

ASIAN DEVELOPMENT BANK

**PRICING LOCAL CURRENCY LOANS IN
PRIVATE SECTOR OPERATIONS**

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ABBREVIATIONS

ADB	–	Asian Development Bank
DMC	–	developing member country
EBRD	–	European Bank for Reconstruction and Development
IADB	–	Inter-American Development Bank
IFC	–	International Finance Corporation
LBL	–	LIBOR-based loan
LIBOR	–	London interbank offered rate
MBL	–	market-based loan
OCR	–	ordinary capital resources
PSO	–	private sector operations

CONTENTS

	Page
I. INTRODUCTION	1
II. CHARTER PROVISIONS	1
A. Article 6.2(b) Resources	1
B. Currency Swaps	2
C. Local Currency Borrowings	3
III. ADB POLICIES REGARDING LOCAL CURRENCY LOANS	3
IV. PRACTICES AT OTHER INSTITUTIONS	5
V. CONCLUSIONS AND RECOMMENDATION	6
APPENDIX: Charter Provisions	7

I. INTRODUCTION

1. Article 13(ii) of the Agreement Establishing the Asian Development Bank (the Charter) expressly authorizes the Asian Development Bank (ADB) to lend local currency (defined as the currency of the member country in whose territory a project will be carried out) to finance the local expenditure requirements of a project. Though this authorization to make local currency loans applies to ADB's operations in both the public and private sectors, this paper will focus only on the making of local currency loans in its private sector operations (PSO). Lending the currencies of ADB's developing member countries (DMCs) to the private sector in those countries is not a new idea. The Board of Directors has considered and approved the concept on several prior occasions. Among other benefits, it is considered that such local currency loans will (i) promote best practices in risk management by avoiding currency mismatch risks, (ii) help develop local capital markets, and (iii) enhance the sustainability of infrastructure projects by charging long-term fixed rates.

2. This paper will examine the various Charter provisions¹ applicable to the making of local currency loans and related Board policies. In particular, the paper will clarify the nature of currency swap transactions through which ADB may obtain local currency for lending in its PSO, and will propose flexibility in the Board's first (and to date only) statement on how local currency loans should be priced.

II. CHARTER PROVISIONS

3. ADB generally has three sources of local currency: (i) capital contributions from member countries pursuant to Article 6.2(b) of the Charter, (ii) currency swaps through which ADB exchanges a convertible currency for a local currency, and (iii) local currency borrowings. Depending on how ADB sourced the local currency in question, different Charter issues arise with regard to how such local currency may be used.

A. Article 6.2(b) Resources

4. Article 6.2 of the Charter specifies how member countries should pay their initial paid-in capital subscription to ADB: 50% in gold or convertible currencies, and 50% in their own currencies. By expressly directing member countries to pay partly in their own currencies, Article 6.2(b) has enabled ADB to acquire substantial amounts of DMC currencies from the outset. Such amounts have increased with each subsequent capital subscription because ADB continued the practice of permitting a portion (not always 50%) of the paid-in amount to be contributed in the currency of the member country.

5. Article 24.1 of the Charter states that member countries may not restrict the use of gold or currencies held by ADB that are obtained from certain specified sources. Article 24.2 expands on Article 24.1 by stating that member countries may not restrict the use of their own currencies held by ADB that were not obtained from the sources described in Article 24.1, except in three scenarios. Of these scenarios, only one is applicable here. This is Article 24.2(i), which allows DMCs (and not other members) to restrict the use of their currency to payment for goods and services produced and intended for use in their territories. Such restriction is also applicable to Article 6.2(b) payments through Article 24.1(i).

¹ The complete text of all Charter provisions cited in this paper is provided in the Appendix.

6. Reading all these provisions together, it seems clear that ADB is completely free to use the currency contributed under Article 6.2(b) of the Charter by a DMC that has not restricted its use under Articles 24.1(i) and 24.2(i). Such freedom would extend to the making of loans and equity investments in any country. If the DMC concerned has so restricted the use of its Article 6.2(b) payments, then ADB may still use the currency contributed to make loans and equity investments, but only with respect to projects in that DMC. However, since the focus of this paper is the making of local currency loans – that is, lending the currency of a DMC for projects in that DMC – it does not matter whether there is any restriction under Articles 24.1(i) and 24.2(i).

7. Article 13(ii) of the Charter supports the analysis in the preceding paragraph. It expressly authorizes ADB to lend local currency that is not obtained from sales of gold or convertible currencies to finance the local expenditures of a project. By its terms, the currency holdings of ADB derived from Article 6.2(b) payments by its DMCs are not obtained from selling gold or convertible currencies. Therefore, ADB may use its Article 6.2(b) resources to make local currency loans.

B. Currency Swaps

8. A typical currency swap involves the exchange of two currencies in two related transactions. At the outset, the parties exchange one currency for another at the prevailing spot foreign exchange rate. Simultaneously, they enter into a forward contract under which the parties are assured of receiving their original currencies on an agreed upon date in the future. If, as is usually the case, the parties enter into currency swaps in connection with their borrowings, then the exchanges would also include sufficient amounts of currencies to service the borrowings on the various interest payment dates.

9. To obtain local currency for lending in its PSO, ADB would have to exchange part of its convertible currency holdings. There is no market for a direct exchange of the currencies of two DMCs. The convertible currency to be exchanged by ADB could be obtained from (i) ADB's borrowing activities, and/or (ii) the fees and income from ADB's operations. ADB may not be restricted by its member countries from exchanging convertible currencies derived from any of these two sources under Article 24.1 of the Charter.

10. But Article 13(ii) of the Charter itself may be seen to pose a problem. The exchange of a convertible currency for a local currency could be construed as a "sale" of the convertible currency for local currency. Article 13(ii) could be seen to prohibit any such sale of a convertible currency.

11. The origins of this problem date back to when the Board approved ADB's swap policy.² In the course of discussing the Charter provisions applicable to various aspects of currency swaps, the swap policy considered how to characterize properly the exchange of currencies.³ It was determined that a currency swap involved an initial sale of one currency to purchase another currency. Article 24.4 of the Charter – which prohibits ADB from purchasing currencies with gold or other currencies – become applicable, but this prohibition was dealt with by passing a Board resolution, with the required two thirds of the total voting power, that expressly approved the purchase of currencies. It is important to note that the swap policy considered only

² ADB. 1983. *Currency Swaps for Possible Borrowings with Currency Hedged Transactions*. Manila.

³ *Ibid.*, paras. 23–24.

the exchange of *convertible* currencies; to date, ADB has not undertaken any currency swap of a convertible currency for a local currency. Accordingly, there was no issue directly with Article 13(ii). That is not the situation now.

12. The problem may be resolved by keeping in mind that the provisions of the Charter are generally designed to minimize the possibility that ADB's operations will be exposed to exchange risk. For example, Article 12.2 effectively prohibits ADB from using funds borrowed in one currency to make ordinary capital resources (OCR) loans that are repayable in another currency. Article 13(ii) prohibits the making of local currency loans where the local currency was obtained by selling gold or convertible currencies. Article 24.4 prohibits the purchase of currencies using gold or other currencies except in the ordinary course of ADB's business or upon a Board resolution approved by Directors representing more than two thirds of the total voting power. All these provisions share the common objective of limiting the circumstances under which the assets and liabilities of ADB may be denominated in different currencies.

13. A currency swap transaction is completely consistent with the general Charter objective of minimizing exchange risk. Indeed, the very nature of a currency swap precludes any exchange risk. As described in para. 8, a currency swap usually involves two exchanges of currencies in two integrally related transactions such that each party to the swap is assured of recovering its original currency at the end of the swap period. Since the original currency will be recovered, the nature of a currency swap is entirely different from an ordinary sale or purchase of currencies. This is the key distinction between a currency swap and an outright spot foreign exchange transaction. Article 13(ii) is applicable only to the latter transaction, because there cannot be any exchange risk or any other issue in the exchange of a convertible currency for a local currency if exactly the same convertible currency will be recovered. To that extent, Article 13(ii) does not apply to currency swaps.

C. Local Currency Borrowings

14. ADB may borrow local currency through a direct loan from a bank or other financial institution or by issuing bonds in the concerned DMC. In either case, ADB must obtain certain approvals from the concerned DMC under Article 21 of the Charter. ADB follows this well-established process in all of its borrowings. ADB may use the proceeds from such borrowings freely. Article 24.1(iii) clearly states that member countries may not impose any restriction on currencies obtained by ADB from borrowings.

III. ADB POLICIES REGARDING LOCAL CURRENCY LOANS

15. As mentioned earlier, the idea of ADB making local currency loans in its PSO is not new. For example, the recent Private Sector Development Strategy featured ADB assistance in reducing currency mismatch risks through local currency loans to private firms in DMCs as an important means of financial intermediation, which is itself identified as a priority area of operation.⁴ This was reiterated by the identification of local currency loans and related credit enhancement as innovative financial instruments that ADB will employ as part of its private sector operational strategy.⁵

⁴ ADB. 2000. *Private Sector Development Strategy*. Manila. (paras. 28 and 39)

⁵ ADB. 2001. *Private Sector Operations: Strategic Directions and Review*. Manila. (paras. 59–61)

16. That ADB would make local currency loans at all dates back even further. In 1968, the Board approved the first and most comprehensive policy to date on local currency loans.⁶ While not expressly stated, this policy probably contemplated ADB making local currency loans primarily to the public sector. ADB had just commenced operations, and all ADB financing up to that time was to the public sector. PSO were approved only much later, in 1985. That said, the local currency loan policy may reasonably be construed as applicable to ADB making local currency loans to the public and private sectors because, by its terms, it did not distinguish between them and could readily apply to both.

17. In this regard, the critical feature of the local currency loan policy is its requirement that ADB charge the same interest rate on a local currency loan as on a convertible currency loan.⁷ Some of the factors that were considered in arriving at such a policy include refraining from inadvertent distortion of DMC credit policies, preserving ADB's own financial viability, and maintaining a uniform lending rate to different countries.⁸ Consideration of such factors may have been appropriate at that time for pricing local currency loans in ADB's public sector operations, but less so with respect to PSO.

18. From the time that the Board approved ADB's undertaking PSO in 1985, the pricing policy on private sector loans (albeit loans in convertible currencies) had always been on a "cost-plus-spread" basis, where the spread was intended to cover credit risks and expected return. Specifically, in 1985 the Board determined that interest rates on currency-specific OCR loans to the private sector should provide a margin of 2.00–2.25% over ADB's borrowing cost in the relevant currency to reflect the associated costs and risks of lending without a government guarantee and to ensure a reasonable return on equity.⁹ The margin of spread over borrowing cost was reduced to 1.00–2.25% in 1987 to take account of different DMC conditions, varying credit risks and maturities, pricing of colenders, availability of exchange risk protection, operational profitability, and debt servicing capacity.¹⁰ For greater transparency, private sector borrowers were subsequently permitted to select an internationally accepted benchmark such as the 6-month London interbank offered rate (LIBOR) to serve as the base rate for the borrowed currency. Any perceived difference between the benchmark and ADB's corresponding borrowing cost could then be reflected in the spread to be added to the chosen benchmark.¹¹ Greater flexibility was provided when all existing spread-bands on currency-specific loans were removed.¹²

19. The same principle of pricing private sector loans on a "cost-plus-spread" basis was retained when the market-based loan (MBL) facility was approved in 1994. MBL afforded prospective borrowers a menu of several eligible convertible currencies and either fixed or floating interest rates for each eligible currency. For each MBL loan to a private sector borrower, the total cost to such borrower involved an international base rate plus a spread, where the base rate would reflect ADB's cost of borrowing in that currency and the spread would provide adequate compensation to cover credit risks, administrative costs and expected return.¹³ MBL was replaced by the LIBOR-based loan (LBL) facility in 2001. For private sector borrowers, the LBL facility provided greater flexibility compared with MBL with respect to interest payment

⁶ ADB. 1968. *Local Currency Loans*. Manila.

⁷ *Ibid.*, para. 5(d).

⁸ *Ibid.*, para. 4.1.

⁹ ADB. 1985. *Lending to the Private Sector Without Government Guarantees*. Manila. (para. 53)

¹⁰ ADB. 1987. *An Interim Review of Bank Policy and Procedures for Private Sector Operations*. Manila. (para. 31(ii))

¹¹ ADB. 1988. *A Review of Private Sector Operations*. Manila. (para. 92)

¹² ADB. 1990. *Second Review of Private Sector Operations*. Manila. (paras. 171 and 220(B)(ii))

¹³ ADB. 1994. *A Proposal to Introduce a Market-Based Loan Window*. Manila.

dates, interest rate fixing and conversion, currency choice and conversion, and repayment terms. But the key point is that the LBL facility continued to charge a spread over ADB's cost in an eligible convertible currency.¹⁴

20. The Board has consistently supported the principle that ADB's private sector loans in convertible currencies should be priced so as to recover the borrowing cost and to earn a spread that reflects the credit risks and expected return associated with the particular transaction and borrower. The Board has also endorsed the concept of ADB making local currency loans in its PSO; however, a still somewhat relevant but nonetheless dated policy requires that local currency loans carry the same interest rate as convertible currency loans. This policy should therefore be amended so that ADB may charge "cost-plus-spread" for local currency loans in its PSO, following the same principle as for convertible currency loans.

21. Specifically, it is proposed that ADB adopt the same procedure for determining the interest rate on a local currency loan as on a convertible currency loan. ADB's cost of borrowing in the relevant local currency will be determined by considering various factors specific to that DMC, including interest rates, bond spreads and, where available, cost of borrowing benchmarks. The spread will reflect the costs, risks, and expected return associated with the loan and with operating in the relevant DMC. In some cases, the spread for a local currency loan may be lower than for a convertible currency loan – even to the same borrower in the same DMC – because of the absence of certain country risks such as convertibility and repatriation. ADB will minimize disruptions to the local credit markets by ensuring that the terms for its local currency loans do not diverge materially from prevailing interest rates.

IV. PRACTICES AT OTHER INSTITUTIONS

22. Certain institutions such as the International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), and Inter-American Development Bank (IADB) have already offered viable local currency debt financing products and announced significant transactions. For example, IFC has completed a number of local currency lending transactions in India and Thailand. Currently, it is considering similar initiatives in the Philippines and Viet Nam. EBRD has concluded a number of local currency lending transactions in Hungary, Poland, Russia, and Slovakia. IADB has announced a local currency lending transaction in Chile. Similarly, export credit and bilateral agencies such as the Export Import Bank of the United States, Export Credit Guarantee Department of the United Kingdom, Export Finance Insurance Corporation Australia, and Netherlands Development Finance Company have announced local currency lending initiatives in Bangladesh, India, Malaysia, South Africa, and Thailand.

23. All these institutions price their local currency loans at their respective cost of borrowing in the relevant currencies plus a lending spread. They do not charge the same rate of interest on local currency loans as on their convertible currency loans. In the spirit of collaboration, ADB will certainly review their experiences and practices in local currency lending, including lessons learned.

¹⁴ ADB. 2001. *Review of Asian Development Bank's Financial Loan Products*. Manila.

V. CONCLUSIONS AND RECOMMENDATION

24. The Asian financial crisis has reminded financiers of the importance of currency hedging at the project level. Sustained depreciation of regional currencies in Asia bankrupted several projects that had failed to hedge their currency exposures. Projects with built-in pass-through mechanisms for currency depreciation in their respective offtake agreements to pass on the currency losses to consumers through increased tariffs suffered just the same, as the affordability levels of consumers decreased. Sustainability and affordability of high tariffs due to devaluation of local currency was a major risk for “user pay structures” dependent on revenues denominated in local currency that were funded with unhedged borrowings in convertible currency. ADB can play a vital role in accord with international best practices in credit risk management by lending local currency to projects generating revenues in local currency.

25. The review of relevant Charter provisions in this paper has shown that there are no Charter restrictions on ADB using local currency derived from Article 6.2(b) payments and from its borrowing activities. Following a clarification on the nature of currency swaps, it has also been shown that there are no Charter restrictions on ADB using currency swaps to exchange a convertible currency for local currency. It only remains to establish that ADB’s private sector local currency loans should be priced on the same principle as ADB’s private sector convertible currency loans.

26. It is recommended that the Board approve ADB making local currency loans in its private sector operations to finance local expenditures with (i) interest rates to be based on the cost of borrowing in the relevant currency plus a spread that reflects the credit risks of the individual transaction and borrower, and (ii) fees and commitment charges to be determined flexibly on a case-by-case basis.

CHARTER PROVISIONS

Article 6

2. Of each installment for the payment of initial subscriptions to the original paid-in capital stock:
- (a) Fifty (50) per cent shall be paid in gold or convertible currency; and
 - (b) Fifty (50) per cent in the currency of the member.

Article 12

2. In the case of loans made with funds borrowed by the Bank to which the commitment to calls provided for by paragraph 5 of Article 6 of this Agreement is applicable, the total amount of principal outstanding and payable to the Bank in a specific currency shall not at any time exceed the total amount of the principal of outstanding borrowings by the Bank that are applicable in the same currency.

Article 13

In making direct loans or participating in them, the Bank may provide financing in any of the following ways:

- (i) by furnishing the borrower with currencies other than the currency of the member in whose territory the project concerned is to be carried out (the latter currency hereinafter to be called "local currency"), which are necessary to meet the foreign exchange costs of such project; or
- (ii) by providing financing to meet local expenditures on the project concerned, where it can do so by supplying local currency without selling any of its holdings in gold or convertible currencies. In special cases when, in the opinion of the Bank, the project causes or is likely to cause undue loss or strain on the balance of payments of the member in whose territory the project is to be carried out, the financing granted by the Bank to meet local expenditures may be provided in currencies other than that of such member; in such cases, the amount of the financing granted by the Bank for this purpose shall not exceed a reasonable portion of the total local expenditure incurred by the borrower.

Article 21

In addition to the powers specified elsewhere in this Agreement, the Bank shall have the power to:

- (i) borrow funds in member countries or elsewhere, and in this connection to furnish such collateral or other security therefore as the Bank shall determine, provided always that:
 - (a) before making a sale of its obligations in the territory of a country, the Bank shall have obtained its approval;
 - (b) where the obligations of the Bank are to be denominated in the currency of a member, the bank shall have obtained its approval;
 - (c) the Bank shall obtain the approval of the countries referred to in sub-paragraphs (a) and (b) of this paragraph that the proceeds may be exchanged for the currency of any member without restriction; and
 - (d) before determining to sell its obligations in a particular country, the Bank shall consider the amount of previous borrowing, if any, in that country, the amount of previous borrowing in other countries, and the possible availability of funds in such other countries; and shall give due regard to the general principle that its borrowings should to the greatest extent possible be diversified as to country of borrowing.
- (ii) buy and sell securities the Bank has issued or guaranteed or in which it has invested, provided always that it shall have obtained the approval of any country in whose territory the securities are to be bought or sold;

Article 24

1. Members may not maintain or impose any restrictions on the holding or use by the Bank or by any recipient from the Bank, for payments in any country, of the following:

- (i) gold or convertible currencies received by the Bank in payment of subscriptions to its capital stock, other than that paid to the Bank by members pursuant to paragraph 2(b) of Article 6 and restricted pursuant to paragraphs 2(i) and (ii) of this Article;
- (ii) currencies of members purchased with the gold or convertible currencies referred to in the preceding sub-paragraph;
- (iii) currencies obtained by the Bank by borrowing, pursuant to sub-paragraph (i) of Article 21 of this Agreement, for inclusion in its ordinary capital resources;
- (iv) gold or currencies received by the Bank in payment on account of principal, interest, dividends or other charges in respect of loans or investments made out of any of the funds referred to in sub-paragraphs (i) to (iii) of this paragraph or in payment of fees in respect of guarantees made by the Bank; and

- (v) currencies, other than the member's own currency, received by the member from the Bank in distribution of the net income of the Bank in accordance with Article 40 of this Agreement.

2. Members may not maintain or impose any restriction on the holding or use by the Bank or by any recipient from the Bank, for payments in any country, of currency of a member received by the Bank which does not come within the provisions of the preceding paragraph, unless:

- (i) a developing member country, after consultation with and subject to periodic review by the Bank, restricts in whole or in part the use of such currency to payments for goods or services produced and intended for use in its territory; or
- (ii) any other member whose subscription has been determined in Part A of Annex A hereof and whose exports of industrial products do not represent a substantial proportion of its total exports, deposits with its instrument of ratification or acceptance a declaration that it desires the use of the portion of its subscription paid pursuant to paragraph 2(b) of Article 6 to be restricted, in whole or in part, to payments for goods or services produced in its territory; provided that such restrictions be subject to periodic review by and consultation with the Bank and that any purchases of goods or services in the territory of that member, subject to the usual consideration of competitive tendering, shall be first charged against the portion of its subscription paid pursuant to paragraph 2(b) of Article 6; or
- (iii) such currency forms part of the Special Funds resources of the Bank available under paragraph 1(ii) of Article 19 and its use is subject to special rules and regulations.

4. Gold or currencies held by the Bank shall not be used by the Bank to purchase other currencies of members or non-members except:

- (i) in order to meet its obligations in the ordinary course of its business; or
- (ii) pursuant to a decision of the Board of Directors adopted by a vote of the Directors representing not less than two-thirds of the total voting power of the members.