CHAPTER 8:

The Management of Foreign Exchange Risk by Microfinance Institutions and Microfinance Investment Funds

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Introduction

Most microfinance investment funds (MFIFs) and other funders such as official development agencies finance their activities in US dollars (USD) or Euros (EUR), which may be called "hard currencies."[1] However, most microfinance institutions (MFIs)[2] operate in non-dollarised or non-Euro-based economies and lend local currency to their clients.[3]

Funding in one currency and lending in another, and the probability that the relative values of the two currencies will alter, creates foreign exchange (FX) risk.

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[1] This chapter focuses on foreign microfinance investors surveyed jointly by ADA, CGAP and The MIX from July to October 2004 for the KfW symposium in November of that year. It also examines the funding and operating currencies of other microfinance investors (including local investors) using MIX Market 2005 data. The author thanks Julie Abrams, consultant to CGAP, Patrick Goodman, consultant to ADA, and Gautam Ivatury, CGAP for their assistance in gathering the data. Microfinance investors surveyed in this research are identified in Appendix 1.

[2] The term "MFI" is used broadly in this chapter to encompass institutions that provide small-scale financial services, such as loans, savings, insurance, remittances and other services (generally in amounts less than 250 % of GNP per capita). The term encompasses a wide variety of organisations: NGOs, credit unions, non-bank financial intermediaries, rural banks, etc.

[3] "Local currency" refers to a currency other than a "hard currency" (i. e., USD or EUR), even though some MFIs operate in countries where the local currency is the USD (i. e., Ecuador), or the EUR (i. e., Kosovo). This distinction is made because non-hard currencies tend to be more volatile, or have higher fluctuations and hence potential risk, than hard currencies. Nevertheless, some examples are given of EUR/USD transactions that show that the perception of stable hard currencies has been challenged in recent years, creating high costs for both MFIFs and MFIs.

Volatile currency exchange rate fluctuations in many countries where MFIs operate make FX risk a serious issue, but one that has often been accorded little urgency in microfinance. The accelerated development of microfinance through access to capital markets makes it imperative that foreign exchange be managed in ways that are consistent with best practice in finance. Until this is widely achieved, access to capital markets for the benefit of microfinance will be retarded.

Foreign exchange risk is one of many risks that MFIFs face. Interest rate risk is an additional risk that is related to FX risk. As currency values change, interest expense or income will also change. And, spreads between interest rates on both sides of the balance sheet may change, that is, interest rates on money borrowed in one currency by a microfinance institution, for example, may diverge from interest rates on money loaned to microentrepreneurs by the MFI. Each of these effects has implications for MFIF and MFI profitability. For purposes of economy, these second order exchange risks are not discussed further here in.

This chapter explores the nature of FX risk in debt funding by focusing on which party is likely to bear the risk of exchange rate fluctuations in different situations at different points in a funding transaction. The importance of hedging is noted, and mechanisms are listed that MFIFs and MFIs use to address their respective FX risks.

The relationships between currency and risk described below apply to equity funds, while in the case of guarantee funds the situation is reversed.[4] Equity investments, as capital, are always in the currency of the MFI. For the foreign equity investor, "foreign exchange risk becomes one of several risks associated with an investment rather than a central factor in making a loan."[5] Equity and guarantee funds, while not the focus of this chapter, are included in the Appendices with examples to identify when they face a currency risk and the hedging mechanisms they use.

How Does Foreign Exchange Risk Occur? Who Is Exposed?

Foreign exchange risk occurs when there is a mismatch in the currencies in which assets and liabilities are denominated (either at the MFI level, the MFIF level, or both), coupled with uncertainty about foreign exchange fluctuations. In theory, foreign exchange risk – or currency risk – is taken either by the MFI, the MFIF, or both, depending on their asset and liability structure.

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[4] Guarantees are almost exclusively in the currency of the MFIF and enable the MFI to obtain local currency loans. FX risks are absent unless the MFIF offers guarantees in currencies that are different from its funding currency (i. e., FIG issues guarantees in USD, EUR and CHF [Swiss francs]), or if the MFI defaults on the loan to the commercial bank and the local currency *appreciates* vis-à-vis the currency of the guarantee (resulting in a claim on the MFIF that is larger than the amount of the guarantee). See Freedman, Paul L., Designing Loan Guarantees to Spur Growth in Developing Countries, USAID, 2004, page 11.

[5] Ibid, page 36.