Enhancing Multilateral Development Banks' Capacity through Local Currency Financing

Policy Briefing

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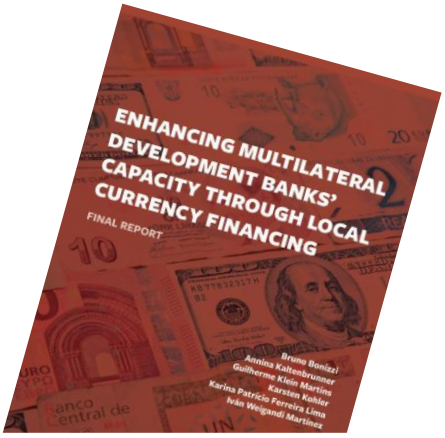

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Introduction

Scaling up financing for development is crucial to achieving the 2030 Agenda for Sustainable Development.[1] The financing gap to meet the Sustainable Development Goals (SDGs) in low- and middle-income countries (LMICs) is estimated at USD 4 trillion annually.[2] Bridging this gap requires a concerted effort to mobilise both public and private financial resources, with multilateral development banks (MDBs) positioned to play a critical role.[3] Recently, policy discussions have explored strategies to strengthen MDBs' financing capacity, including blended finance,[4] reforms to capital adequacy frameworks,[5] and the rechanneling of Special Drawing Rights (SDRs) to MDBs for use as hybrid capital.[6]

While scaling up finance is essential, these initiatives alone are insufficient to ensure debt sustainability. According to the United Nations, the number of countries facing high debt levels surged from 22 in 2011 to 59 in 2022.[7] Currently, 60% of low-income countries (LICs) are at high risk of—or already in—debt

[1] UN General Assembly, 'Transforming Our World: The 2030 Agenda for Sustainable Development' (21 October 2015) UN Doc A/RES/70/1.
[2] United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2023* (United Nations, 2023) xv.
[3] United Nations Inter-Agency Task Force on Financing for Development, *Financing for Sustainable Development Report 2022* (United Nations, 2022).
[4] World Bank, *From Billions to Trillions: MDB Contributions to Financing for Development* (World Bank Group 2015).
[5] Capital Adequacy Frameworks Panel, *Boosting MDBs' Investing Capacity: An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks* (2022).
[6] 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).
[7] United Nations Global Crisis Response Group and Regional Commissions (ECA, ECE, ECLAC, ESCAP, ESCWA), *A World of Debt: A Growing Burden to Global Prosperity* (UN July 2023) 6.

distress.[8] More broadly, LMICs' capacity to service external debt has worsened, with external public debt to exports rising from 71% in 2010 to 112% in 2021.[9] As a result, interest payments in many LMICs have outpaced public spending on health, education, and investment, with 3.3 billion people now living in countries that spend more on interest than on health or education.[10]

A key factor contributing to these vulnerabilities is the currency denomination of debt, with roughly half of public debt in LMICs denominated in foreign currency (FC).[11] This renders LMICs vulnerable to currency depreciation, which can significantly increase debt servicing costs. Despite these risks, MDBs continue to predominantly lend in FC, exposing LMICs to exchange rate risk and further heightening default risks.

Local currency (LC) financing could mitigate these vulnerabilities by reducing currency mismatches on LMIC balance sheets and lowering the need for FC repayments in countries often grappling with balance of payments constraints. For LMICs with access to LC financing, MDB participation could extend borrowing maturities and provide collateral benefits, such as fostering the development of local capital markets. For projects generating LC revenue—such as infrastructure or renewable energy—LC financing is particularly well-suited.

Recognising these advantages, the UN has recently called for MDBs to improve their lending terms, particularly by expanding LC financing options and offering longer maturities to provide LMICs with greater fiscal space.[12] The World Bank has also acknowledged the importance of expanding LC financing as part of its *Evolution Roadmap* implementation process.[13] However, despite these policy developments over the last months, systematic analysis of MDB LC financing remains limited.[14] Concrete policy solutions to enhance MDBs' capacity to provide LC financing are still underdeveloped.

Our report *Enhancing Multilateral Development Banks' Capacity through Local Currency Financing* seeks to address this gap by providing a comprehensive overview of MDBs' existing LC financing practices, the challenges they face, and the associated risks. It offers an in-depth examination of legal and regulatory constraints, as well as the financial risks—such as exchange rate and credit risks—that affect MDBs' capacity to lend in LC. The report concludes with a set of policy recommendations aimed at enhancing MDBs' capacity to engage in LC financing.

Report outline

Chapter 1 provides a review of the existing literature on MDBs' LC financing and establishes the foundation for this study by detailing its justification, methodology, and scope. Our research employs a mixed-method approach, combining secondary data analysis, legal analysis, and primary data collection via semi-structured interviews and a survey of MDB representatives. Our sample comprises 29 MDBs, collectively holding over USD 2.2 trillion in assets and USD 620 billion in capital,

[8] World Bank, *International Debt Report 2023* (World Bank Group, 2023) xvii.
[9] ibid 8.
[10] ibid 14.
[11] S Arslanalp and T Tsuda, 'Tracking Global Demand for Emerging Market Sovereign Debt' (2014) IMF Working Paper No 14/39.
[12] United Nations, *Financing for Sustainable Development Report 2024* (UN 2024).
[13] World Bank Group and International Monetary Fund Development Committee, 'From Vision to Impact: Implementing the World Bank Group Evolution' (March 2024) 7.
[14] A key exception to this gap is provided by 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).

representing approximately 10% of the asset size of Public Development Banks globally.[15]

Chapter 2 offers a comprehensive overview of the various LC financing instruments currently utilised by MDBs, including grants, loans, guarantees, and equity investments. It shows that while many MDBs have established frameworks for LC financing, the scale of these operations remains limited relative to FC lending and is primarily concentrated in the private sector (e.g. infrastructure and energy) in middle-income countries with more developed financial markets. Based on the interviews and survey with MDBs, the chapter further highlights that the main barriers to offering more LC loans are the limited availability and high cost of tools to hedge currency risk, as well as a lack of familiarity or expertise with LC financing.

To prevent currency exposure, MDBs typically enforce strict risk management frameworks that require full hedging. This is often achieved through back-to-back arrangements, where LC lending is matched with equivalent liabilities in both currency and maturity, commonly using derivatives or issuing LC liabilities. Where hedging instruments are available, their high cost—largely reflecting the existing differential between MDBs' funding currency, predominantly the US dollar, and LC rates—makes LC loans unattractive to borrowers. This pricing problem is a major deterrent for LMIC borrowers, especially sovereign borrowers who often opt for cheaper concessional FC loans despite their significant currency risks. The chapter concludes by exploring cases where MDBs have sought to address this pricing issue by assuming a measured degree of currency risk, thus improving the affordability of LC loans for borrowers.

Chapter 3 examines the legal and regulatory challenges that constrain MDBs' ability to expand LC financing. It shows that statutory and non-statutory provisions within MDBs often limit LC financing by imposing strict hedging requirements to mitigate foreign exchange risk. At the domestic level in LMICs, challenges such as cumbersome or uncertain capital markets laws, underdeveloped settlement systems, and regulatory misalignments with MDB operations increase the cost and complexity of LC financing. Additional barriers include the lack of repo eligibility for MDB-issued bonds, which reduces their appeal to local banks, and adverse tax treatment in comparison to government securities. The chapter underscores the need for targeted reforms to both MDB policies and domestic legal frameworks to enhance LC financing.

Chapter 4 delves into the exchange rate risks associated with LC financing. It demonstrates that, while unhedged LC lending across LMICs may yield positive excess returns, these loans are vulnerable to periods of sharp depreciation, especially during global economic instability. The chapter identifies global commodity prices as a crucial predictor of these depreciation events, with the effects being particularly pronounced in LMICs that have a high presence of non-bank financial investors in domestic bond markets. This analysis underscores the need for patient, long-term LC financing by MDBs even in LMICs with relatively developed domestic markets.

Chapter 5 examines the role of credit risk in LC lending and its interaction with exchange rate dynamics, with implications for MDBs' capital adequacy. Using data from credit rating agencies and sovereign default databases, the chapter demonstrates that LC debt generally carries a lower credit risk than FC debt due to the elimination of currency mismatches for

[15] DFI Database, 'Development Finance Institutions Database', Peking University.

domestic borrowers, which reduces default risk in the event of currency depreciation. However, the chapter also addresses how credit rating agencies often overlook this distinction, frequently assigning similar risk profiles to both LC and FC debt, thereby underestimating the lower risk profile of LC lending. Based on a detailed analysis of existing credit rating agencies' methodologies to assess MDBs, the chapter shows that the evaluation of capital adequacy ratios currently pays little attention to the currency denomination of MDBs' lending. It argues that, at least in the short-term, increased LC lending would have little impact on MDBs' credit rating.

The chapter further analyses the interdependence between currency and credit risk, illustrating how LC lending can support MDBs' capital adequacy by minimising exposure to currency risk. In cases of credit downgrades accompanied by currency depreciation, the dollar value of MDBs' exposure to LC assets decreases, thereby reducing the required risk capital. This dynamic provides MDBs with a potential buffer in managing balance sheet risks more sustainably. The chapter concludes by underscoring the need for more granular data on MDB loans to better assess the benefits of LC lending on credit risk, thereby enabling a more comprehensive evaluation of how LC financing could positively influence MDBs' capital adequacy.

Finally, **Chapter 6** builds on the preceding chapters to propose a set of policy recommendations aimed at strengthening MDBs' capacity to offer LC financing in LMICs. Rather than advocating a one-size-fits-all solution, it offers a wide range of initiatives—some scalable and others more specific—that together could create an ecosystem for increasing LC lending to LMICs.

Policy recommendations

Our policy recommendations are structured into four key areas:

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

1.1. Develop capacity in local currency borrowing and lending

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 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. Our survey results 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.[16] 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.

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 4.3).

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.

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.[17] 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. 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,

[16] 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) 6.

[17] These aspects are further discussed in Chapters 2 and 3 of our report.

already implemented by the European Bank for Reconstruction and Development (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 by seeking a wider array of (shorter tenor) hedging instruments and engaging in maturity risk transformation. The ability to engage in maturity risk transformation and fund at shorter tenors might also improve the pricing of LC loans, as it allows MDBs to avoid paying the steep term funding premium.

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 3.1). 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.[18]

2. Scale up and enhance means of hedging currency risk

2.1. Scale up and subsidise TCX

A core set of current proposals in the policy sphere 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[19] or by pooling MDB assets.[20] Tail risks could be addressed either through a donor guarantee[21] or through IMF support.[22]

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.

Our survey results 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.

[18] See further in Chapter 3 of our report.

[19] S Kapoor, H Hirschhofer, D Kapoor, and N Klieterp, 'A Multilateral Solution to Hedging Currency Risk in Developing Country Finance' (Nordic Institute for Finance, Technology and Sustainability, 2021).

[20] A Persaud, *Unblocking the Green Transformation in Developing Countries with a Partial Foreign Exchange Guarantee* (2023).

[21] See, eg, Fink, Lankes, and Sacchetto (n 14) and TCX (n 16).

[22] Persaud (n 20).

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,[23] 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.

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. Promote onshore local currency operations

3.1. Seek and develop onshore hedging sources

MDBs primarily source FC hedges from international banks in global financial markets.[24] 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. Accessing onshore hedging would allow for more effective maturity risk transformation and lending at—frequently more affordable—local rates. 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

[23] Kapoor, Hirschhofer, Kapoor, and Klieterp (n 19).

[24] See further in Chapter 2 of our report.

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 our survey findings. 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.[25] 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.

3.2. FDS Africa Portfolio Transfer Mechanism

Another way of mitigating the currency risk for onshore MDB LC financing is FSD Africa's portfolio transfer mechanism, which aims to involve local market actors in absorbing some of the exchange rate risk faced by MDBs.[26] Whilst its primary objective is to develop local capital markets and provide safe assets to local institutional investors, this mechanism could serve as a valuable complement to MDBs' efforts to enhance LC financing. By transferring LC loans to the balance sheets of onshore institutional investors who are not exposed to currency risk, the mechanism can strengthen MDBs' capacity to offer such financing. Although we are generally cautious about the benefits of securitising MDB assets, when applied selectively to long-term institutional investors in LMIC markets, the FSD mechanism could become a significant tool in supporting the ecosystem for local currency financing by MDBs.

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.[27] 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

[25] See further in Chapter 3 of our report.

[26] E Osano and others, *A Local Currency Solution for Multilateral Development Bank Portfolio Transfer* (FSD Africa 2024).

[27] See further in Chapter 3 of our report.

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.[28] 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 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.[29] These requirements present a significant regulatory hurdle. However, certain US-supported MDBs benefit from exemptions from these requirements, as established in the enabling legislation for each institution.[30]

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

[28] 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.

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

[30] 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.

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.

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.

4. Address 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 this key pricing problem.[31] The core of the high LC lending rates is the very large interest rate differential that exists between hard and local currencies.

[31] See further in Chapter 2 of our report.

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.[32] Furthermore, as our research has found, LC loans can improve risk-weighted capital ratios compared to FC loans, as their value decreases in the event of currency depreciation.[33] This lower credit risk should be fully reflected in the pricing of LC loans, resulting in lower credit spreads and, consequently, reduced lending rates. Such reduced lending rates could be further supported by first-loss donor credit guarantees explicitly directed at local currency loans, such as in the EBRD SME Local Currency Programme.[34]

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 1.2 above, 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.

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, these highly concessional rates may currently apply only to loans in hard currency.[35] 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 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.

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

[32] See further in Chapters 2 and 5 of our report.
[33] See further in Chapter 5 of our report.
[34] EBRD, 'SME Local Currency Programme' https://shorturl.at/gfTOI accessed 4 January 2025.

[35] This issue is discussed in Chapters 2 and 3 of our report in relation to the International Development Association (IDA)'s financing terms.

equity investments.[36] 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 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 as either 'very important' or 'moderately important'.

For LC loans, our analysis indicates that currency risk in these settings may be less severe than typically assumed, with unhedged exposure to LMIC currencies yielding positive returns, especially in LICs.[37] 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, as our research shows, the benefits of LC loans—in terms of lower risk-weighted capital ratios—hold even in cases of partial hedging.[38] 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. According to our research findings, MDB guarantees are especially effective when local lenders have a funding advantage in LC but face credit exposure constraints.[39] 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

[36] See further in Chapter 3 of our report.
[37] See further in Chapter 4 of our report.
[38] See further in Chapter 5 of our report.
[39] See further in Chapter 3 of our report.

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 our survey respondents 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.[40]

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 our research findings that—on average and over some horizon—LMICs excess returns are positive even taking account of potential tail risks.[41]

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 proposal, where losses exceeding a certain depreciation threshold (4.5% in their proposal) are covered.[42] 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

[40] G20 Brazil, 'Minister Haddad Announces the Creation of a G20 Roadmap for Multilateral Bank Reforms' (G20, 18 April 2024).

[41] See further in Chapter 4 of our report.

[42] G Shrimali, AA Farooquee, and S Trivedi, *FX Hedging Facility* (Climate Policy Initiative, 25 September 2015).

the guaranteeing entity.[43] Drawing from the IMF's experience with the Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust (RST), this trust would align with the IMF's mandate to promote international monetary cooperation and exchange rate stability.[44]

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.[45] 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.

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[43] 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, it is explored in Appendix C of our report.

[44] 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).

[45] 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).