Research Update:

The Currency Exchange Fund N.V. Affirmed At 'A/A-1' On Criteria Change; Outlook Stable; Off UCO

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PRIMARY CREDIT ANALYST

Stanislas De Bazelaire
Paris
(33) 1-4420-6654
stanislas.bazelaire
@spglobal.com

SECONDARY CONTACT

Nicolas Hardy
Paris
(33) 1-4420-7318
nicolas.hardy
@spglobal.com

Overview

- We have adopted new criteria for rating alternative investment funds ("Alternative Investment Funds Methodology," published Jan. 13, 2020).
- The Currency Exchange Fund N.V.'s (TCX's) funding and liquidity are rating strengths and its risk-adjusted leverage is robust under our new framework.
- However, the environment for frontier and emerging market currencies, and therefore for TCX, has become much more challenging since the beginning of 2020 and the outbreak of COVID-19.
- We are affirming our 'A/A-1' ratings and removing them from under criteria observation (UCO).
- The stand-alone credit profile remains at 'bbb' and we continue to include three notches of government support to reflect the benefits from its shareholding structure.
- The stable outlook reflects our expectation that, over the next 12-24 months, TCX will keep an adequate capitalization and continue to attract support for its development from its main shareholders and government investors.

Rating Action

On April 1, 2020, S&P Global Ratings affirmed its 'A/A-1' issuer credit ratings on The Currency Exchange Fund N.V. (TCX) and removed the ratings from under criteria observation (UCO). The outlook is stable.

Rationale

The ratings reflect our view of TCX's strong funding and liquidity and its robust risk-adjusted leverage, under our new criteria on alternative investment funds, published Jan. 13, 2020. It also factors in a challenging environment for frontier and emerging market currencies, and therefore for TCX, amid economic and financial fallouts from the COVID-19 outbreak. Our stand-alone credit profile (SACP) is 'bbb' and we continue to include three notches of uplift, to reflect a high likelihood of extraordinary support for TCX by 'AAA' rated public shareholders in the event of financial distress.

Fund overview and investment profile

TCX is a fund incorporated in the Netherlands (AIFM), which started its operations in 2008 to assist its shareholders--mostly development banks of highly rated sovereigns or multilateral financial institutions (Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. [FMO], KfW, The European Bank For Reconstruction and Development [EBRD], and European Investment Bank [EIB])--with their public policy role. Via its hedging activity, the fund promotes long-term local currency financing in frontier and emerging markets.

TCX provides currency hedging, essentially in the form of non-deliverable cross-currency swaps, mainly to its investors. It had $3.0 billion of long local currency derivatives notional at year-end 2019 ($1.8 billion on a net basis). Through the fund, shareholders diversify and mutualize currency risk on frontier and emerging market currencies, which are relatively illiquid and volatile against the dollar, and benefit from scale effects in terms of knowledge, analytics, and operations. TCX provides its shareholders with hedges on currencies or tenors not provided by banks, which makes its position unique, and critical, in the market. Shareholders still support some foreign-exchange-related risk and costs via their participation in the fund, but on average, less than they would individually were their exposures unhedged, due to risk diversification across a large number of currencies (56 as of year-end 2019).

TCX has defined, under its own statutes, a Basel-inspired framework. The framework sets minimum capital to risk-weighted assets ratio thresholds, which if not met, would oblige the fund to reduce its swap exposures or to be liquidated.

Risk-adjusted leverage

Market risk from the book of derivatives is by far the main risk TCX is exposed to. We capture this risk, along concentration risks (by region and currency), in our value at risk (VaR) calculation. Counterparty and credit risks are very low, in our view, because TCX's counterparties are mainly its highly rated shareholders, and the securities portfolio consists predominantly of fixed-income instruments that we rate 'AAA' or in the 'AA' range.

We view the fund's risk-adjusted leverage (RAL) as robust. We measure the fund's RAL, using the ratio of VaR to net asset value (NAV), which captures its exposure to market risk. Our VaR is on a one-year horizon at a 99.7% level. We derive it from the observed volatility of the fund's performance since inception, assuming a normal distribution of returns but with fatter tails. VaR to NAV was 41% as of year-end 2019, a robust level, in our view.

Recent and upcoming capital injections from existing shareholders to support TCX's growth, the continued interest of new investors, and the fund's long-term performance being in line with its mandate all prove that TCX has delivered on its mission, in our view.

Funding and liquidity

We view TCX's liquidity as strong. Our liquidity ratio (liquidity reserve/[NAV + long-term debt]) amounted to 85% at end 2019, which we view as very strong. According to our estimate, the fund has always maintained this ratio above 82%, highlighting that liquidity is a structural strength of the fund. We expect little change in 2020.

We view TCX's funding profile as strong as well. Equity funding comes through fund users, whose incentive to withdraw funds is therefore extremely low. Withdrawals are furthermore subject to a 20% annual cap and possible only if they do not push TCX's capital ratio below its minimum internal requirement (18% of risk-weighted assets, as computed by the fund). TCX has 19 equity investors, which are mostly highly rated multilateral institutions of development banks from all over the world. None of the large investors has left the fund since its inception. The largest three investors (KfW, EBRD, and FMO) hold 50% of TCX's shares. The main rationale from shareholders to own the fund is to use its hedging solutions.

Debt funding is provided mainly by Dutch, German, and U.K. governments, with maturities mainly in 2025 or 2045, generally in the form of convertible subordinated loans, which we view as very stable.

Other rating considerations

Our ratings on TCX are constrained by the fund's complexity and its reward-to-risk profile. The derivatives TCX provides qualify as level 3 assets whose valuation technique uses inputs not observable in the market, exposing the fund to model risk. Also, TCX's reward-to-risk profile, although in line with its mandate, is lower than for a typical fund seeking to maximize profits.

Government-related entity (GRE) support

Our view of a high likelihood of extraordinary support reflects our assessment of TCX's important role for, and its very strong link to, its dominant shareholders and their related governments. Via the lending activity of its shareholders, TCX supports Official Development Assistance for the Dutch, German, and U.K. governments. We reflect this high likelihood of extraordinary support from 'AAA' rated shareholders by adding three notches to our 'bbb' SACP.

Outlook

The stable outlook reflects our expectation that, over the next two years, TCX will preserve its financial profile by continuing to exhibit prudent risk adjusted leverage policies and robust metrics. The outlook also reflects our expectation that the fund will continue to attract support for its development from its main shareholders and government investors. Maintaining this symbiosis with shareholders is essential for its business development.

Downside scenario

We could downgrade TCX should its through-the-cycle investment performance fall short of its mandate, or its risk appetite increased. At this stage, we do not see higher business volumes as credit-negative, provided they are in line with the fund's mandate and risk tolerance, and does not change fundamentally and economically our view on its leverage. We could also downgrade TCX should governments' stance toward its mission become less supportive, or if the dilution in ownership increased the risk of nontimely support to the fund if need be.

Upside scenario

We could upgrade TCX should it display resilient performance in 2020 amid challenging conditions for frontier and emerging market currencies given the COVID-19 pandemic, and that financial profile, especially leverage, stays little changed.

Ratings Score Snapshot

Stand-alone credit profile: bbb

Issuer Credit Rating: A/Stable/A-1

Risk-adjusted leverage: Adequate

- Stressed leverage: Adequate
- Risk position: Adequate

Funding and liquidity: Strong

- Funding: Strong
- Liquidity: Strong

Preliminary anchor: a-

Jurisdictional risk: Neutral

Anchor: a-

Modifiers

- Track record and investment performance: Neutral
- Risk management: Neutral
- Transparency and complexity: Negative
- Comparable rating analysis: Unfavorable
- Likelihood of extraordinary government support: High (+3 notches)

Related Criteria

- Criteria | Financial Institutions | Other: Alternative Investment Funds Methodology, Jan. 13, 2020
- 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

Ratings List

Ratings Affirmed	
Currency Exchange Fund N.V. (The)	
Issuer Credit Rating	A/Stable/A-1

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.