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MEET THE BOSS

Brian Cox is the Executive Director of MFX Solutions.

Brian Cox

MicroCapital: What is the origin of your passion for microfinance?

BC: I spent ten years in the international division of the US Treasury as head of the Eurasia section, where we ran a microfinance program jointly with the European Bank for Reconstruction and Development. All our lending was in US dollars or euros, but our clients were lending in local currency. Since my main job was macroeconomic and currency policy, I was acutely aware of the currency risk problem but - at the time - there was no way to address it. So after leaving Treasury and deciding to devote myself fulltime to microfinance, I was very excited to discover the MFX project, which finally was doing something about the problem that had been so frustrating earlier in my career. So it feels like coming full circle.

MC: Please briefly describe your organization.

BC: MFX is an industry effort to address currency risk in microfinance, by improving understanding of the problem and introducing better tools to hedge currency risk. Our funders include about twenty microfinance investment vehicles (MIVs), foundations and networks. We act as a counterparty for microfinance lenders to hedge their currency and interest rate risks and we provide decision-support tools for microfinance institutions (MFIs) to help them analyze their risks and better plan their funding. We are a hybrid for-profit and nonprofit. We have to be for-profit to operate in the market, but we don't seek to maximize profit. Our goal is to maximize access to hedging for the industry, while providing a reasonable return to our investors. So our social and commercial missions work in tandem.

MC: What products and services do you offer?

BC: We offer cross currency swaps, interest rate swaps and forward contracts. Down the line we may offer options and other more complex instruments. On the education side, we offer tools that allow MFIs to stress test their balance sheets under different economic scenarios to see the consequences of currency and interest rate mismatch. These tools are available free on our website.

MC: What is a hedge?

BC: A currency swap is a way to offset foreign exchange losses or gains that can occur when a lender's assets are in a different currency than its liabilities. For example, if an MIV is dollar-funded but makes a local currency loan, it loses if the local currency depreciates and gains if it appreciates. The MIV can enter a swap contract with MFX that will pay the MIV in the event of a loss, but require it to pay in the event of a gain. The result is that, from a risk perspective, the MIV now has a dollar loan and its assets match it liabilities. We can do a similar contract with an MFI that wants to offset its currency risk from borrowing in hard currency.

MC: Why hasn't currency hedging already become established in microfinance?

BC: Historically there have been two main reasons: lack of awareness and lack of access. Until a year ago, emerging market currencies generally had had eight or nine consecutive years of appreciation. Many MFIs had not been through a business cycle. Now that most have, there is a lot more awareness about the consequences of currency mismatch. The second problem is that commercial hedging is not well suited to microfinance. It is only available in liquid markets, not in the poorest countries where microfinance is most needed. It is geared to large contracts and so becomes very expensive at a smaller scale. Microfinance lenders also often don't have strong credit positions, so banks either won't deal with them or require large amounts of collateral.

MC: What allows you to perform hedges where others have not been able to do so?

BC: What allows MFX to offer hedging in exotic high risk currencies is our partnership with a new USD 600 million fund named TCX (The Currency Exchange Fund), which is backed by the Dutch development bank FMO. TCX is innovative because it operates fundamentally differently than a bank, which can only provide a swap when it can do the opposite transaction in the market to offset its risk. TCX takes a diversification approach to risk. By taking local currency positions in say 25 or 30 currencies, it brings the overall risk down as invariably some currencies will go up and some will go down. This means TCX can provide hedges in really any country with a measurable interest rate benchmark - whether or not there is a liquid swap market. MFX has access to this special resource as an investor in TCX. Also, we have a USD 20 million credit guarantee from the US government agency Overseas Private Investment Corporation that allows us to act as an AAA rated counterparty. Whereas a bank would either not trade or would charge an MFI a large premium, MFX can intermediate to secure much, much better rates.

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MC: What is the projected scale of your operations?

BC: Our initial capitalization is USD 9 million, most of which we have invested in TCX. That gives us between USD 50 million and USD 80 million in hedging in exotic currency and additional amounts where we can use banks to cover our risk, so our total capability is about USD 100 million. We are actively moving to increase our capital because we know - even from the demand that we already have - that there is great appetite in the industry. We plan to raise our capital to about USD 20 million by early next year, which will give us about USD 200 million in hedging capacity.

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MC: What effects do you foresee your work having on microfinance?

BC: Early on, we did a demand study that was striking. We talked to microfinance investors and asked where they would want to lend if they did not have to worry about local currency risk. More than half the demand was for Africa and also for higher risk areas in Asia. Compare that to the actual existing portfolio of microfinance, which is 80 percent Latin America and Eastern Europe, and you conclude that currency risk is a big barrier to lending into these higher risk markets, and therefore a significant factor in where microfinance lending goes. So, the big insight was that if we can make hedging available in these higher risk markets, particularly Africa, then we can change the pattern of lending. This discovery really got people excited about our project.

MC: What trends do you think particularly important in microfinance?

BC: We see ourselves as a bridge to what ultimately needs to be the microfinance funding model: local market funding from local deposits. We think we can help the industry move towards that model. Also, I foresee microfinance funding itself on a floating instead of a fixed rate basis, which is more appropriate to the microfinance asset base. This will reduce the cost of funding and mean a better match of assets and liabilities.

MC: How did you attract so many MIVs as investors?

BC: We can offer MIVs an assured allocation of hedging capacity so they can develop a local currency product that they can go out and market. They know they will be able to hedge when it comes time to sell their loan. We can lock in hedging capacity for MIVs as well as provide a reasonable return on their investment.

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