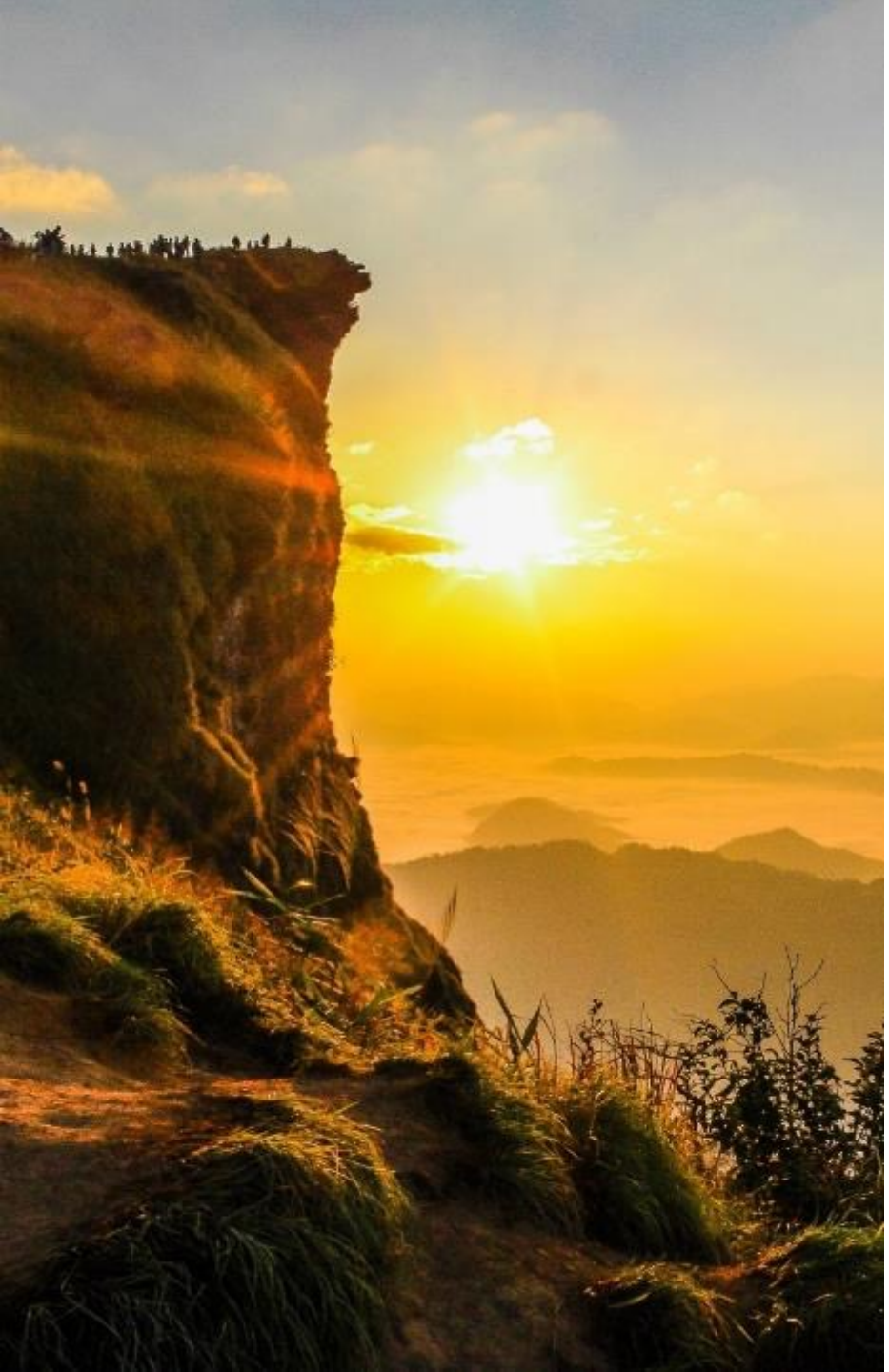

CLIMATE POLICY INITIATIVE

# Managing Currency Risk to Catalyze Climate Finance

Zeïneb Ben Yahmed

# Currency Risk in Climate Finance

## Background information

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# There are several types of currency risks with different effects

| | |
|---|---|
| Fluctuation / Market Risk | • Local currency depreciates against a hard currency in which loans or investments are denominated. |
| Convertibility Risk | • Inability to convert a local currency into a foreign currency due to domestic restrictions. |
| Transfer Risk | • Inability to transfer already converted fund out of a country. |
| Liquidity Risk | • Not enough of a currency available to settle transactions smoothly |

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# A variety of factors, both real and perceived, influence all types of currency risk.

## UNDERLYING DOMESTIC FACTORS

### Political instability

Political unrest, corruption, and political changes impact foreign investment and trade.

### Macroeconomic instability

Conditions like high inflation, budget deficits, and public debt deter investment.

### Underdeveloped local capital market

Limited liquidity and financial instruments increase currency risks.

## EXTERNAL ECONOMIC CONDITIONS

### Dependence on commodity exports

Vulnerability to global price volatility and trade shocks.

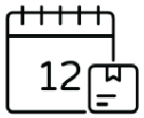
### Reliance on remittances

Exposure to foreign economic downturns and Dutch Disease.

### Dependence on foreign currency

Decreased central bank control and more vulnerable to external financial shocks.

## PERCEPTION-BASED DRIVERS




### Historical precedents

Past crises lead to investor wariness and currency pressures.

### Information asymmetry

Misperceptions reduce capital inflows and investment.

### Herding behaviors

Collective actions cause rapid currency fluctuations.

# Currency Risk in Climate Finance

## Why do we need foreign currency to finance climate transition in EMDEs?

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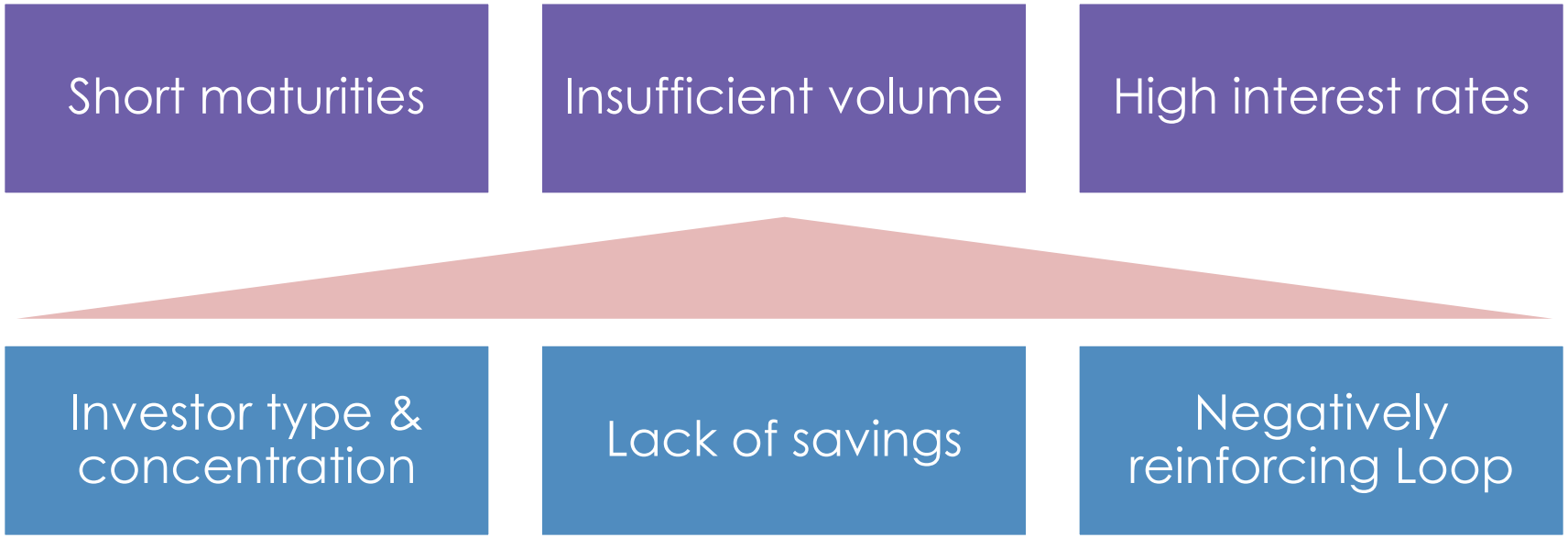
# EMDEs Domestic Financial Markets Are Insufficient (1)

- EMDEs need **$2.4 trillion** annually by 2030 to meet climate goals
- However, EMDEs suffer from significant **domestic capital constraints**:




Even under optimal conditions with strengthened markets and institutions, EMDEs could meet only **50% of their climate finance needs by 2030**

# International Climate Finance Is Necessary

## International Public Finance

- Global ODA to EMDEs: $200 bn annually
- 80% of MDB and DFIs lending is in hard currency

## International Private Finance

- $15 bn per year, far below the  $1.1 tn needed by 2030
- Almost exclusively in hard currency

Given EMDEs' **$2.4 tn need**:

- **In the short-term** inter private finance is critical for achieving climate goals
- **In the longer term**, domestic financial markets should expand to enable more domestically financed projects.

# Currency Risk in Climate Finance

## Why is it problematic to rely on hard currency to finance climate projects?

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# Hard currency financing increases risk for climate projects

## Mismatch between revenues and investment:

- Unlike oil and gas exports, climate projects in EMDEs **generate revenues in local currency**. Yet they often require foreign investment in USD or EUR.
- **Local currency depreciation** makes servicing debts in hard currency costly and threaten project viability.

## Long-term financing:

- Renewable energy assets like solar panels and wind turbines typically **last 25-30 years.**
- Matching financing terms to these long-life spans exposes projects to currency risk for extended period, **making hedging more difficult and costly.**

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# Currency Risk Affects Stakeholders in Different Ways

## Borrowers

### Local Private Sector

- Pay high hedging costs (ie. through local currency borrowing costs)
- Pay higher debt service
- Face project viability risks

### Sovereign

- Use larger shares of fiscal resources for debt services
- Diverts resources from climate change efforts

## Lenders

### Foreign Investors

- Face credit risk when borrowers default due to local currency devaluations.
- Demand higher returns to offset risks
- Shift of funds to lower-risk geographies

### Local Financial Institutions

- Face credits risks when borrowers face FX risks.
- To support balance of payments, neglect climate projects that generate local currency

# ADDRESSING CURRENCY RISK

What are the STANDARD ways to mitigate currency risk? What are the associated challenges?

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# Standard Commercial Currency Hedging Tools

The 4 most common tools for hedging currency risk include **forwards**, **futures**, **options** and **swaps**.

**However**, these tools have drawbacks:

| | |
|---|---|
| ***Perceived*** high cost | • Local borrowers perceive these options as costly because they offset the lower interest rates offered on foreign currency loans |
| Availability Issues | • They are not always available, especially for longer-term financing needs |

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# Standard Currency Hedging Instruments for MDBs and DFIs

MDBs use **back-to-back funding** to provide local currency lending, matching the currency, amount, and tenor of the funds they borrow with what they lend.

**However**, these tools also have drawbacks:

| | |
|---|---|
| Long-term Constraints | • Long-term hedging options are limited or too costly, impacting interest rates and borrower affordability |
| Operational Complexity | • The complex nature of back-to-back funding can complicate to close loans. |

# ADDRESSING CURRENCY RISK

## What are better, innovative tools for managing currency risk?

# TCX: donor-funded guarantee facility

**How does it work?**

- Uses donor capital to buy down cost of hedges
- Targets climate projects in emitting EMDEs

**Strengths**

- Well-established pricing & financing mechanisms
- Can scale rapidly

**Challenges**

- Relies on ongoing donor funding
- Primarily offshore operations

# Eco Invest Brasil

**How does it work?**

- Focus on projects with ability to increase revenues with inflation
- Short-term hedges with local institutions, backstopped by IDB credit line

**Strengths**

- Efficient use of MDB balance sheets to provide liquidity
- Potentially financially sustainable

**Challenges**

- Possibly limited applicability across countries and project types
- Untested financial model

# Onshore DFI hedging platform (Delta)

**How does it work?**

- Borrow local currency short-term from onshore and offshore sources
- On-lend to DFIs long-term (back-to-back)
- Retain liquidity pool to manage risk

**Strengths**

- Potentially financially sustainable
- Strong support for local financial development

**Challenges**

- Requires complex risk management
- Potentially limited applicability
- May increase competition for liquidity

# FSD Africa: MDB portfolio transfer

**How does it work?**

- Transfer MDB private-sector loans to institutional investors in EMDEs
- Potentially refinance hard-currency loans into local currency during transfer

**Strengths**

- Would allow MDBs to recycle capital more quickly
- Supports local financial development

**Challenges**

- Unclear mechanism for refinancing into local currency
- May require changes to MDB operating models

# CPI: FX hedging facility with risk tranches

**How does it work?**

- Divide currency risk into tranches
- Projects absorb first risk tranche, underwriters and/or donors absorbing higher tranches

**Strengths**

- Limits costs of hedging for projects
- Designed for renewable energy sector

**Challenges**

- May require ongoing donor support
- Potential regulatory constraint in EMDEs

# ADDRESSING CURRENCY RISK

## What do we recommend?

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# Action Plan for Each Stakeholder

Providers of concessional capital

- To improve affordability of current hedging tools
- To improve the affordability of local currency loans

MDBs/DFIs

- Expand local currency lending
- Engage with more domestic financial Institutions
- Support the development of local financial markets in EMDEs
- Pilot programs such as FSD Africa

EMEs Governments

- Intensify efforts to support the development domestic financial sector.
- Implement country-sector platforms
- Support regulatory reforms that enable blended finance

# Relevant resources that informed this presentation


- CPI, 2024. *Managing Currency Risk to Catalyze Climate Finance*. Available at: https://www.climatepolicyinitiative.org/publication/managing-currency-risk-to-catalyze-climate-finance/

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- Avinash Persaud, 2023. *An FX Guarantee Mechanism for the Green Transformation in Developing Countries*. Available at: https://www.climatepolicyinitiative.org/wp-content/uploads/2023/06/An-FX-Guarantee-Mechanism-for-the-Green-Transformation-in-Developing-Countries.pdf

- CPI, 2015. *FX Hedging Facility*. Available at: https://www.climatepolicyinitiative.org/fx-hedging-facility/

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## Contact –

Zeineb.benyahmed@cpiglobal.org

**CPI:** climatepolicyinitiative.org

**The Lab:** climatefinancelab.org

@climatepolicy

@climatepolicyinitiative

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# Thank You