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# FX Hedging Instruments



CLIMATE  
POLICY  
INITIATIVE

**Currency hedging** is a risk mitigation tool addressing FX fluctuation (market risk) relevant to EMDEs: the risk that the local currency depreciates relative to the hard currency in which a loan is denominated.

**Hedging instruments** (forwards, swaps, options) allow borrowers to lock in exchange rates or cap downside exposure, enabling long-term financial planning in volatile environments.

## RISKS ADDRESSED

- **Market Risk:** Currency hedges protect borrowers with FX-denominated loans and local-currency revenues from rising debt service costs when local currency depreciates. Without hedging, even modest depreciation can make projects financially unviable or force costly refinancing.

## APPLICATION AND IMPACTS

- Any long-term, locally earning project exposed to hard currency debt is a candidate. Sectors highlighted include:
  - Clean energy and efficiency
  - Low-carbon transport and resilient infrastructure
  - Nature-based solutions and agriculture
- FX risk is particularly acute for non-exporting sectors, unlike extractives or logistics, which often earn in US dollars. Ministries should prioritize hedging in sectors where tariffs, subsidies, or public service pricing are denominated in local currency and are vulnerable to depreciation.

## TYPES OF INSTRUMENTS & PROVIDERS

### A. Commercially available instruments provided by commercial banks, financial institutions, and institutional investors

#### 1. Forwards and Swaps

- Private agreements between a borrower and a financial institution to exchange a fixed amount of currency at a predetermined rate on a future date.
  - If currencies are exchanged only at maturity, it's a forward.
  - If currencies are exchanged both at the start and at maturity, it's a currency swap.
  - In non-deliverable forwards (NDFs), the contract is settled in a convertible currency (e.g., USD), with no actual exchange of the local currency. This is used in markets with capital controls.

- Most used in EMDEs where over-the-counter (OTC) derivatives dominate.
- In EMDEs with shallow markets, long-tenor forwards/swaps may be unavailable or too costly. In such cases, borrowers often use rolling hedges: a series of short-term contracts renewed over time). This approach carries rollover risk, as future hedges may be more expensive or harder to secure.

## **2. Futures contracts**

- Similar to forwards, but standardized and traded on formal exchanges.
- Most used by smaller investors and in markets with developed financial infrastructure.

## **3. Options**

- Provide the right (but not the obligation) to exchange currencies at a fixed rate before a specified future date.
- Most used in more liquid and sophisticated financial markets

## **B. Concessional or public instruments provided by MDBs & DFIs & philanthropic organizations**

### **4. Back-to-back funding**

- Used primarily by multilateral development banks (MDBs) and development finance institutions (DFIs). Institutions such as the EBRD, IFC, World Bank, and IDB raise capital in the same currency, amount, and tenor as the loan they extend, essentially matching their funding and lending profiles one-to-one.
- This allows them to offer local currency loans to clients while avoiding any direct currency risk themselves.

### **5. Blended finance**

- Blended finance structures combine concessional capital from donors or philanthropies with commercial capital to de-risk transactions. In the context of hedging, blended facilities may subsidize hedge premiums, offer partial guarantees to hedge providers, or backstop losses, thereby making hedging more affordable and extending coverage to higher-risk currencies or longer tenors.

### **6. TCX**

- The [Currency Exchange Fund \(TCX\)](#) provides long-term currency hedges in over 90 emerging and frontier market currencies, especially where no liquid market exists. Backed by a coalition of public and private DFIs, TCX absorbs the exchange rate risk on behalf of lenders, offering fixed-price hedges based on long-term fundamentals.

## 7. Eco Invest Brasil (Government of Brazil + IDB)

- [Eco Invest Brasil](#), launched by the Brazilian government with IDB support, is a foreign exchange (FX) facility designed to reduce currency risk and attract private investment in green projects. It includes a USD 3.4 billion credit line for local banks to offer affordable FX hedges and an emergency liquidity line activated during sharp devaluations to help businesses manage short-term cash needs.

## 8. Delta Platform (AIIB, EBRD)

- The Delta Platform, backed by AIIB, EBRD, and Frontclear, helps development finance institutions (DFIs) provide local currency loans without taking on currency risk. It does this by raising short-term local currency from domestic markets, pooling that liquidity, and lending it to DFIs for longer periods. Delta manages the currency and refinancing risks centrally, reducing the burden on individual DFIs.
- It also works with local regulators and banks to improve market infrastructure, making local currency lending more affordable and reliable.

## C. Technical assistance and market-building providers

- **TCX**: Provides hedges and builds local capacity on pricing and risk-sharing.
- **MDBs & DFIs (WB, IFC, EBRD, AfDB, IDB, ADB)** : Support structuring, pilots, and regulatory advice.
- **Bilateral donors (FCDO, USAID/DFC, KfW, SECO, EU)**: Fund studies, pilots, and subsidies.
- **IMF**: Guidance on sovereign FX risk management and fiscal dashboards.

# DEBT SUSTAINABILITY

- **Direct effect**: FX hedging instruments do not reduce debt stock but reduce exposure to exchange rate-driven increases in debt service.
- **Indirect effect**: Protect fiscal space, reduce refinancing needs, and lower sovereign/borrower credit risk by insulating against shocks.

# INTERNAL CAPACITY REQUIREMENTS

## A. Minimum requirements

- Track foreign-denominated liabilities across the public and SOE portfolio;
- Assess currency depreciation risk and its implications for debt service;
- Integrate currency risk into project appraisal and budgeting.

At this level, institutions can typically access basic forward contracts (Instrument #1) through intermediaries such as commercial banks, DFIs (e.g., IFC), or facilities like TCX, which offer standardized products for relatively short durations. These products may not require structuring expertise, but do demand contract literacy, basic pricing knowledge, and the ability to evaluate counterparty risk.

## B. Requirements for full integration

- Options (Instrument #3) for flexible risk caps,
- Swaps (Instrument #1) for aligning debt service profiles with local revenues, or
- Rolling hedge strategies for long-duration loans, institutions require a dedicated treasury or risk management function with:
  - Proficiency in financial derivatives pricing;
  - Understanding of credit support and collateral requirements;
  - Skills to negotiate, monitor, and manage multi-year contracts, including renewal risks;
  - Capacity to engage with multiple providers and evaluate structured offers.
  - Access to these instruments also often requires reliable cash flow forecasting, data systems for exposure monitoring, and clear internal governance for risk approvals.

## C. Pathways

- Embed technical advisors or partner with regional DFIs to co-develop transactions;
- Invest in training programs for public debt and risk management units;
- Leverage multi-project platforms to aggregate demand and spread transaction costs (e.g., sectoral hedging facilities);
- Establish dialogue with providers like TCX to understand terms, pricing models, and risk-sharing arrangements;
- Participate in pilot transactions under donor-supported initiatives like the TCX donor facility or Eco Invest Brasil, to gain institutional learning and signal demand to the market.

# REGULATORY CAPACITY REQUIREMENTS

## A. Minimum

To engage in simple products, ministries of finance and local financial institutions must operate in a jurisdiction where:

- The legal system permits derivative contracts, either under general financial law or through explicit regulation.
- Public institutions are authorized to enter into FX hedging agreements, directly or through intermediaries.
- Access to offshore hedging providers (e.g., commercial banks, TCX) is not restricted by capital controls or foreign exchange regulations.

In these circumstances, institutions may be able to engage in simple forward contracts (Instrument #1) or standardized swaps (Instrument #1), provided the counterparties are licensed and the contracts are governed under offshore law. However, hedging access remains limited by regulatory ambiguity, internal procurement restrictions, or accounting rules that treat derivatives as speculative instruments.

## B. Requirements for full integration

To support more complex, long-duration, or onshore hedging mechanisms the legal and regulatory system must:

- Explicitly authorize public institutions and SOEs to engage in multi-year hedging contracts.
- Permit onshore issuance or intermediation of derivative products by local financial institutions.
- Include clear guidance on risk classification, accounting treatment, and disclosure of hedge-related exposures.
- Integrate hedging into the regulatory oversight of debt and fiscal risks.

This can facilitate the use of instruments such as cross-currency swaps embedded in MDB/DFI loans, rolling hedges tailored to project cash flows, and onshore liquidity platforms like the Delta proposal.

## C. Pathways

To enable advanced hedging use, ministries of finance and financial authorities can:

- Clarify the legal authority of public institutions to engage in hedging via public debt laws or financial regulations;
- Coordinate with the central bank to ensure FX convertibility and forward market development.
- Engage in regulatory reform to allow licensed domestic banks to offer FX hedging products under proper supervision.
- Include hedging capacity and FX exposure tracking in sovereign risk and fiscal reports.
- Use pilot projects with MDBs and DFIs (e.g., initiatives like the Eco Invest Brasil guarantee facility, back-to-back funding mechanisms) to test regulatory interpretations and develop institutional precedent.

# FINANCIAL MARKET READINESS

The ability to access and deploy hedging instruments depends heavily on the depth and structure of a country's financial markets. Financial market maturity affects (1) the availability of counterparties for hedging, (2) the tenor, (3) pricing, and (4) the capacity to support onshore vs. offshore structures.

## A. Shallow financial markets

- **Characteristics:** Limited FX liquidity beyond spot markets; limited supply and liquidity of local-currency bonds at longer tenors; minimal investor base; lack of derivative infrastructure; highly volatile or illiquid currencies.
- **Constraints:** High spreads, short maturities, limited domestic appetite for long-term lending and borrowing, and low aggregation of demand.
  - **Applicable FX solutions:** Offshore and non-deliverable forward contracts or swaps via TCX and regional financial banks.

- **Pathways to build readiness:**

- Strengthen macro stability and support capital market reforms (money market development, investor confidence-building, and regulatory modernization).
- Build out issuance and liquidity at the longer end of the local-currency government bond yield curve.
- Expand legal pathways for FX contract use.
- Build government capacity to engage with offshore providers.

## **B. Emerging financial markets**

- **Characteristics:** Presence of active local currency bond market, growing institutional investor base, but still dependent on DFIs and constrained by tenure mismatch and shallow swap markets.
- **Constraints:** Limited tenor and volume of FX instruments; modest derivative activity; few local providers.
- **Applicable FX solutions:**
  - Onshore forward contracts
  - Options
  - Rolling hedges or short-tenor forwards renewed over time
  - Swaps
  - Participation in innovative blended finance platforms (e.g., Delta, ecoinvest etc)
- **Pathways to build further readiness:**
  - Enable local banks to offer FX instruments
  - Partner with DFIs to test structured hedging through pilot transactions
  - Strengthen regulation on local derivatives and FX settlement

## **C. Mature financial markets**

- **Characteristics:** Deep FX liquidity, institutional investors with long-term appetite, liquid local-currency bond market across the yield curve, diversified financial sector capable of offering a range of hedging products.
- **Constraints:** Often minimal; challenge may lie in coordinating policy across institutions.
- **Applicable FX solutions:**
  - Full range of hedging tools
  - Integration of FX hedging into national PPP units, SOEs, or development banks

## PRICING CONSIDERATIONS

- Commercial hedging instruments are priced at market-reflective levels, which means their cost depends on factors such as currency volatility, tenor, market depth, and counterparty risk.
- In many emerging and developing markets, these prices can be prohibitively high, often erasing any benefit of borrowing in hard currency compared to local currency.
- To reduce the cost of hedging and improve affordability, Ministries of Finance can seek concessional support from donors or philanthropies. This support can take various forms:
  - Subsidies to offset the high upfront cost of hedging;
  - Tail-risk coverage to reduce pricing by capping extreme losses;
  - Capitalization of liquidity buffers to support the hedge provider's risk exposure.
- For example, TCX is working to implement a donor-funded facility to guarantee returns to the hedge provider to provide more affordable hedging instruments.

## AVERAGE TIMEFRAME TO DEPLOY

- **Short-term contracts** (e.g., forwards): within a few days, depending on market readiness for shallow markets
- **Structured solutions** (e.g., back-to-back swaps, rolling hedges, blended hedging structures, or option-based contracts) within 1-6 months, depending on market readiness for emerging and mature capital markets.

## KEY CHALLENGES TO UPTAKE

- **High perceived cost:** Hedging premiums can reach 6-7% of principal.
- **Tenor mismatch:** No long-term hedge available
- **Operational complexity:** Structured instruments like back-to-back swaps require technical expertise, legal clarity, and close coordination with MDBs, DFIs, and local financial institutions. Maintaining consistent terms across project life cycles is often difficult.
- **Market concentration:** Few providers, high transaction costs.

## HOW TO ADDRESS KEY CHALLENGES

### A. Practical steps for Ministries of Finance (MOFs):

- Enable regulatory clarity for public sector use.
- Support legal frameworks, coordinate DFI pipelines, or aggregate local demand to reduce costs.

## B. Role of donors/DFIs:

- **Provide concessional capital** to subsidize hedging premiums (e.g., tail-risk coverage, liquidity buffers, or guarantees for hedge providers).
- **Anchor scalable platforms** like TCX donor windows, Eco Invest Brasil, or Delta Platform, which lower costs for multiple borrowers simultaneously.
- **Fund technical assistance (TA)** for Ministries to integrate FX risk into project appraisal, debt management, and fiscal reporting.
- **Strengthen market infrastructure** by supporting local banks' ability to offer FX hedging, improving liquidity in local currency bond markets, and aligning with central banks on convertibility.

## EXAMPLES

- **Emerging markets: Brazil (Eco Invest Brasil):** \$3.4bn FX facility with IDB support that provides affordable hedges for green projects and an emergency liquidity line during sharp devaluations.
- **Frontier markets: TCX donor-backed guarantee facility:** Provides affordable long-term hedges in 90+ frontier market currencies where no liquid domestic markets exist.
- **DFI-specific: Delta Platform (2024 pilot):** Backed by AIIB, EBRD, and Frontclear; pools short-term local currency liquidity to enable DFIs to extend long-tenor local currency loans while managing currency and refinancing risks.

## RELEVANT SOURCES

- [CPI \(2024\). Managing Currency Risk to Catalyze Climate Finance](#)

## KEY TERMS

<b>FX</b>	Foreign exchange
<b>Forward contract</b>	Agreement to exchange currencies at a fixed rate at a future date
<b>Swap</b>	Contract exchanging currencies at the start and maturity
<b>NDF</b>	Non-deliverable forward, settled in USD or another convertible currency
<b>Option</b>	Right but not an obligation to exchange currency at a fixed rate
<b>Back-to-back funding</b>	MDB/DFI practice of matching fundraising and lending currency
<b>Rolling hedge</b>	Successive short-term contracts used to manage long-term risk
<b>TCX</b>	The Currency Exchange Fund
<b>Eco Invest Brasil</b>	Brazilian FX risk facility (with IDB)
<b>Delta Platform</b>	AIIB/EBRD/Frontclear liquidity pooling platform for local-currency hedges