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The Currency Exchange Fund N.V.

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Credit Highlights

Issuer Credit Rating
A/Stable/A-1

Overview	
Key strengths	**Key risks**
High likelihood of extraordinary support from 'AAA' rated main shareholders	Very high exposure to market risk
Strong funding and liquidity	Volatile earnings
Robust capitalization	Complex products, pricing, and risk management

The macroeconomic environment is very challenging for frontier and emerging markets, and therefore to some extent for The Currency Exchange Fund N.V. (TCX). TCX posted its highest monthly loss on record in March ($128 million) because of the direct effects of COVID-19 on many emerging and frontier markets and their currencies, but also a falling demand for commodities and capital outflows affecting those markets. This loss corresponds almost exclusively to a change in the mark-to-market of the fund's portfolio of derivatives. Its future value will depend on currency exchange rates and interest rate expectations in these markets vs. the U.S., which are by nature difficult to predict. The volatility of TCX's monthly results is not a surprise, however, given the fund's model.

S&P Global Ratings expects TCX to weather this turbulent environment thanks to a robust capitalization and a strong funding and liquidity profile. We believe the fund is entering this period with a robust capitalization, reflected in our ratio of value-at-risk (VaR) to net asset value (NAV) estimated at 46% at March 31, due to large gains from 2016-2019 ($230 million). TCX can also rely on its strong funding and liquidity profile, owing to a very liquid balance sheet and a very stable base of equity and debt investors, to weather this turbulent environment, as it did during previous market volatility.

We expect the fund to benefit from further investor interest and support. TCX raised significant equity capital among its existing shareholders in 2019 ($128 million, or a 25% increase), including the four largest shareholders (KfW, FMO, EBRD, and EIB). We expect further capital raising in 2020, in both debt and equity. Overall, rather than calling into question TCX's business model, the current challenging macro environment might well provide an additional reason for the fund's existence.

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 non-timely support to the fund.

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 its financial profile, especially leverage, stays little changed.

Fund Overview And Investment Strategy

TCX is a fund incorporated in the Netherlands (AIFM license). It started its operations in January 2008 to assist its shareholders--mostly development banks of highly rated sovereigns or multilateral financial institutions--with their public policy roles. Via its hedging activity, TCX promotes long-term local currency financing in frontier and emerging markets. A fifth of the fund's primary hedging portfolio relates to exposures to "least developed" and "other low income countries" (as defined by the OECD).

TCX provides currency hedging mainly in the form of nondeliverable cross-currency swaps and mainly to its shareholders. The fund had $3.1 billion of notional derivatives with long positions on local currencies as of March, and $1.8 billion on a net basis (after taking into account short local currency positions). TCX has about 20 shareholders, the largest of which are KfW, the European Bank for Reconstruction and Development, FMO, and the European Investment Bank, all of which we rate 'AAA' (see table 1).

Table 1

The Currency Exchange Fund N.V.--Main Shareholders As Of End 2019

Shareholder	Rating	% of shares
KfW	AAA/Stable/A-1+	16.8
European Bank for Reconstruction and Development	AAA/Stable/A-1+	16.8
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.	AAA/Stable/A-1+	16.8
European Investment Bank	AAA/Stable/A-1+	10.7
Japan Bank for International Cooperation	A+/Positive/A-1	7.5
Agence Francaise de Developpement	AA/Stable/A-1+	7.1
International Finance Corp.	AAA/Stable/A-1+	4.5
African Development Bank	AAA/Stable/A-1+	4.4
Development Bank of Southern Africa Ltd.	BB+/Negative/B	3.6
Other shareholders	N/A	11.9

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

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. Should banks start offering similar products, the fund would cease to quote derivatives in the corresponding currency (by virtue of its additionality principle). TCX's 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 Dec. 31, 2019).

Risk-Adjusted Leverage

TCX enters this crisis with a robust stressed-leverage profile

Market risk from derivatives is by far the main risk the fund is exposed to (currency risk, followed by interest-rate risk). This risk accounted for 91% of risk-weighted assets reported by the fund at March 31. We assess it, including concentration risks (by region and currency), with our calculation of VaR. 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.

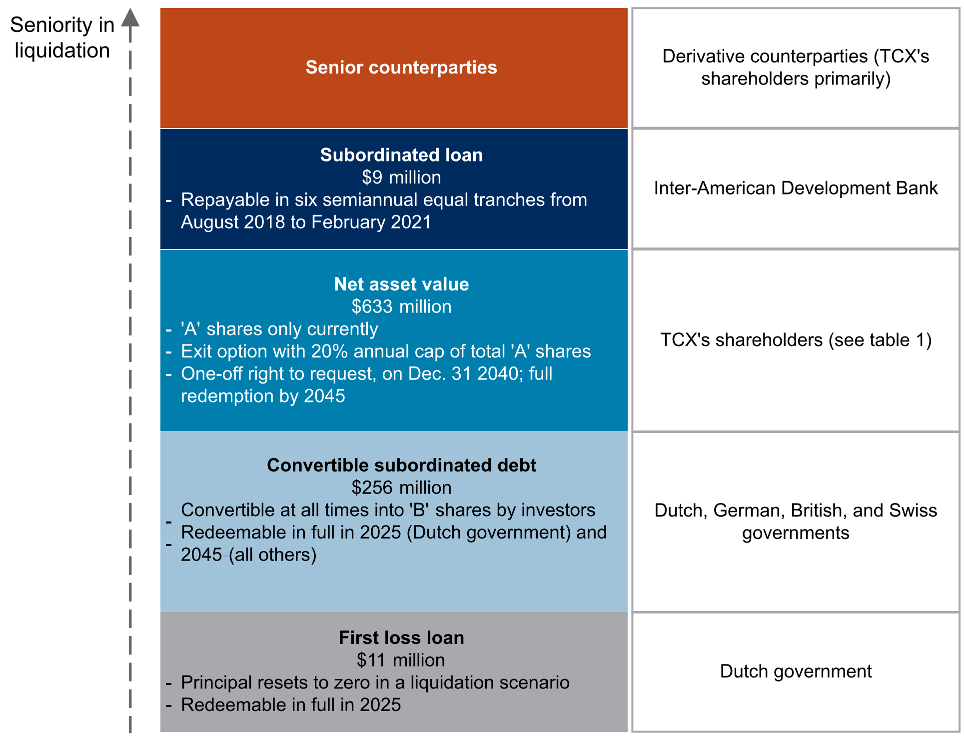
VaR to NAV was 41% as of year-end 2019 and increased to an estimated 46% in March 2020, according to our calculations, following the historically high market volatility observed that month. Market movements are by nature difficult to predict. That said, we believe TCX enters this period with a robust stressed leverage profile.

Of note, the numerator of our stressed leverage metric, NAV, excludes a number of debt instruments, typically from governments , which rank junior to senior (derivative) counterparties in a liquidation scenario (see chart 1). We acknowledge their benefit for senior (derivatives) counterparties and reflect it qualitatively in our analysis. Therefore, should the fund's capital structure be more skewed toward those subordinated debt instruments, and less toward equity, our VAR-to-NAV ratio could deteriorate beyond 50%. However, based on our qualitative analysis of these instruments, it is unlikely such a shift in the capital structure will have a rating impact, as long as VAR to NAV remains well below 75%. Nevertheless, our assessment of the risk-adjusted leverage, on its own, might change in such a scenario.

Chart 1

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

TCX's simplified capital structure as of March 31, 2020



Source: S&P Global Ratings.

VAR-to-NAV adequately captures TCX's exposure to market risk

The risk position assessment refines our purely quantitative stressed leverage assessment. We believe our stressed leverage metric adequately captures the fund's exposure to market risk, hence our neutral assessment of the risk position.

In particular, we see no significant incremental risk from TCX's strategy. In our view, the fund has stuck to its mission, clearly articulated around market creation by providing hedging on currencies and maturities not provided by banks; market deepening, by providing support to bond issuances in local currency by some of its shareholders; and knowledge sharing.

We believe TCX has been delivering on its mission successfully, which equity capital increases in 2019 from existing shareholders ($128 million, or 25% of the fund's NAV at year-end 2018), the interest of new investors recently (Swiss, Canadian and U.K. governments) and the fund's performance (in line with its mandate of 0%+ performance) tend to prove.

Funding And Liquidity

Strong funding profile due to stable equity and debt investors

TCX has a strong funding profile, in our view. 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 20 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 three largest investors (KfW, EBRD, and FMO) hold 50% of TCX's shares. Debt funding is provided mainly by Dutch, German, and U.K. governments, with maturities mainly in 2025 or 2045, predominantly in the form of convertible subordinated loans, which we view as very stable.

Strong liquidity due to a very liquid balance sheet

TCX's liquidity is strong, in our view. Our liquidity ratio (liquidity reserve/[NAV + long-term debt]) amounted to 85% at end 2019, which is very strong by our standards. According to our estimate, the fund has always maintained this ratio above 82%. Liquidity is a structural strength of the fund and we don't expect this to change. TCX's balance sheet consists essentially of highly rated securities (almost all in the 'AA' or 'AAA' categories) and cash.

Jurisdictional Risk

Our assessment of jurisdictional risk is neutral for the rating, reflecting our view about payment culture, rule of law, governance and transparency in the Netherlands.

Other Key Credit Considerations

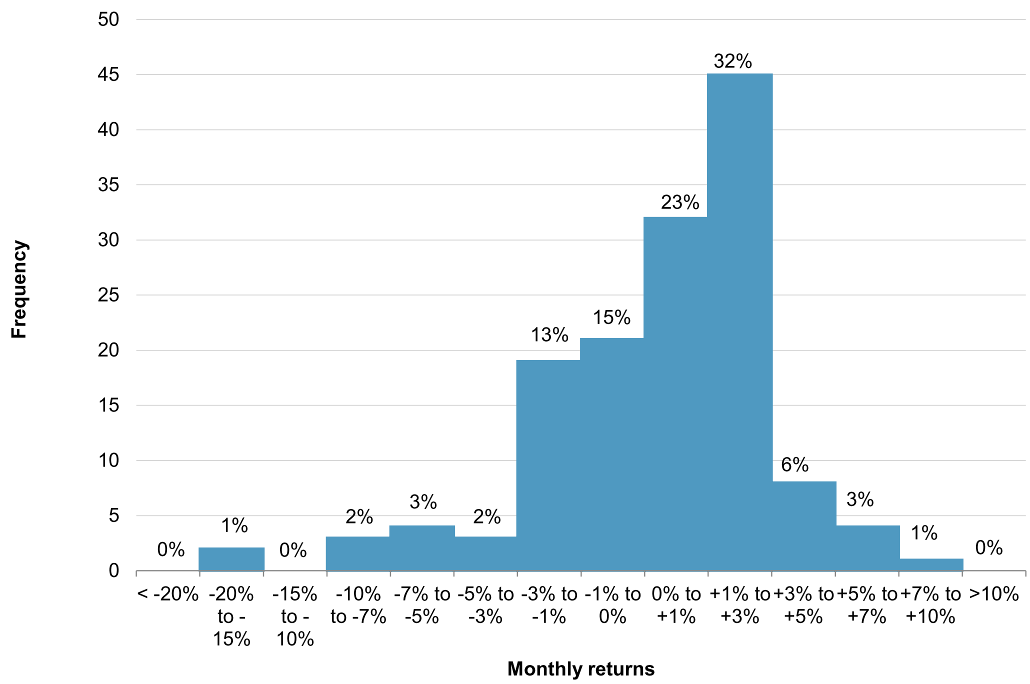
TCX's investment performance is in line with its mandate

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 frontier and emerging market currencies, as well as interest rates in these markets.

The distribution of monthly returns since inception (see chart 2) is left-skewed, which reflects TCX's ability to generate positive returns more often than not to compensate for occasional negative performance, like currently amid the COVID-19 pandemic (negative 17% return on NAV in March).

Chart 2

The Currency Exchange Fund N.V.--Good Times Prepare For Bad Times
Left-skewed distribution of monthly returns



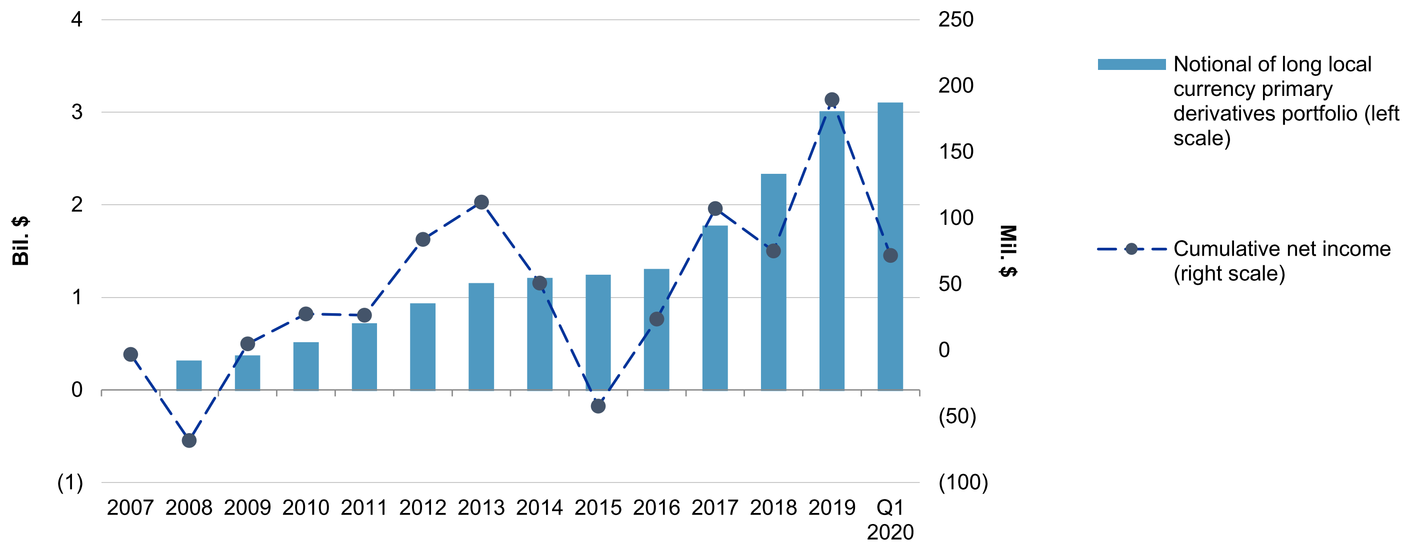
Source: S&P Global Ratings.

In fact, we do not consider negative NAV performance an issue from a credit perspective so long as the fund's business model remains sustainable, be it in terms of through-the-cycle profit and loss, risk management, and links with shareholders. Of note, we do not view the confidence of TCX's shareholders as sensitive to short-term negative performance.

The fund clearly does not cover the rate of return a private investor would require, given the volatility of its performance. This is not a credit issue, in our view, because shareholders solely expect TCX to be sustainable. We believe this is the case considering the fund's structurally positive cumulative P&L since inception (see chart 3).

Chart 3

The Currency Exchange Fund N.V. Has A Track Record Of Sustainable Growth
Growth of derivatives' notional and cumulative P&L



*As of end March 2020. Source: S&P Global Ratings, TCX.

Governance partially explains this good performance, in our view. Pricing is set independently by a pricing committee, which consists of five voting members who have expertise in derivatives pricing in emerging markets, and none of whom is employed by the fund. TCX has two representatives on this committee but with no voting rights. This governance favors the fair pricing of derivative contracts.

Table 2

The Currency Exchange Fund N.V.--Financial Statements

Mil. $

	--Year ended Dec. 31--											
Statement of financial position	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
Assets	1,319.9	988.5	909.6	861.9	803.2	765.9	781.8	756.3	711.1	670.4	565.1	451.8
Cash and cash equivalents	79.0	40.8	73.3	36.2	57.7	33.9	31.0	40.9	29.6	24.3	51.5	25.7
Securities	956.0	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	129.6	99.2	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	155.2	80.7	75.0	70.8	59.8	29.6	21.2	25.2	17.6	19.3	12.7	2.3
Liabilities	1,319.9	988.5	909.6	861.9	803.2	765.9	781.8	756.3	711.1	670.4	565.1	451.8
Cash collateral received	25.0	18.2	18.5	20.0	21.5	5.4	7.7	6.5	0.0	2.9	7.5	0.0
Swap portfolio	250.2	209.5	102.2	145.8	202.7	123.8	47.8	37.7	48.7	27.6	16.8	68.8
Other liabilities	13.0	7.8	11.2	7.2	12.3	10.0	9.4	9.9	8.9	4.4	3.5	1.2
Capital	1,031.6	753.0	777.7	688.8	566.6	626.8	717.0	702.4	653.5	635.6	537.3	381.8

Table 2

The Currency Exchange Fund N.V.--Financial Statements (cont.)												
Redeemable capital	751.3	508.6	558.4	496.3	385.1	478.0	568.2	553.6	524.7	506.8	426.2	345.6
Subordinated convertible debt	257.7	216.6	188.3	161.5	161.5	128.8	128.8	128.8	128.8	128.8	111.1	36.2
First loss loan	10.9	10.9	10.9	10.9								
Subordinated loan	11.7	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	**2019***	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
Investment result	133.9	(14.0)	91.4	79.9	(75.9)	(43.6)	38.4	67.4	11.2	33.1	82.6	(55.3)
Other result	(7.7)	(7.2)	1.8	(5.0)	(6.9)	(6.9)	0.5	0.6	(3.3)	(2.6)	(1.1)	(2.5)
Operational expenses	(11.9)	(10.9)	(9.5)	(9.2)	(10.2)	(10.7)	(10.6)	(10.7)	(9.0)	(7.7)	(8.4)	(7.2)
Net operating income	114.3	(32.0)	83.7	65.7	(92.9)	(61.2)	28.3	57.3	(1.1)	22.8	73.0	(65.0)

*Exchange-rate translation results subject to final allocation. Source: S&P Global Ratings, TCX.

TCX uses a Basel-inspired capital framework

The fund has defined, under its own statutes, a Basel-inspired capital framework. 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.

The fund defines its capital requirement as the sum of the capital required to cover the liquidation trigger event (14% capital ratio) and a Pillar II requirement. Following amendments in 2019, the Pillar II requirement is determined such that the total capital ratio covers both a "two times Lehman" scenario and a "99.9% market stress scenario", floored at 18%, which is currently the binding constraint. The fund's capital ratio amounted to 24% as of March 2020, which provides a $229 million buffer against the 18% threshold.

Should total capital fall below the own minimum capital requirement (18%), TCX would be required to take action to reduce the chances of sliding toward the 14% liquidation trigger event. This trigger provides some protection against the fund reaching the liquidation trigger event, although it might not cushion against the effect of abrupt and lasting market movements.

Shareholders have also agreed to additional restrictions to redemption, including a clause preventing capital redemption if it would lead to the total capital ratio dropping to less than 18%. This provides an additional protection against reaching the liquidation trigger event.

Should the capital ratio fall below the liquidation trigger event, we understand that, as per the fund's statutes, all shareholders would have to discuss at short notice a resolution, agree to provide additional capital, wait for a recovery, or liquidate the fund within 18 months 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.

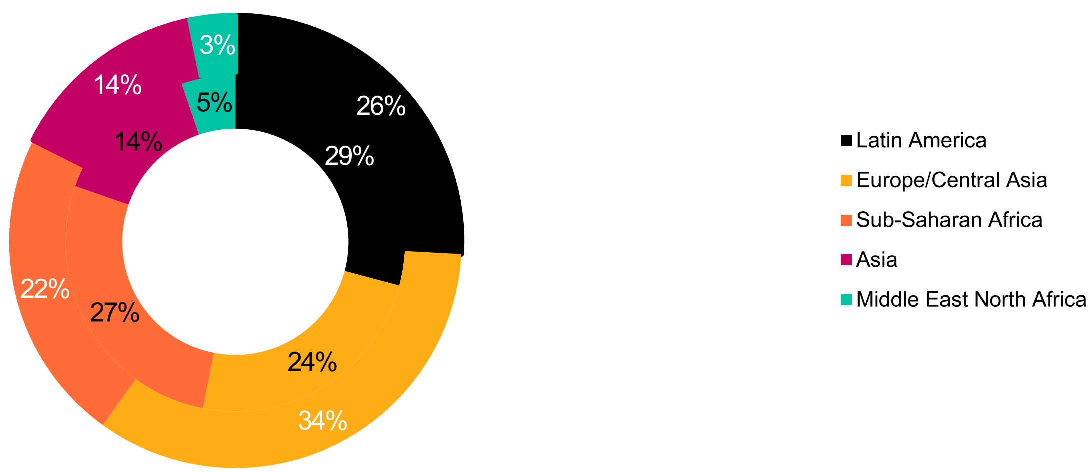
TCX manages market risk via concentration limits (by currency and regions) and the use of offsetting hedges to remain within those limits.

Concentration limits are by currency (the net notional exposure cannot exceed 25% of total capital or 10% of the maximum potential net portfolio, assuming a constant mix and a capital ratio of 18%) and region (limit of 30%-50% of the maximum potential net portfolio). TCX's growth over the past three years was driven by currencies in

Europe/Central Asia (see chart 4), particularly Ukraine and Georgia.

Chart 4

Growth In Recent Years Was Driven By Currencies In Europe And Central Asia
Evolution of the geographical breakdown of TCX's net currency exposures from 2016 (inner circle) to 2020* (outer circle)



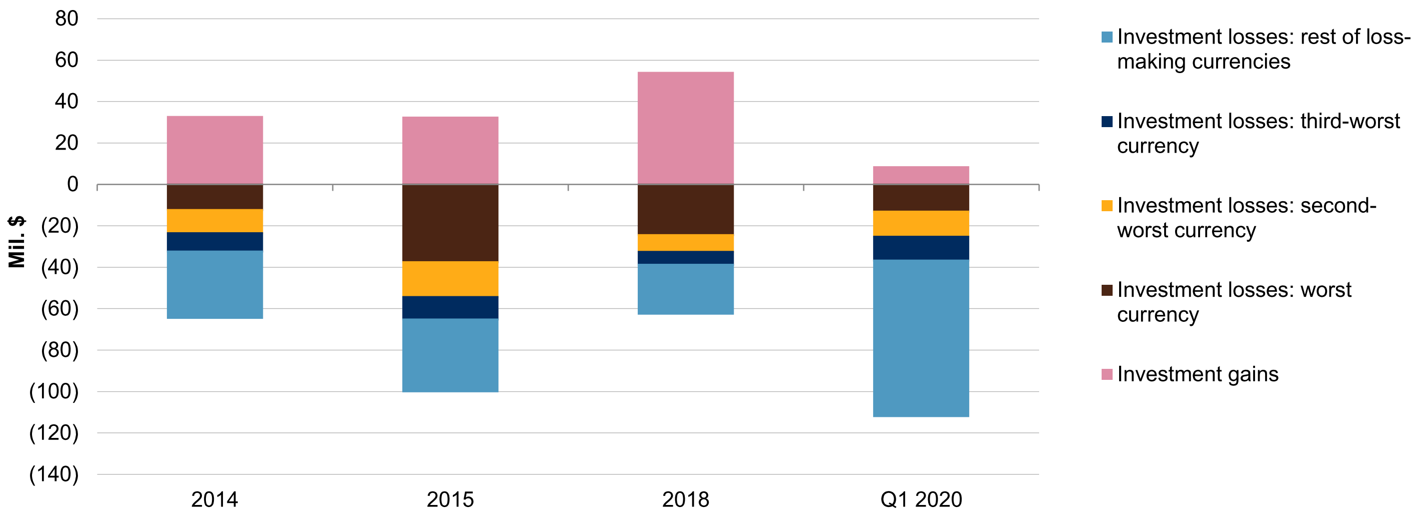
*As of March 31. Source: S&P Global Ratings.

Despite these limits and the fund's relative granularity, with more than 50 currencies covered, negative performance can be largely spurred by just a few currencies. For instance, in the past three loss-making years (2014, 2015, and 2018), three currencies accounted for more than half of TCX's investment losses (see chart 5). Positively, in these same three years, as well as in first-quarter 2020, the fund's negative performance was partially mitigated by gains on certain currencies, highlighting the diversification benefit even in times of stress.

Chart 5

Diversification Usually Mitigates Total Losses When Emerging Markets Are Under Stress

Breakdown of investment performance during loss-making years

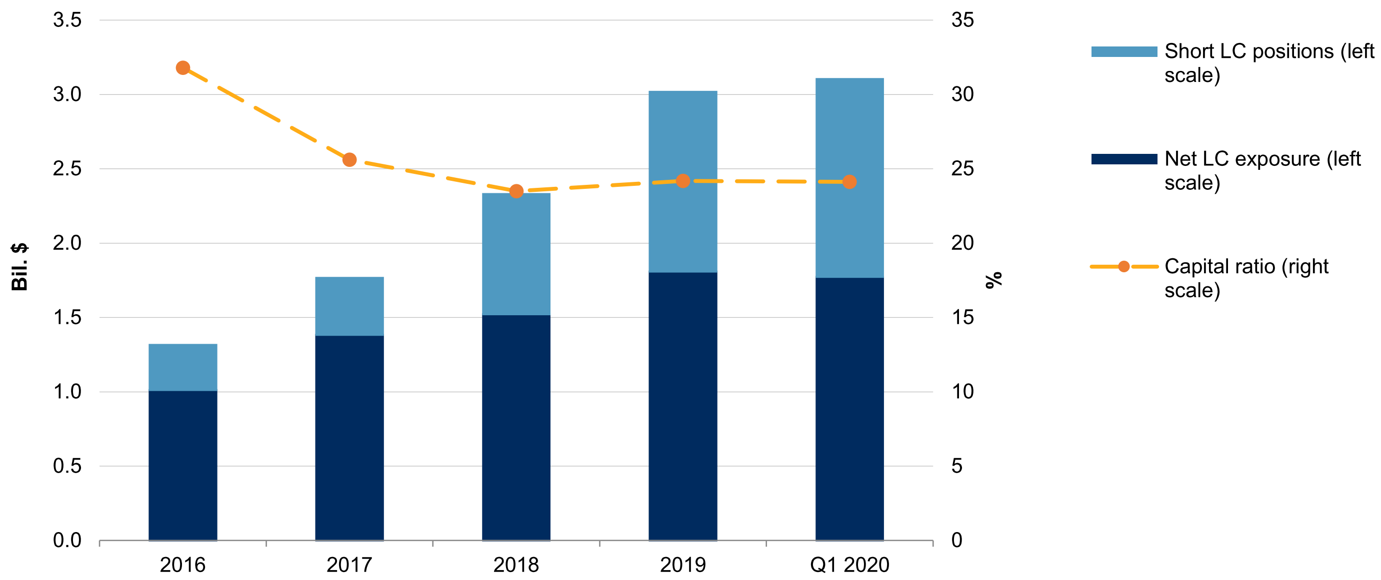


Source: S&P Global Ratings, TCX.

Offsetting hedges play an important role to maintain the portfolio composition within limits by currency and by region. TCX supports the issuance of local currency linked bonds and notes by some of its shareholders which the funds then swaps to U.S. dollars. This provides it with short positions on some of the local currencies on which it has a long position via its primary derivatives portfolio, reducing its net exposure to some of the local currencies and regions, while contributing to the development of local currency bond markets. This risk management technique has gained in importance over the past few years in a context of strong growth and related pressure to optimize capital usage (see chart 6). Short positions on frontier currencies account now for more than 40% of TCX's long positions.

Chart 6

In A Context Of Strong Growth, TCX Is Turning To Capital Optimization Via Short LC Positions
Capital ratio and notional of derivatives



Source: S&P Global Ratings. LC--Local currency.

Level 3 assets expose TCX to model risk

The derivatives the fund provides qualify as level 3 assets whose valuation technique uses inputs not observable in the market. This exposes TCX to model risk.

We note the fund's very good transparency, with frequent (monthly) and comprehensive reporting.

The nonprofit maximization profile weighs on the rating

TCX's reward-to-risk profile is lower than for a typical fund. This is not surprising because profit maximization is not in the fund's mandate, and its owners are typically not for profit entities focused on maximizing their development impact. That said, it implies that TCX relies ultimately on shareholders and debt investors to fund its development.

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. Recent equity capital increases from existing shareholders and investments by the German government (December 2018) in the form of additional subordinated convertible debt ($23 million) and maturity extension (to 2045 from 2025 on $90 million of existing debt) have further supported our assessment. Also, we continue to view the political context for the development of TCX's activities as favorable, on the back of important needs in foreign investments in emerging economies identified by the United Nations to reach the Sustainable Development Goals, and the G20 and the European Commission's support or commitment to increase local currency financing.

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 cooperation and other policies to contribute to sustainable development in developing countries.

Our assessment of TCX's important role for its dominant owners reflects that the focus of the fund's activities is not on the owners' domestic markets, and that these activities do not have systemic relevance. TCX's role for its owners could decrease if governments adopted a less supportive stance toward ODA. In such a scenario, we expect that owners would have the fund run down its operations in an orderly manner and provide support, if necessary, until it finishes its operations.

We assess TCX's link to its dominant owners as very strong, because they created the fund, provided it with capital as an independent entity, and maintain a strong influence on its strategic and business plans.

Although TCX's shareholders are entitled to start claiming capital redemptions gradually, we expect no major claims for capital redemptions that would threaten the fund's financial strength. Furthermore, if shareholders wish to exercise this option, withdrawal rights are capped to 20% of total capital per year.

Ratings Score Snapshot

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

Stand-alone credit profile: bbb

- 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

Related Research

- Credit Conditions Emerging Markets: Longer Lockdowns, Heightened Risks, April 23, 2020
- The Currency Exchange Fund N.V. Affirmed At 'A/A-1' On Criteria Change; Outlook Stable; Off UCO, April 1, 2020
- Emerging Markets: Empty Streets And Rising Risks, March 30, 2020

Ratings Detail (As Of May 27, 2020)*	
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.