Creating Risk Markets for EMDE Currencies – Towards a Systemic Solution to Reduce Currency Risk Vulnerabilities

Inputs for the Roadmap to Belem

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Currency risk is a silent surcharge embedded in almost every climate finance transaction in emerging and developing economies (EMDEs). Moreover, especially in small low income countries, aggregate currency risk exposure amplifies sovereign debt fragilities and macro-risks, thereby inflating the cost of capital and deterring private investment. This slows low carbon transition and makes climate investment prohibitively expensive.

COP-30 must reduce this surcharge by offering scalable solutions towards improving how currency risk is managed in EMDEs. Building on the TCX Proposal for Mitigating FX Risk (2023), this note outlines actionable and mutually re-enforcing policy measures to expand the accessibility and coverage of currency hedging markets. Especially against the background of shrinking donor resources, the expansion of market-based risk-sharing solutions and of risk-resilient lending instruments, especially indexed local currency loans, represents the best chance to crowd in private capital to achieve development objectives.

The necessary financial instruments are ready to be deployed, their effectiveness has been proven and scaling up efforts have already started. For example, the EU-supported Market Creation Facility will deliver up to USD 2 billion of affordable indexed local currency financing.

COP-30 should scale up currency risk markets and risk management opportunities by:

1. ***Mobilizing up to USD 40 billion of local currency hedging by 2030 with governments pledging USD 5 billion to scale the TCX Market Creation Program.***

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2. ***Strengthening the Local Currency Mandate of Public Development Banks and introducing a standardized local currency conversion clause in all loan contracts for borrowers to choose from.***

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3. ***Calling on the IMF and the World Bank to use the ongoing Low Income Countries-Debt Sustainability Framework (LIC-DSF) Review to strengthen incentives to invest in financial resilience.***

The adoption of these measures would lead to measurable actions starting end 2025 and contribute to both climate impact and reduce macro-vulnerabilities at the same time.

1. Call on donors to facilitate USD 40 billion of affordable currency risk hedges by pledging USD 5 billion to scale up the TCX Market Creation Program

TCX has, backed by a triple-A European Union guarantee[1], successfully launched the EU Market Creation Facility (EUMCF). This innovative blending structure promote the growth of currency risk markets in EMDEs. Its deployment during 2024 and 2025 confirmed a significant demand for affordable currency hedging solutions while at the same time catalyzing opportunities to crowd in private risk capital. The EUMCF consists of two synergetic components: A **Capacity Component** provides equity-like capital to allow TCX to expand its balance sheet and take full advantage of its various economies of scale from diversification, operations and networks. A **Pricing Component** is a contingent support facility to lower the costs of currency risk protection for selected projects or sectors consistent with OECD Blending Principles. The former amounts to about EUR 400m and the latter to EUR 170m. With current resources, the Pricing Component will facilitate an affordable hedging volume of about USD 2 billion in the coming 3 years, with the Capital Component expected to remain fully preserved for use in the years beyond.

COP-30 is an opportunity to scale up this currency risk market creation effort and strengthen resilience of EMDE borrowers. To mobilize up to USD 40 billion[2] of currency risk hedging by 2030, about USD 5 billion would be required: USD 3 billion should be fresh equity capital for TCX to increase its risk carrying capacity and USD 2 billion should be dedicated to expand the existing Pricing Component to make hedging for climate finance more affordable. TCX expects to be able to pass on about 75% of the currency risk it onboards to the private sector and the additional blending resources will contribute to cut the average cost of capital of priority climate projects by up to 200 bps.

TCX will continue to innovate to better address the currency risk management requirements of investors and borrowers. Table 1 lists ongoing product innovation efforts.

Table 1. Product Innovation at TCX

Instrument	Function	COP-30 Relevance	Status
Affordable Long-Tenor Cross-Currency Swaps (CCS)	Lock FX rate for 15-20 yrs at below market rates in early period	To facilitate power purchase agreements and other long-term infrastructure agreements denominated in local currencies	Available already with new features in development
Cooperation with Counterparty Risk Guarantee Providers	Reduces cash collateral requirements and allows TCX and other hedge providers to work directly with LIC counterparts	To improve access to hedging instruments for bond issuers and infrastructure projects	Available, but needs to be commercialized
Deliverable and synthetic deliverable CCS	Reduces convertibility risk	To crowd in investors who do not want to take convertibility risk	Pilot transactions in 2025

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[1] The guarantee is provided by the European Fund for Sustainable Development (EFSD).

[2] To put this number in context, the International Energy Agency estimates in its 2024 Report for the Brazilian G20 Presidency "Roadmap to Increase investment in Clean Energy in Developing Countries" (p46) that the poorest countries will require about USD 20 billion per year in concessional finance to achieve universal electricity access.

Price freezing	TCX freezes its swap pricing for a longer period of time and under specific contractually agreed conditions.	To provide pricing stability during negotiations of complicated infrastructure deals benefit from hedge price stability.	Available for selected countries

2. Strengthen the Local Currency Mandate of Public Development Banks

COP 30 should call on public development banks to protect borrowers by lending increasingly in the currency in which they earn their income. Especially MDBs and their highly concessional lending arms are called upon to **"ACT":**

- **A**lert borrowers about the impacts of currency risk,
- help them **C**ompare the costs of hedged versus unhedged financing, and
- offer borrowers a choice to **T**ransact in (indexed) local currency or foreign currency loans.

Borrowers should always have a choice between borrowing in hard currencies or opting for a currency conversion clause which indexes the debt service to the local exchange rate and shifts the currency risk to the lender. Indexed local currency loans have the advantage that the debt service burden is automatically reduced in case of an exchange rate shock. The most practical way to give borrowers a choice and improved ability to manage currency risk would be to introduce in all loan contracts a standard optional currency conversion clause. By informing borrowers of the price for this additional currency risk protection, lenders create risk transparency and improve the risk awareness of borrowers. Moreover, borrowers are given better control over their risk level by having a choice if they opt in or opt out of the clause.

Lenders and their staff will need to make extra efforts to explain the local currency conversion clause and its benefits. To this end, internal trainings should be strengthened, specialized teams formed and appropriate performance incentives introduced.

Finance in Common and TCX launched a program to strengthen the currency risk management capacities at Public Development Banks and reduce their borrowers' and their own currency risk exposure by up to USD 500m. It consists of workshops to strengthen currency risk awareness and explain the currency conversion clause and access to TCX's blending resources for certain project categories. The resources for this effort are provided by the EU Fund for Sustainable Development (EFSD) and its Market Creation Program. This program is scalable. Once additional resources are mobilized as proposed above, this cooperative effort can be expanded with a special focus on climate mitigation and adaptation investments.

3. Use the LIC-DSF Review to strengthen currency risk awareness and remove disincentives to invest in resilience.

The IMF and the World Bank should use the ongoing LIC-DSF review to incentivize the use of risk-resilient lending products and clauses, especially indexed local currency loans and bonds.

A Fourth Category of Public and Publicly Guaranteed (PPG) debt instruments should be added into the LIC DSF to account for external-held local-currency (indexed) debt. The LIC-DSF currently recognizes only three types of PPG debt: (1) external-held foreign-currency- denominated, (2) domestic-held foreign-currency-denominated, and (3) domestic-held local-currency-denominated. This fourth type of debt – foreign-held local-currency (indexed) debt brings together two desirable properties: (i) no currency risk for the sovereign debtor (because debt is local currency-denominated) and (ii) access to external sources of finance (which are often larger and less expensive than domestic ones). Such external debt instruments are disbursed in foreign currencies, the debt service obligations (interest and amortizations) are fixed in local currency terms, and the effective payment is effectuated in foreign currencies. How much foreign currency flows out of the country is contingent on the exchange rate: the amount is larger (smaller) when the currency appreciates (depreciates).

The LIC DSF should mandate additional (shock) scenarios to explore more financing and risk management strategies. LIC-DSF currently has a single (baseline) financing strategy that combines the types of PPG debt mentioned above. It envisages annual gross borrowings for 20 years for each category together with assumptions about their financing terms (interest rates, maturities, grace period, etc.). It would be advisable to add two additional scenarios in which the user can formulate alternative financing strategies with the combination of the four types of PPG debt different from the baseline case. One scenario could envisage full financing from domestic sources in local currency.[3] A second new scenario could envisage a financing strategy that includes debt instruments with built-in currency risk hedging features, such as indexed local currency loans. Compared with the baseline case, both new alternative scenarios are likely to exhibit higher cost of borrowing reflecting additional insurance costs. But once an exchange-rate shock is introduced and a 'loss' is quantified using an indicator sensitive to exchange-rate fluctuations (e.g., the additional local-currency value of debt stock and debt service flows created by the currency depreciation through valuation effects), the advantages of the built-in currency-risk hedging features can be properly appreciated.

We welcome questions and feedback. Please contact Harald Hirschhofer (h.hirschhofer@tcxfund.com).

[3] This alternative financing scenario will highlight trade-offs between (i) no currency risk for the sovereign debtor (because debt is local currency denominated); (ii) no access to external sources of finance (which are often larger, cheaper than domestic ones) and no access to FX resources that are necessary for Balance of Payment (BOP) financing-related reasons; and (iii) extensive efforts that would be necessary to develop domestic government debt markets and adequate domestic savings volumes to avoid crowding out private sector credit.