S&P Global Ratings

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Currency Exchange Fund N.V. (The)

Primary Credit Analyst:
Stanislas De Bazelaire, Paris (33) 1-4420-6654; stanislas.bazelaire@spglobal.com

Secondary Contacts:
Philippe Raposo, Paris (33) 1-4420-7377; philippe.raposo@spglobal.com
Nicolas Hardy, Paris (33) 1-4420-7318; nicolas.hardy@spglobal.com

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Currency Exchange Fund N.V. (The)

Major Rating Factors

Issuer Credit Rating
A/Stable/A-1

Strengths:

- High likelihood of extraordinary support from 'AAA' rated main shareholders.
- Strong capitalization.
- Very liquid balance sheet.

Weaknesses:

- Exposure to market risk.
- Volatile earnings.
- Complex products, pricing, and risk management.

Rationale

S&P Global Ratings' issuer credit ratings on The Currency Exchange Fund N.V. (TCX) refer to the fund's capacity and willingness to meet senior financial obligations, in this case derivative contracts.

Importantly, our ratings speak to the fund's ability to liquidate its portfolio at any given time, in an orderly fashion, after satisfying all of its creditors. The emphasis on liquidation analysis is therefore greater for funds than it is for other types of companies in the financial sector, such as banks.

The ratings on TCX reflect our view of the fund's 'bbb' stand-alone credit profile (SACP) and a high likelihood of extraordinary support for TCX from its shareholders in the event of financial distress. We reflect the latter by adding three notches of support to the SACP under our approach for rating government-related entities (GREs).

Our 'bbb' SACP balances our view of TCX's strong capitalization, very liquid balance sheet, and robust risk management against its exposure to illiquid currencies and related complexity and earnings volatility. Our view of a high likelihood of extraordinary support is based on our assessment of TCX's important role for, and very strong links with, its dominant owners and their related governments. These include Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO; AAA/Stable/A-1+) and the government of the Netherlands (AAA/Stable/A-1+), KfW (AAA/Stable/A-1+) and the government of Germany (AAA/Stable/A-1+), and the European Bank for Reconstruction and Development (EBRD; AAA/Stable/A-1+), as detailed in table 2.

For the first time in its history, TCX has entered a phase in its development where capital could constrain growth. Capital available for growth has become scarce, while the hedging pipeline on frontier and emerging markets currencies is expected to be strong. Capital raising is therefore on the table, and, based on shareholders' interest, is likely to be successful in our view. In this context, TCX's attention has turned to capital optimization via increasing short positions on local currencies (LCs; about one-third of long positions), which it does by swapping LC bond issuances of some of its shareholders, allowing it at the same time to deepen LC bond markets.

We continue to view the political context for the development of TCX's activities as broadly favorable. In 2017, G20 finance ministers agreed on the "Compact with Africa" program, which aims to promote private investment in African countries that are committed to implementing reforms, drawing together various participants, including TCX. Also, in December 2018, the German government increased its investment in TCX (subordinated convertible debt) by $25 million and extended the maturity on part of its existing investment by 20 years. In our view, this is a recognition of TCX's expertise and successful development over the past few years, and suggests that support from shareholders would be forthcoming if needed.

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 in the next two years 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 or increase of its tolerance for leverage as a way to support business growth.

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.

Business Profile

TCX started its commercial operations in January 2008 to assist its shareholders--mostly development banks of highly rated sovereigns or multilateral financial institutions--with their public policy role. It currently has about 20 shareholders. Via its hedging activity, TCX promotes long-term LC financing in frontier and emerging markets. About 19% of the primary hedging portfolio related to exposures to "least developed" and "other low income countries" (OECD definitions) at the end of September 2018. TCX pools the hedging needs of its investors, primarily cross-currency swaps. Through the fund, shareholders benefit from risk mitigation through diversification, realize economies of scale for administrative expenses relating to specialized back office and valuation services and transaction management, and share the risks inherent in dealing in markets for which regular quotations are not available.

Typically, the market would not currently provide for swaps with the same currency or tenor as the ones that TCX concludes with individual shareholders. Should commercial banks start offering similar products, TCX would cease to quote derivatives in the corresponding currency.

Investors engage in these markets to provide their borrowers (microfinance to a large extent, but also small and midsize enterprise financing, energy, and infrastructure) with development loans in local currencies to free them from foreign exchange risk, and thus support the development of their local debt markets. Additionally, TCX allows lending expansion for those sponsors that individually may not be allowed to take on direct currency exposure on their lending activities. TCX's shareholders still carry some foreign-exchange risk via their participation in TCX but, on average, less than they would individually were their exposures unhedged. This is because of TCX's risk diversification benefit. In this respect, TCX has the potential to continue improving its risk profile by taking on, for instance, currency exposure with expected low correlation to the existing portfolio or by increasing the granularity of its exposures.

TCX's counterparties are its investors when the loans are in local currency or more infrequently its investors' borrowers when the loans are in U.S. dollars (direct trades).

The growth of TCX's portfolio will primarily depend on its capital raising, considering its capitalization (23.5% at year-end 2018) close to its internal minimum requirement (20.1% at year-end 2018) and strong demand for its hedging solutions on the back of the G20's and the EU's commitments toward public aid. Our base case assumes successful capital raising allowing the fund to meet its growth ambitions, particularly in the area of infrastructure, with the primary portfolio growing by about 20% annually in the next few years.

Table 1

The Currency Exchange Financial Statements

					--Year ended Dec. 31--						
(Mil. $)	**2018***	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
Assets	988.5	909.6	863.0	803.2	766.0	781.8	756.3	711.1	670.4	565.1	451.8
Cash and cash equivalents	40.8	73.3	36.2	57.7	33.9	31.0	40.9	29.6	24.3	51.5	25.7
Securities	767.9	717.7	687.6	599.0	663.1	714.0	669.5	639.7	614.7	500.9	391.9
Cash collateral posted by TCX	99.9	43.6	67.2	86.7	39.3	15.6	20.7	24.2	12.1	0.0	31.9
Swap portfolio and other assets	79.9	75.0	72.0	59.8	29.6	21.2	25.2	17.6	19.3	12.7	2.3
Liabilities	988.5	909.6	863.0	803.2	765.9	781.8	756.3	711.1	670.4	565.1	451.8
Cash collateral received	18.2	18.5	20.0	21.5	5.4	7.7	6.5	0.0	2.9	7.5	0.0
Swap portfolio	209.5	102.2	145.8	202.7	123.6	47.8	37.7	48.7	27.6	16.8	68.8
Other liabilities	7.8	11.2	8.3	12.3	10.1	9.4	9.9	8.9	4.4	3.5	1.2
Capital	753.0	777.7	688.8	566.6	626.8	717.0	702.4	653.5	635.6	537.3	381.8
o.w. first-loss loan	10.9	10.9	10.9	-	-	-	-	-	-	-	-
o.w. subordinated convertible loans	216.6	188.3	161.5	161.5	128.8	128.8	128.8	128.8	128.8	111.1	36.2
o.w. redeemable capital	508.6	558.4	496.3	385.1	478.0	568.2	553.6	524.7	506.8	426.2	345.6
o.w. subordinated loans	17.0	20.2	20.1	20.0	20.0	20.0	20.0	0.0	0.0	0.0	0.0
Statement of comprehensive income											
Investment result	(16.1)	91.4	79.9	(75.9)	(43.6)	38.4	67.4	11.2	33.1	82.6	(55.3)
Other result	(5.2)	1.8	(5.0)	(6.9)	(6.9)	0.5	0.6	(3.3)	(2.6)	(1.1)	(2.5)
Total result	(21.2)	93.2	74.9	(82.8)	(50.6)	38.9	68.0	7.9	30.5	81.5	(57.8)
Operational expenses	(10.8)	(9.5)	(9.2)	(10.2)	(10.7)	(10.6)	(10.7)	(9.0)	(7.7)	(8.4)	(7.2)
Net operating income	(32.0)	83.7	65.7	(92.9)	(61.3)	28.3	57.3	(1.1)	22.8	73.0	(65.0)

*Subject to final allocation of exchange-rate translation results. Source: TCX's financial statements. Source: S&P Global Ratings, TCX.

Ownership Structure And Legal Status

TCX's main shareholders are FMO, KfW, and EBRD, which each hold a 15.3% stake (see table 1). In addition, the Dutch government and KfW--on behalf of the German government--have together paid US$228 million in debt which provides first-loss protection to the fund's shareholders in case of liquidation, to support the fund's capability and incentive to transact in the "least developed countries" and "other low income countries" (OECD).

TCX is a tax-exempt public limited liability company registered in The Netherlands, with the fund manager licensed under the Alternative Investment Fund Manager's Directive since March 2016. It is a semi-open-ended investment fund with an indefinite term, but with capital redemption provisions (subject to annual limits).

Table 2

The Currency Exchange's Main Shareholders

Foreign currency ratings as of Jan. 1 2019

Shareholders	Rating	Number of shares	% of shares
European Bank for Reconstruction and Development	AAA/Stable/A-1+	140	15
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.	AAA/Stable/A-1+	140	15
KfW	AAA/Stable/A-1+	140	15
European Investment Bank	AAA/Stable/A-1+	94	10
Japan Bank for International Cooperation	A+/Positive/A-1	84	9
Agence Francaise de Developpement	AA/Stable/A-1+	80	9
International Finance Corp.	AAA/Stable/A-1+	50	5
African Development Bank	AAA/Stable/A-1+	49	5
Development Bank of Southern Africa Ltd.	BB/Stable/B	40	4
OPEC Fund for International Development	NR	10	1
Belgian Investment Company for Developing Countries	NR	20	2
MFX Currency Risk Solutions	NR	14	2
Other	N/A	53	6

NR--Not rated. N/A--Not applicable. Source: S&P Global Ratings, TCX.

Performance

TCX's earnings are structurally highly volatile. They are driven by changes in the mark-to-market of the derivatives portfolio, which depend on the exchange rate between the U.S. dollar and the relevant emerging market currencies as well as interest rates in these markets.

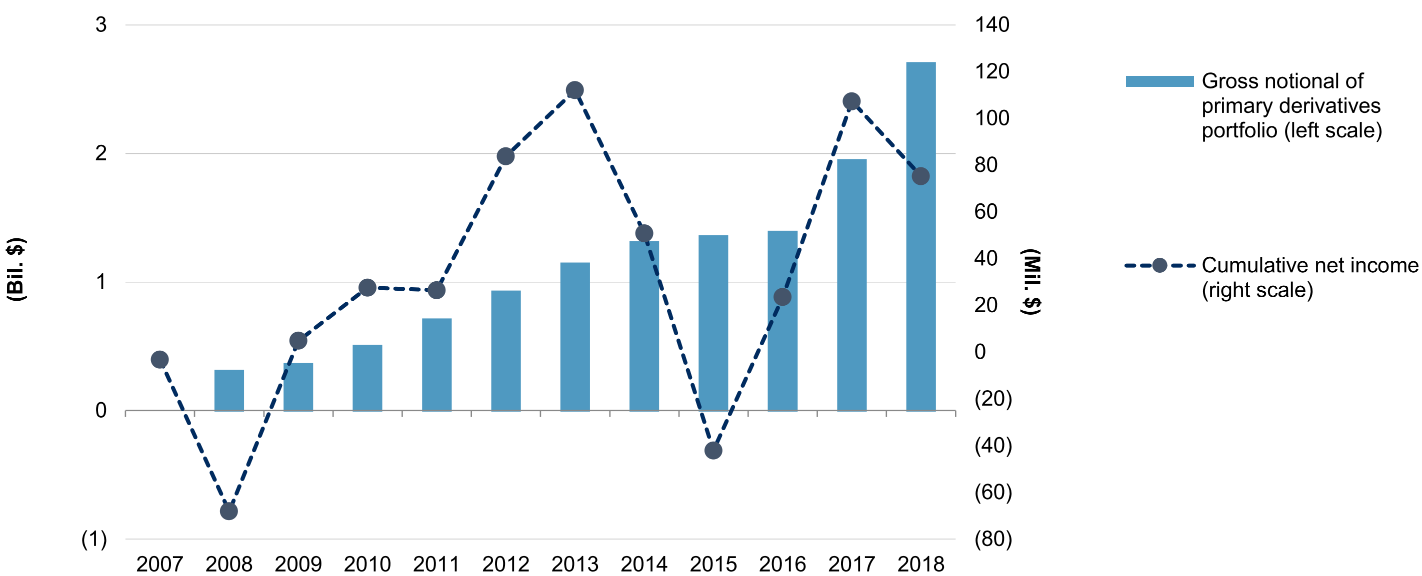
The fund's short-term performance is therefore difficult to predict, in our view. We note, however, that through the cycle, the fund's performance has been essentially positive (see chart 1), fulfilling its mandate to generate a "zero +" internal rate of return (1.4% as of Sept. 30, 2018, since the fund's inception). For this reason, we do not see the fund's shareholder base as sensitive to its short-term performance. The fund clearly does not cover the rate of return a private investor would require, but it's TCX's specificity that it does not have to.

The macroeconomic backdrop for frontier and emerging markets turned unfavorable during most of 2018 after relatively stable two years. Overall, emerging market currencies depreciated in 2018, on the back of trade tensions, idiosyncratic events affecting Argentina and Turkey, contagion effects, and rising interest rates in the U.S. In this challenging macroeconomic context for emerging markets, TCX has been--unsurprisingly--loss-making in 2018 (-$32 million), with the bulk of the losses incurred in August (-$40 million). Losses in 2018 were by far the highest on the Argentine peso (ARS); other badly performing currencies were the Indian rupee (INR), the Myanmar kyat (MMK) and the Uruguayan peso (UYU).

We do not consider negative net asset value (NAV) performance to be an issue from a credit perspective as long as the fund's business model remains sustainable, be it in terms of through-the-cycle profit and loss, risk management, or links with shareholders.

Chart 1

TCX Has A Track Record Of Sustainable Growth



Source: S&P Global Ratings, TCX.

Risk Management

Overall, we believe TCX has strengthened its risk management tools and policies over the past few years, which is partly why we upgraded the fund in July 2018 (see "The Currency Exchange Fund N.V. Upgraded To 'A/A-1' On Improved Business Resilience; Outlook Stable," published July 26, 2018).

TCX's risk exposure stems predominantly from market risk (93% of the fund's own calculation of total risk-weighted assets as of year-end 2018), most of which was currency risk, followed by interest rate risk. TCX is also exposed to liquidity risk and counterparty or credit risk, albeit to limited levels. Credit risk arises through the exposure on its swap portfolio or liquidity portfolio. Liquidity risk is primarily related to the potential obligation for TCX to post cash collateral on its swap portfolio or swap termination payments.

TCX's risk appetite and management are governed by a risk charter, which requires approval from the supervisory board and investors to change. Risk measurement and monitoring are outsourced to a well-established external risk-service provider, Netherlands-based Cardano Risk Management B.V. (Cardano). The fund manager retains the ultimate responsibility for ensuring that all risks are identified, measured, monitored, and kept within the risk appetite limits agreed by shareholders.

Market risk

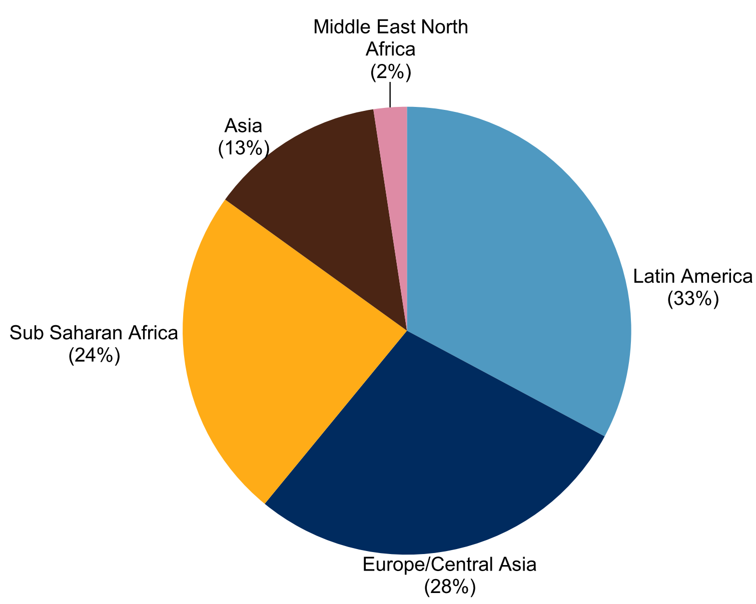
TCX manages market risk via concentration limits (by currency and regions) and the use of offsetting hedges to remain within those limits, and measures market risk with value at risk (VaR).

Concentration limits are by currency (net notional exposure cannot exceed 25% of total capital or 10% of portfolio) and region (limit of 30%-50% of total net notional exposures).

Chart 2

TCX Is Primarily Exposed To Currencies From LatAm, Europe/Central Asia, And Sub-Saharan Africa

TCX's Net Currency Exposures, Year-End 2018

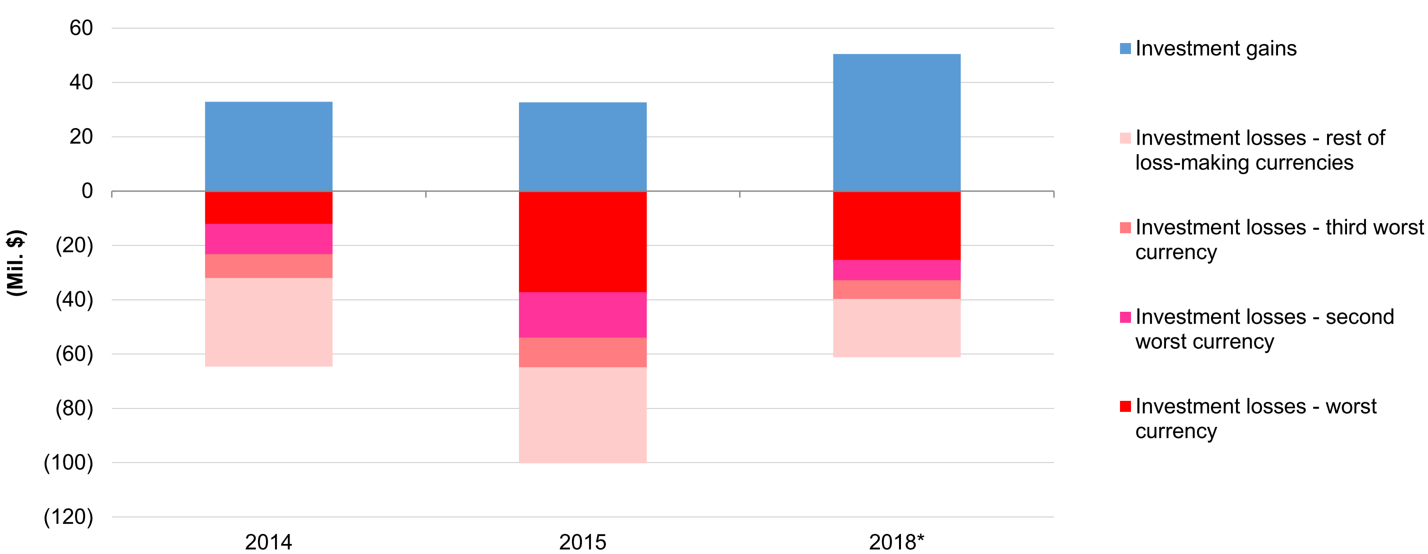


Source: S&P Global Ratings.

Despite these limits and the fund's relative granularity with more than 50 currencies covered, the fund's negative performance can be largely driven by just a few currencies. For instance, in the past three loss-making years (2014, 2015, and 2018), each year three currencies accounted for more than half of the fund's investment losses (chart 3). Positively, we note that during these same three years, the fund's negative performance was partly mitigated by gains on certain currencies (chart 3), highlighting the diversification benefit even in times of stress.

Chart 3

Diversification Usually Mitigates Total Losses When Emerging Markets Are Under Stress



*January to November 2018. Source: S&P Global Ratings, TCX.

Offsetting hedges play an important role to maintain the portfolio composition within these limits if production becomes unbalanced. Indeed TCX has favored the issuance of local currency linked bonds and notes by some of its shareholders that are then swapped with TCX to U.S. dollars. This provides TCX with opportunities to have short positions on some of the local currencies on which it has a long position via its primary derivatives portfolio, hence allowing it to reduce its net exposure to some of the local currencies and regions, while contributing to the development of LC bond markets. We expect this risk mitigation technique to gain in importance in the next few years in a context of strong growth and related pressure to optimize capital usage. Offsetting hedges account for about one-third of TCX's long positions. We expect their share to continue increasing.

TCX's main market risks are exchange rate and interest rate risks in U.S. dollar and local currencies. TCX measures exchange rate risk through an expected tail-risk approach, defined as the average of the five worst monthly losses observed for the foreign exchange book since January 1996. TCX measures interest rate risk through stress testing in emerging markets and historical VaR (99%) in developed markets. Though the VaR is based on a blend of methods, we view TCX's VaR as broadly consistent with a 99% VaR, based on about 125 monthly profit and loss observations.

The main evolution of market-risk management over the past few years has been, in our view, the introduction an internal capital adequacy assessment process in 2014. It allows TCX to review and better assess the fund's 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 2018 in a context of more challenging market conditions for emerging market currencies, this led to an increase in TCX's pillar II (further detailed in the section below) capital requirement to 6% from 3%, at a time when the fund's record production could have incentivized the fund to not increase its capital requirements.

Credit risk

We currently consider TCX's credit risk to be extremely low. TCX does not undertake direct lending activities. Credit risk arises from counterparty risk on derivatives and credit risk associated with cash and security investments.

Credit risk exposures at default are 96% to counterparties rated 'A' or above (at year-end 2018, based on TCX's internal rating system, largely based on those of rating agencies). Exposures on derivative counterparties are mitigated by collateral posting and/or a guarantee. Counterparty exposures to borrowers of shareholders are small (less than 5% of the primary portfolio notional). Securities consist of highly rated bills and bonds (rated in the 'AAA' and 'AA' categories).

TCX strengthened its onboarding process, payment monitoring, and risk mitigation following its first ever credit loss in 2016 (the amount itself was negligible due to the size of the exposure and its collateralization).

Liquidity

Liquidity risk is very limited, in our view. TCX's balance sheet is very liquid, with 4% of total assets in cash (U.S. dollars and euros) and a further 78% in highly rated liquid securities at year-end 2018.

In 2018, TCX introduced a minimum liquidity ratio of 150%, which takes into account collateral calls under stress and potential shareholder redemptions.

In our view, liquid assets comfortably cover--by about 2x according to our calculation at year-end 2018--liquidity needs that would arise in a worst-case case scenario where all liabilities swaps were terminated and capital were redeemed up to the annual maximum (20%). Liquid assets amounted to $809 million at year-end 2018, which compares with a worst-case 20% capital redemption of about $150 million and a mark-to-market of derivatives liabilities of $209 million.

TCX usually posts collateral when the mark-to-market of the derivative contract favors the counterparty. We consider the risk of TCX not being able to meet such obligations to be very low.

TCX does not take deposits or issue debt.

Capital Position

Statutory capital limits

TCX is not subject to bank regulation. Under its own statutes, agreed upon with the shareholders, it has determined minimum capital to risk-weighted assets ratio standards that would trigger obligatory steps to be taken by the risk manager. Risk-weighted assets as calculated by TCX arise in credit, operational, and market risks, the latter of which are by far the main risk drivers.

TCX defines its capital requirement as the sum of the capital required to cover the liquidation trigger event (14% capital ratio) and a Pillar 2 requirement (variable, 6% currently). The Pillar 2 requirement, reviewed every year during the ICAAP process, covers risks that may be insufficiently captured or not captured under its risk weighting, such as the risk of a currency being unpegged, and includes a buffer for going-concern losses.

Should total capital fall below the own capital requirement (20.1% at year-end 2018), TCX would be required to reduce its swap exposures until the ratio requirement is met. This trigger provides some protection against the fund reaching the liquidation trigger event (14.0% total capital ratio), although it may not cushion against the effect of abrupt and lasting market movements. Shareholders have also agreed additional restrictions to redemption, including a clause preventing capital redemption if it would lead to the total capital ratio dropping to less than 18%, providing an additional protection against reaching the liquidation trigger event.

Should the capital ratio fall below 14% of capital over risk-weighted assets ("liquidation trigger event"), we understand that, as per the fund's statutes, all shareholders would have to discuss at short notice a resolution, agreeing to provide additional capital, wait for a recovery, or liquidate the fund within one year by unwinding its positions. Swaps with all counterparties contain clauses, by which TCX and the swap counterparties can unwind existing swap positions after the liquidation event in an orderly manner.

Capital strength

TCX's capital base is currently comfortable, in our view. The total capital ratio stood at 23.5% at year-end 2018, according to TCX's own calculation, compared with a minimum own capital requirement currently at 20.1%.

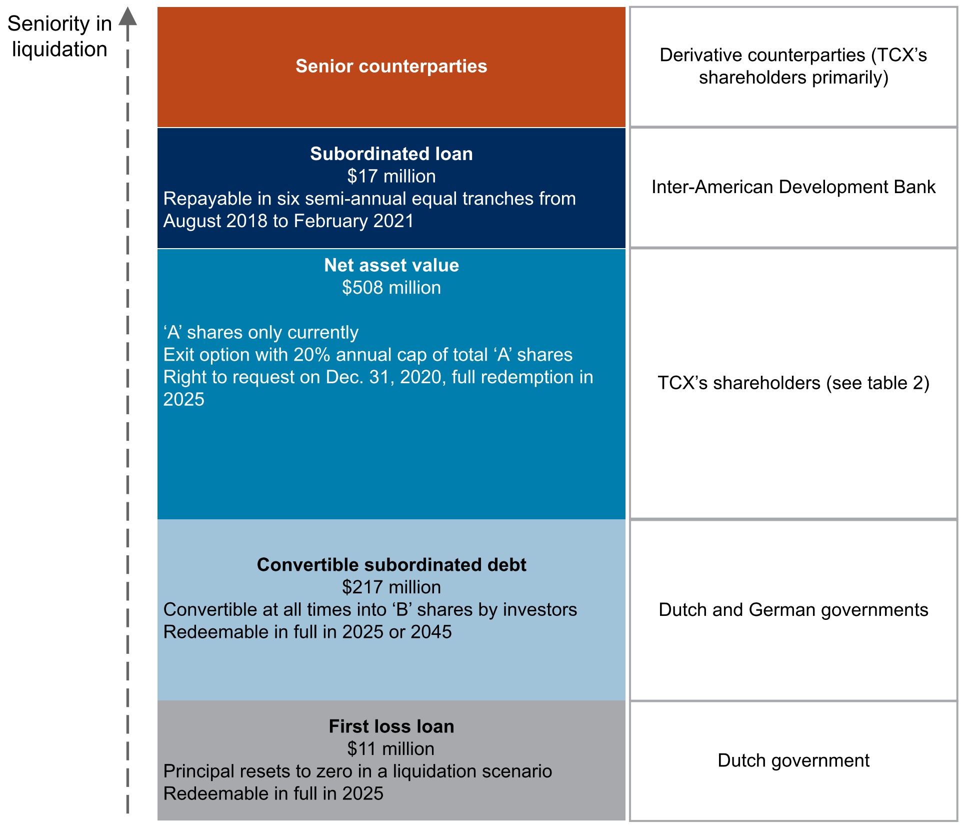
In our view, a default of TCX would only occur should the fund incur losses greater than its total capital. If we rely on a minimum capitalization of 14% (the liquidation trigger event, i.e. $444 million as of year-end 2018), this means that for such a default to occur, TCX would have to suffer a stress similar to each currency performing at its worst over the past 20 years ($482 million loss at year-end 2018), a very stressful scenario, in our view. If we rely on TCX's internal minimum capital requirement (20.1%, equivalent to $638 million at year-end 2018), this very stressful scenario would not even be sufficient to hit TCX's derivative counterparties (in liquidation).

This is partly why we upgraded the fund in July 2018 (see "The Currency Exchange Fund N.V. Upgraded To 'A/A-1' On Improved Business Resilience; Outlook Stable," July 26, 2018).

Chart 4

TCX's Senior Counterparties Are Protected In Liquidation By Equity And Various Types Of Debt Instruments

TCX's Simplified Capital Structure At Year-End 2018



Source:S&P Global Ratings.

The capital base comprises shareholders' redeemable capital ($508 million), subordinated convertible loans ($217 million), subordinated loans ($17 million), and a first loss loan ($11 million). The convertible loans are subordinated to all junior and senior obligations. This capital structure addresses the different risk profiles of exposures that TCX exposes the various shareholders to.

Assessment As A Government Related Entity (GRE)

Our view of a high likelihood of extraordinary support is based on our assessment of TCX's important role for, and its very strong link to, its dominant owners and their related governments. Investments in December 2018 by the German government in the form of additional subordinated convertible debt ($25 million, of which $20 million matures in 2045 and $5 million in 2025) and maturity extension (to 2045 from 2025 on $30 million of existing debt) support our assessment, in our view.

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 (ODA). The Netherlands, Germany, France, and Japan are all members of the OECD Development Assistance Committee, an international forum that promotes development co-operation and other policies to contribute to sustainable development in developing countries.

Our assessment of TCX's important role for its dominant owners also reflects the fact that the focus of TCX's activities is not on the owners' domestic markets, and these activities do not have systemic relevance. By the same token, TCX's role for its owners could decrease if governments adopted a more hostile stance toward ODA. 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 finishes its operations.

We assess TCX's link to its dominant 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. Furthermore, if shareholders wish to exercise this option, withdrawal rights would be limited to a maximum of 20% of total capital per year.

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

Related Research

- The Currency Exchange Fund N.V. Upgraded To 'A/A-1' On Improved Business Resilience; Outlook Stable, July 26, 2018
- Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V., Dec. 28, 2016
- KfW, Nov. 11, 2016
- European Bank for Reconstruction and Development, Oct. 7, 2015

Ratings Detail (As Of January 29, 2019)	
Currency Exchange Fund N.V. (The)	
Issuer Credit Rating	A/Stable/A-1
Issuer Credit Ratings History	
26-Jul-2018	A/Stable/A-1
16-Jan-2017	A-/Stable/A-2
23-Feb-2015	A-/Negative/A-2
Sovereign Rating	
Netherlands	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.