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Research Update:

The Currency Exchange Fund N.V. Upgraded To 'A/A-1' On Improved Business Resilience; Outlook Stable

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Overview

- We rate a fund based on its ability to liquidate its portfolio at any given time, and in an orderly fashion, after satisfying all creditors. The emphasis on liquidation is therefore greater for funds than for other operating entities, such as banks.
- Following a review, we believe that The Currency Exchange Fund N.V. (TCX) demonstrates structurally strong liquidity and adequate capitalization, even under extreme foreign exchange stress in the traded frontier markets.
- We also view favorably TCX's 10-year track record of growth, the high likelihood of ongoing support from its various government owners, and its strengthened risk management tools and policies over the past few years.
- We are therefore raising the ratings on TCX to 'A/A-1' from 'A-/A-2'.
- The stable outlook reflects our view that TCX's business model will remain sustainable in the next two years thanks to adequate pricing and risk management, and durable links with shareholders.

Rating Action

On July 26, 2018, S&P Global Ratings raised its long- and short-term issuer credit ratings on Netherlands-based The Currency Exchange Fund N.V. (TCX) to 'A/A-1' from 'A-/A-2'. The outlook is stable.

Rationale

The upgrade follows a review of the fund's ability to liquidate its portfolio at any given time, and in an orderly fashion, after satisfying all creditors (in this case, the holders of derivatives). The heightened emphasis on liquidation is greater for funds than for other operating entities, such as banks. As a result of the review, which focused on structural liquidity and solvency positions under extreme currency movements, we revised the stand-alone credit profile (SACP) to 'bbb' from 'bbb-'.

In our view, a default of TCX on its derivative obligations would only occur if TCX suffered losses greater than its capital base. This is because we believe liquidity is a structural strength of the business model and is unlikely to be a cause of default. At mid-2018, assets mainly comprised cash and highly rated securities (83%), positive mark-to-market on derivative contracts (8%), and paid cash collateral (8%). Capitalization is inherently more volatile, but we view positively the shareholders' willingness to replenish it should the fund's total capital ratio decrease to 14% of risk-weighted assets (RWAs) as per TCX calculations, or $446 million as of June 2018. This compares with a potential loss of $475 million, equivalent to 14.9% of RWAs at the same date, should each currency perform at its worst level in the past 20 years (in other words, a concurrent event), according to TCX's own foreign exchange stress testing. We therefore consider the capital buffers TCX enjoys to be adequate, and creditors to be adequately protected by the fund's own buffers and support framework, which is critical to our assessment.

Moreover, TCX now has a 10-year track record of sustainable growth and business development, which has established the fund as a reference for emerging and frontier markets currency hedging. The fund's hedging portfolio comprises exposures to 53 currencies globally spread across a gross primary hedging portfolio of $2.1 billion. We also note that the fund's internal rate of return since its inception has been slightly positive, over a period that includes two stressful periods for frontier and emerging markets currencies, in 2008 and 2014-2015.

We also view positively TCX's strengthening of its risk management tools and policies. Notably, TCX introduced an internal capital adequacy assessment process in 2014 to review and better assess its capital and liquidity position by taking into account elements such as un-peg risk and going concern stress test losses. In the first half of this year, this led to an increase in TCX's pillar II capital requirement to 6% from 3%, at a time when the fund's record production (year-to-date) could have incentivized the fund to not increase its capital requirements. TCX has also strengthened its approach to counterparty risk, with a tightened onboarding process and collateral, and guarantees when dealing with onshore borrowers, whose credit standing is typically lower than that of offshore lenders. TCX has also been increasingly using offsetting hedges ($345 million as of June 2018), which support the fund's production while maintaining net hedging volumes within geographical and currency limits.

TCX's main shareholders are the Netherlands Development Finance Company (FMO), KfW, and the European Bank for Reconstruction and Development, which each hold a 14.8% stake. The fund welcomed the European Investment Bank as a new shareholder in June 2016 (10% stake).

We base our view of a high likelihood of extraordinary support on our assessment of TCX's important role for, and its very strong link to, its owners and their related governments. This results in a three-notch uplift from the 'bbb' SACP.

We assess TCX's role as important because it operates as an independent entity that contributes to the provision of an important public policy mandate by its shareholders and their related governments. TCX, via its shareholders, supports official development assistance. The Netherlands, Germany, France, and Japan are all members of the OECD Development Assistance Committee, an international forum that promotes development cooperation and other policies so as to contribute to sustainable development in developing countries. Our assessment of TCX's role for its owners also considers that the focus of TCX's activities is not on the owners' domestic markets, and these activities do not have systemic relevance. TCX's role for its owners could also decrease if it generated insufficient local currency lending business. At the same time, we expect that under such scenarios, the owners would have TCX run down its operations in an orderly manner and provide support, if necessary, until TCX finished its operations.

We assess TCX's link to its owners as very strong, because they created it, provided it with capital as an independent entity, and maintain a strong influence on the fund's strategic and business plans. Both the Dutch government--through the Dutch Ministry of Foreign Affairs--and the German government--through KfW--provide subordinated convertible loans to TCX. Although the shareholders are entitled to start claiming capital redemptions gradually, we expect no major claims for capital redemptions that would threaten TCX's financial strength. If shareholders wished to exercise this option, withdrawal rights would be limited to a maximum of 20% of total capital per year. Furthermore, shareholders have also agreed additional restrictions to redemption, including a clause preventing capital redemption by a shareholder if it would lead to a fall in TCX's internal capital ratio to less than 18% of RWAs.

Outlook

The stable outlook reflects our view that TCX's business model will remain sustainable in the next two years thanks to adequate pricing and risk management, and durable links with shareholders, which have strong incentives to ensure the solvency of the fund and its ability to meet their business needs. These strengths anchor the fund's creditworthiness at 'A', despite its inherently volatile profitability.

Downside scenario

We could downgrade the fund should the strength and predictability of its links with shareholders weaken as a result, for example, of unsustainable performance through the cycle or the implementation of public policies that do not support the fund's role. We would also view negatively the fund's failure to maintain a robust risk management framework.

Upside scenario

Conversely, we could raise the ratings if TCX's financial profile improved significantly, with materially higher capital capable of buffering a concurrent stress scenario across all traded currencies.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Fixed-Income Funds: Counterparty And Debt Rating Methodology For Alternative Investment Organizations: Hedge Funds, Sept. 12, 2006

Ratings List

Upgraded

	To	From
Currency Exchange Fund N.V. (The)		
Issuer Credit Rating	A/Stable/A-1	A-/Stable/A-2