Climate Investment Funds

CTF-SCF/TFC.9/7
October 19, 2012

Joint Meeting of the CTF and SCF Trust Fund Committees
Istanbul, Turkey
November 2, 2012

Agenda Item 3

USE OF LOCAL CURRENCIES IN CIF PROJECTS

PROPOSED DECISION

The joint meeting of the CTF-SCF Trust Fund Committees reviewed the document CTF-SCF/TFC.9/7, *Use of Local Currencies in CIF Projects,* and confirms its commitment to promoting private sector investments within the CIF countries.

More specifically, the meeting:

[Approves that the CTF and SCF Trust Funds bear the currency risk related to the repayments of private sector investments financed by the CTF or SCF Trust Funds that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers.]

or

[Approves that the SCF Trust Fund bears the currency risk related to the repayments of private sector investments financed by the SCF Trust Fund that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers. Further, approves that the CTF Trust Fund bears the currency risk related to the repayments of private sector investments financed by the CTF Trust Fund that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers only if a project meets one of the following criteria or other relevant criteria, taking into consideration other relevant criteria as determined by an approved Enterprise Risk Management Framework:

a) The swap market in the relevant developing country is insufficiently developed or mature to meet the project's need; or

b) More than (50%) of the debt financing for the project/program will be arranged in local currency; or

c) The costs of arranging a swap would be more than (1%) higher than minimum lending margin under the CTF guidelines.

Pending approval of an Enterprise Risk Management Framework, the CTF and SCF Trust Funds may bear the currency risk related to the repayments of private sector investments financed by the CTF or SCF Trust Funds that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers on case by case basis as long as the Trustee has confirmed any potential losses associated with such a project does not impact the Trustee's ability to fulfill its financial obligations vis-à-vis its contributors.]

I. BACKGROUND AND INTRODUCTION

1. As the foundation of economic growth, the private sector has a significant role to play in mitigation and adaptation. Private sector programs and projects are meant to contribute to overall market transformation by using Climate Investment Funds (CIF) to address market and regulatory barriers preventing investments in climate change from happening. Private sector investments benefit from concessional funds provided by the CIFs to address risks and cost barriers. The Multilateral Development Banks (MDBs) structure such funds alongside their own resources mostly in the form of concessional loans and guarantees, which allows investing in beyond "business as usual" and is fundamental to catalyzing investments that would otherwise not happen.

2. The operating currency of the Strategic Climate Fund (SCF) is US dollars. The Clean Technology Fund (CTF) has two operating currencies: US dollars and Euros. Under the current framework of the CIF Funds, funding decisions of the governing bodies are made in the operating currency (ies) of the relevant Trust Fund. In accordance with the relevant CIF documents[1], MDBs may deploy CIF funds to project developers and borrowers in any currency according to their own policies and procedures, subject to the MDB assuming any exchange rate risk. However, in practice, MDBs have found that it challenging to assume this foreign exchange rate risk on donor funded operations within their institutions.

3. As part of the lessons learned by MDBs during the first three years of CIF operations, it has become increasingly evident that projects under the investment plans, and for which concessional funds are needed, would significantly benefit from lending in local currency.

4. At their May 2012, the Joint CTF-SCF Trust Fund Committee meeting reviewed and approved the document entitled, *Proposal for Additional Tools and Instruments to Enhance Private Sector Investments in the CIF* (document CTF-SCF/TFC.8/8), and requested that the MDB Committee, in collaboration with the CIF Administrative Unit, prepare a paper that outlines local currency financing options for the CIF private sector operations[2].

5. This paper lays out the following:

   a) CIF experience in local currency financing to date

   b) Justification for deployment of CIF funds in local currency

   c) Proposed options going forward

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[1] Financing Products, Terms, and Review Procedures for Private Sector Operations in CTF (March 17, 2010), Pilot Program for Climate Resilience Financing Modalities (June 15, 2010), FIP Investment Criteria and Financing Modalities (June 29, 2010), and Scaling-up Renewable Energy Program Financing Modalities (November 8, 2010)

[2] Some members of the Trust Fund Committees have also requested that a Risk Management Framework be in place prior to enabling MDBs to transact in local currencies, in part so that they can more fully understand the risk to the overall portfolio if such instruments are used. The Trustee has contracted with Booz Allen to design and develop the Risk Management Framework, and will be presenting initial findings at the November 2012 TFC meetings.

d) Proposed revisions to the CIF programs' financing modalities – Annexes A and B

II. CIF EXPERIENCE IN LOCAL CURRENCY FINANCING

6. In practical terms, the inability of MDBs to deploy CIF funds in only hard currency[3] can often result in a mismatch for the borrower's balance sheet at the time of repayment, in large part because the borrower's project revenue streams are almost always in local currency while debt repayment outflows are in hard currency. The project/borrower is, therefore; exposed to an additional risk of local currency devaluation or depreciation. This additional currency risk can have a negative impact on the overall project credit worthiness at the time of financing, and may lead other private financiers/international financial institutions (IFIs) to be more reluctant to finance such projects without stringent and costly hedging requirements. This effect is amplified in the case of projects in countries where hedging products are either unavailable or the market is insufficiently developed to fully hedge the risk[4]. In addition, in these markets local sponsors are often less able to bear currency risk or cost, and are ill-prepared to manage the complexity of currency hedging arrangements. Furthermore, in some cases of financial-intermediated projects, local regulations forbid lending in foreign currencies to end borrowers. In these instances, financial intermediaries carry the foreign exchange (FX) risk, and where they might be prepared to absorb such risk, they would likely end up charging excessive margins to their clients to cover the FX risk (in addition to margins charged on project risk), thereby negating the impact of the concessionality element of the CIF funding.

7. As a result, the MDBs' inability to transact in local currency using CIF funds has led to three outcomes, as outlined below.

8. **Outcome 1 – Projects/Borrowers take on CIF funds hard currency exposure without hedging**. There have been cases in which the projects or borrowers themselves have taken on foreign exchange rate risk in order to access CTF funds. As of July 2012, four of seven IFC projects, all three of EBRD's projects, and the ADB's private sector project using CIF funds have been committed with projects or borrowers bearing the risk of currency fluctuations. These cases are typically in middle income countries where projects/borrowers are more likely to have the required financial strength and capacity to manage foreign exchange risk internally or in countries with relatively stable currencies. In such cases, MDBs have deployed CIF funds to those projects in hard currency, but with additional risk/transaction cost to the project/borrower to manage (and indirectly often increasing credit risk for other financiers). These additional transaction costs may include: additional processing time required to address required legal and regulatory approvals to borrow and repay hard currency and to open hard currency accounts, the cost of maintaining these accounts (including the extra costs to perfect lenders' security on additional borrower accounts, possibly offshore), and the cost of converting hard currency into local currency for project costs and converting local currency into hard currency for repayments, and accounting for such transactions. Sometimes, CIF is the only hard currency financier in these projects, adding complexity, transaction time and cost and risk to these projects which

[3] United States Dollars or Euros
[4] Often fragile or post-conflict states, or IDA countries

could reduce, and in some cases even negate, the financial benefits offered in terms of concessionality.

9. **Outcome 2 – Projects/Borrowers take on CIF hard currency but hedge into local currency exposure.** Where CIF funds have been swapped into local currency to hedge currency risk, the project/borrower incurs a swap cost. This has happened in three IFC projects. This swap cost varies depending on various factors, such as volatility of the currency, tenor, depth of the derivatives market, etc. For example, in a middle income country, the swap intermediation cost can be in the range of 30-70 bps of the debt amount. In some cases, swap costs could be higher than 100bps in the low developed countries such as in SCF countries. The additional swap costs thus increases the costs of the project/borrower, which in turn diminishes the level of concessionality and the desired impact of the CIF funds as originally outlined in the CIF approval documents. Instead, some, if not all, of the concessionality provided by the CIF in such projects is lost in transaction costs. Moreover, projects/borrowers are unable to hedge cashflows of unknown size and timing, hence they retain the residual foreign exchange risks for such cashflows (e.g., commitment fees, compensation payments in default scenarios), which affects the overall creditworthiness of the project/borrower and reduces private investor appetite for the project.

10. **Outcome 3 – Projects/Borrowers do not proceed.** Typically projects or borrowers that benefit most from concessional finance are smaller, local companies. .It is financially prudent for these projects/borrowers to borrow only in local currency to match their revenue stream and improve the project's overall credit risk profile to the CIF and to other investors. Many of these project sponsors/borrowers have a limited ability, or in some cases, the inability, to manage foreign exchange rate risk due to either a lack of capacity or the absence of local currency swap markets or the complexity of obtaining approvals for foreign exchange borrowing from regulatory authorities. In these cases, potential projects that could use CIF funds will likely not be able to proceed because swap markets do not exist, or the foreign exchange risk/cost to hedge outweigh the benefit of concessionality offered by the CIF. This outcome is likely in a number of SCF countries.

11. In summary, the inability to transact in local currency with CIF funds could result in:

a) Additional risk/cost to the project/borrower and to other financiers (often including CIF contributor bilateral development agencies);

b) Diminishing the intended impact that CIF funds could have when hedging costs are incurred (in effect eroding the concessionality of CIF funds through transaction costs); and

c) Projects not proceeding.

12. Consequently, opportunities for investing in beyond "business as usual" scenarios may be missed to support projects that have the potential to be highly developmental. This seems to be the case more often in the low developed countries and/or with small and less sophisticated sponsors that need support to leverage investment. In the experience of MDBs, the inability to

deploy CIF funds in local currency has in the past posed a constraint to use CIF funds for private sector investments.

III. Justification for CIF Local Currency Financing

13. Given the MDBs' experiences to date in deploying CIF funds, the benefits of allowing CIF funds to be deployed in local currency would achieve the following benefits:

a) Allows local borrowers to match the currency of their revenues with liabilities.

b) Enhances the creditworthiness of the project/borrower, giving comfort to local banks and mobilizing further private sector funding, and consequently improve the CIF investment.

c) Maintains the intended level of concessionality by removing the burden of transaction costs that erode said concessionality.

d) Removes the cost and risk burden of FX exposure from the client, and the MDB implementing the project. This is consistent with the concessional purpose of CIF funds, and will support efforts to catalyze projects in high climate value sectors that would not otherwise happen.

e) Helps indirectly create a market for local currency financing.

f) The flexibility for MDBs to lend CIF funds to climate change projects in local currency will allow the MDBs to support projects in the desired markets where CIF funds are needed the most, and accelerate the deployment of CIF funds. In short, the ability to lend in local currency will allow MDBs to deploy CIF funds more effectively and efficiently, thereby enabling CIF to achieve its intended impact of scaling up climate change investments by mobilizing the private sector.

14. In certain scenarios, the inability to lend in local currency could also pose reputational risks for the MDBs and the CIF. For example, in a scenario where CIF is the only hard currency financier and there has been a significant devaluation or depreciation of the local currency, CIF may be the only financier seeking to call an event of default, enforce security or causing the borrower to go into bankruptcy if the borrower is unable to meet hard currency commitments due to the devaluation. Other lenders may view this as impeding on customary inter-creditor rights and recoveries.

15. While the local currency financing provides many benefits to the program, the proposal could expose the CTF and the SCF Trust Funds to losses related to the foreign exchange rate fluctuations of the local currencies that are being deployed by the MDBs. This in turn would mean that the fund could have insufficient liquid assets (cash) to meet the timely payments of obligations unless mitigation measures are put in place.

IV. PROPOSED OPTIONS

16. To achieve the benefits outlined in Section III, the MDB Committee would propose the following options to the joint meeting of the CTF and SCF Trust Fund Committees for adoption of local currency financing under the CIF programs:

17. **Option 1**: Agree that the CTF and SCF Trust Funds bear the currency risk related to the repayments of private sector investments financed by the CTF or SCF Trust Funds that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers.

18. **Option 2**: Agree that the SCF Trust Fund bears the currency risk related to the repayments of private sector investments financed by the SCF Trust Fund that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers. Further, agree that the CTF Trust Fund bears the currency risk related to the repayments of private sector investments financed by the CTF Trust Fund that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers only if a project meets one of the following criteria or other relevant criteria, taking into consideration other relevant criteria as determined by an approved Enterprise Risk Management Framework[5]:

a) The swap market in the relevant developing country is insufficiently developed or mature to meet the project's needs (e.g., insufficient liquidity, a limited number of swap counterparties, or the inability of the swap arrangements to match the tenor of the CIF loan); or

b) More than [50%] of the debt financing for the project/program will be arranged in local currency (to ensure harmonization of CTF funds with the other lenders, prevent inter-creditor issues and negotiations on acceleration events); or

c) The costs of arranging a swap would be more than [1%] higher than minimum lending margin under the CTF guidelines (i.e., 1.75%).

19. Pending approval of an Enterprise Risk Management Framework, the CTF and SCF Trust Funds may bear the currency risk related to the repayments of private sector investments financed by the CTF or SCF Trust Funds that are deployed by the MDBs in local currency to meet the needs of local projects/borrowers on case by case basis as long as the Trustee has confirmed any potential losses associated with such a project does not impact the Trustee’s ability to fulfill its financial obligations vis-à-vis its contributors.

20. While the benefits of allowing MDBs to deploy CIF funds in local currencies have been broadly outlined in Section III, there are clearly costs and risks associated with providing such flexibility. With this flexibility, CTF and SCT Trust Funds will be exposed to the risk of currency fluctuations related to the repayments of investments deployed by MDBs in local currency. In an extreme case, the CTF and SCF Trust Fund may bear losses as a result of

[5] Under Option 2, the MDB Committee is proposing to allow local currency flexibility for all SCF programs/projects given the nature of most countries participating in those programs (eg: LICs, IDA)

currency depreciation on such transactions. However, it will also be possible that CTF and SCF Trust Funds experience financial gains should the lending currencies appreciate during the life of the repayment schedules of projects. The ongoing and parallel work to develop and implement an Enterprise Risk Management Framework will help to develop risk mitigation strategies to offset potential financial losses related to either Option above. See Annex B for an explanation of the impacts of local currency appreciation or depreciation on reflows to the CIF Trust Funds.

V. POSSIBLE INTERIM OPTIONS TO MANAGE THE CURRENCY RISK

21. There are several possible options, as outlined below, to manage currency risks arising from local currency lending.

a) **Treat local currency loans as reimbursable grants.** Local currency loans could be thought of as reimbursable grants (i.e. an additional financing product). The funds that would be used in this case would be sourced from the available grant funding and would not be expected to be returned. However, this means that loan contributions or capital contributions would not be used for this purpose thus removing the risk of full non-repayment due to foreign exchange losses.

b) **Expand the current Foreign Exchange Reserve.** The Trustee could expand the foreign exchange reserve to account for the risk of foreign exchange losses arising from local currency lending. This option could manage the risk in the interim; however, it would not mitigate the risk.

c) **Request the Trustee to explore hedging mechanisms to help mitigate the risk of financial losses arising from local currency lending.** This option would require in-depth analysis of the World Bank's Treasury Department and could be very costly to implement and manage if multiple currencies are involved.

22. Options (a) and (b) can both be done in the absence of a fully implemented risk management framework. Option (c) may require the implementation of a risk management framework which integrates this approach. Given the urgency for this flexibility, MDBs would support a sequenced approach which allows the Trustee to manage currency risk exposure in the manners outlined in either (a) or (b) above, and once a more thorough risk management framework is implemented, the Trustee could move to employing hedging mechanisms with World Bank's Treasury Department.

VI. PROPOSED REVISIONS TO THE RELEVANT DOCUMENTS.

23. In the event the joint meeting of the CTF and the SCF Trust Fund Committees agrees to allow for CIF lending in local currency, the MDB Committee, in collaboration with the CIF Administrative Unit, would propose amendments to the CTF, FIP, PPCR, and SREP financing modalities documents as listed in Annex A.

ANNEX A

For the CTF, document CTF/TFC.5/9*, "Financing Products, Terms, and Review Procedures for Private Sector Operations"*

Paragraph 22: Unless otherwise approved by the Trust Fund Committee in the CTF proposal, CTF funds will be allocated by the Trustee to the MDB, and be repayable to the Trustee, in United States Dollars or Euros. However, MDBs may denominate individual financing provided by them to the beneficiaries according to their own policies and procedures, subject to the MDB assuming any exchange rate risk.

Amended Paragraph 22: Unless otherwise approved by the Trust Fund Committee in the CTF proposal, CTF funds will be allocated by the Trustee to the MDB, and be repayable to the Trustee, in United States Dollars or Euros. However, MDBs may denominate individual financing provided by them to the beneficiaries in local currency according to their own policies and procedures for projects that require such funding. If such a need for local currency financing is anticipated within a program or a project, the MDB will indicate the need for local currency financing at the time it presents the CTF project or program proposal for review and approval by the CTF Trust Fund Committee. Such local currency financing will be repayable to the Trustee in the currency of financing with the CTF Trust Fund bearing foreign exchange rate risk.

Footnote 7: It should be noted that not allowing CTF funds to be on-lent in local currencies reduces the flexibility of the funds and increases the costs and complexity of the project, as currency risk must be hedged. It should further be noted that most of the MDBs are prevented by their guidelines to incur such exchange rate risk.

To delete note 7.

For the PPCR, document, "*Pilot Program for Climate Resilience Financing Modalities*" (June 15, 2010)

Paragraph 12: A number of financing products (such as grants, concessional loans and guarantees) will be available under the PPCR. All PPCR financing will be denominated in US dollars.

Amended Paragraph 12: A number of financing products (such as grants, concessional loans and guarantees) will be available under the PPCR. All PPCR funding will be approved by the PPCR sub-committee and allocated by the Trustee to the MDB in United State dollars. However, the MDBs may denominate individual financing provided by them to the beneficiaries in local currency for private sector projects that require such funding. If such a need for local currency financing is anticipated within a program or a project, the MDB will indicate the need for local currency financing at the time it presents the PPCR project or program proposal for review and approval by the PPCR Sub-Committee. Such local currency financing will be repayable to the Trustee in the currency of financing with the SCF Trust Fund bearing foreign exchange rate risk.

For FIP, document, "*FIP Investment Criteria and Financing Modalities"* (June 29, 2010)

Paragraph 38: A number of financing products (grants, concessional finance, guarantees and equity) will be available under the FIP, all of which will include a grant element tailored to the additional cost of the investment, or the risk premium required, in order to make the investment viable. These products could include concessional finance in the form of grants, and concessional loans with a significant grant element, guarantees as well as equity, or a combination of these. The grant element will be tailored to provide the appropriate incentive to facilitate the scaled up deployment of forestry investments or investments positively impacting forest ecosystems. To incentivize transformational change, grants and loans may be disbursed based on mutually agreed milestones or results as outlined in the Investment Strategy. All FIP financing will be denominated in US Dollars.

Amended Paragraph 38: A number of financing products (grants, concessional finance, guarantees and equity) will be available under the FIP, all of which will include a grant element tailored to the additional cost of the investment, or the risk premium required, in order to make the investment viable. These products could include concessional finance in the form of grants, and concessional loans with a significant grant element, guarantees as well as equity, or a combination of these. The grant element will be tailored to provide the appropriate incentive to facilitate the scaled up deployment of forestry investments or investments positively impacting forest ecosystems. To incentivize transformational change, grants and loans may be disbursed based on mutually agreed milestones or results as outlined in the Investment Strategy.

New Paragraph 79: All FIP funding will be approved by the FIP Sub-Committee and allocated by the Trustee to the MDB in United State dollars. However, the MDBs may denominate individual financing provided by them to the beneficiaries in local currency for private sector projects that require such funding. If such a need for local currency financing is anticipated within a program or a project, the MDB will indicate the need for local currency financing at the time it presents the FIP project or program proposal for review and approval by the FIP Sub-Committee. Such local currency financing will be repayable to the Trustee in the currency of financing with the SCF Trust Fund bearing foreign exchange rate risk.

Paragraph 89 (b): The following requirements will apply to all financing products financed by the FIP:
(b) Allocations by the FIP Sub-Committee will be denominated in United States Dollars. However, MDBs may denominate individual financing provided by them to the beneficiaries according to their own policies and procedures, subject to the MDB assuming any exchange rate risk;

Amended Paragraph 89 (b): Allocations by the FIP Sub-Committee will be denominated in United States Dollars. However, MDBs may denominate individual financing provided by them to the beneficiaries in local currency for private sector projects that require such funding. If such a need for local currency financing is anticipated within a program or a project, the MDB will indicate the need for local currency financing at the time it presents the FIP project or program proposal for review and approval by the FIP Sub- Committee. Such local currency financing will be repayable to the Trustee in the currency of financing with the SCF Trust Fund bearing foreign exchange rate risk.

For SREP, document, "*Scaling-up Renewable Energy Program Financing Modalities"* (November 8, 2010)

Paragraph 5: A number of financing products (such as grants, contingent grants or loans, concessional loans, guarantees and equity) will be available under the SREP. All SREP financing will be denominated in US Dollars. It will be important to ensure that concessional terms of SREP financing do not displace investments that might have taken place anyway using commercial or regular MDB borrowing or guarantees, or other carbon finance mechanisms. SREP financing should be designed to minimize market distortions and potential disincentives to private investment.

Amended Paragraph 5: A number of financing products (such as grants, contingent grants or loans, concessional loans and equity) will be available under the SREP. All SREP funding will be approved by the FIP Sub-Committee and allocated by the Trustee to the MDB in United State dollars. However, the MDBs may denominate individual financing provided by them to the beneficiaries in local currency for private sector projects that require such funding. If such a need for local currency financing is anticipated within a program or a project, the MDB will indicate the need for local currency financing at the time it presents the SREP project or program proposal for review and approval by the SREP Sub- Committee. Such local currency financing will be repayable to the Trustee in the currency of financing with the SCF Trust Fund bearing foreign exchange rate risk. Trust Fund

ANNEX B

1. The below scenarios illustrate how the local currency (LC) exchange rate movements against the US dollar (US$) affect reflows to the CIF funds if deployed in local currency.

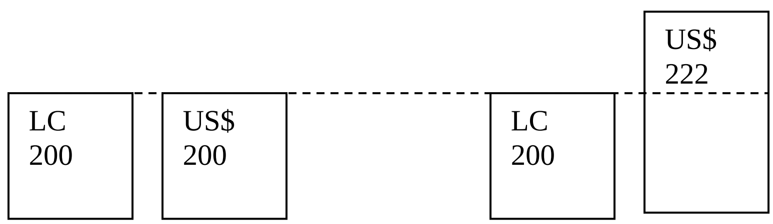
2. The example below illustrates the impact of currency appreciation or depreciation on the ability to repay hard currency (dollar) obligations. In this example, the project requires CIF local currency financing worth US$200 equivalent at the time of disbursement.

3. **<u>Scenario 1 - Currency Appreciation:</u>** At the time of disbursement of the project, 1 LC unit (LC1) is equal to US$1. The MDB acting as implementing entity of the CIF would convert CIF funds at the equivalent local currency amount. In this example, a CIF local currency loan of US$200 is worth LC200.

4. At the date of repayment, if the local currency has appreciated relative to the US dollar, for example, $1 is worth LC0.9, then, the client will repay to the MDB, acting as implementing entity of the CIF, LC200 which is now equivalent to $222. See illustration below:

<u>Repayment Scenario 1 – local currency appreciation</u>

At Disbursement **Date of Payment**



LC 1= US$ 1 **LC 0.9 = US$ 1**

5. In such case, the MDB acting as implementing entity of the CIF will transfer the amount in local back to the CIF Trustee and the Trustee will convert the funds into USD upon receipt. CIF funds would receive a benefit ($22) as a result of the currency appreciation between the time of commitment and the time of repayment[6].

6. **<u>Scenario 2 – Currency Depreciation:</u>** using the same example as above (eg: 1 LC = 1 US$) and the local currency has depreciated relative to the US dollar, for example US$1 is worth one LC1.1, then the client will repay to the MDB acting as implementing entity of the CIF, LC200 which is now equivalent to US$182 . See illustration below:

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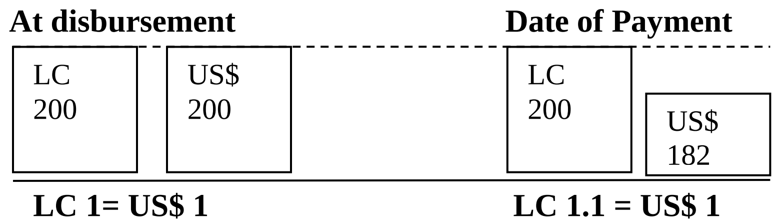
[6] This example illustrates a single repayment event. If the local currency continues to appreciate over time, similar monetary benefits will continue to accrue to the CIF Trustee throughout the tenor of the loan (or if adverse currency movements are observed subsequently to that repayment, the accrued benefits can also make up future shortfalls).

Repayment Scenario 2 – local currency depreciation



7. In such case, the MDB acting as implementing entity of the CIF will remit the amount in local currency to the CIF Trustee and the Trustee will convert the funds into USD upon receipt. CIF funds would in this example incur a loss ($18) against the original hard currency amount committed. Like in Example 1, future repayments may incur a loss or a gain, depending on currency movements.

8. The local currency exchange rate movements are subject to various factors including the volatility of the currency, tenor, depth of the derivatives markets etc. As such, the above example is simply to illustrate the hypothetical impact on CIF funds as a result of currency appreciation or depreciation.