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Research Update:

The Currency Exchange Fund Affirmed At 'A/A-1' On Unfunded CSL From The European Commission; Outlook Stable

November 13, 2020

Overview

- On Nov. 12, 2020, The Currency Exchange Fund N.V. (TCX) was granted a new unfunded convertible subordinated loan (CSL) from the European Commission for a maximum nominal amount of €130 million, to be activated in tranches.
- Although we consequently expect the volatility of TCX's performance will increase moderately over time, we believe the fund's stressed leverage will remain at an adequate level, meaning our value at risk (VaR) to net asset value (NAV) is below 55%.
- Furthermore, following a review, we consider that the funded CSL maturing in 2045 has intermediate equity content, and thus partly add it to the NAV.
- We are affirming our 'A/A-1' ratings on TCX.
- The stable outlook reflects our expectation that TCX will maintain adequate leverage over the next two years, despite increased recourse to hybrid financing, and continue to attract support for its development from its main shareholders and government investors.

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Rating Action

On Nov. 13, 2020, S&P Global Ratings affirmed its 'A/A-1' long- and short-term issuer credit ratings on The Currency Exchange Fund N.V. (TCX). The outlook on the long-term rating is stable.

Rationale

The affirmation follows a review, prompted by the announcement on Nov. 12, 2020, that TCX was granted an unfunded CSL from the European Commission (EC), via the European Fund for Sustainable Development (EFSD). The unfunded loan, which would convert into equity upon TCX's liquidation, will be activated in tranches up to a maximum of €130 million. Only €30 million will be activated on day one; activation of the remainder will be subject to TCX achieving production volumes of up to €325 million in target countries in Eastern Europe and Africa. This instrument will be part of TCX's Tier 1 capital and should support business growth with the addition of about $400 million in derivatives notional. This compares with a primary derivatives portfolio of $3.3 billion at Sept. 30, 2020. The unfunded CSL is provided as part of the EC's External Investment Plan, which aims at supporting investment in EU neighboring countries and Africa. We believe it aligns well with TCX's mandate and confirms its relevance for its public sector banks and government owners. Top-up investments in A-shares recently by Proparco and the International Finance Corporation for an aggregate amount of $19 million further support our view.

Our quantitative measure of stressed leverage (VaR/NAV; 41% at Sept. 30, 2020) indicates adequate capitalization at TCX given its risk profile. Our estimated one-year VaR (at the 99.7% confidence level) is based on the volatility of the fund's historical performance, assuming fatter tails than a normal distribution. In addition, following the review, we also now consider that the funded CSL maturing in 2045 ($191 million) has intermediate equity content, according to our criteria. This is because we now believe that the funded CSL would support timely payments to TCX's senior counterparties, since it would convert into equity if the fund were liquidated, which would most likely happen at a nondistressed level, i.e. while the fund would still be a going concern, albeit in orderly wind-down. We reflect this by adding to the NAV half of the CSL maturing in 2045 with the latter capped at 15% of TCX's capitalization ($1.0 billion). However, we grant no equity content to the recent unfunded CSL because of its unfunded nature.

We expect TCX's stressed leverage will increase as it activates the unfunded CSL over time and gradually expands its derivatives portfolio. That said, considering our VaR/NAV of 41% as of Sept. 30, 2020--including a fraction of the funded CSL instrument maturing in 2045 ($76 million), reflecting our view of its equity content--and the expected very moderate increase in derivatives notional (about 10%), we believe this metric will remain well below 55% in the next two years, supporting our 'bbb' stand-alone credit profile (SACP) and 'A' long-term issuer credit rating.

Today's rating action also factors in TCX's recovery after its largest loss ever in March this year ($128 million, equivalent to 14% of its reported NAV). TCX recovered 81% of this loss over April–September, demonstrating the sustainability of its financial model, which is based on its ability to generate a positive result under relatively stable market conditions. That said, we acknowledge the high uncertainty created by the COVID-19 pandemic and the vulnerability of some frontier and emerging market economies and their currencies in the current environment. We therefore remain cautious on the near-term performance outlook.

Our view of the existing high likelihood of extraordinary government support remains unchanged (see "The Currency Exchange Fund N.V.," published May 27, 2020, on RatingsDirect for more details).

Outlook

The stable outlook reflects our expectation that TCX will maintain adequate leverage over the next two years despite increased recourse to hybrid financing. The stable 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 through-the-cycle investment performance fall short of its mandate, or its leverage increase significantly, as could be evidenced by our VaR/NAV significantly and sustainably exceeding 55%. 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.

Upside scenario

We could upgrade TCX should it display resilient performance in 2020-2021 amid challenging conditions for frontier and emerging market currencies given the COVID-19 pandemic, and if its financial profile, especially leverage, is little changed.

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: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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

Related Research

- The Currency Exchange Fund N.V., May 27, 2020

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.