

Market insights: TCX's research on currency risk management in Africa

Together with Finance in Common (FiC) and Making Finance Work for Africa (MFW4A), TCX researches the state of currency risk and management thereof at African public development banks (PDBs), commercial banks and other non-bank financial institutions (hereafter referred to as FIs).

We conduct surveys and analyze the results to estimate the impact of currency risk on FIs' financial resilience, to identify barriers and ultimately find solutions to reduce currency risk borne by African financial institutions.

Preliminary results of the 2023 surveys

- More than 70% of all African FIs are exposed to currency risk (Figure 1)
- Nearly two-third of PDBs view currency risk as a significant threat and 44% of FIs have seen funding agreements been negatively affected by FX risk (Figure 2)
- There is demand for currency hedging products that is not yet being met: 50% of respondents indicate that the required tenors are not available
- This unmet demand for appropriate risk solutions, as well as operational and regulatory limitations, often limit African financial institutions' capability to effectively manage currency risk
- Efforts should focus policy advocacy and the delivery of currency risk solutions that meet the needs of the market

Open currency exposure at financial institutions in Africa

Nearly one-third of respondents indicate that more than 25% of their loan portfolio is denominated in USD and more than half of banks and other FIs have raised at least a quarter of their funding in the last year in hard currency.

75% of banks indicate to have hedged under a quarter of their current foreign currency exposure. This leaves them vulnerable to fluctuations and may impact the financial stability of the institutions, in case the local currency depreciates against the USD.

Figure 1: Are you exposed to currency risk?

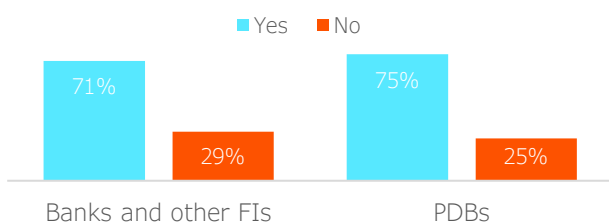
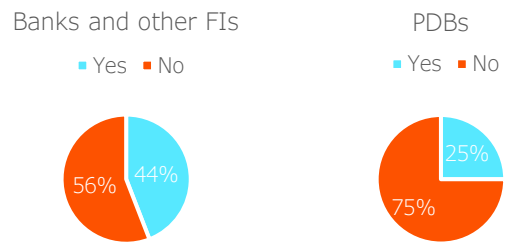


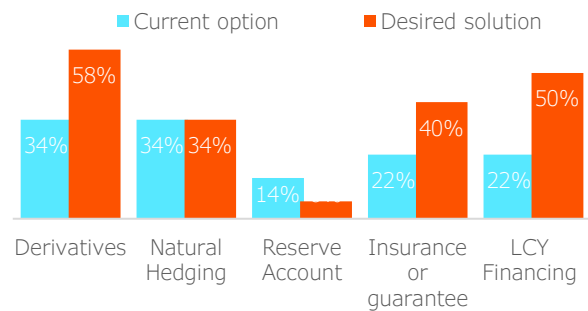
Figure 2: Have you ever had to scale back, postpone or cancel any funding agreement due to FX risk?



A limited product offer

While currency hedging solutions are – in some shape or form – present in more than half of the surveyed institutions' markets, more than 80% indicate that the product offering is too limited: only 12% of respondents indicate that the range hedging products available in their local financial market is sufficient to meet their hedging needs.

Figure 3: What are your current hedging options, versus what you would like to have access to?



The enforceability of ISDA

A necessary step towards serving the demand for LCY financing and derivatives as a hedging solution is ensuring the enforceability of the International Swaps and Derivatives Association (ISDA) agreement. The ISDA covers legal and credit protection for parties who enter into a derivative transaction, a critical form of risk mitigation. Our findings indicate that the ISDA seems not enforceable in more than 40% of the respondents' jurisdictions.

Figure 4: Is the ISDA enforceable in your local market?



A rationale for continued action

While only covering a part of the story, these findings emphasize the need to provide practical solutions to assist African financial institutions with effectively managing their currency risk. TCX commits to working together with stakeholders to:

- Continue its policy advocacy to promote LCY financing and FX risk management.
- Actively fill the gap between FX hedging supply and demand, to ensure a proper product-market fit and a resilient financial ecosystem.

Managing currency risks with TCX

The Currency Exchange Fund N.V. (“TCX”) is a development finance initiative that offers currency and interest rate derivatives in financial markets where such products are not provided by commercial banks or are hard to access for the parties who need them.

The principal objective of the fund is to eliminate currency risk. TCX products have no tenor limits, allowing TCX to support cross-border local currency financing of any required tenor.

Since starting operations in 2008, TCX has hedged over USD 14 billion of local currency loans, of which nearly USD 3 billion in Africa.

TCX covers around 100 currencies worldwide and is rated single A by S&P and A1 by Moody’s.

TCX investors

TCX’s investor and primary client base consists of a number of governments and a wide range of development finance institutions and other impact investors active in emerging and frontier markets.



How to work with TCX

TCX hedges currency risk for lenders and borrowers using two products: cross-currency swaps and FX forwards¹. These instruments can be used in a variety of different contexts, three use cases:

➤ Use case 1: Attracting long-term funding from int’l investors

Situation: a bank attracts debt from international lenders – such as one the shareholders of TCX – which it wishes to use to fund LCY assets. If the debt is in foreign currency, this will lead to a currency mismatch.

TCX’s solution: option A, the int’l lender can source a cross-currency hedge from TCX and offer LCY to the bank (natural hedge); or option B, the bank can source the hedge from TCX, which allows for flexibility related to the hedged amount, the profile, and the timing of the hedge.

Benefits: Borrowing in synthetic LCY or in FCY and hedging with TCX could enable the bank to obtain funding from international sources while being protected against FX rate variation. This can facilitate the growth of long-term LCY assets matched by stable and long-term liabilities which are non-existent or poorly accessible on the domestic market.

➤ Use case 2: develop a local FX forward and/or swap market

Situation: a bank recognizes the need for a (more active) local forward/swap market and it wishes to build this.

TCX’s solution: the bank can source hedging products from TCX and provide these to their local clients.

Benefits: All of the banks’ institutional clients who are exposed to exchange rate volatility in the ordinary course of their business can hedge their risk. Exporters willing to earn a premium to lock in the future FX rate of local currency on the foreign currency they earn through their activities.

➤ Use case 3: Hedging the USD deposit base

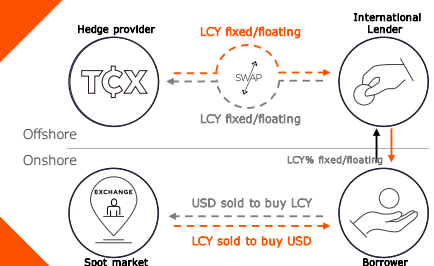
Situation: a bank has ample USD deposits which it wishes to use to finance LCY assets.

TCX’s solution: the bank buys LCY in the spot market and, to avoid a mismatch, sells a corresponding portion of its USD deposits through a TCX swap. TCX then “pays” the bank the USD deposit rate and the bank “pays” to TCX the corresponding LCY interest rate over the agreed tenor.

Benefits: this can be of interest in situations where LCY liquidity is scarce and USD liquidity is sufficient. The swap allows the bank to better match its deposit base with its asset creation.

Product example (cross-currency swap)¹

- The diagram on the right shows how a swap is used to hedge an indexed local-currency loan. Because this is a “non-deliverable” swap (NDS), all the disbursements and settlements are in USD.
- A major advantage of the NDS as an instrument to hedge loan exposures, is its precision.
- The swap can be designed to precisely match every interest and principal repayment in any kind of amortization schedule, allowing always for a “perfect hedge”. This makes it the ideal product for any financial institution that wishes to fully hedge its LCY exposure.



¹ Visit www.tcxfund.com or reach out to communications@tcxfund.com for more information