IGC

State Fragility initiative

REPORT

Mitigating foreign exchange risk in local currency lending in fragile states

Review and options

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List of abbreviations

Abbreviation	Meaning
ACP	Africa Caribbean Programme
ALCBF	African Local Currency Bond Fund
AUM	Assets under management
CCR	Counterparty credit risk
CPIA	Country Policy and Institutional Assessment
DFI	Development Finance Institution
DSA	Debt Sustainability Analysis
FCS	Fragile and conflict-affected settings
FCY	Foreign currency
FX	Foreign exchange
IFI	International Financial Institution
ISDA	International Swaps and Derivatives Association
LCY	Local currency
LCF	Local Currency Facility
LIFT	Livelihoods and Food Security Fund
LSF	Local Sustainability Facility
MDB	Multilateral Development Bank
MSMEs	Micro, small, and medium enterprises
NHSFO	Non-Honoring of Sovereign Financial Obligations
PRI	Political risk insurance
PSW	Private Sector Window
RSF	Private Sector Window
SMEs	Small and medium enterprises
TA	Technical Assistance
T&C	Transfer and Convertibility
UNCDF	United Nation's Capital Development Fund

Executive summary

Achieving the Sustainable Development Goals and tackling the climate crisis are pressing challenges for fragile and conflict-affected settings (FCS). Like other countries, they require a very large step-up in investment and financing, to which the private sector will have to contribute significantly given fiscal constraints. Development finance institutions (DFIs) have a key role to play in these contexts, by catalysing private investment and promoting sustainable development.

DFIs provide finance mostly through equity and debt. Equity investments are typically left un-hedged, and subject to local currency (LCY) risk. DFI lending, due to operating constraints, mostly takes place in foreign currency (FCY). This may shift currency risks onto borrowers and constrain DFI investment pipelines. Challenges to scaling up LCY lending are, on the one hand, rooted in the complexities of the FCS environment, which increase LCY lending risks and costs. But on the other, they are also rooted in DFI risk-management policies, and in the dearth of cost-effective LCY options.

This paper presents a systematic review of existing strategies to tackle these challenges, which can be grouped by (1) reforming DFI internal processes, culture, and risk-management frameworks, (2) expanding options to source and deliver LCY, on and offshore, and (3) lowering the all-in lending rate in LCY. The table on the next page summarises these approaches. While each has their pros and cons, collectively they have not resulted in a significant scale-up of LCY finance in FCS for DFIs as a group, so far.

Building on the existing approaches and in-depth consultations with DFIs and market players, this report sets out forward-looking proposals for further exploration by the DFI community that could deliver LCY financing at scale. These include two cross-cutting proposals and two options related to currency hedging platforms, as detailed in the table below.

Table 1: Proposals to deliver local currency financing at scale

Cross-cutting proposals	TA to central banks to support stability & facilitate cross-currency swaps	
	LCY Credit Guarantee for FCS	
Platform options	**1**	**2**
	LCY Platform as an onshore treasury capability in FCS	TCX Portfolio Return Guarantee for FCS

The cross-cutting proposals consist of:

- Providing technical assistance (TA) to central banks to support development of money markets and financial stability, and facilitate cross-currency swaps, including IMF support in amending the accounting for Net International Reserves.
- A LCY credit guarantee focused on FCS that takes on part of the credit risk of facing the local counterparty in LCY loans or derivative transactions.

Platform options include:

- A platform which acts as an onshore treasury capability (on behalf of lenders) in FCS by seeking LCY hedging with local counterparties, managing local market imperfections, setting up the required onshore infrastructure, and acting as an onshore "paying agent" in FCS for interested investors.
- A TCX Portfolio Return Guarantee in which the delivery of concessional hedging by TCX is supported by a donor offering to guarantee a minimum return for a portfolio of FCS hedges.

Table 2: Overview of available routes to deliver local currency financing

	Modality	Objective	Remaining/new drawbacks
Internal capacity building & organisational changes	Capacity building	Change practices & build know how around LCY lending	Continuous effort & adaptation of practices to market changes
Adjustment of internal risk framework	Increased risk appetite	Secure the flexibility required to operate in imperfect markets	Can accommodate some risks, not all
Synthetic hedging	Derivative	Deliver LCY in a synthetic form	Convertibility & transferability risk remain
Offshore LCY Bond	Bond	Transfer FX risk to investors	Convertibility and transferability risk remain
Convertibility & transferability risk cover	Insurance	Mitigate T&C risk	Not all FCS countries covered
Hedging with a bank	Derivative	Participate in the local market, eliminate the T&C risk	The local market needs to be sufficiently developed - Few FCS will allow for that
Cross currency swaps with central banks	Derivative	Seek attractive LCY funding level	Legal environment & credit standing of the counterpart
Issuing a bond in the local market	Bond	Avoid hedging cost	Funding cost might still be too high
Policy dialogue to improve ALM of local banks	Policy dialogue	Maximise LCY delivery potential of local banks	Low credit standing & uncertain environment
Credit guarantee of collateral backing market transactions	Guarantee	Strengthen activity in the local money market	Short term risk mitigation
Guarantees of LCY finance by local FI	Guarantee	Facilitate LCY delivery by the local market	Local market may not be sufficient in lending capacity
Risk-sharing facilities	Risk Sharing	Partnering with a local FI for LCY funding & share the transaction credit risk	Complexity of implementation

Table 3: Overview of current approaches to lower the all-in lending rate

	Modality	Objective	Remaining/new drawbacks
Policy dialogue & TA to support local money market development	Policy dialogue	Most sustainable solution to scale up LCY finance	Medium to long term impact
Liquidity Sustainability Facility	Facilitation	Lower illiquidity risk premium of Africa sovereigns	Long shot on FCS impact
MIGA's credit guarantee for sovereign entities	Credit risk loss-absorption	Facilitate LCY lending to sovereign entities	Non-available for FCS
EBRD's SME LCY Programme	Credit risk loss-absorption	Reduce the lending margin	Cost reduction might be insufficient for FCS
TCX's Portfolio Return Guarantee	FX risk loss-absorption	Reduce hedging cost	Cost reduction might be insufficient for FCS
TCX's LIFT Programme	Subsidy	Reduce hedging cost	Immediate one for one use of donor grant
IFC's private sector window	Subsidy	Reduce hedging cost	Immediate, unleveraged use of donor grant
Working unhedged as a fund absorbing FX gains & losses	Diversification & long-term view	Avoid hedging cost	Potential local market distortion & non-contribution to market building
Working unhedged as a fund with loss absorbing equity tranche	Diversification & long-term view with FX risk loss-absorption	Avoid hedging cost & mitigate related potential losses	Potential local market distortion & non-contribution to market building

Table 4: Proposed options for scaling up local currency finance in fragile and conflicted-affected settings

		Modality	Objective	Remaining/new drawbacks
Cross cutting proposals	TA to central banks to support stability & facilitate cross-currency swaps	Policy dialogue	Strengthen stability in the local financial sector and facilitate delivery of LCY lending	TA will take time to deliver benefits; CB swaps are complex and bypass local banks
	LCY Credit Guarantee for FCS	Credit risk loss-absorption (& FX risk loss-absorption)	Reduce LCY hedging cost and LCY lending rates for FCS, leverage local financial sector for delivery	Relies on significant donor support to achieve scale
Platform options	TCX Portfolio Return Guarantee	FX risk loss-absorption	Reduce LCY hedging cost for FCS	Less effective in situations of extreme crisis
	LCY Platform as a delegated onshore treasury capability in FCS	Deliverable hedge	Reduce LCY hedging costs, mitigate T&C risk & develop the local market	Hedging cost reduction not as substantial in FCS with no local counterparts

Introduction

Achieving the Sustainable Development Goals (SDGs) and tackling the climate crisis are the most pressing challenges facing the world today and require huge financing to be mobilised.[1]

Mobilisation and delivery are especially urgent for the 960 million people living in Fragile and Conflict-Affected Settings (FCS) who bear the brunt of the impacts of climate change – despite their negligible contribution to global emissions **(Box 1)**. On top of this, FCS face persistent and intensifying social, political, military, and economic challenges, with ripple effects at the global level, through migratory crises and a rise in extremism **(Figure 1)**. Key data on FCS are presented in **Table 5.**[2]

DFIs have a key role to play. FCS's enormous investment needs and constrained domestic savings pools imply that most development funding will have to be sourced externally. Given the scarcity of private capital, development finance represents a highly additional tool to catalyse private sector investment and address some of the key determinants of fragility through private sector development and job creation. To this end, shareholders are expecting DFIs to grow their balance sheets, assume greater risks, and catalyse private investment in the most challenging markets, while continuing to lend on commercial terms and to abide by stringent ESG standards and principles of prudent lending, banking, and investing. Such a strategic push towards FCS is reflected in a number of recent institutional strategies, policies, and tools.[3]

Balancing these sometimes-competing priorities means that DFIs engagement in FCS remains modest, despite these ambitions. Whilst there are many vehicles for LCY financing, and substantial risk is taken with equity investments that are made in LCY, it remains that 80 to 90% of DFI lending takes place in FCY.[4] Reliance on FCY lending may be driven by the various complexities of operating and investing in

1 The United Nations estimates that 4 trillion USD per year are needed to close the widening gap in SDG investment (UNCTAD, 2022).

2 **Annex B, Table 12** provides additional information on socio-economic indicators

3 For example, the World Bank Group launched its **Strategy for Fragility, Conflict, and Violence 2020-2025**; AfDB approved its new strategy for **Addressing Fragility and Building Resilience in Africa 2022-2026; FMO's fragile states strategy** is underway. These efforts are being complemented by events such as the **DFI Fragility Forum**, upstream initiatives, including G7's **Africa Resilience Investment Accelerator (ARIA)**, IFC's **Africa Fragility Initiative**, BII and FMO's **Invest for Impact Nepal**; development of conflict sensitivity approaches, notably IFC's Conflict Affected States in Africa (CASA) initiative, and EIB's **Conflict Sensitivity Help Desk**; and dedicated investment vehicles, including FMO's **MASSIF**, IFC and MIGA's IDA **PSW**.

4 Kapoor, Hirschhofer, Kapoor, and Kleiterp, 2021

FCS which would include wider business environmental challenges as well as a lack of viable alternatives or by prudent DFI financial management. However, one of the impacts is that currency risks are borne by borrowers. Given the FCS' sizable foreign debt stock, dependence on commodities and remittances, poorly diversified economies and exports, and high dollarisation rates, large FCY exposures may contribute to the existing economic challenges within these markets.[5]

This report, commissioned by the DFI Fragility Forum, discusses how DFI practices could evolve to improve the sourcing and delivery of LCY lending in FCS. It does so by reviewing the case for LCY lending and the main approaches implemented by the DFI community and, building on these experiences, presents possible new tools and risk-management practices that would enable a scaled-up DFI LCY offer in FCS.

BOX 1. WHAT DO WE MEAN BY FRAGILE AND CONFLICT-AFFECTED SETTINGS?[6]

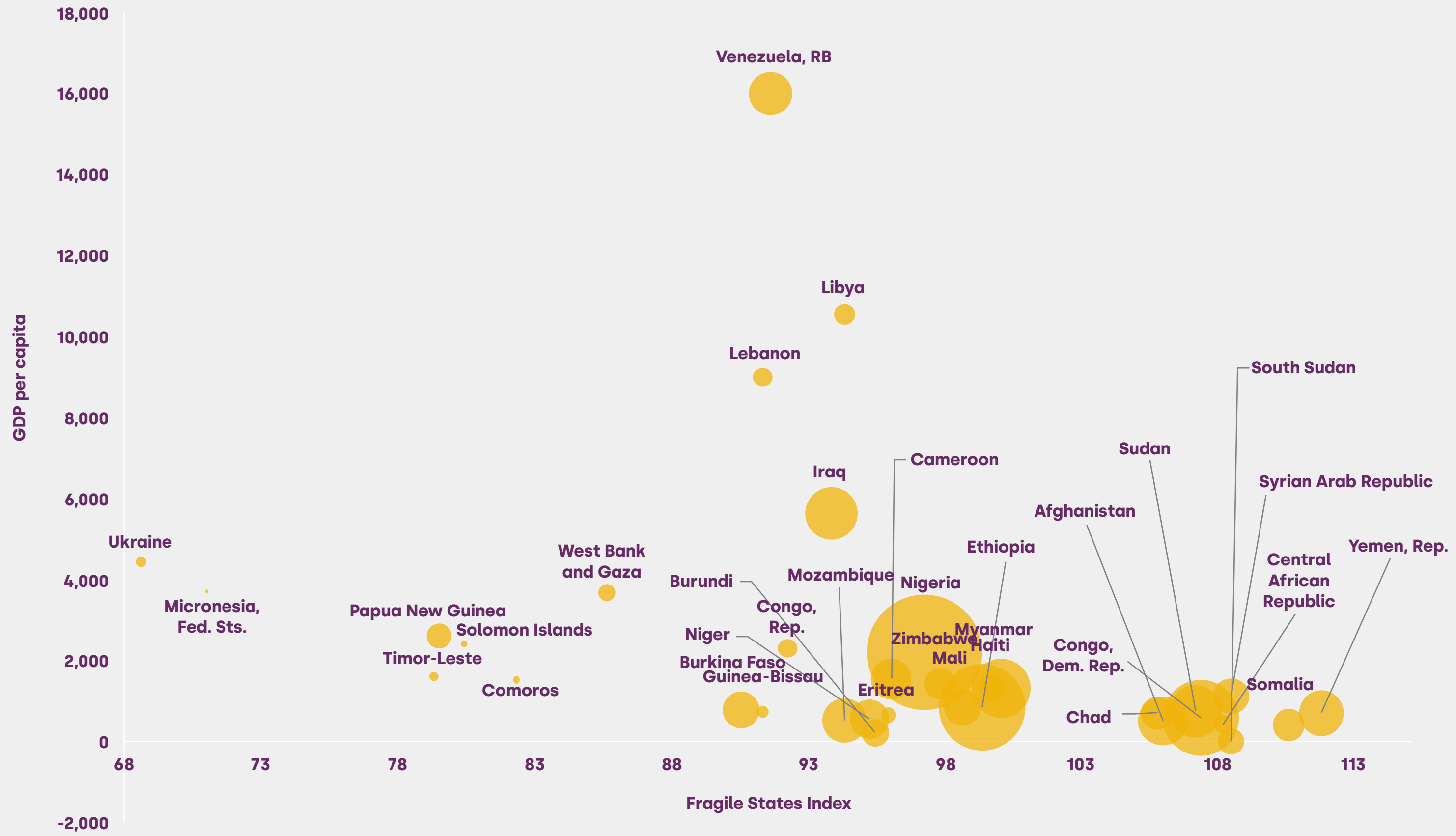
Fragility is caused by a variety of interlocking factors, and fragile contexts differ in the ways in which they are fragile. Common characteristics of fragility include "the lack of basic security, inadequate government capacity, the absence of a properly functioning private sector, and the presence of divided societies."[7] A country affected by fragility is often not unstable or fragile across its whole territory. In many instances, fragility may be concentrated in certain areas, such as the periphery, natural resource rich regions, parts of the country afflicted by conflict, or regions most deeply impacted by environmental destruction and climate change.

There are multiple lists and rankings for FCS, such as those compiled by the World Bank Group, the OECD, and the Fund for Peace. In this paper, we consider the World Bank Group 2023 FCS list (**Annex B, Table 16**).[8]

Of the 37 FCS countries in the World Bank Group 2023 FCS list, seven (19%) have unilaterally adopted a foreign hard currency, as shown in **Table 5**. Therefore, in this report, we are covering FX risk mitigation in the remaining 30 FCS countries. Half of these have a currency pegged either to the EUR or the USD, which is the most challenging configuration when managing FX risk with market instruments.

5 Eichengreen, Hausmann, & Panizza, 2023
6 Logan & Sacchetto, 2021
7 LSE-Oxford Commission on State Fragility, Growth and Development, 2018, p. 4
8 World Bank Group, 2023

Figure 1: Fragile and conflict-affected settings by population, GDP per capita, and fragility intensity



Sources: Fragile States Index, World Development Indicators.
Note: Population data is from 2019; GDP per capita data is from 2019; Fragile States index data is from 2022 (Ukraine's Fragile States Index's ranking precedes the outbreak of the 2022 war). Bubble size is proportional to population. Refer to **Annex D**, **Table 17** for the Fragile States Index's score and ranking.

Table 5: Fragile and conflict-affected settings: key indicators[9]

Country (2023 FCS List)	Currency	Currency (2023)	Monetary policy framework (2020)	Type of XR anchor (2020)	Population, total (m)	GDP per capita (current USD)
Afghanistan	AFN	Afghan afghani	Crawl-Like Arrangement		38	501
Burkina Faso	XOF	CFA franc	Conventional Peg	EUR	21	772
Burundi	BIF	Burundi franc	Crawl-Like Arrangement		12	217
Cameroon	XOF	CFA franc	Conventional Peg	EUR	26	1,539
Central African Republic	XOF	CFA franc	Conventional Peg	EUR	5	426
Chad	XOF	CFA franc	Conventional Peg	EUR	16	702
Comoros	KMF	Comorian franc	Conventional Peg	EUR	1	1,511
Congo, Dem. Rep.	CDF	Congo franc	Crawl-Like Arrangement		90	576
Congo, Rep.	XOF	CFA franc	Conventional Peg	EUR	6	2,289
Eritrea	ERN	Eritrean nakfa	Conventional Peg	USD	3	NA
Ethiopia	ETB	Ethiopian birr	Crawl-Like Arrangement		114	840
Guinea-Bissau	XOF	CFA franc	Conventional Peg	EUR	2	731
Haiti	HTG	Haitian gourde	Other Arranged Management		11	1,325
Iraq	IQD	Iraqi dinar	Conventional Peg	USD	42	5,621
Kosovo	**EUR**	Kosovo	No Separate Legal Tender	EUR	2	4,416
Lebanon	LBP	Lebanese pound	Stabilised Arrangement	USD	6	8,986
Libya	LYD	Libyan dinar	Conventional Peg	Composite	7	10,542
Mali	XOF	CFA franc	Conventional Peg	EUR	21	840
Marshall Islands	USD	US dollar	No Separate Legal Tender	USD	0.01	5,189
Micronesia, Fed. Sts.	USD	US dollar	No Separate Legal Tender	USD	0.1	3,699
Mozambique	MZN	Mozambican metical	Crawl-Like Arrangement		30	508
Myanmar	MMK	Myanmar kyat	Other Arranged Management		53	1,295
Niger	XOF	CFA franc	Conventional Peg	EUR	23	551
Nigeria	NGN	Nigerian naira	Stabilised Arrangement		203	2,204
Papua New Guinea	PGK	Papua New Guinea kina	Stabilised Arrangement		10	2,594
Solomon Islands	SBD	Solomon Islands dollar	Crawl-Like Arrangement	flexible peg/basked	1	2,399
Somalia	**SOS, USD**	Somali shilling (de jure); US dollar (de facto)	Free Floating		16	406
South Sudan	SSP	South Sudanese pound	Crawl-Like Arrangement		10	NA
Sudan	SDG	Sudanese pound	Stabilised Arrangement		43	748
Syrian Arab Republic	SYP	Syrian pound	Other Arranged Management	Composite	20	1,117
Timor-Leste	USD	US dollar	No Separate Legal Tender	USD	1	1,584
Tuvalu	AUD	Australian dollar	No Separate Legal Tender	Other	0.001	4,949
Ukraine	UAH	Ukrainian hryvnia	Floating		44	3,661
Venezuela, RB	VES	Venezuelan bolívar soberano	Other Arranged Management		29	NA

9 **Craw-like arrangement**: The exchange rate must remain within a narrow margin of 2% relative to a statistically identified trend for six months or more (with the exception of a specified number of outliers), and the exchange rate arrangement cannot be considered as floating.
Conventional Peg: The country formally (de jure) pegs its currency at a fixed rate to another currency or a basket of currencies, where the basket is formed, for example, from the currencies of major trading or financial partners, and weights reflect the geographic distribution of trade, services, or capital flows.
Free Floating: Intervention by the central bank occurs only exceptionally, aims to address disorderly market conditions, and if the authorities have provided information or data confirming that intervention has been limited to at most three instances in the previous six months, each lasting no more than three business days.
Floating: The exchange rate is largely market determined, without an ascertainable or predictable path for the rate.
Other Arrangement Management: This category is a residual, and is used when the exchange rate arrangement does not meet the criteria for any of the other categories. Arrangements characterised by frequent shifts in policies may fall into this category.
No Separate Legal Tender: The currency of another country circulates as the sole legal tender (formal dollarisation), or the member belongs to a monetary or currency union in which the same legal tender is shared by the members of the union.
Other Arrangement Management: This category is a residual, and is used when the exchange rate arrangement does not meet the criteria for any of the other categories. Arrangements characterised by frequent shifts in policies may fall into this category.
Stabilised arrangement: Classification as a stabilised arrangement entails a spot market exchange rate that remains within a margin of 2% for six months or more (with the exception of a specified number of outliers or step adjustments), and is not floating.

Country (2023 FCS List)	Currency	Currency (2023)	Monetary policy framework (2020)	Type of XR anchor (2020)	Population, total (m)	GDP per capita (current USD)
West Bank and Gaza	**USD, JOD, NIS**	US dollar, Jordanian dinar, New ollari sheqel			5	3,657
Yemen, Rep.	YER	Yemeni rial	Floating		32	NA
Zimbabwe	ZWD	Zimbabwe dollar	Other Arranged Management			1,421.90
Fragile and conflict-affected situations	-	-	-	-	957	1,874
High income	-	-	-	-	1,236	44,724
Low income	-	-	-	-	680	704
Lower middle income	-	-	-	-	3,314	2,386
Middle income	-	-	-	-	5,798	5,449
OECD members	-	-	-	-	1,363	39,532
United States	-	-	-	-	328	65,120
Upper middle income	-	-	-	-	2,484	9,534
World	-	-	-	-	7,743	11,320

Sources: World Development Indicators, IMF AREAER database
Note: Population data is from 2019; GDP per capita data is from 2019; Currency data is from 2023; Monetary policy framework data is from 2020. Blue shading indicates countries that engage in currency substitution. Yellow sharing indicates countries that adopt a currency peg.

Why there is a need for local currency finance but too little of it

> **Scaling DFI LCY lending in key sectors is desirable from a responsible banking perspective, especially in light of the expected ramp up in SDG financing.[10]**

Most DFI clients and would-be clients in FCS economies lack the capabilities and hedging tools to effectively manage foreign exchange (FX) risk. Therefore, supplying them with LCY lending is both a fair and efficient approach. Notably critical investments in Small and medium enterprises (SMEs), which make up the bulk of the domestic private sector, in housing and in capital-intensive infrastructure projects, such as renewable energy, are especially vulnerable to currency mismatches due to their LCY-denominated cash flows and long-term maturities – on top of limited risk management skills. Under the prevailing practices of FCY lending, the most exposed and vulnerable end-users bear FX risks, including farmers, micro-enterprises, utility customers, and taxpayers.[11] Given the frequent depreciations (sometimes in excess of 10% per year) in FCS, greater LCY lending can critically embed resilience into borrowers' debt profiles. Conversely, in light of the precarious financial position that FCY can place clients in,

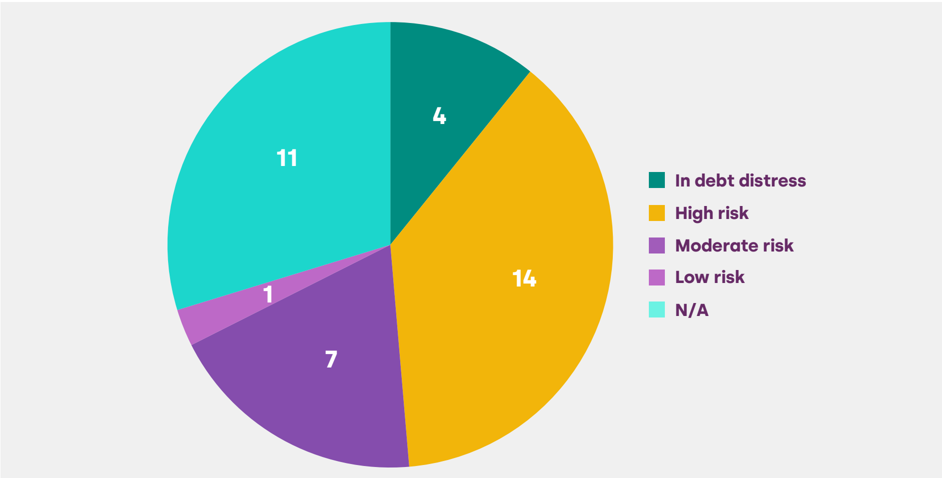
10 The ramp up of SDG funding into developing and fragile economies will generate huge unhedged currency risks which no economy, particularly unsophisticated ones in FCS, can manage effectively (Hirschhofer, 2017).

11 Andreasen, Bartz, Clubb, Efiong, Ehlert Horrocks, Sedemund, Durland, Hirschhofer, & Parplies, 2017

the lack of a well-developed LCY market infrastructure also acts as a serious risk barrier to foreign investors in FCS, whether debt or equity, DFI, and private parties.

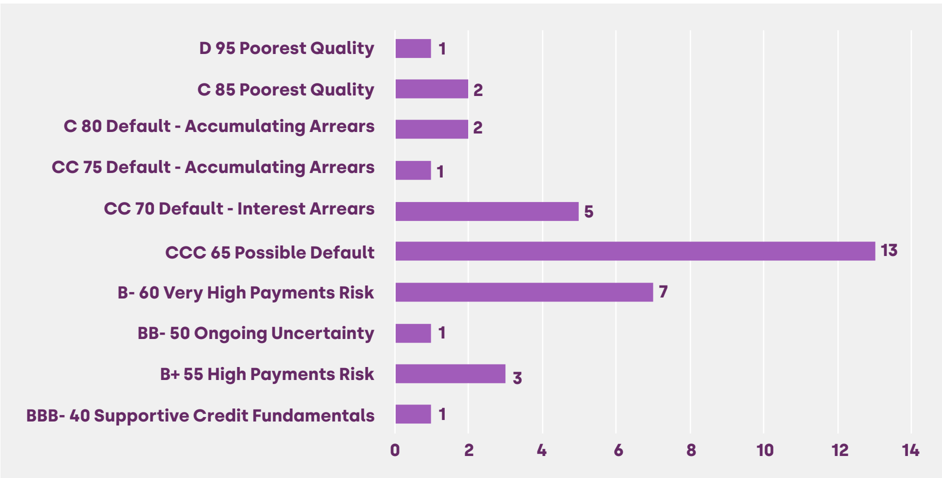
Moreover, excessive FCY lending can add to the difficulties at the macro-economic level. FCS are characterised by large and growing debt stocks denominated in FCY, with 70% of FCS with an available IMF-WB Debt Sustainability Analysis (DSA) score being at risk of or undergoing debt distress (**Figure 2** and **3**). Moreover, FCS tend to have dollarised banking deposits, limited FCY reserves, a reliance on commodity exports, and sizable remittance flows – all of which expose these economies to FX fluctuations.

Figure 2: IMF-WB Debt Sustainability Analysis score for FCS, 2023



Sources: IMF and World Bank

Figure 3: Sovereign risk rating for FCS, 2023[12]



Sources: Global Insight (Wharton School)

12 Data not available for Marshall Islands.

1 What are the challenges to scaling local currency lending?

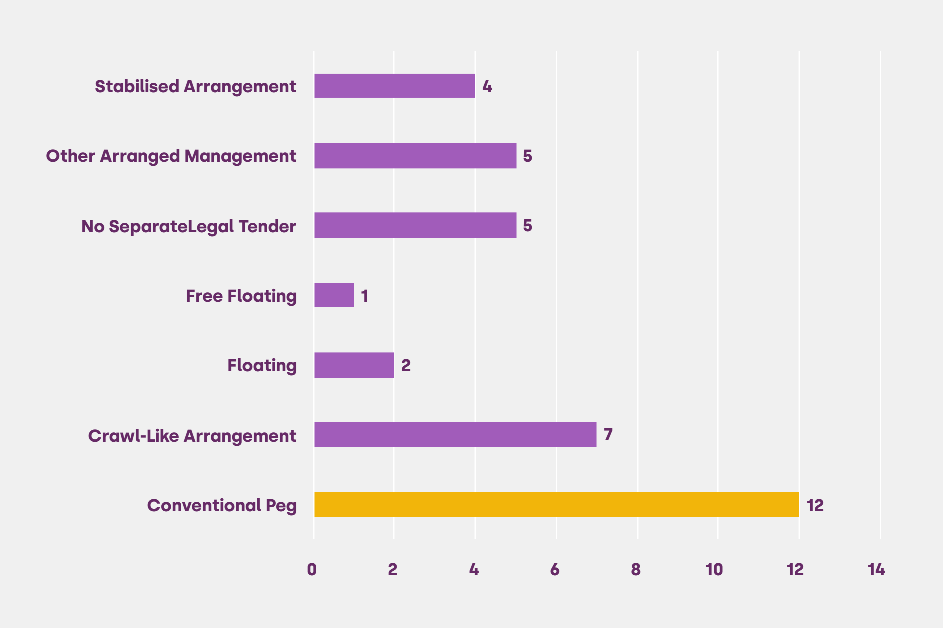
DFI LCY lending in many low-income countries is rare and lending rates are high. This is especially the case in fragile settings that lack swap markets to manage FX and interest rate risks, and local capital markets for companies to borrow from. DFI lending relies overwhelmingly on FCY, given the high costs associated with LCY. Next, we discuss the country-level determinants behind the poor development of the LCY financing offer.

1.1 Lack of trust in local financial systems

Low-income economies with weak institutions tend to have weak currencies. They are managed by a central bank implementing a monetary policy with insufficient credibility and circulate in a banking sector with low credit standing. (**Figure 4**). Distrust rules between market participants, and the ministry of finance and the central bank cooperate with difficulty. Poor fiscal discipline discourages investors. Market infrastructure, starting with securities depositories and exchanges, is poor or inexistent. The legal environment, both in terms of judiciary, legal, and regulatory frameworks, remains underdeveloped and is deemed unsafe for operations by foreign investors. FX and capital controls limit the convertibility of the currency and act as a brake on trade and investments. Finally, poor governance overall, a deficit in economic and financial skills, and the use of practices far from international standards all combine and lead to the absence of the fundamental building blocks of a functioning market, including widely accepted money market indexes, reliable sovereign yield curve, and sufficient supply of risk-free assets.

As a result, currency as a symbol of sovereignty and economic identity is de facto undermined in FCS. The inability to inspire trust and credibility holds true with both local and international financial partners. Combined with a weak economic climate and high inflation, it makes for a LCY market that is inexistent or exceedingly difficult to navigate.

Figure 4: FCS' monetary policy frameworks, 2020[13]



Sources: IMF AREAER database

1.2 Volatility and illiquidity hinder risk management and bankability

LCY lending in such an environment means working with interest rates much higher than in USD or EUR. This clearly undermines the bankability of projects. The issue is compounded for foreign lenders who access LCY via hedging, i.e., via a market operation. The cost of transacting in an illiquid market is justifiably high, and gaps in or the absence of markets represent a risk-management challenge. The perfectly matched risk management that DFIs deploy in advanced markets is simply not feasible in systems characterised by short-term maturities, risk avoidance, the hoarding of liquidity, and the absence of transactions and counterparts.

1.3 Commodity exports, remittances, and dollarisation complicate LCY lending

The limited development of LCY lending is in part due to the fact that foreign currencies are deeply embedded in FCS' economic structures. Indeed, while FCS are a diverse range of countries in terms of size, geography, and the intensity of fragility and conflict, many of them share similar characteristics in that a portion of their economic fabric tends to operate in FCY.

13 Excludes West Bank and Gaza which lacks a monetary policy framework.

First, FCS' income heavily relies on earnings from commodities which dominate their export structures, at an average of 80% (Annex C, Table 13). The type of commodity exported can vary considerably, with countries such as Libya, Iraq, or Chad relying mostly on fuels, Burkina Faso, Democratic Republic of Congo, and Mali on ores and precious metals, and Afghanistan, Ethiopia, Somalia, and some Pacific Islands on agricultural products. Since these export products are typically priced in USD, this exposes their FX earnings to the fluctuations of global commodity prices, with risks to the balance of payments.

Second, personal remittances also contribute considerably to FX earnings and GDP of a few FCS. These include Haiti, Kosovo, Somalia, West Bank and Gaza. Dependence on remittances exposes FCS to migration policies (e.g., during the Covid-19 pandemic) and economic booms and busts in other countries.

Third, the share of FCY deposits in FCS banking sectors varies, but it is often high (Table 6). High levels of so-called *dollarisation* create large risks in case of exchange rate fluctuations. A bank with large FCY deposits or borrowings (from DFIs, for instance) is exposed to LCY depreciation when lending in LCY: liabilities grow in LCY terms and honouring FCY debt obligations with the same LCY revenue stream becomes a challenge. In situations where banks have high FCY funding (deposits or DFI funding) and lend in FCY to avoid currency mismatches in their own balance sheet, they shift the FX risk onto end-borrowers, who have limited access to FCY to repay their now more expensive loans, raising the risk of default. It is also worth highlighting that FCY is often held in the hands of a few export-oriented businesses. Lack of LCY lending, therefore, exposes more vulnerable borrowers (such as SMEs and local entrepreneurs) to FX risks.

Further when banks' dollarisation is high, the effectiveness of central banks' monetary policy is much reduced. In these contexts, DFIs' FCY lending, which effectively constitute local banks' source of medium-term funding, maintains, or contributes to dollarisation, further constrains the banks' ability to on-lend in LCY, and thus weakens their balance sheet management. Indirectly, it also reduces a country's ability to have an autonomous and effective central bank.

Table 6: FCY deposits (% of total deposits) in other depository corporations for selected FCS[14]

Country	FCY deposits (%)	Year	Source
Africa			
Congo, Dem. Rep.	85%	2021	Technical Assistance Report - Financial Sector Stability Review 2022, IMF
Mozambique	27%	2022	Monetary Accounts: Commercial Banks, Summary of Credit Institutions, Bank of Mozambique
South Sudan	70%	2022	Other Depository Corporations Survey, Bank of South Sudan
Middle East			
Yemen, Rep.	42%	2022	Monetary and Financial developments, Central Bank of Yemen-Aden
Europe			
Ukraine	21%	2022	Deposits by other financial corporations, National Bank of Ukraine, 2023
North America			
Haiti	68%	2021	Consolidated balance sheets of commercial banks (includes obligations to the private sector), Central Bank of Haiti

Note: The FCY deposit share excludes deposits at the Central Bank. We only show countries for which FCY deposit share figures were available.

14 Country selection is dependent on data availability.

2 How can challenges to scaling local currency finance be overcome?

Improving DFIs' use of LCY lending hinges on addressing three separate issues.

First, DFI internal processes, culture, and risk management strategies need to be reviewed. Second, supply-side challenges should be tackled through ways that expand options for sourcing LCY. Third, demand-side obstacles need to be addressed through strategies that lower LCY lending rates.

2.1 Internal changes

Internal institutional changes are needed to scale adoption of LCY among DFIs. Historically, FCY-based lending has been the default option in DFIs' investment strategies (see **Box 2**). On top of historical path dependencies, LCY lending is more technically complex and time-consuming than FCY transactions. Given that DFI incentives often favour the volume and number of transactions, investment officers tend to prefer FCY operations since these are typically larger and can be finalised more easily.[15] Moreover, risk management frameworks do not encourage, nor even permit in some cases[16], LCY lending – a reflection of the fact that LCY lending is not generally recognised as integral to DFIs' mandate. Therefore, a genuine and sustainable shift towards greater use of LCY lending requires a review of DFI organisational culture, practices, and strategies.

2.1.1 Organisational changes

Targeted communication, capacity-building efforts, and dedicated resources, transversal within institutions, can help reshape DFIs' attitudes towards LCY lending. The importance of deploying LCY lending, as well as approaches and technical dimensions need to be communicated frequently and effectively within DFIs. This can begin with relatively low-cost efforts, such as sharing success stories of innovative LCY transactions. Investing in and disseminating information databases on country-specific foreign investment regulations

15 Clients tend to have a short-term view of risk that incentivises them to accept FX risk by signing on FCY loans in order to avoid the higher interest rate costs associated with LCY lending. Critically, no empirical evidence supports the notion that LCY is generally more expensive than hard currency.

16 For example, the African Development Bank's charter only allows it to operate in FCY, either USD or South African Rand (ZAR).

(e.g., local bank account requirements, interest rate regulation, repatriation of funds) can critically support teams in evaluating LCY lending options. As a further step, LCY lending considerations should be highlighted since the onset of a transaction cycle. Some DFIs are operationalising this positive approach by capacitating treasury teams with LCY-specific skills (e.g., BII). Some are establishing focal points across front-, middle-, and back-office teams who together constitute LCY-knowledge groups tasked with providing LCY-specific advice along the investment process (e.g., FMO). Implementing KPIs and reward-mechanisms targeted to LCY transactions could help strengthen incentives for investment teams more systematically. Ultimately, investment decision-making processes should be reviewed so that LCY lending features as the first option to consider, provided that domestic market conditions allow.

2.1.2 Adjusting risk management frameworks and rethinking lending practices and models

Tackling the existing barriers driving DFIs' low appetite to adapt to FCS' operating environment is key to achieving greater use of LCY lending. To this end, efforts must tackle and reform DFIs' risk-management policies – or even their founding charters (e.g., AfDB) – which discourage LCY lending either by prohibiting onshore operations altogether or by strictly requiring back-to-back loan hedging, or perfect hedging, against FX risk.[17] Action and support is required by shareholders, allowing freedom for DFIs to review their liquidity management and credit and market risk mitigation policies. Transaction structures should be re-designed to allow a more active risk management with respect to size and maturity.

Amending DFIs' risk frameworks depends on treasury formulating proposals as well as on buy-in and action from shareholders and DFI senior management. Amending risk management frameworks does not mean seeking approval to take open FX risk altogether. Operating in LCY in FCS requires dealing with many imperfections or mismatches and that may be overcome with a well-thought-out dosage of flexibility, provisioning, and risk-taking. For example, one possible adjustment would be to grant flexibility in the management of refinancing risk, by allowing to hedge medium-term loans with short-term instruments, when these are the only ones available. Furthermore, enabling DFIs to take onshore credit and interest rate risk, and opening cash and custody accounts in imperfect markets opens the door to onshore liquidity management, which effectively mitigates convertibility risk. DFIs should consider taking measured risks, making well informed trade-offs with a view to supporting delivery of LCY lending. Other examples of adjustment would be to embed the option to choose between FCY and LCY at disbursement stage in dual currency loan

17 Some DFIs see LCY as a prerogative of the private sector.

agreements or to switch to LCY after the loan has been disbursed in FCY-denominated loan agreements, as highlighted by FMO and IFC; creating capital allowances for high-development impact projects that are allowed to assume greater risks, including LCY risk (e.g., BII's catalyst portfolio), or establishing off-balance sheet structures, such as funds, with unique, higher risk-carrying capabilities, as in the case of EIB's Africa Caribbean Programme (ACP) and FMO's MASSIF.

BOX 2. WHY IS LCY LENDING SO UNDERDEVELOPED?

The limited use of LCY lending among DFIs is primarily due to:

- **Lack of affordable, long-term LCY hedging solutions,** which make FCY the only viable option.[18]

- **Absence of stable macro conditions in FCS,** which does not enable a local market to develop and is not conducive to DFI lending in LCY.

- **Global macro-economic conditions,** including low FCY interest rates and low FX volatility since the Global Financial Crisis, that made borrowing in USD an especially attractive option for borrowers, leading to growing FX exposure and a build-up of FCY-denominated debt. Interestingly, the same could be observed in the decade leading up to the Global Financial Crisis![19]

- **Institutional legacies –** The current DFI institutional setup stems from the Bretton Wood system in which fixed exchange rate regimes (with currencies pegged to gold or the USD) prevailed.[20] In the 1970s, the system became unsustainable, leading to a global transition towards floating exchange rate regimes. Critically, a fundamental part of the international finance architecture – DFIs, multilateral development banks (MDBs), and International Financial Institutions (IFIs) – did not participate in this shift, as they continued lending in FCY. Reasons for this include:

  - **Incentives –** Borrowers, lenders, and donors of development finance all share the same preference for short-term lending at low cost (i.e., low interest rate).

    - Borrowers, private or public, have short-term decision-making horizons (often linked to political cycles) that push them to perpetuate old practices by which FCY debt with

18 Kapoor, Hirschhofer, Kapoor, Klieterp, 2021
19 Institute of International Finance, 2023
20 Kapoor, Hirschhofer, Kapoor, and Klieterp, 2021

lower upfront costs is preferred notwithstanding its risks of becoming more expensive in the long run.

  - Lenders' mandate is to issue as many and as large loans as possible, which is typically achieved more efficiently with FCY lending.

  - Donors prefer the rapid disbursement of concessional loans through MDBs and IFIs over grant finance. Notably, grant mobilisation is more time consuming as it requires parliamentary approval.[21]

  This *unholy alliance* systematically persists today in discouraging LCY lending.[22]

- **Little interest in developing basic liquidity and FX and interest rate markets** – With the collapse of the Bretton Woods system came the need for hedging and derivatives markets, with the first USD/DEM and USD/CHF cross currency swaps signed in 1981 between IBM and the World Bank. Owing to their underdeveloped financial systems, and with DFIs, MDBs, and IFIs being limited in how much TA could be oriented towards the establishment of money markets, developing countries could not keep up with the rapid evolution in advanced countries, as key building blocks of their financial systems were still missing (e.g., money market indices, sovereign yield curves, High Quality Liquid Assets [HQLA] as collateral, International Swaps and Derivatives Association [ISDA] friendly legal environments).

- **Risk averse investment culture –** DFIs' prudential practices reflected in their risk management frameworks typically require perfect hedging.

2.2 Sourcing and delivering in LCY

2.2.1 Staying offshore

2.2.1.1 Synthetic LCY loan

DFIs' main approach to deliver LCY is synthetic LCY loans, which allows them to remain offshore and less exposed to the limitations of the local market. From the borrower's viewpoint, the mechanics of synthetic LCY lending work as follows (**Figure 5**): The DFI disburses in

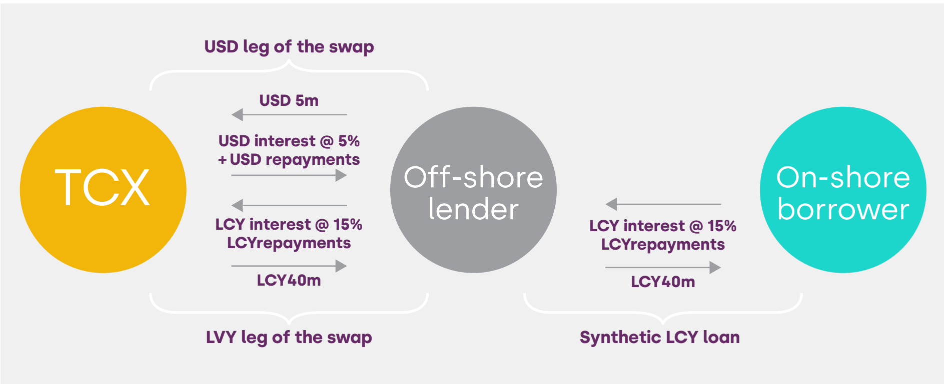
21 Concessional rates often persuade borrowers to accept seemingly highly affordable FCY lending and disregard the potential impacts of depreciation and the real cost of borrowing.

22 Interview with stakeholder

FCY, with a clause in the loan agreement specifying that the principal and interest payments are indexed in LCY. The interest rate on the loan is fixed at an agreed value that factors in the cost of the hedge.[23] Therefore, regardless of currency movements, the borrower always owes exactly what was initially budgeted for in LCY, at repayment dates. The FCY amount transferred to the lender varies depending on the spot rate. In this way, the borrower is protected against currency fluctuations and enjoys predictable debt service repayments. Importantly, at repayment dates, the borrower has the responsibility to exchange the interest payment and loan amortisation in the local market and transfer the corresponding FCY amount back to the DFI.[24]

To manage market risks, DFIs hedge their interest rate and currency risk exposures associated with the LCY loan with a market counterparty, typically TCX[25] or an international bank, through a non-deliverable swap (Box 3).[26] This consists of a forward FX contract whereby, on the contracted settlement date, the DFI owes the market counterparty an amount in FCY based on the spot rate and the market counterparty owes the DFI an amount established at the onset, regardless of exchange rate movements. Any profit or loss is adjusted between the two parties based on the difference between the contracted rate and the agreed prevailing spot FX rate on an agreed notional amount.[27] The DFI always receives the originally agreed interest rate return and principal.

Figure 5: The synthetic LCY loan (flows settled in USD) and the non-deliverable swap[28]



Source: TCX compendium 3.3.1 Synthetic LCY

23 Interest rates tend to be higher than what interest would be on a normal FCY loan because of the cost of the hedge.

24 In a synthetic loan, risks are priced in LCY but cash flows between borrower and lender are in FCY.

25 TCX, established in by a group of national governments, DFIs, aims to provide swaps and forward contracts in emerging market currencies.

26 Non-deliverable because the swap provider never actually swaps LCY for FCY and vice-versa, at disbursement and repayment.

27 Notional value refers to the value of the underlying asset in a derivatives trade.

28 TCX Fund, unknown date. LCY/USD exchange rate is 8/1.

Synthetic LCY loans hedged with non-deliverable forwards, or NDF, represent a scalable risk-resilient alternative to FCY loans. Market risk is borne by the market counterparty. A key advantage of the synthetic hedge is that it allows to split the FX risk from the counterpart credit risk and thus makes it easy to on-sell the related LCY FX exposure. Over the past years TCX has been successful at opening up a whole new investor universe that can absorb currency risk. This is a critical development that marks a turning point in terms of scaling up LCY lending. To date, TCX has been able to maintain a positive performance, except for short-term fluctuations, thanks to the currency diversification of its portfolio. Ultimately, to strengthen responsible lending practices, in the absence of local solutions, DFIs should consider synthetic LCY loans systematically as an alternative to FCY loans.[29]

Notwithstanding their benefits, synthetic loans still present a few challenges and drawbacks linked to costs, maturity, and risk management. As discussed above, the **cost of the hedge** is reflected in the lending cost borne by the borrower via the interest rate, which tends to be high, especially in FCS, due to depreciation risk. Further, the **maturity** of these instruments tends to be limited to 3 to 5 years. This can limit lending operations for projects with longer time-horizons, such as infrastructure. Finally, synthetic loans do not protect against all risks. Critically, borrowers, and therefore their DFI lenders, continue to shoulder two non-negligible risks: **convertibility risk**, or the inability to convert LCY into FCY at repayment date, and **transfer risk**, or the inability to transfer funds to the offshore creditor, even when the amounts were successfully converted into FCY. Both risks (T&C risk) are typically due to exchange rate restrictions imposed by the government or the central bank, with which FCS are fraught. Given the lack of foreign liquidity in FCS markets, convertibility risk is especially relevant. On top of formal transfer and convertibility (T&C) risk, often seen as a political risk, the **liquidity risk in the spot market** also limits the effectiveness of non-deliverable forwards as hedging instruments. In many FCS where the local spot FX market is not deep enough or the FX regime results in zero dollars (e.g., Nigeria), the spot market is so illiquid that it can take months or even years to transfer funds out of the country.[30]

These risks highlight the advantages of working on shore, which requires DFIs to accept some mismatch and onshore interest rate risk. As discussed further in **Section 2.2.2**, onshore treasury capabilities, such as through cash and custody accounts, in parallel with ongoing local funding needs, help mitigate T&C concerns of DFIs who can invest excess LCY in local T-bills or use it to finance new LCY loans. Another, more immediate approach is to purchase T&C insurance products, discussed next.

29 TCX Fund, 2023

30 Deliverable swaps with strong counterparties would mitigate the liquidity risk but may still be subject to T&C risk in the political and legal sense.

BOX 3. THE CURRENCY EXCHANGE FUND NV, OR TCX

Established in 2007 by a group of national governments and DFIs, TCX prices and offers cross currency swap and forward contracts in emerging and frontier market currencies, primarily for development finance operations. Instruments are typically non-deliverable; deliverable contracts are only available for specific currencies. TCX has a capitalisation of 1.1 billion USD, with a 5 billion USD balance sheet of derivatives. Its LCY hedging instruments have an average maturity of 3 to 5 years, with interest rates higher than those on FCY.[31]

Under the current pricing model, TCX has had a positive performance, breaking even or making a modest positive return in most years. Volumes and capitalisation have doubled between 2015 and 2019.[32]

Given the lack of established secondary market in which to sell on its FX exposures (with some exceptions), TCX's diversification across multiple currencies (over 70) in low- and middle-income countries has been key to manage part of the balance sheet risk.[33] Nonetheless, residual risks remain, and current capitalisation levels are insufficient to mitigate wider balance-sheet losses. This, as a consequence, constrains the scale of its hedging operations. Currently, TCX mostly hedges lending to small, private entities rather than financing for larger borrowers, including sovereigns, and is looking to change that. Its engagement in the infrastructure sector, including renewable energy, has been on a rising trend.[34]

2.2.1.2 Tackling Transfer and Convertibility (T&C) risk

Whether in FCY or synthetic LCY, DFIs are often constricted to lend in the presence of T&C risk. Solutions exist but are not available for all FCS. For some institutions, T&C risk is enough to discourage FCS investment altogether. Some opt for including a T&C risk premium in the cost of borrowing, which again raises the all-in lending rate. Others choose to mitigate T&C risks with tailored insurance products when they are available, such as MIGA's Political Risk Insurance (PRI) and EDFI's T&C Facility, discussed below (**Table 7**).

31 Kapoor, 2021; Eichengreen and Poonam Gupta, 2023
32 König, Clubb, & Apampa, 2020
33 Kapoor, Hirschhofer, Kapoor, and Kleiterp, 2021; Eichengreen and Poonam Gupta, 2023
34 Eichengreen and Poonam Gupta, 2023

Table 7: Insurance products against T&C risks

Product	Size (million)	Eligibility		
		Tenor	Coverage[35]	Creditor
MIGA's PRI T&C coverage	-	Up to 20 years	16/37 FCS	Offshore, Any sector
EDFI's T&C facility	EUR 26.2	Up to 7 years	17/37 FCS	Offshore, Independent Power Producers in renewable energy sector

2.2.1.2.1 MIGA's Political Risk Insurance – Transfer and Convertibility coverage

MIGA's PRI protects against four types of non-commercial risk: breach of contract, expropriation, war and civil disturbance, and T&C risk. T&C risk protection is activated in case of losses arising from clients' inability to legally convert and repatriate funds, including dividends on equity and debt service on loans, from LCY to FCY. Eligible underlying transactions include cross border finance and derivatives by any offshore creditor for a tenor of up to 20 years. MIGA's PRI is available in 40% of FCS (**Annex C, Table 15**). Importantly, PRI is provided to transactions under the IDA Private Sector Window (PSW) which, given its mandate, includes several FCS. MIGA's exposure in FCS has increased over time and represents 12% of gross issuance in 2022 (or 592.2 million USD out of 4.9 billion USD).[36] This highlights scope for greater risk appetite and geographical coverage.[37]

2.2.1.2.2 EDFI's T&C Facility

The EU-funded Transfer and Convertibility Facility was launched by EDFI in 2021.[38] While the facility covers T&C risks for renewable energy projects where debts are in FCY and revenues are in LCY, it is covered in this paper because the approach of introducing a T&C reserve facility can be replicated in other synthetic LCY lending contexts.[39] The facility amounts to EUR 26.2 million and is available to European DFIs and their co-funders in 48 African countries, including 17 FCS) (**Annex C, Table 15**). Practically, it will finance project-specific reserve accounts and can be used by lenders in case of a non-convertibility or non-transferability event experienced by the client, for up to 12 months of principal and interest over a covered maximum 7-year period.[40]

35 Based on the World Bank Group's 2023 FCS List

36 MIGA, 2022. This is below the 2015-2017 share (17%); in absolute terms, 2017 figures for FCS amounted to 425 million USD (MIGA, 2017).

37 Meyer, 2018

38 In sub-delegation structure to France's DFI Proparco

39 GET.invest, 2023

40 Proparco, 2021

2.2.2 Operating onshore

Onshore approaches should be the preferred route to LCY lending, but in imperfect markets they still present challenges. An important reason for DFIs to go onshore is that it contributes to local market development which is the priority to resolve sustainably the current and persistent illiquidity in local FCS markets. Further, working onshore mitigates T&C risk. DFIs can chose between a funded and unfunded approach.

2.2.2.1 Funded onshore operations, becoming a local market participant

2.2.2.1.1 Hedging with local counterparts

The first step in the funded onshore approach is hedging FX risk with local counterparties and, on the back of a recurrent flow of lending projects, managing LCY liquidity in the domestic market. Onshore hedging costs are typically lower than offshore hedges, which is a major advantage next to the mitigation of T&C risk. However, hedges might not be available at the required maturity. If this is the case, an imperfect accounting approach for refinancing risk may need to be adopted. Further, when hedging with a local counterparty, a DFI effectively replaces an FX risk with a counterparty credit risk (CCR) on the local banking sector or the local sovereign, since liquidity is typically invested in the domestic equivalent of T- bills. FX and credit risk are correlated because the onshore counterparty is more likely to default in times of crisis, exactly when the currency is depreciating. Therefore, going onshore requires adequate credit risk appetite, which is a serious challenge in most FCS. DFIs typically face strict credit restrictions in their treasury operations and, for example, can only enter trades with counterparties rated A- or above. Further, managing a pool of liquidity onshore requires basic infrastructure, including local cash and custody accounts, and exposes the offshore entity to legal risk.

DFI onshore involvement can take several further forms. These include issuing LCY bonds and undertaking policy dialogue with local authorities and financial institutions, public and private to (i) create an enabling environment for onshore operations, and (ii) strengthen local banks' balance sheet management with a view to increase their lending capacity in LCY. This will allow for effective use of instruments like FX hedging, cross currency swaps, and guarantees.

2.2.2.1.2 Cross currency swaps with central banks seek LCY liquidity at the source

As an alternative to the local banks, several DFIs have actively sought or are contemplating to source LCY liquidity via cross currency swaps with central banks, typically on a 3- to 5-year maturity.[41] These are seen as a win-win solution for both parties: The offshore DFI can access LCY at a rate that is appropriate for the local market; at the same time, the swap acts like a stamp of approval that may reinforce trust in the local financial system. This has special value in difficult periods, such as the Covid-19 pandemic or the conflict in Ukraine, since FX brought in by the swap strengthens FCY reserves. To avoid any distortions, it is paramount that the pricing delivered to the offshore entity through the swap is aligned with the funding cost of the local banking system, to ensure a level playing field. Ukraine is the only FCS that was mentioned as having entered such an agreement.

While such swaps may lead to a more attractive cost of funding in LCY, they can be complex to implement, in particular because of lack of clarity around their accounting treatment. The central bank may be discouraged from entering such an agreement by the fact that in non-ISDA compliant jurisdictions in particular, the final exchange of notional, in which the central bank repays the USD amount received at the outset, may be recorded until maturity as a USD liability for the central bank. In reality, the USD amount received at inception would constitute, in parallel, an asset facing the USD liability, so that both offset each other, and Net International Reserves are not impacted by the swap. Unfortunately, the interpretation may vary in different countries, and the IMF has not yet formally clarified the subject. This is regrettable because there is sometimes no reasonable onshore alternative counterpart in FCS and the central bank remains the main onshore source of LCY. Furthermore, the DFI requirements of minimum counterparty credit rating and enforceable ISDA standards can act as a brake when facing central banks in FCS.

Nonetheless, ways to tackle these obstacles may exist. For instance, in countries with an existing IMF programme, a portion of it could be carved out at the outset as collateral for DFI swaps. The IMF could act as a custodian and ensure availability until the swap matures. Another possibility would be for the central bank to immediately post back as collateral, the USD amount received at inception. Should the central bank prefer to immediately invest the USD notional in a market instrument, the DFI may issue a USD-denominated bond or note with a payment structure similar to the USD cash flows under the swap, that the central bank could buy and carve out for the benefit of the DFI as swap counterpart. These workable solutions remain complex to implement for a central bank in FCS, and, pending clarification

41 The countries discussed were Azerbaijan, Egypt, Georgia, Kazakhstan, Kenya, Moldova, Mongolia, Romania, Rwanda, Tajikistan, Ukraine.

of the IMF on their impact on Net International Reserves, they may be reluctant to enter them for fear of triggering a breach of reserve targets under IMF programmes.

2.2.2.1.3 Issuing a local bond is not the straightforward, immediate, one-card-does-all solution

Some DFIs fund their activity through highly rated bond issuances for which there is huge demand, and in a range of currencies. Confronted with the need to source LCY, it is tempting to want to replicate that successful model in a local market by issuing local bonds, i.e., sourcing LCY by raising funds with domestic investors.

However, this approach presents various challenges related to local financial markets. The insufficient depth and breadth of the domestic savings pool is the main hurdle. With no institutional investor base, except for a few countries, such as Nigeria, buyers are essentially local banks and securing eligibility of the DFI bond to repo with the central bank is paramount for placement. However, since local market regulations typically exclude issuance by non-resident entities, authorities first need to be persuaded that making an exception to that rule for DFIs will benefit the local economy. Ministries of finance are wary of competition for their government bond investor base, in particular if this is coming from a AAA-rated issuer. Domestic banks will be concerned about DFIs competing or undercutting them in LCY, their home turf, and perhaps lobby against. Finally, swapping LCY proceeds out into FCY would drain FX reserves and is an absolute no-no. Therefore, it is important to be ready to manage liquidity in the imperfect local market.

For all these reasons, being able to show on-going momentum in LCY lending in the form of a growing LCY portfolio and pipeline is key to reassure the authorities. Bringing the local market infrastructure, including the money markets, stock exchange, securities depositories, and legal and regulatory environment, closer to international standards, for instance in terms of asset segregation and documentation, is often required for foreign actors including DFIs to be comfortable accessing the market, and the ensuing reforms may take years to complete.

Eventually, after all these efforts, the bond rate on issuance reflects interest rate levels and market conditions on that very day—and these can be particularly volatile in FCS. While issuing a local bond does indeed avoid paying FX hedging costs, the funding rate achieved generally remains above the local sovereign funding level and above the funding level of the domestic banks that operate on the back of an (often) unremunerated deposit base. Last but not least, DFIs' conservative internal risk management framework is again typically by limitations on their ability to take any market risk, meaning that they can only issue bonds when they have projects to fund. The need to match bond issuance with disbursement of underlying loan projects creates a huge hurdle. In practice some DFIs have issued bonds and then immediately converted to USD, because of this treasury restriction. Swapping out makes little sense from a development point of view and is unacceptable for local authorities as mentioned previously.

Given these challenges, while LCY bond issuance may contribute to local market development, it is often not the first step in DFI LCY onshore strategies. Rather, it typically comes after already operating in the LCY for some time and showing commitment to local market development. When thinking about mobilising local capabilities and the domestic savings pool, it may be more effective to work first on empowering the domestic banking sector.

2.2.2.2 With improved balance sheet and liquidity management the local banking sector can become a more effective counterpart and lender

To effectively and sustainably deliver LCY onshore, DFIs should target more of their efforts at money market reform. Through their loans, commercial banks create most of the money in the economy but, in a broken market, without the adequate instruments and skillset, they hardly realise their lending potential. Changing that starts with strengthening the basic building blocks of (LCY) liquidity management, in the money market. The stepping-stones are clearly identified, (1) starting with the definition of a well-defined overnight benchmark rate, and, within a sound monetary policy framework, (2) progressively building an interest rate curve, while also (3) addressing the imperfections of the legal, regulatory, tax, and accounting frameworks around derivative instruments.[42] Activity in the local repo and FX market slowly picks up with improved liquidity management and the Basel capital framework's Pillar 2 (IRRB Interest Rate Risk in the Banking Book) stimulates the emergence of a local interest rate hedging market.[43] The optimised asset and liability management at local banks and the improved interest rate and FX market activity that comes with it allow, on the one hand, to better realise the LCY lending potential of the domestic banking sector including increasing the capacity for larger loans; on the other hand, they enable DFIs and foreign counterparties to manage LCY risks when facing local counterparties, eventually connecting the offshore and the onshore markets.

Frontclear, a financial markets development company co-funded by several DFIs, plays a catalyst role here (**Box 4**). It facilitates local and cross-border short term transactions through guarantees of the collateral involved, and so reduces the CCR of market participants in repos and FX derivatives, both key transactions for liquidity management in the local money market. Frontclear also provides capacity building and TA to support reforms, including those to secure

42 Frontclear & OGResearch, 2018

43 Bank for International Settlements, 2016

the all-important enforceability of close-out netting and settlement finality in the local payment and securities settlement systems.

Buy-in from local authorities is an essential condition for genuine reform. With the commitment of the central bank, ministry of finance, and the local banking sector, impressive progress can be achieved. Measurable differences to the development of local money markets can be seen in little more than 5-to-10 years, as in the cases of Georgia and Armenia. Critically, this will only bear fruit in the long term and in countries that are ready and consistently committed to develop their local risk frameworks. Admittedly, several FCS fall outside of that category, creating an even stronger case for the role of TA addressing their structural challenges.

BOX 4. FRONTCLEAR AND THE DEVELOPMENT OF MONEY MARKETS

The development of onshore money markets is critical to mobilising LCY liquidity and reducing costs. Money markets are central to effective monetary policy, the setting of benchmark interest rates and the efficient allocation of LCY in the financial system. The development of these markets is often constrained by CCR between market participants and especially in the interbank segment. CCR leads to segmentation in the money markets, where larger Tier 1 local and international banks have limited credit appetite to trade with smaller, local banks. In turn, this constrains the allocation of LCY liquidity, with banks becoming excessively liquid. If the inter-bank market was functioning instead, it would enable banks to recycle cash, support bond market liquidity and provide swaps for foreign investors to invest in LCY loans and bonds. In addition to CCR, the development of money markets it further constrained by limited capacity of market participants and regulators, legal and regulatory challenges and a lack of adequate financial infrastructure.

Frontclear, a development finance company dedicated to money market development, aims to address these obstacles. Set up in 2015 by various European development institutions, Frontclear provides credit guarantees and transacts as principal to cover CCR in repo, derivative, and securities lending transactions. Frontclear is provides TA for regulators, banks, and industry bodies to establish the building blocks of functioning money markets, with a focus on the development of regulatory frameworks and relevant financial infrastructure. Its overarching philosophy hinges on the idea that improving the connectivity in local money and inter-bank markets will ensure better and more efficient allocation of LCY and can enable offshore investors to participate and provide funding in LCY through swaps and other hedging instruments.

Frontclear is today engaged in several developing countries, such as Kenya, Uganda, Ghana, Nigeria, Cote d'Ivoire, Zambia, Uganda, Senegal, and Ethiopia. With regards to counterparties, most transactions are private bank-to-bank, in accordance with its mandate to promote inter-bank money markets and support trading activities among banks, with the exceptions of transactions with EBRD in Armenia and Mongolia. In the case of Armenia, Frontclear has assisted EBRD in placing excess Armenian dram (AMD) funding (from local bond issuance) by guaranteeing its risk in the interbank repo market. This has allowed EBRD to manage its LCY operations more dynamically in the country.

2.2.2.3 Unfunded route

The unfunded route leverages local financial institutions through risk sharing agreements in LCY and LCY credit risk guarantees

Risk-Sharing Facilities (RSF) are another, more immediate solution to deliver LCY by teaming up with a local bank. Under this approach, the local bank provides LCY funding for the full transaction, while the credit exposure and related remuneration are shared with the DFI. Sometimes local banks will stick to the short-term tranche and the DFI will take on the full credit risk for the long-term tranche. This route requires a desire to cooperate from both parties, as well as transparency, and some DFIs find it complex to implement. The approach was recently adopted by BII when it partnered with Standard Chartered to sign a USD 40 million Risk-Participation Agreement to create a long-term, sustainable local currency lender in Pakistan and enable access to finance for SMEs, agri-related businesses, and woman entrepreneurship.[44]

Guarantees are also powerful tools. They support LCY delivery via the local financial sector, the least expensive source of LCY. Moreover, they are flexible instruments that can be built into a transaction where and when needed in order to document a risk transfer, with cash flows exchanged only in case of default. Several DFIs issue guarantees in LCY to facilitate bond placement as they lower the related risk weighting in the buyer's balance sheet. Guarantees also help crowd in private capital with a local balance sheet that can invest in long-term debt, including via bonds. It is important to ensure that the guarantee facilitates placement and helps build up investors credit risk knowledge and appetite. Indeed, it often happens that, even if a guaranteed tranche offers a lower remuneration, all investors move

44 British International Investment, 2023

away from the unguaranteed tranche they initially intended to buy, and flock to the guaranteed one after it is announced.

There are a few, notable examples of initiatives guaranteeing credit risk in LCY to support delivery in LCY by domestic financial institutions. These include GuarantCo, focused on providing credit solutions to support sustainable infrastructure projects in lower income countries across Africa and Asia, the African Solidarity Fund and the African Guarantee Fund for Small and Medium-sized Enterprises, focused on SMEs (**Box 5**).[45] In the case of SMEs, guarantees in LCY help raise local banks' appetite for SME credit risk and broaden the range of entities they lend to. With the benefit of a GuarantCo guarantee for instance, local banks are comfortable taking on infrastructure and project finance risk and working on the long-dated maturities typically required by such projects (i.e., either via a credit guarantee to cover risk or a liquidity extension guarantee to extend maturities). It is important to note that the provision of guarantees is a route followed by many DFIs, including IFC and a number of bilateral institutions, that reaches several USD billions in various forms including credit, trade finance, risk-sharing facilities.

Working with the local banking sector is a desirable and effective way forward, but not without challenges. In many FCS countries, the low credit standing and poor local governance prevent international lenders from partnering with local financial institutions and issue guarantees in their favour.

BOX 5. LCY RISK MONITORING AT GUARANTCO

GuarantCo provides LCY credit guarantees to support sustainable infrastructure development in lower income countries across Africa and Asia. GuarantCo is funded in FCY by seven G20 countries. It mitigates its LCY exposure via diversification, being aware that the "right-way risk" will likely play in its favour: In situations where the LCY depreciates, a default on a LCY loan will have a smaller impact in USD terms (i.e., lead to a smaller loss). Given the contingent nature of its exposures and the stage in its evolution and consequent level of currency exposure, GuarantCo currently does not hedge. However, that is a position that is constantly under review as its portfolio evolves and the position is subject to change. Country limits are closely monitored at GuarantCo - and by its parent company the Private Infrastructure Development Group, and a couple of ways in which concentration in a currency is addressed,

45 Africa counts several multilateral financial guarantee institutions, the three main ones being the African Solidarity Fund with 16 member countries, the Fonds Africain de Garantie et de Coopération Economique (FAGACE) with 14 member countries, and the AGF, attached to AfDB. All three support SME finance via financial institutions through portfolio or individual guarantees.

amongst others, is via "local credit-enhancement facilities", whereby risk is borne by or shared with a sister or related entity dedicated to that country with separate donor funding, or by sharing the risks across other entities of the Private Infrastructure Development Group. Whilst the GuarantCo mandate is to provide LCY credit guarantees, it however, struggles to deliver LCY in some FCS as the local financial sector is too weak and the liquidity available for infrastructure lending will only come from international lenders with a USD balance sheet.

2.3 Lowering the all-in lending rate in LCY

Lowering the all-in lending rate is critical to enable the delivery of LCY lending in FCS. The all-in lending cost in LCY is the sum of the funding rate in LCY plus the credit margin (**Figure 6**). With LCY rates being typically much higher than in USD or EUR, adding in the cost of hedging leads to an all-in lending rate that often compromises the bankability of projects. The figure below shows in a simplified way (proportions are indicative and for illustration only) the main components of the pricing of a LCY loan, and the different approaches that have been developed to reduce the all-in lending rate in LCY by tackling its different components. Lowering the all-in lending rate may leverage TA, subsidy, FX loss absorption, credit loss absorption and staying unhedged, and often involves a combination of these approaches.

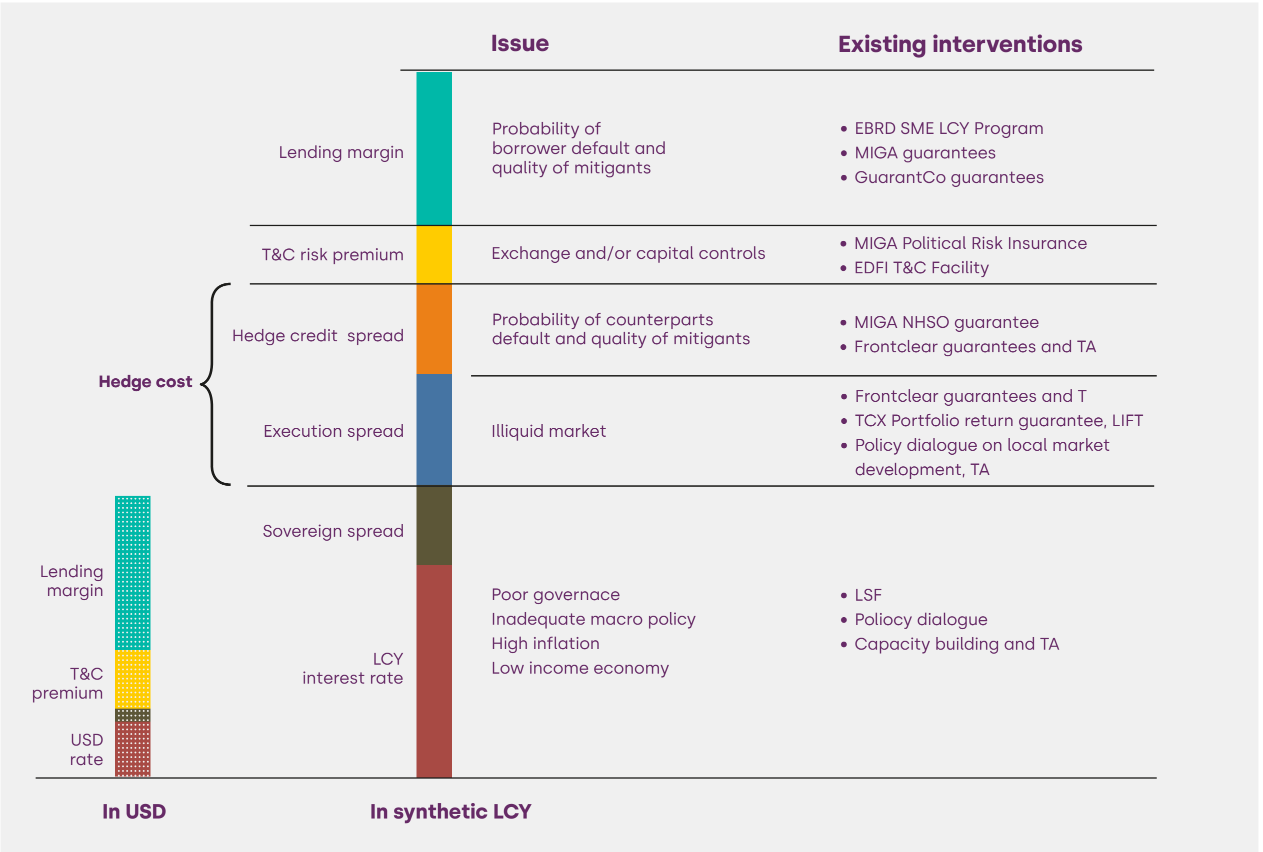


Figure 6: Breakdown of the all-in lending rate

2.3.1 Policy dialogue and TA to support local money market development

To stabilise and lower LCY interest rates, policy dialogue, capacity building, and TA initiatives aimed at establishing a sound macro-economic policy environment and an effective monetary policy framework with inflation under control are effective tools. As discussed previously, these constitute the foundations and pre-conditions to build up momentum in the local money market, and later on, in the capital markets.

In these regards, a notable initiative is Frontclear and EBRD's Money Market Diagnostic Framework, or MMDF.[46] The MMDF is an in-depth assessment of a country's money market, focused on four pillars (current level of money market development, market environment, central bank activity, and market resources) that informs regulators on the starting point to reform the financial system.[47] This tool has been rolled out in 15 countries and will be expanded to another 6 countries this year with funding from IMF and World Bank. Detailed diagnostics and rankings across many countries are critical to create awareness but also healthy emulation among central banks to enact reform.

Progress on this front will not only impact the interest rate levels, but it will also lower the hedging cost through improved market liquidity and credit risk mitigation. It may take several years for these efforts to achieve their desired effect, with stability and the absence of armed conflict an essential condition for success. Most FCS countries unfortunately offer little perspective of creating the required enabling environment in the foreseeable future. Ukraine may be an exception here: The country was well under way toward establishing an inflation-targeting framework and will hopefully resume its journey soon.

2.3.2 The Liquidity and Sustainability Facility aims to reduce the cost of borrowing for African Sovereigns[48]

The Liquidity and Sustainability Facility (LSF) was established by United Nations Economic Commission for Africa (UNECA) and formally launched in November 2022. It intends to improve liquidity in the African sovereign Eurobond market and reduce the high illiquidity premium currently priced in their yield by facilitating repo transactions backed by these bonds. As of today, two African FCS Eurobond issuers, Nigeria and Mozambique, can hope for an improvement in their USD

46 Frontclear, 2023

47 Frontclear, 2023

48 The LSF was designed by the United Nations Economic Commission for Africa, in collaboration with Afreximbank, and closed its inaugural USD 100 million repo transaction in November 2022

yield through the LSF. The facility is a long shot in terms of positive impact on LCY markets. Eurobonds offer a familiar and transparent benchmarking of country risk for international investors. An improved perception of risk around African sovereign Eurobond markets is likely to eventually trickle down to local markets. Private sector borrowers might therefore benefit from it.

2.3.3. MIGA's Non-Honoring of Sovereign Financial Obligations coverage is a credit guarantee in LCY available to offshore lenders and hedge providers

Under the Non-Honoring of Sovereign Financial Obligations (NHSFO) product, MIGA will guarantee up to 95% of the credit risk under a LCY loan or a LCY hedge, typically up to 15 years.[49] Hence, this tool can lower the credit spread included in a hedge or a loan.

However, NHSFO comes with numerous restrictions. Currency devaluation is explicitly excluded from coverage. Further, the guarantee is only granted if the obligor is a sovereign, sub-sovereign or state-owned entity with a MIGA credit rating equal or better than BB-, and provided the guarantee is denominated in a "freely convertible" currency, which currently includes CHF, EUR, GBP, JPY, USD, and Colombian peso (COP) and South African rand (ZAR). In other words, MIGA will guarantee the repayment of a synthetic LCY loan by guaranteeing the repayment of a (freely convertible) USD loan amount plus the related USD interest hedged into LCY, by an eligible obligor. The guarantee's pay-out is capped at a Maximum Aggregate Liability (debt + hedge), i.e., breakage costs are covered up to an agreed ceiling. Importantly, the BB- minimum eligibility rating excludes FCS states (**Annex C, Table 15**).

Notwithstanding these restrictions, this MIGA guarantee is a powerful tool. It takes out the requirement for collateral deposit by the obligor (the non-availability of acceptable collateral being a typical stumbling block in derivative transactions) and it can help lower the all-in lending cost of borrowing in LCY when hedging is involved. Notably, addressing the gap in eligibility for countries with a credit rating lower than BB- would make a significant difference in scaling up LCY lending in FCS.

2.3.4 EBRD's SME LCY programme reduces the lending margin through credit enhancement

EBRD's SME LCY programme supports lending in LCY to financial institutions and SMEs in countries with underdeveloped LCY markets where authorities actively seek to remedy the situation. A pool

49 Eligible transactions are cross currency swaps, FX swaps and interest rate swaps. Repos and FX forwards are excluded.

of donor money absorbs the first loss of a portfolio of LCY lending to SMEs and financial institutions in the eligible countries, leading to reduced credit margins and lower all-in lending rates in LCY. Blended finance rules apply and ensure that the all-in lending rate remains aligned with local market levels. The programme is effective in supporting delivery of LCY lending to SMEs and is remarkably sustainable with a very low default rate since launch in 2011. Many FCS would struggle, though, to meet the eligibility criteria requiring them to proactively work on developing their local money market.

2.3.5 TCX's LIFT programme and Portfolio Return Guarantee supports concessional hedging

TCX's Livelihoods and Food Security Fund (LIFT) programme was developed to support LCY lending in Myanmar by microfinance providers.[50] It acts as a donor and provides a grant that TCX uses to lower the hedging cost. The approach is based on a direct subsidy of the price that TCX quotes for hedging the targeted lending activity. The key advantage of locating grant usage at TCX is that it can be used consistently across transactions and lending activity. However, there is no leverage of donor money since it is used one-for-one as the targeted portfolio builds up.

The Portfolio Return Guarantee is an approach recently developed by TCX, that has been approved but is yet to be implemented. The EU's EFSD+ programme issues a performance guarantee on TCX concessional hedges for LCY funding for renewable energy in selected African countries. Through the instrument, TCX is guaranteed a minimum yearly return on the concessional hedge portfolio it builds based on agreed eligibility criteria. Leverage is adjusted on a country-by-country basis and is expected to help mobilise billions for off-grid projects in Africa as it grows from 120 million EUR of notional to a planned EUR 1.2 billion, with a focus on the energy sector and poverty reduction. Some FCS countries are covered and, with possible overlaps that will require solving, a similar approach could be envisaged for FCS countries more generally, with adjusted leverage and a lending theme to be defined. The programme is only open to DFIs. By contrast with the LIFT programme, in this approach the donor contribution is leveraged. The use of the subsidy can be managed consistently across the hedge portfolio, with clear guidelines on eligibility and implementation taking into consideration local market lending levels.

2.3.6 IFC's Private Sector Window uses direct subsidies

The Local Currency Facility (LCF) part of IDA's IFC-MIGA PSW allows IFC to provide financing in LCY for high impact projects in IDA and FCS countries where LCY solutions are underdeveloped or

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50 TCX Fund, 2017

completely missing. PSW offers credit guarantees on local banks, first-loss cover on credit risk, and can act as hedge provider using one-for-one subsidies in order to improve the all-in lending rate with a view to improve bankability, with blended finance rules framing the decision. It applies to the 75 IDA and FCS countries and users hail the simplicity of the solution in terms of booking and of its effectiveness in lowering prices and delivering a hedge (**Annex C, Table 15**). Donor contributions absorb gains and losses. The main drawback is that this is a relatively expensive solution: The hedge subsidy makes immediate, intensive, one-off use of donor grants, though there is a mobilization component in that IDA hedging can be blended with other sources (including IFC bond issuances, TCX hedging, and commercially provided hedges), and returnable capital is recycled as transactions mature thereby revolving resources.

To achieve leverage for highly concessional sources of hedging like IDA PSW's LCF, IFC can rely on offshore LCY bonds. By blending IDA PSW resources (returnable capital) with bond issuances (in addition to TCX's non-deliverable forwards or commercially provided hedges), it can achieve the needed pricing levels while optimising the use of LCF resources. Notably, the offshore bond represents the functional equivalent of a non-deliverable forward (i.e., a synthetic LCY bond).

2.3.7 Delivering LCY unhedged

Perfectly matched asset and liability management requires DFI to hedge the currency risk stemming from loans. Sound banking and risk-management principles prevent DFIs from taking open FX risk exposure on their balance sheets. This is standard practice outside trading books or investment funds taking FX risks: Unlike equity, which to some extent enjoys a natural hedge from FX since it does not involve fixed nominal obligations, debt borrowers are hit by both currency depreciation and higher interest rates which tend to move hand in hand during bad times.[51] With unhedged FX exposures, capital charges can be very high, and in the extreme, might put AAA rating bond issuance programmes at risk.

Most DFIs are only permitted to enter derivative transactions with counterparties rated A- or better, which means that TCX is often the only eligible hedging counterpart for FCS currencies. On top of risk considerations, delivering in LCY most effectively requires an onshore infrastructure and deep understanding of local market dynamics that most DFIs do not have, especially in FCS.

Within this context, faced with the pricing and complexities of hedging in FCS, several DFIs have chosen to deploy LCY unhedged, with a track record going back more than 10 years. Working

51 Schinasi, 2017

unhedged does indeed bring advantages that are particularly valuable in FCS, including more flexibility in setting the all-in lending rate, which can be prohibitively high in FCS jurisdictions, and making it easier to accommodate required flexibility in the repayment schedule, since there is no need to reposition a hedge.[52]

DFI initiatives to provide LCY loans with open currency risk were initiated with careful monitoring of risks and sustainability. The most sizable ones include the Dutch government's MASSIF Fund, managed by FMO and the EIB's ACP Investment Facility, both described in greater detail below. Notwithstanding some differences in terms of portfolio composition and pricing methodology, both efforts hinge on the principle that the lender takes open currency risk and charges a premium to cover FX losses. Besides these DFI-led efforts, a similar approach is followed in the UN Capital Development Fund's BRIDGE Facility. Furthermore, LCY unhedged investment is also found among private sector investment funds, such as those managed by Symbiotics.

Despite their differences, a number of common factors appear critical in determining the viability and positive financial performance of the facilities. These include their legal structure as funds rather than banks, broad portfolio diversification in terms of currencies, geographies, clients, and sectors; and large size, both in terms of portfolio capitalisation (over 500 million USD) and number of borrowers. Also, only a portion of varying size of the lending portfolio is denominated in LCY, and typically only a portion of the portfolio is left unhedged. An informed decision is made on which countries or transactions the fund invests unhedged. Next, we describe these facilities in detail.

2.3.7.1 FMO's MASSIF

MASSIF is a third-party fund mandated to provide LCY financing in the most challenging markets. Established in 2006 by the Dutch Ministry of Foreign Affairs and managed by FMO, MASSIF aims to strengthen financial inclusion in low- and middle-income markets. Within these settings, it targets four groups: unbanked micro, small, and medium enterprises (MSMEs) in fragile states and regions with low levels of financial penetration; MSMEs in rural areas and agricultural value chains, women-owned businesses, youth, and refugee entrepreneurs, and innovative and inclusive businesses (e.g., digital financial services). Funding is channelled to these clients via financial intermediaries, including microfinance institutions, small local banks, leasing companies, and private funds. The fund manages a committed portfolio of 600 million USD, spread over 40+ countries and 120+ clients. MASSIF's financing offer is based on a mix of LCY seed capital,

52 Schinasi, 2017

LCY loans, mezzanine structures, as well as grant-based capacity development financing.

LCY loans make up 15% of the total portfolio, the rest are liquid currencies. The pricing strategy builds off TCX's reference price.[53] In exceptional cases, where the resulting all-in lending rate is too high for bankability, MASSIF allows for deviations on a case-by-case basis. Deviations are informed by client-specific risk assessment for instance in situations where the borrower has a good credit standing in a country where the local sovereign is badly rated and the business expertise and model call for a favourable treatment. Potential drawbacks to this approach include the risks of market distortions and undercutting the local banking sector, something particularly toxic for the already fragile local financial sector.

The fund's performance has been positive and financially sustainable, to date.[54] Shareholder expectations are for MASSIF to break even, with a revolvability target of 100% or more, despite recent fluctuations linked to its USD exposure.[55] The fund's diversification at country, currency, and client level as well as its portfolio size seem to be key determinants of this. Importantly, MASSIF's fund structure is what makes its model possible. Unlike FMO, MASSIF is not a bank and thus does not abide by the same risk policies that would require hedging its FX exposure.

2.3.7.2 EIB-EU's Africa Caribbean Programme

EIB Global lends in FCS via third party funds and partnered in 2003 with the EU to create the Africa Caribbean Programme, or ACP, to enable a higher level of risk-taking in countries in the Caribbean and Sub-Saharan Africa. ACP operates as a risk-bearing "revolving fund", with reflows being reinvested in new projects.[56] ACP's financing mix combines equity, LCY debt, and grants for TA.[57]

ACP's unhedged LCY tranche currently stands at about EUR 900 million and represents 20% of total capital raised. It is diversified across 15 currencies including Kenya, Tanzania, Uganda, Rwanda, Mozambique, South Africa, Zimbabwe, Haiti, Dominican Republic, Jamaica, South Africa, USD. Three of these are in FCS – Haiti, Mozambique, and Zimbabwe. LCY loans target SMEs and are mostly

53 This is a combination of a market-based rate (e.g., government bonds) plus a margin, based on forecasts of the LCY's development. Notably, TCX has always been able to provide a quote in the target countries, even in the most challenging ones, to date.

54 Oomes, Belt, Berthiaume, Keijser, van Manen, & Rougoor, 2020. MASSIF's positive performance, demonstrating the LCY lending can be done sustainably, spurred the development of the Cardano group, to which TCX belongs.

55 Revolvability means that MASSIF's capital needs to remain intact, and a minimum. All operational costs (e.g., management fees) and losses need to be covered by the existing capital allocation. The USD exposure is due to the fact that the equity portion of the portfolio (60%) is valued in USD – the reporting currency of most GPs.

56 European Court of Auditors, 2015

57 European Court of Auditors, 2015

channelled through financial intermediaries. A few corporates have also been able to receive support, but there has been no infrastructure finance, to date.

The all-in lending rate on ACP LCY loans factors in administrative costs, a credit margin, and an FX risk premium. Borrower eligibility criteria are defined and screened through an in-house model. While the borrower's credit rating is not restricted, lending policy defines a maximum tenor, with the absolute maximum across the pool being 7 years. On top of the credit margin and administrative costs, an FX risk premium is added to the all-in lending rate to cover the risk of depreciation. Pricing methodology is comparable to that of TCX but differs in that it focuses on the *expected* currency devaluation, with elements of uncertainty, rather than on unexpected devaluation.[58] To avoid market distortions and undercutting the local private sector, the final lending rate is compared to the government benchmark curve, when available.[59]

The programme has been running for more than 10 years and the approach has on balance proven sustainable and has even made a small return. The LCY tranche taken individually, has in the long term, been sustainable as well. This demonstrates the sustainability and affordability of the approach. However, it is important to highlight that the Programme operates a selection of assets and countries, and refrains from lending in very challenging contexts. From the above list of currencies, only one, Mozambique, is in an FCS country with intense regional conflict. An entity like TCX does not have this flexibility of choice.[60] Similar to MASSIF, ACP's approach is a combination of a long-term investment strategy, a portfolio that is about 20% LCY unhedged and the rest in liquid currency hedged, and broad diversification in terms of clients, currencies, sectors, and geographies.

2.3.7.3 United Nation's Capital Development Fund's BRIDGE Facility

In 2017, the UNCDF launched the BRIDGE facility. This vehicle aims to complement the international finance architecture by filling the so-called missing middle in least-developed countries. Namely, it targets those MSMEs that are too large to benefit from microfinance loans and too small and risky (especially due to their LCY revenue profiles) to receive DFI finance. The four sectors of focus for the facility are renewable energy, fintech, agribusiness, local infrastructure. Target

58 Given TCX's greater geographic and currency diversification (including South and Central America or Asia, and the related stronger emerging currencies) than ACP's, TCX pricing should be more affordable, in principle. However, according to interviewees, on average, ACP's approach appears to yield more affordable results, especially in the most liquid currencies.

59 Comparisons can be especially challenging in countries with no benchmark government curve. Further, the is no guarantee that results of the benchmarking exercise will last over time.

60 In 2017, the cumulative FX premium was estimated to be five times greater than FX losses (Andreasen, Bartz, Clubb, Efiong, Ehlert Horrocks, Sedemund, Durland, Hirschhofer, & Parplies, 2017).

clients are located in least developed countries, many of which are fragile (e.g., Burkina Faso, Democratic Republic of Congo, Myanmar).

Critically, 90% of BRIDGE's financing is in LCY, and the fund takes on an unhedged exposure to currency risk. Compared to MASSIF and ACP, BRIDGE is significantly smaller, with a portfolio of around 35 companies, an initial capitalization of USD 50 million with planned future replenishments.[61] Ticket size can vary, with most falling within the 100 thousand to 1 million USD-equivalent.[62] UNCDF's country-level footprint (notably, technical staff with sectoral expertise) is key to deal origination, which is typically enabled by market scans, challenge funds, and requests for proposals.

The all-in lending rate is based on an internal scoring model that factors in costs, credit risks, and currency risks. With regards to FX risk, TCX provides a reference swap rate for a given country and tenor, which is then used to determine expected losses linked to FX risk. The final cost-recovery rate produced by the model, that factors in UNCDF's costs and the client's credit rating characteristics, provides the basis for the loan pricing. In most cases, rates end up being beyond 25% which is not in line with UNCDF's non-profit mandate and is prohibitive for clients. To overcome this, the rate is lowered to a level that does not jeopardise the client's financial viability (typically, 10-15%). While there are no restrictions on interest levels, the drop in interest is defined so that the debt service coverage ratio approximates 1.2.[63]

BRIDGE's viability to date hinges on a few critical factors. First, a uniquely high appetite for risk and ability to absorb losses. This is made possible by the fund-nature of UNCDF and the fact that the balance sheet is capitalised by grants from donors. Second, the UN's in-country footprint and infrastructure (such as local bank accounts and country offices) which both enable the disbursement of LCY and help manage convertibility and transfer risks.

It is too early in the life of the facility to draw conclusions on its performance. However, it is promising that to date the fund has had only one write-off and a few instances of restructuring. Given the target clients (those unbanked by DFIs), it is important to maintain realistic expectations around future gains.

61 The focus on small transactions constrains the facilities' growth, due to the high unit cost of each deal (as a UN agency, UNCDF can subsidise some of these costs through contributions from member states). There are however expectations for it to grow to 40-50 million USD by mid-2023.

62 Importantly, DFIs' deals rarely go below 5 million USD.

63 With some, context-based exceptions, UNCDF avoids ending up with a coverage ratio higher than 1.2 as it signals a situation in which can comfortably repay their debt.

2.3.7.4 Symbiotics

Symbiotics is an impact investment firm focused on private markets in emerging and frontier economies. It manages 25 investment funds and mandates for a total of USD 3 billion assets under management (AUM) and advisory across Africa, Eastern Europe, and Central Asia. Clients include DFIs, pension funds, and private sector banks. Investments of loans to microfinance Institutions, SME banks, and other impact financing projects. Its mandate is split between hedged and unhedged LCY lending.[64] 50% of the AUM (or 1.375 billion USD) is in unhedged LCY debt and consists of 13 funds of various sizes (from 29 to 196 million USD).

Symbiotics exercises a well-informed decision on whether to hedge or not, with financial return in mind. Given a set return rate and the expected depreciation risk (based on quantitative and qualitative analyses of inflation levels, forecasts, credit-default swap prices when available, and other indicators), hedged and unhedged scenarios are weighted against each other. Hedging may be pursued when it is available at low cost (that is, in efficient LCY markets) or in markets where Symbiotics does not have a view on the risk.[65] Unhedged currency exposure is pursued when Symbiotics has a positive view on the currency development.

The funds' performance has been positive, with much of the return being driven by unhedged FX risk-taking operations. Since 2006, it has consistently outperformed the SMX-MIV Debt Index (Symbiotics Microfinance Index), composed of purely commercial, microfinance impact funds with a monthly net asset value (NAV) and systematic hedge of LCY. The unhedged portion of the portfolio has made critical contributions to the total returns. Its loss expense rate oscillates between 0.5% and 0.7%. In a 2017 paper, Symbiotics also conducted historical analysis of its investment strategy and documents that unhedged lending rewarded risk-taking investors with a premium of 3.7% on average, with peaks of 10%, as opposed to the 2.5% average premium of the hedged strategy.[66]

Diversification of currencies, geographies, and clients has been a key success factor for Symbiotics' performance. The unhedged part of the portfolio is composed both of well-developed currencies (e.g., Mexican peso, Colombian peso, South African rand) that are easy to forecast and less developed ones (e.g., Ugandan shilling, Madagascar ariary, Myanmar kyat) that have long-term positive impacts on returns. In small LCY unhedged funds, diversification is still successful thanks to the lower ticket size (100 to 500 thousand USD). Larger tickets are instead distributed among several funds in 1 million USD tranches. Importantly,

64 Hedged mandates also include hedged-LCY lending. The LCY-hedged part of the portfolio covers 8 funds, ranging from USD 723 million AUM to USD 8 million AUM, for a total of 1,455 million.

65 They rely on TCX when required, as in the case of very exotic currencies.

66 Schinasi, 2017

Symbiotics' Regional MSME Investment Fund for Sub-Saharan Africa fund (REGMIFA), which covers a number of FCS, does not enjoy such a large benefit of diversification due to its structural geographic focus. In this case, blended finance has been key to manage losses.

2.3.7.5 L-Shares

The Green for Growth Fund, or GGF, an impact investment fund focused on climate change mitigation and sustainable economic growth, introduced a funding mechanism called "L-shares", in 2020. This tool aims to improve access to LCY lending for financial institutions in Southeast Europe, the European Eastern Neighbourhood Region, and the Middle East and North Africa. It is backed by EUR 42.5 million investment from the European Union and the German Federal Ministry for Economic Cooperation and Development.[67]

L-shares are meant to absorb FX risk. They complement Green for Growth Fund's capital structure by backing unhedged LCY transactions that the fund may undertake when hedging price compromises the bankability of the project. In practice, the shares absorb any losses that the fund may incur because of FX fluctuations. By sitting between the fund's first-loss tranche and senior shares and given that their target investors are risk-absorbing donors, the L-share approach protects other investors in the fund who will be the last to be hit in case of losses.[68]

While each option described in **Section 2** has pro and cons, collectively they have not enabled a significant scale-up of LCY lending in FCS for DFIs as a whole. Next, we discuss the need for a new risk-management approach in FCS and set out forward looking proposals for further explorations by the DFI community that could deliver LCY lending at scale.

67 Green for Growth Fund, no date

68 Green for Growth Fund, 2021

3 Moving towards increased delivery of LCY lending in FCS

3.1 A different approach to risk management

3.1.1 Treasury management in imperfect markets

Operating in LCY in FCS countries requires a different approach to treasury risk management. The approach may require to (i) accept some uncertainty and the imperfections of the local financial system and (ii) mitigate risks by making use of the following, next to derivatives: Risk pooling and diversification, taking a long-term view, donor support, guarantees, layered capital vehicles.

An adjusted risk operating framework with regards to both *market* and *credit* risk management is a pre-condition for onshore success. Moreover, perfectly matched back-to-back risk management, as is practiced in advanced countries, is an impossible or inefficient stance in FCS. Therefore, a different approach to risk mitigation is critical, based on well-thought-out flexibility, provisioning, and risk-taking. One possible adjustment would be to grant flexibility in the management of refinancing risk, by allowing to hedge medium-term loans with short-term instruments, when these are the only ones available. Internal risk policies further need to allow to take onshore credit and interest rate risk, and opening cash and custody accounts in imperfect markets. Even if local market conditions are undeniably extreme (e.g., insurance is either unavailable or priced at or above the asset price) in most FCS countries, LCY delivery is possible.

As it emerges from discussions with entities operating in LCY, while risks cannot be eliminated, they can be managed and mitigated, and it is possible to operate sustainably in the presence of these risks. In other words, while it might be less comfortable to operate with some uncertainty, in the long run the short-term perception of risk is exaggerated – at least in countries that aren't at the extreme end of the conflict scale. Working in FCS brings uncertainty that DFIs will have to live with; at the same time there are known risks whose perception is sometimes exaggerated and that can be managed. Backed by their AAA-rated balance sheets, DFIs are called to step in and overcome local market imperfections. Importantly, DFIs' shareholders are patient investors, ready for a long-term approach. They want DFIs to take more risks and know that reasonable losses are acceptable. With a focus on cross-DFI collaboration, they are also expected to be supportive of a cross-DFI pooled solution.

BOX 5. HOW THE AFRICA LOCAL CURRENCY BOND FUND HAS DEVELOPED ONSHORE CAPABILITIES IN ITS MARKETS AND ACCORDINGLY ADJUSTED ITS RISK POLICIES

Set up in 2013 under the sponsorship of KfW, with funding provided by the German Ministry for Economic Development, or BMZ, the African Local Currency Bond Fund (ALCBF) aims to support local capital market development in Africa. Investors include DFIs, impact funds, and government agencies. It has invested over 250 million USD in local currency in over 50 companies across 19 countries, in sectors including financial institutions, microfinance institutions, and corporates. This includes several investments in FCS either directly or through multi-national entities.

The Fund acts as an anchor investor in local bond issuances, investing up to 50% of the first-time issuance amount (with the remainder provided by local institutional investors), and provides TA for the preparation of the necessary bond documentation or rating and the delivery of studies on capital market development.

The ALCBF has an obligation to hedge its FX exposures. While the Fund does not have a tenor restriction, in less developed markets hedging generally limits the maturity of investable assets to approximately 7 years before becoming cost prohibitive. Moreover, while ALCBF aims to price in alignment with local institutional investors, the cost of hedging sets a pricing floor. If the pricing floor is above local investor pricing, the issuer can choose whether it requires the Fund to meet its intended issuance amount.

The ability of the ALCB Fund to build a highly diversified local currency portfolio is largely the outcome of its focus on building strong relationships with primary hedge counterparts, including not just TCX but also regional banks. In addition, the Fund's FX Risk Charter, within acceptable risk parameters, allows for greater diversity in managing FX risk than what is generally observed by conventional micro-finance investment vehicles or DFIs, including engaging local banks for alternative hedges. The Fund also has built strong capabilities to manage convertibility risk, which it does not usually make an obligation of the issuer.

3.1.2 Managing the FCS portfolio on or off-balance sheet

Given the high credit and market risk involved, lending in FCS without adequate mitigation touches on the limits of sound banking principles.

The question of taking open FX risk is a recurrent theme that goes well beyond the negotiation of a more flexible risk management framework to accommodate local market imperfections. Today, while the MDBs and DFIs collectively have more than 420 billion USD of balance sheet capital, they do not take any open currency positions on their senior loans, unlike on their equity portfolio. In most cases, this is an operational choice rather than something mandated by foundational documents or rating agency requirements. DFI equity investments in FCS markets generally do not need to be hedged. While taking greater naked FX risk could in theory be authorised by senior management, DFIs remain aligned with the rules of prudent banking that also apply outside the DFI universe and exclude taking FX risks on-balance sheet without adequate mitigation. Depending on the institution, taking greater FX risk may require additional resources in terms of capital (either fresh or reallocated), or concessional capital-like resources. Keeping open FX risks spread across the DFI universe rather than hedged at TCX or in the local market also slows down the growing momentum in the creation of an investor base focused on offshore frontier FX risk taking. This growing investor category is good news as it signals improving familiarity with frontier market risk. It also constitutes a key partner for TCX which can take on some of its risk.

As an alternative to accepting on-balance sheet open currency risk or leveraging loss-absorbing provisions, guarantees, or donor grants, some institutions may choose to deliver financing in FCS countries under a separate fund structure. This is already the case for instance with the UNCDF, EIB's ACP fund, FMO's MASSIF fund, and EBRD's West Bank and Gaza Trust Fund. The approach is also similar for the IDA PSW: although the PSW is technically still on IDA's balance sheet, its capital is completely segregated from the rest of the IDA operations, so effectively ring-fenced at a 1:1 capital ratio against notional exposures.

A fund structure, though offering more flexibility when delivering LCY lending, may be less efficient than working on-balance sheet. Leverage and capital layering must be carefully calibrated to account for higher risks in FCS. Further, a fund can only lend what investors/donors have contributed, on a funded basis, into the pool. Fundraising may be a challenge at large scale, in a context where donors increasingly favour unfunded guarantee-based approaches. To optimise the use of capital, it may be preferrable to design an operating framework that relies on a fund only for countries that rank highest in fragility, for instance countries most affected by conflict, where long-term capital replacement is less likely.

3.2 Options for scaling up LCY lending in FCS

Building on existing approaches and in-depth consultations with DFIs and market players, this report sets out forward looking proposals for further exploration by the DFI community that could deliver LCY lending at scale. These include two cross-cutting proposals to be considered in any instance, and two alternative options, all of which rely on a platform approach, as detailed in the table below (**Table 8**).

Table 8: Proposals and options

Cross-cutting proposals	TA to central banks to support stability & facilitate cross-currency swaps	
	LCY Credit Guarantee for FCS	
Platform options	**1**	**2**
	LCY Platform as an onshore treasury capability in FCS	TCX Portfolio Return Guarantee for FCS

The alternative risk mitigation approaches proposed hereafter are neither inexpensive, nor easy to implement. Donor support, in the form of guarantees or loss absorbing capital, is required to support them. However, measured against the size of the challenge and over the long term rather than representing the immediate use of a grant amount, the proposed solutions use leverage and constitute a relatively efficient use of donor support.

3.2.1 Technical assistance to central banks and facilitating cross-currency swaps

To effectively and sustainably deliver LCY onshore and ensure financial stability, DFIs in coordination with their public-sector counterparts must target their efforts towards supporting the central bank and the local banking sector (Figure 7). Support should be tailored to unique country-level characteristics and the intensity of fragility, as further detailed in **Annex A**, with financial stability and improved banks' liquidity and balance sheet management in mind. Provided that local authorities, especially the central bank, are committed, this starts with policy dialogue, TA, and capacity building initiatives aimed at establishing a sound macro-economic policy environment and an effective monetary policy framework with inflation under control. These constitute the foundations and pre-conditions to build up momentum for local money market, and later on, capital market development. In particular, capacity building towards local money market development, focused on building capabilities for liquidity management, such as defining the overnight benchmark rate, establishing a sound monetary policy framework, progressively building an interest rate curve, and addressing the imperfections of the legal, regulatory, tax, and accounting frameworks around derivative instruments. Progress on these fronts will not only impact the interest rate levels and help realise the LCY lending potential of local banks, but it will also lower hedging costs through improved market liquidity and credit risk mitigation.

In countries without reasonable onshore local market counterparties, and perspectives to develop a local market, cross currency swaps with central banks remain a cost-effective alternative.[69] As highlighted in **Section 2.2.2.1.2**, the implementation of these cross-currency swap transactions hinges in good measure on the IMF clarifying their accounting treatment, and in particular how the cash flows and related possible collateral would impact the Net International Reserves. The absence of clarification discourages FCS' central banks and governments from entering such transactions for fear of appearing to weaken their reserve positions or even breaching reserve targets under IMF programmes. Because of the undisputable advantages of cross currency swaps with central banks as a source of LCY when it comes to delivering LCY lending in FCS, whether from a hedging cost or risk mitigation perspective, DFIs could jointly approach the IMF and encourage it to issue much-needed clarification, in order to eliminate ambiguity (typically in programme technical memoranda).

To mitigate counterparty risk, the central bank could be asked to immediately post back as collateral, the USD amount received at inception. Should the central bank prefer to invest the USD notional in a market instrument, the DFI may issue a USD-denominated bond or note with a payment structure similar to the USD cash flows under the swap, that the central bank could buy and carve out for the benefit of the DFI as swap counterparty.

Figure 7: Technical assistance to central banks

Policy dialogue and technical advice to:

Facilitate cross currency swaps with central banks

- Fair and transparent framework
- Accounting of transaction & related collateral
- Impact on Net International Reserves

Support money market development and financial stability

- Strengthen financial sector foundations
- Key building blocks of liquidity management

69 We are grateful for advice on this section by the IMF's Shakill Hassan, Parisa Kamali, Tito da Silva Filho and Bahrom Shukurov.

3.2.2 LCY Credit Guarantee for FCS

Another proposed approach consists in LCY credit guarantees focused on FCS, provided by a donor or a sovereign. The LCY guarantee takes on the credit risk in LCY loans or LCY derivative transactions to support lending in LCY in FCS. This is key in FCS where the problem tends to be as much the low credit standing of the local counterparts, whether end-borrower or financial institutions, as the illiquidity of the hedging market. Mitigating the credit risk that the lender bears, either in the FX hedge or the LCY loan itself, enables delivery and reduces the overall spread on the LCY loan.

The LCY credit guarantee approach has additional strengths. It leaves flexibility in terms of how it is being used by creditors. Guarantees can be flexible in their scope, eligibility, pricing, and percentage covered, which allows for adjustments to reach a bankable all-in cost of lending. It also facilitates delivery of LCY lending by offshore lenders and enables to leverage the local financial sector. In war-torn countries in particular, local banks are best placed to deliver financing to actors running the minimal economic activity important for subsistence. Furthermore, guarantees reduce or eliminate the requirement to post collateral, which will greatly facilitate both hedging and lending activity.

To implement such a programme, many parameters need to be agreed on. These include the maximum maturity, eligible creditors, the currency in which the premium is paid, and the exact definition of risks covered. One important parameter is whether the guarantee covers a hedged or an unhedged LCY loan. When guaranteeing an unhedged LCY loan, the guarantor takes on the related FX risk. If the LCY depreciates (and this is the central scenario in FCS) a lender in LCY that is hedged, has a lower risk of all-in loss because the gain under the hedge (positive mark-to-market) will reduce the loss under the LCY loan. Hence guaranteeing an unhedged loan is riskier (higher payout in central scenario) than guaranteeing a hedged loan, and the pricing should differ.

As discussed next, the guarantee can be managed centrally by a FCS LCY guarantee vehicle that builds a portfolio of risks across FCS, or in a bilateral manner by (a) guarantor(s).

3.2.2.1 Funded approach: LCY guarantee vehicle

This is a funded approach that requires the creation of a new entity managing the portfolio of guaranteed risks, based on a capital structure similar to the FX Platform described below.

There are several challenges to this approach. First, risk pooling is less powerful when dealing with guarantees because guarantees do not have "upside", i.e., there are no possible gains to offset potential losses. Second, for the guarantee to be effective, the vehicle needs to achieve a sufficiently high credit rating: this is costly in terms of capital, considering the type of FCS risks the vehicle intends to take.

Third, it might add an unnecessary layer between the donor and the financing/hedging entity. Still, the centralised vehicle approach would make sense from a capital raising point of view, provided good diversification can be achieved and the vehicle intends to sell-off risk to the market, such as the private insurance market. It is uncertain though whether a focus on FCS would attract much private sector interest. Another possibility would be to build on existing structures, like MIGA. However, unless large donors can be brought to align priorities and commit significant amounts of capital for the delivery of such guarantees, the unfunded, bilateral approach discussed in the following section appears to be simpler and faster to roll out.

3.2.2.2 Unfunded approach: A guarantor issues LCY credit risk guarantees

Under the unfunded route, the guarantee is backed by the rating of the guarantor and, except for the guarantee fee, no cash flows are exchanged unless the guarantee is called (Figure 8 and 9). In FCS countries, where risks are high and political aspects may prevail, the bilateral route leaves the guarantor in the driving seat, with full flexibility on all aspects including underlying transactions, targeted country(ies), eligible obligors, and price.

Figure 8: LCY credit risk guarantees issued by a guarantor

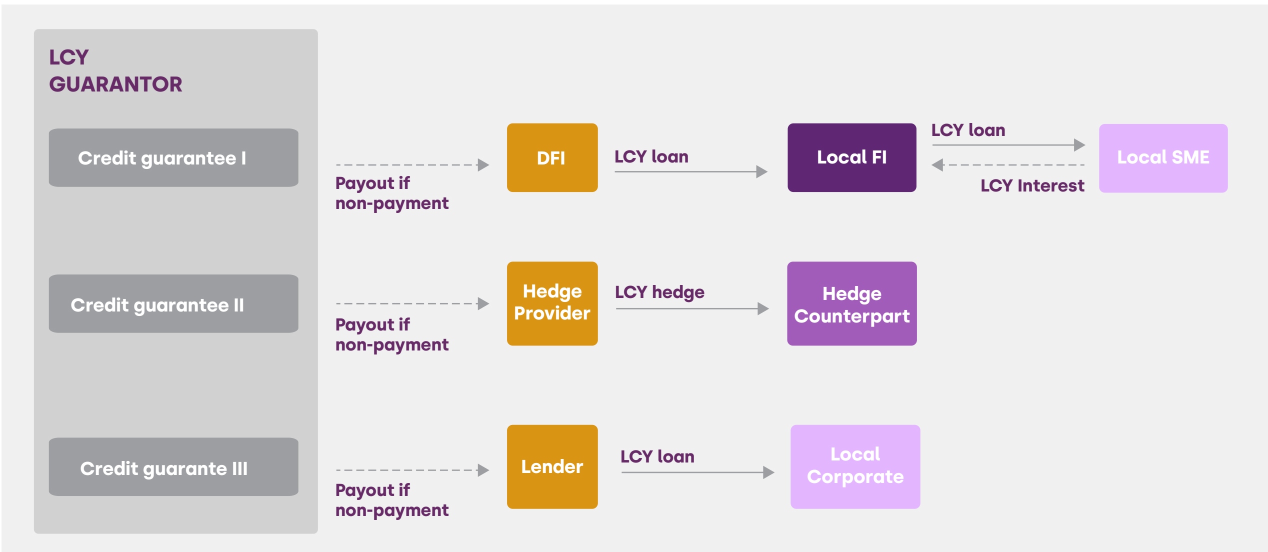
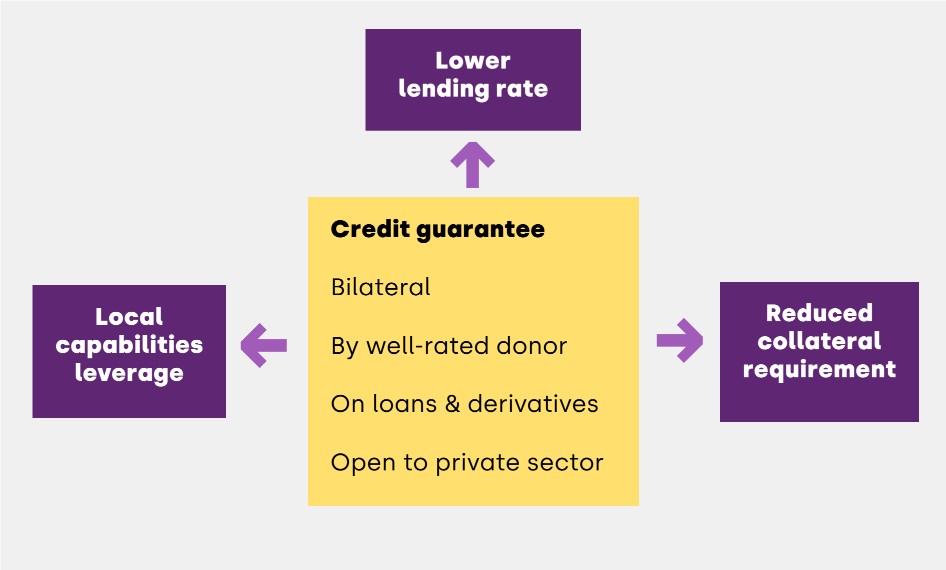


Figure 9: LCY credit guarantee for FCS supports feasibility of hedging and lending



3.2.3 Platform options

3.2.3.1 TCX Portfolio Return Guarantee focused on FCS

The first of the two platform options intends to lower the cost of hedging with TCX in FCS, by introducing a Portfolio Return Guarantee focused on FCS. Here, delivery of concessional hedging by TCX is supported by a donor offering to guarantee a minimum return for a portfolio of FCS hedges.

There are a number of benefits associated with this solution. As described in greater detail in **Section 2.3.5**, it allows DFIs to seek and book hedges in a way that is similar to the way they work in more advanced countries. Moreover, FX risk stemming from the underlying lending portfolio becomes part of the TCX portfolio and can contribute to the development of an FX risk market with offshore investors. TCX's end objective is, indeed, to progressively create markets in LCY by quoting market-based hedging prices and taking on FX risks at levels that can be sold to investors. It makes intelligent use of donor money as well, with leverage.

Performance under this approach, including its cost to donors, must be measured over several years, not within short-term crisis cycles. The guarantee operates based on a well-defined framework, with a maximum drop in hedging level, and strict eligibility criteria. Preliminary, very indicative calculations lead to a guarantee size of 11 million EUR for lowering the hedging rate by 200bp on a 100 million notional FCS loan portfolio with a 3 year average life. However, depending on the type of transaction or currency, 200bp or even 300bp may not be sufficient to secure the bankability of a transaction in FCS. As we saw in the context of synthetic lending, T&C risk remains an issue as well. The approach may need to be combined with other tools described herein.

We next look at mitigating FCS FX risk by seeking a hedge via an FX platform that acts as an interface between international investors and onshore hedge providers and deals with local market imperfections.

3.2.3.2 LCY Platform as an onshore treasury capability in FCS

Working onshore on a funded basis brings undeniable benefits, as well as challenges. Benefits include accessing cheaper hedging and mitigating the convertibility risk. However, it also requires setting up a minimal onshore infrastructure and adjusting market and credit risk management. Since all DFIs are faced with the same difficulties, with a view to facilitate that effort in the context of FCS where the challenge is particularly significant, we propose the establishment of an FX platform that would act as an onshore treasury capability in FCS. It would source LCY from local counterparts, set up the required onshore infrastructure and centralise onshore LCY liquidity management in FCS across DFIs.

The proposed FX platform has many strengths. It allows DFIs to keep FCS lending on-balance sheet without any exposure to FCS FX risk, while fully delegating the management of FCS market imperfections to the FX platform. It also mitigates T&C risk, and the liquidity risk in the domestic spot market. Finally, it allows for flexibility when setting the LCY lending rate delivered by the platform, without the immediate use of donor grants (**Figure 10**).

The platform would function as follows:

1. The platform delivers LCY against FCY with LCY sourced and delivered on shore. The two legs (B and C) between the DFI and the platform might be documented as a loan or a derivative in ISDA-compliant jurisdictions.

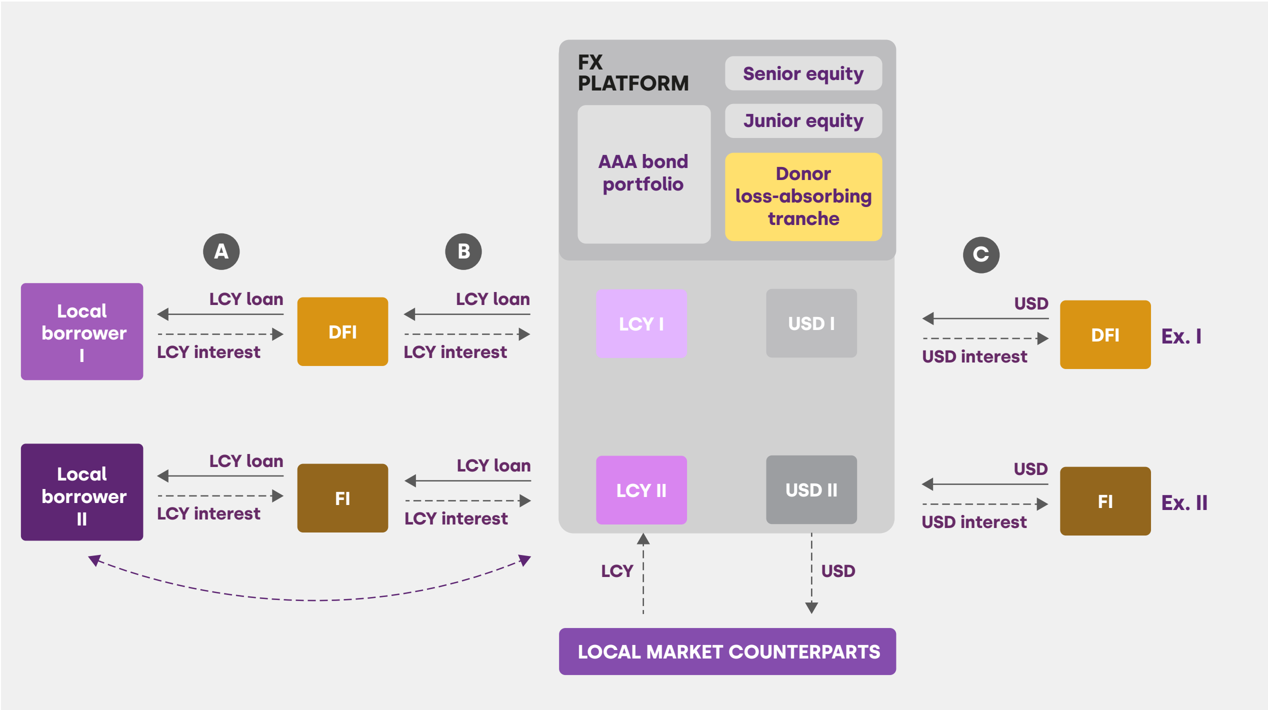
2. The onshore platform seeks hedges in the local market as a priority, and in the offshore market in the absence of any other alternative. In the latter case the platform still manages the onshore spot transaction to ensure onshore LCY disbursement. Further the platform may actively manage its FX exposure and offload some risk to investors.

3. When seeking a hedge, the platform manages local market imperfections and faces local counterparts, recording the corresponding credit risk.

4. The platform works alongside the central bank and local banks to increase momentum in local money market activity and delivers the required TA, in particular to support legal reforms and infrastructure upgrades.

5. The platform shares with the DFIs the benefit of its onshore bank and custody accounts and can act as a local onshore paying agent on behalf of DFIs, coordinating loan-related payment flows between the borrower and the DFIs located offshore if so required.

Figure 10: LCY Platform acting as an onshore treasury capability in FCS on behalf of international investors



Key features of the platform include:[70]

- The objective to develop and participate in the local market and deliver TA with a view to support the reforms required to bring it closer to international standards. This is particularly applicable in FCS countries in a "pivotal moment", when support might be most fruitful. Taking a long-term view, the targeted outcome is a functioning swap market where the platform is no longer needed.

- A donor loss-absorbing tranche that can be formalised as a guarantee, with a view to cover potential losses due to market imperfections, including refinancing risk, and also credit losses as the platform is facing local banks, or local pension funds or other counterparties as relevant.

- A- credit rating, at a minimum, in order to be an acceptable counterpart for DFIs.

70 We are grateful for advice on this section by Frontclear's Philip Buyskes.

- The possibility to share among DFIs the onshore infrastructure and other operating costs and resources related to LCY lending.
- Access to non-DFIs, including private sector financial institutions keen to deliver LCY lending in FCS. The contribution of non-DFI flows would help build momentum in the local market. It would also help mobilise private capital for an increased engagement in FCS.
- The creation of an onshore liquidity pool fed by flows from partnering institutions, which is more efficient as individual DFI flows may not be steady in FCS.

Box 6 summarises the main risks that the platform would manage.

BOX 6. RISKS MANAGED BY THE ONSHORE FX PLATFORM

- Local Spot market liquidity risk: the risk the insufficient depth in the local market hinders the conversion into USD at maturity.
- Market risk: the risk arising when hedges are unavailable on the loan maturity or with other proxy hedges; positions may result in residual currency and interest rate exposures.
- Counterparty credit risk (CCR): the risk that the local hedge counterpart defaults on obligations
- “Wrong way” risk: The risk that the exposure to the local counterparty (mark-to-market value changing due to a weakening local currency) is increasing at the moment it is most likely to default.
- Legal risk: the risk stemming from capacity issues including with local judiciary misinterpreting laws, from non-familiarity with close out netting, or from other legal issues.
- Operational risk: the risk that operational matters, including the performance of local custodians, may result in financial losses.
- Credit risk of local sovereign or alternative (liquidity pool investment): The risk of losses due to sovereign default on bond obligations.
- Convertibility and transfer risk: possibility that the authorities modify introduce or maintain limitations or impossibility of conversion or transfer abroad.

The platform could be self-standing or possibly be attached to an existing facility or programme. During our consultations, Frontclear expressed interest in partnering with DFIs and acting as an onshore treasury capability, in order to support delivery of LCY lending in FCS. Frontclear has already been working on developing LCY markets in 15 frontier countries, and would bring its balance sheet,capabilities, and knowledge. Importantly, Frontclear has developed a 3-tier Market Maturity Ladder as a methodology to position countries on their journey towards more developed markets. Most FCS would appear in the bottom tier, where the basic building blocks still need to be established.

3.3 Overview of the proposed solutions to support LCY lending by DFIs in FCS

In conclusion, as a joint approach between DFIs, we favour a combination of: (i) TA to the central bank, and relevant authorities to strengthen the stability and balance sheet management of the local financial sector, (ii) inviting the IMF to clarify the treatment of swaps with central banks, (iii) LCY credit guarantees, (iv) TCX portfolio return guarantee, and (v) LCY platform as an onshore treasury capability in FCS. Together they effectively:

- **Improve deliverability of LCY lending.** The onshore LCY platform and LCY credit guarantee effectively support delivery of LCY lending where it would otherwise not happen, in particular by mitigating convertibility risk.
- **Significantly lower the all-in LCY lending rate.** While the LCY guarantee lowers the credit margin, both the onshore LCY platform and the TCX Portfolio Return Guarantee improve the hedging cost. They can be combined for maximum impact, in particular for DFIs that hedge the credit margin.
- **Support the immediate and medium-term stability of the financial sector.**

When delivered in combination, these solutions can mark a turning point in scaling up LCY lending in FCS. A summary of existing and proposed approaches, their objectives, modalities, and drawbacks are presented on the next page (**Table 9**).

Table 9: Overview of current and proposed approaches to scale up delivery of LCY finance in FCS

Delivering LCY		Modality	Objective	Remaining/new drawbacks
Internal changes	Internal capacity building & organisational changes	Capacity building	Change practices & build know how around LCY lending	Continuous effort & adaptation of practices to market changes
	Adjustment of internal risk framework	Increased risk appetite	Secure the flexibility required to operate in imperfect markets	Can accommodate some risks, not all
Staying offshore	Synthetic hedging	Derivative	Deliver LCY in a synthetic form	Convertibility & transferability risk remain
	Offshore LCY Bond	Bond	Transfer FX risk to investors	Convertibility and transferability risk remain
	Convertibility & transferability risk cover	Insurance	Mitigate T&C risk	Not all FCS countries covered
Working onshore	Hedging with a bank	Derivative	Participate in the local market, eliminate the T&C risk	The local market needs to be sufficiently developed - Few FCS will allow for that
	Cross currency swaps with central banks	Derivative	Seek attractive LCY funding level	Legal environment & credit standing of the counterpart
	Issuing a bond in the local market	Bond	Avoid hedging cost	Funding cost might still be too high
	Policy dialogue to improve ALM of local banks	Policy dialogue	Maximise LCY delivery potential of local banks	Low credit standing & uncertain environment
	Credit guarantee of collateral backing market transactions	Guarantee	Strengthen activity in the local money market	Short term risk mitigation
	Guarantees of LCY finance by local FI	Guarantee	Facilitate LCY delivery by the local market	Local market may not be sufficient in lending capacity
	Risk-sharing facilities	Risk Sharing	Partnering with a local FI for LCY funding & share the transaction credit risk	Complexity of implementation
Lowering the all-in lending rate				
	Policy dialogue & TA to support local money market development	Policy dialogue	Most sustainable solution to scale up LCY finance	Medium to long term impact
	Liquidity Sustainability Facility	Facilitation	Lower illiquidity risk premium of Africa sovereigns	Long shot on FCS impact
	MIGA's credit guarantee for sovereign entities	Credit risk loss-absorption	Facilitate LCY lending to sovereign entities	Non-available for FCS
	EBRD's SME LCY Programme	credit risk loss-absorption	Reduce the lending margin	Cost reduction might be insufficient for FCS
	TCX's Portfolio Return Guarantee	FX risk loss-absorption	Reduce hedging cost	Cost reduction might be insufficient for FCS
	TCX's LIFT Programme	Subsidy	Reduce hedging cost	Immediate one for one use of donor grant
	IFC's private sector window	Subsidy	Reduce hedging cost	Immediate, unleveraged use of donor grant
	Working unhedged as a fund absorbing FX gains & losses	Diversification & long-term view	Avoid hedging cost	Potential local market distortion & non-contribution to market building
	Working unhedged as a fund with loss absorbing equity tranche	Diversification & long-term view with FX risk loss-absorption	Avoid hedging cost & mitigate related potential losses	Potential local market distortion & non-contribution to market building
Options for scaling up LCY finance in FCS				
Cross cutting proposals	TA to central banks to support stability & facilitate cross-currency swaps	Policy dialogue	Strengthen stability in the local financial sector and facilitate delivery of LCY lending	TA will take time to deliver benefits; CB swaps are complex and bypass local banks
	LCY Credit Guarantee for FCS	credit risk loss-absorption (& FX risk loss-absorption)	Reduce LCY hedging cost and LCY lending rates for FCS, leverage on local financial sector for delivery	Relies on significant donor support to achieve scale
Platform options	TCX Portfolio Return Guarantee	FX risk loss-absorption	Reduce LCY hedging cost for FCS	Less effective in situations of extreme crisis
	Onshore LCY Platform as an onshore treasury in FCS	Deliverable hedge	Reduce LCY hedging costs, mitigate T&C risk & develop the local market	Hedging cost reduction not as substantial in FCS with no local counterparts

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Annexes

A. Different FCS countries with different needs: Implications for LCY lending

While FCS countries have in common that they are stuck in one or more of four "traps" described by Paul Collier's "The Bottom Billion", they vary on key aspects relevant to the delivery of LCY lending. These include levels of income, intensity of conflict, extent of sanctions, priorities in terms of finance, and the credit standing of the sovereign.[71] The political and geopolitical context of each FCS country remain unique and bound to influence choices and conditions on how to and who will provide the donor support required to facilitate delivery of LCY lending.

Therefore, an in-depth, individual analysis of each country situation is required to determine the appropriate strategy. At this stage, we propose to distinguish FCS based on the two broad categories defined in the World Bank Group's classification, namely:

- Countries where fragility is first and foremost driven by a war and conflict, as reflected in high levels annual deaths per 100 thousand people[72]
- Countries where fragility is mostly driven by weak policies and institutions, as reflected in a poor Country Policy and Institutional Assessment (CPIA) score[73]

Financing and TA needs are likely to differ between the two categories.

Countries where fragility is driven by conflict

The 2023 World Bank Group's FCS list highlights the following as 'conflict FCS': Afghanistan, Burkina Faso, Cameroon, Central African Republic, Democratic Republic of Congo, Ethiopia, Iraq, Mali,

71 In his book *The Bottom Billion*: the conflict trap, the natural resources trap, the trap of being landlocked with bad neighbours, and the poor governance trap

72 The World Bank Groups defines conflict as the use of deadly force by a group — including state forces, organized non-state groups, or other irregular entities — with a political purpose or motivation. Such force can be two-sided — involving engagement between multiple organized, armed sides, at times resulting in collateral civilian harm — or one-sided, in which a group specifically targets unarmed civilians.

73 The World Bank Groups defines fragility a systemic condition or situation characterized by: i) an extremely low level of institutional capacity and governance, which significantly impedes the state's ability to function effectively, maintain peace and foster economic and social development; and ii) ongoing and acute political, social and other crises and instability, which disrupt and impede development and growth prospects.

Mozambique, Myanmar, Niger, Nigeria, Somalia, South Sudan, Syria, Ukraine, and Yemen (**Table 10**).

Conflict-driven FCS share a number of features. They are affected by conflict with neighbouring countries or engulfed in a civil war and in which conflict may have been raging for years. They constitute the bottom two clusters in **Figure 1**, meaning that they have low levels of GDP per capita[74] and rank high on the Fragile States Index. All except Niger are under sanctions. While Myanmar is blacklisted under FATF, eight others appear on FATF's "grey" list (**Annex B, Table 14**). Sovereign credit standing is poor, but, as a group, not appreciably worse than fragile countries that are less affected by conflict. Based on the IMF-WB DSA outcomes (that do not cover all these countries), two are in debt distress, five (about one in three) are at high risk and five at moderate risk of debt distress. Only three of the 17 countries score at or above the Default-Interest arrears level of 70 in the Wharton School Global Insight's classification.

The high risk of physical damage in conflict-driven FCS is a challenge for the planning of infrastructure and project finance. Lending focuses on short-term maturities to deliver the day-to-day basics and is generally from local banks. With a deficit of qualified staff and credit-worthy clients, banks minimise risk-taking in an extremely uncertain environment. In these countries, the local banking sector is a key ally for LCY delivery and would benefit from support. A step-up in the volumes or maturities of lending, whether within the local banking system or from abroad (e.g., for the acquisition of foreign equipment) is unlikely without a credit guarantee.

While the perspective of developing the local money market is extremely limited, providing support to the central bank and the authorities to help lay or preserve adequate foundations for the local financial sector should be a priority.[75] Assistance, including the sharing of knowledge and expertise on how best to steer the boat through the storm, can make a huge difference in the short and medium term. Both financial and technical assistance will likely have to be highly concessional. In fact, given the elevated levels of risk, donor support boils down to a budgetary rather than a financing exercise. Moreover, in extreme crisis situations, when local lending rates may be extremely high (well-above 20%), donors focusing on rapid delivery and on providing extensive payment guarantees might only consider FCY as the most immediate solution for bankability.

74 Except for Chad, Iraq, and Ukraine. Ukraine's Fragile States Index ranking is pre-conflict.
75 Kleiman, 2022

Table 10: Conflict-driven fragile states: Key indicators

Country (2023 FCS list)	Currency	ERR	Sanctions	FATF classification	IMF/WB DBSA	Sovereign risk
Afghanistan	AFN	Crawl-Like Arrangement	✓		High	CCC 65 Possible Default
Burkina Faso	XOF	Conventional Peg	✓		Moderate	CCC 65 Possible Default
Cameroon	XOF	Conventional Peg	✓		High	B- 60 Very High Payments Risk
Central African Republic	XOF	Conventional Peg	✓		High	CCC 65 Possible Default
Congo, Dem. Rep.	CDF	Crawl-Like Arrangement	✓		Moderate	CCC 65 Possible Default
Ethiopia	ETB	Crawl-Like Arrangement	✓		High	CCC 65 Possible Default
Iraq	IQD	Conventional Peg	✓		N/A	B- 60 Very High Payments Risk
Mali	XOF	Conventional Peg	✓		Moderate	CCC 65 Possible Default
Mozambique	MZN	Crawl-Like Arrangement	✓		In debt distress	CCC 65 Possible Default
Myanmar	MMK	Other Arranged Management	✓		Low	CCC 65 Possible Default
Niger	XOF	Conventional Peg			Moderate	B+ 55 High Payments Risk
Nigeria	NGN	Stabilised Arrangement	✓		N/A	B- 60 Very High Payments Risk
Somalia	**SOS, USD**	Free Floating	✓		In debt distress	D 95 Poorest Quality
South Sudan	SSP	Crawl-Like Arrangement	✓		High	CCC 65 Possible Default
Syrian Arab Republic	SYP	Other Arranged Management	✓		N/A	C 85 Poorest Quality
Ukraine	UAH	Floating	✓		N/A	B- 60 Very High Payments Risk
Yemen, Rep.	YER	Floating	✓		Moderate	CC 75 Default – Accumulating Arrears

Sources: IMF AREAER database, Global Sanctions Database, IMF and World Bank, Global Insight (Wharton School). FATF classification – Black-shaded cells indicate high-risk jurisdictions (i.e., "black list"), or countries with serious strategic deficiencies to counter money laundering, terrorist financing, and financing of proliferation; grey-shaded cells indicate jurisdictions under increased monitoring (i.e., "grey list"), or countries that are actively working with the FATF to address strategic deficiencies in their regimes to counter money laundering, terrorist financing, and proliferation financing.

Countries where fragility is mainly driven by weak policies and institutions

The 2023 World Bank Group's FCS list highlights the following as "fragility FCS": Burundi, Chad, Comoros, Congo, Eritrea, Guinea-Bissau, Haiti, Kosovo, Lebanon, Libya, Marshall Islands, Micronesia, Papua New Guinea, Solomon Islands, Sudan, Timor-Leste, Tuvalu, Venezuela, West Bank and Gaza, Zimbabwe (**Table 11**).

These 20 countries are characterised by conflict that is less violent or restricted to a region, and suffer mostly from weak institutions, governance, and policies, as reflected by a low CPIA score (**Annex C, Table 12**). This group appears outside of the bottom two clusters in **Figure 1** as it has lower levels of fragility and on average a higher GDP/capita. Ten (50%) are under sanctions, none is blacklisted under FATF, and Haiti is the only one appearing on FATF's "grey" list (**Annex B, Table 10**). Sovereign credit standing is poor, and, as a group, comparable to countries that are most affected by conflict: based on the IMF-WB Debt Sustainability Analysis (covering 16 of these countries), two are in debt distress, seven at high risk and six at moderate risk of debt distress. Eight out of the 20 countries score at or above the Default-Interest arrears level of 70 in the Wharton School Global Insight's classification.

Given these characteristics, LCY delivery remains challenging. Working with a medium-term perspective, including on infrastructure and project finance, should be more feasible than in the conflict group, though far from easy. Credit guarantees will still be required to deliver increased LCY lending, through or alongside the local banking sector. With local political will and committed institutions, it may be possible to work on strengthening the very first building blocks of the local money market. Support to the central bank and authorities on stabilising the macro-policy framework with a view to strengthening the foundations of the local financial system should be provided in any event. Here again, the local banking sector is an indispensable partner for LCY lending delivery, and adequate decision-making and guidance at macroeconomic level is instrumental for their stability.

In fragile FCS, DFIs should consider to strategically intervene when countries are undergoing a "pivotal moment".[76] This is a situation in which a country is potentially transitioning out of fragility and instability and/or experiencing a generally positive reform and governance trajectory and a window of opportunity exists to influence key issues. Political economy analysis and contextual knowledge is needed to properly understand the political context in which the engagement is taking place and the positioning of the policy champions in this context.

76 LSE-Oxford Commission on State Fragility, Growth and Development, 2018

Table 11: States where fragility is mainly driven by weak policies and institutions: Key indicators

Country (2023 FCS list)	Currency	ERR	Sanctions	FATF classification	IMF/WB DSA	Sovereign risk
Burundi	BIF	Crawl-Like Arrangement	✓		High	CC 70 Default - Interest Arrears
Chad	XOF	Conventional Peg			Moderate	CCC 65 Possible Default
Comoros	KMF	Conventional Peg			High	CCC 65 Possible Default
Congo, Rep.	XOF	Conventional Peg			High	CC 70 Default - Interest Arrears
Eritrea	ERN	Conventional Peg	✓		Moderate	CC 70 Default - Interest Arrears
Guinea-Bissau	XOF	Conventional Peg	✓		High	CCC 65 Possible Default
Haiti	HTG	Other Arranged Management	✓		N/A	CC 70 Default - Interest Arrears
Kosovo	EUR	No Separate Legal Tender			Moderate	BB- 50 Ongoing Uncertainty
Lebanon	LBP	Stabilised Arrangement	✓		In debt distress	CCC 65 Possible Default
Libya	LYD	Conventional Peg	✓		Low	B- 60 Very High Payments Risk
Marshall Islands	**USD**	No Separate Legal Tender			Moderate	N/A
Micronesia, Fed. Sts.	**USD**	No Separate Legal Tender			N/A	B+ 55 High Payments Risk
Papua New Guinea	PGK	Stabilised Arrangement			In debt distress	B- 60 Very High Payments Risk
Solomon Islands	SBD	Crawl-Like Arrangement			High	B- 60 Very High Payments Risk
Sudan	SDG	Stabilised Arrangement	✓		N/A	C 80 Default - Accumulating Arrears
Timor-Leste	USD	No Separate Legal Tender			N/A	BBB- 40 Supportive Credit Fundamentals
Tuvalu	**AUD**	No Separate Legal Tender			Moderate	B+ 55 High Payments Risk
Venezuela, RB	VES	Other Arranged Management	✓		High	CC 70 Default - Interest Arrears
West Bank and Gaza	**USD, JOD, NIS**		✓		Moderate	C 80 Default - Accumulating Arrears
Zimbabwe	ZWD	Other Arranged Management	✓		High	C 85 Poorest Quality

Sources: IMF AREAER database, Global Sanctions Database, Financial Action Task Force (FATF), IMF and World Bank, Global Insight (Wharton School). FATF classification – Black-shaded cells indicate high-risk jurisdictions (i.e., "black list"), or countries with serious strategic deficiencies to counter money laundering, terrorist financing, and financing of proliferation; grey-shaded cells indicate jurisdictions under increased monitoring (i.e., "grey list"), or countries that are actively working with the FATF to address strategic deficiencies in their regimes to counter money laundering, terrorist financing, and proliferation financing.

B. Socio-economic data

Table 12: Key economic indicators in fragile and conflict-affected settings and comparator groups, 2019

Country (2023 FCS List)	Population, total (m)	GDP per capita (current USD)	GDP growth (annual %)	Inflation, consumer prices (annual %)	Current account balance (% GDP)	Exports of goods and services (% GDP)	FDI, net inflows (% GDP)	Official exchange rate (LCU per USD)**	Personal remittances, received (% GDP)	Trade (% GDP)
Africa										
Burundi	11.9	217.0	1.8	-0.7	NA	5.2	0.0	1845.6	1.9	29.0
Burkina Faso	21.0	772.2	5.7	-3.2	-3.2	27.6	1.0	585.9	2.9	58.7
Cameroon	25.8	1,538.7	3.5	2.5	-4.3	19.9	2.6	585.9	0.9	43.4
Central African Republic	5.2	426.4	3.1	2.7	NA	15.8	1.2	585.9	0.0	50.1
Chad	16.1	701.6	3.2	-1.0	NA	36.7	5.0	585.9	0.0	74.6
Comoros	0.8	1,510.8	1.8	NA	-3.3	12.8	0.4	439.5	14.1	42.3
Congo, Dem. Rep.	89.9	575.9	4.4	NA	-3.3	25.9	2.6	1647.8	4.0	55.2
Congo, Rep.	5.6	2,288.8	-0.1	2.2	12.8	73.8	-11.2	585.9	0.2	127.0
Eritrea	3.5	NA	NA	NA	NA	NA	NA	15.1	NA	NA
Ethiopia	114.1	840.4	8.4	15.8	-5.2	7.9	2.7	29.1	0.5	28.8
Guinea-Bissau	2.0	730.6	4.5	0.2	-8.9	20.3	5.0	585.9	10.5	55.4
Libya	6.6	10,542.1	-11.2	NA	7.0	42.8	0.0	1.4	0.0	78.2
Mali	20.6	840.2	4.8	-1.7	-7.5	25.7	5.0	585.9	5.6	63.7
Mozambique	30.3	508.2	2.3	2.8	-19.1	32.3	22.0	62.5	1.9	112.0
Niger	23.4	551.0	5.9	-2.5	-12.2	11.4	5.6	585.9	2.4	37.7
Nigeria	203.3	2,204.2	2.2	11.4	-3.1	14.2	0.5	306.9	5.3	34.0
Somalia	16.0	405.8	7.5	NA	NA	17.4	6.9	NA	24.3	101.1
South Sudan	10.4	NA	NA	87.2	-4.2	NA	NA	158.0	NA	NA
Sudan	43.2	748.0	-2.2	51.0	-14.8	0.6	2.6	45.8	1.6	1.2
Zimbabwe	15.4	1,421.9	-6.3	255.3	4.2	27.2	1.1	NA	6.5	52.7
Middle East										
Iraq	41.6	5,621.2	5.5	-0.2	6.7	38.1	-1.3	1182.0	0.4	69.0
Lebanon	5.8	8,985.6	-7.2	3.0	-21.7	20.6	4.0	1507.5	14.3	62.6
Syrian Arab Republic	20.1	1,116.7	1.2	NA	NA	13.0	NA	NA	NA	42.0
West Bank and Gaza	4.7	3,656.9	1.4	1.6	-10.4	15.5	0.8	NA	18.4	69.0
Yemen, Rep.	31.5	NA	NA	NA	NA	NA	NA	486.7	NA	NA
Asia										
Afghanistan	37.8	500.5	3.9	2.3	-20.1	NA	0.1	77.7	4.4	NA

Table 12: continued

Country (2023 FCS List)	Population, total (m)	GDP per capita (current USD)	GDP growth (annual %)	Inflation, consumer prices (annual %)	Current account balance (% GDP)	Exports of goods and services (% GDP)	FDI, net inflows (% GDP)	Official exchange rate (LCU per USD)**	Personal remittances, received (% GDP)	Trade (% GDP)
Myanmar	53.0	1,295.2	6.8	8.8	0.1	30.4	2.5	1518.3	3.7	60.7
Timor-Leste	1.3	1,584.3	23.5	1.0	6.6	21.4	3.7	1.0	4.9	70.9
Oceania										
Marshall Islands	0.01	5,189.0	10.8	NA	24.6	37.2	1.8	NA	13.6	152.3
Micronesia, Fed. Sts.	0.1	3,699.1	1.2	1.5	NA	31.5	NA	1.0	5.7	105.0
Papua New Guinea	9.5	2,593.8	4.5	3.9	NA	NA	1.4	3.4	0.0	NA
Solomon Islands	0.7	2,398.8	1.7	1.6	-9.5	36.5	2.0	8.2	1.6	83.0
Tuvalu	0.001	4,949.2	13.8	NA	-11.2	NA	0.6	NA	1.7	NA
Europe										
Kosovo	1.8	4,416.1	4.8	2.7	-5.7	29.3	3.6	0.9	15.8	85.8
Ukraine	44.4	3,661.5	3.2	7.9	-2.7	41.2	3.8	25.8	10.3	90.5
North America										
Haiti	11.2	1324.8	-1.7	18.7	-1.1	11.7	0.5	88.8	20.5	49.2
South America										
Venezuela, RB	29.0	NA	NA	NA	NA	NA	NA	NA	NA	NA
Comparator group averages										
European Union	447.4	3,5079.5	1.8	1.6	NA	49.3	2.0	NA	0.8	92.1
FCS	957.4	1,874.1	2.2	2.5	NA	24.2	1.4	NA	4.7	52.3
High income	1,235.9	44,723.9	1.8	1.6	NA	31.3	1.9	NA	0.3	61.6
Low income	680.0	704.5	3.7	2.9	NA	18.6	3.5	NA	2.8	48.7
Lower middle income	3,313.9	2,386.5	3.7	3.0	NA	23.4	1.9	NA	4.3	49.7
Middle income	5,797.8	5,448.7	4.0	2.6	NA	23.3	1.8	NA	1.6	46.7
OECD members	1,362.9	39,531.7	1.7	1.7	NA	28.0	1.5	NA	0.4	56.4
United States	328.3	65,120.4	2.3	1.8	-2.1	11.9	1.5	1.0	0.0	26.5
Upper middle income	2,483.9	9,534.0	4.1	2.0	NA	23.3	1.7	NA	0.6	45.7
World	7,742.7	11,319.8	2.6	2.2	NA	28.3	1.8	NA	0.8	56.3

Sources: World Development Indicators
**period average

Table 13: Commodity dependence, 2018-2019

Country (2023 FCS List)	Commodity export value (mln USD)	Commodity exports (% of merchandise exports)	Commodity exports (% of GDP)
Africa			
Burkina Faso	3,265.70	97.4	20.5
Burundi	157.5	93.2	4.9
Cameroon	3,877.90	93.2	10
Central African Republic	82.7	82.7	3.7
Chad	2,870.40	98.8	25.6
Comoros	27.8	58.4	2.4
Congo, Dem. Rep.	8,377.40	95.2	17.1
Congo, Rep.	7,085.40	92.9	50.7
Eritrea	577.1	84	8.9
Ethiopia	2,173.50	79.5	2.5
Guinea-Bissau	276	98.3	19
Libya	23,563.60	95.7	64.7
Mali	3,268.30	91.4	19.2
Mozambique	4,709.30	95	31.8
Niger	705.6	65.9	5.6
Nigeria	62,101.10	97.9	13.8
Somalia	445.7	93.8	30.3
South Sudan	1,571.00	100	19.4
Sudan	3,800.50	98.1	8.4
Zimbabwe	3,478.40	83.7	14
Middle East			
Iraq	81,680.30	99.8	37.9
Lebanon	2,246.70	51.9	4
Syrian Arab Republic	1,413.50	69	7.8
West Bank and Gaza	417.7	34.9	2.5
Yemen, Rep.	1,306.40	93.6	4.6
Asia			
Afghanistan	853.5	91.8	4.2
Myanmar	10,583.80	61.1	13.9
Timor-Leste	80.5	78.6	3.1
Oceania			
Marshall Islands	4.7	9.6	2.1
Micronesia, Fed. Sts.	46.4	97	12.3
Papua New Guinea	10,520.90	96.1	44.7
Solomon Islands	506.6	98.4	39.5
Tuvalu	0.1	83.1	0.2
Europe			
Kosovo	–	–	–
Ukraine	25,962.50	53.3	18.3
North America			
Haiti	140.8	12.3	1.6
South America			
Venezuela, RB	20,617.30	80.6	13.2
Average	**8,243.40**	**91.9**	**16.1**

Sources: The State of Commodity Dependence, UNCTAD

C. Connection to the international financial system

Table 14: Sanctions and Financial Action Task Force's (FATF) listing

Country (2023 FCS List)	Number of sanction (as of 2022)					FATF classification
	Arms	Military	Financial	Travel	Other	
Africa						
Burkina Faso			3		1	
Burundi			4	1		
Cameroon			2	1		
Central African Republic	3	4	5	5		
Chad						
Comoros						
Congo, Dem. Rep.	3	3	8	5		
Congo, Rep.						
Eritrea			1	2	1	
Ethiopia			1	3		
Guinea-Bissau			3	4	1	
Libya	3	3	10	8	2	
Mali		1	6	4	2	
Mozambique			2	1		
Niger						
Nigeria	1	1	3	2		
Somalia	5	4	5	6		
South Sudan	3	2	6	4		
Sudan	3	5	8	4		
Zimbabwe	5	6	6	4	1	
Middle East						
Iraq	3		4			
Lebanon	3	3	8	5		
Syrian Arab Republic	5	2	12	5	4	
West Bank and Gaza			1	1		
Yemen, Rep.	3	3	5	4		
Asia						
Afghanistan	7	7	6	6	3	
Myanmar	5	5	8	5		
Timor-Leste						
Oceania						
Marshall Islands						
Micronesia, Fed. Sts.						
Papua New Guinea						
Solomon Islands						
Tuvalu						
Europe						
Ukraine	2	1	10	8	3	
Kosovo						
North America						
Haiti	1	1	1			
South America						
Venezuela, RB	4	2	9	6	2	

Sources: Global Sanctions Database (GSDB), Financial Action Task Force (FATF).
Note: FATF classification – Black-shaded cells indicate high-risk jurisdictions (i.e., "black list"), or countries with serious strategic deficiencies to counter money laundering, terrorist financing, and financing of proliferation; grey-shaded cells indicate jurisdictions under increased monitoring (i.e., "grey list"), or countries that are actively working with the FATF to address strategic deficiencies in their regimes to counter money laundering, terrorist financing, and proliferation financing. When the FATF places a jurisdiction under increased monitoring, it means the country has committed to resolve swiftly the identified strategic deficiencies within agreed timeframes and is subject to increased monitoring.

Table 15: Eligibility or membership to IDA, HIPC initiative, MIGA, OECD-DAC, 2023

Country (2023 FCS List)	Eligibility to IDA resources	Participation to HIPC initiative	MIGA			EDFI Transferability & Convertibility Facility	Part to DAC list of ODA recipients
			Membership	NHSFO guarantee	Eligibility to convertibility guarantee		
Africa							
Burkina Faso	✓	✓	✓	x	✓	✓	✓
Burundi	✓	✓	✓	x	x	✓	✓
Cameroon	✓	✓	✓	x	✓	✓	✓
Central African Republic	✓	✓	✓	x	✓	✓	✓
Chad	✓	✓	✓	x	✓	✓	✓
Comoros	✓	✓	✓	x	✓	✓	✓
Congo, Dem. Rep.	✓	✓	✓	x	✓	✓	✓
Congo, Rep.	✓	✓	✓	x	✓	✓	✓
Eritrea	✓	x	✓	x	Not open, WB arrears	✓	✓
Ethiopia	✓	✓	✓	x	x	✓	✓
Guinea-Bissau	✓	✓	✓	x	✓	✓	✓
Libya	x	x	✓	x	x	x	✓
Mali	✓	✓	✓	x	x	✓	✓
Mozambique	✓	✓	✓	x	✓	✓	✓
Niger	✓	✓	✓	x	✓	✓	✓
Nigeria	✓	x	✓	x	x	✓	✓
Somalia	✓	x	✓	x	x	x	✓
South Sudan	✓	x	✓	x	x	✓	✓
Sudan	✓	x	✓	x	x	✓	✓
Zimbabwe	✓	x	✓	x	Not open, WB arrears	✓	✓
Middle East							
Iraq	x	x	✓	x	✓	x	✓
Lebanon	x	x	✓	x	x	x	✓
Syrian Arab Republic	✓	x	✓	x	x	x	✓
West Bank and Gaza	x	x	x	x	✓	x	✓
Yemen, Rep.	✓	x	✓	x	x	x	✓
Asia							
Afghanistan	✓	✓	✓	x	x	x	✓
Myanmar	✓	x	✓	x	x	x	✓
Timor-Leste	✓	x	✓	x	✓	x	✓
Oceania							
Marshall Islands	✓	x	x	Not a member	Not a member	x	✓
Micronesia, Fed. Sts.	✓	x	✓	x	✓	x	✓
Papua New Guinea	✓	x	✓	x	x	x	✓
Solomon Islands	✓	x	✓	x	✓	x	✓
Tuvalu	✓	x	x	Not a member	Not a member	x	✓
Europe							
Kosovo	✓	x	✓	x	✓	x	✓
Ukraine	x	x	✓	x	x	x	✓
North America							
Haiti	✓	✓	✓	x	x	x	✓
South Americs							
Venezuela, RB	x	x	✓	x	x	x	✓

Sources: World Bank, IMF, MIGA, EDFI, OECD
Note: None of the countries in the list are eligible MIGA's NHSFO guarantee.

D. State fragility indicators

Table 16: World Bank Group's 2023 list of fragile and conflict-affected settings

Conflict	Fatalities per 100K (ACLED)	Fatalities per 100K (UCDP)	Fragility	CPIA	Refugees per 100K
Afghanistan	80.3	80.5	Burundi	2.9	2,640.7
Burkina Faso	15.9	9.4	Chad	2.8	69.6
Cameroon	4.0	3.3	Comoros	2.4	188.0
Central African Republic	36.8	27.1	Congo, Rep.	2.7	252.0
Congo, Dem. Rep.	6.1	4.4	Eritrea	1.9	14,214.0
Ethiopia	7.2	21.1	Guinea-Bissau	2.4	101.2
Iraq	6.3	2.5	Haiti	2.6	255.2
Mali	14.4	10.2	Kosovo	3.7	1,756.9
Mozambique	3.6	3.8	Lebanon	-	89.5
Myanmar	31.6	17.8	Libya	-	274.3
Niger	4.8	3.5	Marshall Islands	2.6	11.7
Nigeria	5.1	1.8	Micronesia, Fed. Sts.	2.8	-
Somalia	21.7	16.4	Papua New Guinea	2.8	5.6
South Sudan	19.6	2.4	Solomon Islands	2.9	5.4
Syrian Arab Republic	29.5	7.0	Sudan	2.3	1,837.7
Ukraine	7.4	64.4	Timor-Leste	2.8	0.8
Yemen, Rep.	52.5	69.7	Tuvalu	2.9	-
			Venezuela, RB	-	16,044.7
			West Bank and Gaza	-	2,104.1
			Zimbabwe	2.8	53.8

Sources: World Bank Group's FY23 FCS List

Note: Fragile countries are defined as: (i) those with one or more of the following: (a) the weakest institutional and policy environment, based on a revised, harmonized CPIA score i for IDA countries (for which CPIA scores are disclosed)ii that is below 3.0; or (b) the presence of a UN peacekeeping operation because this reflects a decision by the international community that a significant investment is needed to maintain peace and stability there; or (c) flight across borders of 2,000 or more per 100,000 population, who are internationally regarded as refugees in need of international protection, iii as this signals a major political or security crisis; and o (ii) those that are not in conflict (see methodology below), as such countries have gone beyond fragility. Countries in conflict are defined as: (i) those with (a) an absolute number of conflict deaths above 250 according to ACLED and 150 according to UCDP; and (b) above 2 per 100,000 population according to ACLED and above 1 according to UCDP; or (ii) countries with a rapid deterioration of the security situation, as measured by (a) an absolute number of conflict deaths above 250 according to ACLED and 150 according to UCDP; (b) a lower number of conflict deaths relative to the population between 1 and 2 (ACLED) and 0.5 a and 1 (UCDP) and (c) more than a doubling of the number of casualties in the last year.

Table 17: Country Policy and Institutional Assessment (CPIA) and Fragile States Index

Country (2023 FCS List)	CPIA Score: Economic management	CPIA Score: Policies for social inclusion/ equity	CPIA Score: Public sector management & institutions	CPIA Score: Structural policies	Fragile States Index: Ranking	Fragile States Index: Total
Africa						
Burundi	2.7	3.6	2.3	3.2	29th	90.5
Burkina Faso	3.7	3.6	3.4	3.5	19th	95.4
Cameroon	3.7	3.2	3.1	3.3	17th	96.0
Central African Republic	3.0	2.3	2.4	2.5	5th	108.1
Chad	3.0	3.0	2.6	2.5	9th	105.7
Comoros	2.8	2.8	2.4	2.8	47th	82.3
Congo, Dem. Rep.	3.2	3.2	2.5	3.0	6th	107.3
Congo, Rep.	2.7	2.9	2.5	2.7	24th	92.2
Eritrea	1.5	2.6	2.4	1.2	18th	95.9
Ethiopia	3.5	3.8	3.5	3.3	13th	99.3
Guinea-Bissau	2.7	2.3	2.0	2.8	27th	91.3
Libya	N/A	N/A	N/A	N/A	21st	94.3
Mali	3.8	3.3	2.7	3.3	14th	98.6
Mozambique	3.0	3.3	3.0	3.2	21st	94.3
Niger	3.8	3.3	3.2	3.3	20th	95.2
Nigeria	3.5	3.5	2.8	3.0	16th	97.2
Somalia	2.0	2.4	2.0	1.7	2nd	110.5
South Sudan	1.2	1.5	1.4	1.8	3rd	108.4
Sudan	1.8	2.5	2.1	2.5	7th	107.1
Zimbabwe	2.5	3.7	2.9	2.8	15th	97.8
Middle East						
Iraq	N/A	N/A	N/A	N/A	23rd	93.8
Lebanon	N/A	N/A	N/A	N/A	27th	91.3
Syrian Arab Republic	N/A	N/A	N/A	N/A	3rd	108.4
West Bank and Gaza	N/A	N/A	N/A	N/A	37th	85.6
Yemen, Rep.	1.5	2.3	1.7	2.0	1st	111.7
Asia						
Afghanistan	3.0	2.7	2.6	2.3	8th	105.9
Myanmar	3.7	2.7	2.8	2.8	10th	100.0
Timor-Leste	3.0	2.9	2.6	2.8	56th	79.3
Oceania						
Marshall Islands	2.5	2.6	2.8	2.5	N/A	N/A
Micronesia, Fed. Sts.	2.7	2.7	2.8	2.8	81st	71.0
Papua New Guinea	2.7	2.5	2.7	3.3	55th	79.5
Solomon Islands	3.2	2.7	2.7	3.2	52nd	80.4
Tuvalu	2.7	2.9	3.0	2.7	N/A	N/A
Europe						
Kosovo	3.7	3.4	3.3	4.2	N/A	N/A
Ukraine	N/A	N/A	N/A	N/A	92nd	68.6
North America						
Haiti	3.0	2.6	2.2	3.0	11th	99.7
South America						
Venezuela, RB	N/A	N/A	N/A	N/A	26th	91.6

Sources: World Bank Group's Country Policy and Institutional Assessment, Fragile States Index.
Note: CPIA score reflects cluster average (1 = low to 6 = high).

Table 18: Worldwide Governance: 2021 ranking

Country (2023 FCS list)	Corruption	Government effectiveness	Political stability and absence of violence/terrorism	Regulatory quality	Rule of law
Africa					
Burundi	203	189	187	180	192
Burkina Faso	101	154	194	134	134
Cameroon	180	173	188	173	181
Central African Republic	186	199	201	198	200
Chad	199	193	186	187	193
Comoros	192	204	125	189	189
Congo, Dem. Rep.	200	201	191	195	201
Congo, Rep.	196	195	154	193	184
Eritrea	189	200	177	208	198
Ethiopia	127	144	200	174	148
Guinea-Bissau	194	192	132	190	195
Libya	201	202	204	203	203
Mali	167	185	203	148	170
Mozambique	162	162	185	158	176
Niger	142	145	192	157	131
Nigeria	178	179	196	176	165
Somalia	207	206	209	202	208
South Sudan	209	209	202	204	206
Sudan	193	198	198	197	188
Zimbabwe	191	186	179	194	191
Middle East					
Iraq	190	188	205	183	202
Lebanon	187	187	189	170	178
Syrian Arab Republic	208	203	208	200	207
West Bank and Gaza	155	163	197	103	139
Yemen, Rep.	206	208	207	205	204
Asia					
Afghanistan	183	197	206	192	205
Myanmar	176	191	199	185	197
Timor-Leste	100	161	97	161	174
Oceania					
Marshall Islands	90	194	70	182	87
Micronesia, Fed. Sts.	64	88	19	160	65
Papua New Guinea	157	174	152	164	158
Solomon Islands	103	175	82	167	124
Tuvalu	57	138	12	128	52
Europe					
Kosovo	116	120	115	119	119
Ukraine	158	133	184	120	154
North America					
Haiti	198	207	182	191	190
South America					
Venezuela, RB	205	205	190	207	209

Sources: Worldwide Governance Indicators
Note: Ranking in ascending order, N = 209

State Fragility initiative

IGC

The State Fragility initiative (SFi) is an International Growth Centre (IGC) initiative that aims to work with national, regional, and international actors to catalyse new thinking, develop more effective approaches to addressing state fragility, and support collaborative efforts to take emerging consensus into practice. SFi brings together robust evidence and practical insight to produce and promote actionable, policy-focused guidance in the following areas: state legitimacy, state effectiveness, private sector development, and conflict and security. SFi has financial support from the UK Foreign, Commonwealth, and Development Office (FCDO) and The Rockefeller Foundation.

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