of such bonds. It could align the tax treatment of MDB bonds with that of government debt, eliminating withholding taxes or VAT that disincentivise investment in MDB-issued securities.

3.4. Tackling the pricing problem directly

As highlighted above, whilst addressing the problem of lacking – or somewhat too expensive – hedging markets, existing proposals either do not, or rely on external capital to address the fundamental pricing problems. The core of the high LC lending rates is the very large interest rate differential that exists between hard and local currencies.

3.4.1. Reflect lower credit risk of local currency debt

LC debt carries lower credit risk for comparable LMIC borrowers, primarily due to the absence of currency mismatches that could otherwise lead to defaults in the event of significant depreciations. Furthermore, LC loans can improve risk-weighted capital ratios compared to FC loans, as their value decreases in the event of currency depreciation. This lower credit risk should be fully reflected in the pricing of LC loans, resulting in lower credit spreads and, consequently, reduced lending rates.

Achieving this will require active engagement with credit rating agencies (CRAs), as their current methodologies do not fully reflect the lower credit risk of LC debt. Without such engagement, this misalignment may hinder MDBs' ability to lower credit spreads. Our recommendation is to encourage CRAs to assess LC debt in MDB differently, and in particular to reduce the risk weights of LC debt.

Finally, as pointed out in proposal 3.1.2, a more comprehensive analysis of the relationship between credit and currency risk could help to further refine these proposals and initiatives. Greater availability of data, particularly through the dissemination of more granular information to the GEM database, is fundamental to facilitate this analysis.

3.4.2. Provide financing in local currency at concessional rates

Some MDBs offer loans at highly concessional rates, with no or very low interest charges, based on criteria such as the recipient countries' risk of debt distress, level of GNI per capita, and creditworthiness. However, regarding the International Development Association (IDA)'s financing terms, these highly concessional rates currently apply only to loans in hard currency. This makes LC loans less attractive to borrowers, given the significant interest rate spread between the highly concessional rates in hard currency and the typically higher interest rates of LC loans. It is crucial that the concessional financing arms of MDBs ensure that their concessional capital is used to support LC financing at more attractive rates, which help reduce this spread—particularly in their lending and guarantee operations, given the vulnerable financial position of recipient countries.

The survey results support of Bonizzi and others this recommendation, with over 55% of respondents rating the need to offer LC financing at concessional rates as either 'very important', 'extremely important' or 'moderately important'. This indicates a solid backing for extending concessional terms to LC loans, recognising the developmental benefits of making LC financing more affordable.

3.4.3. Take on some currency risk in lending and guarantee transactions

MDBs must exercise prudence in protecting their capital and maintaining high credit ratings, but this must be balanced against their developmental mandate. Current legal and institutional frameworks generally restrict MDBs to assuming currency risk only in their equity investments. However, assuming limited currency risk in their lending and guarantee transactions could greatly enhance access to sustainable finance for vulnerable LMICs. In the absence of external donor-supported mitigation, permitting some degree of currency risk exposure is the most direct way to lower borrowing costs.

The survey results from Bonizzi and others support this recommendation, with around 55% of respondents rating the policy proposal of allowing MDBs to take on currency risk as either 'very important,' 'extremely important,' or 'moderately important'. This reflects institutional recognition that, while prudent risk management is essential, taking on controlled currency risk could significantly expand MDBs' capacity to offer affordable LC financing. Crucially, this policy would rely on careful in-house modelling and pricing of exchange rate risk—a reform recognised by more than half of survey respondents in the report of Bonizzi and others as either 'very important' or 'moderately important'.

For LC loans, currency risk in these settings may be less severe than typically assumed, with unhedged exposure to LMIC currencies yielding positive returns, especially in LICs. Nevertheless, tail risk events remain a concern, which necessitates provisions for potential losses. Currency exposure should thus be reserved for projects with the most significant developmental impact in the most vulnerable economies. Additionally, the benefits of LC loans—in terms of lower risk-weighted capital ratios—hold even in cases of partial hedging. By taking on some currency risk, MDBs could enhance their developmental impact while maintaining financial stability.

Guarantees also have the potential for enhancing LC financing capacity of MDBs, which may be currently underappreciated, particularly if they assume some currency risk. MDB guarantees are especially effective when local lenders have a funding advantage in LC but face credit exposure constraints. In such cases, MDBs can support LC lending by local lenders. The potential of guarantees in the context of unhedged currency exposure relies on the offsetting relationship between credit and currency risks. During a macroeconomic crisis, when defaults increase and more guarantees are called, local currencies typically depreciate. This depreciation lowers the cost for the guarantor, as the value of the guarantee in foreign currency terms decreases. While this mechanism works under normal conditions, extreme depreciation poses a risk—if it triggers widespread defaults, MDBs would face substantial demands to fulfil guarantees.

Although we consider taking on some currency risk to be feasible and consistent with the developmental mandate of MDBs, we also recognise the additional risks and potential consumption of risk capital that this could entail, particularly if such initiatives are scaled up. To address these limitations—especially in the presence of significant tail risks—we propose two potential mechanisms.

a. Fund structure

The first option involves creating a fund structure established by MDBs, designed with a ring-fenced, off-balance sheet model specifically for delivering unhedged LC financing. Similar to TCX, this fund would assume the currency risk associated with MDBs' LC loans. However, unlike TCX, it would also assume credit risk. By not explicitly providing hedging services to MDBs, this structure could lower the cost of financing LC loans, enabling MDBs to offer more competitive borrowing rates in LMICs. Importantly, while the loan rates could be lower than those of fully hedged loans, the fund's sustainability would depend on carefully modelling and pricing exchange rate risk

The fund could be structured as either:

- Single MDB-based fund: The fund could be hosted by a specific MDB, akin to the EIB's ACP Facility. This option would likely require external funding for initial capitalisation, potentially from donors. Once capitalised, the fund would provide unhedged LC financing to LMIC borrowers.

- Joint MDB fund: Alternatively, the fund could be jointly financed by several MDBs. Although survey respondents of the report by Bonizzi and others expressed mixed views on whether MDBs should pool currency risk, the diversification benefits of such a structure could significantly reduce idiosyncratic currency risks, effectively acting as a partial hedge against exchange rate fluctuations. This approach aligns with the current G20 Brazilian Presidency's roadmap for reforming MDBs to work together as a system to achieve scale and effectiveness.[45]

Regardless of the structure, the fund would likely require strong funding for initial capitalisation, , given that it will be fully exposed to currency risk without relying on third-party risk mitigation. This recommendation is based on the result that – on average and over some horizon – LMICs excess returns are positive even taking account of potential tail risks.

b. SDR-based risk-sharing scheme against extreme depreciation

To further unlock the potential of LC loans and guarantees, MDBs need a backstop for extreme depreciations. Donor resources could support unhedged LC loans and guarantees through an external entity offering a partial exchange rate risk guarantee, covering losses from extreme currency depreciation, provided MDBs take on some currency risk. For loans, this could replicate the India Innovation Lab Hedging Facility (Shrimali, Farooquee, and Trivedi) proposal, where losses exceeding a certain depreciation threshold (4.5% in their proposal) are covered. Within that threshold, upside and downside currency risks are borne by the MDBs themselves. While backed by donor capital, this facility could become financially sustainable if MDBs pay fees proportional to gains from currency appreciation.

For MDB-provided guarantees, the entity would cover losses arising from systemic events where significant LC depreciation leads to widespread defaults. In order to achieve this, the guarantee could be set to cover losses on MDBs' guarantees portfolio exceeding a certain threshold, combined with a context of significant LC depreciation. In exchange, MDBs would pay a fixed fee—set lower than the fees earned on credit guarantees extended to local lenders—to the guaranteeing entity.

Given the political sensitivities surrounding donor resource pooling, a trust structure funded by rechannelled SDRs could support the guaranteeing entity. Drawing from the IMF's experience with the Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust

[45] G20 Brazil, 'Minister Haddad Announces the Creation of a G20 Roadmap for Multilateral Bank Reforms' (G20, 18 April 2024) https://www.g20.org/en/news/minister-haddad-announces-the-creation-of-a-g20-roadmap-for-multilateral-bank-reforms accessed 14 October 2024.

(RST), this trust would align with the IMF's mandate to promote international monetary cooperation and exchange rate stability.[46]

The trust would function as a counter-guarantor, covering only tail risk. . Standard currency risk would be borne by the MDBs, modelled appropriately, and incorporated into their pricing structures. In cases where MDBs benefit from currency appreciation, provisions could allow compensation to the trust fund. The impact of these transactions on the trust's resources would fluctuate, and while resource depletion may not always occur, external donor funding would be needed to provide a financial buffer and ensure the trust's long-term viability.

SDRs held within the trust would represent liabilities, requiring either interest payments by MDBs at the SDR rate or donor contributions to support concessional financing.[47] In non-concessional financing, the spread earned by MDBs would likely exceed the SDR interest rate, ensuring financial sustainability at the transactional level.

SDRs have a unique potential to mitigate currency risk because their value is based on the IMF's basket of currencies (the US dollar, euro, Chinese renminbi, Japanese yen, and British pound sterling). Even if one currency depreciates, the overall value of SDRs tends to remain stable, offering a reliable benchmark for mitigating currency risk. This lowers the likelihood of sharp losses that could occur if a guarantee were denominated in a single currency.

A legal question arises as to whether this structure would conflict with the domestic legal frameworks of potential donor countries. Given the current relevance of this discussion,[48] it will be explored in more detail in the appendix.

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[46] Articles of Agreement of the International Monetary Fund (adopted 22 July 1944, entered into force 27 December 1945) 2 UNTS 39, Art 1(i) and (iii).

[47] See further on T Pforr, F Pape, and S Murau, 'Bretton Woods, Brussels, and Basel: European Cross-Border Finance and the Rebirth of the Global Monetary System after the 1960s' (INET Working Paper No 180, February 2022) https://www.ineteconomics.org/uploads/papers/WP_180-Murau-et-al.pdf accessed 10 October 2024.

[48] See, e.g., K Berensmann and others, 'How to Make the World Bank and IMF Support Global Public Goods' (IDOS Policy Brief, 2024) https://www.idos-research.de/fileadmin/user_upload/pdfs/publikationen/Policy_Brief/2024/PB_30.2024.pdf accessed 10 October 2024; S Paduano, 'SDR Rechanneling and ECB Rules: Options for Africa and Beyond' (FinDevLab, May 2023) https://findevlab.org/wp-content/uploads/2023/05/FDL_SDR-Rechanneling-and-ECB-Rules.pdf accessed 10 October 2024.

Appendix: Legal Considerations of SDR-Funded Partial FX Guarantee

One of the policy recommendations made in the paper relates to an innovative trust structure funded by rechannelled Special Drawing Rights (SDRs). This structure would function as partial foreign exchange risk guarantee, covering losses from extreme currency depreciation, provided MDBs take on some currency risk in their lending and guaranteeing transactions.

The potential rechannelling of SDRs through multilateral development banks (MDBs) is currently at the centre of policy discussions.[1] Notably, the AfDB and Inter-American Development Bank (IDB) have proposed a mechanism by which countries could lend SDRs to MDBs in the form of hybrid capital.[2] In May 2024, the IMF Executive Board authorised IMF members to use SDRs to purchase hybrid capital instruments issued by prescribed holders, including MDBs, up to a cumulative limit of SDR 15 billion, with IMF members allocating SDRs through capital contributions expected to have Voluntary Trading Agreements (VTAs) in place to ensure sufficient liquidity.[3]

Regarding European Union law, concerns have been raised about whether channelling SDRs to MDBs to support their lending operations might breach Article 123 of the Treaty on the Functioning of the European Union (TFEU), which prohibits monetary financing.[4] While the legal status of this issue remains uncertain, it is crucial to distinguish the nature of the legal arrangement proposed in the paper. Foreign exchange guarantees are not strictly a form of

[1] See, e.g., K Berensmann and others, 'How to Make the World Bank and IMF Support Global Public Goods' (IDOS Policy Brief, 2024) https://www.idos-research.de/fileadmin/user_upload/pdfs/publikationen/Policy_Brief/2024/PB_30.2024.pdf accessed 10 October 2024; S Paduano, 'SDR Rechanneling and ECB Rules: Options for Africa and Beyond' (FinDevLab, May 2023) https://findevlab.org/wp-content/uploads/2023/05/FDL_SDR-Rechanneling-and-ECB-Rules.pdf accessed 10 October 2024.

[2] International Monetary Fund, 'Use of SDRs in the Acquisition of Hybrid Capital Instruments of the Prescribed Holders' (IMF Policy Paper No 2024/026, 15 May 2024) https://www.imf.org/en/Publications/Policy-Papers/Issues/2024/05/15/Use-of-SDRs-in-the-Acquisition-of-Hybrid-Capital-Instruments-of-the-Prescribed-Holders-549003 accessed 10 October 2024.

[3] International Monetary Fund, 'IMF Executive Board Approves Use of SDRs in the Acquisition of Hybrid Capital Instruments Issued by Prescribed Holders' (IMF, 14 May 2024) https://www.imf.org/en/News/Articles/2024/05/14/pr24162-imf-exec-board-approves-sdr-acq-hybrid-capital-instr-issued-prescribed-holders accessed 10 October 2024.

[4] C Lagarde, 'Speech at the Forty-Fourth Meeting of the International Monetary and Financial Committee' (IMF Annual Meetings, 16 November 2021) https://www.bis.org/review/r211116g.htm accessed 10 October 2024. See also International Monetary Fund (n 2).

financing, as they do not involve the direct provision of capital, loans, or credit facilities to beneficiaries. Instead, they serve as risk mitigation tools, protecting the borrower or lender from currency depreciation and reducing financial exposure without extending liquidity or funding. As such, a foreign exchange guarantee does not transfer capital but shifts specific risks—related to currency fluctuations—from the borrower or lender to the guarantor. In line with Article 123's prohibitions, a foreign exchange guarantee provided in SDRs would not constitute a breach because it does not involve the creation of money or credit facilities. Instead, it provides assurance against exchange rate volatility, functioning as an indirect support mechanism for financial transactions rather than a direct form of funding.

It is worth noting that the European Central Bank (ECB) already maintains an agreement with the European Investment Bank (EIB) that allows the EIB to repo ECB-eligible collateral, enhancing the EIB's operational liquidity resilience.[5] This arrangement allows the EIB to quickly convert high-quality assets into cash, ensuring it can meet its short-term liquidity needs, particularly during periods of market stress. Essentially, this is a liquidity management tool that helps the EIB mitigate risks associated with temporary funding shortfalls. A FX guarantee functions as a similar risk mitigation tool, though it focuses on managing exchange rate risk rather than liquidity risk. In both cases—repo collateral arrangements and FX guarantees—the institution is shielded from adverse market conditions by having mechanisms to offset potential losses.

[5] European Investment Bank, *Financial Report 2021* (EIB 2022) 30. See Paduano (n 1).

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