

De-dollarization of Sovereign Debt

Solution Hedges Risk for Frontier Market Sovereigns by Converting Supranational Loans to Local Currency

Case Study

The Challenge	<p>Frontier market sovereign entities such as governments, municipalities and state-owned enterprises often accumulate hard-currency debt through loans granted by supranational organizations. The borrower's ability to repay the debt is primarily based on access to local currency. Borrowing in foreign currency therefore results in a currency mismatch and exposes borrowers to foreign exchange risk and currency volatility over long periods of time. To compensate for this exposure, borrowers typically increase precautionary reserves, which threatens sovereigns' ability to achieve their budgetary goals.</p> <p>As the currency risk associated with long-term debt may impact the borrower's ability to repay, both the sovereign borrower and, especially supranational lenders, are eager to re-denominate the hard-currency debt to local currency. However, this is complicated by underdeveloped or non-existent swap markets and local debt capital markets in frontier market countries, which makes it difficult to hedge currency risk.</p>
The Solution	<p>Supranationals and Citi share a common goal of promoting growth and economic development while deepening local capital markets. As the leading global money center bank with a large corporate presence, Citi is differentiated by its strong local currency balance sheets in many emerging and frontier markets with restricted currencies. Citi is able to leverage its unique local presence and relationships with local investors, local market trading capability and global array of products to quote large long-tenor frontier cross-currency swaps and facilitate execution of local currency trades.</p>
The Result	<p>Citi has executed numerous cross-currency swaps in frontier markets with multilateral development banks, allowing their borrowers to re-denominate interest and amortization on outstanding loans to local clients from USD to local currency. While local franchises often have available balance sheet to take this currency risk, Citi is able, due to its large institutional client base, to find an offsetting pairing to maximize efficiency of the cross-currency swap.</p> <p>By converting the USD debt of frontier countries, which typically lack derivatives markets, to local currency, Citi helps development banks' clients better withstand any future financial shocks to the local currency while at the same time promoting economic development in the country. Solutions to mitigate currency mismatches connect governments, local currency hedgers/payers, with local currency investors such as pension funds and insurance companies looking for long-duration local currency assets; they enable these investors to diversify or extend duration of their local currency portfolio.</p> <p>This risk management tool delivers tremendous benefits as part of an appropriate hedging strategy, including its simplicity, economics, internal political benefits and development impact.</p>