INVESTMENT PERSPECTIVES

Prudential Regulation, MDB Treaty Mandates, and the Hidden Barriers to Local-Currency Financing for EMDEs

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Introduction

Foreign-exchange (FX) risk remains one of the most entrenched barriers to scaling investment in emerging markets and developing economies (EMDEs). Despite decades of development actor efforts to expand local-currency financing, such funding continues to remain prohibitively expensive. Consequently, most capital still flows to EMDE borrowers in hard currencies such as the USD or EUR, leaving governments, utilities, and firms unable to borrow internationally in their own currencies—a structural vulnerability famously described as "Original Sin" by Barry Eichengreen, Ugo Panizza, and Ricardo Hausmann. This reliance on foreign-currency debt exposes EMDE borrowers to exchange-rate volatility they are ill-equipped to manage. While the "Original Sin" literature explains why such constraints persist, this article focuses on how legal and regulatory structures shape where that FX risk ultimately resides.

This outcome is often framed as a market failure, characterised by shallow domestic capital markets, limited liquidity, or macroeconomic instability. But these explanations only go part of the way. FX risk is fundamentally shaped by investor risk appetite and global market conditions, yet legal and regulatory frameworks play a critical, and often underexamined, role in determining who is able to bear that risk, under what terms, and at what cost.

Institutional capital holders: prudential regulations that make FX costly

At the top of the investment chain sit large institutional capital holders—insurers, pension funds, and banks—whose investment behavior is shaped by post-Global Financial Crisis prudential regulation. While these frameworks are designed to safeguard financial stability and protect policyholders and depositors, they also materially influence the availability of local-currency financing by increasing the regulatory cost of holding unhedged FX exposure.

Under the EU's Solvency II framework, currency risk is treated as a distinct capital charge, with Article 188 of the Solvency II Delegated Regulation requiring insurers to calculate capital requirements separately for each foreign-currency exposure. In practice, EMDE local-currency assets often attract higher regulatory capital than comparable hard-currency instruments. In simple terms, this means insurers must hold more capital against these investments, making them more expensive and less attractive, and therefore encouraging a shift toward hard-currency or fully hedged positions. The same also applies to most banks, where Basel-derived rules, including the Capital Requirements Regulation (CRR), require capital to be held against net open FX positions, increasing the balance-sheet cost of unhedged local-currency lending.

However, these constraints are not limited to global investors. Pension funds in Kenya, Nigeria, and South Africa face regulatory limits on foreign allocations—often below 5%. In Egypt and Uganda, pension funds are prohibited from investing abroad. Domestic institutional capital is therefore also structurally constrained.

Public lenders: Multilateral Development Bank statutes, non-statutory rules and the hedging implications

If private capital is structurally discouraged from holding FX risk, MDBs might appear natural candidates to intermediate that risk, given their development mandates and public balance sheets. However, it is important to note that MDBs operate within a market-based funding model, where they borrow predominantly in hard currency from global investors who value their low-risk, highly rated bonds. Taking on significant FX exposure could affect their balance sheet risk profile, credit ratings, and funding costs. While these market-based constraints are well understood, less attention is given to how MDB legal mandates further limit their capacity to take on such risk.

Across MDBs, treaty provisions and operational frameworks often require back-to-back or risk-minimizing currency matching. The International Bank for Reconstruction and Development (IBRD) Articles, specifically under Article IV, Section 3(a)–(b) permit local currency provision only in "exceptional circumstances," establishing a narrow legal basis for local currency lending. Article 15(3) of the Agreement Establishing the African Development Bank requires that outstanding principal in any currency not exceed the amount borrowed in that currency, effectively prohibiting net open FX positions.

Beyond statutory text, internal treasury and risk policies often go further. Local-currency lending is typically conditioned on market-based funding or hedging, and open FX exposure is largely avoided—even in concessional windows. While not legally binding under international law, these policies are operationally binding and reflect institutional risk management frameworks that treat currency volatility as a transaction-level risk rather than a systemic development issue. Despite rising debt vulnerabilities, 80–90% of Development Finance Institutions (DFIs) and MDB financing remains denominated in foreign currency.

The resulting market structure is thus one where prudential regulation reduces private demand for unhedged local currency finance assets, and MDB law and policy reduce MDB capacity to absorb that risk. The residual bearer is the EMDE borrower.

Rethinking FX risk as a systemic issue

None of this implies that prudential regulation is misguided or that MDBs should behave like hedge funds. Financial stability matters, and public banks must remain financially sound. While existing mechanisms, such as The Currency Exchange Fund (TCX), can alleviate currency risk at the transaction level, they have not resolved the issue at scale because they operate within—rather than reshape—the underlying allocation of FX risk. Thus, recognizing FX risk as a systemic allocation problem opens space for more targeted reforms.

Regulators and MDB shareholders could work together in revisiting how FX risk is treated, for example by refining the prudential treatment of MDB-linked local-currency assets and by reconsidering internal rules that rigidly enforce perfect hedging, echoing long-standing recommendations from the G20 Capital Adequacy Framework Independent review. In practice, this could involve allowing limited, controlled net open FX positions alongside more favorable capital treatment for such exposures. Encouragingly, recent progress, such as updated Standard & Poor's revised rating methodology, suggests MDBs can expand lending significantly (by an estimated USD 600–800 billion) while maintaining AAA ratings.

And if we were willing to think even bigger, MDBs could start pooling FX risk across countries and over time, aligning currency management with their long-term development missions rather than short-term market pressures.

But getting there would require meaningful legal and policy shifts—not just market tweaks. Until then, FX risk will continue to flow downhill, not because EMDE borrowers are best placed to bear it, but because the legal architecture of global finance leaves them holding it.

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