UNLOCKING LOCAL CURRENCY FINANCING IN EMERGING MARKETS AND DEVELOPING ECONOMIES

What role can donors, development finance institutions and multilateral development banks play?

Paul Horrocks, Catriona Marshall, Callum Thomas,
Thomas Venon, Dave Portmann, Wuraola Okuwobi

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Abstract

Scaling local currency financing solutions in emerging markets and developing economies (EMDEs) requires addressing critical foreign exchange (FX) risks that limit the mobilisation of resources towards sustainable development outcomes. Challenges include structural constraints in multilateral development bank (MDB) and development finance institution (DFI) business models, underdeveloped local financial markets, and a lack of incentives and scalable instruments to engage institutional investors. While current market solutions provided by donors –such as currency hedging tools, local currency bonds, and other blended finance approaches– offer potential, they also face a number of critical limitations. This paper proposes policy options for expanding local currency financing flows, deepening domestic capital markets and mobilising local actors, with aims of fostering long-term economic resilience and stability in EMDEs.

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Executive summary

In emerging markets and developing economies (EMDEs), the significant currency risk –often referred to as foreign exchange (FX) risk– associated with finance denominated in hard currencies –such as USD or EUR– is a critical barrier to *external* financing for sustainable development. One major concern, particularly for small and medium-sized enterprises (SMEs) and infrastructure projects, is that *domestic* funding is hardly a viable alternative: the lack of local currency financing options in underdeveloped capital markets prevents the effective mobilisation of such resources.

Borrowing in hard currency leaves both governments and businesses exposed to exchange rate volatility, increasing the risk of default during periods of local currency depreciation. This is problematic for infrastructure projects and SMEs which are burdened by foreign-denominated debt but generate income in local currency. With debt-to-GDP ratios in key emerging market sovereigns projected to rise by up to 5% between 2023-2030 according to latest S&P Global Ratings analysis, it is urgent to rebalance financing strategies and reduce systemic vulnerabilities. However, because of the lack of depth and breadth of local capital markets in EMDEs, local currency solutions have traditionally been a marginal component of the development finance agenda, as well as an under prioritised policy theme. Expanding the availability and affordability of local currency finance therefore represents an effective way for development finance providers to rebalance currency risks more equitably and reduce the burden borne by borrowers. Recent calls under Brazil's G20 2024 presidency to increase local currency lending solutions reflect the growing recognition of this agenda.

From a macroeconomic perspective, higher levels of local currency financing can help to bolster domestic financial markets and promote resilience to global financial shocks, thereby supporting long-term economic development and poverty alleviation efforts. Access to local currency finance is essential for enabling SMEs to create jobs and drive inclusive economic development. Similarly, as infrastructure projects (e.g. utilities) typically receive income in their local currency, they will prove more financially resilient where local currency financing can be sourced. Large-scale infrastructure projects in need of imported construction material will have to continue to access funding in hard currency, however, and therefore bear the risks associated with local currency depreciation. This typically raises the cost of capital and discourages private sector participation in future transactions.

Striking the right balance between local and hard currency financing solutions is inherently complex and has been a long-standing area of difficulty for donors, development actors and financial institutions. Rapid or poorly planned shifts to local currency financing risk overwhelming local markets, causing inflationary pressures and potentially destabilising economies. Factors such as a country's level of foreign exchange reserves, export-import dependencies and credit ratings, amongst others, all affect the adequate financing mix between local and hard currency needs, making the balancing act even more complex. Local currency financing is thus no silver-bullet-solution: its implementation must be carefully phased and sequenced within the broader financial system, requiring continuous iteration and innovation.

As the main financiers of development projects in EMDEs, donors, multilateral development banks (MDBs) and development finance institutions (DFIs) play a crucial role in supporting both hard and local currency financing. However, even where local currency financing options exist, the bulk of DFI and MDB funding

—around 80-90%— remains in foreign currency, leaving borrowers disproportionately exposed to currency risks. Whilst the structural obstacles they face –from restrictive liability models which affect their risk appetites, to a lack of incentives and scalable instruments to effectively engage institutional investors– constrain their capacity to provide local currency financing, several donor-driven blended finance solutions exist, and are currently utilised across the development finance system. Although these initiatives help to mitigate FX risk tied to financing development projects, other, more actionable and long-term oriented policy solutions will be required to strengthen market resilience and stability within local financial systems:

Short-term measures

- **Unlock the local currency potential of development finance.** Donor countries should mandate MDBs and DFIs to review their currency risk frameworks and encourage collaboration on treasury functions to enhance local currency financing solutions.
- **Unlock the potential of local financial actors.** Local currency mobilisation efforts should prioritise engagement with local financial actors, encourage MDBs and DFIs to structure transactions compatible with local currency assets, and support local bank lending to SMEs and non-bank financial institutions.
- **Support existing mitigation and market-building initiatives.** Donor countries should scale up targeted initiatives like FrontClear and the Liquidity and the Sustainability Facility (LSF) to better streamline donor resources and enhance market-building efforts.

Long-term measures

- **Reform frameworks.** MDBs' founding documents should be reviewed to facilitate local currency debt issuance and financing.
- **Develop local capital markets.** Donors and MDBs should prioritise developing financial infrastructure and scalable instruments like bonds; conduct gap analyses of financial markets; and ensure concessionality levels are appropriately tailored to market maturity.
- **Co-ordinate donor efforts.** Donors should work more effectively to harmonise regulatory standards, improve cross-border co-operation, and prioritise the integration of local financial markets into their practices to enhance market efficiency, boost liquidity and attract private investment.

Substantially increased flows of local currency funding to local SMEs and infrastructure assets, coupled with a rebalancing of currency risks that unlocks greater levels of economic activity will not occur without the concerted efforts of donors and development actors. Through such efforts, far larger volumes of global and local private capital may be unlocked, and development outcomes improved significantly.

Abbreviations and acronyms

ADB	Asian Development Bank
AFD	Agence française de développement
AfDB	African Development Bank
AfT	Aid for Trade
AFRAEXIM	African Export-Import Bank
ALM	Asset and Liability Management
AVCA	African Private Equity and Venture Capital Association
BADEA	Arab Bank for Economic Development in Africa
BII	British International Investment
BIS	Bank for International Settlements
BMZ	German Ministry for Economic Cooperation and Development
BNDES	Brazil's national development bank
BNY Mellon	The Bank of New York Mellon
BRD	The Development Bank of Rwanda
BV	Arise Investment
CA	Crédit Agricole
CCR	Counterparty Credit Risk
CDFS	Centre for Development Finance Studies
CFA	Financial Community of Africa
DBSA	Development Bank of South Africa
DEG	German Investment Corporation
DFI	Development finance institutions
EAVCA	East Africa Venture Capital Association
EBRD	European Bank for Reconstruction and Development
ECA	Export Credit Agency
EDFI	European Development Finance Institution
EIB	European Investment Bank
EMDE	Emerging Market and Developing Economy
FCDO	UK's Foreign, Commonwealth and Development Office
FCY	Foreign Currency
FMO	Dutch Entrepreneurial Development Bank
Frw	Rwandan Franc
FSD	Financial Sector Deepening Africa
GBI-EM	JP Morgan's Government Bond Index-Emerging Markets
GEM	Global Emerging Markets risk data base
GIIF	Global Impact Investment Facility

GRDs	Global Depositary Receipt
IABD	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IFIs	International Financial Institutions
ILX	ILX Management B.V
IPO	Initial Public Offering
ISDA	International Swaps and Derivatives Association
KEPFIC	Kenya Pension Funds Investment Consortium
KfW	German Development Bank
KSH	Kenyan shillings
LCY	Local Currency
LIC	Low Income Country
LSF	Liquidity and Sustainability Facility
MCPP	Managed Co-Lending Portfolio Programme
MDB	Multilateral Development Bank
MIC	Middle Income Country
MIV	Microfinance Investment Vehicle
MSME	Micro, small and medium enterprises
MTN	Medium-Term Note Programme
NBIM	Norway's Norges Bank Investment Management
NDBs	National Development Banks
NSE	Nairobi Securities Exchange
ODA	Official Development Assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Cooperation and Development
OPIC	The Overseas Private Investment Corporation
OTC	Over-the-Counter
PEI	Private Equity International
PSI	Private Sector Instruments
REX	Real Exchange Rate Liquidity product
SEK	Swedish Krona
SET	Stock Exchange of Thailand
SLB	Sustainability-Linked Bonds
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
T&C	Transfer and Convertibility risk
TCGC	Thai Credit Guarantee Corporation
TXC	The Currency Exchange Fund
UNECA	United Nations' Economic Commission for Africa
USAID	United States Agency for International Development
WB	World Bank

1 The role of local currency in strengthening financial markets in developing countries

Increasing the availability of financing denominated in local currency in developing countries is crucial for fostering sustainable economic growth and financial stability.[1] Local currency is important for several reasons.

Access to finance for small and medium enterprises (SMEs) is vital for helping them to contribute to job creation and inclusive economic development. SMEs typically need local currency financing to ensure that access to credit is in the same currency as the income used to make repayments.

Similarly to SMEs, infrastructure projects (e.g. utilities) often receive income in their local currency and should therefore prove more financially resilient where local currency financing can be sourced. However, large-scale infrastructure projects may need to access both onshore and offshore hard currency as certain projects will need access to imported construction material and therefore funding in hard currency.

Local currency also reduces an economy's dependency on foreign currency, bolsters domestic financial markets, and promotes resilience to global financial shocks, thereby supporting long-term economic development and poverty alleviation.

However, local currency financing is not a panacea for the challenges faced by developing countries; its implementation needs to be carefully phased and sequenced. While increasing the use of local currency can mitigate exchange rate risks and bolster financial stability, it must be integrated thoughtfully within the broader financial system. Rapid or poorly planned shifts to local currency financing could overwhelm local financial markets, lead to inflationary pressures, and potentially destabilise the economy. For example, transitioning rapidly from a hard currency to a typically weaker domestic currency can sharply increase the cost of foreign goods, potentially triggering inflationary pressures depending on the country's reliance on imports.

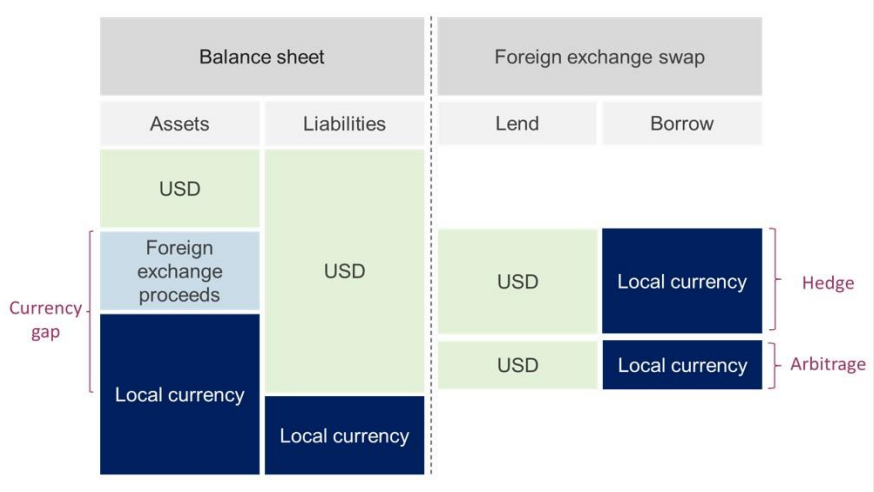
The effective implementation of local currency financing solutions requires robust financial infrastructure, sound macroeconomic policies, and the gradual development of local capital markets to support its growing demand. Aligning assets and liabilities in local currency can also help mitigate financial instability caused by exchange rate fluctuations, as illustrated in Box 1.1.

Box 1.1. The importance of assessing currency mismatches

Analysing currency mismatches between assets and liabilities provides a comprehensive view of their associated risks. Case studies and anecdotal examples will be used where possible to highlight currency mismatches and local currency mobilisation in practice. Importantly, these aim to be illustrative and non-exhaustive to support discussions among donors and relevant policy makers.

Currency mismatches can arise from an overall currency balance sheet misalignment across all remaining maturities, or a currency maturity mismatch at shorter horizons, or both. For example, a currency balance sheet mismatch arises if the currency denomination of a borrower's liabilities differs from that of their assets (Figure 1.1). Currency movements then affect valuations of assets and liabilities across all remaining maturities, and hence affect solvency. Even in the absence of an overall balance sheet mismatch, the borrower may have a currency maturity mismatch: a mismatch between currency liabilities against the currency resources readily available (from foreign exchange income, hedges, or liquid currency). Overall, a borrower is fully hedged only in the absence of currency mismatches affecting valuations even over long horizons, and liquidity shortfalls at shorter maturities.

Figure 1.1. Illustrative example of currency mismatch and foreign exchange swap dynamics



Note: Volumes are illustrative and do not represent any entity, country or territory.
Source: OECD Authors' illustration. Adapted from IMF (2022[1]) *Background Note 2: Assessing Systemic Financial Stability Risks Due to FX Mismatches,* https://doi.org/10.5089/9798400204593.007 and BIS (2023[2]), *Bank positions in FX swaps: insights from CLS*, https://www.bis.org/publ/qtrpdf/r_qt2309b.pdf.

The resulting currency mismatch can exacerbate valuations and solvency issues due to currency movements. This misalignment necessitates foreign exchange swaps to manage short-term liquidity and long-term solvency risks. However, it should be recognised that as hedging in many developing countries and sectors will be required, efforts should be used to assess local currency financing opportunities. Moreover, macroeconomic sector-specific considerations, such as inflationary pressures, commodity price dependency, market liquidity and interest rate fluctuations, further complicate local currency mobilisation efforts and can increase financial instability.

Donors, development finance institutions (DFIs) and multilateral development banks (MDBs) play a significant role in the financing of developing countries, where domestic savings are insufficient to meet vast investment needs. As such, the nature of the funding that these institutions provide has a significant impact on the use of transactions, portfolios and the development of financial systems. However, whilst local currency financing options exist, the majority of DFI and MBD funding—around 80-90%—remains in foreign currency, leaving borrowers to shoulder significant currency risks in these volatile markets.

There is an inherent tension in developing countries between the demand for local and hard currency financing due to the diverse scale and nature of financing needs. Local currency financing often addresses community-level funding through formal and informal financial systems, while broader public sector and large-scale infrastructure projects require a combination of local and hard currency resources.

From a macro perspective hard currency is vital for repaying existing foreign debt and maintaining import levels, which is critical for economic growth. However, different economic actors and project-specific needs often create a tension between the advantages of local currency financing and the reliance on the deeper, often more affordable, hard currency markets. Therefore, while increasing local currency financing is important for financial stability and growth, developing countries must also ensure adequate access to hard currency to meet their extensive and diverse financing requirements. To address these challenges, it is vital to mitigate currency risk by aligning assets and liabilities and exploring projects and portfolios that increasingly leverage local currency funding.

However, financial systems in developing countries often lack the depth and maturity to absorb large-scale investments, limiting their capacity to effectively use and manage substantial inflows of local currency financing. This inadequate absorption capacity can lead to market distortions, inflation and other economic imbalances, posing significant challenges to the sustainable development of local financial ecosystems. Addressing these obstacles requires coordinated efforts to develop robust local capital markets and create mechanisms to manage currency risk more effectively.

Local financial institutions in developing countries additionally often face significant challenges in managing the long-term financial implications of hard-currency loans, such as those denominated in US dollars. These loans may typically appear more attractive in the short term due to their initially lower interest rates compared to local currency loans. However, over the long term, the depreciation of the local currency against the hard currency can lead to substantially higher repayment costs, ultimately making these loans more expensive. This discrepancy underscores the necessity of building up the institutional capacity of local financial institutions to manage and utilise local currency financing effectively, thereby helping mitigate the risks associated with currency depreciation and foster more sustainable economic growth.

2 What are the key constraints to local currency mobilisation in ODA-eligible countries?

This chapter discusses the different ways of providing local currency funding for infrastructure projects and SMEs in developing countries. It firstly provides an overview of FX market dynamics in ODA-eligible countries (Box 2.1), before investigating critical local currency issues from the point of view of the DFIs and MDBs, which are the institutions most explicitly tasked with financing assets conducive to sustainable development in developing economies. It explores the risk appetite limitations imposed by the liabilities and rules and regulations of DFI and MDB business models, and then outlines several ways in which currency risk can be managed. Options for mobilising local currency for SMEs, through balance sheet mobilisation and direct mobilisation of private capital, whilst relevant obstacles to these are also investigated.

Understanding the obstacles faced by DFIs and MDBs is crucial to identifying the structural barriers that hinder the mobilisation of institutional investors, such as pension funds and insurance companies. These investors, whether global or local, often prioritise financial returns over development objectives and may have limited experience or exposure to investments in developing countries.

Box 2.1. An overview of foreign exchange markets in ODA-eligible countries: structures, performance and challenges

Foreign exchange (FX) markets play a pivotal role in countries' economic stability and growth, including in those eligible for official development assistance (ODA). FX markets facilitate international trade and investment by enabling currency conversion, which is crucial for countries striving to integrate into the global economy.

The FX markets in ODA-eligible countries are often characterised by limited liquidity, volatility, and a high degree of vulnerability to external shocks. Many of these economies rely heavily on a narrow range of exports and face significant capital flow fluctuations, which can lead to sharp exchange rate movements. These dynamics are influenced by various factors, such as reliance on a particular commodity priced in US dollars (USD), political instability, economic policies, and financial trends in global markets. Understanding these intricacies is essential for formulating effective policies that can mitigate risks and harness the potential benefits of foreign exchange operations.

Foreign exchange markets in lower-middle income countries (LMICs), particularly in Africa,[1] have undergone significant transformations over the past three decades. The most notable changes include the liberalisation of foreign exchange markets and capital accounts, and the shift towards more flexible exchange rate regimes (European Investment Bank, Okot, A., Kaltenbrunner, A. and Perez Ruiz, D., 2022[3]). The dynamics of these markets are influenced by a variety of factors. A study by the European Investment Bank found that terms of trade, export concentration and export prices have a significant impact on the exchange rate level and volatility (European Investment Bank, Okot, A., Kaltenbrunner,

A. and Perez Ruiz, D., 2022[3]). These factors reflect the countries' distinct productive and export structure, often concentrated in a few agricultural and mineral-based commodities, such as in Nigeria and Zimbabwe for example.

Financial factors such as interest rate differentials, international market conditions and short-term financial flows also influence the likelihood of sudden and large exchange rate movements (World Bank, 1987[4]), making it difficult for EMDE borrowers reliant on predictable FX rates to manage their hard currency debts**.** This highlights the role of financial integration in shaping the dynamics of foreign exchange markets in these countries. However, it is important to note that while most of these countries have functioning foreign exchange interbank markets, they are often characterised by foreign exchange volatility. In such environments, FX market volatility can encourage hoarding and grant large-scale importers or financial institutions with access to hard currency undue market power. This undermines competitiveness and creates inequities that disrupt economic activity, particularly for smaller firms and consumers dependent on stable import costs.

A positive trend that looks to address this is that more Central Banks are encouraging free-floating currencies (where exchange rates are determined by market forces). International policymaking bodies generally support foreign exchange flexibility, as a free-floating currency reflects macroeconomic realities better than a managed or pegged currency and is less susceptible to currency shocks. However, this approach may lead to greater short-term volatility compared to heavily managed or pegged currencies. The West and Central African Monetary Union remains a significant bloc with pegged currencies: the West African CFA franc (XOF) and Central African CFA Franc (XAF) are pegged to the Euro. The downside of maintaining heavily managed and pegged currencies is that when the exchange rate or peg becomes unsustainable, a significant and often painful adjustment is typically required. For example, in 1994, the XOF was devalued from 0.02 to 0.01 French francs, resulting in a 50% depreciation in local currency terms. The float and variability of the local currency should therefore be taken into consideration when exploring a transition to local currency.

Given these factors, gradually scaling up financing denominated in local currency could help mitigate exchange rate risks and enhance monetary policy independence. Judicious and careful management when changing the balance of local versus hard currency, as already highlighted, requires a staged approach to ensure optimal economic outcomes.

Note: 1. According to the World Bank 2021/22 country income group classification, LMI Africa has 23 member states: Algeria, Angola, Benin, Cameroon, Cape Verde, Comoros, the Republic of the Congo, Côte d'Ivoire, Djibouti, Egypt, Ghana, Kenya, Lesotho, Mauritania, Morocco, Nigeria, São Tomé and Príncipe, Senegal, Eswatini, Tanzania, Tunisia, Zambia and Zimbabwe.

While the evolution of foreign exchange markets in ODA-eligible countries presents opportunities for expanding local currency financing, particularly in regions with greater financial integration, challenges such as liquidity volatility and currency pegging complicate these efforts. This brings us to the role that DFIs and MDBs can play in local currency capital mobilisation, which is deeply influenced by the liabilities inherent in their business models, shaping their appetite for local currency funding.

Liabilities in DFI and MDB business models can affect their appetite for local currency funding

The untapped potential of DFIs and MDBs in mobilising local currency funding is immense, given that these institutions are the main providers of development finance. This is particularly the case in a number of countries where these institutions have significant roles in their financing systems, allowing them to more effectively catalyse private sector investment. By aligning their funding models with local currency needs, DFIs and MDBs could enhance the resilience of investments and foster deeper capital market development

in these regions. However, this potential remains underutilised due to several structural obstacles tied to their business models, particularly the liabilities they carry.

To understand the role of DFIs and MDBs' liabilities, it is necessary to consider two types of funding models (OECD, 2023[5]):

1. Equity-only funding models: some bilateral DFIs are exclusively funded through equity from their shareholder(s), for example British International Investment (BII) and Norfund.
2. Debt-leveraged funding models: the MDB funding model involves using shareholder equity, as a base to raise additional funds through the issuance of debt, such as bonds for example. By leveraging their equity, MDBs and certain bilateral DFIs – including the Dutch Development Bank (FMO), Agence Française de Development (AFD) and Proparco – can significantly expand their capital base, allowing them to finance a larger portfolio of development projects. This funding model enhances their ability to support long-term investments, as the debt raised is typically used to fund projects while aiming to maintain a balanced risk-return profile.

We begin by discussing the simpler equity-only models, which helps to identify obstacles which will become more numerous once more complex funding models are introduced.

Institutions with an equity-only funding model have broader mobilisation scope, but still face constraints

This equity-only model is largely the preserve of bilateral DFIs and specifically BII, with this model offering greater capacity to take on currency risk. Bilateral DFIs do not traditionally pay dividends to their shareholders, nor do they have to meet interest payments if they do not resort to debt to fund their activities. Decisions on the financing products each institution offers are therefore not linked to cash flows to external parties resulting from liabilities on their balance sheets. An exclusive reliance on equity capital theoretically equips these institutions with a comparatively higher capacity to take on currency risk from an asset and liability management point of view.

DFIs are however concerned with two important aspects, which have implications for their mobilisation of local currency: (1) preserving the equity capital they receive from their shareholders in their domestic currency; and (2) the ability to cover administrative costs, particularly their "liability" to their employees: staff costs which are typically incurred in the domestic currency of the DFI in which they account for and present their financial statements in.

Capital preservation

Financial self-sustainability is an often-unwritten rule of the development finance system. Recapitalisation cycles are notoriously long and challenging, and shareholders cannot be reliably expected to systematically reach for the taxpayer's pocket. This is a key element and constitutes one of the root causes of risk aversion across the development finance system. A mismatch between an institution's funding currency and the currency in which capital is deployed introduces significant risk which may be unacceptable to either or both management and shareholders.

Operational costs

Both DFIs and MDBs need to ensure the returns generated by their assets allow them to cover their operating costs. These are often incurred in the domestic currency for bilateral DFIs, or in hard currency for MDBs. Deploying capital and generating income in a different currency therefore risks them not being able to meet these costs. The higher the ratio of operational costs to income from investments, the more significant this risk. There is no uniform level of operational costs across the development finance ecosystem.

Table 2.1. Financial Performance and Operational Constraints of selected DFIs and MDBs

	British International Investment (BII)	Swedfund	International Finance Corporation (IFC)	Asian Development Bank (ADB)	African Development Bank (AfDB)	Dutch Development Bank (FMO)
Income from investments net of borrowing costs (a.)	GBP 158 100 000	SEK 255 129 000	USD 1 836 000 000	USD 1 869 000 000	UA 495 712 000	EUR 325 473 000
Administrative Expenses(b.)	GBP 134 800 000	SEK 103 523 000	USD 1 430 000 000	USD 775 000 000	UA 207 164 000	EUR 152 440 000

Note: Figures are for 2022 or latest available year. UA refers to the AfDB synthetic currency.
Source: Relevant websites of the selected MDBs and DFIs.

It must be noted that income from investments, net of borrowing costs, can vary significantly from one year to another. This is particularly true when interest rates change significantly, as has been the case in the recent past. In addition, reporting formats, the product mix and therefore the operations of these institutions also differ significantly.

The product mix of individual institutions is an important factor. In theory, a focus on debt provides more predictable levels of income compared to large allocations to equity risk. BII is predominantly an equity investor (whose equity returns are often unpredictably subject to market conditions), so relying on the income figures it derives from its portfolio (interest income, dividends and loan and guarantee fees) might mask the broader financial challenges or fluctuations related to equity exits, portfolio valuation changes, or unrealised gains and losses.

For MDBs, the unpredictability of equity returns and exits over recent years means that portfolio income is a key contributor to cost coverage and ensuring financial stability. Whilst breaking down the operating constraints of equity funded bilateral DFIs is useful in highlighting the importance of these concepts, operating costs are equally relevant to more complex institutions. The IFC, for example had “Income from investments and liquid asset trading activities, after charges on borrowings” of USD 1 836 billion during the year ending June 2023, and incurred administrative expenses of USD 1 430 billion (IFC, 2023[6]) (Table 2.1). Here again, the investment income was the subject of significant volatility, and this illustrates the relationship between these two line-items, and therefore the importance to institutions of not increasing the risk the first represents for the second by adding unhedged currency risk into the mix.

Institutions with a debt-leveraged funding model are even more constrained

The introduction of debt-based leverage to the equation introduces additional constraints. Leveraged DFIs and MDBs overwhelmingly rely on hard currency borrowing. Debt service is akin to operational costs in that amounts must be paid in full and in a timely manner. The United States dollar (USD) is unsurprisingly the main borrowing currency across the board. There are three key points to keep in mind concerning the borrowing practices of DFIs and MDBs:

1. Hard currency debt liabilities, in other words the obligation for MDBs and DFIs to repay the investors they borrow from in hard currency, increase the need for hard currency assets and the incentive to hedge any open exposure to currencies different from those the debt is issued (Box 2.2).

2. The net interest margin resulting from borrowing in US dollars or Euros (i.e. the deepest, most liquid pools of debt capital) is a revenue driver that would be challenging to replicate in local currency pools where premia paid to lenders may be difficult to pass on to borrowers.
3. In relation to sovereign lending (i.e. loans provided by development finance institutions or MDBs directly to national governments), the ability to provide concessional funding is dependent on accessing these same deep and liquid pools.

Box 2.2. DFI sensitivity to hard currency risk

The vast majority of bilateral DFIs share an importance characteristic: their reporting is neither in US dollars (the most commonly used development finance hard currency), nor in any currency commonly used in any developing country. Typically, they report in their national currency, meaning financial obligations, including operational costs and staff expenses, are typically denominated in that currency. The currency issue is therefore not limited solely to 'local' currencies. There is also sensitivity to the risk created by exposure to another hard currency, which is at times explicitly expressed in their internal policies and demonstrated by the efforts they deploy to mitigate it.

In many instances DFIs hedge exposure to USD back to their operating currency and aim to lock in exchange rates or offset potential losses, ensuring that their USD exposure does not negatively impact their financial performance or cause volatility in their financial statements when converted back into their national currency. This is for example the case for BII, the Dutch Development Bank (FMO) and the German Investment and Development Company (DEG). BII's 2022 financial statements bear additional evidence of how exchange rate movements influence DFI profitability, as losses were recorded on the fair value of both equity and loan portfolios (approximately GBP 192 million and GBP 97 million respectively). These however pale in comparison to foreign exchange gains of approximately GBP 453 million and GBP 157 million respectively on these portfolios, as well as gains of GBP 15 million on the guarantees portfolio, mitigated by losses of GBP 219 million on foreign exchange differences (FFECs) used for hedging purposes.

Following the decision in 2019 to adopt a new strategy for managing currency risks, Swedfund does not hedge back to Swedish Krona (SEK); in 2022 it recorded unrealised exchange rate profits/losses almost as large as its income from investment activities, as was indeed the case for Norfund. In summary this highlights the importance of managing exposure to hard currencies like USD, as DFIs seek to mitigate potential volatility and financial risks, reflecting their broader sensitivity to currency risk in both local and foreign currency environments.

Note: These numbers provide anecdotical evidence of the magnitude of exchange rate movements for DFI profitability, even where advanced economies currency pairs, which are in theory less volatile, are involved. As the volatility of individual developing economies currencies can be much higher, it is important to recognise that the magnitude of this foreign exchange rate disparity has the potential to be even greater if not addressed effectively.
Source: BII (2022[7]), *Annual Accounts 2022: Investing in a Better Tomorrow*, https://www.bii.co.uk/en/annual-review-2022-investing-for-a-better-tomorrow/; Swedfund (2022[8]), *Integrated Report 2022, Investments with ripple effects,* https://assets.website-files.com/6407144290c3f66380001c05/6426ead623fb422a82ff3b5a_Swedfund%20-%20Integrated%20Report%202022%20-%20INDEX.pdf; Norfund (2022[9]), *Annual Report 2022,* https://www.norfund.no/annualreport-2022/

Rules and regulations can also be an obstacle

The inability to take on currency risk is in some instances built into MDBs' statutes. For example, "some MDB's charters prevent them from taking on exchange rate risks (this is, for example, the case for the World Bank and the IADB)" (Wolff-Hamacher, 2007[10]). The founding agreements of several World Bank Group entities do indeed limit what is authorised in terms of local currency lending (for example Art IV

section 3(a) (b) of IBRD Agreement), but also in terms of local currency borrowing (for example Art IV Section 1.b of the IBRD Agreement and Art III Section 6 of IFC Agreement).

MDBs are not regulated *de jure*, but it should be noted that some bilateral DFIs are registered as banks and as such are subjected to more stringent and risk-averse banking regulatory frameworks. Additionally, regulatory requirements for local currency loans can be a disincentive for DFIs. These mean that for every local currency loan for a currency not covered, a new product process is mandatory, each with its unique and typically costly regulatory aspects. Individual DFIs therefore may find it costly from a regulatory capital standpoint to take on currency risk they cannot hedge. Consequently, DFIs often resort to off-balance sheet vehicles – which include special purpose vehicles (SPVs) or joint ventures – to provide local currency financing and manage risks without affecting their balance sheets. This helps DFIs comply with regulatory capital requirements and maintain financial flexibility. These will in some instances be subject to the relevant fund regulation, and will still generally need to manage risks, including currency risk.

DFIs and MDBs also frequently establish their own self-imposed internal policies to manage currency risk, proactively avoiding exposure to fluctuations in currency values that could jeopardise their financial stability and profitability. While altering the foundational charters or agreements that govern MDBs can be a lengthy and complex process, reviewing and potentially modifying internal management decisions and policies presents a more practical and timely solution. Such adjustments may involve refining lending practices or re-evaluating performance incentives.

Many DFIs and MDBs adopt conservative lending policies to safeguard their credit ratings, as a high credit rating is crucial for signalling financial stability and reliability to investors and donors. This strong credit rating enables them to borrow money at lower interest rates, thus reducing capital-raising costs essential for funding projects in developing countries. Consequently, the benefits of cheaper borrowing are passed on to clients, allowing these institutions to offer loans and financial products at more favourable terms. This approach helps DFIs and MDBs function effectively in volatile financial environments, maximising the positive impact of their financial activities in emerging market and developing economies (EMDEs).

Strategies for mitigating currency risk

Before discussing how mobilisation can help the institutions that make up the development finance system increase provision of local currency financing, it is useful to consider how the currency risk resulting from a mismatch between hard currency liabilities and local currency assets can be mitigated. These observations are equally relevant to non-development finance actors, although they have fewer incentives to find solutions.

Hedging is increasingly used

Hedging is a risk management strategy whereby an investment is made to offset potential financial losses, typically by reducing exposure to adverse price movements in exchange rates or other variables. While it limits financial losses, it may also reduce potential gains, as the expected gain or loss is balanced against the cost of the hedge. The ability to cost-effectively hedge currency exposure is a feature that has become increasingly more available over time. (Box 2.2). Table 2.2 illustrates the over-the-counter (OTC) foreign exchange turnover of selected emerging market currencies over the last 20 years or so. It highlights a clear increase in foreign exchange (FX) trading volume, particularly in currencies like the Indian Rupee (INR), Mexican Peso (MXN), and South African Rand (ZAR). This growth in turnover indicates the expanding ability of these countries to hedge currency risks more effectively, reflecting deeper capital markets and increased liquidity pools.

Global financial institutions in turn are now offering FX derivatives across a larger subset of emerging markets' currencies. However, this accessibility is still out of reach for many countries. In these cases, the

lack of a well-developed marketplace (where various participants engage in trading at different times and for different purposes), coupled with the absence of adequate capital market infrastructure, limits the availability of such financial tools. Additionally, many countries have enacted cross-border capital controls to stabilise their economies (IMF, 2020[11]). While these controls are designed to reduce currency volatility, they can also restrict participation in foreign exchange markets, making it harder to develop the kind of robust market necessary for offering and using FX derivatives effectively.

Table 2.2. Turnover of emerging market currencies in over-the-counter foreign exchange is growing

Currency name	Currency code	1998	2001	2004	2007	2010	2013	2016	2019	2022
Indian Rupee	INR	1	3	6	24	38	53	58	114	122
Mexican Peso	MXN	7	10	21	44	50	135	97	111	114
South African Rand	ZAR	6	12	14	30	29	60	49	72	73
Brazilian Real	BRL	3	6	5	13	27	59	51	71	66
Thai Baht	THB	2	2	4	6	8	17	18	32	31
Indonesian Rupiah	IDR	1	1	2	4	6	9	10	27	28
Chilean Peso	CLP	1	2	2	4	7	16	12	19	24
Philippine Peso	PHP	0	1	1	4	7	8	7	19	18
Malaysian Ringgit	MYR	1	1	1	4	11	21	18	10	14
Colombian Peso	COP	0	0	1	2	4	6	8	12	14
Argentine Peso	ARS	2	0	1	1	2	1	1	4	1

Note: Reflects all instruments, "net-net" basis, daily averages in April 2022 in USD billions.
Source: BIS (2022[12]), *Triennial Central Bank Survey: OTC foreign exchange turnover in April 2022,* https://www.bis.org/statistics/rpfx22_fx_annex.pdf

Offshore currency markets can partly help overcome these barriers. Using facilities such as the Currency Exchange Fund (TCX, for details see Box 3.2), DFIs and MDBs can provide synthetic local currency lending in EMDEs. This process involves offering loans in local currency terms while hedging the currency exposure offshore using foreign exchange derivatives or swaps. Essentially, the DFI or MDB lends in the local currency, but instead of taking on direct currency risk, they hedge it in international markets, creating a synthetic local currency position.

However, concerns surrounding the cost of such facilities, and the finite nature of the public funding they require, are likely to continue to limit progress. Brazil's recent announcement of its intention to create a "hedging platform" which will, among other offerings, provide credit lines to support hard currency investments during devaluations, is a promising initiative but the extent to which it can catalyse market activity is yet to be established (IDB, 2023[13]).

Diversification could be a currency risk mitigation tool for larger MDBs

Diversification can provide risk mitigation benefits in situations in which there are no affordable currency hedging solutions. By spreading investments across various currencies and regions, institutions can reduce their exposure to the risks associated with fluctuations in any single currency. Historical data suggest that a suitably diversified exposure to USD and other major hard currencies could deliver at least some diversification benefits (Wolff-Hamacher, 2007[10]).

TCX demonstrates the potential benefits of this diversification, delivered through the aggregation of positions from across the development finance sector: “the fundamental risk management tool that TCX deploys is diversification of its portfolio over a large number of currencies worldwide” (Chadwick, Fazilet and Tekatlı, 2012[14]). Outside of TCX, there does not appear to be any co-ordination amongst DFIs or MDBs on diversification and what this could mean for balance sheets.

Given that such a high degree of diversification would need to be maintained by individual institutions over time, and that pipeline dynamics and low levels of asset liquidity combined may curtail their ability to engineer this diversification, its benefits may be limited. This is particularly true where portfolios are comprised of relatively few positions, or where there is a significant concentration of exposure to regional baskets displaying higher levels of correlation due to geographical mandates. This last aspect would for example be particularly relevant to regional MDBs such as the African Development Bank (AfDB), where their geographic mandate inherently limits their ability to diversify across multiple global currencies. African economies often exhibit higher correlations in their economic cycles, driven by shared exposure to external shocks such as commodity price dependency or political instability. This regional concentration increases the risk of currency correlations across countries, meaning that the AfDB's portfolio could potentially be more vulnerable to regional downturns and currency movements than institutions with a more global mandate. As a result, the benefits of diversification for the AfDB are more limited than for MDBs with wider or multi-regional operations. The same challenge applies to sub-regional levels as well, for example affecting institutions such as the Western African Development Bank (BOAD) or the National Development Bank of Southern Africa (DBSA), where geographic and economic concentration further limits diversification opportunities. As such, whilst diversification could be viewed as a currency risk mitigation tool for larger MDBs with a wide geographical mandate, allowing for a more balanced risk return profile, smaller institutions will find that the fragmentation of the system is not to their advantage, which is also true for other aspects of their activities.

Balance sheet mobilisation can enhance local currency provision

Development finance actors can use several techniques to enhance their ability to provide local currency funding from their balance sheet through the mobilisation of private capital. These involve creating local currency liabilities that can be matched to local currency assets, or the transfer of local currency assets (or the risk thereof) from their balance sheets to private sector investors.

Issuing local currency bonds can have significant benefits

A local currency bond market is the cornerstone of domestic financial markets and a necessary foundation for any functioning bond market. As capital markets develop, more local currencies are typically being added to the mix. This is especially true if interest rates remain supportive, domestic secondary markets keep growing, and the availability of local funding sources increases (Dembele, Schwarz and Horrocks, 2021[15]). As such, the lack of issuance of bonds or notes in emerging markets’ currencies is a restriction to the development finance system and hinders increased engagement by local financial actors. Thus, the limitation of local financial actors' ability to invest in domestic assets and participate in capital markets reduces their capacity to support local economic development.

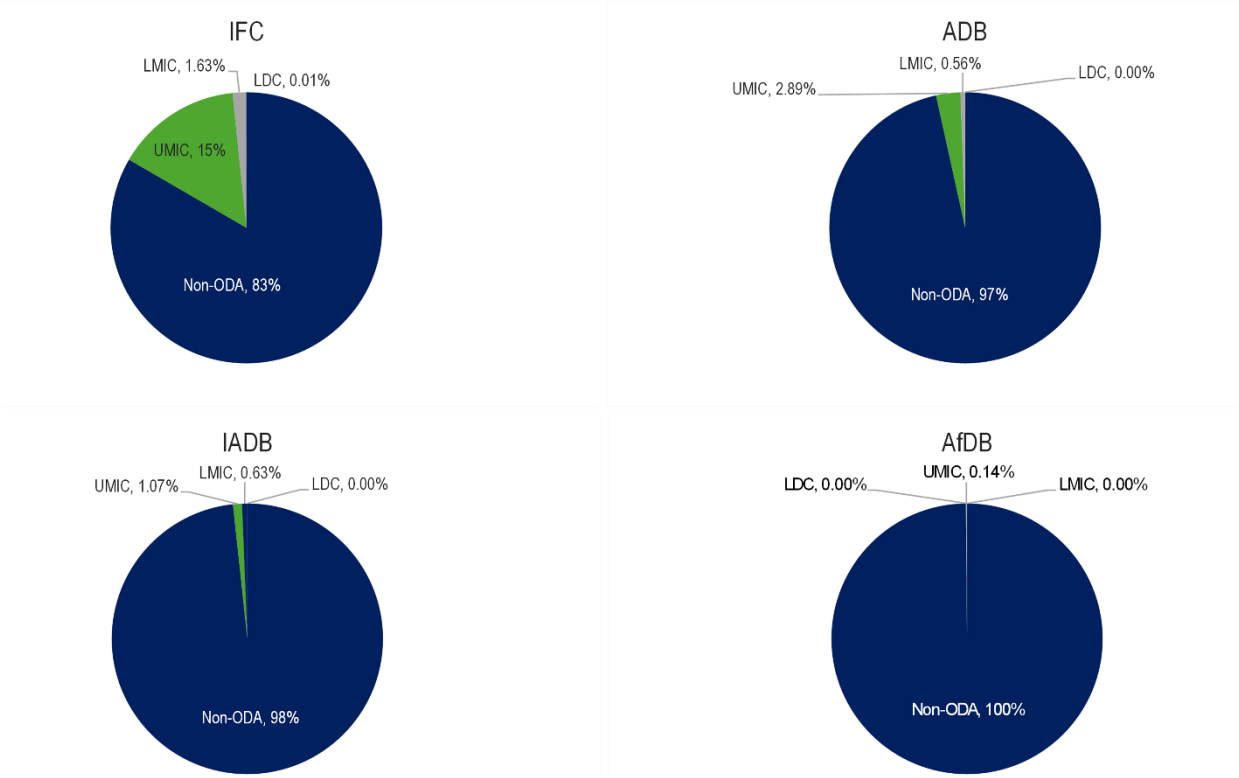
The potential benefits of local currency bond issuance by development finance actors can be significant, especially for mitigating risks associated with currency mismatches between assets and liabilities. Issuing local bonds typically involves raising capital in domestic markets, helping to reduce currency risk by matching the currency of liabilities with local assets. This facilitates the more efficient deployment of funds for development projects while engaging local investors: an important policy topic for donors. The recognition of the importance of mobilising local currency funding may inform ongoing discussions surrounding the inclusion of DFI and MDB bond issuances in the measurement of private capital mobilisation.

Figure 2.1 summarises the contribution of developing countries' currency issuance to the funding portfolios of a sample of DFIs and MDBs. This is categorised into ODA country classification groups including upper-middle income (UMIC), lower-middle income (LMIC), least developed countries (LDC), and non-official development assistance countries (non-ODA) (OECD, 2024[16]). The figure shows that MDBs overwhelmingly borrow from non-ODA eligible countries, with minimal borrowing from LMIC and LDC markets, thus highlighting the inherent challenges of mobilising local currency in less developed markets where financial systems are less mature and present higher risks. It is important to distinguish between institutions issuing debt in the markets in which they deploy funding and the instances where they do so in an "out-of-mandate" emerging market for cost or diversification reasons. The Asian Development Bank (ADB), for example, reports that on average 1% to 2% of its annual issuance is raised in what is referred to as "local currency" (typically Indian rupee, Georgian Lari, and Azerbaijani Manat). However, it also has a private placement programme that issues debt in emerging market currencies outside of its regional mandate (such as the Nigerian Naira or the Mexican Peso) (ADB, 2022[17]).

The scope and size of MDBs' issuances from developing countries' currency issuance programmes can vary significantly. Whilst the ADB, IADB and AfDB primarily focus on issuance raising from non-ODA-eligible countries, the IFC for example sources a significant proportion of its borrowings from UMICs and LMICs (IFC, 2024[18]) as seen in Figure 2.1

Figure 2.1. MDBs rarely borrow from LMIC and LDC markets

Borrowing by ODA grouping currencies (latest available year*)



Note: Categorised by ODA country classification groups, including upper middle income (UMIC), lower middle income (LMIC), least developed countries (LDC), and non-official development assistance countries (non-ODA) i.e. developed economies. *International Finance Corporation (IFC) data are reported from 2023, whereas Asian Development Bank (ADB) Inter-American Development Bank (IADB), and African Development Bank (AfDB) data are from 2022.
Source: Respective DFI and MDB websites, latest available financial statements.

There are several limitations to the use of local debt issuance as a solution to the local currency problem. These include deployment constraints and the capacity of the relevant market to absorb, primarily determined by the size of the economy and domestic savings base. For small economies, it may be challenging to build a liquid market. Furthermore, a low domestic saving rate, even for larger markets, may constrain the demand for interest-bearing financial assets, including that of government securities. Additionally, denominating bonds in hard currency as opposed to local currency can also be conducive to pricing benefits when selling bonds to a wider international investors base, given their lower risk appetites and historical preference for "reliable" hard currency investments (Dembele, Schwarz and Horrocks, 2021[15]). The deployment dynamics of development finance are associated with long timelines. Debt issuance on the other hand creates an instantaneous exposure on the liabilities side of the issuer's balance sheet. Even assuming that it is the original intention of the issuer to redeploy the local currency thus raised into the market, and that it does eventually identify transactions to deploy the amount raised, there will be a temporary unhedged exposure. Where risk management frameworks prohibit this situation, this exposure would, in a rather self-defeating fashion, have to be hedged back to the operating currency of the issuer.

The extent to which deployment dynamics are a limitation can depend on the extent to which the terms of the debt instruments issued match those of the loans being extended. In an ideal scenario, the debt issuance is matched to opportunities for re-deployment. For example, in the IFC's initial Taino bonds

issuance, proceeds of issues raised from local investors were redeployed in identified projects in the Philippines (IFC, 2016[19]).

It may however not be possible to match the terms of bonds being issued to those of loans being extended. The DFI and MDB bespoke lending model, as well as the need to offer terms to projects fitting their cash flow patterns (for example, the construction phase of infrastructure projects), are real impediments to a borrowing-based asset and liability management (ALM) solution. In other instances, such as the case of FMO's notes issuance, local currency debt issuance is construed as a market development tool. It further serves to create positions useful to help solve TCX's own ALM problems (FMO, 2018[20]). It must however be noted that, "swapping LCY proceeds out into FCY would drain FX reserves and is an absolute no-no" from the point of view of local governments (Fink, Lankes and Sacchetto, 2023[21]).

The potential of local currency debt issuance is further constrained by the capacity of capital markets to absorb this issuance. This is not solely a question of whether there is appetite for a specific issuance by a specific DFI or MDB, but of the consequences of this issuance for other funding needs and for host economies. This is particularly true, albeit not exclusively, of the mobilisation of local pools of capital. Thus, not strictly speaking a zero-sum game, the ability to raise capital from limited pools of local savings is a growth-adjusted zero-sum game, and issuers will need to take the potential displacement of government bonds from portfolios as well as inflationary pressures into consideration.

Given the untapped potential of local currency bond issuances, in 2011, the G20 launched an initiative to prepare an action plan for the development of local currency bond markets. Since then, the International Monetary Fund (IMF) and World Bank have produced notes that take stock of bond developments, and released a joint *Guidance Note for Developing Government Local Currency Bond Markets* in March 2021 (IFC, 2021[22]). Since the early 2000s, the IMF and the World Bank have also produced several reports to promote the development of local currency bond markets (LCBMs).

Risk transfer through securitisation has potential but faces obstacles

Securitisation, defined as the process of pooling financial assets to create marketable securities, has gained momentum in the development finance conversation and its benefits go beyond addressing the local currency issue (CDFS, 2023[23]). It involves transferring the exposure to the currency risk or the assets themselves from the DFI and MDB balance sheet to third parties. By transferring local currency assets that they have originated through an SPV-based true sale securitisation, or through a slice of the risk and the returns they generate through a synthetic securitisation, DFIs and MDBs can eliminate or mitigate the associated local currency exposure. The opportunity it presents to concurrently allow MDBs and DFIs to recycle their capital faster and to mobilise private capital is increasingly acknowledged. The West African Development Bank (BOAD) has set a precedent for LCY securitisation by a regional MDB.[2]

Whilst there are several securitisation initiatives in the making across MDBs, case studies of the successful implementation of this technique remain isolated. The originate-to-share model is increasingly mentioned as the direction of travel for the sector, however, would be a significant departure from the status quo. An intermediate model (whereby established financial institutions streamline the securitisation process of DFI and MBD loans) is an existing alternative. Initiatives such as Singapore's Bayfront,[3] a platform which provides structured financing mechanisms that facilitate the pooling and securitisation of DFI and MDB loans, could be construed as the cornerstones of a future market for such loans (Asia Biz Today, 2023[24]). The deployment of securitisation as a standard tool for DFI and MDB mobilisation and balance sheet management is facing considerable challenges, however, including the lack of technical know-how and the likely initial impact on profitability resulting from slow re-deployment (MOBILIST, 2021[25]).

Transferring local currency loans to an SPV for a true sale securitisation may remove the currency risk from the DFI and MDB balance sheet, but it does not eliminate the issue altogether. Unless it is possible to create sufficiently diversified baskets of loans all denominated in one currency, and in turn to place them

with investors seeking this exposure, most likely in domestic capital markets, the currency risk management issue will remain, and with a counterparty (the SPV) that may not be acceptable to providers of hedging solutions. The risk retention rules of the regulatory frameworks for securitisation and the practicalities of synthetic securitisation also mean that the sponsor of a securitisation would retain some of the exposure to the portfolio and therefore to the currency risk. This might become manageable, however, depending on the specific parameters of the transaction.

As we saw above, the time it takes DFIs and MDBs to deploy capital means local currency debt issuance will result in temporary unhedged currency exposure on the liabilities side until the capital is deployed. However, the time it would take DFIs and MDBs to build local currency assets portfolios wide and deep enough to satisfy the requirements of a securitisation-based risk transfer would mean that unhedged local currency exposure would exist on the assets side until the transaction takes place. Given the aversion to the sale of assets observed in the sector, a solution that still requires foreign exchange risk to be hedged for some time may seem unattractive. An off-balance sheet warehouse solution, which involves using an SPV to hold and manage local currency loans, thereby isolating these assets and associated risks from a DFIs or MDBs balance sheet, may be a way forward. However, the cost of establishing and maintaining an SPV can be significant. In any scenario, the risk appetite of institutional investors (global and local) is of course a key consideration.

Direct mobilisation of private capital lacks appropriate instruments

This section delves into the strategies and challenges associated with the direct mobilisation of private capital in development finance, with a particular focus on the significant structural obstacles stemming from the lack of appropriate instruments available.

Private capital mobilisation efforts to date have been focused on a blended finance approach where private sector actors invest alongside DFIs and MDBs, most often on a pari-passu basis.[4] These efforts are therefore mechanically aligned with the product mix of DFIs and MDBs, a mix dominated by direct lending and intermediated private equity investment.

If this is true of the “easier” mobilisation in hard currency, before tackling the obstacles specific to the local currency issue, it is therefore necessary to highlight the enduring misalignment between the instruments generally used by DFIs and MDBs and those predominantly used by institutional investors. Given that over 90% of institutional investor capital globally is deployed in either bonds or listed equities (OECD, 2021[26]), the successful mobilisation of these pools of capital is linked to the availability of appropriate instruments that institutional investors and fund managers can use as building blocks for their portfolios.

Direct lending is not widely used by institutional investors

Direct lending, no matter what currency it is associated with, is rarely an option for institutional investors because of the internal resources and processes this requires. Mobilisation using this instrument has therefore historically focused on loan syndication, which is the process of pooling resources from multiple lenders to provide a single loan to a borrower, targeted at other development finance actors and banking institutions. Here again it must be kept in mind that Basel capital requirements mean banks are incentivised to be economical with currency risk.

Intermediated aggregation vehicles, which facilitate the pooling of capital from various investors to collectively invest in private debt opportunities may offer a compromise, but private debt funds remain a marginal feature of asset allocations. Co-lending funds such as ILX[5] are more recent introductions to the market and have yet to prove their ability to meet investor requirements over an investment cycle. Liquidity tests associated with stringent stress scenarios are a feature of the regulatory framework for European banks and insurers alike, and the illiquid nature of private debt renders it unattractive. Ex-ante risk sharing,

as exemplified by the IFC's MCPP[6] is only a fit for a small subset of admittedly large institutions and may be faced with issues linked to deployment timelines.

Any mobilisation mechanism focused on co-lending is inevitably replicating DFI and MDB lending patterns. Their reluctance to lend in local currency therefore automatically reduces any associated mobilisation. As such, direct lending is not widely used by institutional investors due to these regulatory and internal resource restraints.

Intermediated private equity needs to be better aligned with institutional investors' requirements

Private equity allocations are still a relatively small and far from universal component of institutional asset allocations; where they exist, sub-allocations to developing economies remain marginal. The heavy fee burden carried by private equity investors is also increasingly raising concerns in developed markets, and the continued reluctance of DFIs and MDBs to use the leverage afforded to them by their role in the private equity industry across developing economies means that the economics of private equity vehicles are likely to be at least as off-putting to those investors they seek to mobilise. Private equity funds, particularly those relevant to the SME sector, de facto expose investors to currency risk, notwithstanding the typically hard currency in which calls, net asset value calculations and distributions, are made.

The performance and consequently the ability of these funds to attract private capital varies greatly depending on how far along the development path the host country or region is. Currency risk is however deemed a considerable factor affecting performance by investors (limited partners, typically institutions like pension funds, endowments, and insurance companies that contribute capital to private equity or investment funds but do not actively manage the investments) and fund managers (general partners, responsible for making investment decisions, managing the fund, and overseeing the portfolio) alike. The complexity and costs of hedging uncertain cash flows taking place at uncertain points in the future are significant hurdles. GPs often profess to consider expected currency movements when assessing the financial merits of opportunities, but there is little protection against sudden and unexpected devaluations, and this approach may merely serve to reduce the pipeline of opportunities to those offering rich enough prospects to make up for conservative expectations of currency-driven losses. However, energy infrastructure projects in emerging markets and developing countries have lower default rates due to the strong security packages that are often required by investors during the due diligence stage.

The continued focus of DFI and MDB private capital mobilisation efforts on the instruments they traditionally use, rather than the institutions which they wish to allocate the bulk of their capital to, is a major obstacle to mobilisation at scale. The reason for this is because institutional investors typically favour more liquid and standardised instruments like bonds and listed equities, which align with their risk tolerance, regulatory requirements, and liquidity needs. By focusing on instruments that institutional investors find less appealing or illiquid, DFIs and MDBs create a mismatch between the available capital and the investment structures, limiting the potential for large-scale private capital mobilisation. In this context, exceptions or frontrunners can lead to unsound decision making. Whilst, from time to time, large institutional investors may invest in emerging market private equity funds, these instances remain the exception rather than the rule and should not be construed as an indication that other comparable investors will or can invest.

DFIs and MDBs should aim to develop investment vehicles that offer liquid, standardised instruments which align with the risk tolerance, liquidity preferences, and regulatory frameworks of institutional investors, while also mitigating currency risks through enhanced risk-sharing mechanisms.

Understanding incentives and obstacles to mobilising institutional investors

Institutional investors play a critical role in financing development, yet they have limited incentives to engage in mobilising local currency investments, particularly in EMDEs. Given the immense pools of capital they hold, unlocking these untapped sources of finance and more effectively channelling them into EMDEs is a priority amongst development actors. Research shows that a shift of only 3.7% of the USD 100 trillion of assets held globally by institutional investors towards sustainable activities in developing countries would be sufficient to fill the USD 3.7 trillion gap (OECD, 2020[27]). The obstacles to mobilisation highlighted above are equally valid whether the mobilisation instruments are denominated in hard or local currency and apply both to "global" advanced economy institutional investors and to their local counterparts in developing economies. As such, greater emphasis needs to be given to engaging effectively with both local and global institutional investors. However, the difference in the currency of their liabilities creates a strong divergence in the local currency appetite of both sets of institutional investors.

International institutional investors face numerous obstacles

The challenges of a currency mismatch between assets and liabilities are just as relevant to institutional investors (typically pension funds and insurers) as they are to DFIs and MDBs. Given institutional investors' lack of a development mandate, however, they have even fewer incentives to seek solutions. Pension funds and insurers, the two archetypical categories of institutional investors, serve to fulfil liabilities. These liabilities are generally exclusively in their operating currency, and therefore for the purpose of mobilising capital of investors from advanced economies, generally in hard currency. The purpose of this section is to highlight some of the obstacles they face in addition to this fundamental issue.

Rules and regulations reduce risk appetite

Regulation of the sector serves to rein in specific categories of risk, and risk appetite is therefore not entirely left to the discretion of individual institutions. Prudential regulatory frameworks impose capital charges for positions in currencies other than the reporting currency of each institution (with some exceptions, including for euro-pegged currencies such as the CFA Franc). Solvency II, which applies to European insurers, is particularly relevant (Box 2.3).

Box 2.3 provides an overview of the key regulatory details of Solvency II, which consequentially increases the cost of holding foreign currency assets for institutional investors. By requiring higher capital reserves for currency risks, it directly affects willingness and ability to invest in EMDEs, particularly in local currency instruments.

Box 2.3. Solvency II: references to capital requirements for currency risk

The Solvency II directive came into force in the EU on 1 January 2016. The directive sets out regulatory requirements for insurance firms and groups, covering financial resources, governance and accountability, risk assessment and management, supervision, reporting, and public disclosure. The aim of Solvency II is to ensure the adequate protection of policyholders and beneficiaries by requiring insurance and reinsurance companies in the EU to hold sufficient capital to reduce the risk of insolvency.

These requirements are critical because they ensure that firms are adequately capitalised against potential losses arising from foreign exchange volatility, illustrating how regulatory frameworks can increase the cost of currency risk for institutional investors. Article 188 lays out the key details:

Article 188

1.The capital requirement for currency risk referred to in point (e) of the second subparagraph of Article 105(5) of Directive 2009/138/EC shall be equal to the sum of the capital requirements for currency risk for each foreign currency.

…

For the purposes of this Article, foreign currencies shall be currencies other than the currency used for the preparation of the insurance or reinsurance undertaking's financial statements ('the local currency').

2.For each foreign currency, the capital requirement for currency risk shall be equal to the larger of the following capital requirements:

(a)the capital requirement for the risk of an increase in value of the foreign currency against the local currency;

(b)the capital requirement for the risk of a decrease in value of the foreign currency against the local currency.

3.The capital requirement for the risk of an increase in value of a foreign currency against the local currency shall be equal to the loss in the basic own funds that would result from an instantaneous increase of 25 % in the value of the foreign currency against the local currency.

Source: EIOPA (2009[28]) https://www.eiopa.europa.eu/rulebook/solvency-ii-single-rulebook/directive-1382009ec-solvency-ii-directive_en

In addition, other regulatory hurdles may limit the mobilisation of private finance for sustainable development. For example, the fact that "the treatment of MIC/LIC infrastructure exposures within the Solvency II rules is disproportionate to their true risk" (MOBILIST, 2023[29]) challenges the ability of advanced economy insurers to contribute to the financing of much-needed infrastructure in developing countries.

This regulatory rigidity means that even when institutional investors have the technical capacity to engage in EMDE markets, the perceived and actual costs imposed by frameworks such as Solvency II make these investments less attractive compared to safer, lower-risk options in advanced economies. As such, these regulatory frameworks are key structural barriers that inhibit the mobilisation of private capital into EMDEs, especially in local currencies.

Where regulations do not act as constraints, the subjective interpretation of behaviourally oriented prudential rules can be just as prescriptive across a range of risks and is most likely to discourage these institutions from taking on non-core exposure such as emerging markets currency risk. Examples include

the “prudent person rule” for pension funds, or the frameworks used by large European insurers who have opted to use “internal models” rather than the Solvency II standard formula for Solvency Capital Requirement calculations.

Index considerations can inhibit the flow of capital to developing countries

Global investors do take on local currency exposure where they deem the risk return profile of such investments to be favourable. There are sizable emerging market local currency bond funds, and emerging markets’ public equity funds largely comprised of stocks, trading on local exchanges in local currency (though global depositary receipts – GDRs[7] – are sometimes used).

Modern institutional asset management relies on benchmarking funds and portfolios against indices. The importance of indices has been significantly reinforced by the advent of passive investing. Emerging markets’ local currency bond indices (such as the JP Morgan GBI-EM Global Diversified Index, which measures the performance of a specific set of bonds or stocks within emerging and frontier markets) are constructed according to mechanical rules that create a size bias in favour of the larger issuers at the expense of frontier countries. Similarly, emerging and frontier market equity indices display concentration patterns that are not conducive to the channelling of institutional investor capital towards those markets where mobilisation is most sorely needed. One solution could involve the development of alternative indices in collaboration with DFIs and MDBs that better capture investment opportunities in frontier markets, ensuring broader inclusion and more equitable capital allocation.

Local institutional investors have more potential for local currency investments

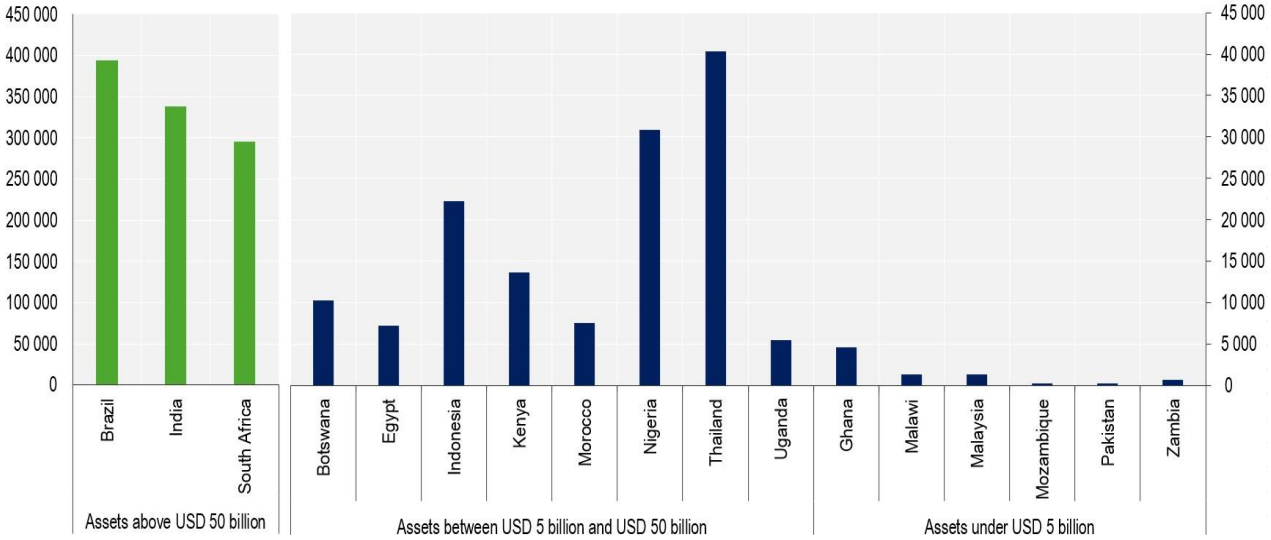
The development finance system of local institutions is active across a vast and contrasted landscape. There is therefore significant disparity not only in the size of the local pools of capital, but also in regulatory frameworks, the sophistication of institutional asset owners and the intermediary they use to deploy capital, and crucially the supply of instruments they can use to gain exposure to their own economy. This section is therefore only able to highlight the type of challenges that face the mobilisation of local capital, understanding that only the granular study of individual national contexts can yield actionable knowledge.

In stark contrast to their global counterparts, local institutional investors, whether they be pension funds or insurance companies, have local currency liabilities and should therefore seek to match the bulk of these with local currency assets. Where pension funds are concerned, the long-term nature of their liabilities, particularly where their members are comparatively young, should also mean they need exposure to long-term assets. As such, this dynamic provides an important opportunity for local institutional investors to invest in infrastructure projects, or in providing equity capital to SMEs.

In many cases, development finance is used to invest in countries which may not have significant pools of savings available for potential mobilisation. Where this is the case, and as their relatively early stage of development is equally likely to deter global investors, the potential for mobilisation is low across the board. The development finance sector must organically generate and sustain investment flows into countries with limited domestic savings and low appeal to global investors, ensuring these countries can progress on the path to sustainable development despite these challenges. Figure 2.2 illustrates the range of the size of such pools, including in some LMICs (such as Kenya and Indonesia) and LDCs (Malawi, Uganda). An example of success in recent years has been Nigeria’s pension industry: between 2017 and 2020 it doubled its investment in local currency terms across the three sub-asset classes (assets above USD 50bn, assets between USD 5bn and USD 50bn, and assets under USD 5 billion) from NGN 68.8 billion to 176 billion (OECD, 2023[30]). However, until sufficient data and capacity to understand currency and complexity are created, non-domestic investors will be reluctant to participate (Juvonen et al., 2019[31]).

Figure 2.2. Pension fund assets vary in size across developing countries

Local pension funds' assets, total, in USD million (2021*)



Note: *2021 or latest available year; data for South Africa and Malawi are for 2020. Left axis includes data for assets above USD 50 billion, whereas right axis includes data for assets between USD 5 billion and USD 50 billion, and assets under USD 5 billion. Scales may differ.
Source: OECD (2023[30]), *Pensions at a Glance 2023*: OECD and G20 Indicators, https://doi.org/10.1787/678055dd-en.

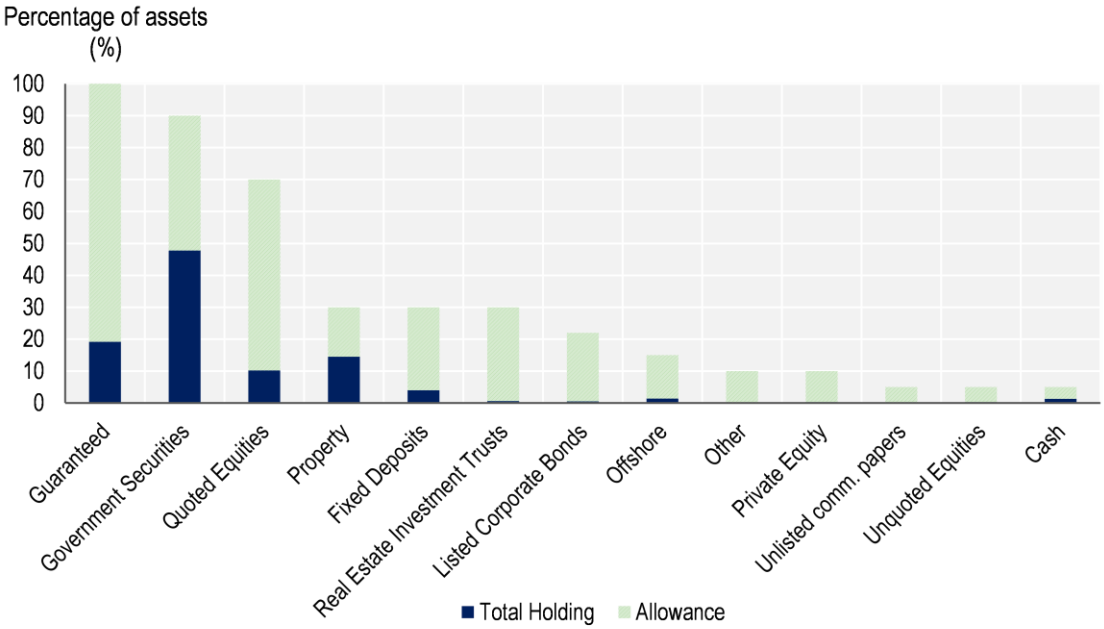
Insufficient know-how and operational capacity hold back investment in SMEs and infrastructure

Institutional investors in advanced economies are not uniformly sophisticated and do not have an equally widespread capacity to analyse, assess and execute complex investments in private equity, infrastructure, or even private credit. This may in part explain why mobilisation of global capital is not delivering. To varying degrees, this is augmented by the challenges of smaller size and means, which make the hiring of external expertise, assuming it is available, unaffordable. Insufficient know-how and operational capacity of institutional investors are key obstacles to the mobilisation of local capital pools for SME equity financing or infrastructure investment. There is no uniformity in this dimension, and levels of sophistication vary significantly from one market to another, and between institutions within the same market.

Even where investments in alternative asset classes are permissible under regulatory frameworks, allocations do not reflect this due to the challenges mentioned above. In Kenya for example, although pension funds are allowed to deploy up to 10% of their assets into private equity funds, the data show that allocations across the sector amount to 0.32%. Whilst the 10% "any other" bucket does theoretically allow for infrastructure investment, these investments are simply not made, and this highly flexible allowance remains unused (Figure 2.3).

Figure 2.3. Kenyan pension funds are investing well below their potential

Total holdings of the sector versus allowances, 2023



Source: Kenyan Retirement Benefits Authority (2023[32]), *Retirement Benefits Industry Report for June 2023*, https://www.rba.go.ke/download/industry-brief-june-2023/?wpdmdl=5184&refresh=666fd777b22cb1718605687

The size of investments is also a concern for relatively small schemes that often struggle to reconcile the minimum ticket sizes required to access opportunities with the need to diversify their portfolios and avoid concentration risks. Initiatives such as the Kenya Pension Funds Investment Consortium (KEPFIC) for example pool resources from individual pension schemes, enabling collective investment in sustainable, long-term infrastructure projects and other assets. This approach addresses key obstacles and underscores the relevance of these solutions, or at least provides a shared diagnostic of the key challenges.

In addition, pension fund trustees may lack the knowledge and the tools they require to fulfil their duties where relatively complex financial instruments are concerned. The 2019 *Market Study on Private Equity Investing for Pension Funds in East Africa*, published jointly by the East Africa Venture Capital Association (EAVCA), Financial Sector Deepening (FSD) Africa and the IFC, notes that "the assessment of private equity risk is within a context of a fixed and considerably short time frame of less than 60 months", which suggests that the investment "culture" of pension trustees in East Africa is not always aligned with the long-term nature of pension liabilities (EAVCA, FSD Africa, IFC, and RisCura, 2019[33]). This is significant in the context of infrastructure project finance, or the patient investment required in SME equity. The market study further highlights that the reality is that "most pension schemes in East Africa enter balanced mandates, without a specific reference to private equity". Or for that matter without a specific reference to infrastructure or private credit.

These balanced mandates, managed by local fund managers, are predominantly focused on stocks and bonds, much like their advanced economy counterparts. But there are important differences: very high levels of concentration within the listed equity bucket as a result of underdeveloped equity capital markets offering few opportunities for diversification, and the oft-observed absence of corporate bonds (0.44% allocation by Kenyan pension funds as illustrated in Figure 2.3). Institutional investors that do not invest in

listed corporate bonds are unlikely to consider less liquid private credit opportunities requiring a higher level of due diligence, with the possible exception of property transactions.

The challenges associated with assessing complex investments to the satisfaction of regulators and against fiduciary duties should not be underestimated, particularly in situations where external advisors may not be available, or affordable.

Regulatory frameworks also put the brakes on local investment

Regulatory frameworks in developing economies can significantly hinder the mobilisation of local currency investments by limiting diversification opportunities and encouraging institutional investors to favour high-yield government securities over assets in EMDEs, ultimately constraining their ability to access both local and global markets effectively. It may be tempting to assume that regulatory frameworks that allow for allocations to private equity or private debt of up to 10 or 20% do not represent obstacles to mobilisation initiatives. However, it is important to observe that they are not designed to enforce prudent diversification levels. The lure of high-yielding government securities can for example distract institutional investors from other types of opportunities. Brazilian pension funds long relied on large allocations to government securities offering a generous yield, allocating very little to global markets. This only started to change when interest rates came down abruptly after 2017 due to monetary policy adjustments made by the Brazilian Central Bank to stabilise the economy (Center for Economic and Policy Research, 2017[34]).

Many developing economies' pension regulators understandably limit the ability of pension schemes to invest overseas to keep funds onshore. Brazilian pension funds can for example only deploy 10% of their assets outside of the country. Whilst there may be exemptions for investments in neighbouring countries, this means that the ability to diversify globally or at least regionally is curtailed. This in turn means that investing in local assets through offshore vehicles or instruments is not attractive for developing economy pension funds due to the fact there is a limited opportunity to gain exposure to liquid assets in advanced economies – inhibiting their ability to leverage the benefits of a broader market presence. This is relevant given the prevalence of offshore vehicles as the preferred private equity deployment tools for DFIs and MDBs (ODI, 2017[35]). The "offshoring" of local assets for the convenience of non-local investors and fund managers is problematic. It does however find some of its roots in inappropriate local capital markets infrastructure. The reality is that many countries lack either the legal and regulatory framework and/or the universe of service providers required to launch parts of the range of investment vehicles used by DFIs and MDBs.

A shortage of appropriate instruments within MDB and DFI portfolios is a key roadblock inhibiting institutional investment opportunities

The inadequate supply of appropriate instruments is a key obstacle to the mobilisation of local pools of capital. Direct lending to corporates and infrastructure projects, and private equity funds, are the two main instruments used by DFIs and MDBs. Public equity and bonds are either marginal or excluded from their suite of products, and yet they are universally the building blocks of institutional investor portfolios. While bespoke lending can benefit borrowers and cater to the unique needs of infrastructure financing, it is crucial to consider the needs of potential investors when structuring financing for mobilisation, especially since DFIs and MDBs typically have lower liquidity requirements. Setting appropriate concessionality levels in local currency blended infrastructure projects is one such strategy to better mobilise institutional investment. In terms of contributions to project costs, IFC has shown a commitment to local currency, with an average concessional level as a percentage of total project cost of 11% (IFC, 2020[36]). As such, structuring instruments that can readily be bought by both global institutional investors and local institutional investors – such as thematic green, social, sustainable and sustainability-linked (GSSS) bonds for example – should become the rule rather than remain the exception.

Allocations to government securities are another hindrance

Institutional investors globally play a key role in financing government. Their role is particularly sensitive where it has few alternatives. Where there are high levels of concentration in government securities in the portfolios of local institutional investors, mobilisation efforts will most likely divert funding away from these. Whilst such efforts would yield benefits in terms of diversification and arguably risk-adjusted performance for these portfolios, there may be unintended consequences for the ability of domestic governments to fund their budgets.

Institutional investors in developing economies often hold significant portfolios of debt securities issued by their respective governments. Kenyan pension funds allocate just short of half of their assets to government securities (Table 2.3). For insurance companies, the corresponding allocation is closer to 78% (Insurance Regulatory Authority Kenya, 2023[37]) (Table 2.4). Between them they hold government securities equivalent to roughly one-third of the Kenyan treasury bonds outstanding (Table 2.5) In Nigeria, pension funds allocate 70% of their assets to government bonds.

Table 2.3. Kenya's pension industry allocates nearly half its assets to government securities

Overall pension industry investment portfolios in Kenya

Asset category	Q1 2023 (KES billions)	Q1 2023 (%)
Government Securities	814.3	47.8
Quoted Equities	174.1	10.2
Immovable Property	246.3	14.5
Guaranteed Funds	327.0	19.2
Listed Corporate Bonds	7.5	0.5
Fixed Deposits	67.7	3.9
Offshore	23.1	1.4
Cash	22.6	1.3
Unquoted Equities	5.1	0.3
Private Equity	5.4	0.3
Real Estate Investment Trusts	10.6	0.6
Commercial Paper, Non-listed Corporate Bonds	0.03	0.002

Source: Kenyan Retirement Benefits Authority (2023[32]), *Retirement Benefits Industry Report for June 2023*, https://www.rba.go.ke/download/industry-brief-june-2023/.

Table 2.4. Kenyan insurance companies allocate 78% of their assets to government securities

Long-term insurance business investments in Kenya

Asset category	Q1 2023 (KES billion)	Q1 2023 (%)
Government Securities	491.4	78
Quoted Equities	18.3	2.9
Investment Property	53.2	8.4
Term Deposits	29.9	4.7
Unquoted Equities	16.2	2.6
Loans & Mortgages	10.0	1.6
Investment in Subsidiaries	8.0	1.3
Any Other Assets	3.2	0.5

Source: Insurance Regulatory Authority Kenya (2023[37]), *Insurance Industry Report for the Period (January to March)*, https://ira.go.ke/assets/file/Q4_2023_Industry_Release.pdf.

Table 2.5. Kenya's total banking sector assets are largely focused on loans and advances, along with government securities

Total assets of the banking sector in Kenya

Asset category	Q2 2023 (KES billion)	Q4 2022 (%)
Government Securities	1884.1	28.6
Loans and Advances (Net)	3349.4	50.8
Balances at Central Bank	233.6	3.5
Placements	272.1	4.1
Investments	154.7	2.3
Other Assets	607.5	9.2
Cash	88.4	1.3

Source: Central Bank of Kenya (2022[38]), *Bank Supervision Annual Report 2022*, https://www.centralbank.go.ke/uploads/banking_sector_annual_reports/1376276635_2022%20Annual%20Report.pdf

The data in Table 2.3 and Table 2.5 highlights the systemic reliance of local institutional investors on government securities, which has significant implications for local currency mobilisation efforts. In Kenya, the outsized allocation of pension funds and insurance companies to government bonds—at 47.8% and 78%, respectively—illustrates a structural crowding-in effect, where domestic institutions prioritise government securities over more diversified or alternative assets, such as infrastructure or SME financing, in local currencies. Additionally, this heavy reliance contributes to a feedback loop, where the stability of government financing depends on these concentrated portfolios, creating potential vulnerabilities if institutional investors were to diversify away from this approach. These dynamics highlight the challenge of mobilising local institutional capital for sustainable development, necessitating targeted interventions to incentivise diversification without destabilising domestic markets.

As evidenced in this chapter, the constraints to local currency mobilisation in ODA-eligible countries stem from a combination of structural, market and instrument-specific challenges faced by DFIs, MDBs, and institutional investors. Despite the potential for DFIs and MDBs to play a transformative role, structural obstacles linked to their liabilities and funding models continue to impede local currency mobilisation efforts. Overcoming these barriers requires both innovative risk management techniques and the alignment of instruments to suit institutional investor preferences. The next chapter will focus on providing some key case studies highlighting the role donors can play in scaling up local currency-denominated activities and strengthening local capital markets.

3 Donors' role in scaling up local currency denominated activities

It is characteristic of the current development finance system's approach to the local currency issue that most of the recent initiatives to address it aim to manage the symptoms rather than its cause. The key actors in the development finance system embedding hard currency into contracts and portfolios are DFIs and MDBs, as these are the institutions that put in place the loan or equity in a structure and thus can typically decide the terms, including the currency. The current approaches pre-suppose that development finance will continue to be extended in hard currency and that the objective is therefore to mitigate the downside of the resulting currency risk from the point of view of both lenders and borrowers. This observation should not be construed as criticism of DFIs and MDBs, and the alternative would require a transformation of the assets and liabilities status quo in the development finance system, and of the rules guiding their management. This would present a daunting governance challenge associated with uncertain but distant time horizons.

"Blended finance" has proven to be an appropriate tool to help MDBs and DFIs deliver local currency financing and work around the currency liabilities and asset matching challenges. By combining concessional finance with private capital, blended finance can reduce risks for private investors and make projects more commercially viable. It is defined by the OECD Development Assistance Committee (DAC) as the strategic use of development finance for mobilising additional finance for sustainable development in developing countries. Blended finance helps to mobilise the private sector (but primarily in hard currency), leveraging public and philanthropic funds to attract private investment into development projects. However, more could be done in local currency by DFIs and MDBs in order to mobilise greater levels of local private capital.

Blended finance encourages private sector participation, innovation and efficiency, complementing local and hard currency financing efforts to meet the extensive development needs of these countries. However, development actors can play a key role in facilitating the flow of finance and supporting the development of both hard and local currency financing systems.. The concessionality of the finance not only rests with the pricing and conditions but also with the currency in which it is provided. International discussions have increasingly focused on the need for local currency, including the recent High Level Expert Group on Scaling up Sustainable Finance in Low- and Middle-Income Countries (European Commission, 2024[39]).

This chapter begins by describing some of the blended finance instruments (past and present) designed by donors and development finance actors to address the issue and where possible facilitate the mobilisation of (hard currency) private capital. A number of case study examples highlight ongoing initiatives and inspire policy thinking on options around local currency facilitation. While the case studies are not all examples of blended finance per se – covering a number of approaches from the issuance of the financing to global and local capital mobilisation – they can all have direct and indirect impacts on encouraging local currency. Each case study will be appropriate to an individual situation and market maturity; together they give insights into practices occurring in the market and lessons emerging from them.

De-risking local currency

A first set of interventions is concerned with addressing the currency issues linked to the activities of development finance providers, whether they be bilateral or multilateral, as discussed in Chapter 2. These include the deployment of currency hedging instruments, financial guarantees and targeted investments to mitigate currency risks. These strategies aim to protect lenders and borrowers from the impact of a range of currency-related risks.

Managing transfer and convertibility risk can free up currency movements

Transfer and convertibility (T&C) risk is a significant obstacle to lending in developing countries. It refers to the risk associated with a sovereign state restricting the movement of funds across borders or the conversion of local currency into foreign hard currency (which affects the ability to repatriate profits, dividends, or loan repayments). Whilst T&C risk can be assessed based on a sovereign state's broader foreign exchange regime, economic policy orientation and external policy (S&P Global, 2022[40]), donors have looked to address T&C risk with tailored insurance products typically focused on a particular sector (Box 3.1).

Box 3.1. Mitigating risk in the energy sector: EDFI's T&C Guarantee Fund

The European Development Finance Institutions' (EDFI) T&C Facility is an innovative guarantee product, funded by the European Union and managed by EDFI in collaboration with Proparco. Launched in 2021, the T&C Facility aims to protect investors against losses resulting from an inability to legally convert local currency into hard currency or transfer hard currency outside the host country due to government actions or inactions. Specifically designed to address challenges faced by development finance actors in the energy sector, this facility provides a partial guarantee for up to 12 months to cover payment obligations hindered by transfer and convertibility restrictions.

The T&C Facility plays a crucial role in mitigating T&C risk within the energy sector, which is frequently impacted by foreign exchange reserve constraints in developing countries. Given the macroeconomic instability and fluctuating foreign exchange reserves, especially in many exporting countries, the risk of inconvertibility and non-transferability is a crucial challenge – particularly in the energy sector where electricity is sold in local currency, while power plants are often financed in foreign hard currency. The inability to convert local currency revenues into hard currency to meet debt obligations can delay or derail project development.

With a total guarantee level amounting to EUR 26.2 million, the facility helps the operations of European DFIs and their co-funders across 48 African countries, including 17 fragile and conflict-affected states. The facility finances reserve accounts for eligible projects, which lenders can access during an event of inconvertibility or non-transferability, covering up to 12 months of principal and interest payments over a maximum period of seven years. This mechanism not only protects lenders and investors from T&C risks but also encourages continued investment in essential infrastructure projects. By mitigating the financial risks associated with currency conversion and transfer, the T&C Facility enhances the attractiveness of local currency financing and ensures energy projects can proceed without delays, thereby fostering deeper and more resilient local capital markets.

Source: European Development Finance Institutions (2024[41]), *Transferability and Convertibility Facility (T&C)*, https://www.get-invest.eu/fund/the-transferability-and-convertibility-tc-facility/

Hedging solutions allow hard currency lending and local currency funding

While EDFI's T&C Facility helps to mitigate transfer and convertibility risks by securing local currency revenues against foreign exchange constraints, other strategies look to allow development finance actors to continue lending in hard currency while ensuring that borrowers receive local currency funding. This is primarily done through hedging instruments such as non-deliverable cross-currency swaps and forward contracts in emerging and frontier market currencies. One major provider of this type of hedging solution is The Currency Exchange Fund (TCX; Box 3.2).

Box 3.2. The Currency Exchange Fund

Established in 2007 by a consortium of national governments, DFIs, specialised microfinance investment vehicles (MIVs) and donors to manage currency risks in emerging and frontier markets, TCX plays a critical role in de-risking development finance and channelling local currency. By offering non-deliverable cross-currency swaps and forward contracts converting hard currency development lending into local currency-denominated lending, the fund absorbs the currency risk faced by emerging market borrowers, thereby enhancing their financial resilience and ensuring stable, more predictable debt service repayments. By focusing on markets where commercial alternatives are either inadequate or absent, TCX aims to create maximum development impact without crowding out domestic commercial banks.

With a capitalisation of USD 1.1 billion and a USD 5 billion balance sheet, TCX's hedging instruments have an average maturity of three to five years. At present, TCX offsets 45% to 55% of its long exposures. This offsetting of risk, extensive diversification and prudent risk management allow TCX to carry USD 5 of gross currency risk exposure for every USD 1 of capital.

By diversifying its currency exposure across more than 70 low- and middle-income countries, TCX helps to manage balance sheet risks despite the lack of robust secondary markets for its foreign currency exposures. This extensive diversification is crucial for maintaining the fund's stability and operational effectiveness, thereby contributing to bolstering the development of local capital markets, protecting investment flows and fostering economic growth.

Additionally, by transferring a significant portion of currency exposure to private investors and thereby protecting borrowers, TCX not only mitigates risks but also mobilises private sector involvement, contributing to the development of both onshore and offshore capital markets.

Source: TCX (2024[42]), *The Global Solution for Local Currency*, https://www.tcxfund.com/ and consultations with TCX colleagues

Synthetic lending and off-balance sheet vehicles are other tools

Using facilities such as TCX, DFIs can deliver synthetic local currency loans, which are disbursed in foreign currency but indexed to the local currency, allowing them to stay offshore and avoid some of the limitations of local markets (Box 3.3). The loan's interest rate can be fixed or variable, incorporating the hedge cost, ensuring the borrower owes the exact local currency amount originally budgeted, regardless of currency fluctuations. This protects borrowers from exchange rate volatility, whilst also directing liquidity back into the real economy, reinforcing market indices and limiting unhedged currency mismatches on DFI/MDB balance sheets (EBRD, 2024[43]). Where the regulatory status of a DFI presents an obstacle, the use of off-balance sheet vehicles may represent an attractive structuring solution.

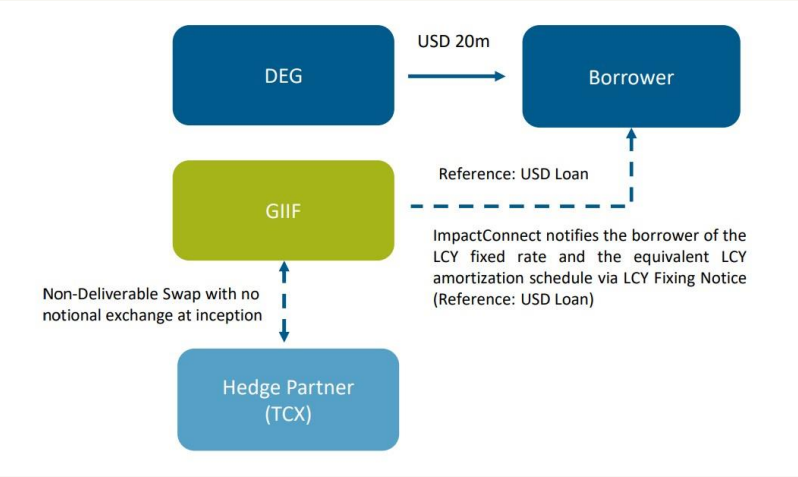
Box 3.3. The Global Impact Investment Facility

The Global Impact Investment Facility (GIIF) was established by the German Ministry for Economic Cooperation and Development (BMZ) to support sustainable development in emerging and frontier economies by means of co-financing structures alongside the German Investment Corporation (DEG), and risk mitigation through local currency loans. The facility provides local currency loans that align with the borrower's revenue streams, thereby reducing currency mismatch and risk. This is particularly crucial during periods of currency devaluation, where foreign currency loans can lead to increased costs and financial instability. This approach ensures that businesses can maintain stable operations and continue contributing to economic growth and employment.

In 2023, DEG, in collaboration with the GIIF, provided a USD 20 million floating rate synthetic local currency loan to Coopenae, a co-operative financial institution in Costa Rica. The loan, converted into the local currency via a hedge agreement with TCX (Figure 3.1), aims to fund loans for private individuals in social housing and micro, small, and medium-sized enterprises. Coopenae, the largest financial co-operative in Costa Rica with 220,000 members, benefits from the fixed local currency debt service schedule where interest and principal payments are indexed to the local colon currency, eliminating currency risk and stabilising its financial operations. This arrangement allows Coopenae to focus on its core business and enhances financial inclusion in Costa Rica. In addition, this financing contributes to reducing the prevailing high degree of dollarisation of Costa Rica's economy.

The loan also supports Coopenae's financial education initiatives, which include workshops and online courses aimed at helping individuals and small business owners manage their finances and avoid over-indebtedness. By providing stable and predictable financing, the synthetic local currency loan enables Coopenae to offer more loans to underserved segments, helping to promote economic growth and social development across the region.

Figure 3.1. The Global Impact Investment Facility's local currency loan in Costa Rica



Note: Illustrative figure by DEG staff
Source: Consultations with DEG staff

First-loss guarantees can be a powerful mobilisation tool

First-loss guarantees are another effective de-risking product, where provisional first-loss capital helps to absorb initial losses for investors, thereby reducing perceived risks and enhancing the attractiveness of investments in volatile markets. Additionally, guarantees have proven to be the most effective instrument in mobilising private resources, typically in hard currency, where OECD data on private finance mobilised during the period 2012- 2018 indicate that guarantees mobilised more capital than any other financial instrument, and were the most effective tool for mobilising in every year for which data is available (Garbacz, Vilalta and Moller, 2021[44]). A good example of how these tools can be used effectively is the European Bank for Reconstruction and Development (EBRD) SME Local Currency Programme, which provides a precedent for their application to SME local currency lending, linked to a market-building approach (Box 3.4. By mitigating the risk through first-loss guarantees, the programme not only facilitates increased access to affordable local currency financing, but also encourages the growth and stabilisation of local financial markets, making them more resilient and attractive to both domestic and international investors. GuarantCo, part of the Private Infrastructure Development Group (PIDG), is an active actor in providing currency credit solutions that transform capital markets by mobilising private sector capital to finance infrastructure projects. For example, GuarantCo has closed guarantees totalling USD 1.4 billion, which had mobilised USD 5.2 billion of private sector investment by the end of 2022 (GuarantCo, 2023[45]).

Box 3.4. The EBRD's SME Local Currency Programme

The EBRD's Local Currency Programme (a successor to the Early Transition Countries) had approved local currency lending for an aggregate amount of USD 1.1 billion by the end of Q1-2024. Its current portfolio of USD 244.4 million is backed by USD 68.8 million of first loss risk cover sourced from EBRD and from donor funds.

The programme's core concept is that rather than spending donor funds on subsidising interest rates, their use as a first-loss guarantee acts to reduce investment risks, thereby lowering the margin required by the EBRD. Should no default occur, the donor funding can thus be recycled. The programme's lending largely relies on intermediation to reach SMEs, with approximately 80% of the current portfolio deployed through local financial institutions.

There are two important conditions governing the programme's operations. The first is that the interest rate offered can under no circumstances undercut the local market. The second is that eligible countries must engage in money market development activities, in recognition of the fact that money markets are the cornerstone of local capital markets. Each of the 14 currently eligible countries has signed a framework agreement for running a Money Market Diagnostic to monitor progress on a regular basis. The funding remains available as long as the country is working on market development.

Though no country has thus far "graduated" from the programme, there are encouraging signs that the volumes of programme transactions in some eligible countries has decreased over time, suggesting market development is bearing fruit. It should be noted that the banks the programme lends to are provided with technical assistance, for example in the case of "green lines" (funding lines specifically allocated for projects that promote environmental sustainability) to help them develop credit assessment capabilities.

Source: Consultations with EBRD colleagues and EBRD website information: https://www.ebrd.com/what-we-do/sectors-and-topics/sme-local-currency-programmes.html#:~:text=The%20EBRD's%20US%24%20500%20million,the%20countries%20it%20invests%20in

Infrastructure guarantees can attract local institutional capital

Infrastructure guarantees are financial instruments that mitigate sector-specific risks associated with investing in infrastructure projects, enabling investors to mobilise local and hard currency funding and enhancing the creditworthiness of these investments. By providing assurance against potential default, infrastructure guarantees can attract local institutional capital and foster the development of a robust local currency bond market. Nigeria offers a live example of a functioning, if fledgling, local currency infrastructure bond market. The establishment of the Infrastructure Credit Guarantee Company Limited (InfraCredit) in 2017 created the model for funding infrastructure assets in local currency through the provision of local currency guarantees and the resultant mobilisation of local pools of institutional capital (Box 3.5).

Box 3.5. Funding infrastructure in Nigeria: The Private Infrastructure Development Group and InfraCredit

In the early 2010s, GuarantCo, an already established provider of local currency guarantees, recognised that the scale of the opportunity in Nigeria was considerably larger than it could address within the constraints of its risk exposure limits. It held discussions with the Nigerian Sovereign Investment Authority (NSIA) on shared observations of local institutional investors' appetite for diversification opportunities into Naira-denominated infrastructure assets. As a result, these two organisations decided to bring together the capital and technical capabilities required for creating a "local champion" to credit enhance infrastructure bonds and provide the capacity building capabilities necessary to familiarise a local capital market otherwise heavily concentrated in government securities. This led to the launch of InfraCredit in 2017 (GuarantCo, 2021[46]).

Initially capitalised by NSAI and GuarantCo, InfraCredit has subsequently grown its capital base to include other DFI shareholders and subordinated debt providers, such as the Africa Finance Corporation, InfraCo Africa, KfW and the AfDB. Importantly, it has also demonstrated its ability to attract local institutional investors LeadWay Assurance and AIICO Insurance as shareholders, thereby further establishing itself as a truly domestic institution.

Adopting the GuarantCo model, InfraCredit leverages its strong capital base and credit ratings to issue high-quality local currency guarantees that significantly enhance the credit quality of supported infrastructure projects. This has the effect of making them attractive to local institutional investors looking for diversification and mission-bound to seek opportunities to support local economic development. Since inception, InfraCredit has supported the financial close of some 20 infrastructure projects and in doing so mobilised 19 local pension funds. Moreover, the provision of InfraCredit guarantees has both allowed for an increase in tenors to up to 20 years. Over time it has seen a halving of the spread to equivalent government bonds, thereby reducing the cost of capital and making more infrastructure projects bankable (GuarantCo, 2024[47]).

Prior to InfraCredit, institutional investors in Nigeria avoided infrastructure investments, limiting their asset portfolios predominantly to government bonds and – where they could find them – qualifying corporate bonds and equities. This was in part due to the limited availability of product and the not unusual low-risk appetites of pension fund trustees in African markets (Eighteen East, 2021[48]). Significantly, it was also due to the limited understanding of the infrastructure asset class and their consequent inability to price them. Through the support and technical expertise of its DFI partners, as well as FSDA Africa who provided technical assistance, InfraCredit has been able to roll out a targeted capacity development programme that includes training sessions, roundtables, and co-due diligence exercises aimed at investors and regulators that include the Nigerian Pensions Commission

(PENCOM). These programmes have improved the understanding of infrastructure investment risks and returns among institutional investors, and created the conditions for a functioning local market.

An aphorism of development finance is that an intervention truly succeeds when it is no longer necessary. In this regard the oversubscribed NGX10 billion infrastructure bond issued by Axxela *sans* guarantee from InfraCredit or any other third-party credit enhancements, offers evidence of the power of local currency guarantees to foster new markets and unlock private sector confidence in key development asset classes.

Source: GuarantCo (2021[46]), Developing local currency guarantors to support the development of local capital markets: InfraCredit Nigeria and beyond, https://guarantco.com/blended-knowledge/developing-local-currency-guarantors-to-support-the-development-of-local-capital-markets-infracredit-nigeria-and-beyond-2/; GuarantCo (2024[47]), *Unlocking Long term Local Currency Infrastructure Finance in Nigeria*, https://infracredit.ng/update/wp-content/uploads/2024/04/Factsheet-April-2024_15-04-24-2.pdf; Eighteen East (2021[48]), *MOBILIST. The exit-mobilisation opportunity in Africa*, https://www.18eastcapital.com/wp-content/uploads/18E_FCDO_ExitMobilisationReport_Mar2021_FINAL.pdf; Axxela (2020[49]), *Axxela N10 Billion Bond Issue Successful; 24% Oversubscribed,* https://www.axxelagroup.com/axxelan10-billion-bond-issue-successful-24-oversubscribed/

Donors can support local currency mobilisation

Whilst the above case studies are focused on reducing the risk and all-in lending rate of local currency financing, donors have used other strategies that prioritise the mobilisation of local currency solutions through initiatives such as building long-term FX liquidity facilities and addressing the borrower's inability to meet debt servicing obligations. This section explores some of these strategies using case studies.

Global capital mobilisation requires action to shelter borrowers from currency mismatches

As noted in Chapter 1, in many scenarios the scale of the funding needs will mean that local pools of capital, whilst being optimally positioned to provide local currency finance, are insufficient. In these cases, tapping into the wider global pools of hard currency finance is necessary. Doing so means sheltering borrowers from the potential adverse consequences of assets and liabilities currency mismatches (Box 1.1).

Foreign exchange liquidity facilities can cushion against exchange rate volatility

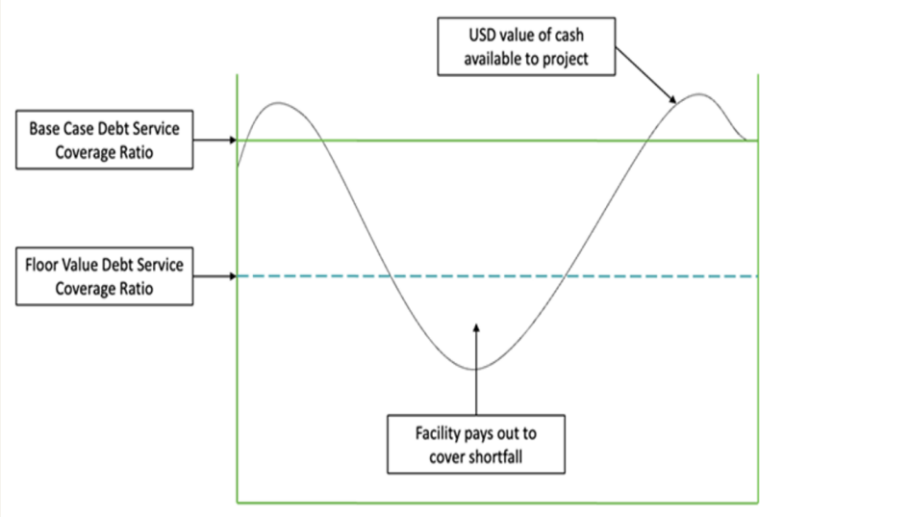
Structures such as foreign exchange liquidity facilities, which provide borrowers with access to foreign currency, can be designed to temporarily address the borrower's inability to meet debt servicing obligations resulting from an adverse foreign exchange rate movement. The Inter-American Development Bank (IADB) is understood to be working towards a foreign exchange liquidity facility with the support of the UK's Foreign, Commonwealth and Development Office (FCDO) (Box 3.6). This model is based on the idea that real exchange rates are less volatile than nominal exchange rates and that it is therefore possible to cushion projects against this more manageable level of volatility with a relatively small facility, if calibration is correct. Moreover, it is a potentially cost-effective solution to lower borrowing costs and facilitate the mobilisation of USD debt capital markets.

Box 3.6. Recycling old ideas for new solutions: Lessons from IADBs forex liquidity facility

The IADB is currently conducting work, with the financial support of the FCDO, to revive and adapt a concept last deployed in 2001 by the USA's bilateral DFI, then known as the Overseas Private Investment Corporation (OPIC). The initiative is focused on better protecting infrastructure projects against devaluation risks and was designed to shelter the US dollar financing of a Brazilian hydroelectric project from the risk of devaluation of the Brazilian Real. The basic idea was that the facility would pay out the dollar value of the cash available to the project to pay back its debt when falling below a pre-agreed "floor" value, calculated based on exchange rate fluctuations and project cash flows. Because one of the stipulations was that the prices at which the project sold its electricity should be indexed to inflation, this value is linked to both the nominal exchange rate and the rate of inflation at the time calculations are made to establish whether a payout is due. Should the real exchange rate swing back to a level that allows the project to cover its debt payment, it would then pay back to the facility any amounts drawn (Figure 3.2).

The size of the facility was established by calibrating for the historical volatility of the real exchange rate (the product of the nominal exchange rate and the ratio of prices between the two countries) and the project's debt service coverage ratio (the target ratio of cash available to debt payments due).

Figure 3.2. Payout mechanism of a foreign exchange liquidity facility



The OPIC facility, which closed in May 2001, in effect insulated the buyers of the USD 300 million debt certificates issued by the project's sponsor from much of the forex risk, allowing them to achieve an investment-grade credit rating, though they lost it shortly afterwards due to trouble at the parent company (Fitch Ratings, 2003[50]).

Source: United Nations (2003[51]), *Capital Markets Financing for Developing-Country Infrastructure Projects*, https://sustainabledevelopment.un.org/getWSDoc.php?id=3020.

Derivative markets and auction-based blended finance *are two other routes*

As development finance stakeholders seek to concurrently mobilise global pools of capital and identify local currency solutions, they could leverage the market infrastructure of existing capital markets, thereby accelerating market development rather than seeking to reinvent ideas that are already available. The Brazilian Ministry of Finance and the IADB are currently working to finance the Eco Invest Brasil programme via a foreign exchange liquidity facility designed along the same lines as the initiative described in Box 3.6, and also with the support of the United Kingdom's FCDO (Box 3.7).

Box 3.7. Eco Invest Brasil: Mobilisation and currency hedging

In April 2024, the Government of Brazil published a provisional measure[1] heralding Eco Invest Brasil, a foreign capital mobilisation and currency hedging programme designed to help finance its Ecological Transformation Plan (Presidency of Brazil, 2024[52]). Structured as a new credit facility within its Fundo Clima,[2] the programme is composed of four lines contributing to its objectives (Table 3.1).

Table 3.1. Eco Invest Brasil's four credit lines

	Credit line	Objective
A	Blended finance	Reduce the cost of capital through blended financing to promote integration of Brazilian companies into the global financial system, attract foreign investments, and foster a sustainable and resilient economy
B	Long term FX liquidity facility	Mitigate challenges faced by companies with foreign currency debt and revenues generated in Brazilian Real in cases of material devaluation, allowing for effective cash management and credit enhancements
C	Foreign exchange derivatives	Enhancing the availability and reducing the cost of FX Hedging in Brazil, and to attract Foreign Direct Investments for green projects
D	Project structuring	Catalyse the development of large sustainable initiatives in Brazil, bridging the current gap in the nation's green project landscape.

Source: Presidency of Brazil (2024[52]), *Da garantia a operações de crédito no âmbito do Programa Acredita no Primeiro Passo,* [Guaranteeing Credit Operations under the Acredita no Primeiro Passo Program] https://www2.camara.leg.br/legin/fed/medpro/2024/medidaprovisoria-1213-22-abril-2024-795526-publicacaooriginal-171592-pe.html

The first three lines are most relevant to this study. Line A (blended finance) introduces a competitive process through which local financial institutions can bid for the concessional funding offered by Fundo Clima. Not only will this component be provided in local currency, but bids will need to demonstrate that exposures are FX hedged. Programme funding is allocated through an auction system that primarily assesses bids based on the mobilisation multiplier they promise. Whilst this aspect is not directly relevant to the local currency issue, its implementation should be closely monitored by the blended finance community. Line B is essentially seeking to apply an enhanced version of the foreign exchange liquidity facility described above in Box 3.6. Line C is focused on enhancing availability and reducing the cost of and enhancing access to foreign exchange derivatives. It is based on the combination of two instruments:

1) A "derivatives pipeline" that links international capital markets to local financial institutions, with the IADB and Brazil's central bank bridging the gap that separates them. This allows the IADB to bring to bear the favourable terms (cost and collateral) it receives from its International Swaps and Derivatives Association (ISDA) counterparts for long-term FX hedges. The central bank maintains an ISDA agreement with the IADB and, in turn, enters into General Derivatives Contracts (*Contrato Geral de Derivativos* or CGD) with local financial institutions.

2) A catalytic credit line from Eco-Invest Brasil to support the offer of derivatives to the final beneficiaries by highly credit-rated local financial institutions. This line is currently under development, with expectations to be operational in 2025.

It will be particularly useful to observe the efficacy of the different lines. Should Line C be successful in delivering higher volumes and lower costs of hedging, it will potentially deliver an accelerated price discovery process through the data generated by the derivatives operations of the local banks involved, thereby creating the conditions for a further reduction in the cost of mitigating currency risk for projects.

Importantly, the provision of the availability of public catalytic capital through the Program's credit line could be structured differently by donors to deliver similar capacity building in other countries.

Notes:
1. Following the Provisional Measure, the law 14.995/2024 that established Eco Invest Brasil has been approved in October 10th 2024, consolidating the Program.
2. A climate fund in Brazil aimed at financing projects that reduce greenhouse gas emissions and promote climate resilience.
Source: Presidency of Brazil (2024[52]), *Da garantia a operações de crédito no âmbito do Programa Acredita no Primeiro Passo,* [Guaranteeing Credit Operations under the Acredita no Primeiro Passo Program] https://www2.camara.leg.br/legin/fed/medpro/2024/medidaprovisoria-1213-22-abril-2024-795526-publicacaooriginal-171592-pe.html

Supporting local capital mobilisation strengthens local financial markets and helps fund critical sectors

Local capital mobilisation is another important strategy donors should look to employ, as it allows countries to better leverage domestic resources and reduce dependency on foreign currency funding. This approach not only strengthens local financial markets, but also provides opportunities to finance critical sectors through innovative financial instruments such as sustainability-linked and project bonds.

Sustainability-linked bonds can leverage national development banks

Sustainability-linked bonds (SLBs) are financial instruments whose coupon can vary based on the issuer's achievement of predefined sustainability or ESG (environmental, social, and governance) objectives, serving as performance-based tools that encourage future improvements in sustainability outcomes within a specified timeframe (ICMA, 2023[53]). Scaling the issuance of sustainability-linked bonds with aims of leveraging national development banks not only helps to mobilise local capital, but also provides investors with an innovative method for channelling finance into areas such as biodiversity and climate change adaptation, which can be challenging to finance using green, social and sustainability (GSS) bonds in certain situations due to a lack of pipelines of sizeable and bankable assets that GSS bonds must, by definition, be linked to finance (OECD, 2024[54]). Africa is a region that presents significant opportunities for local capital mobilisation, particularly using bonds tied to both underlying assets and to bonds tied to key performance indicators (KPIs), given the continent's vast development needs and the potential for tapping into underutilised resources from national development banks (NDBs). Africa is home to a range of development banks, some 95 in total (AFD, 2021[55]). However, the combined holdings of the relative multitude of national development banks (NDBs) across the continent accounts for just 1% of global NDB assets (Fitch Ratings, 2021[56]). This undercapitalisation should drive African NDBs, typically fully funded by taxpayers (local and foreign), to strive to significantly increase their local currency lending and investment activities by mobilising local sources of private capital funding, as has been done by the Development Bank of Rwanda (Box 3.8).

Development actors have already been supporting the issuance of vanilla local currency corporate bonds, which feature fixed interest rates and straightforward repayment terms without complex features like options or derivatives, making it easier for investors to understand and assess its risks. In 2012, KfW and

the German Government established the African Local Currency Bond Fund to promote corporate local currency bond markets as a viable source of funding in Africa. The fund had three overarching goals: (1) act as an anchor investor and provide technical assistance to financial service providers; (2) improve the sustainability and diversity of funding sources for issuers, reducing risks for individual institutions and the financial sector; and (3) ensure greater economic opportunity for target beneficiaries, specifically low-income households and micro, small and medium enterprises (MSMEs), by facilitating sustainable borrowing, long-term investment and financial-sector sustainability.

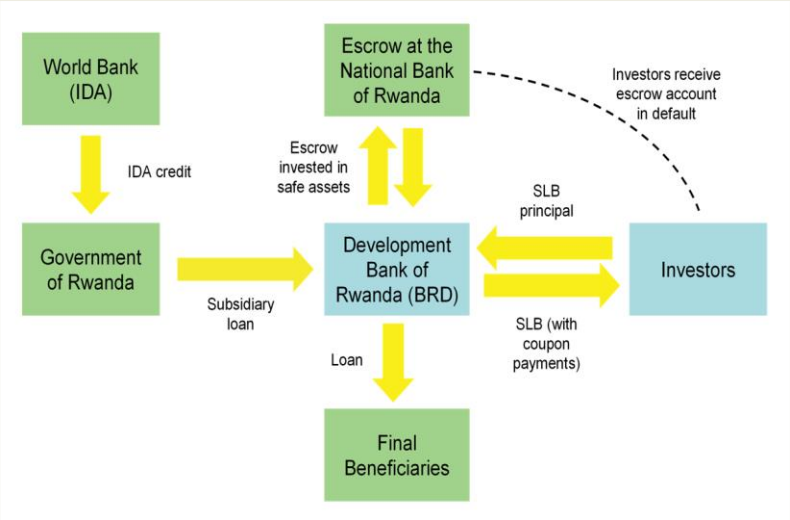
Box 3.8. National development banks and sustainability-linked bonds: lessons from the Development Bank of Rwanda

The Development Bank of Rwanda (BRD) is 98% owned by the Government of Rwanda and its external funding needs are met by a range of public lenders, including the World Bank, AfDB, *Agence française de développement*, the European Investment Bank, Afreximbank, and Arab Bank for Economic Development in Africa (BADEA) (Development Bank of Rwanda, 2023[57]). According to its latest annual report, as of the end of 2022 the BRD had total liabilities of 370 billion Rwandan francs (RWF), of which 25% are hard currency borrowings. The other side of the ledger shows a similar percentage of total assets held as hard currency loans and placements with other banks (Development Bank of Rwanda, 2023[58]).

As with so many of the institutions in the development finance system, NDBs are obliged by their funding to invest significant proportions into their own markets in hard currency. This reduces opportunity, places currency risk on the borrowers and hamstrings the development of local capital markets. The BRD is attuned to these challenges and has taken the strategic decision to diversify its sources of funding, and in particular to attract local private capital. As part of its 2024-2028 strategy, the institution announced in 2023 its intention to issue a sustainability-linked bond (SLB) and subsequently issued it into the local markets under its Medium-Term Note programme. SLBs are differentiated from more familiar green, social and sustainability bonds in that proceeds are not required to be allocated to specific green or sustainable projects or assets. SLBs are instead designed to incentivise issuers to meet sustainability targets: the bond's structural and/or financial characteristics change depending on whether the pre-determined targets are met. The BRD's SLB for example is structured to positively incentivise the attainment of key performance indicators relating to the implementation of an Environmental and Social Management System, a framework to manage and mitigate potential environmental and social risks associated with their operations and to comply with relevant regulations, along with the increased financing of women-led SMEs and affordable housing projects (World Bank, 2023[59]).

Aside from the novel use of the SLB structure – this is the first such issuance by a development bank – what makes the product particularly interesting is its ability to blend a hard currency credit enhancement to leverage funding in Rwandan francs from local institutional investors. The total size of the programme is RWF 150 billion (USD 120 million), with the first tranche issued at RWF 30 billion (USD 24 million). Crucially, this was supported by a USD 10 million credit enhancement line from the World Bank's IDA provided to the Government of Rwanda which allowed for the funding of an escrow account to be used as collateral in the case of default (Figure 3.3). This reduced risk and lowered the cost of borrowing. The issuance was oversubscribed and drew demand from more than 100 investors (World Bank, 2023[60]), demonstrating appetite on the part of local investors for credit-enhanced Rwandan Franc exposure to development assets.

Figure 3.3. Development Bank of Rwanda's sustainability-linked bond (SLB) structure



Note: IDA stands for the International Development Association, which is part of the World Bank.
Source: World Bank (2023[60]), *Rwanda Issues First-Ever Sustainability-Linked Bond (SLB)*, https://thedocs.worldbank.org/en/doc/743272cfbb73c6a9a1e97ecfcadb2d58-0340012023/original/Case-Study-Rwanda-SLB.pdf

The BRD's design and issuance of this SLB has created the dual outcome of diversifying and increasing the local currency component of the BRD's funding mix, allowing it to lend more in local currency, and promoting the further development of the domestic capital market. Given an acknowledged mismatch between the relative availability of hard currency funding sources in the development finance system and the on-the-ground local currency investment needs across developing countries, the BRD SLB is a successful and potentially powerful precedent for NDBs and other DFIs seeking to diversify their sources of funding and foster increased local capital market activity.

Hard currency funding for infrastructure projects is not inevitable

Project finance and its application to the infrastructure needs of developing countries is the original bread and butter of development finance. Added to the very real expertise DFIs and MDBs have built, default and recovery statistics suggest that it is good – i.e. relatively safe – business (IFC, 2024[61]); (GEM, 2022[62]). The consolidation of DFI/MDB funding around infrastructure projects is supportive of this. For example, 11 DFIs and MDBs and one export credit agency (ECA) were involved in financing Lake Turkana Wind Power in Kenya (DFID, 2015[63]). However, developing countries' institutional investors and banks are too often absent from the financing of local infrastructure projects which, unsurprisingly, are typically financed in hard currency.

There is a potentially flawed assumption in parts of the development finance system that infrastructure is naturally and justifiably financed in hard currency. The need to import core machinery from overseas is often cited as a justification. However, this is not equally true of all types of infrastructure: hydropower is for example associated with a significant amount of labour salaried in local currency. Moreover, the income generated by these assets is in most cases in local currency, especially in the utilities and telecom sectors or the road system. Direct evidence suggests that the recourse to hard currency funding for infrastructure projects is not inevitable (PPIAF, 2024[64]).

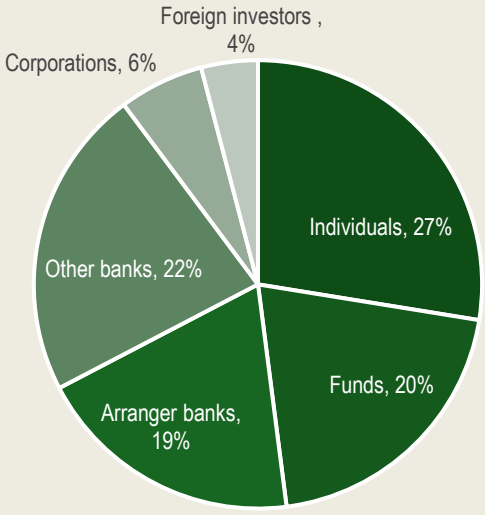
Brazil provides a striking precedent – not only for the local currency financing of infrastructure assets but also for the mobilisation of local pools of capital to do so (Box 3.9). It points at a way forward for the

application of blended finance principles to delivering this two-pronged objective. Project bonds such as those developed by Brazil are in fact attracting institutional investor capital across the globe (Figure 3.5), offering issuers advantages ranging from fixed pricing and maximised tenor to more diversified sources of funding and enhanced flexibility (Credit Agricole, 2018[65]). The Brazilian case, whilst important to acknowledge that the country already has a relatively well-developed banking sector and capital market, thereby giving it greater capacity to provide local currency, still demonstrates the ability of project bonds to mobilise local currency funding from local investors. Whilst it is understood that, apart from Mexico, Peru and Colombia, this remains a relatively isolated instance in an ocean of hard currency and that the fiscal incentivisation may not be replicable elsewhere, it might be successfully replaced by the application of blended finance instruments.

Box 3.9. Brazil's incentivised project bonds or *Debêntures Incentivadas*

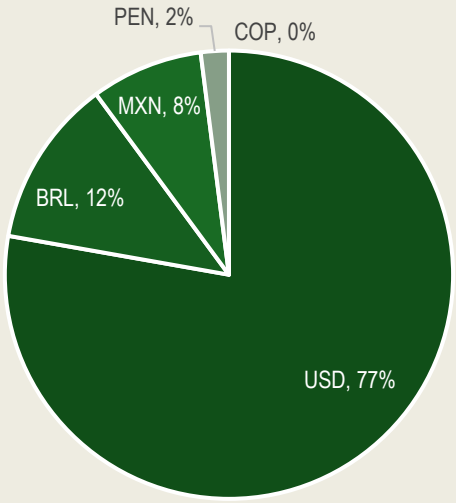
Brazil launched incentivised bonds to finance infrastructure assets following changes introduced in Basel III that increased the regulatory cost of capital linked to bank lending, and in part to reduce the infrastructure sector's dependency on funding from Brazil's national development bank (BNDES). The incentive aspect is derived from a tax exemption or reduction, depending on the category of investor, for capital gains and income (IADB, 2022[66]). These project bonds have to be denominated in local currency, be of a minimum tenor and linked to infrastructure finance. They are generally inflation-linked and according to Inter-American Development Bank (IADB) research, taken up by a wider range of investor categories (Figure 3.4). This phenomenon is a regional feature: Credit Agricole's project finance research noted in January 2021 that "Latin America has been a consistent contributor to the global Project Bond market with more than USD 76.8 billion issued across 16 countries in the region over the past 10 years" (Credit Agricole, 2021[67]).

Figure 3.4. A wide range of investors have been attracted to Brazil's *Debêntures Incentivadas*



Source: Inter-American Development Bank (2022[66]), *Infrastructure Bonds: The Case of Brazil*, https://publications.iadb.org/en/infrastructure-bonds-case-brazil

Figure 3.5. Latin America Project Bond Issuance Volume by Currency highlights a mix of both hard and local currencies (2011 to 2020)



Note: USD (United States Dollar), BRL (Brazilian Real), MCX (Mexican Peso), PEN (Peruvian Sol), COP (Colombian Peso), Source: Credit Agricole CIB (2021[67]), *Project Bonds in Latin-America*, https://www.ca-cib.com/sites/default/files/2021-04/Project-Bond-Focus-Latin-America-2021.pdf.

Project bonds and other structures can work well for blended finance

Direct lending of any sort is difficult for many local institutional investors, and more so in foreign currency. While buying bonds may be a forgotten option in places, it is an option, nonetheless. Given that any infrastructure project will be associated with at least some local currency content and will therefore need some local currency funding, DFIs and MDBs could structure part or all of the funding package as local currency project bonds rather than hard currency direct loans.

The cash flow patterns of infrastructure projects, often characterised by upfront capital expenditures during the construction phase followed by delayed revenue generation, make them less suitable for traditional bond financing, as the lack of early cash inflows complicates the ability to service debt obligations in the initial stage. This is often cited as an obstacle to matching local currency bonds issued by DFIs and MDBs to local currency loans. However, the various investment banks that have accompanied the growth of the project bond universe have thought this through. Credit Agricole, for example, points out that the negative carry issue can be addressed through delayed draws and hybrid financing, and that the creative use of special purpose vehicles (SPVs) can be deployed to match issuer needs and investor preferences (Credit Agricole, 2018[65]).

Project bonds and associated SPV-based structures are beneficial applications for blended finance. The provision of guarantees by development finance actors would help local institutional investors take a first step towards financing their own local infrastructure through simple instruments, as seen below with the International Development Associations Local Currency Facility (Box 3.10). The resulting de-risking could act as a substitute for the fiscal incentive deployed in Brazil. Bonds carrying a credit rating and listed on local exchanges would contribute to capital markets development and create observable data points that would negate the need for the data development that finance institutions claim to be unable to share.

Box 3.10. The IDA's Local Currency Facility

The International Development Association (IDA), a part of the World Bank, supports a range of development activities in poor countries. It is one of the largest sources of assistance for the world's 75 poorest countries.

IDA's local currency facility – a subset of the Private Sector Window (PSW) whose goal is to mobilise sustainable private sector investment – is relevant in situations where capital markets and market solutions are not adequately available to address local currency investment needs. By using these facilities and funds as a backstop, IDA can provide local currency investments and solutions in these countries by adequately addressing the following key risks that may be associated with local currency investments:

1. **Counterparty credit risks:** when the counterparty is non-traditional or does not meet traditional credit quality standards. The LCF absorbs credit losses associated with hedging for these counterparty risks.
2. **Short-term liquidity risks in local currency instruments** are risks associated with currency fluctuations. The IDA PSW covers negative changes in the value of local currencies associated with proceeds of bond issuances.
3. **Transfer/convertibility risks:** associated with converting or transferring local currencies. Swaps are used to hedge market risks. The LCF covers losses when the underlying hedged loan matures.
4. **Open currency/interest rate risks:** open risks that occur when market-based solutions are not available. The LCF is used to hedge these open risks. If a loss is realised, a request is made to IDA to cover the respective losses.

Source: World Bank (2024[68]), *Local Currency Facility (LCF)*, https://ida.worldbank.org/en/financing/ida-private-sector-window/local-currency-facility-lcf; World Bank (2024[69]), *About IDA*, https://thedocs.worldbank.org/en/doc/7bb20579fde2489e1c12e638bf212316-0410012024/original/About-IDA-Brochure-March-2024.pdf; (World Bank Group, 2024[70]), *What is the IDA Private Sector Window?*, https://ida.worldbank.org/en/financing/ida-private-sector-window/what-is-ida-private-sector-window

Deepening local lending capacity is crucial for SMEs and local economies

Deepening local capital markets is crucial for fostering more robust and resilient local capital ecosystems, especially in emerging markets where access to finance for SMEs remains a challenge. By improving the capacity of local financial institutions to lend to SMEs, these enterprises can gain access to the capital they need to better contribute to the broader economy whilst reducing reliance on foreign currency borrowing and associated FX risk. Within this process, as local banks become better equipped to mobilise local resources, including customer deposits and local institutional capital, they can play a pivotal role in recycling local capital and addressing the financing gaps that SMEs face, thereby enhancing overall financial stability of SME projects.

Local banks need to be equipped to mobilise their local deposit base

Local banks stand to play a key role in the local currency financing of SMEs. They are the custodians of a significant source of local currency funding in the form of the deposits made by their customers. Crucially, deposits are a more consistent feature of developing countries than significant pools of institutional investor

capital (IMF, 1995[71]). Whilst there is no uniformity across developing countries, in some places deposits are also associated with low levels of remuneration (Zambia, Kenya, etc…), making them a low-cost as well as relatively abundant source of local currency capital for SMEs.

Through the issuance of debt securities on local capital markets, local banks are also positioned to act as the conduit for local institutional investor capital. As such they are mobilisation vectors, and their engagement with the development finance sector is directly relevant to the mobilisation of private capital to fund the important SME sector across developing economies. They play a key role in the creation of money. As the IMF reminds us, once they have put aside the appropriate reserves, "banks create money when they lend the rest of the money depositors give them" (IMF, 2017[72]).

Whilst deposits do equip most local banks with a significant source of local currency capital, the short-term nature of large proportions of this base means that, to extend longer-term local currency loans to their clients, they will often require other sources of funding, such as loans and facilities (including from DFIs and MDBs) or the issuance of bonds for ALM purposes.

The challenge is for the development finance system to both incentivise and equip local banks to mobilise their local currency deposit base, and eventually local capital markets, to fund lending in local currency to those SMEs that require it.

Local banks have traditionally been the recipients of a large share of the funding deployed by DFIs and MDBs. The 2021 MOBILIST report on exit-mobilisation, for example, finds that 44.76% of loans extended by a sample of ten DFIs and MDBs over a ten-year period in sub-Saharan Africa were made to local financial institutions (MOBILIST, 2021[25]). Perhaps more importantly, the same report highlights that at the end of 2019 the share of the debt issued to these local institutions (ten East African banks) with market capitalisations in excess of USD 100 million sourced from DFIs and MDBs was on average 84%. Diamond Trust Bank and the Co-operative Bank of Kenya derived 100% of their long-term debt from DFIs and MDBs, with KCB Group at 98%. The bulk of this debt was denominated in US dollars.[8]

Supporting SMEs is only one of many reasons DFIs and MDBs lend to local banks. Their provision of attractively priced hard currency loans and facilities to SMEs plays a key systemic role in financing sustainable development. Where businesses generate hard currency income, it is appropriate that they should resort to hard currency debt. While situations differ significantly across countries, sectors and enterprises, on-lending practices that result in pushing significant currency risk onto SMEs, where they have no identified foreign currency income streams and are ill-equipped to mitigate it, are problematic.

Local banks in receipt of hard currency funding earmarked for SMEs can choose to absorb this currency risk through asset and liability management. This is however not universally observed, and – unsurprisingly given the limited range or punitive cost of instruments to hedge currency exposure – the management of currency risk often relies on a close matching of foreign currency assets and liabilities.

The development finance sector has been successful in providing hard currency financing to local banks at a price that allows them to profitably on-lend. Building the same local banks' ability to source attractively priced funding in local currency, allowing them to on-lend profitably, would be an important step for resolving the local currency issue. Where the cost of lending is too high, the ability of DFIs and MDBs to build on the success of their hard currency financing of local banks and to deliver attractively priced local currency funding could catalyse local banks to increasingly mobilise their deposit base.

Development finance actors could consider prioritising the provision of local currency lending where SME on-lending is the objective. As described in Chapter 2, this is not without its challenges, and it is acknowledged that the size of MDB/DFI loan books dedicated to SMEs varies from one institution to another, but given the comparatively modest amounts involved, it may in places be associated with a manageable level of currency risk. Donors could equip MDBs and DFIs with pools of de-risking capital to facilitate this process, where appropriate.

Credit bureaus and data transparency could reassure local investors

Lending to SMEs is an operationally more costly endeavour than lending to large businesses, notwithstanding the credit risk involved. In recognition of the tangible costs of engaging with SMEs, donors could subsidise originating fees, which are the costs incurred by banks or lenders to process and approve new SME loans – including credit evaluations, paperwork, and administrative tasks – thereby simultaneously sheltering borrowers and incentivising origination. Analysis also suggests that national regulatory frameworks that limit the enforceability of loan contracts may be in part to blame for banks being "excessively liquid" and a situation where "deposits by customers are not always recycled in the form of loans, because banks choose to cover their liabilities either by acquiring government securities or by investing abroad" (Andrianova, 2011[73]).

They also note that "the evidence suggests that many banks suffer from a shortage of information about the creditworthiness of some of their customers" and that, "as a result, local savings are not channelled into local investment". This, they propose, should warrant the creation of additional credit bureaus. This finding more generally supports demands for greater data transparency and presents an opportunity for donors to support aligned initiatives. However, a wide array of country-specific factors exists, and donors should consider grounding remedial efforts in up-to-date country-specific gap analyses.

Helping SME lenders become banks could be a simpler approach

Instead of trying to turn banks into SME lenders, the development finance community could help SME lenders become banks. The efficacy of the use of local commercial banks as SME on-lending intermediaries is being questioned. Jean-Michel Severino notes that "…few SME credit lines or bank guarantee products reach their target: it is difficult for DFIs to check whether the impact is real, and whether these products result in an increase in the share of the total bank portfolio devoted to SMEs. It is therefore likely that at least some of these products generate windfall effects for banks, which, even when heavily guaranteed, are reluctant to allocate more than a clearly identified part of their balance sheet to an asset class that generates high management costs and high loss levels." (Severino, 2023[74]).

Where donor countries are focused on SME funding, it may in places involve steering banks construed as local intermediaries from an "easy" business model reliant on cheap hard currency funding and loans to a small number of large export-oriented corporates towards a "difficult" business model capable of providing a vast universe of SMEs with riskier, local currency loans. It might not be easy for the development finance community to bring about such a change.

Instead of seeking to change commercial banks' business models, the solution may be found in helping non-bank financial institutions specifically dedicated to SME financing to graduate to bank status, thereby enabling them to access the same deposits that provide the former with an inexpensive, and in their case underutilised, source of local currency funding. Instead of trying to turn banks into SME lenders, they could help SME lenders become banks. Inspiration can be found in the business model of the Thai Credit Bank, for example (Box 3.11).

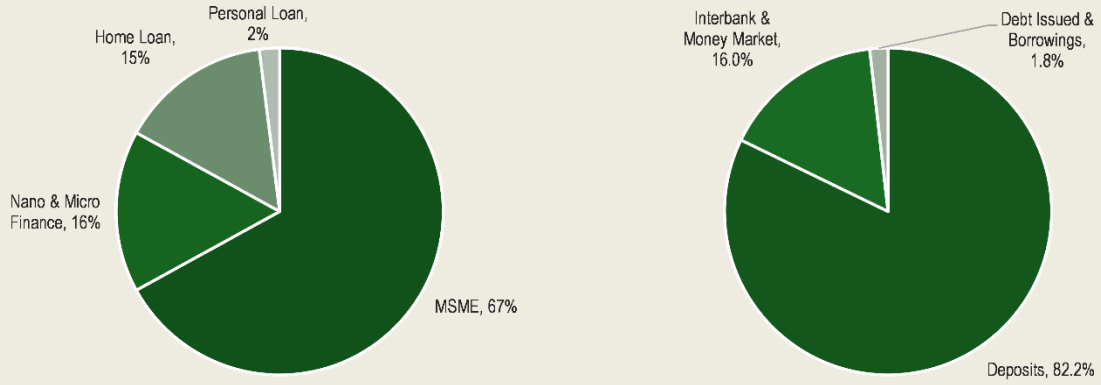
Box 3.11. How the Thai Credit Bank supports micro and small enterprises

The Thai Credit Bank, which operates as a commercial bank, derives the bulk (67%) of its loan book from the MSME sector, with a focus on rural areas. It does so with support from the state-owned Thai Credit Guarantee Corporation (TCGC), which provides coverage for 72.5% of its MSME loans. Around 82% of Thai Credit Bank's USD 3.9 billion funding stems from deposits, and another 16% from interbank lending and money markets (Figure 3.6). This serves to illustrate what the combination of customer deposits and guarantees can deliver in terms of local currency SME lending.

The Thai Credit Bank's initial public offering on the Stock Exchange of Thailand (Bangkok's SET) was recently supported by the UK's FCDO's MOBILIST (MOBILIST, 2024[75]), the Asian Development Bank and the IFC as key investors to facilitate the initial public offering (IPO) and expand the bank's lending to underserved MSMEs in Thailand.

Figure 3.6. Thai Credit Bank lends mostly to MSMEs using deposits in local currency

Loans outstanding (left-hand graph) and sources of funding (right-hand graph) (2023)



Note: Data from March 2024.
Source: (IFC, 2024[76]). https://www.ifc.org/en/pressroom/2024/ifc-and-thai-credit-bank-partner-to-support-women-owned-small-businesses-in-thailand

Donors could consider deploying resources through the development finance system to help specialist non-bank financial institutions to achieve bank status and access a vast and often under-remunerated source of local currency funding: customer deposits. This could be operationalised through equity investments and the provision of technical assistance. The use of guarantees can also help recreate the Thai Credit Guarantee system where no such government-sponsored facility is available.

To date, equity investments, technical assistance and guarantees are the main tools DFIs, MDBs and development agencies have been comfortable deploying in a local currency setting. A further step could involve the provision of guarantees to allow these SME banks to tap debt capital markets through bond issuance and to facilitate interbank lending, both of which would contribute to local capital markets development.

Deepening local capital markets requires local financial infrastructure

The challenges to mobilising local currency cannot be overcome without building local capital markets, local pools and flows of capital, and local financial infrastructure. Local capital markets are essential drivers of economic growth, playing a pivotal role in mobilising domestic savings and providing businesses with access to long-term financing. Well-developed capital markets not only offer companies alternative funding sources, allowing them to secure larger volumes and longer maturities, but also serve as vital mechanisms for governments to finance fiscal deficits and public activities including infrastructure projects (World Bank Group, 2020[76]). As such, understanding the maturity of local capital markets is crucial for donors and MDBs to tailor their assistance effectively. It also supports the development of indices, which provide transparency around pricing. An example is the IFC Domestic Capital Markets Size, Access, and Activity Index,[9] (based on three sub-indices: the government bond market index, the corporate bond market index, and the equity market index), as well as the IMF Financial Development Index[10] (a relative ranking of countries on the depth, access, and efficiency of their financial institutions and financial markets), which can provide critical insights into the levels of capital development on a country-by-country basis.

The Aid for Trade Initiative (AfT), established in 2005 by the World Trade Organization (WTO), aims to support developing countries to build trade-related infrastructure and productive capacities, which can also play a crucial role in developing local capital markets (WTO, 2024[77]). In 2022, 12% of total AfT disbursements, or about USD 6.12 billion, were directed toward building capacity in banking and financial services (OECD/WTO, 2024[78]), which is a vital step in enhancing local currency mobilisation efforts. This is particularly relevant for financing exporting SMEs through local intermediaries, helping to mitigate currency mismatches that affect trade competitiveness. With a strong focus on economic infrastructure, AfT can help strengthen local financial systems, supporting sustainable growth and reducing dependence on foreign currency borrowing.

Additionally, initiatives such as the Liquidity and Sustainability Facility (LSF) and FrontClear are also designed to help build critical financial market infrastructure:

- **The Liquidity and Sustainability Facility** is designed to jumpstart repurchase (repo) agreement markets for Africa's sovereign Eurobonds.[11] Repo agreement markets are financial markets where securities are sold with an agreement to repurchase them at a later date, functioning as a form of short-term borrowing. By allowing investors to refinance their positions in eligible bonds, the LSF seeks to enhance the liquidity of these instruments, eventually reducing the liquidity premium issuers bear and thus the cost of debt for African governments. Liquidity enhances market participation by investors and helps put a downward pressure on pricing, including local currency financing.
- **FrontClear,** already supported by a number of DFIs, MDBs and development agencies (Box 3.12),deploys guarantees and technical assistance to build the functioning money markets that are needed for banks to operate efficiently, avoiding liquidity hoarding and eventually expanding lending volumes. This is a crucial piece of work focused on the foundations of capital markets.

Box 3.12. Enhancing money markets in emerging and developing economies: FrontClear's Guarantee Scheme

FrontClear, established in 2015 and co-funded by various European development institutions and FSD Africa, is dedicated to enhancing money markets in emerging market and developing economies. The institution aims to contribute to economic growth and financial stability by making these money markets more inclusive and liquid. FrontClear achieves this by providing credit guarantees to mitigate counterparty credit risk (CCR) in repo, derivative, and securities lending transactions. Additionally, it offers technical assistance to regulators and industry bodies to develop the necessary skills, regulatory frameworks, and market infrastructure. This dual approach not only facilitates local and cross-border short-term transactions, but also supports the enforceability of critical financial mechanisms such as close-out netting and settlement finality.

FrontClear seeks to address key constraints in the development of onshore money markets, including high costs, CCR, limited capacity of market participants, legal and regulatory challenges, and inadequate financial infrastructure. By providing credit guarantees and acting as a principal in transactions, FrontClear reduces the perceived risks among larger Tier 1 banks when trading with smaller local banks. This reduction in risk facilitates a more effective allocation of local currency liquidity, enabling banks to recycle cash, support bond market liquidity, and provide swaps for foreign investors to engage in local currency loans and bonds. In line with its mandate to promote more inclusive money market activities, FrontClear has helped to support effective long-term market development and economic growth in fragile and underserved communities.

A notable example of Frontclear's impact in this space is its facilitation of Kenya's first cross-currency repo transaction between Standard Bank of Southern Africa and Commercial Bank of Africa. Traditionally, Kenya's unsecured interbank market was segmented, with smaller banks facing limited access due to high perceived credit risks. This imbalance restricted liquidity and inhibited smaller banks from serving their clients effectively. Repo markets can mitigate such credit risks by collateralising loans with government securities, but Kenya lacked true repo markets with legal title transfer of collateral. Frontclear addressed this by structuring the USD 25 million deal with a guarantee and legal title transfer, demonstrating a critical step forward in market development, providing stability to smaller banks' funding and paving the way for a more inclusive financial system. Through technical assistance and regulatory co-operation, Frontclear's work in Kenya lays the foundation for a robust interbank market, enabling more efficient capital allocation and enhancing financial stability across the region.

Source: Consultations with FrontClear staff. (FrontClear, 2015[79]), *FrontClear Impact Report*, https://www.frontclear.com/wp-content/uploads/2019/05/FrontclearImpactReport2015.pdf. Also: https://frontclear.com/

Repo markets and money markets are two pieces of a much wider capital market infrastructure puzzle. They are however the result of initiatives by market practitioners. The absence of a systematic, strategic approach means that gaps will continue to remain. Donor countries could create the conditions for a significantly accelerated process by commissioning a gap analysis of capital markets at national and regional levels, allowing for the efficient allocation of funds.

Building corporate bond markets could encourage local banks to seek local currency assets

Financial institutions are the cornerstone of global corporate bond markets. The International Capital Market Association (ICMA) estimates that as of August 2020, 53% (USD 21.5tn) of outstanding corporate bonds were issued by financial institutions.[12] The same institution notes this dominance is also found in

the South African corporate bond market and the much smaller Nigerian market, and banks are also early issuers in nascent markets elsewhere on the continent.

The development finance system could consider encouraging and supporting local banks to issue debt on local capital markets, where necessary applying guarantees to attract local institutional investors (for example in Kenya, where bank bond issuance has all but vanished (Anyanzwa, 2024[80]). This would both contribute to local capital market development, which is a desirable objective in the context of the local currency issue and of the need to build the resilience of financial actors, and create an incentive for local banks to seek longer-term local currency assets to match these new-found longer-term local currency liabilities.

Developing local public equity markets will require exit mobilisation

The relative willingness of MDBs to take on currency risk in their equity portfolios, combined with the low availability of other sources of equity capital in many of their target countries, means that higher efficiencies in this part of their portfolios may have disproportionate benefits. MDBs are under increasing pressure from shareholders to enhance the redeployment of their capital. Much of the focus has understandably been on their much larger loan portfolios and how risk transfer techniques can be applied to them. Here again arguably the most untapped sources of capital are local capital markets and owners. As described in Chapter 2, the vehicles used by development finance to deploy equity capital, though justified in many aspects, are not a fit for local institutional investors' capabilities.

Underdeveloped public equity markets deprive private equity practitioners in frontier and emerging markets of a natural exit route. According to the CEO of the African Private Equity and Venture Capital Association (APEVCA), "The illiquid and underdeveloped nature of stock exchanges in Africa contributes to the lack of a thriving Initial Public Offering (IPO) market" (PEI, 2023[81]). IPOs and the development of public equity markets are a key ingredient to remedy this situation. However, there is a cyclical challenge in which the paucity of evidence of DFI and MDB limited partners effectively leveraging their influence on fund managers to advocate for public market listings hampers the development of local equity markets, thereby restricting the potential for more robust market offerings and the overall growth of public equity markets.

Whilst there is no question that this will often not be feasible, more could and should be done to add this dimension to DFI and MDB mandates. The small size and lack of diversification of equity allocations of most institutional investors in sub-Saharan Africa poses a very real financial sustainability risk. The case of Safaricom in Kenya is particularly striking, as its market capitalisation accounts for around KSH 700 billion out of the KSH 1 700 billion total for the Nairobi Securities Exchange (NSE).

Encouraging local public market exits for DFI and MDB private equity positions would not only replenish the equity risk pockets they have been using to combat local currency risk but would also provide local savers with a much-needed opportunity for diversification. It is also worth noting that it would in many instances result in the "passive" mobilisation of global investors. For example, the Thai Credit Bank IPO mentioned above (Box 3.11) saw Norway's Norges Bank Investment Management (NBIM), often referred to as the oil fund, become a shareholder alongside development finance actors.

The argument is more pronounced in cases in which DFIs and MDBs have held publicly listed stakes in local companies for some time. Whilst supporting at the IPO stage does result in significant mobilisation levels, it is perhaps more questionable to hang on to stakes that local investors could presumably quite easily take over, albeit gradually. In this context, it is worth considering whether vehicles like Arise Investment (BV), which Norfund and FMO co-own with financial institutions from various countries, could enable local investors in Africa to own their banks. This would not only empower local investors, but also allow development finance capital to be recycled into assets they typically cannot access.

Technical assistance can support sustainable local money markets and capital markets

Establishing sound macroeconomic policies and effective monetary frameworks – critical for sustainable local money market and capital market development – will require long-term technical assistance programmes. Donors can support the development of robust financial infrastructure, including payment systems, clearing and settlement mechanisms, to facilitate efficient trading and settlement of local currency-denominated assets. Donors can also help to enhance the effectiveness of credit rating agencies to enable them to provide better and more accurate credit ratings of local currency assets, which would reduce the challenges associated with the perceived versus real risk of credit ratings in developing countries.

Donors can also support financial literacy curricula and investor education programmes to increase awareness and confidence in local currency assets among domestic investors. By enhancing understanding of financial products and the benefits of investing in local currency, these programmes can encourage more individuals and institutions to participate in local capital markets. Increased financial literacy also empowers investors to make informed decisions, contributing to the overall stability and growth of local currency markets.

Advocating for reforms and collaboration are other key roles for donors

Advocating for reforms in macroeconomic policies and fiscal management is vital to achieving macroeconomic stability and reducing currency volatility. This can involve implementing sound fiscal policies, controlling inflation, and maintaining sustainable debt levels to help build investor confidence and encourage the issuance and trading of assets denominated in local currency.

Collaboration with international organisations and regional initiatives is crucial for harmonising regulatory standards, improving cross-border co-operation, and promoting regional integration of local currency markets. By working collaboratively, donors can help to establish consistent and transparent regulatory frameworks that facilitate smoother and more efficient market operations. This regional integration enhances liquidity, making local currency markets more attractive to investors and resilient to external shocks. Improved cross-border co-operation also allows for the sharing of best practices and resources, further strengthening the overall financial stability and growth prospects of the participating development actors.

4 Policy considerations for donors and the shareholders of DFIs and MDBs

Local capital markets in developing countries and emerging markets provide neither the depth nor the breadth required to meet the financing needs of sustainable development. Whilst the development finance system must strive to bridge the gap between developing country borrowers and the deeper pools of global capital markets, it must also acknowledge the complexities of balancing and integrating local and hard currency financing options. Local currency finance today is largely a marginal element of the development finance system. Hard currency lending has traditionally dominated, offering greater liquidity and predictability for international donors, while the complexities of structuring local currency financing—such as navigating shallow capital markets, managing exchange rate volatility, and addressing inflation risks—further deter its widespread adoption. There is much that donor countries can do to enhance the availability and affordability of the much-needed local currency finance without threatening the fragile equilibrium of developing economies. The burden of currency risk has thus far been unevenly shared in the lenders' favour.

This final chapter suggests measures for donor countries, and the shareholders of DFIs and MDBs to expand local currency financing solutions and deepen local capital markets. Some measures put forward offer short-term implementation focused on mitigation strategies, with other measures requiring a more long-term view concerned with delivering onshore solutions. Some involve broader changes within the development finance system; others require engagement with local capital markets and actors.

Short-term measures

Unlock the local currency potential of development finance

- Donor countries could, in their capacity as shareholders across the system, mandate the management teams of MDBs and bilateral DFIs to review risk mandates that govern approaches to currency risk. Whilst it is understood that some rules are built into the risk mandate and operation statutes of these institutions, they should be critically interrogated for their role in enhancing risk appetites.
- Donor countries should encourage collaboration across the treasury functions of MDBs to identify synergies and reduce inefficiencies (as highlighted in Chapter 2) and create onshore treasury operations in local markets, as suggested, inter-alia, in Fink (2023). AIIB and EBRD for example are developing a joint initiative, code-named Delta, to create local currency liquidity pools through an onshore vehicle, allowing MDBs and smaller DFIs to offer flexible local currency financing solutions coupled with policy dialogue and market development approaches (AIIB, 2024[82]).
- The shareholders of bilateral DFIs should revisit their regulatory status if it hinders their ability to take on currency risk exposure, given the questionable risk to their financial systems presented by development finance lenders. This would negate the need for the current

inefficient recourse to off-balance sheet vehicles to circumvent these constraints. Donor funds should continue to support credit enhancement mechanisms allowing for the increased availability of affordable local currency lending (e.g. the EBRD Local Currency Programme; see Box 3.4).

Unlock the potential of local financial actors

- Mobilisation initiatives should prioritise local financial actors as a principle, unless hard currency finance is necessary. This would not only provide a natural source of local currency funding but would also enhance the financial resilience of these actors through higher levels of diversification and provide them with increased exposure to their own economic growth.
- Donor countries should mandate MDBs and DFIs to adopt a structuring approach compatible with an originate-to-share model focused on local financial actors seeking to match local currency liabilities with local currency assets (e.g. project bonds). The focus should be on structuring instruments that can readily be bought by local institutional investors. This may involve structuring transactions with hard currency and local currency components. Shareholders should recognise that a departure from the status quo may have a financial cost.
- MDBs and DFIs should be encouraged to assess the efficacy of their local bank-intermediated lending model for leveraging local currency bank deposits to provide SMEs with the financing they require in the currency that makes financial sense for them.
- MDBs and DFIs should consider deploying resources to help specialist non-bank financial institutions to achieve bank status and access a vast and often under-remunerated source of local currency funding such as customer deposits.
- The provision of technical assistance and capacity building to local institutional investors is key to equip their teams with the technical know-how they require to increase their exposure to risk assets and through them to build their own economic growth. This should however not be construed as negating the need for MDBs and DFIs to structure transactions, as described in chapter 3.

Support existing mitigation and market-building initiatives

- Donor countries should consider focusing resources on existing initiatives that require support to scale. FrontClear (Box 3.12) and the Liquidity and Sustainability Facility are good examples of mechanisms that have been fully developed but require funding to deliver on their potential.

Long-term measures

Reform MDBs

- Review elements of MDBs' founding documents to facilitate local currency debt issuance and the deployment of local currency funding (e.g. Art III Sec 6 of the IFC agreement).

Develop local capital markets

- Acknowledge that it is not possible to "leapfrog" local capital market development to solve the local currency issue. Development actors must prioritise establishing the necessary infrastructure and liquidity to ensure local markets can support long-term, sustainable financing solutions in local currencies.

- Whilst ambitious, donors should work with MDBs and DFIs to expand their toolkit beyond direct lending and private equity to include more scalable instruments, such as bonds, which are some of the foundational building blocks of institutional investor portfolios. While bespoke lending caters to specific infrastructure needs, developing products that align with institutional investor preferences is crucial. As AAA-rated institutions, MDBs can especially leverage their counter-cyclical capacity to provide long-term financing solutions, including in local currency, helping to diversify risk and reduce the capital constraints faced by banks.
- Donor countries should commission a gap analysis of financial infrastructure levels in EMDEs. The gap analysis should also take into consideration the significant variations in the maturity of local capital markets in developing countries (using the market indices mentioned in Chapter 3), allowing donors to tailor their support based on specific market needs. By adopting a "scaling up vs. developing" approach, donors can calibrate concessionality levels accordingly—for instance, offering higher concessionality financing instruments in nascent or volatile markets and lower concessionality or loans in more advanced, mature markets. This would help donor countries to readily recognise the need to support market-building initiatives as they are presented to them, enabling a co-ordinated and systematic approach to creating an increasingly level playing field.
- Donor countries should engage with partner country governments to highlight the need for greater participation by local financial institutions in development finance assets, explore solutions for diversifying away from government securities and work towards a shift away from liquidity hoarding in their banking system. An optimal approach to achieving this is likely to involve donors, MDBs and DFIs co-operating and co-ordinating to ensure a joint up approach.
- Donor co-ordination with international organisations and regional initiatives is critical for aligning efforts to harmonise regulatory standards, improve cross-border co-operation, and integrate local currency markets. By working together, donors can establish robust frameworks that enhance market efficiency, boost liquidity, and attract investment, while sharing best practices and resources to strengthen financial stability and growth across participating regions that actively includes local currency financing.

If donors aim to achieve a more balanced distribution of currency risk in development finance and to make local currency finance more accessible and affordable, they will likely face arguments for maintaining the current approach. One common argument is that borrowers in developing countries often avoid local currency funding due to its high cost. However, if appropriately priced local, currency financing was available, many SMEs and infrastructure project sponsors might avoid taking unhedged hard currency loans, which essentially forces them to take on foreign exchange risk. This risk is often accepted due to a lack of viable alternatives or a misunderstanding of interest rate dynamics. Unlike commercial banks, development finance institutions have a responsibility to provide borrowers with what they genuinely need, even if it differs from what borrowers think they want.

Notes

[1] A local currency is typically a national currency issued by a central bank or monetary authority and can be spent in a particular geographical locality at participating organisations.

[2] For details see www.boad.org/en/boad-securitization/boad-titrisation-launches-a-fcfa-150-billion-operation/.

[3] See www.bayfront.sg/.

[4] A pari-passu basis is where private sector investors and DFIs/MDBs hold equal rights and priorities in the investment structure, meaning they share the same level of risk and receive returns proportionately based on their respective contributions without any preference given to one party over the other.

[5] ILX is an Amsterdam-based asset manager that invests for impact in SDGs and climate-focused private debt in emerging markets. It is a private credit fund that invests in an unlevered diversified portfolio of loan participations originated, structured and syndicated by multilateral development banks and global development finance institutions.

[6] See www.ifc.org/en/what-we-do/sector-expertise/syndicated-loans-and-mobilization/portfolio-syndications.

[7] A global depository receipt is a general name for a depositary receipt where a certificate issued by a depository bank, which purchases shares of foreign companies, creates a security on a local exchange backed by those GDRs and are generally denominated in USD, but theoretically may be denominated in any currency shares. They make it possible for foreign investors to trade in the issuing company's stock without the problems commonly associated with custody and settlement in foreign markets.

[8] It may be worth reflecting on the extent to which the role played by development finance exerts an influence on the funding and lending models of supported banks. Where it is as preponderant as in East Africa, it is implausible that this influence is not significant.

[9] Launched in 2020, the IFC Domestic Capital Markets Size, Access and Activity Index serves as a tool to assess and track the development of domestic capital markets across multiple dimensions. More can be found here: https://documents1.worldbank.org/curated/en/228291627375113518/pdf/Capital-Markets-Development-A-Primer-for-Policymakers.pdf.

[10] Launched in 2016, the IMF Financial Development Index covers dimensions such as the depth, access, and efficiency of financial institutions and markets. More can be found here: https://data.imf.org/?sk=f8032e80-b36c-43b1-ac26-493c5b1cd33b&sid=1480712464593.

[11] Launched on the initiative of the United Nations' Economic Commission for Africa (UNECA) with the support of, African Export-Import (Afrexim) Bank, The Bank of New York (BNY) Mellon, Citi, Eighteen East Capital and White & Case.

[12] ICMA bond market size data: https://www.icmagroup.org/market-practice-and-regulatory-policy/secondary-markets/bond-market-size/#African%20corporate%20bond%20markets.

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Annex A. Glossary

Buffer Escrow Funds	Reserve funds held in escrow to cover potential future liabilities or financial shortfalls, providing a financial safety net.
Capital Adequacy Frameworks	Regulatory standards and guidelines ensuring that financial institutions maintain sufficient capital to cover their risks and protect depositors.
Claims	Financial assets that include central bank bills and assets created on banks' balance sheets through repo transactions with central banks.
Cross-border Credit	Loans or credit facilities extended to borrowers in a different country, involving multiple currencies and regulatory environments.
De Jure	A Latin term meaning "by law," referring to practices that are legally recognised, regardless of whether they exist in practice.
Debêntures Incentivadas	Incentivised debentures in Brazil that offer tax benefits to investors to encourage funding for infrastructure projects.
Debt Service Coverage Ratio	A financial ratio that measures the cash available to meet debt obligations, calculated as net operating income divided by total debt service.
Derivatives Pipeline	A financial structure that connects international capital markets to local financial institutions through the use of derivative contracts.
Development financial institutions (DFI)	A financial institution that provides risk capital for economic development projects on a non-commercial basis.
Dollarised	The process by which a country adopts a foreign currency, typically the US dollar, either officially or unofficially, in place of its own domestic currency.
Ex-ante Risk Sharing	The distribution of risk among parties based on anticipated risks before any financial transactions or investments take place.
Exit-mobilisation	The process of attracting additional investors by demonstrating successful initial investments or exits from equity positions.
First-loss Risk	The initial risk absorbed by an investor or guarantor, often to protect other investors from potential losses.
Floor Value	The minimum value that an asset or financial instrument can reach, often established through contractual agreements or regulatory measures.

Foreign Exchange Interbank Markets	Markets where banks trade foreign currencies among themselves, setting exchange rates and providing liquidity.
Foreign Exchange Liquidity Facility	A financial arrangement designed to provide liquidity in foreign currency to financial institutions facing temporary shortfalls.
Fundo Clima	A climate fund in Brazil aimed at financing projects that reduce greenhouse gas emissions and promote climate resilience.
Multilateral Development Bank (MDB)	A multilateral bank is a financial institution that is owned and operated by multiple countries, typically governments, and is designed to provide financial and technical assistance to support economic development projects, particularly in developing or emerging economies.
Mobilisation Multiplier	A measure of the effectiveness of financial interventions in attracting additional private capital, typically expressed as a ratio.
Money Market Diagnostic	An assessment tool used to evaluate the functioning, structure, and efficiency of a country's money markets.
Net-net Basis	A method of reporting that accounts for all expenses and income, providing a clear picture of net financial performance.
Non-core Exposure	Financial exposures that are not central to an institution's main business activities, often involving higher risk or less familiarity.
Off-balance Sheet Vehicles	Entities or instruments used to keep certain assets or liabilities off a company's balance sheet, often for regulatory or risk management purposes.
Off-balance Sheet Warehouse Solution	A financing arrangement where assets are held off the balance sheet to improve liquidity and risk management.
Originate-to-share Model	A financial model where loans are originated by one entity and then shared or sold to other investors or institutions.
Pari-passu	A Latin term meaning "equal footing," referring to the equal treatment of creditors or investors in terms of repayment priority.
Passive Mobilisation	The indirect attraction of global investors to local markets without active solicitation or direct investment efforts.
Real Exchange Rate	The nominal exchange rate adjusted for differences in price levels between two countries, reflecting the true purchasing power.
Recapitalisation Cycles	Periodic processes of injecting capital into financial institutions to restore or enhance their capital adequacy and stability.
Repo agreement markets	Financial markets where securities are sold with an agreement to repurchase them at a later date, functioning as a form of short-term borrowing

Retail Note Programme	A programme that offers debt securities directly to retail investors, often with simplified terms and lower denominations.
Solvency II	A European Union directive that sets out regulatory requirements for insurance firms, focusing on capital adequacy, risk management, and governance.
Synthetic Local Currency Loans	Loans structured using derivatives to replicate the effects of a local currency loan, mitigating currency risk without actual currency exchange.
Synthetic Securitisation	A financial transaction where credit risk is transferred using derivatives rather than the sale of actual assets.
True Sale Securitisation	The process of transferring assets to a special purpose vehicle in a way that the sale is legally recognised, removing the assets from the originator's balance sheet.
Unhedged Currency Exposure	The risk associated with holding assets or liabilities in a foreign currency without using financial instruments to protect against exchange rate fluctuations.


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