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Managing Currency Risk in Volatile Times: A Microfinance Industry Approach

November 13, 2008

MFX Mission

- Help the microfinance industry -- both institutions (MFIs) and investors (MIVs) -- understand, quantify and reduce currency risk.
- Be a one-stop-shop for microfinance currency hedging, using TCX and commercial banks to leverage hedging capacity for its clients.
- Be a service organization to the MF industry, providing free decision-support tools and unbiased information so MFIs and MIVs can make choices appropriate to their risk profile.
- Transparently pass on the pricing advantages MFX obtains from counterparties to its clients, while covering operating costs and a providing a fair market return to investors.

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An Industry Effort

MFX Investors

- Omidyar Network
- *ACCION International**
- Triodos Investment Mgmt
- *CalMeadow Foundation**
- Incofin
- *Global Partnerships**
- *Calvert Foundation**
- Grameen Foundation
- ADA
- Blue Orchard
- Gray Ghost/Grassroots Capital
- Seed Capital/Microvest
- Microcredit Enterprises
- Developing World Markets
- Unitus
- Mecene Investment (Africap)

MFX Grant funders

- Ford Foundation
- TCX
- FMO
- USAID
- *MicroRate** (in kind)

*MFX Project Steering Committee

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The urgency of an industry solution to currency risk in microfinance

- The current crisis in emerging markets will slow local financial market development and increase reliance on international lending.
- Normally currency risk is born at the lowest levels in the value chain – the MFI or the micro-borrower. With food crisis, drying up of local liquidity, climate change, etc. these entities are even less able to bear it.
- Currency risk is a major barrier for the neediest markets (e.g. sub-Saharan Africa). Meanwhile, as financial markets tighten, it is becoming harder for even larger MIVs to access commercial currency hedging in more advanced markets.
- Given the benign conditions in emerging markets until the current crisis, many MFIs are not ready to deal with currency volatility.

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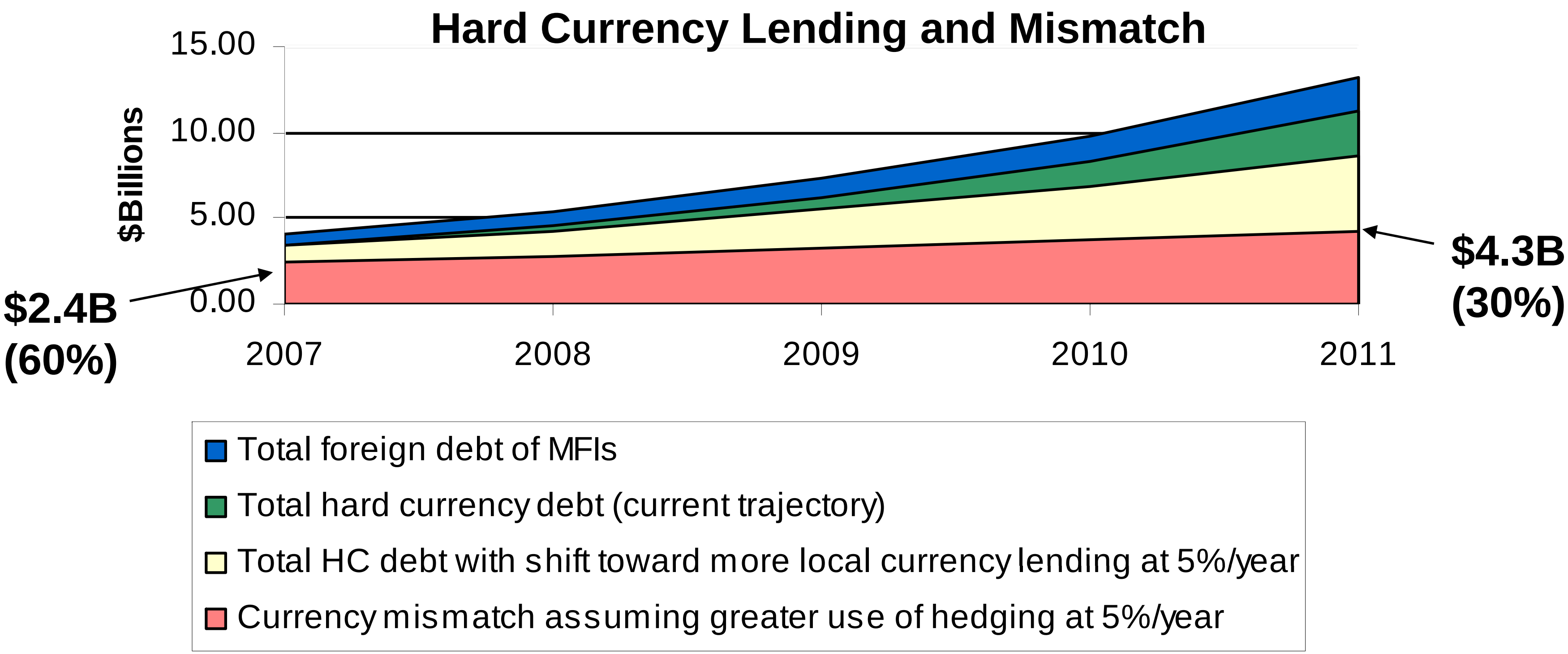
The challenge: currency mismatch grows even if falling as % of total lending



Based on CGAP data (2006/2008) and MFX projections

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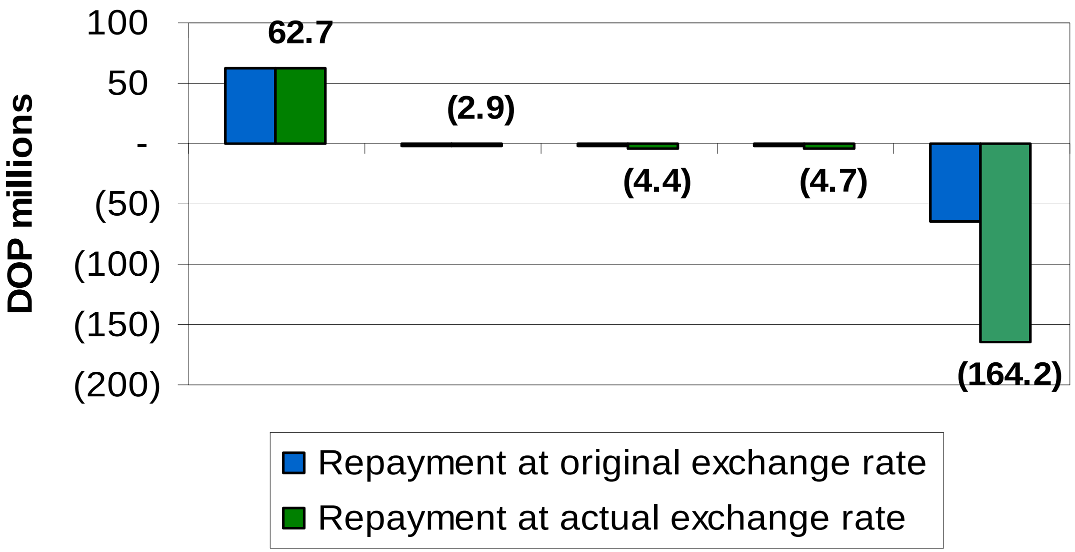
The risk: effect of a currency devaluation on MFI funding Ex: Dominican Republic 2002-2004

Local currency cash flow on a 2 yr $ loan (7/1/02-7/1/04)



Interest rate in dollars = 8%
Effective interest rate = 91%

Effect of a currency devaluation on an MFI balance sheet Ex: Dominican Republic 2002-2004

MFI Balance Sheet*

Before Crisis (7/1/2002)

	Assets	Liabilities	%	
Loans	$10,000	$ 3,500	35%	$ debt
		$ 4,500	45%	LC funding
		$ 2,000	20%	equity
		$ 10,000		

After Crisis (7/1/2004)

	Assets	Liabilities	%	
Loans	$ 4,802	$ 3,500	73%	$ debt
		$ 2,572	54%	LC funding
		$ (1,269)	**-26%**	**equity**
		$ 4,802		

*Assumes 10%/year asset growth and 20% deposit growth

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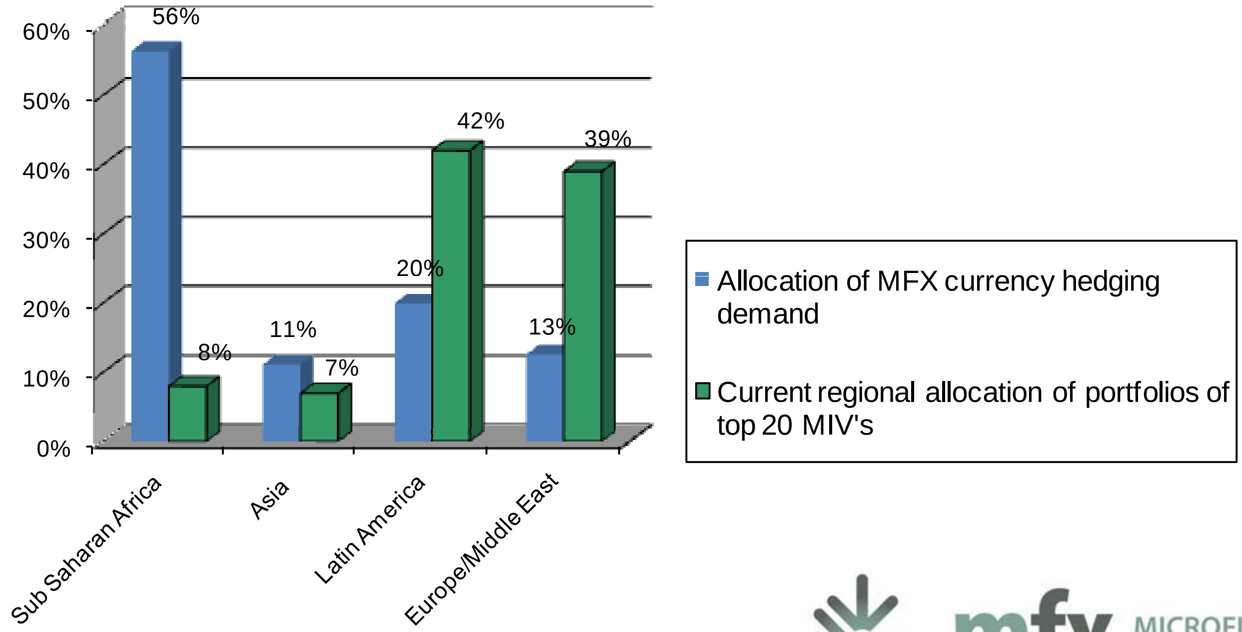
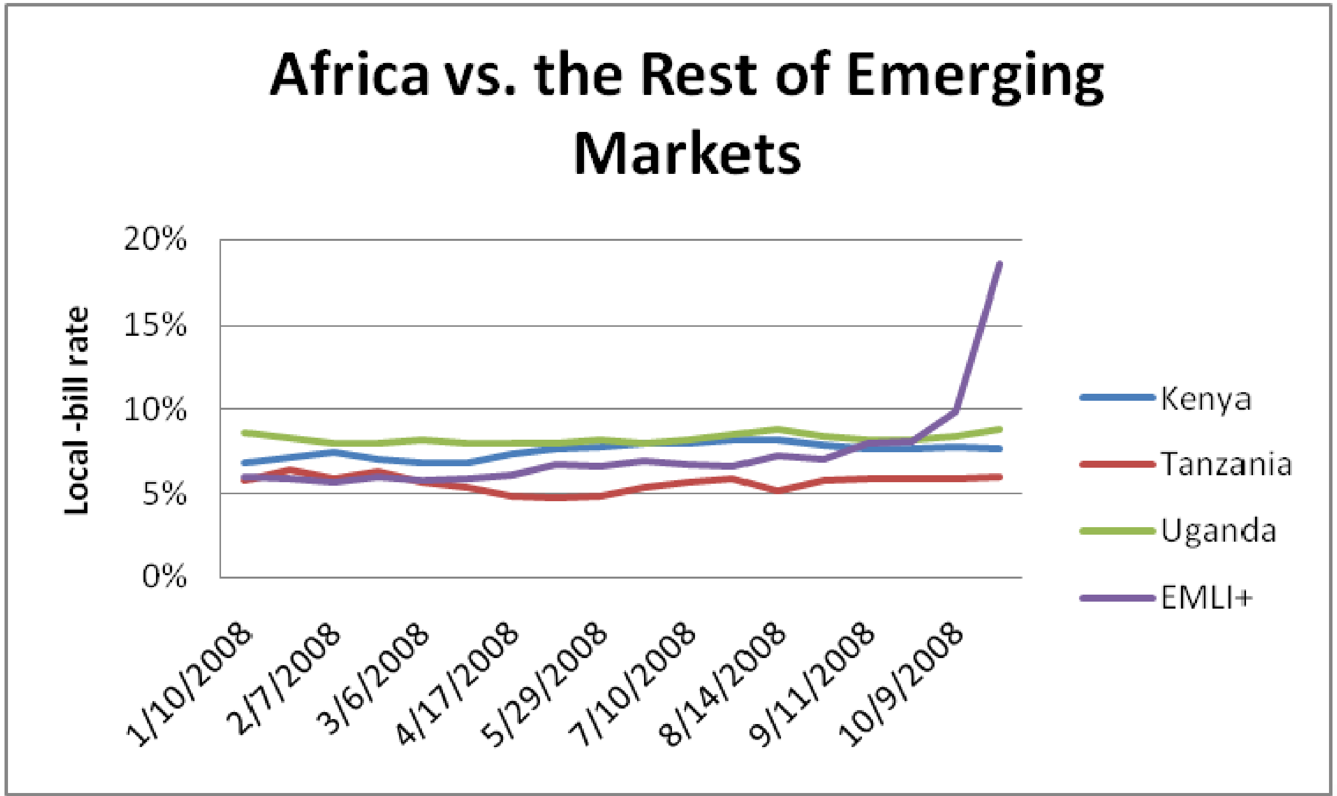
Hedging allows MIVs to serve higher risk regions

MFX's demand survey uncovered strong pent up demand for hedging in Africa if currency risk can be mitigated. Hedging therefore has the potential to fundamentally shift MF lending toward underserved markets.



Relative improvement in risk perception for Africa



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MFX Operational Strategy

Hedging

- Use TCX to manage MFX's market risk in exotic currencies.
- Aggregate MF client transactions and hedge MFX's risk in commercial markets.

Education

- Develop easy- to-use decision support tools to help MFI managers understand and quantify their risk.
- Deploy the tools through a variety of training platforms in partnership with other MF organizations.

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MFX Hedging Products: Currency Swaps and Forwards

- Floating rate cross-currency swaps (Libor/Euribor for local reference rate) and forward contracts.
- Fixed rate hedges (currency swap + interest rate swap) eliminates both FX and interest rate risk for the borrower.
- Initially, settled as non-deliverable contracts (i.e. net payments are made in $ off-shore). <u>No collateral required.</u>
- Terms and pricing based on terms MFX receives from its counterparties (TCX, banks) plus spread to account for credit risk and to cover operating costs.

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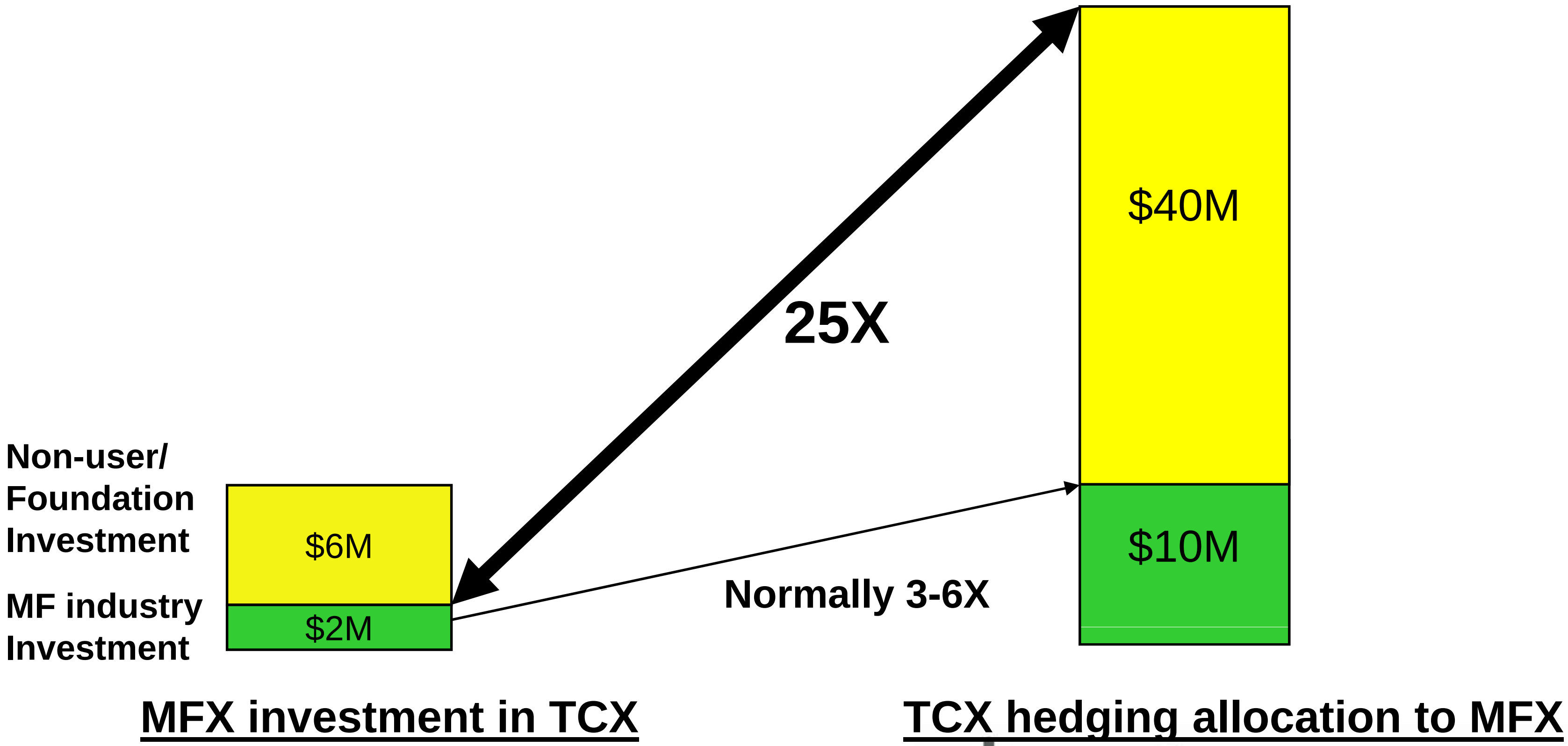
Leveraging TCX hedging capacity for the microfinance industry



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MFX impact on the market

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Returns to investors in MFX

- MFX Sources of ROE
  - Return on TCX investment (baseline IRR 10% + potential IPO exit value).
  - Operating profit from credit spread/fees over counterparty pricing.
    - Will be kept minimal to provide maximum benefit to the MF industry.
- Double bottom line: Increasing the stability and growth of MF.
  - Success Benchmarks: Reduction in currency mismatch attributable to MFX; shift in composition of int'l MF lending from hard to local currency; number of hedged local currency loans to sub-Saharan Africa.

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