Understanding Non-Derivative Alternatives for Mitigating FX Risk

A Guide for Microfinance Practitioners

Non-Derivative Alternatives for Mitigating Currency Risk

Below are alternatives used by some MFIs to minimize foreign exchange exposure on hard currency capital without using financial derivatives:

- **Back-to-Back Lending**
  Under this arrangement, the MFI deposits the foreign/hard currency loan proceeds into an interest bearing deposit account at a local bank, and pledges the hard currency account as collateral to support a local currency loan.

- **Letters of Credit**
  Under this arrangement, the MFI provides the proceeds from the foreign/hard currency loan as collateral, usually in the form of a cash deposit, to an international commercial bank that provides a Letter of Credit to a domestic bank.

- **Guarantees and Credit Enhancements**
  Under this method, instead of transferring funds directly to the MFI, the lender can provide a Standby Letter of Credit (SLBC) or other collateral to secure local funding.

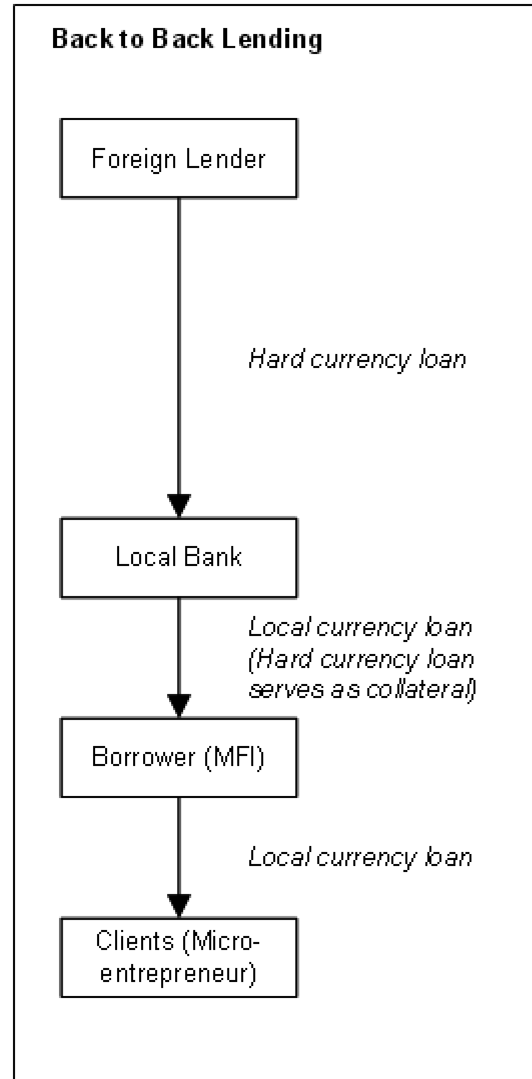
- **Local Currency Loan Payable in Hard Currency with a Currency Devaluation Account**
  Under this arrangement, in addition to regular hard currency interest payments, pre-determined hard-currency deposits must be paid into the "currency devaluation account."

- **Indexation of Loans to Hard Currency**
  Under this arrangement, the interest rates charged by MFIs on the local currency loans issued to local borrowers, are indexed to the value of the hard currency financing the loans on the local currency loans. When the local currency depreciates, interest rates increase.

- **Self-imposed Prudential Limits**
  Under this arrangement, instead of hedging the foreign exchange risk exposure, the MFIs simply limit their foreign currency liabilities.

Back-to-Back Lending

Under this arrangement, the MFI deposits the foreign/hard currency loan proceeds into an interest bearing deposit account at a local bank, and pledges the hard currency account as collateral to support a local currency loan. In the microfinance sector today, back-to-back lending is the most commonly used method to hedge against *devaluation or depreciation risk*.



In some countries, the same local bank can both receive the US dollar or Euro deposit and make the local currency loan, while in others, such as Colombia, a foreign bank affiliate is needed to take the US dollar (or Euro) deposit offshore, and a local bank then issues the local currency loan. Where the foreign currency is deposited in an international account, *convertibility risk* is mitigated such that regulatory limitations on converting local currency into hard currency no longer pose a risk to the borrower.

The local currency loan is typically un-leveraged as the foreign currency deposit provides complete security for the domestic bank. In this method, the strength of the institution taking the deposit, and the existence and level of deposit insurance is an important credit factor to ensure the borrower's capability to repay the foreign currency loan.

Once the MFI repays the domestic loan, the domestic bank releases the foreign currency deposit, which is then used to repay the original lender's foreign currency denominated loan. However exposure to *transfer risk* remains unmitigated under this arrangement and if the local government imposes a freeze on withdrawing hard currency assets or transferring them offshore, the MFI may not be able to access the hard currency principal to pay off the hard currency loan.

Another issue that may be concern is that if the local currency appreciates, the value of the hard currency principal will decrease and leave the

local bank undersecured, which may in turn lead the local bank to request additional collateral. Additionally, any mismatch in the maturity and amortization schedule of the US dollar loan versus the term of the foreign currency principal deposit will leave the MFI with an exposure equal to the difference between the outstanding balance of the loan and the amount of the deposit.

Back to back lending can be costly because the MFI pays interest on both loans though this cost can be partially offset by interest earned on the foreign exchange deposit. MFIs should also seek to maximize the leverage on the transaction by increasing the size of the local currency loan relative to the amount of the deposit.

Letters of Credit

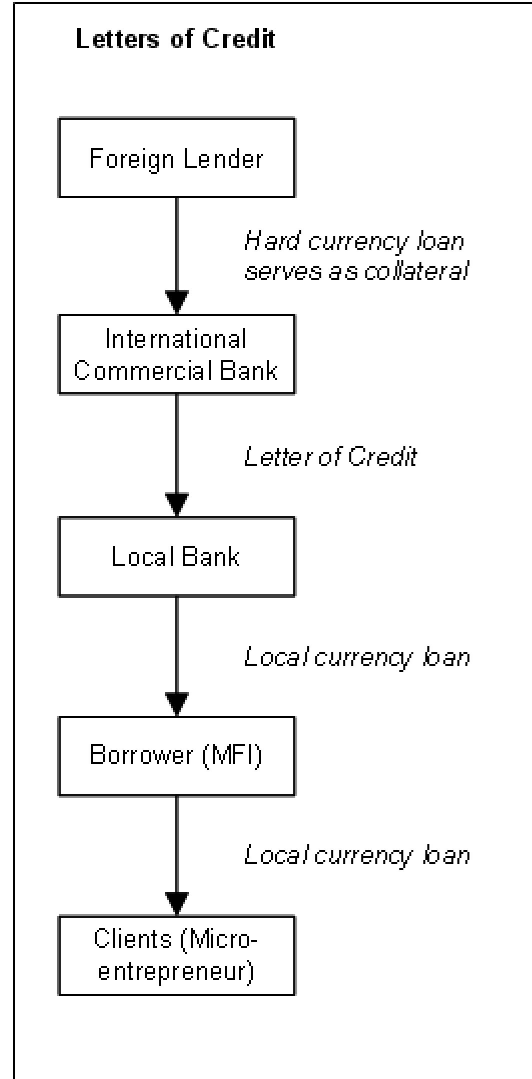
Under this arrangement, the MFI provides the proceeds from the foreign/hard currency loan as collateral, usually in the form of a cash deposit, to an international commercial bank that provides a Letter of Credit to a domestic bank. The domestic bank, using the Letter of Credit as collateral, extends a local currency loan to the MFI.

The Letters-of-Credit method is similar in many ways to the back-to-back lending method and is used by some of the larger MFIs.

Sometimes the domestic bank is directly affiliated with the international commercial bank (as a branch or sister company) or the domestic bank may have a correspondent banking relationship with the international bank. Sometimes the two banks are unrelated. The MFI is not exposed to the credit risk of the local bank because no hard-currency deposit is placed with the local bank.

This arrangement protects the MFI against devaluation or *depreciation risk* as well as *convertibility risk* and *transfer risk* on the loan principal deposited as collateral to the international commercial bank. However, the MFI still faces foreign exchange exposure on the hard currency interest payments.

Finally, purchasing a Letter-of-Credit can be costly and some local banks may not be willing to accept a Letter of Credit in lieu of other forms of collateral.

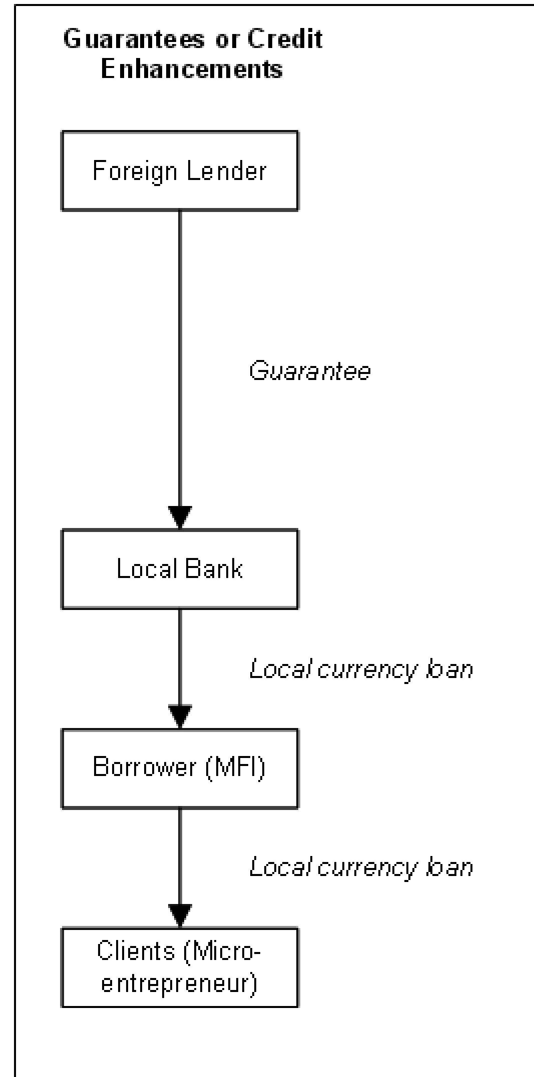


Guarantees and Credit Enhancements

Under this method, instead of transferring funds directly to the MFI, the lender can provide a Standby Letter of Credit (SLBC) or other collateral to secure local funding. The SBLC is considered to be a liquid instrument and terms can go out to five years. Guarantees and credit enhancements strengthen (or enhance) the collateral provided by the MFI to its local banks.

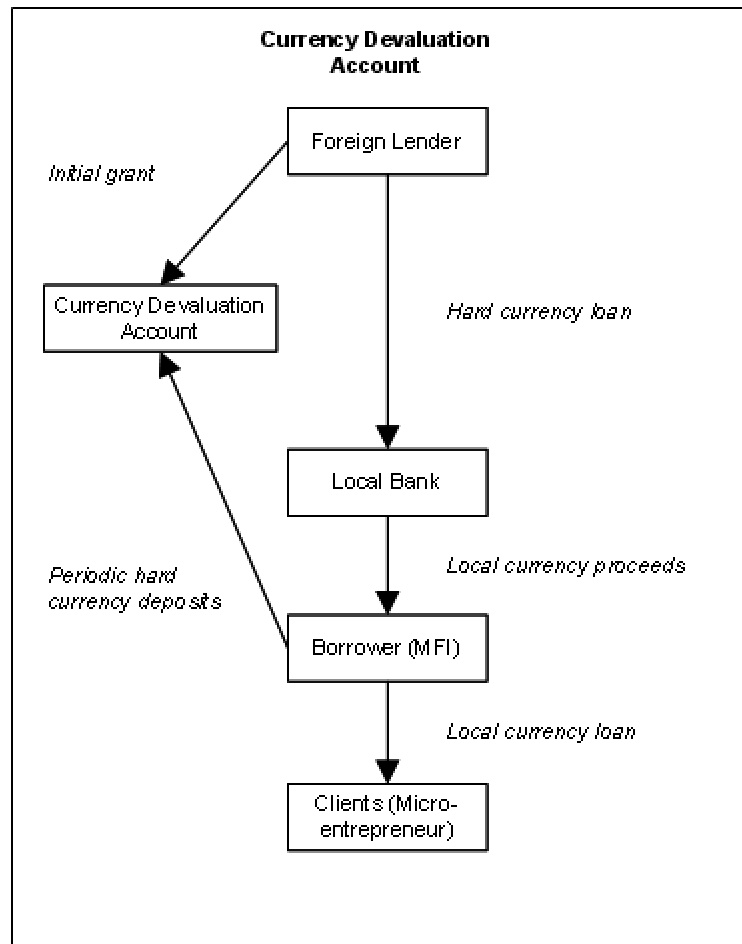
This arrangement can prove costly to the MFI as the lender typically charges an annual fee for providing the guarantee. Depending on the size of the loan and the credit quality of the MFI, the guarantee fee can range from one percent to two and a half percent. However, the MFI may leverage the guarantee or the letter of credit to get much larger domestic loans.

This arrangement protects the MFI against devaluation or *depreciation risk* as well as convertibility risk and *transfer risk* because no hard currency needs to cross borders.



Local Currency Loan Payable in Hard Currency with a Currency Devaluation Account

Under this arrangement, in addition to regular hard currency interest payments, pre-determined hard-currency deposits must be paid into the "currency devaluation account" which serves to mitigate the currency exchange risk to the lender on the principal amount of the hard currency loan. The deposit amounts are based on the average depreciation of the local currency versus the hard currency over the last ten years. The lender shares in the cost of this mechanism for foreign exchange risk management by providing the initial deposit for this account in the form of a grant.



In this method, the MFI converts the hard currency proceeds from the foreign/hard currency loan into local currency. The principal amount of the loan is set at the local currency amount, but is payable in hard currency at maturity of the loan at the prevailing exchange rate.

The periodic interest payments are payable in dollars but accrue on the local currency principal amount; it is the lender that bears the foreign exchange risk on the interest payments.

At loan maturity, the principal is repaid according to the original exchange rates, and any shortfall due to the prevailing exchange rate is made up by the currency devaluation account. If the deposit in the currency devaluation account is more than required, the balance is returned to the MFI. If there is less, the lender suffers that loss.

This arrangement ensures that the devaluation or depreciation risk is shared between the borrower and the lender. In addition, the MFI's risk is capped due to the criteria based on which the currency devaluation account is set-up. However, depending on where the currency devaluation account is held, the MFI may still remain exposed to *convertibility risk* and *transfer risk*.

Indexation of Loans to Hard Currency

Under this arrangement, the interest rates charged by MFIs on the local currency loans issued to local borrowers, are indexed to the value of the hard currency financing the loans on the local currency loans. When the local currency depreciates, interest rates increase. This arrangement protects the MFI against *devaluation* or *depreciation risk* on the loan as the risk is passed on to the end borrower i.e. the MFI's client (the micro-entrepreneur).

Indexation of loans to hard currency can prove costly when the likelihood of default by the MFI clients increases as the local currency depreciates. It is to be noted that these clients who are the most exposed to increased debt-servicing costs under this arrangement, are also the least able to understand foreign exchange risk

This method does not protect the MFI from *convertibility risk* or *transfer risk* on its hard currency loan.