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# Ex-Post Evaluation Brief

## TCX Subordinated Convertible Debt Facility

| **Sector** | Formal financial institutions (CRS Code 24010) | |
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| **Project** | Local Currency Fund TCX / BMZ No. 2007 66 659 | |
| **Implementing Agency** | The Currency Exchange Fund (TCX) | |
| **Year of random sample/Year of Evaluation: 2012/2012** | | |
| | Plan | Realized |
| **Investment BMZ** | 40 Mio EUR | 40 Mio EUR |

**Ex-Post Evaluation in German Financial Cooperation (FC):** Ex-post evaluations are an inherent part of the project cycle in FC. A representative sample of all completed projects/programmes (technically completed and/or all financial contributions disbursed) that have been in operation for at least two years is subject to a standard ex-post evaluation. Therein, the whole project cycle is reappraised, from project identification to needs assessment to operational experience, with a special focus on developmental outcomes and impacts actually achieved. The project "The Currency Exchange Fund (TCX)" was part of the random sample 2012 and accordingly was evaluated in the same year.

**Project description:** The Local Currency Fund N.V. Amsterdam ("TCX") is an investment company which provides foreign currency (FX) hedging for international investors which lend to financial institutions in developing countries. In 2009 KfW, acting on behalf of the German Federal Government (BMZ) provided a subordinated convertible debt facility ("Facility") to TCX. The participation of the German Financial Cooperation (FC) amounted to 40 Mio EUR[1)] and was disbursed in October 2009. From September 2012 the *Facility* can be converted into shares of TCX.

**Project objectives as stated in the appraisal report submitted to BMZ in 2008:** The primary project goal of the *Facility* is to contribute to TCX being a sustainable and transparent fund, enable it to mobilise additional funding, and increase its engagement in Sub-Saharan Africa (SSA). The development objective of the *Facility* is twofold: The first objective is to foster cross-border local currency financing to developing countries and as a consequence to reduce the substantial currency risk of their financial sectors. The second objective is to enhance the access of micro, small and medium-sized enterprises (MSME) in the SSA region to long-term credit, fostering their investment and employment.

**Target group:** Development Finance Institutions (DFIs), Microfinance Investment Vehicles (MIVs), MFIs and MSME worldwide.

**Overall assessment: Rating 2**
The *Facility* provided by FC has fulfilled its project goals in an effective and efficient manner. TCX has also contributed strongly to financial sector development. TCX has enhanced the availability of hedging instruments for illiquid developing country currencies, fostering cross-border funding to developing countries in local currency. By doing so, TCX has contributed to reducing the systemic currency risk of the financial sector in many developing countries. The impact of TCX on financial stability could be enhanced though by focusing more on the Eastern Europe and Central Asia (ECA) region where currency risk is most severe. It seems unlikely that TCX-hedged local currency loans lead to an alleviation of credit constraints of MSME in the SSA region. If shareholders strongly value the impact of TCX on MSME credit availability they should target their TCX-hedged investments to countries where monetary conditions rather than institutional environments constrain long-term lending to MSME.

1) An additional contribution of 50 Mio EUR to the subordinated debt facility was provided by the Government of the Netherlands.

**Overall assessment (Rating 2)**

The subordinated convertible loan *Facility* to TCX has fulfilled its project goals in an effective and efficient manner. The Facility has also contributed significantly to financial sector development: TCX has significantly enhanced the availability of hedging instruments for illiquid country currencies, fostering local currency funding to developing countries, especially to the SSA region and to the microfinance sector. By fostering cross-border funding in local currency, TCX contributes to reducing the fragility of the financial sector – and in particular the microfinance sector – in many developing countries. The contribution to financial sector stability could however be enhanced if hedging instruments provided by TCX were directed more to the ECA region where currency exposure is most severe.

TCX does not seem to contribute significantly to fostering long-term borrowing and investment by MSME in SSA. The reluctance of MFIs in the SSA region to provide medium-term and long-term loans does not seem to be primarily driven by monetary uncertainty but rather by the weak institutional environment. If shareholders strongly value the potential impact of TCX on credit availability, in particular for MSME, they should target their TCX-hedged investments to countries with strong legal environments but uncertain monetary conditions.

**Relevance – Financial sector development (Rating 1):** Financial institutions in developing countries have limited access to long-term deposits, wholesale funding or debt in their domestic market. For access to medium-term and long-term funds these institutions rely heavily on international lenders, i.e. DFIs and MIVs. Cross-border funding by DFIs, MIVs and also commercial banks in hard currency has led to a substantial foreign currency exposure of the financial sector in many developing countries. Foreign currency risk is most severe in Eastern Europe, but is also relevant for MFIs in Sub-Saharan Africa.[1] Measures to foster local currency funding of financial institutions in developing countries are therefore highly relevant to reducing the risk of individual financial institutions as well as the systemic risk of the financial sector as whole. DFIs and MIVs have limited capacity to maintain open positions in illiquid developing country currencies and thus rely on cross-currency swaps in such currencies to offer local currency funding. The market availability of such hedging instruments is very limited. As a consequence the provision of cross-currency swaps for illiquid developing country currencies is highly relevant to reducing currency risk and increasing financial stability.

**Relevance – Availability of long-term credit for MSME (Rating 3):** The availability of currency hedging instruments does foster the long-term local currency funding of MFIs in developing countries. However, it is far from clear that such funding may increase the provision of long-term credit by MFIs to small businesses. The provision of long-term credit to

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[1] While a substantial share of cross-border funding of banks in Eastern Europe originates from parent banks and is denominated in foreign currency existing evidence (Brown and De Haas, Economic Policy 2012) casts doubt on a causal relationship between wholesale funding and foreign currency lending in that region. Instead it seems that foreign currency lending is stronger driven by foreign currency customer deposits.

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MSME in many developing countries may not be primarily constrained by a lack of long-term currency funding. This will only be the case if interest rate risk and/or liquidity risk driven by monetary uncertainty is the main reason why MFIs are reluctant to offer long-term credit. Cross-country comparisons and anecdotal evidence for MFIs in Sub-Saharan Africa suggest that monetary uncertainty is not the key constraint to the provision of long-term MSME credit. Instead it seems more likely that long-term lending is inhibited by the weak institutional and legal environment in these countries.

**Effectiveness (Grade 1):** The *Facility* of 40 Mio EUR (129 Mio USD) to TCX by FC has fulfilled all project goals. The outstanding volume of primary transactions related to the SSA region increased from 108 Mio USD in 2008 to 213 Mio USD at the end of 2012:Q1. The outstanding volume of transactions related to the MFI sector increased from 127 Mio USD in 2008 to 441 Mio USD at the end of 2012:Q1. The *Facility* has played a key role in the increase of transactions related both to the SSA region and the MFIs. Since inception TCX has attracted 20 investors in class A shares with a total investment volume of currently 500 Mio USD. While most of this investment occurred prior to the disbursement of the *Facility* it seems reasonable to assume that the anticipation of this first-loss provision contributed significantly to mobilizing shareholder funds. TCX is a transparent and sustainable fund. The return on equity of TCX has exceeded the benchmark performance of the USD 6-month LIBOR between 2008 and 2012:Q1.

**Efficiency (Grade 1):** As a coordinated initiative of public investors[2] and private investors, TCX is an efficient mechanism for promoting local currency funding to developing countries.[3] With TCX the involved DFIs and MIVs have diversified the risk of providing local currency hedging by pooling currency risks across a larger volume of transactions in a larger number of currencies. Moreover, this coordinated initiative has enabled a pooling of resources to create the know-how required to provide and manage hedging instruments for developing country currencies.

While TCX has maintained a clear focus on managing currency risk, it has forged partnerships with investors to also tackle the credit risk involved in providing currency hedges to low-rated or non-rated counterparties. Guarantees provided by investors for non-investor MIVs as well as the partnership with MFX solutions[4] to channel hedging instruments to MFIs in developing countries are efficient means of dealing with the constraint of the counterparty.

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[2] On the same rank as the BMZ/KfW *Facility*, The Netherlands Ministry of Foreign Affairs through its Directorate-General for International Cooperation, DGIS, contributed EUR 50 Mio of a subordinated convertible debt facility (class A shares), while other public investors, e.g. the European Bank for Reconstruction and Development (EBRD), and The Netherlands Development Finance Company (FMO) invested into class B-shares.

[3] The assessment of efficiency is based on whether the subordinated loan to TCX meets its project objectives in a resource-effective manner. Thus while the loan may not have achieved both of its development objectives (see assessment of development impact below) it may still be efficient in reaching its project objectives.

[4] MFX solutions offers currency risk hedging to MFIs in developing countries which are characterized by high counterparty risk. Being an investor in TCX, MFX solutions thus channels currency hedging products from TCX to financial institutions which TCX cannot deal with directly.

**Development impact – Financial sector (Rating 1):** TCX has contributed substantially to financial sector development by fostering local currency investments in developing countries and thus reducing the risk exposure of the recipient institutions. TCX has substantially expanded the availability of hedging instruments for developing and emerging country currencies. TCX currently offers hedging instruments for all DAC currencies and had an exposure in 44 currencies at the end of 2011. For each currency TCX offers cross-currency swaps which have much longer maturities than those available from commercial providers. The provision of hedging instruments to low-rated and non-rated counterparties is facilitated through guarantees and partnerships with investors, e.g. MFX solutions.

Through research and initial transactions in developing country currencies TCX has reduced the technical and regulatory barriers for commercial providers to enter this derivatives market.[5] TCX has gathered comprehensive information on sources of benchmark interest rates and has introduced an in-house macroeconomic forecasting tool for countries with illiquid currencies. By conducting initial transactions, having these positions valued by an international auditor (Ernst & Young) and being rated by one of the major agencies (Standard & Poor's, S&P) TCX has increased the industry capacity to assess derivative positions in illiquid currencies.

By fostering cross-border funding of financial institutions in local currency, TCX contributes indirectly to reducing the fragility of the financial sector in many developing countries. More than two-thirds of the MFIs worldwide have a foreign currency exposure which exceeds 10% of their equity. Currency exposure thus poses a systemic risk to the financial sector – or at least the microfinance sector – in many countries. The TCX-hedged provision of local currency credit to MFIs through REGMIFA has for example strongly reduced the currency exposure of many MFIs in Sub-Saharan Africa. That said, the contribution of TCX to enhancing financial stability could be enhanced if the fund was to allocate more of its transaction volume to Eastern Europe and Central Asia (ECA) where the currency risk of MFIs (and their borrowers) is much more severe than in any other region.

**Development impact – Availability of long-term credit for MSME (Rating 3):** The cross-country evidence and case studies presented in this evaluation cast considerable doubt on the impact of TCX-hedged local currency funding on the availability of long-term credit for MSME. The three case studies presented for Sub-Saharan Africa suggest that it can hardly be expected that additional long-term local currency funding will lead to a significant increase in the provision of long-term credit. In all three cases the MFIs already had significant access to medium-term and long-term funding but were not using these funds to provide long-term credit. Given that two of these MFIs are mature, profitable, deposit taking institutions it is unlikely that their reluctance to lend long-term is driven by a lack of know-how.

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[5] This includes the "Joint Donor Escrow Account", an internal pool of grant funds funded by TCX's payment of "interest" on the donor facility and the creation of Mantis, a frontier market research initiative with current coverage of circa 50 currencies in the least developed markets.

By contrast it seems more plausible that these MFIs are reluctant to provide medium-term and long-term loans due to the weak institutional environment in the SSA region. In this case it is very unlikely that the TCX-hedged local currency funding would have a significant impact on the availability of long-term credit for MSME. A comparison of monetary uncertainty (e.g. inflation risk) and the legal environment across countries suggests that the latter has a much stronger impact on the availability of long-term credit for MSME. Thus it seems likely that the impact of TCX-hedged local currency lending on MSME credit would be much stronger beyond the SSA region. Such an impact can only be expected in countries where monetary uncertainty can be identified as the key inhabitant to long-term credit provision, e.g. countries with strong legal environments but high (past) inflation and exchange rate volatility (e.g. some countries in the ECA and Latin America and the Caribbean (LAC) regions). If shareholders strongly value the impact of TCX on credit availability for MSME they should target their TCX-hedged investments to such countries.

**Sustainability (Rating 2):** The recent performance of TCX suggests that the fund is on track to be a sustainable institution. In 2010 and 2011 TCX more than doubled the volume of outstanding investments and has recovered well from the high losses occurred in 2008 due to the financial crisis. Overall net asset values for shareholders have grown more strongly than the benchmark (LIBOR) rate. While TCX is still operating below its maximum capacity the opening up of the fund to non-investors and partnerships with investors to channel hedging instruments to low-rated and non-rated counterparties suggest that the current growth in transaction volume and the stabilization of returns should continue.

It is unlikely that a withdrawal of the subordinated loan Facility or a non-conversion into class B shares, would lead to an exodus of all existing class A shareholders. However, for some shareholders the lower risk due to the first-loss embedded in the *Facility* is viewed as a significant compensation given the low return and the innovative character of the fund.

The most recent rating of TCX by S&P (December 2011) still views a major strength of the fund in “the likelihood of extra support by shareholders and the German and Dutch Government”. Thus the ability of TCX to mobilize additional funding from new investors may be limited if the first-loss provision of the *Facility* were to be withdrawn. However, given that the fund is currently well capitalized and highly liquid the performance of TCX will hardly be constrained by a lack of new funding in the foreseeable future.

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## NOTES ON THE METHODS USED TO EVALUATE PROJECT SUCCESS (PROJECT RATING)

Projects (and programmes) are evaluated on a six-point scale, the criteria being relevance, effectiveness, efficiency and overarching developmental impact. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

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| 1 | Very good result that clearly exceeds expectations |
| 2 | Good result, fully in line with expectations and without any significant shortcomings |
| 3 | Satisfactory result – project falls short of expectations but the positive results dominate |
| 4 | Unsatisfactory result – significantly below expectations, with negative results dominating despite discernible positive results |
| 5 | Clearly inadequate result – despite some positive partial results, the negative results clearly dominate |
| 6 | The project has no impact or the situation has actually deteriorated |

Ratings 1-3 denote a positive or successful assessment while ratings 4-6 denote a not positive or unsuccessful assessment

**Sustainability is evaluated according to the following four-point scale:**

Sustainability level 1 (very good sustainability) The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability): The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected).

Sustainability level 3 (satisfactory sustainability): The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability): The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and is very unlikely to improve. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The overall rating on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. Ratings 1-3 of the overall rating denote a "successful" project while ratings 4-6 denote an "unsuccessful" project. It should be noted that a project can generally be considered developmentally "successful" only if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are rated at least "satisfactory" (rating 3).