

Local Currency Funding for MFIs
EFSE Conference
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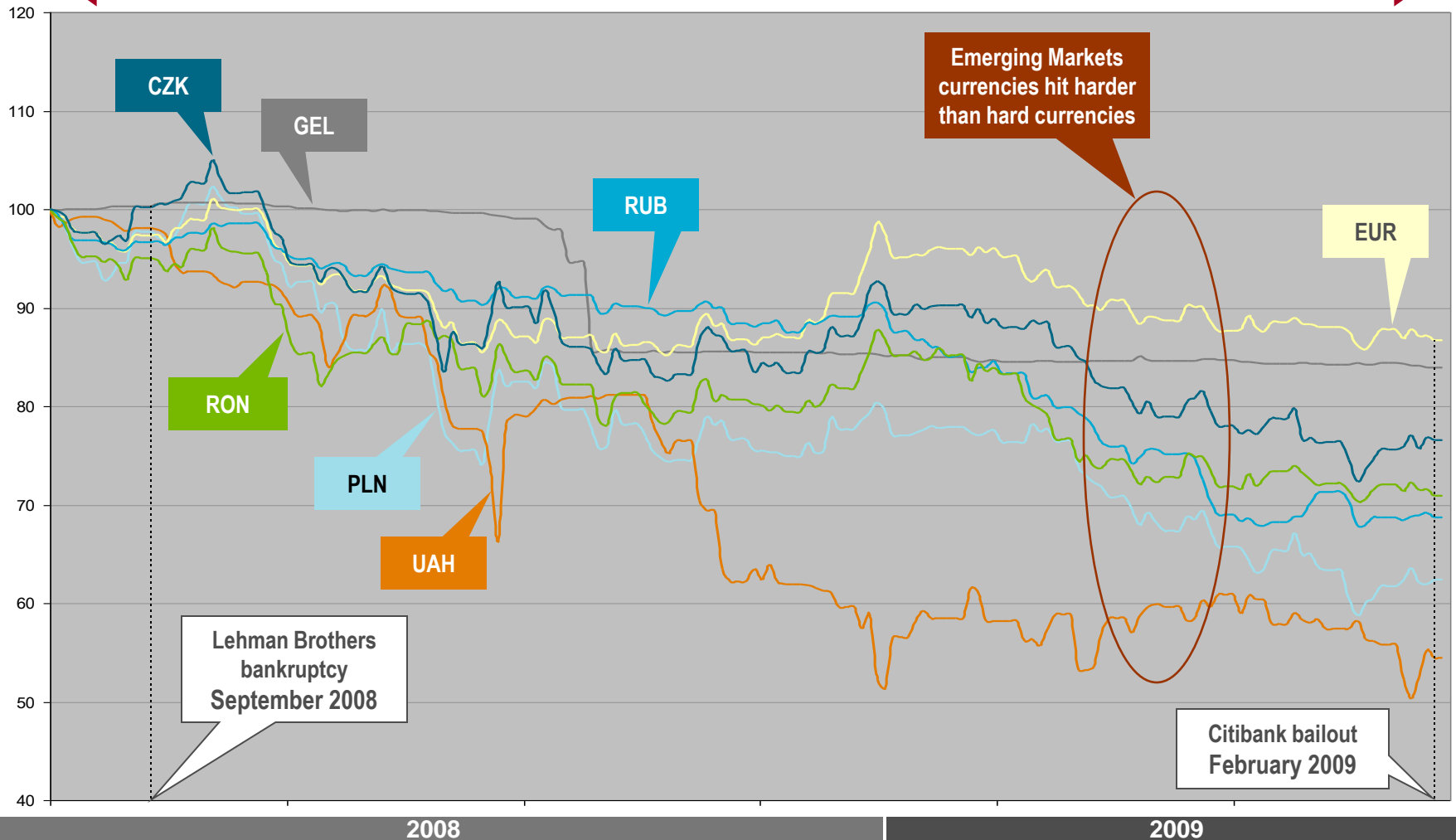
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Impact of Financial Crisis

Collapse of Eastern European currencies against the USD

Nearly all currencies depreciate vs US Dollar as investors seek safety of US Treasuries



Impact of Financial Crisis

Currency Risk in Cross-Border Transactions

Regardless of whether an MFI borrows in hard currency or local currency, someone will have to bear the currency risk.

Borrowing in Hard Currency

If an MFI borrows in hard currency, then it faces the risk that the local currency will depreciate against the hard currency, thereby increasing its liabilities.

To mitigate this risk, an MFI may:

- **Lend to its borrowers in hard currency or through loans indexed to the hard currency, which would pass on the risk to the end borrowers**
- **Hedge the risk by entering into a derivative contract**

Borrowing in Local Currency

If an MFI borrows in local currency, then it will not have currency risk, since the investor will bear the risk.

Key items to consider when seeking local currency funding:

- **Understand the components that make up hedge pricing, because this will impact the overall price of the loan**
- **Learn to compare local currency versus hard currency rates**

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Borrowing in Hard Currency – an example

An MFI in Albania has all assets and liabilities denominated in Albanian lek (ALL). The MFI is looking for additional funding and borrows USD 1,000,000.

- The MFI agrees to pay 8% interest on the loan for 1 year with annual interest and bullet notional repayment at maturity.
- Once the USD 1mm is received, the MFI converts this to lek at the prevailing spot rate of 77.55

Assuming Spot Rates of:

- Spot Exchange Rate in Apr 2008: 77.55 USD-ALL

An MFI borrowing in hard currency faces currency risk.

April 2008

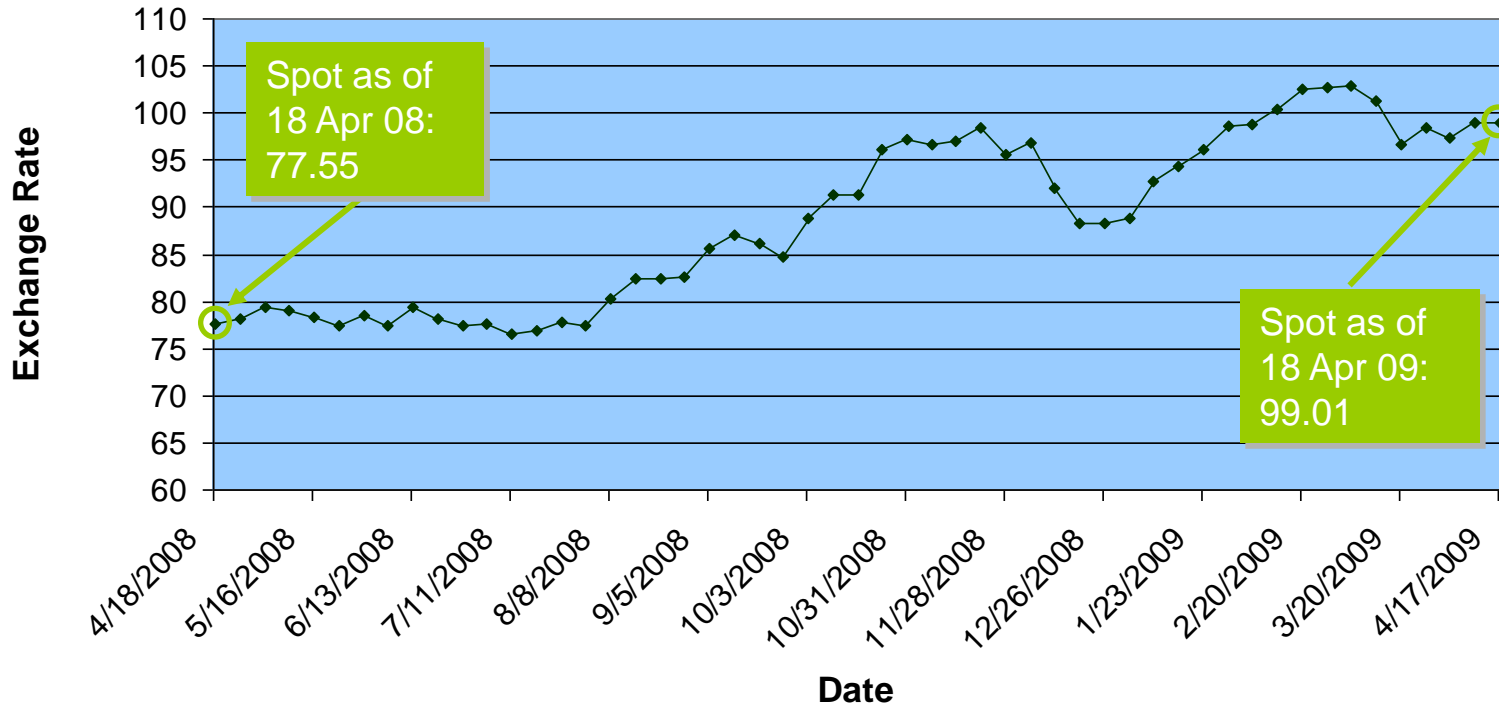
MFI receives USD 1mm and converts it at spot to Albanian lek.



Borrowing in Hard Currency – an example

Over the next year, the lek devalues significantly against the dollar.

USD-ALL Spot Exchange Rates: 18-4-08 to 18-4-09



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Borrowing in Hard Currency – an example

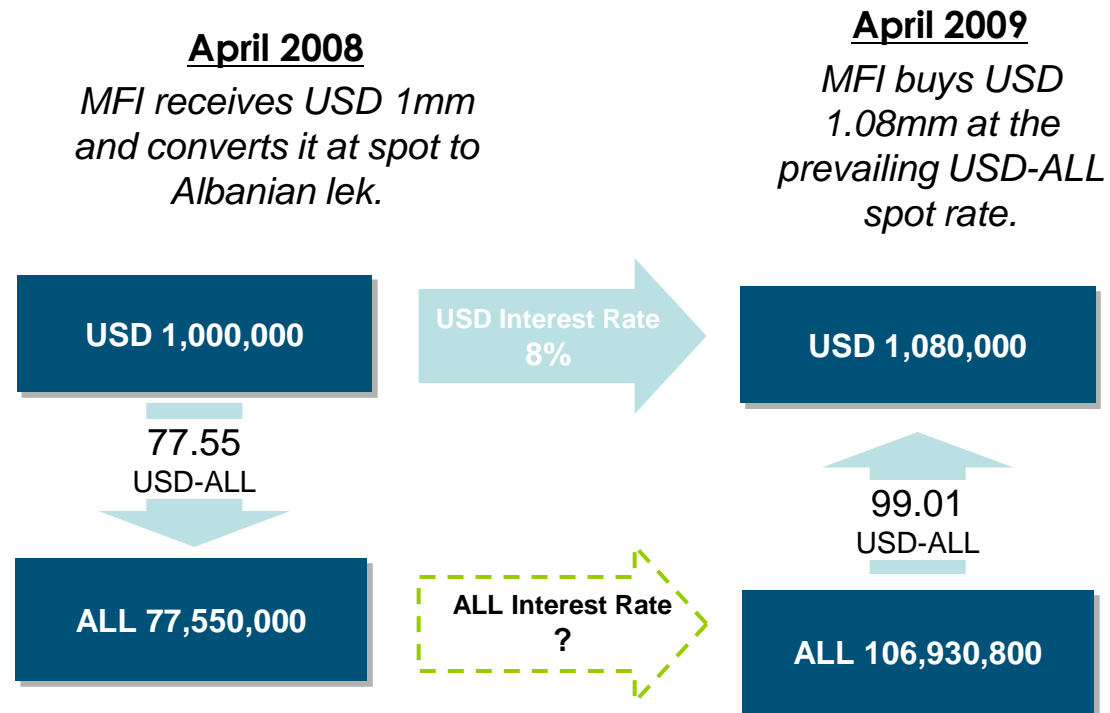
In April of 2009, the MFI needs to repay the USD 1mm loan plus 8% interest for a total of USD 1,080,000.

- The prevailing spot rate is USD-ALL 99.01, so the MFI will need to pay ALL 106,930,800 to buy USD 1,080,000.
- This results in an effective interest rate for the MFI of 37.9%

Assuming Spot Rates of:

- Spot Exchange Rate in Apr 2008: 77.55 USD-ALL
- Spot Exchange Rate in Apr 2009: 99.01 USD-ALL

The MFI is forced to repay significantly more lek than it originally received.



MFI's Effective Interest Rate is 37.9%.

Managing the Risk

Borrowing in Local Currency – an example

Example of Comparing Interest Rates on Different Currency Loans

MFI in Poland is Seeking a Loan:

- MFI wishes to borrow the equivalent of USD 1,000,000.
- An MIV offers the MFI a choice:
 - USD loan at an interest rate of 8.00%; or,
 - PLN loan at 9.00%.
- Both loans would be for 1 year with annual interest and bullet notional repayment at maturity.

Assume the Following FX Rates (01-June-10):

- Spot Exchange Rate: USD-PLN = 3.37
- 1 Year Forward Rate: USD-PLN = 3.41

Which loan should the MFI choose?

Managing the Risk

Borrowing in Local Currency – an example

MFI in Poland is Seeking a Loan:

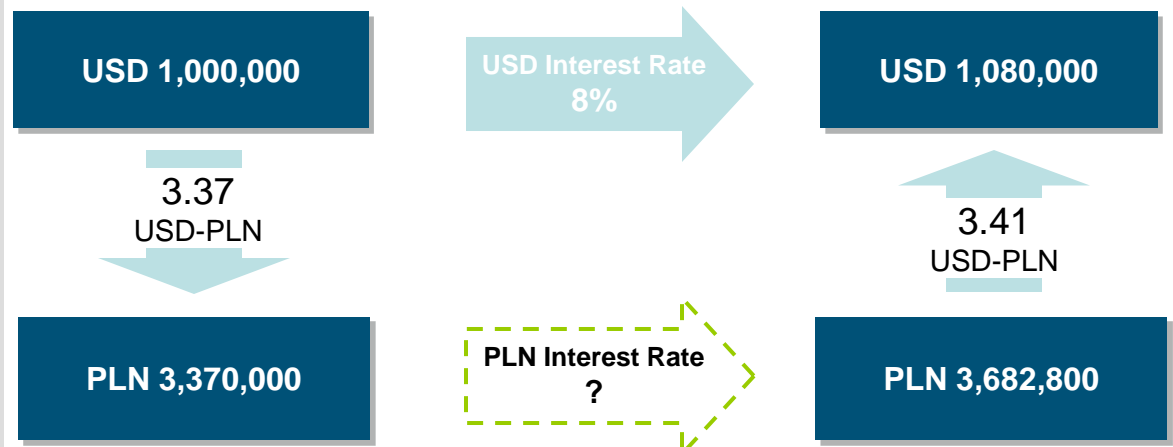
- The MFI is seeking a loan for the equivalent of USD 1,000,000.
- An MIV offers the MFI a USD loan at an interest rate of 8.00% or a PLN loan at 9.00%.
- Both loans would be for 1 year with annual interest and bullet notional repayment at maturity.

Assuming FX Rates of:

- Spot Exchange Rate:
3.37 USD-PLN
- 1 Year Forward Rate (01-June-10):
3.41 USD-PLN

Which loan should the MFI choose?

Determine what PLN interest rate is equivalent to 8.00% USD:



$$\frac{3,682,800}{3,370,000} - 1 = 9.30\%$$

The USD loan is the equivalent of a 9.30% PLN loan, so the PLN loan at 9.00% is the “better deal”.

Hedge Products

- ❖ **FX Forward:** an obligation to exchange a specified amount of one currency for another at a particular exchange rate on a specific date in the future.
- ❖ **FX Option:** an agreement giving the purchaser the right (but not the obligation) to exchange one currency for another at a particular exchange rate at a specific date in the future.
- ❖ **Cross Currency Swap:** a combination of FX Forwards structured to hedge periodic principal / interest payments and the final principal payment.

Practical Challenges of Hedging

- ❖ Many emerging market currencies cannot be hedged through dealer banks
- ❖ Credit lines for hedging can be difficult for investors, and more difficult for MFIs, to access
- ❖ Tenors for matching the maturity of loans may not be available
- ❖ Deliverability is not possible for some currencies

Questions?

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