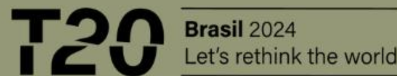
T20 Policy Brief



Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Enhancing Local Currency Lending by Multilateral Development Banks: A Critical Reform Agenda

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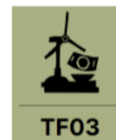

Abstract

This policy brief highlights the crucial role of local currency lending by Multilateral Development Banks (MDBs) in achieving the Sustainable Development Goals (SDGs), particularly in low- and middle-income countries (LMICs). While current policy discussions emphasise the need to increase MDBs' lending capacity, this alone may not ensure sustainable lending practices. It is vital to provide financing that aligns with recipients' absorptive capacity and minimises macroeconomic vulnerabilities.

A key aspect of this discussion is the currency denomination of financing arrangements, which has gained attention in policy agendas such as the Bridgetown Initiative. This framework stresses the need to avoid currency mismatches that could exacerbate debt crises in LMICs. Despite growing consensus on the need to increase local currency lending by MDBs, there remains a significant gap in systematic analysis and understanding of these practices.

This brief aims to bridge the gap by discussing the advantages of borrowing in local currency and analysing the reasons for MDBs' reluctance to lend in these terms. The central argument is that the risks associated with local currency lending are often overestimated, resulting in insufficient financing. This overestimation stems from perceived risks in LMICs, which drive up the costs of risk management, particularly for exchange rate risk. Moreover, local currency lending could unlock untapped opportunities and benefits for MDBs.

We offer several policy recommendations to the G20 to enhance MDBs' capacity to lend in local currency. These include scaling up and improving methods for hedging currency risks, facilitating local currency funding in onshore markets, and reforming risk management frameworks. Additionally, we advocate for integrating local currency lending into the core of the developmental mandate of MDBs and strengthening the technical assistance provided by these institutions to support these efforts.

Diagnosis of the Issue

Scaling up financing for development is essential to meet the 2030 Agenda for Sustainable Development. The financing gap to achieve the SDGs in LMICs is estimated at around USD 4 trillion per year (UNCTAD 2023, xv). Mobilising public and private financial resources is crucial to bridge this gap, with MDBs serving as key sources of finance for these countries (United Nations Inter-Agency Task Force on Financing for Development 2022; Capital Adequacy Frameworks Panel 2022).

The Addis Ababa Action Agenda on Financing for Development highlights that borrowing is necessary to finance the investments essential for sustainable development. It asserts that while borrowing countries must manage their debt prudently, lenders should ensure their lending practices do not undermine a country's debt sustainability (United Nations 2015, 43-44), in line with the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing (UNCTAD 2015).

However, merely increasing financing is insufficient to ensure the sustainability and long-term resilience of the international financial architecture. In recent years, LMICs have become more vulnerable to currency risk due to the increasing share of their external debt denominated in foreign currencies (World Bank 2023, 27). As of 2022, foreign currency-denominated general government debt in LMICs constituted 25% of total debt, up from 17% a decade ago (Kose et al. 2022). This shift transfers the responsibility for managing currency risk from MDBs' sophisticated treasuries to often capacity-constrained LMICs, subjecting these countries to higher debt servicing costs when exchange rates fluctuate. As the Bridgetown Initiative (2022) highlights, it is crucial that additional financing does not exacerbate existing debt vulnerabilities, which are already substantial, with 60% of low-income countries at high risk of, or already in, debt distress (World Bank 2023, xvii).

Given these challenges, the currency denomination of MDB financing is crucial for achieving sustainable development. Despite the G20's support for developing local currency bond markets (G20 2011), most MDB lending remains in hard currencies, such as the US dollar and the euro (Figure 1). Although these lending practices may initially seem cost-effective due to low interest rates, they can lead to increased debt burdens for borrowers due to currency mismatches.

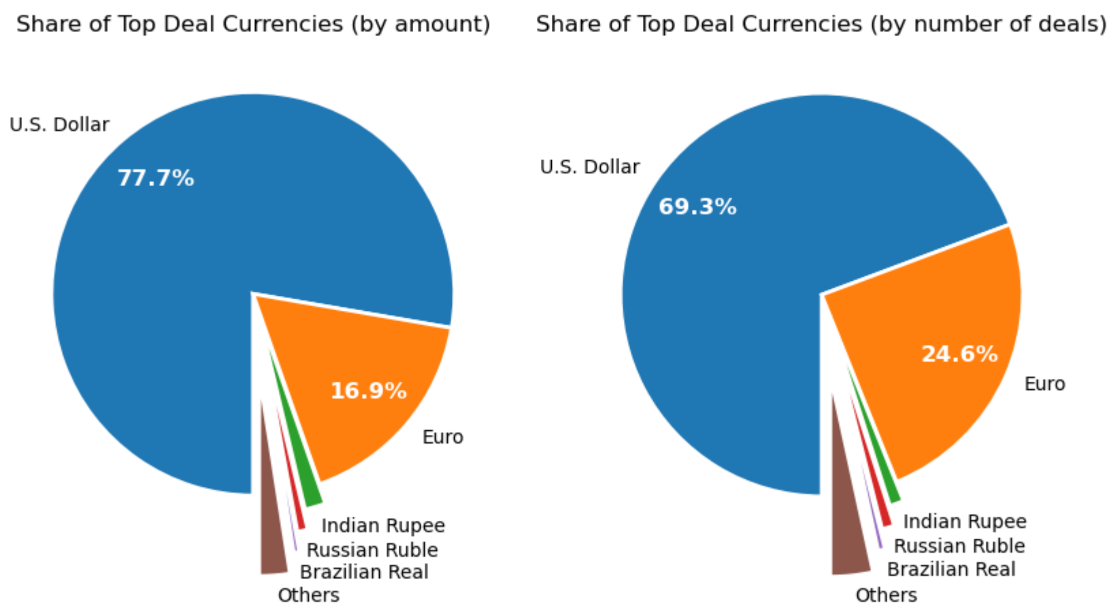

FIGURE 1. Currency denomination of syndicated loans

Source: Own elaboration based on data from Refinitiv LoanConnector Dealscan.

The primary reason MDBs hesitate to lend more in local currencies is their aversion to currency risk. In some cases, this reluctance relates to statutes or bylaws limiting exposure to exchange risk, but it is more often due to Board decisions motivated by the fiduciary duty to protect the bank's capital from perceived high risk of currency fluctuations. This perceived higher risk means MDBs must allocate more capital to cover local currency risks to satisfy shareholders and rating agencies (i.e., to maintain their triple-A rating).

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This reluctance to take on exchange rate risk limits local currency lending to transactions where the risk can be mitigated, either through currency derivatives or the issuance of local currency liabilities. However, mitigating this risk in LMICs is costly due to structurally high interest rates, often exceeding the risk of future exchange depreciation (Persaud 2023). The risk of extreme depreciations is also smaller than often believed. As shown in Figure 2, only 5% of depreciation events (measured quarterly) exceeded 13.5% across a range of low- and middle-income countries. Additionally, the magnitude of these depreciations has declined over time, with 'extreme' events implying depreciations of 32.3% in the 1990s, 9.2% in the 2000s, and 8.8% in the 2010s. Moreover, these depreciations typically revert within four quarters. Hence, while currency risks are real, they are often overstated, and there is a strong case for MDBs to model this risk themselves to determine whether allowing some currency risk might be appropriate.

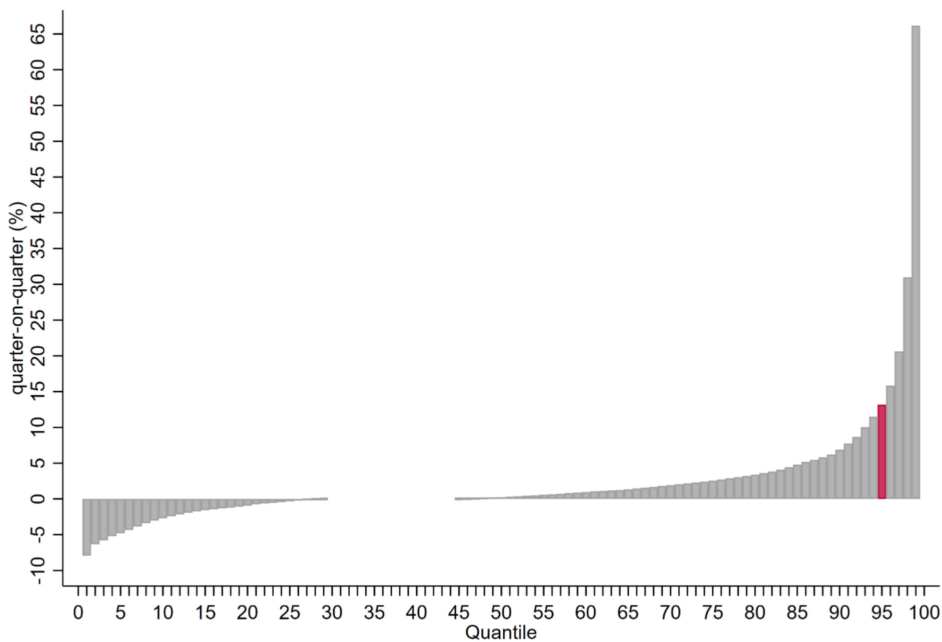

FIGURE 2. Quantile function of rate of depreciation across 94 LMICs, excluding hard pegs. *Source*: Own elaboration based on International Monetary Fund (IMF)'s International Financial Statistics (IFS).

The high costs of hedging and borrowing in LMIC currencies result in MDB local currency financing at rates that may not be attractive to borrowers, particularly sovereigns. This is because MDBs either fund themselves in local currency at rates similar to those of sovereign governments or incur hedging costs reflecting the differential between local and international (mainly US dollar) interest rates. Consequently, local currency lending rates remain high, generally not lower than those available to sovereign borrowers, limiting the borrower pool to the private sector and non-sovereign public entities.

In summary, two key constraints on local currency lending to LMICs are identified: high perceptions of currency risk by MDBs and their shareholders, and the costs associated with mitigating that risk. Our recommendations aim to address both constraints.

Recommendations

1. Scale up and enhance means of hedging currency risks

Where available, hedging services in LMIC currencies are costly for MDBs, leading to higher interest rates on local currency loans. Borrowers often face a timing issue: local currency loans, based on risk-based pricing by MDBs, typically result in a higher upfront interest burden compared to loans in hard currencies. However, these upfront costs may eventually be offset by the benefits of exchange rate protection.

To address these challenges, several strategies could be adopted:

- **Diversifying local currency hedging sources:** MDBs largely source foreign currency hedges from international banks, which can inflate costs due to differences in balance sheet structures and risk assessments. Local onshore banks might offer more cost-effective hedges, but MDBs are often restricted from using them due to counterparty risk. Reducing these counterparty restrictions could lower hedging costs and, consequently, the interest rates charged on local currency loans by enabling the use of local financial institutions for currency hedging.

- **Scaling up and subsiding TCX:** In many less-developed financial markets, hedges are often unavailable. TCX, a non-profit entity established by a consortium of development finance institutions, mitigates risk through currency diversification. Although TCX has demonstrated medium-term profitability (TCX 2023), there is a need to increase hedge sizes and reduce costs to enhance MDBs' local currency lending capabilities. Scaling up TCX's facilities with increased capital from shareholders, along with concessional financing from donors, could provide portfolio risk guarantees and interest rate subsidies, thereby lowering the cost of hedges offered by TCX.

- **Paying equity capital in local currency:** Another option, particularly for lending to the private sector, is to allow shareholder countries to pay their equity capital in their own currencies. This approach would enable MDBs to increase lending capacity without incurring currency hedging costs, up to the limit of the paid-in capital. It is especially valuable in frontier currency markets in low-income member countries where hedging solutions are scarce or non-existent.

2. Facilitate local currency sourcing in domestic markets

The following strategies could facilitate local currency fundraising in domestic markets:

- **Issuing local currency bonds to central banks:** In underdeveloped financial markets with few local financial institutions or a functioning domestic bond market, local central banks could purchase MDB local currency bonds. These purchases would provide local currency funding to MDBs while allowing central banks to diversify their yield-seeking portfolios into high-credit-rating assets.

- **Promoting a harmonised transnational securities regulation framework for MDBs:** Issuing bonds onshore often involves high transaction costs due to diverse regulatory frameworks. A harmonised regulatory framework for MDBs would reduce these costs and streamline approval processes. Typically, local regulations designed for domestic entities compel MDBs to navigate complex exemption and approval processes, which are particularly burdensome in smaller economies. To address these challenges, MDBs could collaborate to create a transnational forum for an ad-hoc securities regulatory framework specifically tailored for MDB local currency bond issuance. This framework would align disclosure requirements and other criteria for the scrutiny and approval of prospectuses and marketing documentation, making approval processes as

expedient, simplified, and streamlined as possible within the confines of national laws. Article 25 of the European Union's Prospectus Regulation provides a model with its passporting mechanism, where a prospectus approved in one Member State can be used across others without additional approvals. Although this proposal maintains state-specific approval requirements, it would harmonise the securities regulations applicable to MDBs across jurisdictions.

3. Reform risk management frameworks

The perception of elevated exchange rate risk in LMICs frequently acts as a barrier to local currency lending. While these risks are present, they may be exaggerated in certain contexts. As with credit risk, MDBs have the capacity to manage a certain level of exchange rate risk, especially considering the substantial benefits such management can confer on recipient economies.

- **Moving from a back-to-back risk management framework to a portfolio approach:** Many MDBs currently operate with a 'back-to-back' risk management framework, requiring local currency operations to be perfectly matched by a liability or currency hedge. This approach can restrict MDBs' ability to lend in local currency, given the scarcity of funding and hedging instruments for LMICs' currencies. Adopting a portfolio approach to risk management, which sets total limits for different risk categories such as market risk, would allow greater flexibility in local currency lending. Under this approach, MDBs could take on some currency risk, provided it does not generate excessive volatility for the overall portfolio, thereby increasing the space for extending local currency loans.
- **Pricing currency risk in-house:** By fully hedging currency risk, MDBs effectively accept the risk models of hedge providers, which may include a premium for

LMIC currencies. Institutions such as TCX specialise in providing swaps and forwards, largely priced as a spread over the interest rate differential. While LMICs often have volatile currencies, it is possible for MDBs to assess currency risk independently, allowing them to make more informed judgements about the appropriateness of market quotes.

- **Encouraging risk-sharing across MDBs:** TCX, through diversification across a wide array of LMIC currencies, has successfully generated modest profits since its inception. MDBs could benefit from similar diversification by creating an off-balance sheet fund pooling local currency assets to diversify both credit and currency risk. Such a fund could significantly mitigate idiosyncratic currency risks and function as a de facto partial hedge against currency risk. Depending on the overall risk appetite of the MDB, the fund could then hedge the remaining undiversifiable currency risk with swaps or local-currency liabilities. Additionally, a donor-provided guarantee against extreme depreciation events, serving as loss-absorbing capital, could offer an additional layer of risk mitigation.

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

Despite recent advancements in local currency lending, MDBs remain dollar-based institutions, often relegating local currency options to a secondary choice for borrowers. This approach overlooks the crucial role that financing in local currencies plays in the sustainable development of recipient countries. It is essential to make the currency denomination of financial arrangements central to the developmental mandate of MDBs. Local currency operations should be significantly expanded beyond their current modest scope, typically limited to small amounts or confined to countries with more developed financial markets.

To bring local currency lending to the forefront of MDBs' developmental mandate, the following policies are recommended:

- **Providing loans in local currency at concessional rates:** Some MDBs offer highly concessional loans with very low or no interest charges, based on criteria such as recipient countries' risk of debt distress, GNI per capita, and creditworthiness. However, these concessional terms currently apply only to loans in hard currencies, making local currency loans unattractive due to the significant interest rate spread between concessional rates in dollars and the higher rates of local currencies. Providing loans in local currency at concessional rates would reduce this spread, making local currency borrowing more attractive for borrowers in eligible countries.
- **Taking on currency risk**: In addition to the overestimation of currency risk and excessive hedge costs, exposure to local currency risk can be justified on developmental grounds. Assuming limited currency risk may facilitate access to sustainable finance in vulnerable LMICs that would otherwise be forced to borrow in foreign currencies. This strategy would require a calculated provision for potential losses, involving concessional capital, and should be reserved for projects with clear developmental impact in economically and financially vulnerable countries.

5. Increase awareness and capacity in local currency financing

National debt management offices (DMOs) in LMICs often lack the training and knowledge needed to understand the basic risks of borrowing in foreign currencies. According to an IMF survey, roughly half of the responding DMOs—80% of which were LICs—do not conduct stress tests and are not fully aware of the risks in their debt portfolios related to domestic interest rates or foreign currency debt. Additionally, less than half have a currency risk management strategy (Jonasson et al. 2024). This disparity

creates a knowledge asymmetry in development finance transactions, where borrowers with limited currency risk management skills engage with highly qualified international financial institutions, including MDBs.

MDBs should take on greater responsibility for providing technical assistance and building capacity in LMICs, thereby increasing awareness and understanding of the benefits of local currency lending.

Scenario of Outcomes

These proposals to enhance currency lending by MDBs vary in terms of timescale and complexity but go beyond simple technical fixes. This section recognises potential contradictions and trade-offs from adopting these proposals.

- **Financial resources:** Implementing our recommendations, particularly scaling up TCX and providing concessional local currency loans, will require additional financial resources from donors and MDB shareholders. Increased concessional and first-loss capital will be essential to mitigate risks associated with local currency exposure. These resources may compete with other urgent needs, especially during financial crises. However, these investments are justified on developmental policy and risk management grounds.
- **Policy transparency:** Proposals to allow MDBs to source equity capital in local currencies and engage directly with local central banks could be viewed with suspicion, potentially being misconstrued as monetary financing. High transparency is crucial to avoid conflicts of interest and ensure these initiatives are not politicised. These political issues are likely limited, as most local currency lending is directed to private sector borrowers.
- **Regulatory and administrative hurdles:** Issuing local currency bonds and harmonising regulatory frameworks may initially increase MDBs' regulatory burdens and crowd out domestic borrowing. However, these measures will stimulate local financial market development, enhance financial stability, and eventually reduce long-term administrative burdens.
- **MDB governance hurdles:** Shifting risk management frameworks to increase local currency exposure might face resistance within MDBs due to perceived financial

risks. Many of these recommendations, however, can be implemented without altering MDBs' governance structures or charters. A gradual and carefully monitored implementation can demonstrate the long-term benefits, alleviating stakeholder concerns and promoting more adaptive governance within MDBs.

- **Coordination challenges:** Effective implementation of proposals such as creating pooled funds for local currency lending and harmonising securities regulations requires extensive coordination among MDBs, shareholders, and member states. While complex, these efforts are essential to reducing operational inefficiencies and significantly expanding MDB capacity to lend in local currencies.

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