Climate Investment Funds

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Estimated Cost of Hedging for Local Currency for CIF Trust Funds

(Submitted by Trustee)

Figure 1 below outlines possible costs of a currency forward strategy for trust funds. The column headed "Par Forward Rate" illustrates exchange rates that could be offered by market counterparties for a one year forward instruments compared with "Spot Rates" of the same trading date. Since currency forward strategies involve no up-front payment, costs are embedded in the exchange rates offered. These implied costs are shown in the last column. The cost would depend on the currency used for lending by MDBs and reflects the risk that the currency would depreciate. For example the cost of hedging THB would be lower than the cost of hedging EGP as the forward rate for EGP assumes higher volatility.

Figure 1: Illustrative costs of 1-year currency forward contracts

Currency	Spot Rate	Par Forward Rate	Implied Costs Par Forward
MXN	13.0090	13.5307	4.0%
COP	18.1785	18.9394	4.2%
CLP	4.7957	5.0266	4.8%
ZAR	8.7425	9.1930	5.2%
PHP	41.2558	41.3223	0.2%
THB	30.6796	31.2500	1.9%
EGP	6.1013	6.8701	12.6%
VND	4.7988	4.3000	-10.4%
EUR	1.2934	1.2979	0.3%
INR	53.7606	56.8182	5.7%

Rates are as of 25 October 2012; forwards are based on 1 year terms

Implied costs are as a percentage of the transaction volume.

Source: Bloomberg

As Figure 1 shows, hedging for local currency can be a costly option since the one-year forward contract would have to be rolled forward through final maturity of the local currency loan. Furthermore, the Trustee will need to address collateral management, transaction tracking and contingency management issues before it can implement this option.

- Collateral management. Trust funds are obliged to post collateral under the existing ISDA Master Agreements. If IBRD agrees to intermediation services for the CIF trust funds, it is also likely that the CIF trust funds would be required to post collateral with IBRD as well. Posting collateral would result in a reduction of the programming ability for the CIF unless donors agree to post collateral on behalf of the CIF.

- Transaction tracking. Additional costs would be charged by the World Bank treasury department to monitor derivative transactions executed on behalf of the CIF.

- Contingency management. Contingency management policies, including handling of overdraft charges or penalties due to delays or non-payment of reflows, need to be agreed and established.