Currency Risk-Sharing Facility for Scaling Up Local Currency Climate Finance in Uganda

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Currency risk is a structural constraint on scaling sustainable climate finance in low-and middle-income countries. Climate and infrastructure projects typically generate revenues in local currency, while financing is largely provided in foreign currency, transferring exchange rate risk to borrowing countries and institutions. Large currency depreciations have been a recurrent driver of debt distress, yet development finance models continue to place most of this risk on vulnerable borrowers. Addressing currency risk more systematically is therefore essential to enable long-term local currency financing and strengthen the resilience of development finance.

The problem

Uganda needs over USD 28 billion by 2030 to meet its climate action commitments. Mobilising finance for renewable energy, climate adaptation, and sustainable infrastructure requires long-term local currency funding, since the revenues of such projects are almost always generated domestically.

The Uganda Development Bank (UDB), the country's national development finance institution, provides climate loans in Ugandan Shilling (UGX) through its Climate Finance Facility. Yet Uganda's development finance system faces a structural dilemma.

High domestic funding costs, combined with a lending cap of 12 per cent that applies across UDB's portfolio, make it difficult for the bank to provide local currency loans at affordable rates.

This cap reflects UDB's development mandate: many climate and infrastructure projects generate relatively modest and long-term returns, and higher lending rates would render a large share of these investments financially unviable. With inflation in Uganda currently in the low single digits, the cap still implies a positive real lending rate, but one that remains consistent with the financial viability of climate and infrastructure projects. To maintain affordability for borrowers, UDB therefore relies on concessional credit lines from international partners, typically denominated in foreign currency (USD or EUR).

This funding model creates a currency mismatch: UDB lends in UGX but borrows in foreign currency. When the UGX depreciates, the cost of servicing this debt rises sharply in local currency terms, putting pressure on the bank's balance sheet and financial position.

Traditional hedging instruments exist, but they are costly and often difficult to access for the long maturities required for climate and infrastructure projects. In practice, comprehensive hedging for long-term exposures typically involves double-digit costs in UGX terms, far above the concessional interest rates UDB pays on its foreign currency credit lines.

Without affordable and long-term risk-mitigation tools, UDB must absorb the currency risk on its own balance sheet, exposing it to exchange rate volatility. This limits the scale of local currency financing and makes climate investment structurally vulnerable to currency risk, with potential implications for debt sustainability.

The innovation

Funded by the Finance in Common (FiCS) Innovation Lab, this project is a partnership between UDB, the Climate Policy Initiative (CPI), the University of Leeds, and City St George's University of London. It develops a first-of-its-kind currency risk-sharing facility that strengthens UDB's local currency operations under the Climate Finance Facility by providing a middle-ground solution between full exposure to currency risk and costly full hedging.

The facility distributes currency risk across three layers:

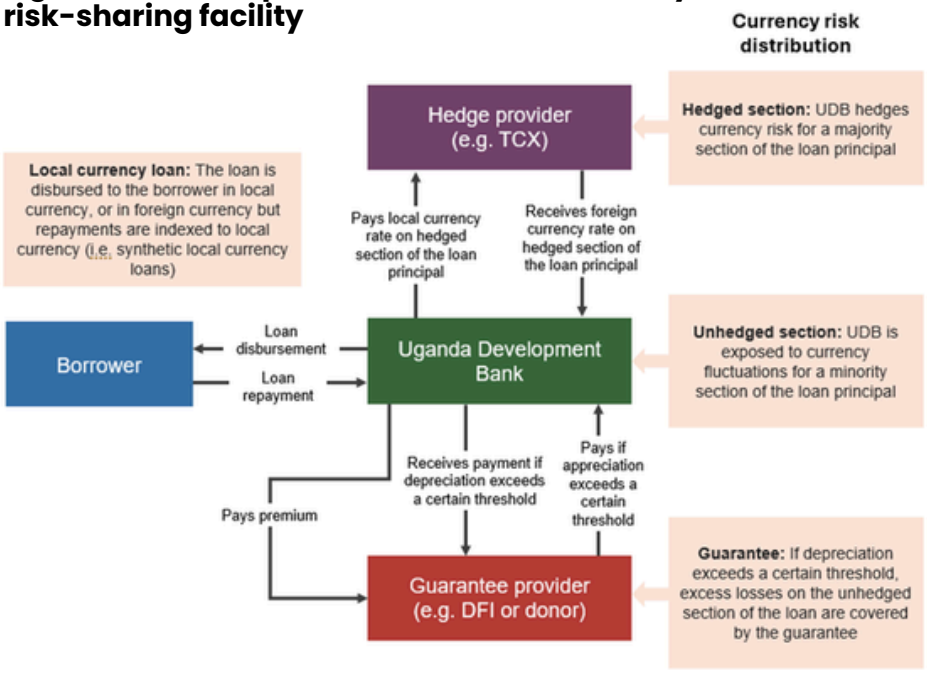
1. A hedge provider (e.g. TCX) covers a portion of the exposure through a traditional hedging instrument such as a swap;

2. UDB retains the currency risk on the remaining portion up to a predefined loss threshold, and

3. A donor provides tail-risk protection beyond this threshold (hereafter referred to as a 'guarantee' for simplicity).

By slicing the exposure in this way and combining a partial hedge with a donor-backed tail-risk guarantee, the facility lowers UDB's cost of managing currency risk while significantly reducing its exposure, thereby enabling the sustainable expansion of local currency climate finance (Figure 1).

Figure 1: Visual representation of the currency risk-sharing facility



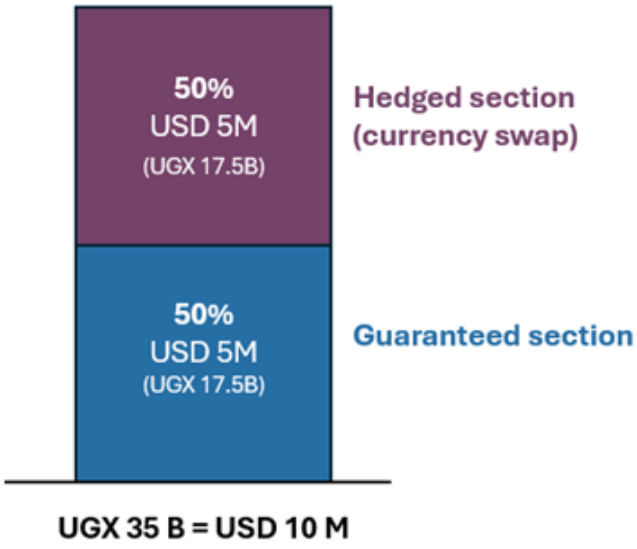
How it works

The following example illustrates how the facility would operate in practice (Figure 2). All parameters are indicative and subject to calibration.

1. Foreign currency borrowing
UDB receives a concessional credit line – for example, USD 10 million over seven years at 2.5 per cent interest – to finance local currency climate projects.

2. Local currency financing
The funds are converted to local currency (approximately UGX 35 billion) and on-lent to borrowers at around 12 per cent, generating revenue in UGX.

Figure 2: Illustrative risk-sharing structure for a USD 10m UDB credit line



3. Risk allocation

- Around 50 per cent of the exposure is hedged through a traditional currency swap.
- The remaining portion is unhedged but protected by a donor-backed guarantee.
- UDB pays a fixed annual premium to the guarantor.
- UDB absorbs moderate annual depreciations up to a predefined threshold (e.g. 5 per cent).
- If depreciation exceeds this threshold, the guarantor covers the excess loss.
- If the UGX appreciates beyond an agreed level, the guarantor shares in the upside.

This symmetric structure helps ensure that the guarantee remains financially sustainable while maintaining incentives for prudent risk management.

The facility can be calibrated to different cost-risk preferences by adjusting the proportion of hedged exposure, the depreciation threshold, and the point at which the guarantee becomes active.

This flexibility allows institutions to tailor the balance between cost reduction and risk protection to their operational needs.

The impact

The facility provides a balanced and cost-effective approach to managing currency risk:

- **Lower risk at lower cost:** it reduces funding costs relative to full hedging while limiting downside exposure compared with full exposure to currency risk.
- **Flexible cost-risk calibration:** the structure allows UDB to adjust the relative shares of hedged exposure, retained risk, and guaranteed protection, enabling different configurations that balance risk reduction and cost efficiency.
- **Balance sheet protection:** by limiting exposure to large depreciations, the facility helps protect UDB's capital adequacy and frees balance sheet capacity to scale up local currency lending and mobilise additional climate investment.
- **Targeted donor exposure:** the guarantee covers only extreme currency movements beyond the predefined threshold, allowing donors to focus their support on tail risks rather than absorbing full currency or credit risk exposures.
- **No upfront capital commitment:** the guarantor provides contingent protection and only makes payments if predefined depreciation thresholds are exceeded.

Preliminary modelling suggests that large depreciations exceeding the proposed threshold occur relatively infrequently – on average once every seven years. The analysis uses option models based on market UGX and USD interest rates combined with historical UGX exchange rate volatility.

Using historical rather than implied volatility avoids the risk premia embedded in FX option prices, which reflect the illiquidity of these markets and the risk aversion of private investors. On this basis, guarantee calls are expected to remain limited.

Under the proposed symmetric risk-sharing structure, the facility can remain financially sustainable for the guarantor and may even generate positive returns over time.

If the guarantee is triggered, the guarantor makes a cash payment equal to the difference between the realised exchange rate and the strike rate that activates the protection, denominated in the currency of the underlying foreign currency obligation. Even under severe depreciation scenarios, the guarantor's maximum liability is capped at the loan value minus a haircut (reflecting the difference between the initial spot rate and the strike threshold).

From a donor perspective, the facility therefore resembles a credit guarantee in its overall risk profile. However, instead of covering borrower default, the guarantee protects against extreme exchange rate depreciation.

By addressing a key structural barrier to local currency lending, the facility delivers strong developmental additionality, enabling development finance institutions to expand long-term local currency financing for climate investments.

Scalability and replicability

The facility is designed to be both scalable and adaptable across institutions and countries. By reducing the cost of managing currency risk and limiting exposure to exchange rate volatility, it allows development finance institutions to lend more, for longer maturities, and in local currency – precisely where climate finance is needed most.

A pilot implementation with UDB would demonstrate the operational feasibility of the model and generate quantitative evidence to support broader adoption.

Over time, the approach could be replicated across multiple currencies and institutions, contributing to a structural shift towards more sustainable and resilient local currency climate finance in low- and middle-income countries, with reduced reliance on donor support.

Partners

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