Market insights: obstacles to 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 stability, 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 – also when hedging is possible – available tenors do not match their hedging needs
- This unmet demand appropriate risk solutions limits African financial institutions' capability to effectively manage currency risk
- The dynamics underlying these findings are complex, but tangible solutions exist to improve currency risk management at African financial institutions

Figure 1: Are you exposed to currency risk?

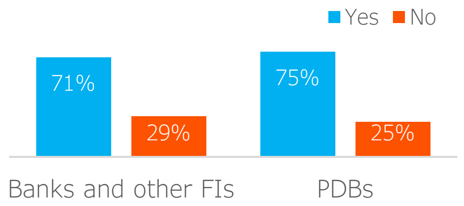
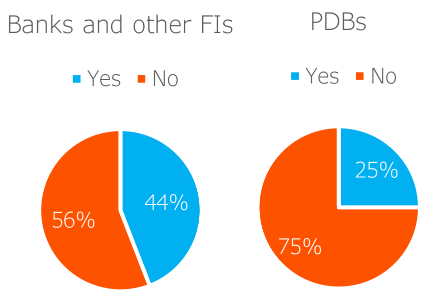


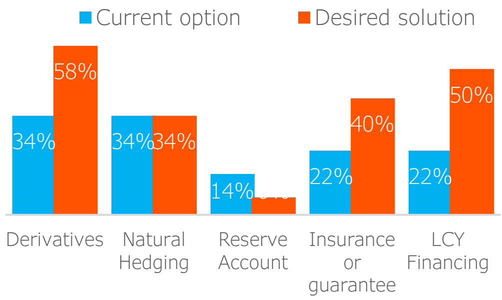
Figure 2: Have you ever had to scale back, postpone or cancel any funding agreement due to FX risk?



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 currency exposure, leaving them vulnerable to fluctuations.

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



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: 12% of indicate the range hedging products available in their local financial market are sufficient for them to meet their hedging needs.

A necessary step towards serving the demand for LCY financing and derivatives as a hedging solution is the enforceability of the International Swaps and Derivatives Agreement (ISDA), that ensures certain legal and credit protection for parties who enter into a derivative transaction. Our findings indicate that the ISDA is not enforceable in nearly half of the respondents' markets.

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

While preliminary, these findings emphasize the need to provide practical solutions to assist African financial institutions in effectively managing their currency risk.

TCX commits to working together with stakeholders to:

- Continue to foster efforts to promote LCY financing
- Actively fill the gap between FX hedging supply and demand, and to ensure a proper product-market fit
- Provide technical assistance and training to reinforce internal capabilities at financial institutions

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 associated with loans from international lenders to borrowers based in emerging and frontier markets. TCX products have no tenor limits, allowing TCX to support cross-border local currency financing of any required tenor.

TCX covers around 100 currencies worldwide. Since starting operations in 2008, it has hedged over USD 14 billion of local currency loans, of which nearly USD 3 billion in Africa. TCX is rated single A by S&P and A1 by Moody's.

How to work with TCX

TCX hedges currency risk for lenders and borrowers using two products: cross-currency swaps and FX forwards[1].

These instruments can be used in a variety of different contexts, two examples:

Example 1: LCY/LCY interest rate swap

Situation: a bank has floating interest rate LCY liabilities (deposits or other funding sources). It wishes to provide credit to its customers at fixed interest rates.

TCX's solution: TCX provides a fixed-for-floating interest rate swap.

Benefits: the bank reduces its exposure to interest rate volatility and creates more flexibility in its product offering.

Example 2:Hedging hard currency liabilities

Situation: a bank attracts debt from offshore sources which it wishes to use to fund LCY assets. If the debt is in USD, this will lead to a currency mismatch.

TCX's solution: the bank can source a cross-currency hedge from TCX.

Benefits: the direct hedging route, i.e. borrowing in USD from offshore lenders and hedging with TCX, gives the bank great flexibility in relation to the hedged amount and the timing of the hedge: the bank can freely determine whether it wishes to hedge the full loan or only a portion and whether to hedge at disbursement or at a later stage

TCX investors

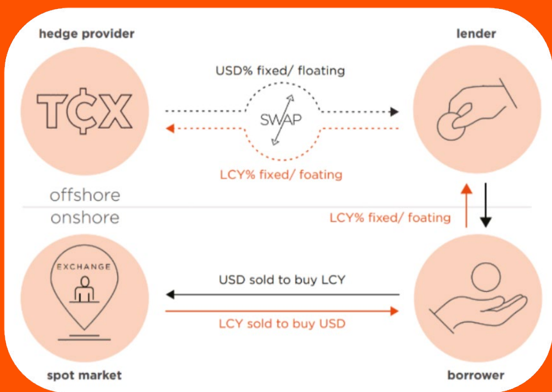
TCX's investor and primary client base consists of a number of governments and a wide range of development finance institutions and other impact investors active in emerging and frontier markets.

The 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 loan exposure.



[1] Visit www.tcxfund.com or reach out to t.oostheim@tcxfund.com for more information

Scan the QR code to learn more about the non-deliverable swap and forward