Local Currency Solution for Multilateral Development Bank Portfolio Transfer:

Feasibility Study

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1.
Executive summary

Introduction

In June 2023, FSD Africa was awarded funding from the MDB Challenge Fund to develop a project focused on a 'Local Currency Solution for Multilateral Development Bank (MDB) Portfolio Transfer' (the project). FSD Africa's proposed solution aims to empower MDBs and Development Finance Institutions (DFIs) to provide more financing to developing and emerging economies. This is aligned with the recommendations of the G20 Independent Review of MDBs' Capital Adequacy Framework (CAF) report. The focus area is on promoting financial innovation and development of new instruments to catalyse private investment.

The purpose of this study is to explore the potential for transferring asset portfolios funded by multilateral development banks (MDBs) to domestic institutional investors in Africa through a local currency solution.

The primary aim is to expand the scope of MDBs' investments by freeing up capital while benefiting local institutional investors and capital market development and reducing the foreign exchange risk of those benefiting from the investments funded by MDBs.

The study focuses on markets in East and West Africa with relatively deep institutional investor bases, including Kenya, Tanzania, Uganda, Ghana, Nigeria, Cote d'Ivoire, and Senegal.

Assessment of eligible MDB assets and engagements with MDBs/DFIs

The project team built its findings on desktop research to identify a suitable portfolio of MDB assets. This focused primarily on non-sovereign loans funded on private sector terms in the selected markets, originated by the African Development Bank (AfDB), the International Finance Corporation (IFC) and the European Investment Bank (EIB).

Screening criteria were applied to IFC and AfDB portfolios, to identify loans made in the selected countries on private sector terms, with a minimum remaining maturity of three years. Preliminary estimates identified assets eligible for transfer of $1,571 million from the IFC assets and $882 million from the AfDB. Eligibility for an additional US$5,284 million of IFC and AfDB projects was subject to accessing yet undisclosed information on the type of financing instrument, tenor and maturity. The study found that publicly available data on MDB portfolios is often incomplete and inconsistent. This lack of standardised information hampers accurate assessment of MDB exposures and identification of potential assets for transfer.

While there is a central database - the GEMS database - where MDB investments are recorded, the level and transparency of disclosure are uneven. Expanding and standardising data access would considerably facilitate the selection and tailoring of asset to be transferred.

Market sounding with pension funds

According to the Blended Finance Taskforce, current domestic capital under management in Africa is estimated at US$2.4 trillion. This asset base is expected to grow by about 6% per annum to US$6.4 trillion in 20240. The team engaged fund managers from Kenya, Ghana, Nigeria, Uganda, Tanzania and WAEMU cumulatively managing approximately US$35 billion assets under management (AUM). The team also engaged regulators of institutional investors and reviewed investment regulations/guidelines and their restrictions on the ability of the fund managers to invest in alternative assets, regionally and internationally. Considering these limitations and the AUMs,

pension funds could allocate up to US$8.7 billion to the portfolio transfer vehicle across the seven countries if the investment vehicle(s) were locally domiciled. Were the vehicle to be offshore, the potential allocation would decrease to US$6.6 billion.

Engagement with institutional investors, especially pension funds, confirmed significant interest in investing in assets transferred from MDBs, with the following key themes emerging:

- Institutional investors expressed considerable interest in diversifying their investment portfolios to include alternative asset classes.
- Infrastructure projects present a natural investment opportunity for institutional investors, given that their need for long-term funding matches the maturity profile of commitments made by institutional investors.
- While guarantees would provide extra comfort to institutional investors, they do not consider them as a requirement. Recent newly published GEMs data confirm high recovery rates in sub-Saharan Africa, challenging perceptions of high risk and supporting the notion that asset transfers without guarantees are feasible.
- It would be possible to establish pools of transferred assets that are ESG compliant, making asset transfers more attractive to institutional investors aspiring to climate-focused objectives.
- Across the selected markets, pension regulators have set investment allocation guidelines, but thresholds set are not a major barrier to the portfolio diversification to include alternative assets as investments in alternative assets are currently below the limits set by national authorities.

Implications for structuring the investment vehicle

This study found several key considerations important to the institutional structure of asset transfers. Among these are pooling the transfer of assets across several MDBs, considering participation agreements rather than full ownership transfer, the extent to which investors can place reliance on the MDB' preferred creditor status and possible use of first loss guarantees.

Addressing currency mismatch risks is crucial. Three approaches were considered:

- Less-developed countries could refinance MDB loans locally, though this is unlikely to be an acceptable approach, because it would deplete the foreign exchange reserves of those countries where asset transfers take place.
- MDBs could issue local currency securities to mitigate currency risks and deepen local markets, though this raises challenges in managing liquidity on local markets.
- Local institutional investors could co-invest with MDBs on a project-by-project basis, matching currency exposures to project needs.

Recent estimates reveal that US$8.69 billion of pension assets could be allocated to the portfolio transfer vehicle across the selected countries were the investment vehicle to be locally domiciled.

Identifying the institutional setup of the investment vehicle

FSD Africa intends to establish a permanent vehicle for asset transfers and to appoint a Fund Manager to oversee this task. FSD Africa has issued a call for expressions of interest from fund managers interested in this role. As part of its developmental mandate, FSD Africa intends to co-create the Fund with the Fund Manager, leveraging its relationships with institutional investors and pension supervisors.

Risks and challenges to be addressed include:

- promoting greater information exchange on MDBs' exposures to establish a project portfolio suitable for transfer,
- defining the roles and responsibilities of the Fund Manager,
- ascertaining institutional investor demand, and
- considering the need for guarantees/wraps.

Next steps

This feasibility study is to be presented at the 2024 AfDB Annual Meeting with a view to seeking endorsement for the proposed approach.

Following this, a Fund Manager will be selected and onboarded, to lead the design of the legal, institutional, and procedural processes for the development of the proposed special purpose vehicle. These tasks will also include the development of a business plan to attract investors.

The Fund will be implemented in phases, beginning with a limited pilot phase. Lessons from this phase will be considered in subsequent iterations of the fund model as it expands. Ongoing engagement with stakeholders, including MDBs, institutional investors, regulators, and industry practitioners, will be crucial for refining the approach and maximising its impact.

2. Introduction

Feasibility study overview and rationale

In June 2023, FSD Africa was awarded funding from the MDB Challenge Fund to develop a project focused on a 'Local Currency Solution for Multilateral Development Bank (MDB) Portfolio Transfer' (the project). FSD Africa's proposed solution aims to empower MDBs and Development Finance Institutions (DFIs) to provide more financing to developing and emerging economies. This is aligned with the recommendations of the G20 Independent Review of MDBs' Capital Adequacy Framework (CAF) report. The focus area is on promoting financial innovation and development of new instruments to catalyse private investment.

The purpose of this feasibility study is to explore the potential for transferring portfolios funded by multilateral development banks (MDBs) to domestic institutional investors through a local currency solution.

The working hypothesis is that by transferring parts of MDBs' portfolios to local institutional investors in emerging markets, MDB capital will be freed up so that the MDBs can expand the scope of their investments. At the same time, the transfer of investment assets in local currency to local institutional investors will benefit the development of those capital markets and reduce exposure to foreign exchange risk for local users.

The MDBs can recycle the resulting liquidity into new projects, leveraging their underwriting capabilities and enhancing their development effectiveness. By providing project funding in local currency, the process of asset transfer will also enhance the affordability for local users/off-takers. Projects chosen for local currency financing can target priority longer-term investment needs, such as investments that assuage climate risk, and could be focused on sectors, such as renewable energy, infrastructure and urban development, including housing.

Furthermore, this will deepen domestic capital markets in smaller emerging markets, by providing institutional investors, such as pension funds, greater opportunity to diversify and invest in highly rated assets.

This feasibility study focuses on markets in East Africa and West Africa with a relatively deep institutional investor base. These include Kenya, Tanzania and Uganda in East Africa, and Ghana, Nigeria, Cote d'Ivoire and Senegal in West Africa.

To effectively utilise the headroom created by the partial transfer of their assets to the private sector, MDBs will need to increase the size and pace with which they create their project pipelines, possibly placing greater emphasis on preparing more standardised and easily replicable investments.

The objectives outlined above follow those outlined in Recommendation 3B in the G20's ***Independent Review of MDBs' Capital Adequacy Frameworks*** (2022), as summarised in Box 1 below.

Box 1: Scaling up the transfer of risks embedded in MDB loan portfolios[1]

MDBs have a significant comparative advantage in investment origination, including high standards, project preparation skills and technical assistance. However, the developmental benefits of holding loan assets on their balance sheets for long periods are less clear. There is a logic to shifting a part of MDB portfolios from an originate-to-hold model to an originate-and-distribute model. Such a shift can be accomplished through outright sales, or by transferring risk to the private sector through insurance or synthetic securitisation. Such transactions can be accomplished at scale for portfolios, not just individual loans, freeing up capital for new lending.

MDBs remain the lender of record and administer the loans even after some part of the risk has been transferred. They remain responsible for overseeing project implementation and ensuring that impact, ESG objectives and standards are met for the entire life of the project.

Risk transfers can be undertaken for both sovereign and non-sovereign assets. For sovereign assets, however, low (below-market) margins may in many cases necessitate additional public subsidies to boost returns to levels attractive to private risk off-takers.

Lessons from previous experiences

Several MDBs, primarily insurance companies and pension funds, have on-going programmes that facilitate asset transfers to private investors. Hitherto, these efforts have focused on transferring assets to institutional investors in advanced markets. This section summarises these experiences – further details can be found in Annex 1.

Similar to the proposal being explored here, these efforts have focused on the private sector (non-sovereign) lending of the MDBs. This is primarily because such lending takes place on market terms, making it easier to test the appetite of institutional investors for asset transfers.

Syndication of MDB asset portfolios
Since 2016, the Independent Finance Corporation (IFC) has undertaken regular transfers of non-sovereign assets through its Managed Co-Lending Portfolio Programme (MCPP).[2] The programme allows large institutional investors[3] to benefit from co-investing in projects involving lending to infrastructure programmes and to financial institutions in developing countries, building on the IFC's deal origination and approval, and loan management. Several other MDBs, such as the Asian Development Bank (ADB) and the Eastern and Southern African Trade and Development Bank (TDB), have established programmes for private placements similar to the transactions under the IFC's MCPP.

Synthetic securitisation
The AfDB pioneered an approach involving synthetic securitisation under its Room to Run (R2R) transaction launched in 2018. While the R2R programme provides transparency, the size of the transfer was impacted by the securitisation process, whereby AfDB retained about 70% of the reference portfolio. The requirements of the securitisation process are onerous, both in terms of structuring the transaction and the cost of providing loss and guarantee coverage. See further discussion on the R2R programme in Annex 1.

A private sector initiative
In January 2022 ILX, a fund manager sponsored by the Dutch pension industry, launched a fund that co-invests with a broad range of leading MDBs and other development finance institutions (DFIs) that have experience in direct investments in line with the SDGs in emerging and frontier markets.

[1] Extract from G20's ***Independent Review of MDBs' Capital Adequacy Frameworks*** (2022), page 35.
[2] See description in https://www.ifc.org/content/dam/ifc/doc/mgrt/mcpp-infrastructure-final-10-5-2016.pdf
[3] By 2020, six large global insurance companies had taken part in the MCPP: AXA XL, Aspen Insurance, Everest Insurance, Liberty Specialty Markets, Munich Re and Tokio Marine HCC. The total funds raised amounted to US$10 billion.

Seventy-five percent of ILX's investments are in new loans being originated by MDBs and DFIs, while the remainder is invested in the refinancing of existing loans. Investors purchasing loan participation agreements issued by ILX denominated in US dollars are primarily European pension funds.

Core elements of FSD Africa's approach

While lessons can be learnt from the experiences described above, to date the approach taken by MDBs has been somewhat experimental. FSD Africa aims to design an approach that is systematic and thereby supports more widespread adoption. FSD Africa's approach also focuses on local currency financing with a view to deepening domestic capital markets. As explained below, this feasibility study encompasses the first phase of the two-phase approach adopted by FSD Africa:

- **Phase 1: This feasibility study.** Explore the feasibility of the proposed local currency solution for MDB portfolio transfer, including determining an appropriate portfolio transfer model/vehicle(s), sounding markets and building support for the identified model(s) among MDBs, local investors, industry practitioners and regulators.
- **Phase 2: Piloting the portfolio transfer model/vehicle(s).** Informed by the findings of the feasibility study, and subject to the availability of funding, pilot the portfolio transfer model/vehicle(s) identified in the feasibility study. The intention from the outset is to develop a structure that, once tested, can be applied more broadly.

In this context, the following describes the rationale for the core parameters to be applied in designing the proposed local currency solution for MDB portfolio transfers:

- *Focus on transfer of MDB assets financed on market/non-concessional (IFC-type) terms.* These assets yield a market return equivalent to those offered by other borrowers. It is not the intention to limit the scope of the portfolio transfer process to those financed on market terms, as the case for freeing up MDB capital through portfolio transfers is also strong for those MDB assets financed on IBRD and even IDA-type terms.[4] However, where assets are financed on concessional terms, it will be necessary to compensate private investors for the shortfall in yield.
- *Assets to be included in the portfolio transfer.* The intention is to transfer portfolios that primarily consist of 'brownfield' (already operational) or secondary assets, for the most part encompassing investments in infrastructure and loans to financial intermediaries with an initial outstanding minimum tenor of three years. The cut-off for minimum tenor is intended to ensure that transferred assets can provide capital relief for a significant period (before they are fully amortised). Once assets transferred as part of the portfolio transfer become fully amortised, further assets will need to be transferred to replenish the value of the pool of transferred assets.
- *Encouraging MDBs to finance their lending in local currencies.* As discussed further in this study, it may prove challenging to refinance secondary US-dollar-denominated assets in local currencies, and when portfolio transfers are undertaken in local currency, it may be expedient to rely on funding undertaken by MDBs through issuance of securities in local currencies relying to a greater extent on the transfer of primary assets. One challenge for MDBs issuing securities denominated in local currencies is that such issuances would be larger than the size of the project pipeline. As a result, MDBs would face market risk, as they would need to invest part of the proceeds of their issuance of securities locally before being able to deploy the resources raised.
- *Targeting markets with a relatively deep institutional investor base.* Given the intention is to transfer MDB assets to the private sector with a view to deepening local capital markets, the feasibility study will focus on those African markets in East Africa and West Africa with a

[4] The 'subsidy' required to make loans provided on concessional terms attractive to private investors would provide capital relief to MDBs at a fraction of the cost of making a new capital injection.

relatively deep institutional investor base. The sub-Saharan countries selected for the pilot are Kenya, Tanzania and Uganda in East Africa, and Ghana, Nigeria, Cote d'Ivoire and Senegal in West Africa.[5]

- *Pooling assets across MDBs to create critical mass.* The intention is to establish a process (described in subsequent sections) whereby assets from various MDBs are assembled to form the basis for portfolio transfer to institutional investors. Involving various MDBs has the advantage of increasing the pool of eligible assets within one country or across countries within the same sub-region (e.g. the East African Community (EAC), Southern African Development Community (SADC) and West African Economic and Monetary Union (WAEMU)), which is necessary if institutional investors are to participate in investments denominated in local currency or in a currency within a sub-region.
- *Making portfolio transfers more attractive to institutional investors.* By specifying those project investment objectives eligible for inclusion in portfolio transfers, it may be possible to increase the attractiveness of transferred assets to institutional investors. This could also encourage MDBs to augment the financing of projects addressing the preferred designated objectives, e.g. addressing climate risk and urban development.

[5] A subsequent project (not encompassed by this proposal) could review mechanisms for undertaking similar transfer of MDB assets that would work to the benefit of smaller African markets.

3.
Assessment of eligible MDB assets and engagements with MDBs/DFIs

Identification of MDB assets suitable for transfer

To identify an eligible and suitable portfolio of existing assets for transfer, the project team conducted desktop research to assess assets held by MDBs. These assets are non-sovereign loans made by MDBs on private sector terms in Kenya, Nigeria, Ghana, Tanzania, Uganda, Cote d'Ivoire and Senegal, across all sectors. The project team assessed assets held by the AfDB, the IFC and the European Investment Bank (EIB), which have large mandates across Africa. The desktop research gathered information from various sources, including annual and periodic reports published by MDBs, project information disclosed on their websites, data from the International Aid Transparency Initiative (IATI),[6] the Global Emerging Markets (GEMs) Risk database,[7] and through triangulation of investee disclosures in financial statements. This multi-faceted approach ensured comprehensive and reliable data collection.

Preliminary findings

Discussions with the EIB revealed that it does not have a historical portfolio in Africa and only started investing in Africa in 2023. The EIB's current portfolio of US$4.55 billion is essentially a fund that it manages on behalf of the EU. It would be very difficult to transfer or securitise this, as it would require EU parliamentary approval by all member countries. In addition, the returns on this portfolio are not fully commercial as they reflect the EIB's lower cost of funding as an MDB, which is passed on to clients coupled with an EU guarantee. Furthermore, as investments wind down, the funds are returned to the EU Commission to meet the EU's budget.

The new portfolio on the EIB's balance sheet in Africa is fully guaranteed by the EU (only African investments are offered this treatment), and thus the EIB does not reflect a capital charge for its investments in Africa. Therefore, there is no incentive to transfer the portfolio.

Discussions with the Development Bank of Southern Africa (DBSA) and the TDB, both of which have undertaken private placements involving transfer of non-sovereign assets, demonstrated interest from these regional MDBs in recycling capital. Though data on projects flows for the TDB is not publicly available, an analysis of its financial statements shows that 66% of its US$ 1.447 million trade finance and project loans are provided to sovereigns. However, discussions with the TDB revealed that part of its lending to sovereigns is on commercial rather than concessional terms. The DBSA, which has a sub-Saharan Africa mandate, invests in both the public and private sectors at commercial rates (except when it comes to South Africa municipal loans). These investments are made in US dollars, euros and South African rands (ZAR) with two-thirds of the portfolio being denominated in ZAR.

An initial screening of information made available by the IFC and AfDB was based on the screening criteria in Table 1.

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[6] https://d-portal.org/ctrack.html#view=search
[7] https://www.gemsriskdatabase.org/

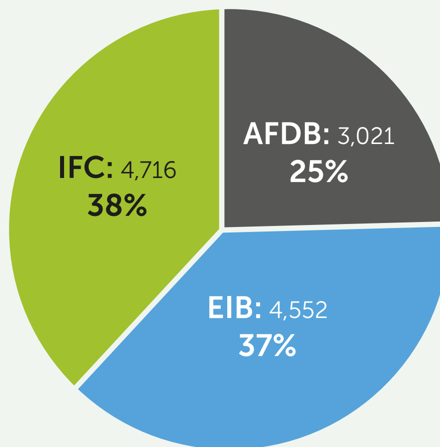
Table 1: Screening criteria

Countries:	Kenya, Uganda, Tanzania, Senegal, Cote d'Ivoire, Nigeria, Ghana
MDBs:	AfDB and IFC
Sovereign vs non-sovereign:	Non-sovereign project only (private sector terms)
Finance type:	Loans only
Sectors:	All
Project end:	Projects conceptualised from 2010 and with a minimum of 3 years before maturity as of 2023 (2026 onwards)

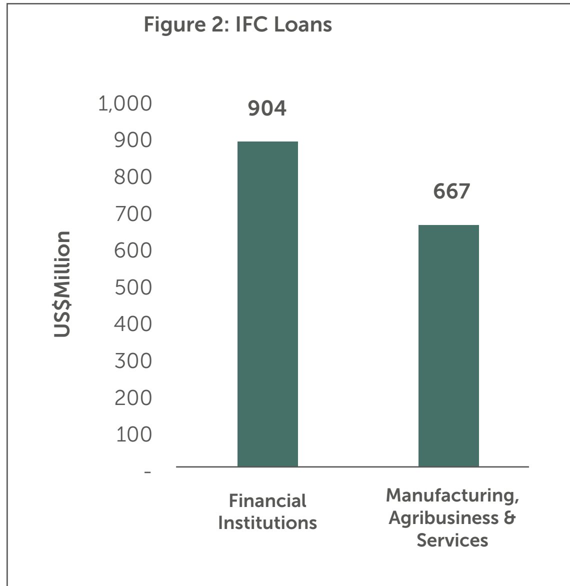
This screening restricts the eligible portfolio to:

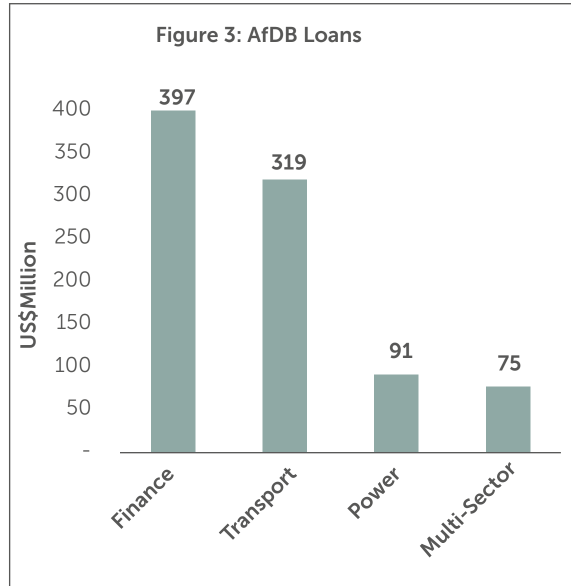
- countries identified as being suitable candidates as their capital markets are relatively well developed
- loans made on private sector terms to non-sovereign borrowers as well as loans to sovereigns when they are made on similar terms as to non-sovereigns
- loans with a minimum remaining tenor of three years (as of 2023) – to avoid a situation requiring replenishment of the loan pool in the short term.

Figure 1: Loans assessed

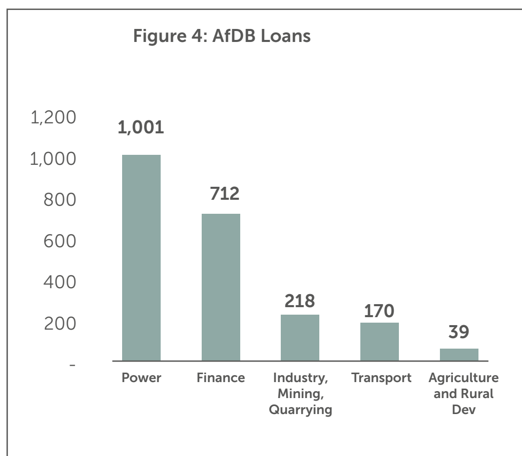


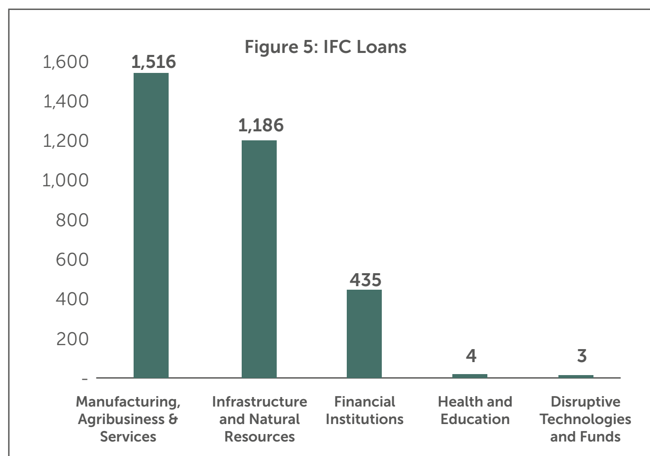
A further analysis of the IFC and AfDB's portfolios based on currently available information showed that US$1.571 million of IFC assets and US$882 million of AfDB assets, cumulatively amounting to US$2.453 million, are eligible across the sectors depicted in Figures 2 and 3. However, it needs to be emphasised that this is a preliminary estimate only, as the terms and conditions of the individual commitments are not readily available.





Preliminary research findings indicate that more information on the IFC and AfDB projects shown in Figures 5 and 6 (amounting to US$5.284 million) is required to assess eligibility. The eligibility of these projects depends on being able to access as-yet-undisclosed information on the type of financing instrument, tenor and maturity.





Data challenges

While the MDBs have publicly disclosed a list of projects on their respective websites, the level of disclosure is inadequate, fragmented, partial and often inconsistent. The choice of reported metrics is also left to the discretion of the individual capturing the data. Other issues relate to clerical mistakes and omissions of amounts. While the level of granularity has improved over time, efforts have not been made to bring older data to the same level. MDBs do not disclose project flows – rather, if available, disclosure is at a global scale, showing total exposures at regional, country or sector level.

The team's efforts to triangulate the data did not yield results as most investee entities have not disclosed the investments in their financial statements or on any other public platform. This may be because some of the private sector entities are privately held and there is no obligation for them to publish investment information or financial statements publicly.

Making the case for a common database

Ascertaining the size and terms and conditions of MDBs' exposures is complicated by the fact that information on MDB investments is not available on a standardised basis or assembled on a central website. Setting up and maintaining an MDB portfolio transfer programme is predicated on greater transparency regarding MDB exposures at the country and sector levels, as well as regarding the terms and conditions on which funding is provided. Currently MDBs report project data on the website hosted by IATI and the GEMs Database, but the information is not current or complete, and the scope of disclosures is inadequate. As the risks associated with lending on specific projects are often syndicated among MDBs, an important advantage of using a shared database would be to facilitate transfer of such assets.

In addition, access to more accurate data on MDB exposures would enable more accurate credit assessments on the part of the private sector when considering investment in assets secured in MDB assets. As the most active stakeholders in long-term development finance, the track record of development banks is highly relevant, but remains unavailable for public analysis. Without access to the data, models have relied on sovereign ratings that suggested much higher risk than experienced by the MDBs.

A significant advancement is the recent release of default statistics on private sector and sub-sovereign lending activities by MDBs spanning from 1994 to 2022.[8] This release was made by the GEMs risk database consortium in March 2024. The database, as shown in Table 2 below, indicates that the recovery rates for private sector transactions are highest in sub-Saharan Africa. This challenges the perception that African countries are inherently risky borrowers, supporting a more nuanced understanding of the region's investment landscape.

Table 2: Recovery rates for contracts of private counterparts, by 2022 World Bank Group region

Geographic region	All	Infrastructure	Financials	Other
East Asia and the Pacific	69.7%	65.0%	62.9%	71.9%
Europe and Central Asia	72.5%	79.1%	73.8%	70.8%
Latin America and the Caribbean	71.7%	73.1%	65.4%	72.8%
Middle East and North Africa	82.5%	87.9%	82.6%	81.4%
South Asia	68.1%	68.9%	78.6%	63.9%
Sub-Saharan Africa	83.0%	94.3%	82.1%	80.8%
N/A	63.8%	70.5%	56.7%	66.9%
Average	74.7%	78.7%	74.1%	73.9%

Source: Recovery statistics, GEMs Database

The above shows that it would be beneficial to mainstream the transfer of assets from MDBs to private sector investors if all MDBs committed to making their exposures and asset pledges on the GEMs Database publicly available (as is, access is limited to the MDBs and international financial institutions established by treaty). This would facilitate both 'packaging' of assets tailored to specific investor preferences (e.g. by currency or within sub-regions) and make it easier to ascertain where various MDBs have contributed to the funding of the same asset. Altogether, the 'lumpiness' of MDB commitments and co-investment by several MDBs may limit possibilities for assembling a diversified portfolio of transferred assets. Collecting information on MDB exposures in a central database could important in ensuring the transfer of commitments to a diversified asset base.[9]

In undertaking this feasibility study, the team interacted with relevant parties at several MDBs,

[8] https://www.gemsriskdatabase.org/#Default%20Statistics%20Publication
[9] Here it will also be important to leverage the findings of work currently being undertaken by other MDB Challenge Fund grantees.

including the IFC, AfDB, EIB, TDB and DBSA, and generally found interest and support for the proposed approach. During the second phase, in which the suggested approach will be piloted, the preliminary findings of the feasibility study regarding the availability of suitable MDB assets for portfolio transfer will be tested by the appointed fund manager.

The second phase will also provide a platform for further supporting the establishment of closer coordination among MDBs regarding disclosure of information on potentially transferrable assets, including information on size, tenor, interest rate and fees paid, etc. While initially this coordination framework will target the pilot transaction that builds on this feasibility study, once the approach to asset transfer has been piloted, the aim is to lay the foundation for a common framework that can be mainstreamed.

Exploring options for transferring assets denominated in local currency

In endeavouring to support the deepening of local capital markets and recognising that regulations limit the extent to which institutional investors are allowed to invest in foreign currency assets (discussed further in the next section), this study explored the various approaches to alleviating this constraint. Annex 2 provides a full account of these considerations, which are briefly summarised here.

MDBs have traditionally lent to sovereign governments and the private sector exclusively in 'hard currencies', predominantly US dollars (US$s). When lending in US$s, MDBs have relied on their preferred creditor status: the mutual commitment of their shareholders (including representation of all advanced-economy governments) to secure their capital in case of default by any borrower. This preferred creditor status ensures that their lending to less-developed countries is protected and has the highest status among the MDBs' borrowers. In this way, MDB lending has been protected both against devaluation risk (which arises because inflation in most less-developed countries is higher than in advanced economies), and transfer and convertibility risks that could arise when developing countries experience shortfalls in their access to foreign exchange. While preferred creditor status also mitigates the MDBs' exposure arising from exposure to credit risk on sovereign and sub-sovereign portfolios, it may be less relevant for their private sector portfolios.

While less-developed countries expose themselves to risk when borrowing in US$s, they generally welcome having access to hard currency due to their reliance on imports (mostly industrial goods, but in many instances also commodities and even agricultural goods). Given this underlying imbalance, less-developed countries welcome the US$-denominated lending provided by MDBs, despite the associated foreign currency risks, as it goes towards alleviating the US$ shortage.
With a view to creating greater opportunities for local institutional investors to invest in MDB portfolio transfers, this study considered three approaches to addressing the currency mismatch issues associated with borrowing from MDBs.

First, obligors in less-developed countries could refinance their borrowing from MDBs by issuing securities on local markets and using the proceeds to repay their US$ exposures. A variant of this option is the establishment of a local currency fund structure that supports obligors to refinance, in whole or in part, MDB obligations. While this refinancing approach might be feasible in the more developed capital markets considered by this feasibility report, it would be equivalent to depriving less-developed countries of scarce foreign exchange reserves. The resulting local-currency-denominated assets might be attractive to institutional investors, but the cost to governments in terms of depletion of their foreign exchange reserves could be prohibitive. Various approaches could be considered (and have been tested) to hedge the risks associated with foreign currency borrowing by less-developed countries, but such over-the counter hedging techniques have been found to be expensive, as liquidity on financial markets – even for tenors at the shorter end of the yield curve – is limited, and hedging of longer tenors, equivalent to the longer maturities offered by MDBs on their lending, is generally unavailable.

The second approach considered by this study would involve MDBs issuing local-currency-denominated securities. Instead of financing their lending in US$s, MDB could finance it on local markets through local securities issuance. While this would have the dual advantages of avoiding currency mismatch risks and contributing to the deepening of local capital markets on the funding side, projects would still face foreign currency risks in as much as they rely on imported equipment and other inputs. However, MDBs have so far been reluctant to pursue this approach, for several reasons:

- First, local capital markets may be underdeveloped, particularly for the longer tenors required by the projects supported by MDBs, which typically fund investments requiring longer amortisation periods.
- Second, MDBs have expressed concerns as to whether there is sufficient demand among local institutional investors for the securities that they might issue. The reason for this scepticism is that institutional investors in less-developed countries have been conservative regarding the choice of asset classes in which to invest. They have limited themselves to asset classes they are comfortable with (typically real estate, government securities and bank deposits). More importantly, there have been concerns around the pricing of local currency issuances by the MDBs. On the one hand, domestic investors have difficulty assessing the local currency credit rating of the MDBs relative to the sovereigns. On the other hand, sovereign issuances in the local markets have certain advantages, such as zero risk weighting, repo-eligibility, and liquidity classification, that may not be enjoyed by MDB issuances. This potentially renders local currency issuances by MDBs less attractive to local investors. As discussed in the next section, dialogue with institutional investors in the countries identified for consideration as part of this feasibility study generally refutes the validity of this concern, i.e. institutional investors would be interested in diversifying their investments to include participation in assets secured in loans by the MDBs.
- Third, if MDBs were able to issue local-currency-denominated securities in the countries considered by this study, MDBs would need to consider that it is unlikely that the proceeds from the securities issuances could be deployed immediately. This would happen gradually depending on the scope of the project pipeline. As a result, MDBs would have to contend with managing liquidity locally, as more projects become available and eventually absorb the funds accessed through the securities issuance. Hitherto MDBs have been reluctant to bear any such exposure in terms of market risk, and fully hedging such market risks lies beyond the capacity of capital markets in most less-developed countries. Attempts being piloted by the European Bank for Reconstruction and Development (EBRD), working with Frontclear, are underway to support development of capital markets in less-developed countries that would ease the exposure of MDBs (and other investors) in managing local currency liquidity. As of now, however, MDBs have largely shied away from such risk exposure.

Altogether the factors considered above suggest it would be advantageous if MDBs were to further explore possibilities for funding on local capital markets. While local currency issuance could expose MDBs to market risks to a greater degree, issuing securities on local markets would make a significant contribution to developing local capital market liquidity. Such efforts would be particularly likely to bear fruit in those countries committed to sound macroeconomic management. This would result in greater trust in, and depth of, local financial markets, and it would also provide local institutional investors with an attractive alternative asset class in which to invest.

The third approach considered by this study would involve local institutional investors co-investing with MDBs on a project-by-project basis or through a fund structure. The local investors would provide a portion of the financing required, e.g. for an infrastructure project in local currency, while the MDBs would provide the US$ component of the financing stack. This solution would match the currency exposures of the funding to the financing needs of the projects being financed.

4.

Market sounding with pension funds (the demand side)

According to the Blended Finance Task Force,[10] current domestic capital under management in Africa is estimated at US$2.4 trillion, made up of assets held by banks (US$ 1.5 trillion), insurance companies (US$0.4 trillion) and pension funds (US$ 0.5 trillion). It is estimated that this asset base could expand by about 6% per annum to US$6.4 trillion in 2040 through economic growth and targeted measures to grow the size of private capital under management relative to GDP. Different countries would need different measures, depending on the current size and maturity of their financial markets.

The Task Force reasons that deploying this capital for investment in climate-related investments could close about half of the investment gap associated with achieving investment in climate resilience and other sustainable development goals. The remaining funding would need to come from a combination of public national and international capital as well as international private capital. Against this background this feasibility study explores the interest of institutional investors in investing in assets transferred from MDBs, particularly pension funds which are rapidly accumulating assets given the young age of the working population.

The team engaged fund managers from Kenya, Ghana, Nigeria, Uganda, Tanzania and WAEMU, cumulatively managing approximately US$35 billion of assets under management (AUM), about their interest in investing in the proposed initiative and any constraints they would have. All the fund managers engaged were excited by the opportunities presented by the initiative. The feedback below was provided with the intention of refining the offering to facilitate their optimal participation.

Summary of findings from discussions with institutional investors and their regulators

- *There is a considerable appetite for alternative asset classes among institutional investors.* With portfolios heavily concentrated in government securities, equity and bank deposits, the prospect of being able to diversify into a new asset class is attractive to institutional investors. Currently they invest up to 75% of their assets in highly liquid fixed income securities, predominantly government securities.

  Institutional investors expressed differing views regarding the extent to which their demand for the new asset class would depend on its liquidity. In discussions with institutional investors in one target country, given the tenor of the underlying investments undertaken by MDBs, it was recommended interventions be designed to ensure the liquidity of securities issued by the fund, using mechanisms such as exit clauses, liquidity windows or an amortising repayment structure. In another instance, the new asset class was regarded as so attractive that investors – partly due to the liquidity of the sizable proportion of their assets invested in government securities – would be able to compensate for the lack of liquidity of these specific investments.

- *Local market conditions influence investor demand.* Although the market's perception of the riskiness of the transferred portfolio will be important in determining demand on the part of institutional investors, local market conditions will also play an important role. For example, currently institutional investors in Nigeria have few alternatives to investing a large part of their assets in government securities yielding a negative real rate of interest. As a result, to be

[10] Mobilising domestic capital to drive climate-positive growth (2023).

attractive, an issuance offering participation in a fund secured in MDB assets to Nigerian institutional investors could 'benefit' from the distorted market environment.

Care will be required in setting the level of interest rate required to attract institutional investors, as this will vary depending on local circumstances. As pointed out above, the level of interest rates attractive to institutional investors in Nigeria will reflect the naira interest rate, negative in real terms, which they can otherwise earn on government securities. Care is needed in using market rates as a benchmark, as the transferred MDB portfolio will benefit from the MDB's credit assessment process. In addition, in the case of participation agreements where MDBs retain the risk associated with a certain part of each asset transferred (somewhat equivalent to first loss coverage) and where, with their participation, investors benefit from the MDBs' preferred creditor status, investors will be exposed to less risk. This will mean it will be less relevant to compare the return on the transferred portfolio with 'market rate' on loans of similar or comparable entities.

- *While guarantees would provide extra comfort, institutional investors would not regard them as a requirement.* The diversification offered by the new asset class offers a hedge against credit risk, as does the fact that the MDBs retain some 'skin in the game'. In several instances pension fund managers pointed to trustees as being averse to unfamiliar territory, and in such cases guarantees in the initial stages of the launch of the new asset class would be desirable.
- *As regards the sectoral diversification of the transferred MDB assets*, regulators are increasingly aware of the need for ESG compliance and are preparing to roll out ESG disclosure requirements. Nonetheless, while ESG-related criteria for selection of investments remain an important objective, in the pilot phase such criteria are unlikely to apply to investment decisions undertaken by institutional investors. Discussions with institutional investors revealed a clear interest in investing in assets secured in infrastructure investments. Depending on the sectoral distribution of assets to be transferred in the pilot phase, it might be possible to sensitise institutional investors to the advantages associated with incorporating criteria such as climate risk and urban development.

Regulatory landscape – a focus on alternative investments and offshore investments

Regulations will have a bearing on the appropriate institutional design of the transfer mechanism. In the five selected markets, pension regulators have set specific investment allocation guidelines for pension funds, as follows:

Table 3: Investment allocation limits

Asset class	Instruments	Ghana	Nigeria	Tanzania	Uganda	Kenya
Government securities	Treasury bills	60%	60%	20–100%	80%	100%
	Treasury notes					
	Treasury bonds (Infra and Eurobonds)					
	Central bank securities					
	Green bonds					
	Municipal and local government bonds/bills	15%	10% if guaranteed, 3% if not guaranteed	-	-	-
	Statutory agency bonds/bills					
	Cocoa bonds					
Corporate debt	Bonds	35%	35%	20%	30%	20%
	Debentures					
	Notes					
	Preference shares					
	MBS/ABS					
	Commercial paper					
	Green bonds					
Supranational bonds	Supranational bonds	-	20%	-	-	-
Ordinary and preference shares	Ordinary and preference shares (listed and unlisted)	20%	30%	25%	70%	75%
Guaranteed funds	Guaranteed funds	-	-	100%	-	100%
Bank securities/money market instruments	Fixed deposits	35%	30%	40%	35%	35%
	Negotiable CDs					
	Bankers' acceptances					
	Repos					
CISs	Unit trusts	15%	25%	30%	70%	20%
	Mutual funds					
	ETFs					
Alternative investments	PE funds	25%	10%	-	15%	10%
	Infrastructure funds		10%	-	-	10%
	External/offshore investment in securities		-	-	-	15%
	Immovable property and REITs/funds		25%	30%	30%	60%
	Infrastructure investments		-	25%	-	-
	Others		-	10%	5%	10%

Source: National Guidelines on Investments in Pension Funds

Broad regulatory support for diversification

Traditionally, these guidelines have been conservative, leading pension fund portfolios to primarily invest in:

- **Government securities:** In countries like Kenya and Tanzania, pension funds are permitted to invest up to 100% of their AUM in government securities and guaranteed funds, which are regarded as low-risk investments. In fact, investments in government securities make up more than 50% of the total investments in the focus countries. In most countries, pension funds must also seek regulatory or ministry approval if investing in alternative assets or offshore investments.

- **Short-term assets:** This approach has caused a misalignment with pension funds' long-term liability profiles.

However, as shown in Table 3, the investment allocation thresholds established by national regulators are not a significant barrier to the further diversification of pension funds into alternative assets. In fact, investments in alternative assets remain significantly below the national limits. For instance, investments in infrastructure are below 1% in Kenya and below 3% in Nigeria (well below the approved limit of 10%).

More recently, investment guidelines in certain markets have been revised to allow for diversification of pension investments into alternative asset classes and in many jurisdictions, there is broad regulatory support for pension fund investment in alternatives:

- In the **WAEMU region**, the pension sector regulator, Conférence Interafricaine de Prévoyance Sociale (CIPRES), does not set a specific numerical limit on pension funds' investment allocations but encourages them to opt for assets with a lower risk profile. However, pension funds in the region must obtain approval from the regional central bank and/or Ministry of Finance before investing in foreign assets. One pension fund mentioned allocating up to 10% of their AUM to offshore investments. Unlike the predominantly privately managed funds in Anglophone countries, the primary pension funds in the WAEMU region are state controlled.

- In **Nigeria**, the pension industry is overseen by the National Pension Commission (PenCom). Nigeria aims for 40% of its pension industry's assets to be allocated to alternative investments, particularly in infrastructure such as energy and transport. According to regulations, pension funds are permitted to allocate up to 10% of their AUM to both infrastructure and private equity funds.

- In **Ghana**, under regulations issued by the National Pensions Regulatory Authority (NPRA), a pension fund can allocate up to 25% of its assets to alternative assets collectively. The NPRA defines alternative assets as including real estate investment trusts (REITs), private equity (PE) funds and external investments. Each sub-category within alternative investments is restricted to a maximum of 10%, except for external investments, which are limited to a maximum of 5%.

- In **Kenya**, the Retirement Benefits Authority (RBA) regulates and supervises the establishment and management of retirement benefits schemes. The RBA imposes limits on the allocation of pension funds as follows: up to 10% in PE funds, up to 10% in infrastructure funds and up to 15% in offshore investments. An additional allocation of 10% is eligible, subject to approval by the RBA.

- In **Uganda**, the investment regulations set by the Uganda Retirement Benefits Regulatory Authority (URBRA) allow for a 15% allocation in PE funds. An additional 5% allocation for other investments may be considered eligible, pending approval by URBRA.

- In **Tanzania**, there is no single regulator overseeing the pension sector. The investment activities of pension funds are supervised by the Bank of Tanzania (BOT), while policy directions are provided by the Ministry of Labour. BOT sets the investment limits for the sector. Tanzanian regulations currently do not specifically allow investments in PE and infrastructure funds, but these may be eligible under the 10% allocation designated for 'others', subject to BOT approval.

These policy and regulatory adjustments, coupled with the growth in AUM, have spurred demand for alternative investments.[11] Additionally, the substantial demand for infrastructure finance in Africa presents a natural investment opportunity for institutional investors.

However, diversification into alternative assets has experienced three main challenges:

- *Greater reliance on domestic markets for government borrowing* results in higher 'risk-free' interest rates on sovereign debt issuances. Consequently, the relative appeal of longer-term alternative assets has diminished from a return standpoint, reducing the incentive of institutional investors to diversify into other assets. The traditional view is that for alternative assets to be attractive, their investment returns must sufficiently compensate for the increased risk. On the other hand, given recent experiences in Ghana, pension fund investment managers acknowledge that the notion of government securities being low risk needs to be reviewed.
- *Local capital markets in Africa are underdeveloped*, as reflected in limited product variety, shallow liquidity and a small investor base. This is true even in those countries with more advanced capital markets which were selected for this feasibility study. These markets lack a sufficient range of innovative investable assets, particularly those that align with the long-term obligations of pension funds. According to feedback from some engaged fund managers, many of the alternative investment vehicles presented to them lack proper structuring to incentivise their participation.
- *Capacity challenges.* Firstly, pension funds have limited familiarity with and expertise in alternative asset classes, such as private debt and infrastructure funds, which are relatively new in the African market. The extent of such capacity constraints varies by market, with Nigerian pension funds exhibiting more advanced knowledge in this area. Secondly, there are significant costs associated with conducting due diligence on fund structures, legal frameworks and project sponsors. In Kenya and South Africa, some pension fund managers have formed consortiums, such as KEPFIC and Batseta respectively, pooling their assets for collective investment in infrastructure projects. This collaborative model helps mitigate the risks of individual investments, reduces costs and enhances fund managers' capacity to manage infrastructure investments.

Regulatory implications of structuring the investment vehicle

Broad regulatory support for diversification exists despite the challenges above. Still, regulations in individual countries need to be considered carefully, as they give rise to specific opportunities in structuring sub-funds for transferring MDB assets.

For instance, in Nigeria, pension funds are permitted to allocate up to 10% of their AUM to both infrastructure and private equity funds as noted above. However, 60% of these fund allocations must be invested domestically, and the investment vehicle must be registered with the Nigerian Securities and Exchange Commission (SEC). In Ghana, for a PE fund to be eligible for investment by pension funds, it must have an office domiciled in Ghana. Due to these regulations, either separate country-specific sub-funds would need to be established or the sub-fund would need to be domiciled in Ghana and seek registration with the Nigerian SEC.

Within the East Africa Community (EAC), pension fund regulators have agreed to consider investments within the EAC as equivalent to local investments, thus facilitating the establishment of an EAC sub-fund.

Considering the limitations imposed by the regulatory authorities, Table 4 illustrates the potential demand size that could originate from pension funds taking into consideration the size of the assets under their management. According to these estimates, up to US$8.69 billion of pension assets could be allocated to the portfolio transfer vehicle across the seven selected countries if the investment vehicle were to be locally domiciled. Were the vehicle to be offshore, the potential allocation would decrease to US$6.6 billion.

[11] https://www.ifc.org/content/dam/ifc/doc/mgrt/gauging-appetite-of-african-institutional-investors-for-new-asset-classes-published.pdf

Table 4: Demand sizing

Fund size (pension funds only)						
	US$ bn	If fund is locally domiciled (%)	If fund is locally domiciled (US$ bn)	If fund is externally domiciled (%)	If fund is externally domiciled (US$ bn)	**Comments**
Kenya	12.5	30%	3.75	15%	1.88	The fund can qualify as PE, infra fund or 'other' investment.
Nigeria	12.7	20%	2.54	20%	2.54	PFAs can invest in regionally domiciled alternative investment funds as long as 60% of the fund is invested in Nigeria.
Ghana	2.7	15%	0.41	5%	0.14	Regulations limit to 5% for offshore investments.
Senegal	1.08	10%	0.11	10%	0.11	There are no specific regulatory limits by asset class in WAEMU. A pension fund in the region has invested approx. 10% of its AUM offshore through a fund. Ministry of Finance approval is required.
CIV	2.7	10%	0.27	10%	0.27	
Uganda	5.56	20%	1.11	30%	1.67	The proposal includes 5% allocation labelled as 'other' that requires URBRA approval.
Tanzania	5.06	10%	0.51	0%	0.00	Tanzania's regulations currently do not allow investments in alternative investment funds. However, the proposed fund may be eligible for a 10% allocation under the category of 'others', which necessitates approval from the Bank of Tanzania.
	42.30		**8.69**		**6.60**	

Source: Calculations based on national investment guidelines for pension funds.

Pension fund managers bear a fiduciary responsibility to the trustees and members of the fund. This responsibility entails safeguarding members' savings while simultaneously maximising returns and diversifying risk. It is crucial, therefore, for regulators, trustees and fund managers to be engaged from the inception of any project. This ensures that the proposed structure aligns with the investment objectives of the pension fund, thereby promoting sound decision-making and protecting the interests of all stakeholders.

5.

Institutional design considerations (the supply side)

This section explores several key parameters that will be important to the institutional structure of the envisaged asset transfer:

- *Transfer of MDB assets financed on market/non-concessional (IFC-type) terms*. The reason for focusing on assets financed on market/non-concessional terms is that such assets yield a market return equivalent to those offered by other borrowers, so transferring such assets to private investors is more straightforward than transferring assets financed on concessional terms. It is not the intention to limit the scope of application of the portfolio transfer process to those financed on market terms, as the case for freeing up MDB capital through portfolio transfers is also strong for those MDB assets financed on IBRD and even IDA-type terms.[12] However, where assets are financed on concessional terms, it will be necessary to compensate private investors for the shortfall in yield.

- *Pooling assets across MDBs to create critical mass.* There could be some benefits, not least relating to the transparency of the process, of using securitisation, such as that undertaken in the AfDB's Room to Run programme. However, in laying the ground for a broader inter-institutional approach (involving several MDBs), the greater flexibility associated with private placements will be more of an advantage. The intention is to establish a process whereby assets from various MDBs are assembled to form the basis for portfolio transfer to institutional investors. On the one hand, involving various MDBs has the advantage of increasing the pool of eligible assets within one country or across countries within the same sub-region (e.g. EAC, SADC and WAEMU), which is necessary if institutional investors are to participate in investments denominated in local currency or in a currency within a sub-region. On the other hand, the asset transfer process will differ among MDBs, so in the pilot phase it is likely to be expedient to limit the establishment and testing of the roll-out of the asset transfer process to a few MDBs.

- *Participation agreements, with MDBs retaining a stake, rather than full ownership transfer.* Legal constraints apply to the transfer of the assets of MDBs, as contracts between MDBs and non-sovereign borrowers may not envisage the transfer of MDB assets to third parties. Experiences derived from those MDBs that have engaged in various forms of asset transfers – whether they be securitisations, syndications or participation agreements – suggest that, rather than transferring the full value of those assets found to be eligible for transfer, it is important that a minority stake remains on the balance sheet of the MDB. This has several advantages:
    - The MDB retains 'skin in the game' in the form of what is in effect a first-loss tranche. Ideally the size of this commitment should be slightly larger than the historic level of loan non-performance experienced by the MDB.
    - The MDB retains responsibility for oversight of the underlying loan, and having originated the loan, the MDB will have a comparative advantage in supervising the performance of the borrower.
    - By maintaining a stake in loans to be transferred, those investing in funds composed of participation agreements in partially transferred MDB assets stand to benefit from the MDB's preferred creditor status (see further below).
    - Finally, use of participation agreements has been widely adopted by MDBs in recent asset transfer arrangements piloted by ILX, a fund manager specialising in assembling participation agreements in MDB assets in funds which are syndicated to investors in advanced countries.

[12] The 'subsidy' required to make loans provided on concessional terms attractive to private investors would provide capital relief to MDBs at a fraction of the cost of making a new capital injection.

The return on transferred MDB assets will depend on the extent to which creditors are protected. If MDBs retain a small proportion of their exposure to the transferred assets (equivalent to or somewhat larger than the expected losses) or third-party guarantees are provided by reputable quasi-sovereign parties (such as the EU, the Swedish International Development Cooperation Agency (SIDA) or African Trade & Investment Development Insurance (ATIDI)), then the credit risk on the transferred portfolio may be considered lower even than on sovereign issuances. This could result in payment of a lower interest rate than on commensurate sovereign issues.

- *Considerations regarding preferred creditor status and the need for first-loss guarantees.* The preferred creditor status enjoyed by MDBs refers to sovereign borrowers' obligation to service their debts to MDBs prior to those to other creditors. In transferring MDB assets to third parties, the question arises as to whether the preferred creditor status is also transferable. A situation could arise where obligors are incentivised to selectively default on those loans on which MDBs have transferred the credit risk to a third party. In the case of the AfDB's R2R securitisation this risk is mitigated by establishing a tranched structure, with the AfDB retaining responsibility for first losses.[13] In the case of participation agreements this risk is similarly mitigated, as the MDBs retain a certain portion of the transferred assets on their balance sheets. Initial soundings with institutional investors in markets targeted by this feasibility study suggest that such additional security would not be required as part of an MDB asset transfer process, i.e. institutional investors are willing to accept the risks associated with investing in funds with underlying security in the form of participation agreements in MDB assets. Several factors appear to explain this. First, institutional investors in the targeted markets welcome the risk diversification associated with investing in this new asset class: hitherto their investment choices have largely been limited to government securities, real estate and bank deposits. In addition, further comfort is provided by the fact that the overall performance of non-sovereign borrowers funded by MDBs has proven to be superior to the performance of loans made by commercial lenders to private sector borrowers. This is confirmed by the recently published data from the GEMs Database (Table 2 above).

- *Institutional process for asset transfer.* It is considered advisable to establish a permanent vehicle, an SPV or a closed-end investment company to facilitate the asset transfer from MDBs. A permanent vehicle will support replication and a higher degree of standardisation of instruments used in transferring MDB assets.

  The structure of the vehicle would need to take into consideration the availability of suitable assets, the demand for these assets by institutional investors and regulatory investment guidelines in each geography. Therefore, it may be necessary to set up an umbrella vehicle with country-specific and sub-regional funds to reflect these considerations. The intention is to set up one sub-fund in US dollars, in which institutional investors would be able to invest to the extent to which this is sanctioned by investment guidelines in target markets. In addition, sub-funds could be set up in Kenyan shillings,[14] Nigerian naira, Ghanaian cedi and the CFA franc (for countries that are members of WAEMU).

  See Annex 3 for a tentative fund structure, to be further refined in the second phase of this project.

- *Assets to be included in the portfolio transfer.* The intention is that the portfolio of transferred assets will primarily consist of 'brownfield' (already operational) or 'secondary' assets, for the most part encompassing investments in infrastructure and loans to financial intermediaries with an initial outstanding minimum tenor of three years. However, as in the case of ILX, it will be possible to engage with MDBs in co-financing 'primary' projects, i.e. those that are in the process of being developed. The cut-off as regards minimum tenor is intended to ensure that transferred assets can provide capital relief for a significant period (before they are fully amortised). Once assets transferred as part of the portfolio transfer are

[13] The AfDB's R2R securitisation was predicated on first loss coverage of 2% of the asset transfer (equivalent to slightly less than the expected loss on AfDB's portfolio), a mezzanine tranche targeting specific pre-identified private investors, and guarantee protection provided by the EU, equivalent to 10% of the value of the transferred portfolio.

[14] According to the investment guidelines adopted by members of the East African Community, investment by institutional investors in securities denominated in other currencies from within the community are regarded as equivalent to domestic investments.

fully amortised, further assets will need to be transferred to replenish the value of the pool of transferred assets.

- *Creating assets denominated in local currency to be transferred.* Preliminary findings suggest that the process of identifying existing operational assets for transfer denominated in US dollars will be a good deal easier than identifying similar assets denominated in local currency. As mentioned above, the process of refinancing US dollar assets in local currency would need to be tested, as it would require the support of the local authorities. In some instances, refinancing of foreign debt locally may not meet with local authority approval, especially where countries are hard-pressed to finance their current account deficits. In other instances, where fund managers already have permission to hold FX assets and in practice have been funding their FX needs through the market mechanism, the practice of refinancing foreign currency exposures locally would be accepted within reason. Nonetheless, establishing sub-funds in local currency may be facilitated if collaborating MDBs issued securities in local currencies to finance their investment programmes. While this is an approach endorsed by several MDBs, it remains to be tested. The process of issuing securities on local markets could possibly benefit from collaboration among MDBs if projects sponsored by various MDBs could be assembled in a single pipeline of projects to be funded from the issuance of securities on local markets. See Annex 2 for further discussion of the potential upsides and hurdles associated with funding in local currencies.

- *Adopting ESG-related criteria for selection of investments to be transferred.* Establishing a precedence for including assets compliant with ESG-related criteria remains an important objective but is not fundamental to the test of concept to be undertaken in the pilot phase. The fund manager of the pilot should explore whether incorporating criteria such as climate risk and urban development will be possible without jeopardising the implementation of the pilot due to limited availability of suitable assets for transfer.

6.
Identifying institutional setup

As outlined in Section 5 above, the intention is to set up a permanent vehicle, an SPV or a closed-end investment company to facilitate the asset transfer from MDBs and avail those assets for investment by local institutional investors.

FSD Africa will appoint a dedicated Fund Manager for a specialised debt fund, with responsibility for:

- exploring whether a common platform for managing sub-funds of transferred MDB assets could be used across different eligible countries (this would allow such sub-funds to be administered under a common governance framework)
- exploring the institutional structure and domiciliation of the Fund, considering taxation factors and other jurisdictional requirements
- exploring the legal aspects of the portfolio transfer process, identifying a pipeline of eligible MDB portfolios and securing the necessary approvals from MDBs to transfer their portfolios
- designing a viable business model, an appropriate capital structure and an investment strategy for the Fund
- determining the governance and implementation arrangements of the fund
- identifying and securing investors for the Fund
- registering and operationalising the Fund
- once registered and operationalised, managing and overseeing the day-to-day administration of the Fund to achieve a profitable portfolio and a suitable financial return for investors.

As part of the feasibility assessment, FSD Africa has advertised a call for expression of interest (CFEI), inviting interest from fund managers with experience in setting up and administering multi-jurisdictional funds of this nature in Africa. In response to the CFEI, 16 African fund managers have expressed interest in setting up and administering the fund.

Building on responses to the CFEI and following a shortlisting process, the intention is to ask those fund managers considered qualified to respond to a request for proposals (RFP) with a view to identifying a General Partner (GP) to manage/sponsor the umbrella fund, setting incentives and remuneration for administering the process of asset transfer, and assuming responsibility for issuing and marketing the various sub-funds.

As part of its developmental mandate, FSD Africa will co-create the Fund with the identified Fund Manager as much as possible, leveraging its relationships with institutional investors and pension supervisors through the Pan African Fund Managers Association (PAFMA) and the Africa Pension Supervisors Association (APSA), as well as its connections with other stakeholders, to address constraints to operationalising the Fund.

Risks and challenges

The following summarises the core risks and challenges to be addressed by the pilot phase:

- *Promoting greater information exchange on MDBs' exposures to establish a project portfolio suitable for transfer.* This will involve creating and maintaining greater transparency regarding MDB exposures at country and sector levels, as well as regarding the terms and conditions on which funding is provided. The possibility of better utilising the IATI website, known as the Publish What You Fund website, or establishing an alternative common MDB Portfolio disclosure website, will be explored. Specific assets to be included in the portfolio to be transferred in the pilot phase will be identified.

- *Defining the roles and responsibilities of the Fund Manager*. The portfolio transfer will be managed using a specialised, disciplined and efficient investment process. The Fund Manager will support innovation in MDB portfolio transfer to local institutional investors, building expertise both in the origination of assets (by sustaining close relations with MDBs) and in the issuance of collateralised securities (communicating with a network of local institutional investors). Following the CFEI, shortlisted fund managers will be asked to prepared proposals with a view to identifying a GP to manage/sponsor the fund and define incentives and remuneration. Governance, transparency and incentives will be structured around a private equity-type approach with a fixed fee level to cover costs and incentives structured as carried interest.

- *Ascertaining institutional investor demand*. Investor preferences will be explored with regards to size, tenor, currency and location (off or on-shore) of pilot-phase issuance. A business case and information memorandum for the fund/portfolio transfer vehicle will be developed, with a view to attracting local institutional investors to securities to be issued by the Fund.

  While the analysis of investment rules suggests that pension fund managers could invest significant sums in externally domiciled funds, their willingness to invest in dollar-denominated funds secured with MDB assets remains to be tested. The project will need to consider whether to establish one fund or different sub-funds across countries or regions, and decide the denomination(s) of the fund/sub-funds, bearing in mind that local currency issuance reduces 'off-taker risk' when projects service domestically oriented sectors such as infrastructure and SMEs.

- *Considering the need for guarantees/wraps*. Partial asset transfers where MDBs retain a certain minority proportion of transferred assets (as is the case with the R2R securitisation) provide comfort, as continued reliance can be placed on the MDBs' asset origination and management capacity. Consideration will be given to whether asset transfers need to be accompanied by such first loss partial credit guarantee coverage. Cases where guarantees were used include the AfDB's credit insurance programme (wholly underwritten by ATIDI), the EU/EIB's Juncker programme which used a structured guarantee programme to provide first loss coverage, and the similar approach adopted by GuarantCo in attracting institutional investors to brownfield projects originated by InfraCredit in Nigeria.

7. Next steps

This feasibility study will be disseminated at an event on the sidelines of the 2024 AfDB Annual Meeting to be held in Nairobi on 30 May 2024. During the event, this report will be discussed with MDBs, local institutional investors, regulators and industry practitioners, to confirm their endorsement of the fund transfer model and the proposed implementation modalities. Further engagements, including webinar events and roundtable discussions with relevant stakeholders, will be considered as means of obtaining further feedback on the proposed solution.

Following a shortlist of expressions of interest received from fund managers, an RFP process will commence. This will identify a Fund Manager/General Partner responsible for co-designing and establishing the Fund and setting their incentives and remuneration.

Once the Fund Manager is onboarded, they will lead the design of the legal, institutional and procedural processes for the proposed SPV, working closely with FSD Africa and other professionals to design an appropriate structure for the investment vehicle and the mechanism for portfolio asset transfer from MDBs.

To advance the proposed design, the Fund Manager will develop a business plan and information memorandum with a view to attracting investors to securities to be issued by the Fund. These investors may include anchor investors such as FSD Africa Investments and other investors participating in the Fund's capital structure at various levels to de-risk investment for local institutional investors. The Fund Manager will also participate in road shows to secure the participation of local institutional investors in the Fund.

The Fund Manager will implement the Fund in phases, starting with a limited pilot to test the core design of the Fund. In the initial pilot phase, the Fund Manager may establish a dollar-denominated Fund, with a portfolio of assets transferred from one or a few MDBs. In addition to brownfield assets transferred from the selected MDBs, the Fund Manager will explore the possibility of the Fund co-investing in local currency in new 'primary' assets alongside MDBs.

Lessons from the pilot phase will be considered in subsequent iterations of the fund model, which will expand the portfolio of included assets and may entail implementation of local-currency-denominated funds in more geographies. In addition, lessons from the pilot will inform the establishment of a platform to support closer coordination among MDBs on information disclosure for potentially transferable assets, including information on their size, tenor, interest rate and fees paid, etc. Once the approach to asset transfer has been piloted, the aim is to lay the foundation for a common framework that can be mainstreamed.

FSD Africa's developmental role in facilitating the proposed solution will reduce as the solution becomes more market driven. There may, however, be a role in continuing to support alignment of the Fund's investment strategies with emerging development priorities in Africa and supporting further replication of the proposed approach to asset transfer beyond the initially identified geographies.

Annex 1:
Lessons from previous experiences

Earlier efforts to mobilise capital from institutional investors have taken various forms. Like the proposal being explored here, these efforts have focused on the private sector (non-sovereign) lending of the MDBs, primarily because such lending takes place on market terms making it easier to test the appetite of institutional investors for asset transfers. The focus is on transferring assets funded on private sector terms to avoid the need for additional public subsidies, which would be required to raise the return on transferred assets so that they are attractive to private investors.

As acknowledged by the G20 report (Box 1), testing the asset transfer model on non-sovereign lending is advisable in advance of broadening the initiative to encompass sovereign lending. Transfer of sovereign assets will significantly expand the scope and thereby augment the impact of the asset transfer programme. This aim will be pursued once the pilot phase has demonstrated the feasibility of transferring non-sovereign assets.

The IFC's Managed Co-Lending Portfolio Programme

Since 2016 the IFC has undertaken transfer of non-sovereign assets through its Managed Co-Lending Portfolio Programme (MCPP).[15] It demonstrates how large institutional investors[16] can benefit from investing in infrastructure programmes and financial institutions in developing countries building on the deal origination and approval and loan management of the IFC. In further limiting exposure of institutional investors and meeting their risk/return requirements, the Swedish International Development Cooperation Agency provided a limited first loss guarantee on the transferred investments.[17] Rather than being quoted on a market, the IFC's co-investment platform is organised as a private placement. As is the case with other earlier asset transfer programmes (discussed below), the IFC's programme results in transfer to institutional investors in Western markets rather than to investors from emerging markets.

The AfDB's Room to Run programme

While used extensively by private banks to economise on high capital charges, the AfDB's Room to Run (R2R) transaction represents the first time that a synthetic securitisation transaction has been used to transfer risk from the balance sheet of an MDB to private sector investors. The structure of the securitisation transaction is summarised in Figure 6 below and has the following core features:

- *Pre-assignment of portfolio:* R2R consisted of 45 well-performing, brownfield, non-sovereign loans to entities in 16 countries (50% infrastructure/50% finance institutions) for total of US$1 billion with an average B+ credit rating. Non-sovereigns represent about 20% of the AfDB's loan book and the R2R portfolio represents about 20% of the bank's exposure to non-sovereigns. No single obligor was allowed to represent more than 5% of the reference portfolio.
- *Structuring of synthetic securitisation:* Securitisation permits the investment risk to be parcelled out to different participants in the deal to match their respective levels of risk appetite. Risk transfer is achieved through a tranche structure, which makes it possible to match the risk involved in the different tranches to the risk appetite of different investors. Importantly, the junior tranche equivalent to 2% of the investment stayed with the AfDB as its 'skin in the game'.[18] The senior tranche (equivalent to 17.25% to 27.25% of the investment value) was rated A- by S&P and sold to private sector institutional investors. The mezzanine

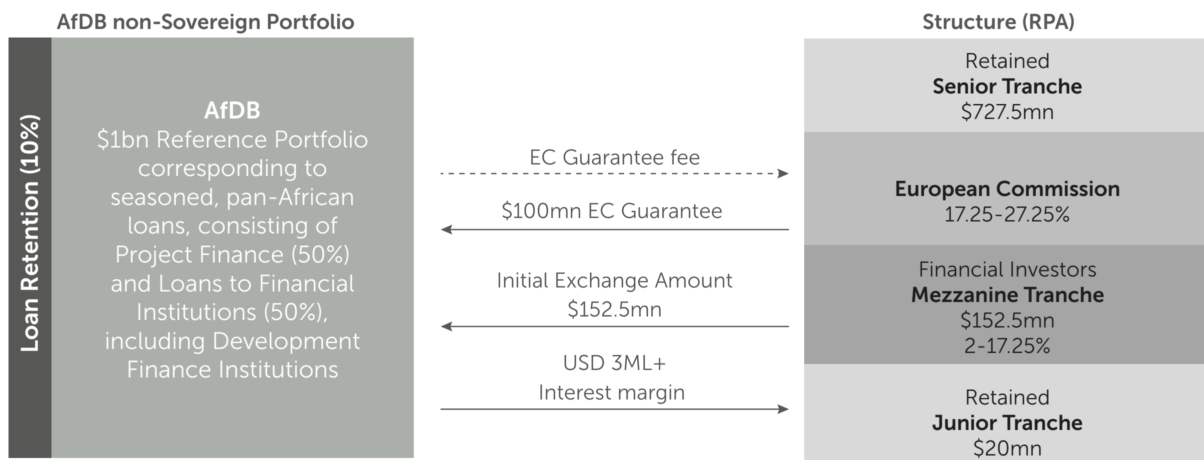
[15] See description in: https://www.ifc.org/content/dam/ifc/doc/mgrt/mcpp-infrastructure-final-10-5-2016.pdf
[16] By 2020, six large global insurance companies were taking part in the programme: AXA XL, Aspen Insurance, Everest Insurance, Liberty Specialty Markets, Munich Re and Tokio Marine HCC. The total funds raised amounted to US$10 billion.
[17] SIDA has provided similar guarantees to cover risk transfer associated with principal repayment on sovereign loans to ADB (2016) and IDB (2020).
[18] The size of this tranche was slightly less than expected loss on the portfolio (of 2.73%). Retention of a larger junior tranche would have been prohibitively costly for the AfDB, as it would result in an equivalent capital cost.

tranche (from 2% to 17.25% of the investment) was purchased by two anchor investors: International Infrastructure Company Fund (IIFC), a private investment vehicle managed by US-based Mariner Group (80%), and a multilateral regional investment fund, Africa50 (20%). Both these investors were identified before closure of transaction.

- *Guarantee protection:* In addition to mezzanine investors, a guarantee by EU equivalent to 10% of the value of the securitisation (US$100 million 17.25% to 27.25%) provided further protection of the senior tranche against failure to pay, bankruptcy and restructuring. The size of the mezzanine tranche and the guarantee were determined by the need to ensure that the AfDB's senior tranche retained an A- rating.
- *Investors:* R2R investors were European institutional investors, including insurance companies, banks and pension funds.

Compared to private placements, R2R's securitisation process has the advantage of being transparent. Observing the requirements of securitisation process are quite onerous though, both in terms of structuring the transaction and in terms of the cost of providing loss and guarantee coverage.

Figure 6: Structure of the AfDB's Room to Run securitisation



Tranche	Size	Attach-Detach	Placed/Retained
Senior	$727.5mn	27.25% - 100%	AfDB Retained
EC (Unfunded)	**$100mn**	**17.25% - 27.25%**	**Expected Execution before 31 Dec 18**
Mezzanine (Funded)	**$152.5mn**	**2% - 17.25%**	**Placed**
Junior	$20mn	0% - 2%	AfDB Retained

Source: Mizuho International Plc (2018)

Other public and private programmes

Broader interest in private placements: Several MDBs, such as the Asian Development Bank and the Eastern and Southern African Trade and Development Bank, have undertaken private placements similar to the transactions under the IFC's MCPP.

Discussion with a regional player, the Development Bank of South Africa, revealed interest in creating capital 'headroom' by providing opportunities for refinancing its assets.

A credit insurance programme was launched by the AfDB in 2020 with the same dual objectives as synthetic securitisation: i) to create headroom for more non-sovereign lending by freeing up capital from a rating agency perspective, and ii) to expand the pathways for commercial investors to support development. The AfDB's idea was to test/compare the two approaches. While the premium charged by African Trade & Investment Development Insurance and its reinsurers was proportionately higher than the cost of the guarantee instrument used in the synthetic securitisation, the benefit in the form of capital relief provided to AfDB (in terms of risk-weighted assets) of obtaining credit protection from ATIDI is sizeable due to ATIDI's A- rating.

Alternative approaches to providing comfort to prospective investors – such as those adopted by the EU/EIB Juncker programme and the approach adopted by GuarantCo in working with InfraCredit in Nigeria involving guarantees and first loss arrangements – will be further explored by the feasibility study.

An initiative sponsored by the private sector: In January 2022 ILX, a fund manager, launched a fund that co-invests with a broad range of leading MDBs and other development finance institutions that have a track record of experience in direct investments in line with the SDGs in emerging and frontier markets. Seventy-five percent of ILX's investments are in new loans being originated by MDBs and DFIs, while the remainder is invested in the refinancing of existing loans. Investors purchasing loan participation agreements issued by ILX denominated in US dollars are primarily European pension funds.

The Amsterdam-based fund invests in private sector loans arranged by MDBs and DFIs, such as the ADB, the AfDB, the EBRD, IDB-Invest (the private sector arm of the Inter-American Development Bank), the IFC and the Dutch development bank, FMO.

European pension funds investing in ILX enjoy MDB privileges (including preferential treatment) pari passu because they are investing through loan participation agreements whereby ILX's funding is transferred first to the MDBs before being on-lent to the underlying project. This means that investors have the same level of risk and return as the development banks with which they co-invest. The loans' default ratio is low, while the risk-adjusted returns are attractive.

Annex 2: Resolving challenges associated with foreign currency financing of investments in less-developed countries[19]

Introduction

The transfer of assets originated by MDBs to institutional investors in less-developed countries (LDCs), as proposed by this Feasibility Study, is hampered because MDB lending is predominantly denominated in US$s. As the liabilities of institutional investors in LDCs are denominated in local currency, LDC regulators restrict the proportion of their investments in foreign currency-denominated assets. This note explores different approaches to resolving this currency mismatch dilemma, potentially significantly expanding the scope of assets available for transfer to institutional investors in LDCs.

In the coming years, LDCs will need to significantly increase their investments to achieve the Sustainable Development Goals, including mitigating the risks associated with climate change. The financing of such investments will largely depend on the transfer of foreign resources because the scope of these investments lies beyond both the limited saving/revenue-generating capacity of developing countries and stretches the capacity of local capital markets to generate the necessary long-term financing.

As covered by this study, the transfer of assets from MDBs can create 'headroom' for larger investments in LDCs. The climate crisis also provides added impetus to funding investments in LDCs. Given the scope of the envisaged investments, attracting funding from the private sector will be crucial, and development assistance can play a significant role in catalysing such private sector funding. However, one major factor characterising such investments is their denomination in foreign currency. Foreign currency risks are endemic to development assistance dollars and any external funding the private sector provides, most of which is financed in US dollars. As a result, borrowers in LDCs will likely become increasingly exposed to currency mismatch risks, as they have income in local currency and foreign currency debt.

Hedging foreign currency risks in LDCs is difficult, as foreign exchange forward markets are notoriously underdeveloped. A central finding of the Bridgetown Initiative[20] is that even in industrialising developing countries which – as opposed to the majority of LDCs – have liquid forward markets, the costs of hedging foreign currency risks are so high that, after adjusting for hedging costs, the returns on investment are too low to generate external investment demand by the private sector.[21] This is attributed to macroeconomic uncertainty proxied by foreign exchange forward premiums, which are much higher in developing countries than in advanced markets.

This note discusses several approaches currently being explored to mitigate the risks associated with foreign currency financing. The proposed solutions discussed below are to establish a guarantee fund that provides partial coverage of foreign exchange risks; to use over-the-counter (tailored) currency hedging techniques to create synthetic local currency loans; to provide first-loss guarantees to facilitate the issuance of bonds denominated in local currency attractive to institutional investors; and to provide funding that reduces the risks associated with longer-term funding on local currency capital markets.

[19] This is a summary of a longer paper available to interested readers on request.
[20] The Bridgetown initiative promoted by the Government of Barbados is an action plan to reform the global financial system to better respond to the scale of current global challenges such as climate change.
[21] The Bridgetown Initiative (2022) in conjunction with COP27 builds on analysis of the issues that arise when using foreign currency to finance investments in developing economies. This reasoning here refers to analysis undertaken by Avinash Persaud for the Bridgetown Initiative on "Unblocking the green transformation in developing countries with a partial exchange guarantee" (June 2023).

Approach 1: The Bridgetown Initiative (COP27) – guarantee fund with partial foreign exchange risk coverage

According to the Bridgetown Initiative, the IMF, working with the MDBs, should establish a partial guarantee fund to absorb risks associated with the cost of hedging LDC foreign currency exposures.

Guarantees are flexible instruments that can be built into transactions to support the delivery of financing in local currency. They can be designed to provide local currency solutions that bridge the gap between a project's financial requirements and the financial terms available on the local market.

The argument for establishing a guarantee fund is built on observations suggesting that currency market hedging of foreign currency risks is overpriced. Comparing where exchange rates end up being and where they were predicted to be by the forward FX market reveals that these hedging costs include a substantial excess risk premium or 'overpayment' for actual currency risks. By intervening at specific times and pooling risks, the partial guarantee fund will reduce hedging costs and LDCs will benefit due to the increased returns available to foreign private sector investors.

The reasoning behind this proposal has several caveats. First, in identifying excess hedging costs, the focus is solely on the selected larger developing countries, all of which have relatively deep short-term money markets.[22] Second, the analysis suggests that rather than being symptomatic of market failure, the observed periodic 'over-pricing' on forward markets reflects varying degrees of risk aversion. This seems to underplay the structural nature of the challenges faced in developing countries, often characterised by structural deficiencies and 'missing markets'. Third, the currency risks associated with the targeted investments could be of much longer duration than reflected by the analysis of short-term hedging costs, requiring access to hedging cover for the gestation period of the envisaged investments.

Approach 2: Operating offshore using synthetic local currency loans

Taking a different approach that focuses on smaller, more vulnerable economies with less-developed financial systems, TCX[23] makes a case for considerably upscaling the provision of synthetic local currency loans to expand such LDCs' capacity to hedge currency risks associated with their foreign borrowing.

Using synthetic local currency (LCY) loans allows DFIs to remain offshore and less exposed to local market institutions.[24] The interest rate on these loans is fixed at an agreed value that factors in the cost of the hedge. The main drawback with this approach is that the cost of the hedge, as reflected in the interest rate charged to the borrower, is likely to be high due to depreciation risk. Other drawbacks relate to the maturities of these hedging instruments, which tend to be limited to three to five years, and the fact that synthetic loans do not protect against convertibility risk or transfer risk, i.e. lack of access to convert local currency into foreign currency at repayment date, and to transfer funds on a timely basis to the offshore creditor.

While supporting establishing a guarantee fund as suggested by the Bridgetown Initiative, TCX proposes a much more selective use of grant funding. This is to increase the availability and affordability of long-dated hedging transactions in larger emerging markets, such as those analysed in the Bridgetown Initiative, and, more broadly, to reduce the pricing of short-dated hedging operations in smaller LDCs. However, due to the high costs of hedging, greater adoption of the hedging products offered by TCX depends on grant funding to reduce the cost and stimulate the uptake of synthetic local currency financing. Due to the scarcity of such funding, TCX has not enabled the DFI community to scale up LCY lending significantly in emerging markets.

[22] Deep money markets are crucial in establishing benchmark interest rates required to undertake FX hedging transactions.
[23] TCX is a fund based in the Netherlands, established by a group of DFIs to offer hedging solutions to manage currency risk in developing and frontier markets.
[24] TCX, Scaling Up Currency Risk Hedging for Low and Lower Middle-Income Countries: a Proposal to Mitigate Currency Risk at Scale and Mobilize Private Finance for Sustainable Development, September 2023.

Approach 3: Operating offshore using first-loss guarantees

GuarantCo, originally established by FCDO and now funded by seven G20 countries, provides credit solutions to support sustainable infrastructure projects in lower-income African and Asian countries. Other than payment of guarantee premiums required by GuarantCo, cash flows are only exchanged in the case of default. GuarantCo's guarantees lower the risk to those purchasing securities denominated in local currency, thus crowding in longer-term local private capital, primarily from pension funds.

In Nigeria, GuarantCo has partnered with InfraCredit to achieve a significant impact in developing the local capital market by providing first-loss guarantee coverage to naira bonds issued to refinance brownfield infrastructure projects. Bonds issued by infrastructure programmes sponsored by InfraCredit benefiting from GuarantCo's first loss coverage have become an asset class attractive to local pension funds. By facilitating credit guarantees, InfraCredit can match the need of projects for long-tenor, cost-effective, fixed-rate, local-currency-denominated debt with institutional investors' need for longer-term, local-currency assets. The guarantees facilitated by InfraCredit allow infrastructure bonds to be issued at a reasonable spread to equivalent government securities.

Rather than being constrained by scarcity in the form of limited availability of first loss coverage, the expansion of InfraCredit's portfolio of project refinancing is constrained by the limited availability of suitable brownfield infrastructure projects for refinancing. Thus, the main bottleneck to greater deployment of GuarantCo's guarantees is the absence of a well-articulated project pipeline and the underdeveloped market for project development and construction.

The solution offered by GuarantCo has significant advantages. First, being a guarantee instrument, leverage is built into the product's design. Second, the scope of the currency mismatch is much smaller than in the case of instruments which directly seek to hedge currency exposures and working with a reputable local institution, such as InfraCredit, provides assurance in assessing and monitoring such risks. Third, scaling uptake of the first loss guarantee instrument encourages InfraCredit to support project development, consistent with the objectives of stepping up delivery of economically sustainable infrastructure projects and deepening local financial markets.

Approach 4: Operating onshore to strengthen the absorptive capacity of local capital markets

Development assistance could be financed in local currency if DFIs, rather than providing funding in hard currencies such as US dollars, were to issue securities in emerging market currencies. While intuitively attractive, this solution faces several hurdles. First, local capital market institutions may be insufficiently developed, so the issuance of local corporate bonds may be predicated on the development of the local legal, regulatory and institutional infrastructure. Second, the local institutional investor base may not be sufficiently developed to absorb a bond issuance by a foreign DFI. Third, if the issue is larger than the currently available project pipeline, DFIs will be faced with the prospect of temporarily investing 'residual' funds to be deployed later once projects become bankable. In this context, several donor initiatives are being undertaken to support the development of local financial markets.

Frontclear, a financial markets development company established by FMO and today co-funded by several DFIs, has developed a sequenced approach to strengthening local currency liquidity management. It involves creating a well-defined overnight benchmark interest rate, building an interest rate yield curve, and addressing imperfections in the legal, regulatory, tax, and accounting frameworks around derivative instruments.[25] This approach will gradually support banks in expanding their lending activities while providing a better foundation for managing any local current liquidity held by DFIs.

[25] Frontclear also provides credit guarantees and transacts as principal to cover counterpart credit risk in repo, derivative and securities lending transactions.

The EBRD has adopted a broader approach, engaging in policy dialogue, capacity building and technical assistance initiatives to support a sound macroeconomic policy environment and an effective monetary policy framework. The EBRD uses an in-depth assessment tool known as the Money Market Diagnostic Framework (MMDF) to reduce pressure on interest rates and lower hedging costs through improved market liquidity and market and credit risk mitigation.[26]

Building on the need of the development banking community to increase its capacity to lend in local currency, the EBRD has recently proposed establishing a Delegated Treasury Platform (DELTA) to resolve challenges posed by maturity transformation required to finance longer-term investments in financial systems with underdeveloped capital markets. The DELTA platform intends to offer loans with more flexible features and better pricing than 'back-to-back solutions'.[27] The platform is envisaged to be a standalone entity, capitalised by DFIs, the platform's users. The amount and the form of the maturity mismatch that the platform would be willing to take will be driven by its risk appetite as well as the risk absorption capacity of the local financial system. In taking on the risks associated with maturity transformation, the platform would work towards lessening the constraints associated with managing DFI liquidity in local markets that arise when DFIs issue securities on local markets but cannot deploy the funds raised immediately. The extent of the risks assumed by the platform will depend on the capacity of the local financial system to generate local project borrowing capacity. Constraints regarding the capacity to generate bankable projects are similar to those described above regarding generating infrastructure projects, which can suitably absorb the first loss guarantee coverage provided by GuarantCo.

Concluding considerations

In seeking to lessen the impact of foreign currency financing, one conclusion common to the various approaches outlined above – whether anchored offshore or onshore – is the imperative of developing local financial markets in developing countries as the basis for currency hedging and laying the foundation for maturity transformation. Local financial market development is inextricably linked to sound macroeconomic management as the basis for strengthening the liquidity of short-term money markets, extending yield curves to establish benchmarks for medium- and longer-term commitments, and encouraging trust in financial markets required to support an enhanced savings culture.

In this context, it is sobering to observe that over the past decade, the quality of macroeconomic management, as captured by the Country Policy and Institutional Assessment (CPIA) rating undertaken by the World Bank, has deteriorated in sub-Saharan Africa.[28] Thus, countries in sub-Saharan Africa will need to shift their commitment to macroeconomic management significantly to help shield their economies from the impact of foreign currency-denominated borrowing.

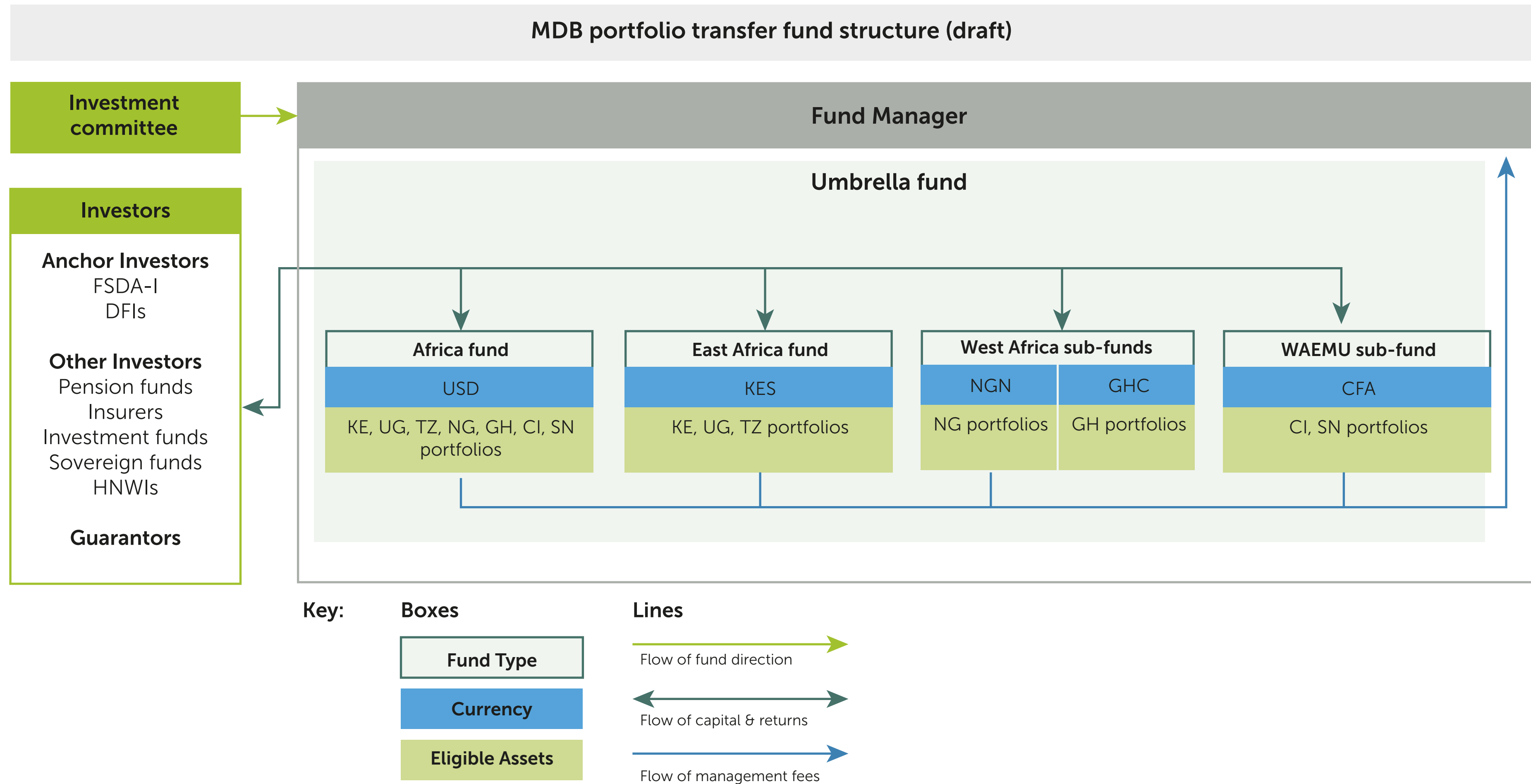
Another conclusion drawn from the experiences reviewed above is that grant funding/blended finance has a role to play in reducing the risks associated with funding in foreign currency – whether in lowering the cost of hedging foreign currency risks (Bridgetown Initiative and TCX), establishing a platform that will enhance maturity transformation on local markets (EBRD) or guaranteeing credit exposures in local currency (GuarantCo). In many ways, these approaches are complementary in addressing the dilemmas arising from foreign currency exposure. However, in terms of targeting crucial infrastructure investments, not least those related to mitigating the impact of climate change and leveraging scarce donor funding, the first loss guarantees provided by GuarantCo come closer to achieving multiple core objectives than the provision of broader support to currency hedging.

Providing first loss coverage to the issuance of project bonds incentivises project development while supporting the development of an alternative asset class suited to local institutional investors.

[26] This tool has already been rolled out in 15 countries and is to be expanded to another 6 countries with funding from the IMF and World Bank.
[27] Due to lack of risk appetite, most DFIs only lend in local currency on a back-to-back basis, i.e. DFIs are unwilling to take maturity, liquidity or interest rate risks on local LDC financial markets. This hampers their willingness to issue securities denominated in local currencies.
[28] World Bank, *Africa's Pulse: an Analysis of Issues Shaping Africa's Economic Future*, October 2023.

Recent efforts to transfer assets from the balance sheets of MDBs to create headroom for more significant investments in developing countries are confronted with similar issues. While creating headroom provides opportunities for augmented investment by MDBs, developing a sufficient project pipeline in which to invest poses challenges. Thus, the incentives supported by making available first loss guarantees are beneficial to local market deepening and well aligned with the interests of the MDBs.

Annex 3:
Tentative fund schematic



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