FX risk in the African Banking sector: Survey report

By TCX Fund and MFW4A

Contents

Executive Summary

The exposure of African financial institutions to currency risk is a critical aspect of their operational landscape, influencing their solvency, profitability, resilience, and ultimately their ability to support economic growth. The Making Finance Work for Africa (MFW4A) partnership and TCX collaborated to conduct a survey of African banks and non-bank financial institutions (NBFIs) to understand how foreign exchange risk, and matters arising from it, affect both them and their clients.

African financial institutions are particularly vulnerable to currency risk, as banks hold some of their assets and liabilities in foreign currency. Almost 70% of African banks and NBFIs surveyed report being exposed to foreign exchange risk. Usually, these banks rely on a significant amount of USD or EUR funding from international investors, Multilateral Development Banks (MDBs), and/or Development Finance Institutions (DFIs), while their loans are mostly denominated in local currencies, causing a currency mismatch on the balance sheet. This set-up leads to multiple issues including balance sheet volatility and potential solvency concerns, as banks can face difficulties with debt repayment if domestic currencies depreciate.

These institutions are aware of the currency risk they face and have established different strategies and procedures to manage the risk. However, they identified multiple challenges in implementing effective risk management/hedging solutions, including a lack of capabilities, the cost of the hedging solutions, and regulatory considerations.

This study presents how banks and NBFIs are exposed to currency risks and the practices they have adopted to mitigate these risks, as well as the challenges they are facing. Based on the findings of the study, we have developed a set of recommendations for three key stakeholders:

- **For Regulators and Policymakers**

Recommendation 1: Taking initiatives to foster an environment conducive to the growth of African capital markets, including foreign-exchange markets with regulations and policies (eg ISDA enforceability) that encourage the financial sector to actively participate and invest in capital markets development tools, resources and systems*.*

Recommendation 2: Establishing and proactively adjusting effective prudential rules, regulations and supervision to ensure the resilience of financial institutions and the financial sector in the case of a strong depreciation of domestic currencies. Rules and guidelines regarding net open positions, hard currency lending and hard currency holdings are particularly notable.

Recommendation 2.a: Regulators should define clear boundaries for the net open FX position of commercial banks, revisiting these limits as necessary to adapt to evolving market conditions.

Recommendation 2.b: Lending in hard currency should be restricted to those earning hard currency, safeguarding local currency earners (consumer protection) from foreign exchange volatility by limiting their ability to borrow in dollars.

Recommendation 2.c: Regulators need to form clear guidelines on the extent to which commercial banks are permitted to sell and purchase dollars with the central bank, while also setting limits to excess dollar liquidity for these banks.

- **For International investors, MDBs, and DFIs**

Recommendation 3: Enhancing local currency financing and lending offerings to banks and NBFIs. These stakeholders should aim to offer banks and NBFIs the flexibility of obtaining financing in local currency with all possible tenors, and leverage blended programs to offer them more flexibility, affordability, and sustainable financing solutions.

- **For Financial Institutions: Banks and NBFIs**

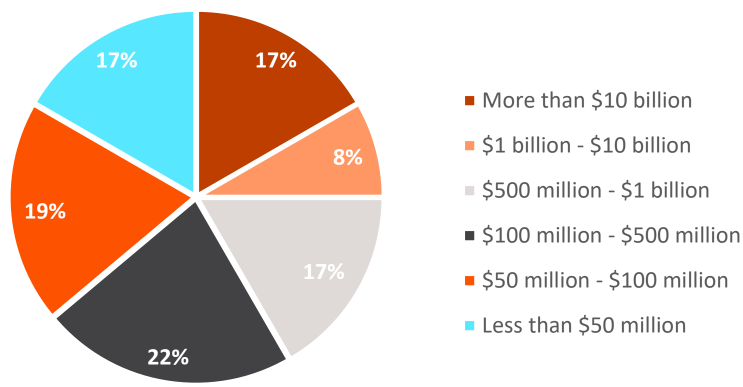
Recommendation 4: Financial institutions to strengthen internal capabilities through investment in training programs and participation in collaborative platforms.

1. Introduction

Over the past year, most African local currencies have experienced a depreciation against hard currencies (USD and/or EUR), intensifying the currency risk for financial institutions via currency mismatches in their assets (loans) versus liabilities (funding), and potential credit risk arising for forex exposed borrowers.

This report examines a comprehensive survey conducted among African banks and non-bank financial institutions (NBFIs), undertaken by TCX and Making Finance Work for Africa (MFW4A) from July to December 2023. The survey incorporated 36 African financial institutions, comprising 6 from East Africa, 7 from Southern Africa, 1 from Central Africa, 3 from North Africa, and 19 from West Africa. More specifically, the survey covers 31 banks and 5 NBFIs.

Figure 1: Total gross loan portfolio at the end of 2022



75% of the banks and NBFIs surveyed have a total gross loan portfolio of maximum USD 1 billion, but the range of gross loan portfolios is quite broad and well distributed from less than USD 50 million to more than USD 10 billion, allowing the responses to capture a wide range of banks and NBFIs across the space.

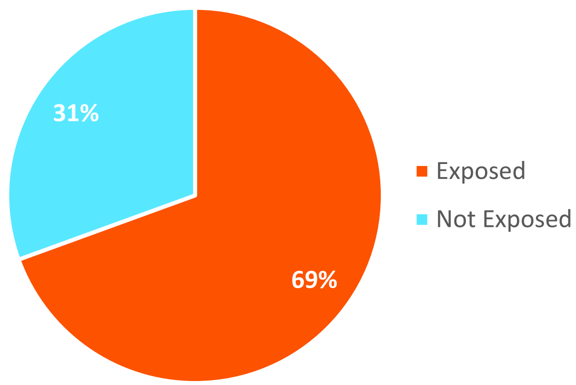
The survey aims to analyze the impact of foreign exchange risk on these institutions while exploring effective strategies, policy measures, and practical steps to successfully mitigate these risks.

The rest of the survey report is structured as follows: Section 1 analyzes the sources of foreign exchange risk and the mechanisms by which financial institutions are affected; Section 2 presents the impact of currency risk on the activities of banks and NBFIs; Section 3 shows how banks manage foreign exchange risk and the tools they use to deal with it; finally, Section 4 outlines some recommendations for key industry stakeholders.

2. African financial institutions' exposure to currency risk

The significant depreciation of many African currencies in recent years has had an impact on the activities of financial institutions.

Figure 2: African Banks and NBFI exposure to currency risk

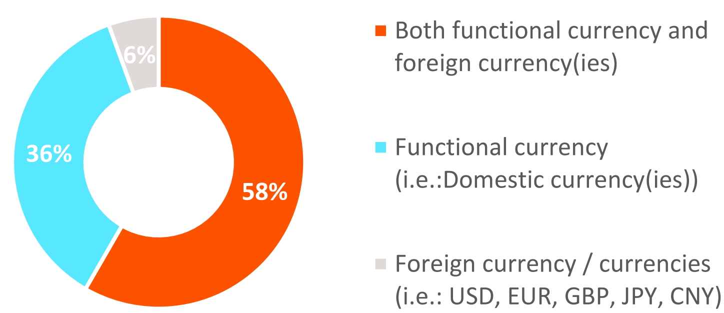


Almost 70% of African banks and NBFIs surveyed report being exposed to foreign exchange risk. Most of them belong to countries whose currencies have depreciated sharply against hard currencies in recent years.[1]

The main foreign exchange exposure for banks arises from the mismatch created from holding debt in hard currencies and giving loans in local currency. Out of the 36 banks surveyed, 22 saw their currency depreciate relative to foreign currencies, and 18 had difficulty repaying debts denominated in foreign currencies. Foreign currency funding remains an important source of funds for African financial institutions. If these banks borrow in a currency that appreciates against their local currency, their debt service obligations increase. Furthermore, foreign currency funding leads to a balance sheet mismatch as the funding in foreign currency is used to provide loans most often denominated in local currency.

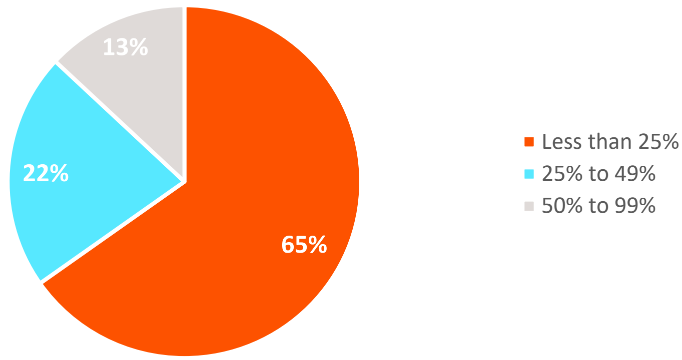
a. Gap between funding in foreign currency and lending mainly in local currency

Figure 3: Lending currencies



[1] For instance: Ghana, Nigeria, Sierra Leone, Sudan, Tanzania, and Zimbabwe.

Figure 4: Percentage of gross loan portfolio indexed in foreign currencies



The majority of the respondents (58%) use both local and foreign currency as their lending currency. The 6% that lend only in foreign currency are located in countries where the economy is heavily dollarized, such as South Sudan and Somalia.

However, among banks and NBFIs who lend in foreign currencies, 65% state that less than a quarter of their loan portfolio is denominated in foreign currency. This can be explained by prudential measures typically put in place to discourage banks from lending in foreign currency on the local market (see 3 b. ii). Most of the time, banking regulations do not allow foreign currency loans at all. In other cases, the regulations only allow those who earn foreign currency as part of a clearly documented legal activity to borrow in foreign currency. The regulations also impose additional risk weights for currency mismatches.

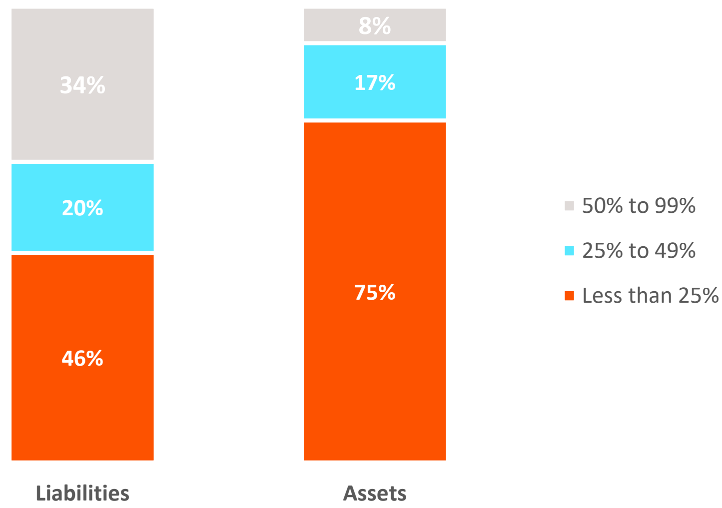
We can observe that the proportion of loans in foreign currency is particularly high in Southern Africa, with 42% of financial institutions having half or more of their gross loan portfolio indexed in foreign currency.

This high proportion of foreign currency loans may be due to the dynamic banking sector and capital markets in southern Africa, led by South Africa[2] where numerous foreign investors operate, and have their income denominated in the foreign currency of borrowing. On the other hand, the banks in this region are the only ones that lend in other African currencies, which, given the dominance /importance of the South African Rand to multiple countries in the region, does not come as a surprise. Still, the foreign currencies in lending that are most used by the banks and NBFIs are USD (61%) and EUR (36%).

The banks and NBFIs from the other African regions have generally less than 50% of their portfolio denominated in foreign currency.

2 https://www.imf.org/en/Publications/CR/Issues/2022/06/16/South-Africa-Financial-Sector-Assessment-Program-Technical-Note-on-Systemic-Liquidity-519722

Figure 5: Assets and liabilities in foreign currency (% of total)

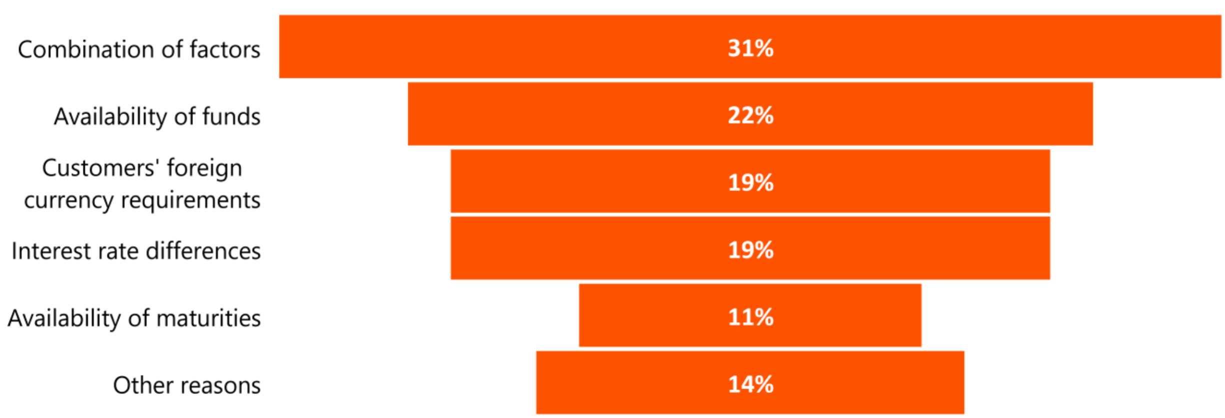


From the liability side, more than a third of the surveyed institutions have 50% or more of their funds and deposits raised in hard currency, and one fifth of the respondents have between 25-50% of their funds and deposits in hard currency. Together, this suggests that the majority of surveyed institutions have at least one fourth of their funding in hard currency.

The responses suggest that the proportion of fundings and deposits raised in hard currency is higher than that of loans denominated in foreign currency, leading to a mismatch between assets and liabilities in foreign currency. Half of the institutions with more than 50% of their funding and deposits in hard currency have less than a quarter of their loans denominated in foreign currency. This shows that the funding obtained in hard currency is mainly converted into loans in local currency. Therefore, the banks are quite exposed to currency risk and might suffer shocks in the event of depreciation.

b. Why are banks financing themselves in foreign currency?

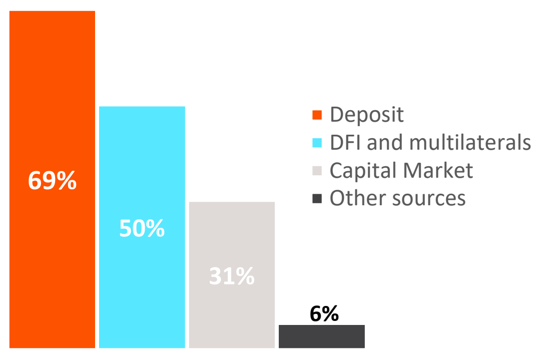
Figure 6: Reasons for seeking foreign currency financing



Note: Respondents were able to select multiple answers. Combination of factors: Availability of funds, Financing Maturity, and Interest rate, simultaneously.

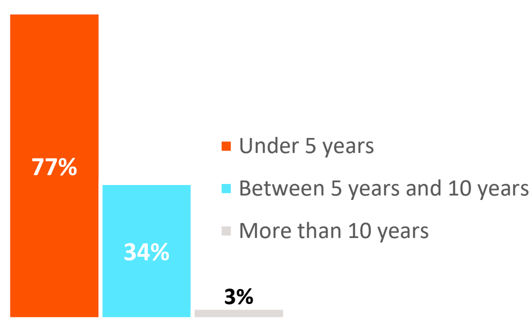
The dependency of African banks on foreign currency funding arises from various factors, especially the availability of needed funds, the lack of local currency offerings in the desired maturity, and the costs of these funds. Banks can source funding with flexible maturities and "affordable interest rates" from DFIs, very often denominated in hard currency.

Figure 7: Medium and long-term funding sources



Note: Respondents were able to select multiple answers

Figure 8: Preferences in terms of local currency financing maturities



Note: Respondents were able to select multiple answers

Although deposits (generally denominated in local currency) are the most common source of medium and long-term funding, over half of the banks and NBFIs indicate that they receive medium to long-term financing from DFIs (generally denominated in foreign currency). Of these 18 banks, 12 stated that they are exposed to foreign exchange risk. Finally, only 31% of the surveyed institutions receive financing from the local capital markets, and most of these are listed on their local stock markets. Clearly, the lack of depth of African capital markets may also explain the dependence on medium- to long-term foreign currency funding from DFIs.

As regards the maturity of local currency financing, banks and NBFIs prefer short-term financing. 77% of the financial institutions surveyed prefer financing with maturities of less than 5 years.

3. Impact of foreign exchange risk on banks and NBFIs

The activities of African banks and NBFIs can be impacted by exchange rate risk in several ways. They may experience repayment difficulties due to the appreciation of the currency in which they have borrowed. On the other hand, their own customers who have borrowed in foreign currencies may also experience payment difficulties due to the appreciation of the currency in which they have borrowed against the local currency.

a. Profit and income

Figure 9: Inclusion of a provision for currency risk in the income statement

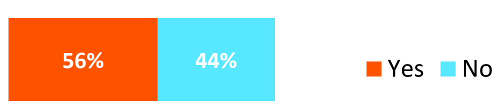
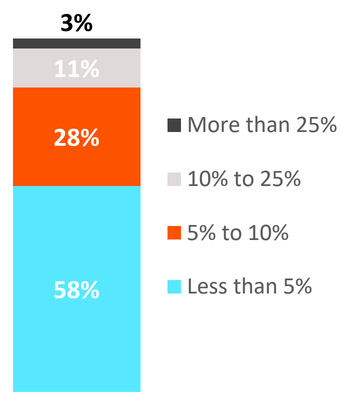


Figure 10: Net open position when exposed to currency risk (% of total equity)



More than half of the banks and NBFIs (56%) include a provision for foreign exchange risk in their income statement. However, of the 25 banks claiming to be exposed to foreign exchange risk, only 16 include a provision for foreign exchange risk in their income statement. It should also be noted that it is only in North Africa and East Africa where all financial institutions exposed to foreign exchange risk provision for it in their income statement. In West and Southern Africa, half of the banks exposed to risk have no provision for foreign exchange risk in their earning report.

The net open FX position (NOFP)[3] is a key measure to assess the exposure of banks and NBFIs to FX risk. For 58% of financial institutions in our survey, their net open position represents less than 5% of their total equity. Approximately 14% of them have a net open position representing more than 10% of their total equity. Paradoxically, 80% of banks with a net open position of more than 10% do not include a provision for foreign exchange risk in their income statement.

Around 50% of banks and NBFIs also say they have been at least moderately affected by changes in foreign exchange reserve requirements over the past 24 months. The highest proportions are found in West and Southern Africa, where 37% and 43% respectively of the financial institutions surveyed are significantly affected by these changes. In the future, a larger proportion (<65%) of respondents expect to be at least moderately or significantly affected by changes in foreign reserve requirements.

3 The net open FX position (NOFP) is the sum of all net long and net short positions (assets, liabilities, off-balance sheet items) in a foreign currency. The position can be composed of spot, forwards, options, profits, guarantees, and other future income or expenses in certain cases.

Figure 11: Impact (changes) in foreign currency reserve requirements (past vs upcoming 24 months)

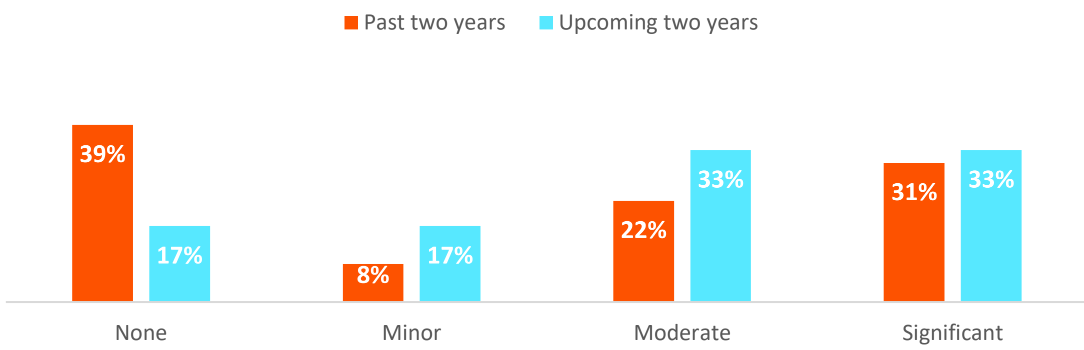
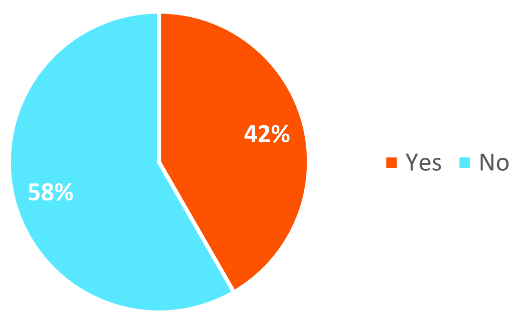


Figure 12: Reduction, postponement or cancellation of a financing agreement due to currency risk



Exchange rate risks can also have a negative impact on financial institutions' access to financing. Over 40% of the surveyed institutions indicated they have been forced to postpone, reduce the amount of, or cancel a financing agreement because of currency risk. As banks and NBFIs generally bear the currency risk, they may no longer wish to go through with the agreement because they expect the local currency amount to be repaid in foreign currency will rise as a result of the depreciation of the local currency. It could also be the case that the pricing of the loan from the foreign provider rises significantly in response to the perceived increased currency risk. If banks and NBFIs lack the competencies and products to efficiently manage these risks, they are obliged either to cancel the agreement altogether, reduce the financing, or postpone it in the hope of finding solutions to hedge the currency risk or gain better terms.

b. Capital planning

The banks and NBFIs also indicate that (the risk of) FX movements add significant uncertainty to investment plans and profitability by worsening capital adequacy and leverage ratios..

In conclusion, the survey confirms that most banks and NBFIs are negatively affected by foreign exchange risks, which harms their profitability, assets, and liabilities, and thus their performance. Foreign exchange also impedes these financial institutions' access to financing, as it leads to institutions postponing, reducing, or canceling their financing agreements, thereby hindering their growth.

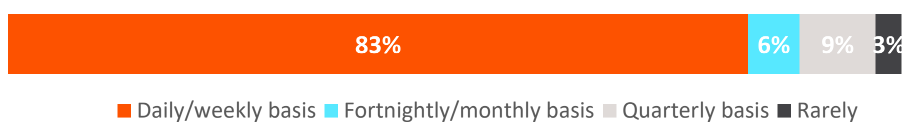
4. How do banks manage the FX risks and challenges they are facing?

Given the importance and potential impact of FX volatility for banks and NBFIs as described in Section 1, it is important for them to put in place mitigating strategies to maintain their solvency and profitability. This requires not only internal resources and capabilities, but also external support.

a. Internal processes, resources, and capabilities to manage FX risks

Banks and NBFIs have put in place various strategies and procedures to manage FX risk in their books. In terms of human resources, 24 out of the 36 banks say they have the in-house talents and specialists needed to manage foreign exchange risk, while only 6 call on external specialists.

Figure 13: Management and monitoring of the net open FX position – frequency



Almost all the banks surveyed (83%) manage and monitor their net open FX position on a regular basis. The majority of those who monitor and manage their open position less actively (17%) are NBFIs (5 out of 7 institutions). This dynamic monitoring of the open FX position by banks may be explained by the stringent control through regulators (see 3 b. ii).

In terms of strategy, the survey reveals that banks and NBFIs generally prefer "adjusting" strategies, i.e. taking measures to minimize actual losses from moves in foreign exchange rates, over hedging strategies to proactively cover potential losses. Hedging strategies involve the use of financial instruments or contracts to protect against the adverse effects of expected currency fluctuations (forward contracts, options, or futures contracts), allowing companies to, for example, lock in exchange rates and mitigate the risk of future losses due to unfavorable exchange rate movements for their transactions.

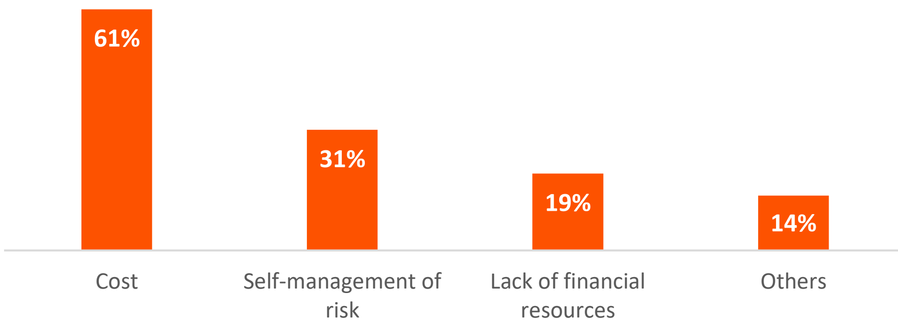
Table 1: Procedures of monitoring and managing currency risk

Tools	Banks and NBFIs
Combination of internal and external tools such as tracking systems and market analysis software	20
Regular review and update of foreign exchange risk management policies and procedures	17
Use of hedging strategies including forward contracts and options	9
Diversification of portfolio of currency exposures	13
Regular assessment and testing of currency risk exposure	20

Note: Respondents were able to select multiple answers

The main tools used by banks to monitor their foreign exchange risk include monitoring systems and market analysis software. They also conduct regular assessments and testing of their foreign exchange risk. Only 25% of banks and NBFIs manage FX risk by using hedging strategies.

Figure 14: Reasons not to hedge against currency risk

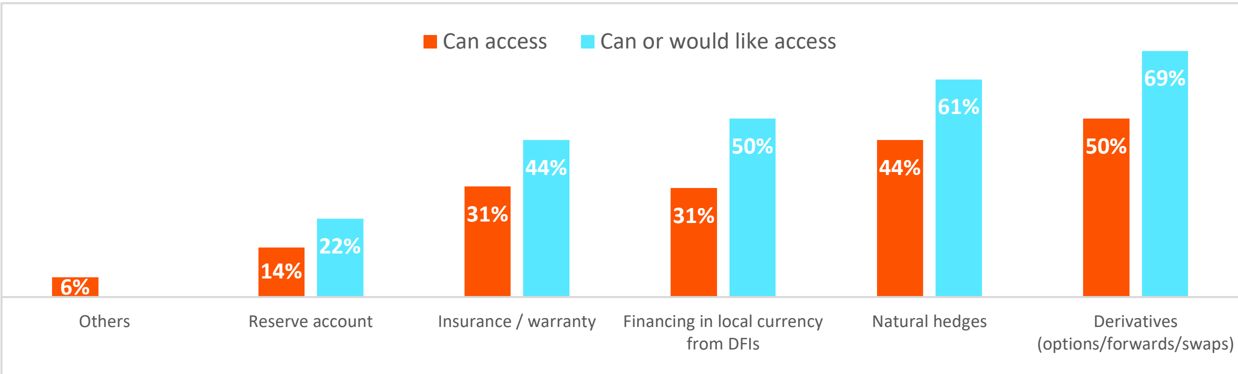


Note: Respondents were able to select multiple answers

The main reason for the low take-up of currency hedging is the perceived cost of these instruments. Around 60% of banks and NFBIs find currency hedging products expensive. Therefore, they decide to cope with the foreign exchange risk and attempt to self-manage it internally. Furthermore, around one fifth of respondents state they do not have the financial resources to do so.

b. Hedging solutions: challenges and perspectives from banks and NBFIs

Figure 15: Current and preferred hedging solutions

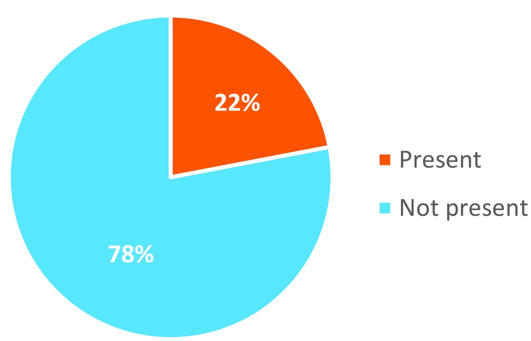


Note: Respondents were able to select multiple answers

Figure 15 shows that banks and NBFIs across Africa generally would like access to more hedging solutions than what is currently available.

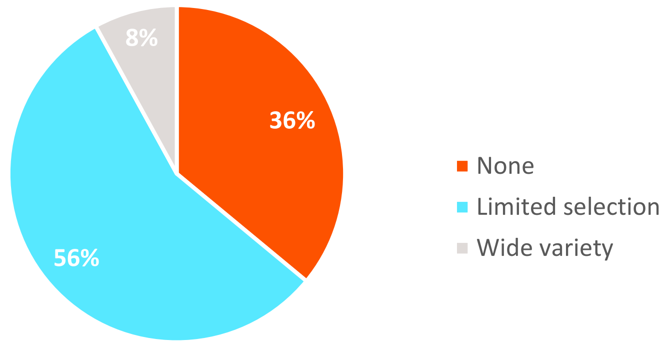
Derivatives are the most popular hedging solution currently in use among financial institutions (50%), followed by natural hedging (44%) against currency risk and financing from DFIs in local currency (31%). These are also the most preferred method of "hedging" by the local institutions. For all hedging solutions presented – and especially for the top-3 preferred solutions – the survey responses reveal a significant discrepancy between supply and demand.

Figure 16: Presence of legal or regulatory obstacles to foreign exchange derivative hedging activities



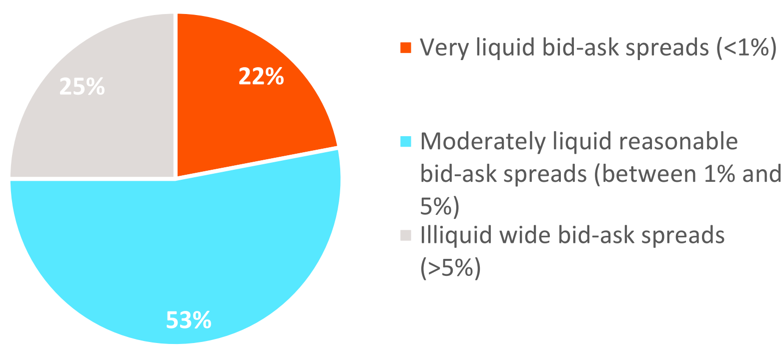
The limited use of derivative products by the respondents is more linked to the availability of products than to regulatory constraints. Indeed, when asked if any legal or regulatory barriers prevent them from engaging in FX-derivatives hedging activities, nearly 80% of banks and NBFIs responded no.

Figure 17: Currency hedging products availability



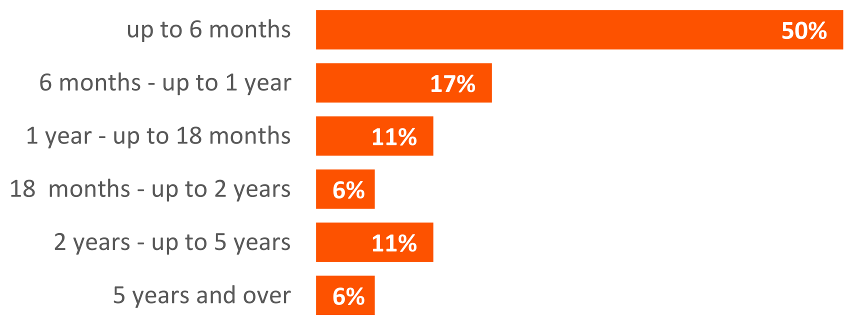
Instead, most banks mention the low availability of such hedging products. Only 8% of banks have access to a wide variety of currency-hedging products. More than half find the offer limited, while 36% of banks do not even have access to it. In addition to cost and lack of resources, this explains the low use of hedging products among the banks and NBFIs surveyed. Respondents having access to a wide variety of hedging products are located in Kenya, Ghana, and Morocco. 71% and 84% of banks and NBFIs in Southern and East Africa, respectively, have at least some access (limited or wide) to hedging products, making them the regions where these products are most available in our study sample. Only 55% of banks surveyed have access to hedging products in West Africa.

Figure 18: FX derivatives market liquidity



Besides the availability of products, the liquidity of the markets is another challenge highlighted in the survey. More than half of financial institutions (53%) consider the foreign exchange derivatives market they operate in to be moderately liquid, compared with 25% who consider it to be not liquid at all.

Figure 19: Maximum tenor of reliable hedging of foreign exchange exposure



In terms of maturity, in line with previous findings, most of the financial institutions interviewed do not have the means to hedge their exposure to risk over the long term. More than 70% of them can reliably hedge their exposure to foreign exchange risk over a maximum period of one year.

Almost half of the banks (44%) surveyed find the maturities of hedging products offered on their markets inappropriate. Out of the 16 banks that answered in that sense, 12 can reliably hedge their exposure for a maximum period of 12 months. This may imply a gap between the offer and the demand in terms of the maturity of the products, especially short- to mid-term products. It is also interesting to note that the responses on duration probably mean the prohibitive cost of hedging as stated by respondents likely refers mainly to shorter term hedging instruments.

An important factor for the use of derivatives products is the legal framework. The International Swaps and Derivatives Association (ISDA) has established the ISDA master agreement as a template for entering into a contractual obligation for derivatives, creating a basic structure and standardization for these transactions.

Table 2: ISDA agreement implementation

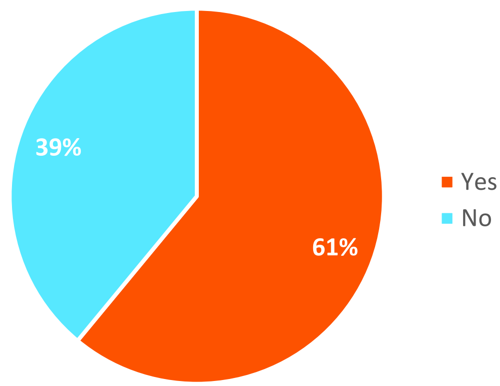
	No	Yes	Partially
ISDA (International Swap and Derivatives Association) Agreement is enforceable in the local market	47%	53%	0%
Availability of resources and capabilities (legal experts, operational and commercial) to manage the execution of ISDA standards	58%	39%	3%

More than half of the banks and NBFIs (53%) say that the ISDA agreement is enforceable in their local market. However, North Africa is the only region in our study where all the financial institutions agree to this. For all other regions, the results are mixed. One reason for this may be a lack of information about ISDA or lack of practice or checks, given limited hedging experience or investigation, or even a failure to trade hedging products under the ISDA framework. Indeed, out of the 54% of financial institutions claiming that ISDA is enforceable, 14 use hedging products against currency risk; of the remaining institutions reporting that the framework is not enforceable, only 2 use hedging products.

As for the human resources needed to negotiate and manage the execution of ISDA standards in the best possible way, only 40% of banks claim to have the necessary resources.[4] This illustrates that when banks and NBFIs have more resources, they use more hedging products. Out of the 14 banks that declared that they had adequate human resources, only 1 did not use hedging products against currency risk, whereas out of 21 banks that said no, only 2 did use these products.

The main sources of banks' and NBFIs' foreign exchange risk results from the practice of obtaining financing in hard currency while lending to clients in local currency. A natural hedge would avoid this 'mismatch' in the balance sheet. Depending on the balance sheet, a natural hedge of the foreign exchange risk could be established by increasing foreign currency loans or assets, or by increasing local currency borrowings as required to match currency on the assets and liabilities' side. While this sounds relatively straightforward, this is often not the case.

Figure 20: Presence of external or internal policies/regulations restricting foreign currency lending to non-FX linked borrowers



61% of the respondents report external or internal policies or regulations restricting the provision of FX loans to non-FX linked borrowers. These restrictions seem to come more from internal guidelines than from central bank regulations. Some respondents in East and West Africa mentioned a lack of clarity around central bank regulations on this matter.

[4] Understanding of ISDA agreements and tools (Derivatives products, Interest rate, Credits derivatives, Central clearing…)

5. Way forward – recommendations

The survey reveals the ways that African financial institutions are exposed to foreign exchange risks and their negative effects. These institutions, to varying degrees, have found it challenging to actively manage these risks, which hinders the ability of the financial sector to adequately service individual and commercial needs. The survey revealed that there is a lack of adequate hedging services on local markets, and even when they are available, hedging is seen to be relatively expensive. Finally, there is also the question of adequate internal capabilities to manage foreign exchange risk, which African banks are lacking.

Given the above, we can come up with some recommendations for regulators, policymakers, international investors, DFIs, banks, NBFIs, and hedging providers. Applying these recommendations will reduce the exposure to and impact of currency risk on the activities of banks and NBFIs. Eventually, this can also lead to a reduction in the cost of financing, and boost local economic activity and financial sector resilience to achieve greater sustainable and inclusive economic growth in African economies.

a. For regulators and policymakers

Recommendation 1: Reinforcing the national capital markets, particularly foreign exchange market

The relative lack of capital market funding amongst survey respondents, high demand for DFI funding, and lack of longer term FX derivative options suggest local governments and other stakeholders must take the necessary initiatives to foster an environment conducive to the growth of African capital markets. *Governments should also take measures to develop well-functioning foreign exchange markets able to increase the availability of derivatives to banks and NBFIs* (e.g., ISDA enforceability). *The survey shows that using derivatives remains a preferred hedging solution for banks provided that they are available at a reasonable cost.*

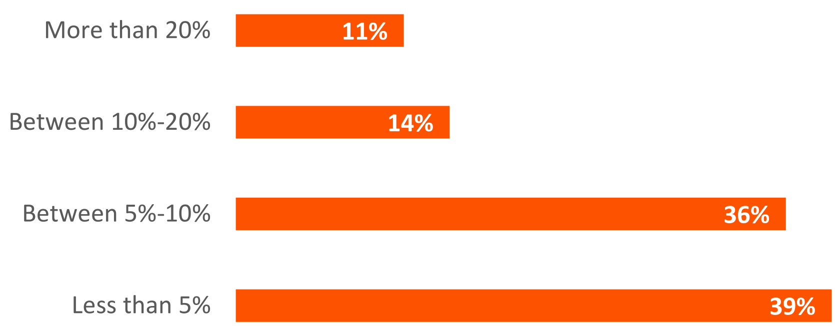
Recommendation 2: Ensure effective regulations and supervision

With the survey showing that a majority of banks are exposed to currency risk and have had financing challenges as a result, prudential rules are important to mitigate the potential negative impacts of currency risks on banks and NBFIs*, ensuring the resilience of the financial system in case of significant depreciation. Regulators enforcing those rules should make sure that currency risk is correctly considered by banks. The central bank must ensure that adequate capital buffers and risk management frameworks are in place across the sector. Additionally, some particular rules and guidelines can include:*

(i) Continuing to set, monitor, and adjust clear guidelines for local banks' net open FX position (NOFPs).

As the survey showed, NOFPs are quite limited and within allowed bounds across nearly all respondents. Additionally, most respondents mentioned that regulators "very stringently" monitor NOFPs. It is important that banks and NBFIs continue to monitor these actively whilst knowing regulators will continue to do same.

Figure 21: Regulatory limit for net open position on foreign exchange markets (% of equity)



Difficult market conditions have limited hard currency availability, and the sharp depreciations that have occurred in many African markets recently suggest that more stringent or nuanced limits may be appropriate in certain countries. An example can be seen in Nigeria, where recent policy moves to liberalize the FX market and improve foreign inflows saw the NOFP set at 0% long or 20% short.

(ii) Limiting hard currency lending to hard currency earners and/or a % of commercial banks' equity.

Nearly 40% of respondents noted there are no rules (internal or external) that restrict granting FX loans to non-FX linked borrowers. This shows there is still scope for tightening, particularly to protect consumers and businesses from banks and NBFIs simply offloading the direct risks from themselves to these parties. Another way to limit dollar lending and thus dollarization is to cap dollar lending to a fixed percentage of a bank's equity. It is notable that a commercial bank's net open FX position can be low but hard currency lending to individuals and businesses high. In situations like this, NOFP regulation alone may not be adequate enough to satisfactorily mitigate underlying forex risks in the financial system. This can also limit dollarization in the economy helping support local capital markets.

(iii) Carefully managing foreign currency reserve requirements dependent on market conditions, and establishing clear guidelines for the selling and purchasing of hard currency from the central bank.

Central banks on the continent generally use foreign currency reserve requirements as of one of the main ways to manage dollar liquidity and try to support local currency. The results of the survey show that these requirements have had a significant impact on banks and NBFIs, and are expected to continue have even more of an effect going forward. This illustrates the importance of regulators managing foreign currency reserve requirements carefully to manage balancing dollar liquidity and local currency support without restricting legitimate markets too much. Commercial banks generally purchase and/or sell dollars from/to the central bank regularly, and the rules guiding these purchases should be clearly established to balance the provision of adequate dollar liquidity with the need to preventing dollar hoarding by banks all whilst carefully managing critical central bank reserves. A one size fits all rule on sales and purchases cannot be prescribed given heterogenous markets and changing market conditions. The strictest version of a rule may necessitate commercial banks sell all excess dollars (what qualifies as excess would have to be defined carefully) to the central bank whilst purchases from the central bank would only be met when a particular proportion of a commercial bank's (unencumbered) dollars is at or below a certain threshold.

b. For international investors, MDBs, and DFIs

Recommendation 3: Enhancing local currency financing and lending offering to banks and NBFIs

(i) MDBs, DFIs, and international investors are encouraged to offer banks and NBFIs the flexibility of obtaining financing in local currency.

Such financing mitigates the exchange rate risk inherent in hard currency loans, thereby promoting financial stability. It reduces the vulnerabilities associated with currency mismatches, enabling banks and NBFIs to conduct their business more effectively. This financing instrument is the most favored by the banks and NBFIs interviewed, but it is one of the least used because of the limited supply. International investors, MDBs, and DFIs can offer local currency financing to banks either through classic loans denominated in local currency or through synthetic[5] local currency arrangements tailored to meet the unique requirements and preferences of the borrowers. Another option is for investors to insert a local currency conversion clause[6] in the loan agreement when offering financing in hard currency. In order to offer and promote local currency financing to banks and NBFIs, international investors, MDBs, and DFIs should engage and collaborate with various players to reduce systemic barriers and transaction risks. Effective cooperation and coordination between MDBs, DFIs, regional development organizations, banks, and NBFIs will strengthen local currency financing initiatives. This can be achieved through the establishment of a formalized network or platform that serves as a collaborative space for sharing knowledge, expertise, and best practices. Through regular meetings, workshops, conferences, and online platforms, member institutions within the regional network can actively engage in the exchange of experiences, lessons learned, and policy frameworks. This exchange of information enables countries in the same region to benefit from each other's successes, challenges, and strategies, ultimately contributing to the development and refinement of effective local currency financing policies and practices.

(ii) Actively participate in blended finance initiatives and supply.

Banks' and NBFIs' access to blended finance can increase the attractiveness and flexibility of financing options. In addition, it mitigates the risk associated with local currency finance, for example by providing concessional finance which can also be a solution to reduce borrowing costs and provide loans and grants at below market rates and on better terms. Some financial mechanisms also effectively combine public and private capital to reduce investment risks. For example, risk-sharing agreements and insurance products spread the burden of risk and therefore reduce the cost of credit.

c. For financial institutions

Recommendation 4: Strengthen internal capabilities.

Banks and NBFIs need to invest in specific training programs focused on foreign exchange risk management to ensure that their staff, whether in finance, risk management, legal, treasury, or any other related departments, have the necessary expertise. Among the financial institutions surveyed,

5 A Synthetic Local Currency Loan is a loan denominated in the borrowing country's currency; the loan is disbursed in that local currency, and repayments (interest and principal) are based on a local interest rate. Finally, payments will be made in hard currency but based on defined (unchanged) local currency amounts then converted into hard currency (USD or EUR) based on a pre-agreed FX source (normally the Central Bank FX rate).

6 A local currency conversion clause is a provision that allows the investees to return to the investor throughout the life of the transaction and request a conversion to local currency should a series of conditions be met.

those with the human resources to make the best use of ISDA standards tend to use more hedging products. Banks and NBFIs should therefore strengthen their staff's skills in hedging strategies, the use of ISDA derivatives tools, and foreign exchange stress test analysis. Finally, banks, NBFIs, hedging product providers, and ISDA need to work together to bridge the skills gap by engaging in knowledge-sharing and peer-to-peer learning platforms. Such platforms offer institutions opportunities to share their experiences, lessons learned, and best practices in dealing with currency risk. The MFW4A platform can serve as a facilitator for these collaborative efforts in collaboration with regional and national banking associations. All these efforts will enable banks and NBFIs to make informed decisions to effectively mitigate the effects of currency risk on their operations and to enhance the use of hedging products.