Executive Summary of Review of the FX Management (Hedging) Pilot for the Global Partnership for Education (GPE)

For Discussion – GPE Finance and Risk Committee (FRC)

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Executive Summary

The World Bank, as Trustee of the Global Partnership for Education (GPE), received approval from World Bank Finance and Risk Committee (FRC) in November 2022 and from the GPE Board in June 2023 to develop an FX management (hedging) solution for GPE on a pilot basis with the aim of reducing FX volatility risk and enabling more predictable financial planning. The two-year pilot was launched in May 2024 and hedged contributions in EUR and CAD totaling approximately USD 116 million across six contributors (see Annex A for details).

An internal working group within the World Bank, comprising colleagues from Treasury, Accounting and Reporting, Legal, and Development Finance, conducted a thorough assessment of the FX hedging pilot. This assessment was also informed by feedback from peer reviewers from the Trustee team of the Green Climate Fund (GCF) and the GPE Secretariat.

This note summarizes the outcome of the pilot assessment at its conclusion and highlights key considerations for the GPE Finance and Risk Committee's assessment of whether the FX Management strategy should be continued for GPE's future replenishments.

How the FX Management Strategy Was Implemented

The FX management strategy was designed to reduce FX volatility risk by partially hedging future non-USD contribution receivables to in turn, provide predictability and availability of resources for GPE operations. In order to implement the strategy, the following key steps were taken:

- **Legal Amendments:**
    - *GPE's Governance Framework* was updated to allow GPE to assume 100% liability for all costs and liquidity demands from FX hedging activities and set aside a restricted FX Liquidity Reserve (FXLR, see definition below).
    - The *General Investment Authorizations (GIAs) of IBRD and IDA* were amended to allow IBRD to enter into hedging transactions on behalf of World Bank Trust Funds (TFs) and Financial Intermediary Funds (FIFs) to lock in the value of future receivables.
- **Engagement with GPE Contributors:**
    - *Contribution Agreements* with each GPE contributor were updated to reflect that: i) installments receivable may be used to carry out FX transactions; and ii) GPE is responsible for any costs associated with the FX management activities.
    - *Donors with non-USD contributions and defined installment schedules* were consulted to confirm whether their future installments would be hedged.

- **Guidelines:**
  - The *FX Risk Management Framework for FIFs* was developed to establish policies, procedures, and guidelines for managing receivables, collateral management, trading, and reporting.
  - The *GPE FX Hedging Pilot Guidelines* were developed to set out roles and responsibilities, eligible instruments, process workflow, and error resolution procedures for the pilot.
- **Operational Modalities:**
  - *Selection of eligible installments*: Only confirmed (signed in through a Contribution Agreement) installments with specified amounts and payment dates were considered eligible for hedging.
  - *Hedging instruments*: FX forward contracts were used to lock in USD exchange rates for a portion of eligible future receivables, aligning hedge maturities with expected installment payment dates, with a timing buffer to accommodate administrative delays.
  - *Hedge ratios*: Hedge ratios were used to determine the proportion of each eligible installment to be hedged and were applied conservatively, taking into account donors' historical payment patterns, credit ratings, and other relevant risk considerations.
  - *Settlement*: Upon receipt of contributor payments, FX forward contracts were settled at maturity, converting the hedged portion of contributions into USD.
- **Systems, Monitoring and Reporting:**
  - A *GPE dashboard* was developed to indicate the total TF exposure and MTM value, GPE's aggregated FX hedging MTM values, and GPE's collateral posting obligations.
  - The Trustee developed IT systems and functionality to capture and record hedging transactions suitable for the pilot.
  - The *quarterly GPE Trustee Report* was updated to include the MTM valuation of hedging transactions and details of any contributor non-compliance with payment schedules.

This design ensured that the strategy functioned as a disciplined risk-mitigation tool, closely aligned with GPE's cash-flow profile and operational needs.

Key Findings of the Pilot Assessment

Summary

The review concluded that the FX management pilot met its primary objective of predictable financial planning and better management of GPE's programming resources. The strategy reduced the exposure of GPE's programming resources to currency movements by locking in USD exchange rates on a portion of eligible future receivables.

Key Experience and Learning

- **Legal Amendments**: The GPE Secretariat, Trustee, and contributors engaged early and continuously, which built a strong shared understanding of the FX Management strategy and enabled smooth amendments to GPE's Governance Framework. Similarly, the amendments to the GIAs of IBRD and IDA were executed smoothly by the Trustee team in partnership with the World Bank Treasury and legal teams.
- **Engagement with GPE Contributors**: Overall, engagement with active contributors was smooth and collaborative, with individual outreach, written confirmation on hedging preferences, flexibility to opt out, and clear emphasis on the need for defined installment schedules and multi-year Contribution Agreements to maximize the share of receivables that can be hedged.
- **Operational Modalities:**
    - The approach to select eligible installments based on installment schedules, defined hedge ratios based on donors' payment history, recent credit rating changes, and guidance from the GPE Secretariat provided a useful mitigant against donor non-payment risk.
    - FX forwards proved to be an effective instrument for GPE's FX management strategy, with maturities aligned to expected installment dates (plus a 30-day buffer). The hedge settlements worked well across all the trades.
    - The collateral management process was not tested during the pilot, since no collateral posting was required, and no FXLR was needed to set aside, due to the small notional amount of the pilot and the collateral terms.
- **Monitoring and Reporting:**
    - GPE's FX exposure and hedging positions were monitored through the daily dashboard to get a clear sense of overall risk and the MTM changes coupled with donor non-payment flags were reported quarterly.
    - While Trustee systems for capturing and reporting on hedging transactions were sufficient for the pilot, further investment into the trustee systems will be required if GPE is to continue hedging activity. Cost estimates can be more accurately determined once the scale and activity levels are determined.

Experience under donor non-payments (stress test):

- There were two instances of donor non-payment of hedged installments (€43.9m and €5.2m). Since GPE operates in both USD and EUR, it was possible to use GPE's non-committed EUR balance (in place of the contributor installments) to settle the hedging transactions on the expected maturity dates.
- Within the FX Management strategy, past payment history is considered when determining the hedge ratio; as such, should the hedging pilot be extended for GPE, the hedge ratios will be refreshed based on the latest donor payment patterns and refined methodology.
- These two instances acted as stress tests, indicating the importance of donors adhering to payment schedules and maintaining prompt communication if delays

arise. The events also tested the program's operational procedures and safeguards and prompted a thorough review and refinement of them.

Risk Implications

During the pilot, risk mitigation measures in place for identified risks were deemed to be robust with no revisions deemed necessary. The key risks are as follows:

- *Liquidity Risk*: Execution of FX forwards is subject to market liquidity risk, which was low since the trades are in major currency pairs. Separately, the GPE FXLR may have liquidity implications for GPE as this amount temporarily reduces funds available for programming; however, the reserve is small compared to GPE's fund balance, is monitored daily, and factored into funding decisions.
- *Donor Non-Payment Risk*: While there were two non-payment events during the pilot, they were settled using GPE's EUR fund balance as scheduled. There was no need to unwind or restructure any trades. When unwinding or restructuring is necessary, GPE would assume full costs and charges.
- *Operational Risk*: Operational errors in trade execution did not occur during the pilot. FX forwards are managed in Bloomberg, with pre-trade compliance checks and TRO re-confirmations. Robust controls prevented trade errors.
- *Spillover risk:* During the pilot, GPE's FX strategy did not affect other FIF assets, as FX trades were tracked separately with a dedicated FX Trading Desk, Book, and GPE FXLR was set up to satisfy all liquidity demands from FX trades.
- *Counterparty Credit Risk:* Potential default by an ISDA MA counterparty can lead to losses, especially if not sufficiently collateralized. To manage the risk of counterparty default, the FX transactions were only entered under fully negotiated and signed ISDA MAs that contain collateral obligations under a Credit Support Annex (CSA). The credit rating for the counterparty used was AA-. Counterparty credit risk did not materialize under the pilot.
- *Reputational Risk*: ISDA MAs require both parties to adhere to payment schedules, and deviations from the agreed terms can result in reputational risk to the World Bank. Despite the two defaults, payment schedules were honored. More broadly, transparent communication and clearly articulated processes and procedures mitigate reputational risk.

Value added to GPE

While the pilot was small, it effectively reduced GPE's exposure to FX volatility risk, in line with expectations. By stabilizing the level of programming resources, the strategy improved the predictability of available resources in USD terms. If the hedging strategy were applied more broadly, this enhanced certainty would support more effective financial planning, allowing GPE to allocate funds with greater confidence to fulfill its funding allocations.

Areas for Improvement

All aspects of the FX Risk Management Strategy were reviewed with the aim of identifying ways to streamline and improve the internal operational procedures and update the documentation to provide greater clarity. There were two main areas where improvements were identified:

a) The FXLR mechanism. The FXLR mechanism has been adjusted to more accurately reflect its objective. The FXLR is now defined as a pool of restricted GPE funds (not available for program commitments but accessible for short-term investments) that is notionally set aside to ensure that GPE can meet all potential liquidity demands arising from FX hedging activities. Such demands include: i) collateral obligations linked to negative MTM positions, ii) payment obligations related to unwinding or restructuring FX trades due to delayed or canceled contribution payments or counterparty defaults also linked to negative MTM positions, and iii) post-recovery losses in positive MTM positions when the counterparty defaults. In line with this definition, the methodology to determine the size of the FXLR was adjusted to depend on the valuations of the underlying hedging portfolio, market conditions, and CSA terms. This adjustment means that any GPE funds set aside continue to earn investment income.

b) The hedge ratio methodology was reviewed and retained; however, it was enhanced to more clearly define primary drivers (donor's historical payment patterns) and secondary drivers (credit rating changes and other risk factors).

Financial Implications

For budgeting purposes, FX hedging activities are considered to be customized trustee services with costs borne by the GPE Fund and collected through the trustee's annual budgeting process. The associated costs include:

a) *Explicit Costs*. The cost of developing the FX hedging strategy was $792k. The ongoing annual cost for strategy management, based on the principle of full cost recovery, is approximately $400k. As this will vary depending on the trade volume, an estimate will be provided at the start of the FY and adjusted for actuals at the end of the FY for approval by the GPE Board.

b) *Implicit Costs*. Potential costs arising from the unwinding or adjustment of FX trades due to contribution payment cancellations or delays, and temporary liquidity constraints from cash restricted in the FX liquidity reserve and therefore unavailable for commitment.

Next Steps

The pilot has built a foundation for establishing the necessary legal framework, systems, and operational procedures. The pilot combined with the refinements agreed during the review has resulted in the World Bank being equipped with the ability to provide FX hedging services for GPE's upcoming replenishment, within defined parameters. The World Bank will continue to refine internal processes to ensure the FX Risk Management Strategy operates in an efficient and sustainable manner. Using the current replenishment as a proxy for the upcoming replenishment, it is estimated that the World Bank is able to hedge a portfolio of up to $700 million across up to five currency pairs. This recommendation will be presented to the World Bank's FRC once GPE's FRC confirms its willingness to adopt the strategy for the upcoming replenishment.

Annex A – Summary of FX Hedged Contributions under the Two-Year Pilot

The table below summarizes the FX hedging transactions executed under the pilot, consolidated by donor. Individual installment amounts and dates are reflected within each donor line.

USD equivalents reflect values at trade maturity and are intended to illustrate hedged amounts for planning and predictability purposes.

Donor	Contribution Currency	Installment Details (hedged portion)	Hedge Ratio	Hedge Maturity Date(s)	USD Equivalent at Maturity
Germany	EUR	EUR 6.25m (Inst. 7, due Oct 2024); EUR 6.25m (Inst. 8, due Apr 2025); EUR 6.25m (Inst. 9, due Oct 2025)	25%	Nov 2024; May 2025; Nov 2025	20.57m
Italy	EUR	EUR 1.25m (Inst. 4, due Oct 2024)	25%	Nov 2024	1.36m
Belgium	EUR	EUR 4.88m (Inst. 4, due Dec 2024)	75%	Jan 2025	5.32m
Luxembourg	EUR	EUR 0.13m (Inst. 5, due Mar 2025)	25%	Apr 2025	0.14m
France	EUR	EUR 47.11m (Inst. 3, due Jun 2025); EUR 5.23m (Inst. 4, due Dec 2025)	75%	Jul 2025; Jan 2026	57.7m
Canada	CAD	CAD 42.0m (Inst. 5, due Mar 2026)	70%	Apr 2026	31.1m
Total					**116m**