MFI and Open Exposure Case Study
Conducted by Cygma

| **Company Description: MFI** | | | | |
|---|---|---|---|---|
| **Company Type:** | **Investor** | | **Intermediary / Provider** | **MFI** |
| | | | x | x |
| **Relevant Principle(s):** *(Check all that apply)* | x | *1) Risk Mgmt is a shared responsibility among MFIs, Investors and Donors* | | |
| | | *2)Measuring risk is a central part of measuring performance* | | |
| | x | *3) Adopt a comprehensive approach to managing balance sheet risks* | | |

**Headline:**
Open exposure has significant negative impact on MFI's bottom line

**Problem Statement:**
Leadership at the MFI believes strongly that their local currency is going to appreciate, but loan covenants require that the MFI hedge a significant portion of its FX exposure.

**Summary:**
The MFI entered into FX derivatives to reduce its exposure. Due to the strong view on the local currency, the MFI hedged just enough to be in compliance with the loan covenants. During the term of the loan, the local currency greatly declined in value, and the MFI experienced significant losses from the open exposure.

**Take Away / Lesson Learned:**
It may be appropriate for an MFI to maintain some open currency exposure, but risk limits should be defined to limit the potential negative impact of the exposure.

**Body of the Case:**

An MFI was looking for additional funding and received a loan in hard currency. This MFI makes loans to end borrowers in the local currency and has funded itself with other hard currency loans in the past. By taking on additional hard currency borrowings, the MFI increased the asset / liability currency mismatch. The investor offering the loan was not comfortable with the increased risk the MFI was taking on and specified in the loan covenants a maximum amount of hard currency exposure. To comply with this limit, the MFI needed to hedge some of its exposure. The MFI was able to enter into hedges with a dealer bank to reduce the exposure. When the local currency later decreased in value, the hedges offered significant protection, however the MFI also had large losses from the remaining un-hedged exposure.

MFI and Open Exposure Case Study
Conducted by Cygma

| |
|---|
| **Application of Principle:**<br>The MFI recognized the need to hedge to comply with loan covenants and greatly reduced the foreign currency exposure through hedging. However, in determining how much to hedge, the MFI would have benefited from risk policy limts to provide guidance on how much exposure is acceptable. A scenario analysis that looks at projected financial statements based on potential currency movements also would have helped in quantifying the impact of potential currency moves. |
| **Replicable Practices:**<br>The MFI had limited alternatives available to hedge the exposure due to the perceived credit risk of the bank. It is possible that the investor may have had more alternatives available to it. It may have been appropriate for the investor to make a local currency loan and then hedge its own exposure instead of passing the risk to the MFI. |