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Facilitating local capital market development through swap counterparty support¹



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Summary

This article proposes a portfolio insurance approach to help Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs) manage currency risk. The approach facilitates warranted MDB/DFI local currency (LCY) lending and contributes to local capital market development. As they manage currency risk actively, MDBs and DFIs strengthen local financial institutions by enhancing their capabilities to deal with complex financial instruments. This capacity-building benefit gives our proposal extremely high development impact potential.

Currency risk and development finance

MDBs and DFIs operate across borders and lend to the private sector. Many private-sector projects have LCY revenues, so financing such projects in United States dollars (USD) introduces unwarranted currency risk that can threaten the viability of the project. For example, an MDB or a DFI lending USD to a project that generates LCY revenues in a country the LCY of which devalues sharply may witness currency risk morph into credit risk when the project cannot make USD payments. Therefore, a currency mismatch is negative for both the borrower and the lender. In particular, if the MDB or the DFI financed projects with currency mismatches at scale, it would face significant losses that would inhibit its ability to meet financial targets and attract new capital, resulting in developmental opportunity costs for its owners, beneficiaries and potential beneficiaries. (Bekaert and Hodrick 2017)

Thus, MDBs and DFIs do not carry market risks, such as currency risk and interest-rate risk. They manage currency risk using cross-currency interest-rate swaps, forward contracts, and LCY borrowings to ensure long-term development outcomes. However, MDBs and DFIs tend not to have local swap counterparties (SCs) in emerging markets because local institutions do not usually meet MDBs' or DFIs' SC criteria. As a consequence, MDBs and DFIs face

difficulties with extending warranted LCY loans.

While alternatives to cross-currency interest-rate swaps exist, such as borrowing locally and managing LCY treasury pools, swap markets offer unrivaled flexibility and speed. Since MDBs and DFIs play important roles in fostering private sector-driven economic growth and sustainable development, the ability to manage currency risk is vital to the ability to make investments that maximize both single project viability and long-term development impact.

Hence, facilitating the emergence of local SCs — and in the process, promoting warranted LCY lending, transferring financial knowledge, and developing local capital markets — is an activity that has exceptionally high development impact.

This article proposes a practical solution to the LCY financing challenge through a portfolio insurance approach that ought to address MDBs' and DFIs' credit concerns. The approach suggests a collaborative effort among MDBs/DFIs, insurance providers (IPs), and SCs.

A portfolio insurance approach to swap counterparty establishment

As this article aims to outline a portfolio insurance approach, only the basic transactional mechanics are described.

The basic steps are the following:

1. Needing LCY to lend to a local borrower, the MDB/DFI transacts a USD/LCY swap with the SC. In the initial notional exchange, the MDB/DFI delivers USD and receives LCY.
2. Having sourced LCY, the MDB/DFI passes the LCY onto its borrower, extending a warranted LCY loan.
3. Having sourced USD, the SC lends the USD to local institutions. It ringfences the USD loan portfolio, which meets the MDBs/DFIs' credit requirements,

to protect the MDBs/DFIs' credit exposure.

4. The IP offers portfolio insurance on the ring-fenced exposure, helping the SC become acceptable to the MDB/DFI.

Figure 1 shows the basic steps at the time of LCY loan extension.

Figure 2 shows the basic steps during the LCY loan repayment.

By necessity, the basic steps in the above example gloss over numerous details. For example, it is not necessary to use the USD notional amount to create a new USD loan portfolio and doing so is likely to be a lengthy process. It suffices for the SC to create a USD loan portfolio that meets MDB/DFI credit requirements from existing loans. Having clear requirements is important because, since loans with varying maturities will be backstopping a swap with a fixed maturity, loans will have to exit and enter the portfolio.

Regarding the last point above, it is possible for the USD loan portfolio to protect MDB/DFI credit exposure resulting from several swap transactions. In fact, a USD loan portfolio may protect a single-country, a regional, a continental, or a global swap book.

Because a swap is fundamentally different from parallel loans, there can be no MDB/DFI requirements on the use of the USD notional amount. When they transact swaps with highly-rated SCs, MDBs/DFIs do not impose requirements on notional amounts the way they impose requirements on their loans. Similarly, because the USD loan portfolio serves solely as collateral, the IP can have only credit quality requirements on it. In this structure, the IP offers portfolio insurance in order to help develop local capital markets and promote LCY lending.

The generic SC may be thought of as a local bank. A local bank has an LCY deposit base and can provide LCY to MDBs and DFIs. In addition, a local bank has domestic clients who need USD.

Potential Transactional Mechanics: Loan Extension

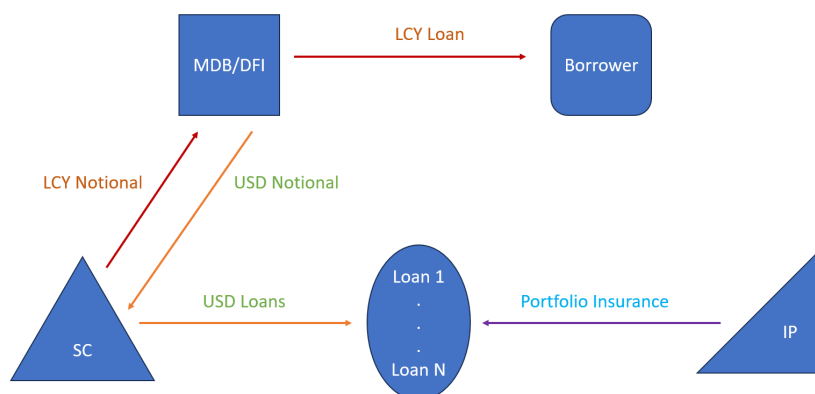


Figure 1

Potential Transactional Mechanics: Loan Repayment

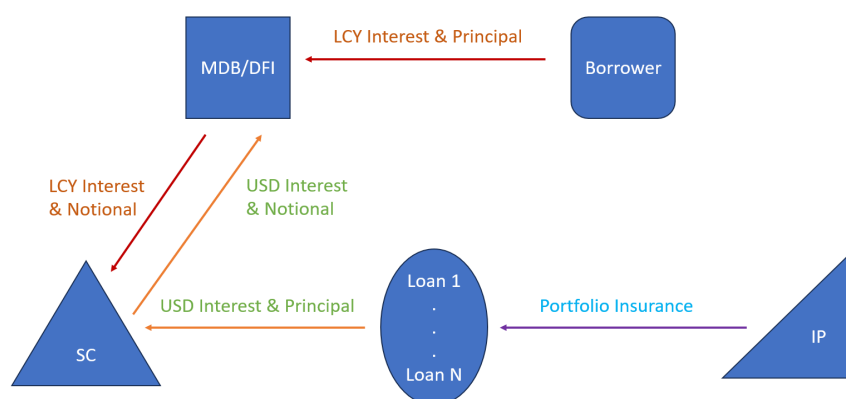


Figure 2

Conclusion

The portfolio insurance approach proposed in this article should help to address MDBs' and DFIs' credit concerns associated with local SCs, and thereby facilitate warranted MDB/DFI LCY lending that contributes to local capital market development.

As described in the example above, each transaction represents a collaborative effort among an MDB/DFI, an IP, and an SC: the MDB/DFI offers its borrower the right product; the IP enables capital market development; and the SC engages in a new MDB/DFI activity. This collaborative effort has the potential to unlock extremely high development impact without imposing significant costs on the participants.

By making LCY investments in projects with LCY revenues, MDBs and DFIs increase project viability. By relying on local SCs, they promote local capital market development. Developed capital markets reduce the

dependence on foreign currencies and help insulate economies from external shocks. Specifically, currency risk management encourages the development of hedging products, such as swaps and options, in emerging markets. Deep and liquid LCY bond markets are essential for financial stability, which, in turn, reduces the overall risk profile of economies and promotes the foreign and domestic private-sector investment that is urgently needed to set developing countries on sustainable development trajectories. (Griffith-Jones and Ocampo 2018 and Allen et al. 2018)

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Footnotes

1. Version of October 17, 2024.

2. Writing in his personal capacity.