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OVERVIEW OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION'S (IDA'S) EXPERIENCE OF HEDGING DONOR CONTRIBUTIONS

(PREPARED BY THE TRUSTEE)

Introduction

During the third meeting of the GEF-7 replenishment held in Brasilia (January 25-27, 2018), the Trustee offered to provide Participants with an overview of IDA's experience of hedging donor contributions in the context of the discussion on the option of implementing a hedging solution for the GEF to manage its exposure to foreign exchange risk. This Note aims to provide an overview of IDA's approach to manage foreign exchange risk over time, with a focus on the experience gained since IDA moved to a *market-based hedging strategy* in 2009.

Executive Summary

IDA is exposed to foreign exchange risk due to currency mismatches between its inflows from donors and outflows to recipients. While IDA's commitments are denominated in SDR, the contributions from donors are pledged in the currency of donors' choice and are paid in over a period up to 9 years in accordance with IDA's expected disbursements. Without some means of managing this currency mismatch, IDA's lending envelope would fluctuate, making planning for IDA projects and use of IDA country envelopes difficult for project and country teams.

Until IDA15, IDA dealt with the currency mismatch by aligning its total resources (including expected inflows from replenishments) to the currency distribution of the SDR, and rebalancing its investment portfolio for any currency fluctuations on a quarterly basis to maintain SDR alignment. This is referred to as an *investment portfolio-based approach.* The limit to this approach is that, at some point, the size of the investment portfolio becomes insufficient to deal with the anticipated donor flows. In recognition of this, and with the aim of more effectively managing its foreign exchange risk, IDA moved to a *market-based hedging approach* for the IDA15 replenishment in 2009. Given the success achieved in reducing foreign exchange risk, IDA has hedged all subsequent replenishments using the same approach.

Background

IDA's *investment portfolio-based approach* to currency risk management was initially adopted because, at that time, IDA had limited access to market-based derivative instruments for hedging purposes.

In 2008, with no currency risk management measures in place, IDA's currency risk exposure was US$500 million per year at a 95% confidence level. The *investment portfolio-based approach* could reduce this exposure to US$350 million per year at a 95% confidence level – still a substantial amount of exposure to foreign exchange risk. Considering this level of remaining exposure, a decision was taken to allow the International Bank of Reconstruction and Development (IBRD) to intermediate on IDA's behalf to enable access to capital markets to hedge this risk. This market-based approach had the advantages of being cost effective, efficiently implementable, and leveraging the Bank's experience in such activity for client countries. The objective was to stabilize the financial resources that IDA had available for commitment.

IDA began hedging in IDA15 using derivatives to convert non-SDR currency contributions and mapping them to one of the SDR constituent currencies. Using this approach, IDA could cover a US$340 million currency risk exposure at 95% confidence level, arising from non-SDR currencies. The remaining US$10 million of currency risk exposure stemmed from smaller, less liquid emerging market currencies which were not hedged.

Since IDA15, IDA has hedged all subsequent replenishments using the same approach. In IDA15, IDA16 and IDA17, the total US$ equivalent value of hedges implemented were US$ 6.8 billion, US$ 6.6 billion and US$ 7.0 billion respectively.

Risk Considerations

Credit risk: IBRD intermediation meant that IBRD was using its balance sheet to support IDA's hedging transactions, and consequently had credit risk to IDA. This risk was mitigated in several ways but mainly due to the size of IDA's liquidity portfolio, which could support the levels of collateral that might be required should IDA's derivative transactions have a large negative mark-to-market.

Operational risk: The large number of transactions involved in the intermediation process meant that there would be an incremental increase in operational risks. This risk was mitigated by a sound foreign exchange management framework, the lack of complexity of the instruments used, as well as substantial Bank experience in intermediation for client countries. Hedging donor cashflows meant there was an increased need to monitor the donor payments that had been hedged. Furthermore, there was a need to set up holding accounts where the hedged cashflows would remain until the derivative transaction matured.

Financial risk: IDA faced some financial and reputational risk, in case donors defaulted on payments or delayed payments, which could have potentially required IDA to adjust its lending envelope. This risk was deemed to be low given donors' historical track record in delivering on their commitments. Furthermore, the hedging decisions would consider any potential timing issues. In IDA, there have been no donor defaults after receipt of an unqualified Instrument of Commitment (IoC).

Operational Procedures

Timing of hedging: IDA usually starts preparing hedges at the conclusion of the previous replenishment. Before implementing the hedging transactions, IDA works closely with donors to confirm their payment schedule. IDA then implements the hedges before the start of the new replenishment. Taking IDA17 as an example, IDA completed the hedging transactions in June 2014, while the replenishment started in July 2014.

Reporting of funding: IDA updates the volume of the replenishment envelope after the hedging transactions have been completed. IDA agrees a financing target with its donors for a new replenishment before the pledging session and publishes the actual financing result in SDR terms following pledging. This pledging result is not used for any business planning purposes because the hedges will alter the funding amount available for the replenishment. As such, IDA determines its final commitment authority amount according to the value of hedged resources, and updates the replenishment volume in the very early stage of the replenishment.

Adjustment of hedges: In practice, IDA only needs to directly hedge a portion of the total contribution to align the total contribution with SDR basket and significantly reduce its FX risk. In addition, IDA only hedges contributions from donors that have a strong history of timely payment. Occasionally IDA may need to adjust its hedges due to changes to payment schedules by donors, which may result in immediate gains or losses on IDA's income statement. Hedge adjustments are such a rare occurrence that IDA does not charge its donors in the event of realized gains or losses.