JUNE 7-8, 2023

MEETING OF THE BOARD OF DIRECTORS

BRUSSELS, BELGIUM | BOD/2023/06 DOC 07 | FOR DECISION

FOREIGN EXCHANGE MANAGEMENT FRAMEWORK

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:

- The Finance and Risk Committee (FRC) considered the Foreign Exchange Management Framework at its April 25-26, 2023 meeting and is recommending the proposal to the Board for its approval, while noting (1) that the size of the collateral would depend on the volume of funds hedged and the cash balance, (2) the delays from donors to fulfill their pledges and related impact on the framework, and (3) the need from all donors to agree on the amendments to the contribution agreements.
- The FRC approved the changes to the GPE Fund Governance Document and the Standard Contribution Agreement/Arrangement, subject to Board approval of the proposed Foreign Exchange Management solution and the encompassing Foreign Exchange Management Framework.

Objective

1. The Board is requested to review the proposed Foreign Exchange (FX) Management solution and the encompassing framework prepared by the Trustee and consider the decision to authorize the Trustee to proceed with the implementation of the solution.

Recommended Decisions

BOD/2023/06-XX—<u>Foreign Exchange Management Framework:</u> The Board of Directors:

1. Approves the proposed Foreign Exchange Management Solution and the encompassing Foreign Exchange Management Framework as set out in Annex C for a pilot period of two years noting the ongoing operating costs of such arrangements, approximately US$400,000 per year, are to be integrated into the annual Trustee budget.
2. Notes that following approval of the proposed solution, and amendments to the GPE Governance Framework, the Trustee will engage with GPE donors to amend their Contribution Agreements, which is a prerequisite condition and the legal basis for the Trustee to implement hedging activities for the GPE Fund.

3. Notes that an assessment will be initiated 18 months into its implementation to assess the efficacy of the hedging operations, implications on systems and identify issues and improvements.
4. Requests the Finance and Risk Committee to consider the findings of this assessment and report to the Board with any applicable recommendations concerning the continuation of the Foreign Exchange Management Framework.

Background

1. At its June 2022 meeting, the Board of Directors, noting the impact of foreign exchange volatility on GPE's financial position and the importance of predictability of funding, authorized (BOD/2022/06-04) 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 BOD/2022/06 DOC 07 Annex B.
2. It further requested the Trustee and the Secretariat to revise the GPE Fund Governance document and the Standard Contribution Agreement for decision by the FRC, and for the FRC to review the Foreign Exchange Risk Management Framework to be developed by the Trustee in order to make a recommendation to the Board for its decision to proceed.
3. The proposed Foreign Exchange (FX) management strategy developed by the Trustee is set out in Annex C and is now ready for implementation on a pilot basis. The pilot will be reviewed after 18 months of implementation to determine if it should be continued and what changes if any should be made. The changes required to both the GPE Fund Governance Documents and the Contribution Agreements/Arrangements needed to give effect to this proposal are also set out in Annex D. Both annexes are in the Governance Portal.
4. The Secretariat's assessment of the proposal and summary of changes to GPE Fund Governance document and Standard Contribution Agreements are summarized in Annex A below.

Annex A – Secretariat assessment of the proposal and overview of changes to the GPE Fund Governance document and Standard Contribution Agreement

Annex B – Trustee Executive Summary

Annex C - Proposal for FX Management Framework by the Trustee

Annex D – Changes to the Fund Governance Document and Contribution Agreement

Annex A – Secretariat assessment of the proposal and overview of changes to the GPE Fund Governance document and Standard Contribution Agreement

1. The Secretariat recommends approval of the proposal. This is the first time that currency hedging will be available from the World Bank for any Financial Intermediary Fund. While the proposal will not fully eliminate FX risk, it will help reduce the exposure. The main features of the proposal are set out below.

2. The Trustee, on behalf of the GPE Fund, be able to enter into FX Forward contracts that fixes the USD rate in advance for the future receivables in any of the following currencies, AUD, CAD, CHF, DKK, EUR, GBP, NOK, and SEK. The flexibility to hedge all non-USD currencies is very welcome.

3. The contracts would be based on signed donor contribution agreements that have a specific payment schedule. The Trustee will take into account track record of paying on time, and will consult with the Secretariat around known risks of a donor not paying on time before determining the amount to be hedged.

4. Under the current proposal, donor pledges that have not been signed into a contribution agreement would not be eligible for hedging. An assessment of the pilot will be initiated 18 months into its implementation to determine changes if any are required and feasible. The findings will be available by mid-2025 and will allow predictability on future FX management arrangements prior to GPE's next financing cycle in 2026.

5. There will be a requirement for the GPE Fund to post collateral to ensure that, in the event an installment receivable that has been hedged is either not received or received late from the donor, the costs of unwinding or restructuring the underlying hedging trade are fully covered by the GPE Fund. The amount to be collateralized will depend on the liquidity of the currency, the amount being hedged, and the maturity date of the contract. The collateral will be temporarily held in a restricted account and will be used to cover costs, if a donor does not make their payment as scheduled.

6. The Secretariat's assessment is that the amounts to be set aside as collateral should not have a material impact on GPE's liquidity but will include the need to post collateral into guidance on GPE's overall optimal cash balance levels. However if donors do not make scheduled payments based on their signed agreements, there is a risk that some of the collateral will be utilized to cover the unwinding cost and this will reduce overall funding available for allocation. Therefore payment discipline from donors will be needed to manage this risk.

7. The FX management approach is not meant to time the market to generate a gain nor be used as an investment vehicle. Its sole purpose is to provide predictability of funding by fixing the USD amount to be received by the GPE Fund.

8. In addition to the one time set-up costs previously approved by the Board estimated at US$800,000 and to be adjusted based on actual expenses, there is an expected ongoing operating cost of approximately USD 400,000 per year to be adjusted based on actual expenses and factored into the annual Trustee budget.

9. As part of their quarterly reporting process, the Trustee will disclose the Mark to Market (MTM) valuation of all hedging positions and will report on any non-compliance with payment schedules by individual donors, the associated costs, and implications on hedging transactions.

10. The changes to the Fund Governance Document and Standard Contribution Agreement/Arrangements are relatively few. For the Fund Governance document, it includes the addition of the following sentences (which are highlighted in Annex D).
    a. **3.iv.f (Board of Directions – Roles and Responsibilities)**: *authorizing the Trustee to carry out foreign exchange transactions in accordance with Trustee's policies and procedures.*
    b. **5.e**: (**Trustee)**: *The Trustee shall enter into foreign exchange transaction agreements, in accordance with the decisions of the Board.*

11. The changes to the Contribution Agreements/Arrangements include the addition of the following sentences (which are highlighted in Annex D).
    a. **4.:** *Addition of installments where applicable*
    b. **6.:** *[In the event that the Contributor foresees that the payment of any Installment, or part thereof, may be delayed, the Contributor shall notify the Trustee no later than three (3) months prior to the due date of the relevant installment]*
    c. **Annex: 4. Commingling, Exchange, and Investment of Contributions, 4.6:** *Contribution funds not yet received by the Trustee may be used to carry out foreign exchange transactions in accordance with the provisions of the Trust Fund Governance Document. Neither the Trustee nor the Contributor shall bear any responsibility for any costs in connection with any foreign exchange transactions. For avoidance of doubt, the Trust Fund shall bear all liabilities associated with these transactions.*

Annex B – Trustee Executive Summary

Foreign Exchange Management Solution for the Global Partnership for Education (GPE)

Executive Summary

In recent years, the GPE Board through the GPE Secretariat has requested the World Bank, as Trustee of the GPE Fund, to explore possibilities for foreign exchange (FX) management frameworks that would enable more predictable financial planning and ultimately better management of GPE's programming resources.

In June 2022, the World Bank as Trustee of the GPE Fund, presented to the GPE Board, a proposal for managing the FX exposure of the GPE Fund that aims to limit the exposure of the GPE Fund to FX volatility using market instruments and, in turn, provide predictability of resources for GPE operations. The GPE Board provided an "in-principle" approval for the World Bank, as Trustee of the GPE Fund, to further develop the proposal and implement the FX management solution after securing the necessary approvals by the World Bank.

Under the proposed FX management solution, the GPE Fund would access capital markets as part of the World Bank's Trust Fund (TF) Pool whereby the World Bank would enter into derivative contracts with commercial market counterparties to manage the currency exposure for GPE Fund.

As per the proposal, the GPE Fund would assume all liabilities and costs related to FX management transactions resulting from any donor's failure to meet scheduled payment obligations that might result in unwinding of the underlying hedging transactions. The GPE Fund would also bear the remote risk of default by a commercial counterparty.

Following the GPE Board's consent, the Trustee secured approval from the World Bank's Finance and Risk Committee (FRC) in October 2022 to implement the FX management solution for GPE on a pilot basis for two years. The Trustee is now seeking endorsement from the GPE FRC, and the GPE Board on the proposed solution, and to begin with its implementation. The Trustee is also seeking approval of the FX Management Framework, as well as the annual operating budget of USD 400,000 to implement the proposed Pilot.