TCX

Scaling Up Currency Risk Hedging for Low and Lower Middle-Income Countries

This 2-pager is an abstract version of TCX's comprehensive proposal to mitigate currency risk at scale and mobilize private finance for sustainable development.

Background

The Bridgetown Initiative correctly identified that, unless proactively addressed at scale, unhedged currency risk undermines any serious efforts to deliver the UN Sustainable Development Goals (SDGs) and tackle climate change. Without urgent action, the unhedged currency exposure of developing economies may triple by 2030 from its already excessive current level of $2 trillion. This threatens borrowers in low and lower middle-income countries (LICs/LMICs) where currency risk exposure has been the single biggest driver of debt distress.

Currency risk also affects overall financial risk of climate projects as it undermines borrowers' ability to predict their debt obligations. Depreciations can unexpectedly and substantially increase debt service repayments. The easiest way for private investors to mitigate this risk is to refrain from investing.

TCX has developed a '*roadmap to financial resilience*' that identifies required policy actions and mandates to significantly increase the supply and demand of currency risk solutions, making borrowers more financially resilient and thus more attractive for private finance.

Measure 1: MDBs should improve responsible lending practices and commit to an (indexed) local currency lending target.

The first and most impactful measure is to gradually shift MDB lending from hard currency denomination towards (indexed) local currency loans. This shift should logically be led by the concessional lending arms of the MDBs, such as IDA and the ADF. They are the most critical sources of financing for the low-income economies most vulnerable to currency risk and debt distress.

In principle, we advocate that development lenders should always offer their public sector and private sector clients the option to add risk mitigation clauses to the standard loan products. The MDBs should not keep the additional risks associated with such clauses on their books but should play a catalytic role in triggering the growth of underlying risk markets. Once a borrower chooses to add a special clause to the MDB loan contract, the MDB treasuries will access risk markets to pass on all or most of the resulting risks.

Setting even a modest near-term target of indexing only an additional 2.5% of all new lending to be indexed to the local exchange rate by 2025 will be useful in stimulating both demand and supply. It will also greatly support the build-up of risk capacity at sovereign Debt Management Offices (DMOs), as it will stimulate active currency risk management.

Measure 2: Improve the scale and scope of TCX to facilitate large volumes of hedging in LICs/LMICs currencies.

A development initiative, TCX was established in 2007 by several donor governments and development finance institutions as a solution to FX risk for the most challenging markets. TCX is impact-maximizing and offers currency risk solutions in markets where commercial options are inadequate or inexistent. It functions as a currency risk pool for development finance and commercial investors in LICs/LMICs.

TCX's balance sheet should be scaled up to become a larger catalyst for mobilizing investor interest in frontier currencies and improving liquidity for such currencies in the market. TCX can increase its capital base from the current level of $1.3 billion to $5 billion with adequate donor and MDB support in the near term. This would enable TCX to increase its leverage ratio and hedging capacity which can accommodate the expected increase in currency hedging demand from MDBs and DMOs.

TCX can also increase the scope of its product offerings to include solutions to transfer & convertibility risks and counterparty credit risks, in collaboration with institutions such as MIGA.

Measure 3: Policy reforms to mitigate currency risk at scale.

Complementary policy reforms in the development finance architecture that reinforce each other is necessary to achieve meaningful impact:

1. **The IMF should review how modern risk management tools, such as cross currency swaps, are accounted for in its Debt Sustainability Analysis and Debt Limits.**

The current policy framework already provides the IMF sufficient flexibility to treat special risk-resilient loan clauses, such as currency indexation, more favourably by offering more headroom in its revised DSAs and offering higher borrowing limits under its revised debt limits policy. Giving borrowers clarity about the future treatment of currency indexation and other clauses will be important in tilting incentives towards reducing the excessive currency risk that exists today.

2. **Existing capacity building programs should build up and reinforce currency risk management capacities of DMOs, central banks, regulators, and finance ministries.**

A forthcoming IMF survey shows that DMOs are ill-equipped to manage and quantify currency risk in their debt portfolios. They should be given training and relatively simple tools to build up their capacities. To facilitate this, donors will need to re-direct technical assistance to build currency risk and interest rate risk management capacities, for example through the World Bank's Debt Management Facility (DMF).

3. **Encourage and advise on legislative and regulatory changes to standardize the way that currency risk hedging is treated in national jurisdictions.**

Sound regulatory treatment of collateral frameworks, acceptance of netting, counterparty risk, and deliverable derivative products can encourage the formation of liquid risk and hedging markets.

Measure 4: Improve the affordability of (indexed) local currency financing.

In response to the Bridgetown Initiative, a donor-funded Guarantee Trust is proposed to share pricing risks with TCX's shareholders. This allows TCX to reduce its risk premium. The concept is very similar to a contingent subsidy and has already been deployed with the help of the EU EFSD program as a small pilot program. The objective is to establish a sufficiently large Trust to lower hedging costs below the standard TCX or market price for a swap portfolio of up to USD 10 billion. This portfolio will exclusively support climate mitigation and climate adaptation projects globally.

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