IMPACT REPORT 2018

confidential

frontclear

A financial markets development company

Introduction

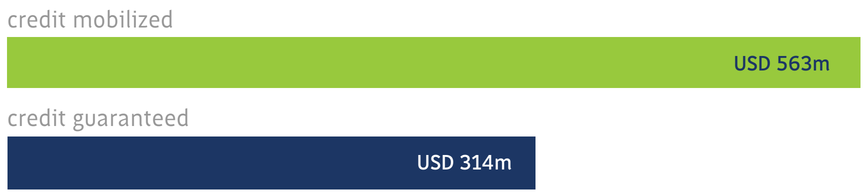
Frontclear is a financial markets development company established in 2015 and is uniquely focused on the development of money markets in emerging and frontier economies, with a strong focus on repo and derivative markets. By issuing guarantees, Frontclear absorbs key risks that prevent market development and assists local financial institutions in emerging and frontier markets (EMDCs) to access both local and global money markets, often facilitating use of local currency securities as collateral.

Frontclear's guarantees are complemented by the deployment of technical assistance in partnership with both global and local industry associations and regulators, to remove structural barriers to market development. Combined, Frontclear's guarantees and technical assistance provide significant flexibility to deliver tailored solutions that drive real market development. Ultimately, Frontclear seeks to establish and guarantee local financial infrastructure providers, such as central clearing counterparties, to support the establishment of stable and inclusive money markets.

2018 in short

Frontclear realized a strong acceleration of activities in 2018. The year's performance marks the transition from Frontclear as an innovative start-up into a quickly maturing operation with tangible development impact results.

Frontclear contribution to money market liquidity & access



Frontclear contribution to money market system development

Capacity Building
1000+ obligors and regulators trained

Regulatory Reform
12 legal and regulatory advisory services provided

Financial Infrastructure Development
8 market infrastructure advisory services provided

Institutions crowded-in to impact money markets

On-boarded partner beneficiaries
12 in total
3 added in 2018

Agreements with Central Banks
6 in total
3 added in 2018

Private sector members active in the FTAP Partnership Facility
6 in total
2 added in 2018

Box 1: Blended finance facility

Frontclear is a pioneer in leveraging the power of blended finance. Frontclear has successfully blended its public sector investor capital with private sector risk participation and has successfully combined the knowledge of the development finance community, government aid institutions, capital markets industry bodies and private sector experts in money market development. Cumulatively, Frontclear has mobilized $2 of private capital for every $1 of guarantee issuance. In 2018, this role expanded to include:

- Crowding-in more on-boarded banks and global insurers at the transaction level, contributing to additionally mobilized funding; and
- Crowding-in more sector knowledge such as counterparty clearing experts and money market regulator support at the FTAP Partnership Facility level in the form of in-kind contributions.

In 2019, Frontclear will continue to expand its blended finance quality to include more of the above and additional investors at the fund level.

Money markets matter

A resilient money market is a key precondition to a stable financial sector that promotes accelerated economic growth and sustainable poverty reduction.[1] In the absence of a money market that mitigates risks and buffers volatility, financial intermediaries and financial markets will struggle to perform their core role of converting household savings into productive loans to SMEs and corporates, among others. This is especially the case in EMDCs, where financial systems are bank-centric and bond markets are under-developed.

Box 2: The challenge in EMDCs

In an emerging market and developing country context, money markets should help mobilize domestic local currency savings from households, corporates, pension funds and insurance companies and make it available to banks and capital markets. Money markets should facilitate the flow of liquidity between banks and support international flows by providing hedging instruments such as swaps to investors and investees alike. Yet, money markets in EMDCs face multiple barriers preventing stability and inclusiveness and have remained significantly segmented. Segmented local interbank markets render local institutions unable to manage liquidity and market risk positions effectively. Indeed, the financing conditions in money markets have been shown to disproportionately impact SME lending by banks. Lack of market liquidity limits price discovery and yield curve development, adding to the root of the problem. Banks will stockpile high liquidity buffers to mitigate lack of access. This reduces their capacity to actively develop and grow their loan portfolios and to offer their clients the financing in the currency, tenor and interest type they need. This ultimately leads to exposure to unnecessary financial risk for actors in the real economy and slower economic growth.

"The development of capital markets, by fostering financial development and financial integration, would promote economic growth through improving the efficiency of capital allocation and allowing for better risk sharing." [2]

Inclusive money markets are where banks have access and are together with regulators, able to actively participate and catalyze interbank trading. Interbank trading enables banks to optimize asset and liability management (ALM), reduce costs and manage risks effectively. Money markets allocate liquidity in the financial system, finance trade, support secondary bond market activity, improve intermediaries' ability to lend long-term and transmit monetary policy. Inclusive money markets allow banks and other key actors to manage inventory and risks in bond markets, thereby deepening liquidity of these markets. In this way, financial intermediaries and capital markets can optimally allocate capital to productive purposes that support growth and poverty alleviation.

Development Impact Strategy

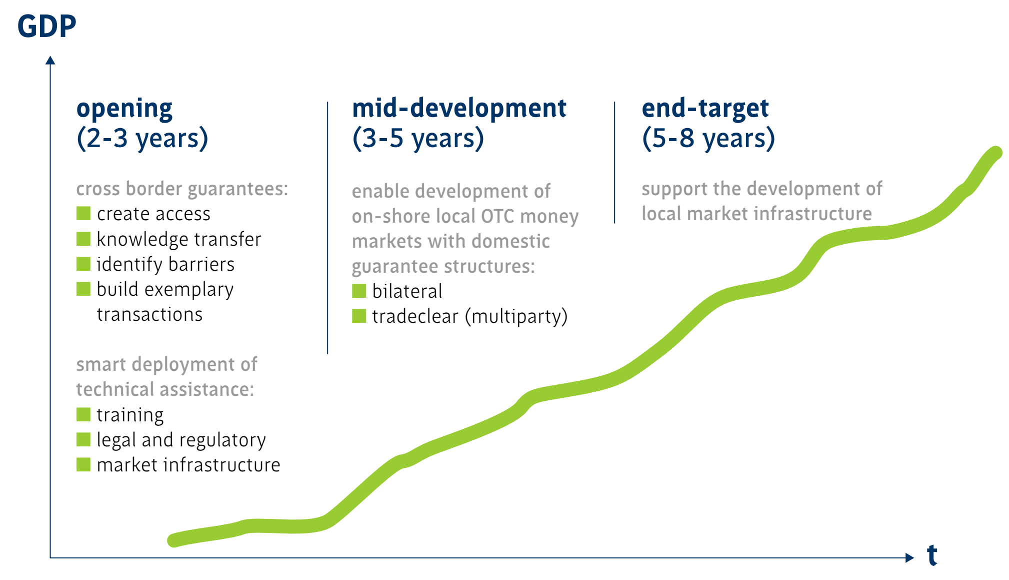
Frontclear is strategically focused to catalyze the inclusion of a wide range of financial intermediaries and regulators to actively participate in the development of a more stable and liquid money market. This impact is the result of a supercharged combination of risk bearing capacity (through the issuance of guarantees) and technical assistance, joined in a long-term effort (see Figure 1).

Initially, cross-border transaction(s) with our global partner beneficiary banks introduce both best practice and market understanding, and lay bare the practical challenges to structural money market development. Understanding is deepened by full market due diligence and wide consultation with local market participants. These combine to furnish comprehensive understanding and relationships on which to build a relevant and effective transaction structure and technical assistance programme suitable for the local market. The long-term end impact target is the establishment of market supporting financial infrastructure.

1- For instance, see Financial Stability Board. (2011). Financial stability issues in emerging market and developing economies. Report to G-20 Finance Ministers and Central Bank Governors. Section V; World Bank. (2013). Rethinking the role of the state in finance. Global Financial Development Report. Page 153; African Development Bank. (2014). Segmentation and efficiency of the interbank market and their implication for the conduct of monetary policy. Working paper series 202 – April 2014; OECD. (2009). Impact of global crisis on SME financing and policy responses. IMF, World Bank. (2016). G20 note on Development of local currency bond markets, see paragraphs 41-46; IMF. (2013). Local currency bond markets – a diagnostic framework. See paragraphs 27-28; IMF. (2014). The development of local capital markets: Rationale and Challenges. IMF working paper; and IMF. (2009). Developing essential financial markets in smaller economics. Occasional Paper 265.

2- Laeven, Luc. "The Development of Local Capital Markets: Rationale and Challenges". IMF Working Paper, WP/14/234 (2014).

Figure 1: Frontclear Development Impact Strategy



In 2018, an independent evaluation[3] confirmed Frontclear's progress to paving measurable results in line with its long-term impact strategy:

"Our findings strongly support the hypothesis that combining FTAP activities with transactions has been both effective and efficient for the program and ultimately for the development of more liquid money markets in Sub-Saharan Africa." [4]

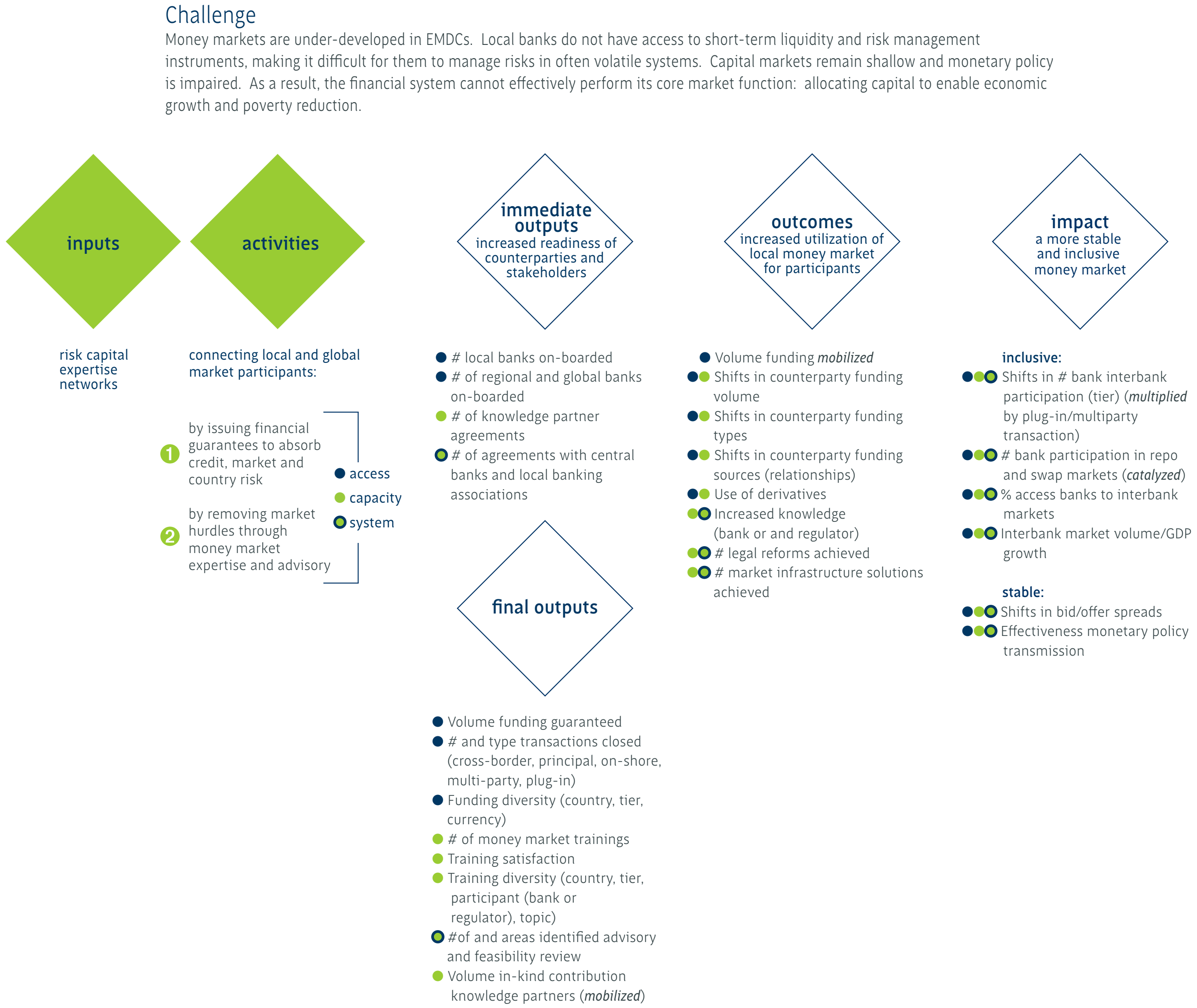
Frontclear's long-term impact goal and mission, per its Theory of Change (see Figure 2), is a more inclusive and stable money market in each of its target markets. Stable and inclusive money markets underpin a resilient financial system that enables poverty reducing economic growth (vision). The Theory of Change (TOC) illustrates the causal results – output, outcome and impact levels – stemming from Frontclear's three key inputs: Risk capital, expertise and networks. Key Performance Indicators (KPIs) are measured at each of the result levels.

The output results are immediate and quantifiable, gathered through regularly collected and recorded data. Outcomes are nearly all quantifiable, visible and measurable at a minimum of six months following input. In addition to these qualitative KPIs, outcome results are complemented by counterparty surveys (online). Finally, impact indictors are similarly mixed. However, just a couple KPIs are quantifiable and easily tracked by Frontclear. The remaining KPIs can be drawn through country case studies on both counterparty and market development, meaningful after only 5-8 years of country implementation.

3- The Financial Sector Deepening Africa ("FSDA"), a first close investor in Frontclear's Subordinated Fund commissioned EA Consultants (www.eac-global.com) to conduct an impact assessment to evaluate their investment in Frontclear.

4- EA Consultants, Frontclear Mid-Term Impact Assessment, p.28.

Figure 2: Frontclear Theory of Change



Case 1: Ghana – Building Systemic Impact

Frontclear facilitated a cross-border repo transaction in Ghana in December 2018, a first for the otherwise nascent local interbank market. The repo transaction was structured as a total return swap and used FCC Securities (a 100% subsidiary for Frontclear) as a structuring vehicle to address collateral constraints faced by local banks and the lack of netting certainty. Frontclear guaranteed USD 40m, of which it *mobilized* USD 25m from global private capital markets through risk sharing agreements.

The transaction featured a free-of-payment (FOP) transfer of collateral that was backed and approved by the Securities and Exchange Commission (SEC) and CSD of Ghana. It carried a strong *demonstration* effect in that it was a first of its kind in the market and required the outright support of the Bank of Ghana and Ministry of Finance. The regulators subsequently introduced FOP market-wide in January 2019, thereby enabling a fundamental building block to the establishment of a repo market in the country.

The transaction is the culmination of a two-year investment in the market's infrastructure and capacity implemented together with the Ghana Fixed Income Market (GFIM), starting in 2016. GFIM membership includes the Central Bank (BOG), Ghana Stock Exchange (GSE), Central Securities Depository Ghana (CSD), Ghana Association of Bankers (GAB), ACI Ghana, and Licensed Dealing Members (LDMs). Together with GFIM, Frontclear delivered a market-wide training programme including repo product and GMRA documentation, fixed income trading, derivatives and ISDA documentation, and Basel II/III and Risk Management.

"Frontclear made it possible for all institutions to participate in a competent and constructive fashion in the development of our bond markets."
Ekow Afedzie, Deputy Managing Director of the Ghana Stock Exchange

In January 2018, Frontclear embarked on an advisory project, beginning with a Regulator Repo Roundtable on GMRA to develop repo guidelines for the local market, *catalyzing* the BOG's leadership to develop and adopt GMRA in partnership with Frontclear and ICMA. The combined efforts of the transaction and FTAP engagement is thus facilitating concrete steps by the market towards the establishment of a local repo market.

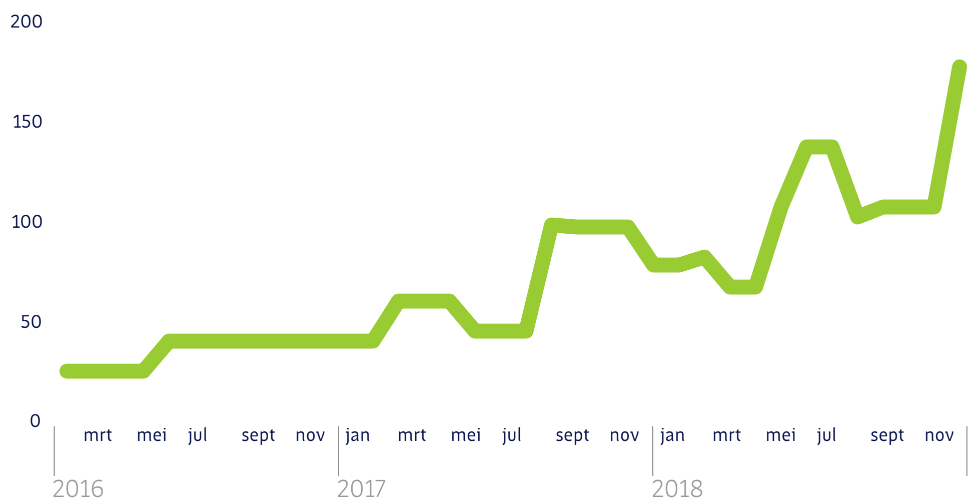
Performance 2018

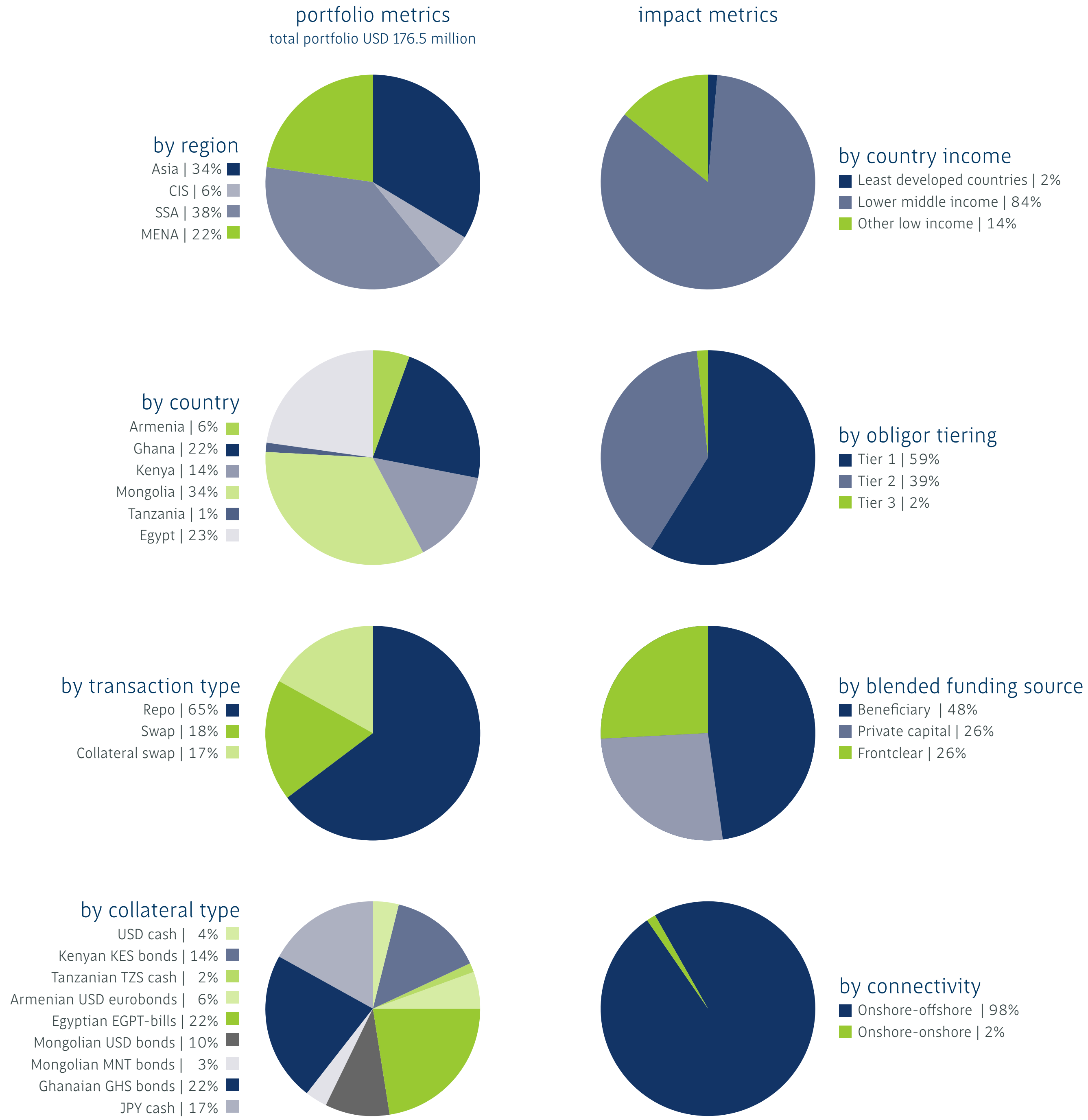
Guarantee portfolio

Frontclear's 2018 guarantee portfolio enjoyed significant growth, expanding 82% year-on-year to USD 176.5 million. For the first time, Frontclear issued guarantees in the Caucasus (CIS), Middle-East and North Africa (MENA) and Asia regions, confirming that the development challenge of under-developed money markets is pervasive across developing regions and that Frontclear's approach is applicable globally.

As at 31 December 2018, Frontclear has cumulatively facilitated USD 563 million in bilateral interbank transactions in Sub-Sahara Africa (SSA), MENA, CIS and Asian regions through the issuance of USD 314 million in guarantees. The diagrams to follow provide key metrics with regards to the portfolio at year-end 2018.

Portfolio growth





Case 2: Mongolia – Supercharged Combination

Frontclear executed a collateral swap transaction in Mongolia in July 2018, the first of its kind in the market. It made it possible for State Bank to competitively access funding from ING Bank Singapore branch through a back-to-back repo. The repo was made possible through the collateral swap with Frontclear, whereby State Bank exchanged illiquid Mongolian government bonds for US Treasuries. Frontclear in turn sourced the US Treasuries from the European Bank for Reconstruction and Development (EBRD) in a back-to-back transaction. The transactions were closed under ISDA documentation, introducing best practice structuring and learning into the market. They also helped clarify legal and operational issues related to bond trading in Mongolia. Frontclear guaranteed USD 30m, of which it *mobilized* USD 15m from global capital markets.

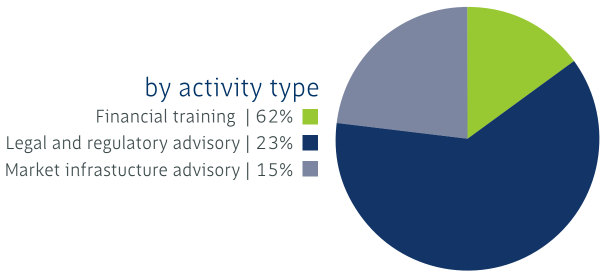
Catalyzed by the first transaction, the Development Bank of Mongolia approached Frontclear to close a second deal in the market in December 2018. The goal was to provide market access for the Development Bank of Mongolia to hedge currency exposure related to its Samurai JPY bond issuance programme. Frontclear guaranteed USD 15m and *mobilized* again, an additional USD 15m from global private capital markets.

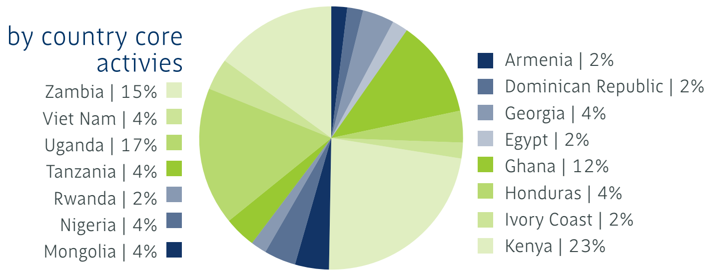
Frontclear's FTAP programme sought to directly address the regulatory and operational constraints preventing a broader market from developing. In September 2018, Frontclear hosted a Regulators' and Executives' Roundtable on these key market challenges to increase awareness in the local market and among the regulators. Over 30 high-ranking decision-makers participated including from the Mongolbank, the Mongolian Securities Clearing House, the Financial Regulatory Commission and multiple local bank treasurers. The roundtable was followed by a two-day training programme of banking industry staff from treasury, trading and risk departments, on the repo product and GMRA documentation.

As a result, the Bank of Mongolia has formally requested assistance to address the identified legal and operational challenges for which Frontclear will provide ongoing technical assistance funding and expertise in 2019 in partnership with EBRD and *crowding-in* ISDA, ICMA and ABN AMRO Clearing through the FTAP Partnership Facility.

Technical Assistance portfolio

As of 31 December 2018, FTAP had USD 2.7 million in available funds, of which USD 1.8 million had been committed to 37 projects, some with multiple activities and in more than 18 countries. The figures below provide an overview of commitments by activity type and by country.





Partnerships are key to realizing Frontclear's development mandate. Frontclear's FTAP Partnership Facility aims to bring together and pool resources from various stakeholders to better coordinate market development initiatives. In 2018, two additional parties joined the FTAP Partnership Facility. ABN AMRO Clearing began sharing its expertise in-kind to support clearing and trading systems in Nigeria and Mongolia, while the Overseas Development Institute (ODI) has partnered with Frontclear to place Fellows in EMDC central banks. ISDA and ICMA, being the leading industry bodies for derivatives and repos respectively, remain key partners to Frontclear's regulator engagement.

In 2018, three new partnerships were established with central banks to further the development of their money markets, being the Bank of Zambia, Bank of Uganda, and the MongolBank. The partnerships entail activities or long-term technical assistance to develop local money markets.

Box 3. Overall conclusions Independent Mid-Term Impact Assessment (p.10 transcription)

Overall, we find that Frontclear is on track and offers good value, particularly in terms of the *relevance* of the project to the banking sector in many sub-Saharan African countries, where short-term money markets are illiquid and particularly difficult to access by Tier II and Tier III banks. These banks, in turn, are often those most likely to lend to small and medium enterprise and households.

The program's unique structure – combining transactions with high-quality training - has been *effective*, in that both offer reinforcing elements that "supercharge" the effectiveness of the other. Despite this, there are some challenges in ensuring that the seeds planted by Frontclear will lead to lasting structural change.

Similarly, we found the program *efficient*, particularly in its delivery of trainings by some of the most qualified experts in the region at a reasonable cost and with reasonable volume. Transactions are less efficient and time-intensive in this early phase of the project and Frontclear takes a strategy of planting many seeds and spreading itself somewhat thinly across the region in hopes to diversify its risk of transaction delays or failures.

We discuss the *impact* of the project in somewhat abstract terms, as impact has been difficult to measure, perhaps as a result of an overly ambitious theory of change that while theoretically logical, is nearly impossible to measure. However, we consider Frontclear's impact to have been very high in terms of creating the conditions needed for local capital markets to flourish, even if it is not yet possible to measure it in terms of increased private sector lending.

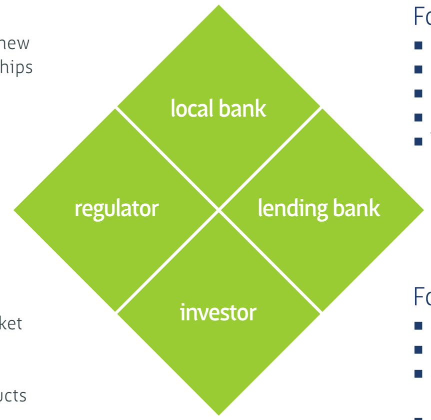
Finally, we assess the *sustainability* of the effects of the program in the markets and consider the relationship between market demand and the broader sustainability of Frontclear's program. It is expected that sustainability should be achieved in the next few years, once the number of transactions and the amount of Frontclear capital increases.

Outlook

Stable, inclusive and liquid interbank markets are critical to resilient money markets, which are a pre-condition to lasting economic development and growth. In 2018, Frontclear continued to pave the way towards this development policy objective, accelerating results relative to previous years. Increasingly, a broad spectrum of local and global actors and institutions are joining in this effort to realize shared benefits (see Figure 3).

Figure 3: Proven benefits to working with Frontclear

For the local bank
- (Inter)national connectivity through new and re-established banking relationships
- Improved ability to manage liquidity
- Reduced cost of funding
- Better risk management and ALM
- Opportunities to expand knowledge and skills

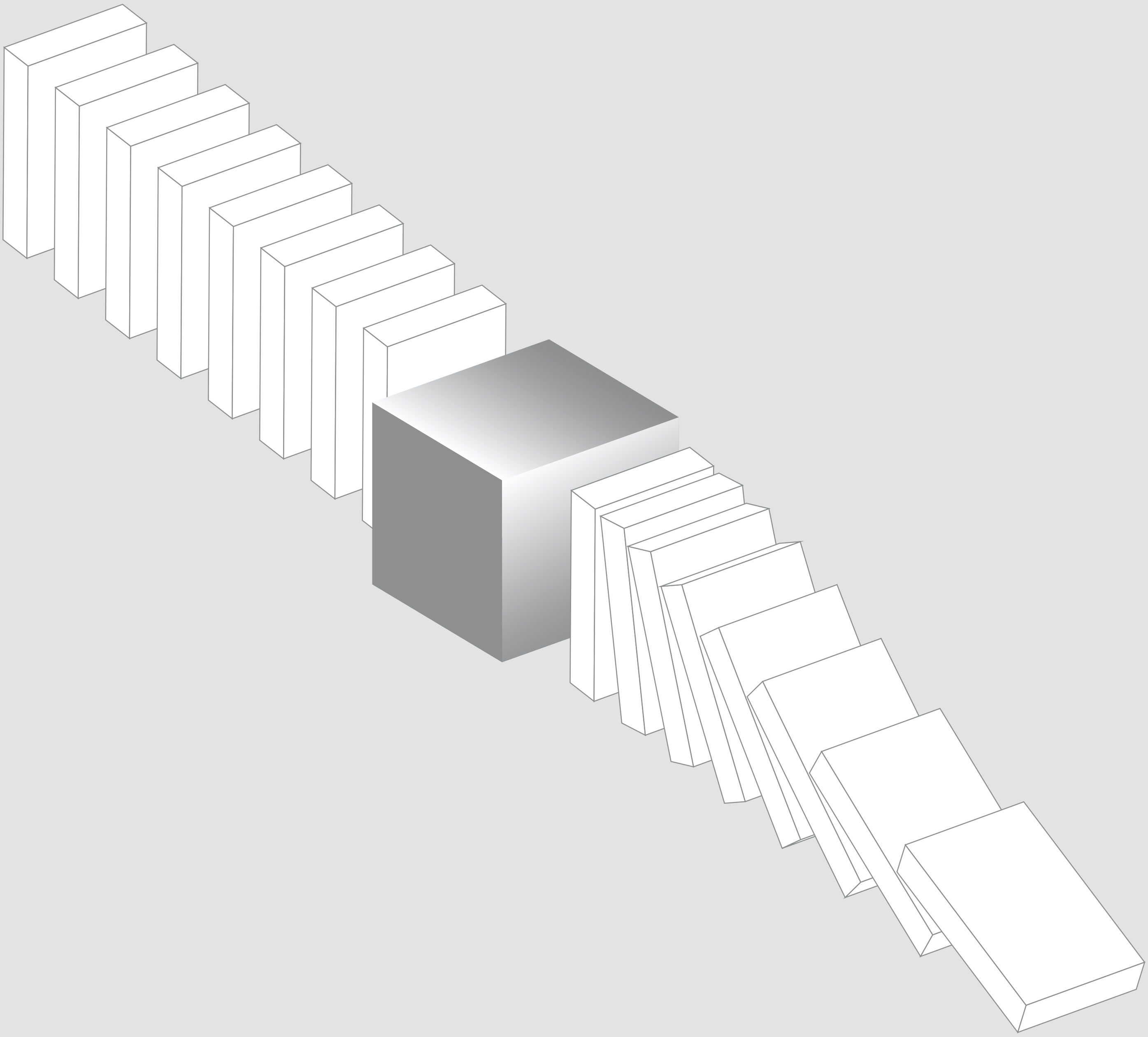


For the lending bank
- Market development for future business
- Capital relief under Basel III IRB
- Reduced legal and operational risk
- Profitability of transactions
- Tangible stewardship role

For the regulator
- More liquid, stable and inclusive market
- Better monetary policy transmission
- Improved price discovery and development of risk mitigating products
- Reduced legal uncertainty
- Opportunities to expand knowledge and skills

For the investor
- Strengthened local capital market for FI clients
- Collaborating to build money market expertise
- Supporting more robust and shock resistant financial market systems
- Participating in a proven blended finance facility
- ROI and development impact

The continued acceleration of Frontclear's development impact is partially dependent on Frontclear's transaction capacity. Money market transactions are historically large on a notional basis given their primary role in transferring liquidity between large financial intermediaries and Frontclear continues to see a substantial increase in the size of transactions in its pipeline. Being able to facilitate these transactions is core to Frontclear's impact strategy. Going forward, Frontclear is seeking to significantly scale its capital base and technical assistance resources in order to further accelerate impact. Frontclear will also continue to mobilize key partners globally and locally to achieve lasting impact in EMDCs and its vision of catalyzing EMDC financial systems that are resilient and support poverty reducing economic growth.



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