JUNE 13,14 AND 16, 2022

MEETING OF THE BOARD OF DIRECTORS

VIA VIDEOCONFERENCE	BOD/2022/06 DOC 07	FOR DECISION

FOREIGN EXCHANGE MANAGEMENT PROPOSAL

Please note: In accordance with the GPE Transparency Policy, documents are public only after their appraisal by the relevant governance instance. Governance officials may circulate documents to their constituency for consultation purposes, except for documents of a confidential nature.

Key issues for consideration:

- Request for the GPE Board of Directors to consider approval of the proposed currency hedging solution that would provide GPE with the ability to mitigate foreign exchange risk.
- The Finance and Risk Committee (FRC) considered the Foreign Exchange Management Proposal at its April 28-29, 2022 meeting and recommends it for Board approval, noting that the amount of funds hedged would depend on number of donors participating through signing of multi-year contribution agreements, while the size of the collateral would depend on volume of funds hedged and the cash flows.
- The request from FRC members for clarifications on the pilot nature of the proposal and the scope for further improvements have been reflected in the recommended decision language.

Objective

1. This document outlines the key parameters and implications of the foreign exchange management proposal developed by the Trustee in discussion with the GPE Secretariat, for Board consideration.

Recommended decision

BOD/2022/06-XX—<u>Foreign Exchange Management Solution:</u> The Board of Directors:

1. Noting the impact of foreign exchange volatility on GPE's financial position and the importance of predictability of funding, authorizes the Trustee in coordination with the GPE Secretariat to further develop the Foreign Exchange management solution based on the proposed pilot approach set out in Annex B.
2. Authorizes up to US$800,000 in additional funding for the Trustee towards one time set up costs, noting there may be an additional impact on the annual Trustee budget.
3. Requests the Trustee and the Secretariat to revise accordingly the GPE Fund

Governance document and the Standard Contribution Agreement for approval by the Finance and Risk Committee, and to report regularly to the Committee on progress to finalize the approach.

Background and overview

2. The vast majority of contributions to the GPE Fund (over 80%) are made in non-USD currencies while disbursements from the GPE Fund are predominantly made in USD (97%). This means that most contributions must be converted into USD upon receipt. These contributions are exposed to changes in value between the time a pledge is made and when the payment is actually received and converted to USD. For several years, the Finance and Risk Committee and the Board have recognized the need for a solution that would allow GPE to fix the exchange rate in advance of payments being made and thereby protect the value of the contribution and increase predictability of resources.

3. Foreign exchange risk is not unique to GPE but it is particularly problematic due to the level of mismatch between the currencies of contributions and the currency of disbursements from the Fund. In addition, GPE aims to provide Partner Countries with predictability by announcing indicative allocations as early as possible and in advance of receipt of contributions. Currency hedging, as a tool to mitigate foreign exchange risk, is common practice not only for commercial entities, but also development organizations. The World Bank (WB) provides hedging for IDA, as do similar funds like the GAVI alliance and the Global Fund to Fight AIDS, Tuberculosis, and Malaria for their donor contributions. However, it has never been available from the WB for Financial Intermediary Funds like GPE.

4. Previous proposals to address foreign exchange risk were deemed unsuitable based on the requirements of irrevocable donor contribution agreements being unacceptable to many GPE donors. This proposal addresses this challenge by making it clear that the risks arising should a donor not pay on time and resulting in a transaction being unwound would be a cost borne by the GPE Fund itself, meaning an individual donor is not legally bound to contribute or make good on any costs arising from unwinding a trade.

5. The proposed approach, set out in Annex B, would involve the Trustee entering into forward rate contracts with counterparties that would provide USD in exchange for the contribution currency at an agreed foreign exchange rate. Such transactions would only be based on signed donor contribution agreements with clear payment schedules. The GPE Secretariat analysis of the proposal is set out in Annex A.

Annex A – Secretariat analysis of the proposal
Annex B – Potential Foreign Exchange Management Solution (prepared by the Trustee)

Annex A – Secretariat analysis of the proposal

1. While this proposal brings considerable benefits, there are also some downsides to hedging, including:

    a. The need to pay set up costs for the solution, ongoing administration by the Trustee, and the costs which are built into the exchange rate agreed for each transaction. However, an estimated US$800,000 for one time set up costs, and US$400,000 for annual administration of the solution, along with the rate built into the transaction are only a fraction of the funds that could have been secured over the past 8 years had a currency hedging solution been available.

    b. The need to set aside collateral to protect the World Bank should a donor not contribute on time resulting in the need to unwind a transaction. Collateral is not a cost – it merely means that some funds are set aside until the transaction is completed and would be temporarily not available to disburse. Once the payment is made, the collateral is released and becomes available for disbursement. However, if a trade has to be unwound due to delayed donor payments, and there are costs involved, then these costs come would come from the collateral. Where there is a high risk of delays in donor payments, this will be reflected in terms of how much is hedged, and therefore the risks of the collateral being used to cover expenses are somewhat mitigated.

    c. Currency hedging protects against further downside risk and provides predictability. However, it means that any upside gains should the USD weaken would not be available to GPE. As it is unlikely that all contributions can be hedged due to the need for signed contribution agreements, and for such transactions to take into account the risk of delays to payments, there will still be a significant amount of contributions that are unhedged, meaning they would be exposed to any downside or upside risks from USD foreign exchange rates.

2. Currency hedging will not fully eliminate foreign exchange risk, but the solution proposed will reduce it. It will take some more time to operationalize this approach, and the real benefits are likely to be seen at the next GPE replenishment. This solution helps to mitigate one of the biggest risks to GPE's financial position. In addition, GPE has the opportunity to be a pioneer, being the first Financial Intermediary Fund hosted by the World Bank that would have a currency hedging solution. The solution could then potentially be expanded to other Funds at the World Bank given they also face similar issues, and therefore from a donor

perspective for those who contribute to other funds the investment here may pay off in many other sectors.

3. It is important to note that issues around costs and collateral are common for any hedging arrangement, be they with the World Bank or through commercial banks. Therefore, if concerns around these issues result in the decision not to pursue the proposed solution, then we will have essentially reached the end of the road on viable options with respect to currency hedging. GPE would need to accept the risks and focus on mitigating them through other means and manage the impact when these risks arise as they currently have with respect to either reducing grant allocations or increasing the level of unfinanced obligations (see BOD/2022/06 DOC 04 - Financial Forecast for details)

Annex B - Potential Foreign Exchange Management Solution for GPE

1. The GPE Fund is exposed to fluctuations in foreign exchange (FX) rates between the time a contributor pledges in national currencies (non-USD) and when contributions are received and converted to United States Dollars which is used for majority of funding allocations/decisions by GPE. An FX management solution could help GPE's mission by reducing the foreign exchange volatility of the programming envelope and provide predictability in the availability of GPE resources for downstream activities.

2. The World Bank as Trustee is committed to help GPE manage foreign exchange volatility of its programming envelope. GPE resources held by the World Bank as trustee of the GPE Fund are managed in a commingled investment portfolio (TF Pool) with more than 1,000 other trust funds (TFs) and financial intermediary funds (FIFs). The risks and benefits are shared by all funds in the TF Pool. Offering an FX hedging solution for GPE Fund without proper ringfencing poses risks to the other TFs and FIFs in the TF Pool that do not participate in the FX hedging. A change in meeting scheduled payment obligations such as delay and/or default on contribution installments by a donor can result in a financial loss on the underlying hedging activities, that spills over to other TFs and FIFs in the TF Pool, known as *spillover risk* (refer to Box 1).

> Box 1: Spillover risk
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> The entire TF Pool faces market counterparties in all financial transactions and is legally liable for all derivative transactions[1]. In the absence of irrevocable contribution agreements, any financial loss from delayed or cancelled installment payments by GPE donors could easily spill over to other TFs and FIFs in the TF Pool. It is therefore essential to ensure that TFs and FIFs that do *not* participate in hedging activities are not exposed to financial risks due to hedging transactions undertaken for GPE. Further, only the liquidity of the GPE Fund should bear the costs of any collateral calls or losses related to foreign exchange hedging transactions without impacting on the assets of other TFs and FIFs that do not participate in FX hedging.

3. Recognizing the abovementioned risks to the TF Pool including the importance of managing the spillover risks, the Trustee is proposing a customized solution to implement the foreign exchange hedging for the GPE Fund. Under this proposal, in the event of any GPE donor's failure to meet scheduled payment obligations, the GPE Fund will assume full responsibility to indemnify the Trustee for any costs arising from the payment delays/changes of payment schedules resulting in unwinding or modifying the underlying hedging transactions. *This is the only way to ensure that other funds in*

[1] The ISDA agreements are currently arranged for the commingled portfolio (TF Pool). It is impractical and/or not possible for any TFs to enter into hedging agreements with market counterparts on a trust fund-by-trust fund basis.

TF Pool are not exposed to costs and losses due to any GPE donor's default, delays and/or changes in meeting its payment schedules.

4. With respect to how this hedging approach would work, the Trustee would enter into foreign exchange Forward transactions with commercial market counterparties (FX dealers) on behalf of the GPE Fund to exchange future non-USD payments from donors for USD amounts at an agreed market foreign exchange rate of exchange. The USD value of future receivables for the GPE Fund would then, by design, be locked in, thereby reducing the FX volatility of the programming envelope consistent with the objective of the FX hedging programme.

5. Foreign exchange Forward transactions with market counterparties would be governed by the International Swap Dealers Association (ISDA[2]) agreements signed by the World Bank Treasury with the counterparties for managing the TF Pool. Depending on future exposure and availability of credit lines, additional ISDA agreements might be signed by the World Bank Treasury on behalf of the TF Pool. ISDA agreements require adherence to payment schedules and timelines by both parties to the agreement. As such, deviations from the agreed terms and conditions usually result in monetary and reputational risks to the World Bank as Trustee.

6. The implementation of this foreign exchange management proposal would require the following modifications to GPE's governance arrangements and contribution agreements:

   a) **GPE Governance Framework:** The GPE Fund's governance framework to be updated to the effect that GPE Fund shall be liable for all costs of hedging including liabilities associated with unwinding and/or restructuring of foreign exchange management transactions stemming from delays/changes in donor payment schedules. Such costs would be drawn by the Trustee from the resources of GPE Fund.

   b) **Contribution Agreements:** Contribution Agreements would be updated to reflect that further to GPE operations, donor contributions to the GPE Fund would be used to cover costs of hedging including losses associated with unwinding and/or restructuring of foreign exchange management transactions. In addition, where firm installment payment dates are missing in the contribution agreements, donors would be required to provide a non-binding installment schedule for the payment of their contributions.

[2] An ISDA (International Swaps and Derivatives Association) Master Agreement is a standardized agreement negotiated and signed between counterparties that sets out the legal and administrative terms that apply to all derivative transactions entered into between those parties.

7. **Payment Schedules:** Donors would need to provide schedules for the payment of their contributions to enable the Trustee to enter into hedging transactions with market counterparties. The practice of providing an installment payment schedule when entering into a contribution agreement is not new. GPE donors are privy to such arrangements through their contributions to the GPE Fund and other TFs and FIFs administered by the World Bank. These schedules are essential for the purpose of liquidity management, forecasting cash flow and programming ability.

8. In instances where a contributor is unable to include an installment schedule in a contribution agreement, or where the payment is expected to be made within 3 months of signing of the agreement, the contributions will not be hedged by the Trustee. While such contributions will not be hedged, they do not impact the ability of the Trustee to enter into hedging transactions for other contributions that do have defined payment schedules.

9. Any potential deviations from the agreed donor payment schedules might lead to unwinding/restructuring of hedging transactions with cost implications for the GPE Fund and potential reputational damage to the World Bank and the GPE Fund.

10. The Trustee intends to disclose instances of non-payment to all donors. The Trustee would periodically report non-compliance of payment schedules by individual donors, the associated costs, and implications on hedging transactions to the FRC and the GPE Board.

11. In instances of non-compliance, the Trustee would work with the relevant donor to agree on a new payment date to facilitate a restructure or unwinding of the foreign exchange transaction.

Foreign Exchange Risk Management Framework

12. A Foreign Exchange Risk Management Framework would be developed by the Trustee to implement the foreign exchange solution for GPE. The framework would include policies, procedures and guidelines governing donor receivables, collateral, and trading. It will also define acceptable exposure and risk limits for the FX management pilot. For instance, hedge ratios would be defined to limit the contribution receivables that could be hedged to less than 100% of total receivables. The underlying analysis would be based on donor profiles, history of payments, currency of contribution, etc.

13. **Collateral Set-aside:** To mitigate potential spillover risks from foreign exchange transactions and to ensure there is available liquidity to cover potential losses, liquidity calls from counterparties due to negative mark-to-market (MTM) valuation of the FX trades (margin deposit), and costs associated with hedging transactions for the GPE Fund, the Trustee will carve out a Collateral Pool funded from GPE Fund's liquidity. The

size of the Collateral Pool depends on the total volume of hedging transactions and the underlying exposure which is driven by market conditions. While the Collateral Pool would not necessarily impact the ability of the GPE Board to approve funds, any funds held in the pool will not be available for commitment or disbursement until the collateral is released. Once donor contributions that have been hedged are made on time, the corresponding collateral linked to the transaction becomes available for commitment and disbursement. The introduction of collateral will require GPE to continue to closely monitor its liquidity levels to ensure it has sufficient funds at all times to commit and disburse against approved grant allocations as they come due.

14. The size of the Collateral Pool will mainly be driven by MTM of the foreign exchange forward trades in place. A simulation of FX trades performed on the 2021 GPE replenishment amount indicates that collateral requirements will reach a maximum of 20% of the notional value of the foreign exchange trades with a high degree of certainty over the replenishment period (refer to Table 1). Significant market volatility could trigger material changes in MTM values, at which point other measures could be considered to limit the exposure. As noted in above paragraph, collateral is required to provide credit protection to the World Bank and to mitigate spillover risks in the TF Pool. As such, the collateral will not be available for GPE's operations and would be held in the most liquid investment portfolio such as Model Portfolio 0 (MP0). The Collateral Pool will be managed on a rolling basis. Over time, as the FX trades approach maturity, the associated collateral will be reduced until it is eventually zero.

Table 1: Illustrative Amounts of Collateral at 99% Confidence

Date	Hedged Amount (USD million)	Collateral Required (USD million)	Collateral as a proportion of Hedged Amount (%)
1-Jan-22	3,150	0.5	0.02%
8-Apr-22	3,000	43	1.43%
1-Jan-23	2,700	252	9.32%
1-Jan-24	1,940	294	15.14%
1-Jan-25	1,200	244	**20.31%**

15. **Hedge Ratios:** In order to account for uncertainty associated with payments of donor contributions, the Trustee will analyze historical patterns to estimate the degree of confidence that payment contributions would be fulfilled as indicated in the Contribution Agreements. Depending on the conclusion of this analysis, the Trustee may hedge a proportion of future receivables to minimize the risk of donor non-payment.

Cost Implications

16. The hedging activities reflect customized Trustee services and as such, any costs associated with the implementation of the foreign exchange management solution would be additional to the services currently included in the Trustee budget. The associated costs would include the following:

    a) **Explicit Costs** will include the cost of developing a robust FX Risk Management Framework, and associated policies (including management of donor receivables, collateral, and trading). It is expected that the GPE Fund would incur a one-time fee of approximately USD 800,000 for the development of the solution including associated staff and management time, followed by an annual fee of approximately USD 400,000 for ongoing management, based on the principle of full cost recovery.

    b) **Implicit Costs** will include i) the costs associated with delay or cancellation of donor installments as GPE liquidity will be used to pay to the counterparty in such cases, and ii) foregone investment income as a result of the Collateral Pool being invested in most conservative asset classes (in MP0).

17. **Costs of Unwinding the Foreign Exchange Trades**: The data from GPE Donor payments in FY19-FY22Q2, indicates that 77% of installments were paid on time, and remaining 23% payments were delayed. Accordingly, assuming a quarter of all installment payments are delayed, the illustrative costs of unwinding the foreign exchange trade contracts could range from 3% to 15% of the contract value for maturities ranging between 3 months to 5 years (refer to Table 2). For example, if a contribution of €10 million is not paid, and the FX forward has a 2 Year maturity, there is a 25% chance that the cost would be greater than €800,000 (8% of €10 million).

Table 2: Indicative Unwinding Costs for Foreign Exchange trades

Maturity of Forward	EUR	GBP	CHF	NOK	SEK
3M	3%	3%	3%	4%	4%
6M	4%	4%	5%	5%	5%
12M	6%	6%	6%	8%	7%
2Y	8%	8%	9%	10%	10%
3Y	10%	9%	10%	12%	12%
4Y	11%	10%	12%	14%	13%
5Y	13%	12%	13%	15%	15%

18. Upon in-principle endorsement by the GPE Contributors, the Trustee would take the following next steps toward developing an foreign exchange management strategy for GPE:

- Internal clearance within the World Bank's Governance Framework including the New Business Committee (NBC), the Finance and Risk Committee (FRC) of the World Bank, and the World Bank Board
- Formal presentation of the foreign exchange hedging proposal to the GPE Board for endorsement
- Formulation of policies and procedures around Contribution Management, Collateral, and Trading Strategies, etc.
- System Enhancements and Readiness Assessment
- Roll-Out and Implementation

19. **In an optimistic scenario the foreign exchange management solution could be operationalized in eight months upon receipt of the in-principle endorsement for the proposal by the GPE contributors.**