

ASIAN DEVELOPMENT BANK

INTRODUCING THE LOCAL CURRENCY LOAN PRODUCT

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ABBREVIATIONS

ADB	–	Asian Development Bank
ALM	–	asset-liability management
CCS	–	cross-currency swap
CSP	–	country strategy and program
DMC	–	developing member country
JBIC	–	Japan Bank for International Cooperation
LBL	–	LIBOR-based loan
LCL	–	local currency loan
LIBOR	–	London interbank offered rate
LTSF	–	Long-Term Strategic Framework

Note

In this report, \$ refers to US dollars.

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I. INTRODUCTION

1. Traditionally, the Asian Development Bank (ADB) has offered loans exclusively in foreign currency. However, in light of important economic changes in ADB's developing member countries (DMCs) over the past decade, a review of how ADB can enhance its menu of financial products to meet the evolving financing demands is warranted. As DMCs underwent economic restructuring and moved away from fixed exchange rates following the 1997 Asian financial crisis, lenders and borrowers became more vigilant to avoid currency mismatches. More recently, large current account surpluses and substantial capital inflows have allowed some DMCs to build up significant foreign exchange reserves. In addition, a number of borrowing countries have liberalized the capital account, allowing sovereigns and large local borrowers to access international bond and syndicated loan markets. This has opened an additional source of foreign currency borrowing at competitive rates. At the same time, local capital markets in some DMCs are developing rapidly, reducing the need to borrow offshore.

2. ADB-financed projects also have become much more varied. For example, some social sector projects have a high proportion of local rather than foreign currency expenditures. Further, local industry can meet the needs of some infrastructure projects in middle-income countries, reducing the reliance on imported foreign supplies.

3. ADB's loan product based on the London interbank offered rate (LIBOR) continues to be attractive and competitive. However, certain borrower groups might be unable to hedge currency risk associated with borrowing in foreign currency. While national governments have been the traditional clients for ADB's public sector operations, political decentralization in a number of DMCs has devolved certain responsibilities to subsovereign entities in some sectors that are important for achieving ADB's long-term strategic objectives. Unlike national governments, subsovereign entities typically do not have the capacity to manage foreign currency risks, thereby requiring local currency financial solutions.

4. As a result of these developments, DMCs have encouraged ADB to consider offering local currency financial solutions. This paper reviews ADB's ability to provide loans denominated in local rather than foreign currency,¹ a key component of offering greater flexibility to meet such demand. Moreover, this paper proposes that ADB introduce a local currency loan (LCL) product.

5. The concept of ADB making local currency loans is not new. It was discussed as early as 1968 when the Board of Directors approved its first policy on LCLs.² A Board paper, *Pricing Local Currency Loans in Private Sector Operations*,³ discussed LCLs in the context of ADB's private sector operations. Following its approval of this paper on 4 November 2002, the Board approved the first LCLs to private sector borrowers in India and the Philippines. In India, ADB also issued in 2004 its first bond in a DMC whose proceeds were retained in local currency with the objective of onlending to local borrowers, rather than swapping the proceeds into a convertible currency. Additional LCLs to private sector borrowers are being considered in the People's Republic of China, India, Indonesia, Pakistan, Philippines, and Thailand.

¹ This paper does not address issues related to providing partial credit guarantees in local currency. These will be addressed in a separate review paper on ADB's guarantee operations to be submitted to the Board in 2005.

² ADB. 1968. *Local Currency Loans*. Manila.

³ ADB. 2002. *Pricing Local Currency Loans in Private Sector Operations*. Manila.

6. On 15 June 2005, the Board discussed a working paper that reviewed the economic context and rationale of local currency lending, and considered the creation of a new local currency lending facility.⁴ Directors reached a broad consensus on the imperative to respond to the needs of ADB's borrowers and emphasized the need to ensure that the proposed LCL product be structured to respond clearly to borrowers' demands. Further, they stressed that the proposed LCL product should be thoroughly grounded in ADB's Long-Term Strategic Framework (LTSF),⁵ the Poverty Reduction Strategy,⁶ and the new Managing for Development Results initiative. Directors also expressed the need to spell out clearly the operational, resource, and financial implications of introducing an LCL product. This paper incorporates the Board's guidance and recommendations on the working paper, while minimizing repetition. Appendix 1 lists the key points raised by directors, and how they have been addressed in this paper. This paper seeks Board approval for the recommendations on the introduction of the LCL product.

7. The paper begins with a contextual analysis of local currency loans and ADB's LTSF. Section III describes the proposed policies and terms and conditions of the LCL product, while Section IV analyzes the implementation and resource implications. Section V offers the conclusions and recommendations for approval by the Board.

II. LOCAL CURRENCY LOANS IN THE CONTEXT OF ADB'S STRATEGIC FRAMEWORK

A. ADB's Strategic Framework and the Role for Local Currency Loans

8. ADB's LTSF responds to the development challenges of the region. It reflects ADB's evolving role and focus on investments for the provision of infrastructure and growth-promoting activities that ensure sustainable economic growth, including social development, and governance.

9. Building and upgrading physical and social infrastructure throughout the developing Asia and Pacific region is a precondition for sustained growth that requires substantial investment. Extensive unfulfilled demand exists across the region, ranging from basic infrastructure needs in the poorest economies to requirements for sophisticated infrastructure, services, and skills in the more advanced DMCs. For example, ADB, the World Bank, and Japan Bank for International Cooperation (JBIC) recently undertook a study that analyzed the physical infrastructure requirements in East Asia.⁷ The study estimated that East Asia's annual financing requirements for infrastructure investments will be about \$200 billion, a figure that highlights the importance of developing local capital markets. Since the vast majority of infrastructure projects in the region derive revenues in local currency, ADB must develop new modalities and instruments that can meet the huge financial requirements of infrastructure investments without exposing borrowers to currency risks and mismatches. ADB's ability to lend in local currency will be important to remain a relevant and responsive development partner in this process.

⁴ ADB. 2005. *Local Currency Lending*. Manila (Working Paper 1-05).

⁵ ADB. 2001. *Moving the Poverty Reduction Agenda Forward in Asia and the Pacific: The Long-Term Strategic Framework of the Asian Development Bank*. Manila.

⁶ ADB. 2004. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

⁷ ADB, World Bank, and JBIC. 2005. *Connecting East Asia: A New Framework for Infrastructure*. Manila (Advance edition).

10. Large investments continue to be required in the social sectors and in social infrastructure, particularly education, health, shelter, and water supply and sanitation. These investments are essential for sustained growth and productivity, as well as for promoting human development and improving quality of life. Virtually none of these important sectors have foreign currency revenues or the ability to manage, let alone hedge, foreign currency risks. Thus, finding innovative local currency financial solutions will be critical to addressing the needs of social sector projects.

11. New infrastructure needs also are emerging. The region's rapid growth, rising population, and increased rural-to-urban migration are resulting in extensive urbanization and increasingly congested and polluted cities. At the same time, some DMCs have been undergoing political decentralization, devolving to local governments the responsibility for delivering basic services and providing physical infrastructure. As a result, in some countries, local governments and their associated entities are playing a key role in the delivery of social and economic services (public health, education, housing, and urban infrastructure) and provision of infrastructure (power, irrigation, and transport).⁸ Therefore, helping local governments find solutions for rapidly evolving financing needs is an emerging—and increasingly important—area for ADB. In its Poverty Reduction Strategy, ADB made a commitment to this effort: “ADB will take initiatives to bring its operations closer to the poor. Such measures could include lending directly to local governments.”

12. Clearly, ADB's ability to lend in local currency is essential to providing responsive financial solutions in this emerging area. Local governments should not be exposed to foreign currency risk they would not be able to manage. In many cases, they are legally prohibited from borrowing in foreign currencies.

13. ADB's LTSF emphasizes the need to strengthen the domestic private sector in the countries of the region, an especially important task in countries with emerging private sectors, such as economies in transition. Strengthening entrepreneurship and small and medium enterprises will contribute directly to poverty reduction. In particular, ADB aims to support small-scale enterprises in urban and rural areas through microfinance programs and other appropriate means. Most small and medium enterprises and microfinance programs clearly will require local currency financial solutions, because such borrowers do not have foreign currency revenues or the ability to manage currency risk.

14. ADB's LTSF also stresses the need for ADB to contribute to local financial market development: “Many countries of the region have high domestic savings rates; the challenge is to create policies and institutions that mobilize these savings for productive investment to support development.” ADB can play an important role as a direct participant in the local financial market. In addition to providing policy support through instruments such as program loans and technical assistance, ADB can be a catalyst for capital market development by being a direct borrower in local financial markets. The next section will describe this role in more detail.

15. The LTSF also addresses ADB's assistance to the more advanced countries in the region: “For middle income DMCs, DMCs with limited international capital market access, and even for more advanced DMCs, ADB's role in financing development and catalyzing development finance will remain crucially important.” The LTSF mentions, in particular, that ADB should “provide longer-term finance for physical and social investment with long gestation

⁸ Kim, Yun-Hwan. 2003. *Local Government Finance and Bond Markets*. Manila: ADB.

periods.” As long-term local currency markets often are not well-developed, ADB can make important contributions to the development of this market in local currencies, even in more advanced economies.

16. To identify the demand for local currency financing more thoroughly, a detailed demand analysis will be conducted in 2006 as part of the Innovation and Efficiency Initiative. This study will look at the existing and projected market structure, as well as key features of the enabling environment, particularly issues involving subsovereign borrowers. The study also will analyze the level of development of local capital markets. The findings of the study will be shared with the Board.

B. Potential Benefits and Issues of Direct Local Currency Lending

16. Sovereign governments have been the traditional clients of ADB’s public sector operations. However, these governments are unlikely to generate demand for LCLs, as typically they can raise funds domestically at lower costs than borrowing from ADB.⁹ Instead, subsovereign borrowers, such as local governments and selected public sector enterprises, will account for most of the demand for local currency financial solutions.¹⁰ In the past, ADB has channeled LCLs to subsovereign borrowers by providing a foreign currency loan to the national government, which onlends the equivalent amount in local currency to the subsovereign borrower (or uses fiscal transfers to channel local currency funds to the subsovereign borrower). If the sovereign borrower opts to onlend using an LCL, the interest rate the national government charges should cover the currency risk inherent in the mismatch of keeping an asset in local currency and a liability in foreign currency.

17. ADB’s lending experience suggests, however, that the traditional lending approach still might entail currency mismatches¹¹ since national governments choose different approaches to manage currency risk.¹² ADB’s traditional lending structure also might be at odds with the general principle and objective of decentralization—to devolve fiscal and management responsibility to subsovereign entities. By coursing financing through the national government, ADB deprives subsovereigns the opportunity to increase their financial independence, a key objective of decentralization. In addition, the national government might have limited desire to take on additional foreign currency debt at certain times. This could be the result of sovereign asset-liability management (ALM), fiscal policy considerations, foreign currency borrowing restrictions, or sufficient foreign currency reserves.

⁹ This applies despite the fact that ADB has a better credit rating than its borrowers. Local investors normally consider the sovereign to be the best credit in the local currency, because of its ability to print money. However, some sovereigns may borrow in local currency from ADB for nonfinancial reasons, including getting access to technical and project expertise, or ensuring that ADB’s project management experience is applied to a project.

¹⁰ As noted in the joint ADB-World Bank-JBIC report on East Asia’s infrastructure requirements, the public sector finances about 95% of the region’s infrastructure investments. While governments should strive to create the right enabling environment to increase the private sector share of infrastructure financing in the future, working with public sector entities in the infrastructure sector will continue to be critical when addressing the infrastructure challenges in the region.

¹¹ Currency mismatches occur when assets and liabilities of an entity are denominated in different currencies such that the entity’s net worth and/or net income are sensitive to changes in the exchange rate.

¹² See Working Paper 1-05, *Local Currency Lending*, Box 1 (referenced in footnote 4).

18. For these reasons, ADB should consider direct lending in local currency to subsovereign borrowers. Such direct lending could have a range of benefits for DMCs:¹³

- (i) **Reducing currency mismatches.** Recent empirical evidence shows that currency mismatches played an important role in virtually all the financial crises in emerging markets in the 1990s. Empirical researchers observed that the largest declines in output occurred in emerging economies with the largest currency mismatches (Box 1). Foreign currency-denominated liabilities frequently have financed local currency activities, while the stock of foreign currency-denominated assets has been comparatively small. In such cases, a large and unexpected depreciation of the domestic currency can lead to a financial crisis and a sharp decline in economic output. Borrowers typically opt to take out foreign currency loans because local financial resources are not sufficient, maturities in the local market are too short, or borrowing offshore offers lower interest rates. While borrowers from developed economies typically are able to borrow internationally in their domestic currency (or to enter a fully hedged transaction if borrowing in a foreign currency), borrowers from emerging markets often are unable to do so.¹⁴ ADB potentially could contribute to reducing currency mismatches in its DMCs by providing suitable policy advice, helping develop the local financial sector, and catalyzing the mobilization of local currency financial resources. One of the most effective ways for ADB to assist could be to lead by example and begin extending LCLs, where appropriate and feasible, in close cooperation with the local financial sector to complement and catalyze local financial resources.
- (ii) **Furthering capital market development.** ADB's local currency funding activities could have important benefits to capital markets. In international capital markets, ADB is known as an innovative issuer that has opened new markets, introduced new financial instruments, and filled important gaps in the investment and issuer landscape. ADB could play a similar role in local capital market development by (a) following best practice standards when issuing local currency bonds, (b) setting new benchmarks, (c) providing role model transactions in terms of documentation and execution, (d) stretching the yield curve, (e) introducing innovations for available financial instruments in local capital markets, and (f) providing significant diversification opportunities for local institutional investors such as insurance companies and pension funds (Box 2).
- (iii) **Catalyzing local financing.** ADB's involvement in local currency lending could have important catalytic effects, generating additional investor and cofinancing interest in projects. Thus, ADB could employ its local currency financial products to contribute to effective mobilization of local financial resources, particularly for longer range maturities that are underdeveloped in many DMCs. Since the local currency bond market is still inaccessible to many nongovernment issuers, ADB

¹³ In addition to the benefits listed, direct lending by ADB to subsovereign borrowers also might reduce transaction costs in dealing with these clients, as assistance could be extended directly without the added layer of the national government. This might reduce delays in disbursement, as well as improve monitoring and supervision.

¹⁴ Borrowing internationally in foreign currency on an unhedged basis has been referred to by some authors as "original sin" (e.g., Eichengreen, B., and R. Hausmann, 2005. *Other People's Money—Debt Denomination and Financial Instability in Emerging Market Economies*. Chicago: University of Chicago Press).

could be instrumental in channeling domestic financial savings to borrowers that are unable to tap the local bond market directly.¹⁵

Box 1: Reducing Currency Mismatches in Emerging Economies

Until the 1990s, currency mismatches did not figure prominently as an explanatory factor in theories of economic growth and business cycles. This view changed after the Asian financial crisis of 1997 and other crises in emerging markets over the past decade. Important economic research has been conducted since these crises. Theoretical research and empirical studies have demonstrated a strong causal link between excessive foreign currency-denominated debt and economic growth. Since one of the Asian Development Bank's (ADB) key strategic goals as stated in its Long-Term Strategic Framework¹ is the support of economic growth, understanding the relationship between foreign currency mismatches and sustainable economic growth is critical.

In influential recent research, Eichengreen and Hausmann (2005)² found important empirical evidence that the level of foreign currency debt is a key determinant of the stability of economic growth, the volatility of capital flows, and credit ratings of emerging economies. Similarly, Goldstein and Turner (2004)³ reviewed the empirical literature on this topic and found that "currency mismatches not only increase the chance of getting into a financial crisis but also seem to increase the cost—especially the output cost—of getting out of one."

Since the Asian financial crisis, emerging economies have developed their local capital markets and reduced their dependence on international borrowings. ADB has played an important role in assisting its DMCs in developing local financial markets. As a lender, however, ADB's product range is limited to foreign currency loans. Thus, expanding ADB's product range to include local currency financial products is a logical consequence of its focus on developing local financial markets, and helping DMCs to reduce or eliminate foreign currency mismatches in the economy.

¹ ADB. 2001. *Moving the Poverty Reduction Agenda Forward in Asia and the Pacific: The Long-Term Strategic Framework of the Asian Development Bank*. Manila.

² Eichengreen, B., and R. Hausmann. 2005. *Other People's Money—Debt Denomination and Financial Stability in Emerging Market Economies*. Chicago: University of Chicago Press.

³ Goldstein, M., and P. Turner. 2004. *Controlling Currency Mismatches in Emerging Markets*. Washington D.C. Institute of International Finance.

¹⁵ See ADB. 2005. *Asia Bond Monitor*. Manila, for an overview of the issues and challenges facing the corporate bond market in the region. Partial credit guarantees by ADB of local currency bond issues could be another effective way to facilitate access of local borrowers to local bond markets.

Box 2: Contributing to Local Capital Market Development

Academic researchers have found powerful empirical evidence that the development of the local financial market and economic growth are correlated. Burger and Warnock (2002), for example, found that the size of a nation's local currency-denominated bond market and gross domestic product per capita are significantly correlated.¹ Similarly, credit rating agencies have begun to pay closer attention to local currency market development, noting that "a sovereign could enhance its creditworthiness by further developing its market for local currency securities".² Therefore, one key area for Asian Development Bank (ADB) assistance clearly should be the development of local currency bond markets. As the required ingredients for developing such markets have been widely analyzed elsewhere, they are not repeated here. ADB has been active in assisting the development of such markets in many developing member countries (DMC), and its financial sector road maps regularly include analyses on how to advance local bond market development.

The potential impact of ADB's borrowing in local currency on the development of local capital markets has been less well-researched. Such borrowing could have several benefits:

- **"Icebreaker"**. Bond issues by ADB could have a positive "icebreaker" effect, particularly on international investors, by strengthening confidence in the local currency. Other foreign borrowers such as multilateral development banks, bilateral financial institutions, and multinational corporations might follow suit, contributing to the international integration of the local capital market. This would help local borrowers access international capital markets in domestic currencies. ADB has been the "icebreaker" in a number of Asian markets, including Japan, Korea, Taipei, China, Malaysia, and Thailand.
- **Investor Diversification**. ADB bond issues, which carry the highest possible credit rating, could contribute to diversification benefits that accrue to local investors that are often overexposed to domestic economic and financial risks. Therefore, local investors likely would welcome the opportunity to diversify their holdings without having to incur currency risk. At the same time, rather than crowding out local issuers, such issuance would open up new limits for them due to the diversification and the resulting risk reduction benefits provided by a non-local issuer such as ADB.
- **Developing the "Long End"**. While governments have issued longer-dated securities in a number of DMCs, nongovernment issues with a long tenor still are rare. Thus, if ADB were to concentrate on developing the longer end of the market—in line with the long tenors that are typically required by infrastructure projects—such bonds could help meet the demands for local institutional investors, such as life insurers and pension funds keen to match their long-dated liabilities with long-term assets.
- **Derivative Markets**. ADB local currency borrowings typically are associated with interest rate or cross-currency swaps (section III). Liquidity in swap markets in most DMCs in the region is thin. Thus, ADB could contribute significantly to the development of liquidity in these markets by entering into such swap transactions, and by becoming the counterparty to another local party that has a matching requirement and, therefore, would be able to hedge interest rate or currency risk.

- **Knowledge Transfer.** ADB is an experienced issuer in Asian capital markets. It has been a pioneer in many markets and currencies in the region by opening new markets, creating innovative instruments, and working with local authorities on improving the regulatory and administrative framework. The wealth of know-how that has been accumulated within ADB, which is probably unique among issuers in the region, can be drawn upon in policy discussions with local regulators, as well as to inform the financial sector road maps on local capital market development.

¹ Burger, J., and F. Warnock. 2002. *Diversification, Original Sin, and International Bond Portfolios*. Washington: Federal Reserve Bank.

² Standard & Poor's. 2005. *The Importance of Going Local: Shifting Away from Foreign Currency Sovereign Debt in Latin America*. New York.

19. While ADB lending in local currency is expected to have significant benefits, potential concerns include the possibility of ADB crowding out local financial institutions. ADB could crowd out local financial institutions in two ways: as an issuer of bonds, or as a lender.

20. The ASEAN+3 Bond Market Initiative recently examined in detail the issue of ADB (or other nonresident issuers) crowding out local issuers when selling bonds. Five country case studies of Asia and Pacific countries, where foreign issuers have sold local bonds, examined this issue further. The research clearly demonstrates the significant benefits of such issuance. Crowding out was not found to be a problem in any of the countries. In fact, foreign issuance made important contributions to developing the local bond market, and complemented—rather than competed with—local issuance.¹⁶

21. The issue of ADB potentially crowding out local lenders needs to be assessed in the context of the size of local lending activities in DMCs. ADB's lending in local currency would comprise a tiny percentage of total lending volume in DMCs. As noted in the joint ADB-World Bank-JBIC report on infrastructure in East Asia, for example, the combined lending by all development institutions has accounted for approximately 1% of gross investments in the infrastructure sector in the past. Since ADB's objective in providing financing is to catalyze, not replace, other local lenders, ADB financing will not crowd out local financial institutions. Further, ADB seeks to cofinance wherever possible to leverage its participation in a project. Thus, ADB does not lend to projects or borrowers—in local or foreign currency—if sufficient financial resources are available from commercial lenders at comparable terms and conditions. Instead, ADB financing in local currency should (i) assist in mobilizing domestic savings, and channel it to projects that otherwise would not receive financing on comparable terms; (ii) mobilize other financial institutions to participate in a project; and (iii) improve or enhance the local currency market.

22. Another important issue in the context of local currency financing is the relative competitiveness of ADB's LCL products. Clearly, the competitiveness of ADB's local currency operations would depend on (i) the capital market and regulatory environment in a particular

¹⁶ For a summary of this research, see ERD Working Paper Series No. 63: *Developing the Market for Local Currency Bonds by Foreign Issuers: Lessons from Asia*. Manila. February 2005.

DMC, (ii) specific market conditions, and (iii) ADB's Treasury policies for the proposed LCL product. These issues are discussed in the next section.

III. PROPOSED NEW LOCAL CURRENCY LOAN PRODUCT

23. In view of the borrowers' demand for local currency loans, and the need for ADB to be an effective and responsive financial intermediary, Management proposes the introduction of an LCL product. This new product would be available to public and private sector borrowers. In defining and structuring the LCL product, Management was guided by two product design principles:

- (i) **Flexibility for borrowers.** Like the LIBOR-based loan (LBL) product, the proposed LCL product should provide flexibility to borrowers by giving them an enhanced choice of currency and interest rate, subject to ADB being able to transact the necessary funding and hedging transactions in the local currency market.
- (ii) **Low-risk intermediation for ADB.** The proposed LCL product should avoid currency and interest rate risk exposure for ADB. The financial risks and the costs associated with borrowers' choices in terms of the LCL product should not adversely affect other borrowers or ADB's net income position.

24. The following sections outline the key features of the proposed LCL product. The term sheet for the sovereign guaranteed LCL product is in Appendix 2, while the term sheet for the nonsovereign guaranteed LCL product (including private sector loans) is in Appendix 3.

A. Funding Policy

1. Pool Funding Versus Back-to-Back Funding

25. Gaining cost-efficient access to local currency funds is an obvious requirement for ADB to offer local currency financing. ADB has two options when raising local currency funds: raising such funds on a project-by-project basis by entering into back-to-back funding transactions, or by establishing a floating-rate liquidity pool in a specific local currency similar to ADB's funding approach with convertible currencies. A pool-funding approach allows the decoupling of lending and funding transactions, provides more flexibility in the disbursement mode and frequency, and offers greater certainty regarding the all-in borrowing costs and related loan terms. However, for ADB to consider creating a pool in a specific local currency, certain preconditions need to be fulfilled:

- (i) **Sufficient expected volume of lending.** The expected volume of local currency lending needs to be sufficiently large and frequent before ADB could consider creating a pool. Liquidity targets for a local currency pool would be determined based on demand and disbursement projections, and would be included in the annual borrowing program paper approved by the Board. Thus, the Treasury Department would have to work closely with the relevant operational departments within ADB to develop demand forecasts. Local currency lending should be included in country strategy and program (CSP) discussions.

- (ii) **No significant negative carry.** A floating-rate pool could be considered only if no significant negative carry issues arise. The term “carry” refers to the spread between ADB’s cost of funding and the return on investment earned if it retains liquidity. Thus, for pool funding to be feasible, ADB would need to secure favorable funding costs and be able to realize investment returns that closely match or exceed those funding costs.
- (iii) **Regulatory approvals in place.** To achieve the necessary funding and investment targets, ADB would need to secure standing regulatory approvals to access the local currency markets in a DMC. Such regulatory approvals would allow ADB to fund cost-efficiently any funding operation and reduce the time to market. Typically, such standing approval is documented in a multiyear debt issuance program. Without such a standing approval by DMC governments, ADB would have difficulty optimizing market timing. Obtaining government approvals, which are required under ADB’s Charter for each funding operation, could take several weeks or months. Appendix 4 provides details on the type of regulatory approvals that ADB typically seeks before accessing local currency markets in a DMC.

2. Main Funding Options

26. ADB has two main options to raise local currency funds: issuing a bond or entering a cross-currency swap (CCS):¹⁷

- (i) **Funding via bond issues.** The regulatory treatment of ADB local currency bonds in the relevant market is a key factor for the pricing of such bond issues. Clearly, if governments provide a more favorable regulatory treatment of ADB bonds, funding costs will be lower, which ultimately translates into lower interest rates for borrowers. For past ADB bond issues in local currencies, ADB has issued at spreads within a relatively narrow range of approximately –5 to +20 basis points below/over the relevant government benchmark Treasury bond. As ADB typically issues fixed-rate bonds that are swapped into floating-rate liabilities, ADB’s ultimate cost of funding is not determined only by the spread below/over the relevant government benchmark security. Conditions in the interest rate swap market also drive ADB’s cost of funding (see below).
- (ii) **CCS funding with commercial counterparties.** Commercial CCS markets are a relatively recent market development. While CCSs are now commonplace in the world’s major currencies, the development of CCS markets has occurred only over the past decade in emerging markets. Most DMCs do not have active and liquid swap markets.¹⁸ Thus, funding local currency through CCS with a commercial counterparty is an option only in a limited set of countries. However, where such swap markets do exist, CCS could be a flexible and cost-efficient funding route, particularly for a back-to-back funding approach. A CCS could be

¹⁷ Unlike a local currency bond issue, a CCS does not generate additional liquidity for ADB; it merely transforms existing liquidity from one currency to another. In principle, ADB also could borrow local currency from a local financial institution. However, in most cases, the terms of such borrowings are unlikely to be competitive vis-à-vis the funding options discussed in this section.

¹⁸ India, Indonesia, Malaysia, Philippines, and Thailand have active CCS markets.

structured in smaller amounts, closely matching the disbursement schedule of a loan. In addition, a CCS could be structured with an amortizing schedule that corresponds to the amortization schedule of the loan to be financed. These advantages could eliminate the need to hold local currency liquidity. On the negative side, a CCS is more vulnerable to market disruptions, and thus might not be available on an ongoing basis. Available amounts and maturities also might be more limited than those available through bond markets.

27. The decision for ADB to raise local currency funds through a bond or a CCS (where available) would depend primarily on costs. If a pool approach is adopted, ADB should have the flexibility to fund when advantageous funding opportunities arise—in the bond and/or the swap markets. Experience has shown that timing and choice of funding instrument can make a significant difference in the cost of funding to ADB. Since swap markets in emerging economies are much more volatile than those in developed economies, significant fluctuations in swap spreads below/over the benchmark are not uncommon. Such fluctuations provide ADB with the opportunity to achieve cost-efficient funding if provided with the flexibility to fund at times when swap levels are favorable.

28. Whether ADB follows a back-to-back or pool funding approach, regulators should provide the flexibility to choose funding options as freely as possible. This would minimize costs—a benefit that ultimately is passed on to borrowers.

B. Financial Risk Management and Policy Issues

1. Asset-Liability Management Issues

29. ALM involves matching the term structure and cash flows of an organization's assets and liabilities to maximize returns for a given level of risk, or minimize risks for a given level of return. ALM also addresses potential mismatches, including currency mismatches that can arise if ADB has an outstanding liability in a currency that is different from the assets it is holding. By following the principle of matchfunding¹⁹ for the proposed LCL product, ADB would avoid any currency mismatches, as stipulated in the ADB Charter.

30. Interest rate mismatches can arise if ADB has floating-rate obligations while holding fixed-rate assets, or the reverse. For back-to-back funding, such interest rate risks are hedged by matching the terms of loans and funding transactions. Where this is not possible, ADB enters into interest rate swaps that hedge ADB's assets and liabilities. Thus, ADB normally can enter local currency markets only where an interest rate swap market is in place, or bilateral interest rate swaps can be arranged, unless funding and lending are done on a full back-to-back basis with matching terms.

31. Basis mismatches refer to cases where the underlying base of two financial transactions differs. Basis risk would be created, for example, if one leg of a swap refers to 6-month local currency LIBOR-equivalent, while the other leg refers to 3-month LIBOR-equivalent. ADB ensures that such basis risk is minimized in its financial transactions in local currencies by entering into the appropriate hedging transactions.

¹⁹ Matchfunding is essentially one type of ALM strategy. Under this strategy, ADB would fund LCLs with liabilities in the same currency and therefore does not incur any currency risk.

32. ALM also addresses the issue of “warehousing risk”, i.e., holding liquidity in a local currency, thus potentially incurring a cost of carry. The cost of carry might be positive or negative depending on whether ADB’s investments in local currency when holding liquidity will earn more or less than the cost of ADB’s local currency liabilities. Thus, ADB’s cost of funding (as discussed above), as well as its return on investment when holding local currency liquidity, drive the cost of carry.

33. ADB’s investment strategy is laid out in the 1999 *Review of Investment Strategy and Authority*.²⁰ The review establishes the basic guidelines for ADB’s investment strategy, which aims to optimize the trade-off between risk and return. Modern portfolio theory is used to establish an efficient frontier to maximize the expected return for the selected level of risk.²¹

34. Regarding non-US dollar portfolios, which would cover any local currency portfolio, investing in corporate or other nonsovereign guaranteed bonds is precluded under the 1999 Investment Strategy and Authority. Thus, investment in local currency would be limited to sovereign and quasi-sovereign government securities and investment opportunities offered by highly rated international issuers and financial institutions.

35. In addition, ADB would have to be able to invest in a range of local instruments, including, (i) government bonds and bills, (ii) short-term money market instruments, and (iii) repo and reverse repo transactions where available. As ADB enjoys tax-free status on investment income under its Charter, DMC governments would have to grant the necessary approvals to allow ADB to receive interest income tax-free.

36. In summary, ALM for the proposed LCL product would follow the same principles as those for the ADB’s LBL product. ADB has accumulated significant experience in best-practice ALM, and recently upgraded its ALM systems and technology. These systems could be enhanced to include local currency ALM. Thus, a significant expansion of ALM resources would not be required to accommodate the proposed LCL product.

2. Pricing of Loan Products

37. ADB aims to price its LCL product according to transparent pricing principles. As proposed, the pricing approach for LCLs would follow the basic principles of ADB’s LBL product, as far as possible and wherever applicable. However, due to the specific nature of local currency capital markets, certain modifications and adjustments would be required. This section outlines the proposed approach to pricing LCLs.

38. Pricing should be based on the following parameters:

- (i) **ADB’s cost base rate.** The cost base rate depends on whether financing in a local currency is based on back-to-back funding or the pool-based approach. For back-to-back funding, the cost base rate comprises ADB’s cost of a funding transaction undertaken to finance a specific loan, including related swap costs and negative carry, if any. For a pool-based funding approach, the cost base rate is based on the local floating-rate benchmark (equivalent to LIBOR), adjusted by

²⁰ ADB. 1999. *Review of Investment Strategy and Authority*. Manila (R72-99, approved by the Board on 4 May 1999).

²¹ “Efficient frontier” refers to the set of portfolios with the optimal trade-off between risk and return for each level of risk. A particular asset allocation is considered efficient if, among the given asset classes, no other allocation has a higher expected return for a given level of risk.

ADB's funding spread over/below the benchmark. For the pool-based approach, rebates and surcharges will apply for sovereign guaranteed loans (see section 4 below).

- (ii) **Interest rate basis.** Similar to the LBL product, all LCLs will initially have a floating rate until borrowers request for fixing. For a floating-rate loan, the lending rate will change based on the underlying local currency benchmark. For fixed-rate loans, the lending rate will be based on the swap equivalent of ADB's cost base rate, with value applied on the rate-fixing date that corresponds to the maturity and amortization schedule of the disbursement. Rate fixings are subject to ADB being able to enter into appropriate hedging transactions in the local market.
- (iii) **Lending spread.** The lending spread should follow similar principles as those applied to ADB's LBL product.²² For loans guaranteed by the sovereign government, the proposed lending spread is 60 basis points (before Board-approved waivers). For nonguaranteed loans, risk-based pricing would be used to determine the lending spread. This would be negotiated separately for each loan based on similar principles as loans to private sector borrowers. In determining the lending spread for these loans, security arrangements, market-based pricing levels, and credit risk factors for a specific loan, among others, must be considered.
- (iv) **Front-end fee.** The proposed front-end fee is 1% for sovereign guaranteed loans (before Board-approved waivers), with the option to capitalize the fee, following the same approach as for the LBL product. For nonguaranteed loans, the front-end fee would be loan-specific, typically ranging from 1.0% to 1.5% of the loan amount, or less if the overall project return justifies it, following LBL practices.
- (v) **Commitment charge.** The commitment charge for local currency sovereign guaranteed loans should follow the LBL practice, i.e., 75 basis points on progressive amounts of undisbursed loan balances (to be reviewed in upcoming Commitment Fee Review Paper). For nonguaranteed loans, the commitment fee would be loan-specific in a proposed range of 50–75 basis points on undisbursed loan balances.

3. Prepayments and Cancellation

39. As proposed, borrowers would be allowed to prepay all or part of the disbursed and outstanding balance during the life of the loan. However, prepayment charges would apply based on the estimated negative carry, if any, that ADB incurs as a result of the prepayment for the remainder of the term of the prepaid loan. As in prepayments of LBLs, the negative carry would be calculated based on the difference, if any, between the rate at which the proceeds from the prepayment could be reinvested and ADB's funding liability for the prepaid amount. If a fixed-rate loan is prepaid, and the corresponding hedge transactions terminated, the borrowers would be charged the unwinding costs of the hedge transaction, if any. No prepayment charge would apply for floating-rate loans funded under the pool-based funding approach if prepayments occur on interest payment dates.

40. Borrowers would be allowed to cancel all or part of the undisbursed balance at any time. No cancellation charge would apply if ADB follows a pool-based funding approach. For back-to-back funding, if ADB has agreed with the borrower to pre-fund the local currency requirement

²² These principles were detailed in ADB. 2004. *Review of the Asian Development Bank's Income Planning Framework*. Manila.

for a particular loan and the borrower later decides to wholly or partially cancel the loan, a cancellation charge would apply based on the same principle used for prepayments (i.e., to compensate ADB for negative carry costs, if any, resulting from the loan cancellation).

41. Charges for prepayment and cancellation, and their calculation principles, would be included in the loan documents to ensure full transparency for borrowers.

4. Rebates and Surcharges

42. Rebates and surcharges would apply for sovereign guaranteed loans that are funded under the pool-based approach. These would be calculated based on ADB's funding cost relative to the local floating-rate benchmark. Thus, the actual sub-benchmark funding cost margin would be returned to the borrower through a rebate, and over-benchmark funding cost margin would be recouped from the borrower through a surcharge. This principle is identical to the pricing approach for the LBL product, and upholds the principle of automatic cost pass-through pricing.²³

5. Interest Rate Conversion Options of Local Currency Loans

43. Borrowers would be allowed to change the interest rate basis of a local currency loan at any time during the life of the loan by requesting an interest rate conversion to fix or unfix their interest rate, subject to relevant swap market opportunities available to ADB in the local market. The terms and conditions that ADB can achieve by executing the necessary hedging transactions would be passed on to the borrower, plus a transaction fee of 0.0625%, which is identical to the fee charged for these transactions under the LBL policy, except for the first series of interest rate conversions for which no fee shall be charged.

6. Currency Substitution

44. The local currency loan agreement would include a currency substitution clause. This would allow ADB to substitute temporarily another currency for the loan currency selected by the borrower if an extraordinary situation arose that prevented ADB from providing the selected currency for funding the loan due to access constraints in the local currency capital market. This principle follows established practices for the LBL product.

C. Impact on ADB's Financial Position

45. Local currency operations are expected to open up new lending opportunities for ADB, namely, borrowers unwilling or unable to borrow in foreign currency. ADB's local currency operations, therefore, would be largely an addition to—not a replacement of—its foreign currency operations. Since the proposed policies, terms, and conditions of the LCL product would follow essentially the same principles and approach as the LBL product, no material difference in net income contribution is expected between the two products. Thus, any migration from the LBL product to the LCL product should be net income neutral. If the LCL product could attract new clients, and increase ADB's overall lending volume, the product would be expected to raise ADB's net income.²⁴

²³ The mechanics of calculating rebates and surcharges would follow the same approach as for LBL loans, which are detailed in ADB. 2001. *Review of Asian Development Bank's Financial Loan Products*. Manila (para. 55).

²⁴ Subsovereign lending without sovereign guarantees—in foreign or local currency—might have different implications on net income not analyzed in this paper. The impact depends on, among other issues, ADB's credit risk policies, which will be reviewed and formulated by ADB's new credit risk management unit.

46. Under existing practice, at the end of each fiscal year, ADB's Board of Directors reviews its medium-term financial prospects and the adequacy of its net income and reserves as measures of ADB's risk-bearing capacity. Based on this review, the Board determines, among other things, the adequacy of ADB's loan charges, e.g., the front-end fee, commitment charges, and lending spread. The proposed local currency loan charges would be included in this annual review starting in 2006.

D. Portfolio Limit

47. Since local currency operations are relatively new for ADB, a portfolio limit on such operations is proposed. The proposed portfolio limit for local currency lending and guarantee operations²⁵ (sovereign guaranteed and nonguaranteed) should be set at 10% of ADB's total outstanding and committed loan and equity portfolio. Capping local currency operations would allow ADB to gain experience in this new area, and carefully identify and study the issues that might arise in local currency operations. The new credit risk management unit could review this limit, and the Board could make appropriate adjustments in the future, following a thorough assessment of ADB's local currency financing operations, which would be undertaken as appropriate.

IV. IMPLEMENTATION AND RESOURCE REQUIREMENTS

A. Operational Issues

49. Ensuring effective implementation would be essential to the successful take-up of the LCL product. This section highlights some of the operational requirements needed to ensure that the LCL product would be rolled out and mainstreamed in ADB's operations.

50. The CSP is at the heart of ADB's assistance to DMCs. Specifically, the CSP (i) defines ADB's medium-term development strategy, as agreed with the DMC; (ii) identifies and describes ADB's distinctive role, focused on ADB's overarching goal of reducing poverty, as well as the DMC's development priorities; and (iii) determines ADB's country-specific poverty reduction strategy, and thematic and sector priorities. Lending in local currency could open up new lending opportunities in a DMC, particularly to subsovereign borrowers. Thus, the Treasury Department should explore whether an LCL product could be offered in a DMC, and under what terms and conditions, before CSP and CSP update discussions take place. As part of a country assessment, Treasury would evaluate whether the local market in a country is conducive for ADB to offer an LCL product. This assessment could be undertaken jointly with the relevant operational departments, particularly the governance and finance divisions. For these divisions, this country assessment might be a useful input for the financial sector road maps. Through its involvement in CSP and CSP update discussions, Treasury would be able to talk with the DMC government about the specific terms under which an LCL product could be offered. These discussions could cover the required government approvals for the establishment of a debt issuance program, approvals to enter into CCS where available, and the more specific approvals required for local currency bond issues.

²⁵ Though not discussed in this paper, local currency guarantee operations need to be included in the total exposure limit given their potential impact on ADB's financial position.

51. Additional operational requirements include

- (i) Promoting borrowers' awareness of, and capacity to make informed decisions about, the LCL product using an outreach program, appropriate product information materials, workshops, and orientation sessions. The LBL product outreach program, which includes such workshops, easily could be expanded to include local currency products.
- (ii) Enhancing product delivery capacity within ADB to ensure that relevant operational staff are well informed about the LCL product features. This would include staff training and orientation sessions. Treasury should be able to integrate these training sessions into its regular outreach and product workshops for the LBL product.
- (iii) Establishing close cooperation between Treasury and operational departments during the design and processing of projects, and at loan documentation, to ensure that the market conditions in a DMC are reflected fully in the relevant project documents.

B. Managing for Development Results

52. The success of ADB's strategy and activities are measured by their impact on development in the region. In the LTSF, ADB committed to developing performance benchmarks for measuring the outputs of its assistance programs. To ensure that the long-term focus of ADB programs is maintained, the impact must be evaluated systematically. Further, the resulting feedback must be used continually to improve and enhance the effectiveness of ADB interventions.

53. Managing for Development Results is a management approach to improve the planning, monitoring, and evaluation of operations to achieve and sustain the intended development results. It requires, among others, (i) clear goals and objectives; (ii) systems for measuring, monitoring, and reporting on performance and results; (iii) application of feedback and learning on ongoing operations; and (iv) links between results, planning, and resource allocation.

54. To ensure that local currency lending operations achieve their stated objectives and contribute to ADB meeting its long-term strategic goals, this paper proposes that the LCL product be monitored on a regular basis. For this purpose, an evaluation matrix has been developed (Appendix 5). This matrix would be used for continual measurement of results and feedback on ongoing operations, as well as a more formal evaluation, as and when appropriate.

C. Resource Requirements

55. Local currency lending for private sector operations was introduced in 2002. Subsequently, Treasury built staff capacity to deal with the specific issues that arise in the context of local currency operations. Two positions within the Funding Division deal exclusively with local currency funding operations, and each covers three major borrowing countries. If local currency operations become mainstreamed across the region, one additional staff position might have to be added on the funding side. For local currency investments, one additional position is likely to be required if ADB establishes local currency pools. Existing staff and programs should handle outreach programs within and outside ADB, so no additional staff

positions should be required. In summary, the introduction of the LCL product would not lead to immediate or significant staff additions in the Treasury Department. The Office of the General Counsel would require one additional counsel position, as local currency operations require extensive legal input, since local capital markets typically have less developed legal and regulatory frameworks.

V. CONCLUSIONS AND RECOMMENDATIONS

56. This paper argues that ADB's provision of local currency financing solutions could play an important role in the context of ADB's LTSF. The private sector and subsovereign borrowers are likely to generate most of the demand for local currency loans. ADB potentially could contribute significantly in this area. Moreover, ADB's local currency financing activities could have major benefits for DMCs by developing local capital markets, contributing to reductions in currency mismatches, and catalyzing additional investor and cofinancing interest. To meet the demand of borrowers, Management proposes the introduction of an LCL product.

57. Management recommends that the Board approve the following actions by ADB:

- (i) create a new local currency lending facility, substantially based on the terms described in this paper (particularly in Appendixes 2 and 3), with respect to loans to be made from ADB's ordinary capital resources;
- (ii) the direct borrowing by ADB, from time to time, of funds denominated in the currencies of certain DMCs, subject to the required Charter and DMC regulatory approvals having been obtained and the limits of ADB's annual borrowing programs;
- (iii) the undertaking by ADB from time to time, of any currency liability swap transactions, interest rate swap transactions, and related transactions in connection with the lending operations and risk management transactions contemplated by the new LCL-based product described in this paper;
- (iv) consider the establishment of local currency pools in certain currencies based on the issues discussed in this paper, details of which would be reported to the Board through quarterly Treasury reports; and
- (v) establish a portfolio limit for local currency lending and guarantee operations at 10% of ADB's total outstanding and committed loan and equity portfolio.

**PROPOSED TERM SHEET FOR THE LOCAL CURRENCY LOAN PRODUCT FOR
SOVEREIGN GUARANTEED LOANS**

Features	Loan Terms
Currencies	Loans will be offered in selected local currencies if local market conditions provide suitable opportunities.
Maturity	Loans will be based on project needs for the grace period and final maturity, and subject to suitable funding opportunities available in the local market.
Floating Lending Rate	Loans will initially have a floating rate until borrowers request for fixing. As floating-rate loans, the lending rate will consist of a cost base rate plus a fixed spread. The cost base rate for floating rate loans will be based on a suitable local floating-rate market benchmark. The fixed spread will be set at the time of loan signing and will be fixed for the life of the loan. The fixed spread will be 0.6% per annum (before Board-approved waivers).
Fixed Lending Rate	At the time of fixing, the cost base will be the fixed-rate funding cost of the Asian Development Bank (ADB) for the relevant maturity payable by ADB under the relevant hedge swap transaction.
Lending Rate Reset Dates	For floating rate loans, the lending rates will be reset according to the specific terms of the loan agreement.
Surcharges and Rebates	ADB may grant rebates or impose surcharges if the basic lending spread changes and/or ADB's cost margin relative to the interest rate references changes.
Loan Conversion Options	The floating rate on the whole or part of the disbursed balance may be converted into a fixed-rate, or vice versa, for the whole or part of the loan's residual maturity, if ADB is able to transact appropriate hedging transactions in the local market. Conversions will be executed at the prevailing market rates.
Commitment Charge	75 basis points on progressive amounts of undisbursed loan balances (to be reviewed in upcoming Commitment Fee Review Paper).
Front-End Fee	1% of the loan amount before Board-approved waivers (may be capitalized over the life of the loan).
Transaction Fees	No fee for the first series of interest rate conversions undertaken by the borrower. All subsequent interest rate swaps will be charged a transaction fee of 0.0625% of the transacted amount.
Prepayments and Cancellations	For floating-rate loans, borrowers may prepay any outstanding amounts on the interest payment due date of the loan. However, prepayments will be charged a prepayment charge based on the difference, if any, between the rate at which the proceeds from the prepayment could be reinvested and ADB's funding cost for the prepaid amount. In the event of prepayment of fixed-rate loans or floating-rate loans that involve interest

Features	Loan Terms
	<p>rate conversions and the corresponding hedge transactions have to be terminated, the borrowers will be charged the unwinding costs of the hedge transactions, if any. No prepayment charges will apply for floating-rate loans funded under the pool-based approach if prepayments occur on an interest payment date.</p> <p>Borrowers may cancel all or part of the undisbursed balance at any time. However, for back-to-back funding arrangements, the borrower will need to pay a cancellation charge calculated as the present value of ADB's costs of carrying the canceled funds if ADB had agreed with the borrower to pre-fund the local currency requirement under the loan. No cancellation charge applies to loans funded under the pool-based funding approach.</p>
Currency Substitution	<p>If access to the loan currency is constrained, ADB will retain the right to replace the currency of the loan by a substitute currency until ADB's access to the loan currency is restored.</p>

**PROPOSED TERM SHEET FOR THE LOCAL CURRENCY LOAN PRODUCT FOR
NONSOVEREIGN GUARANTEED LOANS**

Features	Loan Terms
Currencies	Loans will be offered in selected local currencies if local market conditions provide suitable opportunities.
Maturity	Loans will be based on project needs for the grace period and final maturity, and subject to suitable funding opportunities available in the local market.
Floating Lending Rate	Loans will initially have a floating rate until borrowers request for fixing. As floating-rate loans, the lending rate will consist of a cost base rate plus a fixed spread. The cost base rate for floating rate loans will be based on a suitable local floating-rate market benchmark, adjusted by ADB's funding spread over/below the benchmark. The fixed spread will be set at the time of loan signing and will be fixed for the life of the loan. The spread will depend on the assessment of the credit and project risks of the loan.
Fixed Lending Rate	Rate-fixing will be available at the request of the borrower, and is subject to appropriate hedging transactions being available to ADB. At the time of fixing, the cost base will be the fixed-rate funding cost of the Asian Development Bank (ADB) for the relevant maturity payable by ADB under the relevant hedge swap transaction.
Lending Rate Reset Dates	For floating rate loans, the lending rates will be reset according to the specific terms of the loan agreement.
Loan Conversion Options	The floating rate on the whole or part of the disbursed balance may be converted into a fixed-rate, or vice versa, for the whole or part of the loan's residual maturity, if ADB is able to transact appropriate hedging transactions in the local market. Conversions will be executed at the prevailing market rates.
Commitment Charge	50–75 basis points on undisbursed loan amounts.
Front-End Fee	1.0–1.5% on the loan amount, or less if justified by the overall project return.
Transaction Fees	No fee for the first series of interest rate conversions undertaken by the borrower. All subsequent interest rate swaps will be charged a transaction fee of 0.0625% of the transacted amount.
Prepayments and Cancellations	For floating-rate loans, borrowers may prepay any outstanding amounts on the interest payment due date of the loan. However, prepayments will be charged a prepayment charge based on the difference, if any, between the rate at which the proceeds from the prepayment could be reinvested and ADB's funding cost for the prepaid amount. In the event of prepayment of fixed-rate loans or floating-rate loans that involve interest

Features	Loan Terms
	<p>rate conversions and the corresponding hedge transactions have to be terminated, the borrowers will be charged the unwinding costs of the hedge transactions, if any. No prepayment charges will apply for floating-rate loans funded under the pool-based approach if prepayment occur on an interest payment date.</p> <p>Borrowers may cancel all or part of the undisbursed balance at any time. However, for back-to-back funding arrangements, the borrower will need to pay a cancellation charge calculated as the present value of ADB's costs of carrying the canceled funds if ADB had agreed with the borrower to pre-fund the local currency requirement under the loan. No cancellation charge applies to loans funded under the pool-based funding approach.</p>
Currency Substitution	<p>If access to the loan currency is constrained, ADB will retain the right to replace the currency of the loan by a substitute currency until ADB's access to the loan currency is restored.</p>

KEY REGULATORY APPROVALS AND CONFIRMATIONS TYPICALLY SOUGHT BY THE ASIAN DEVELOPMENT BANK ON LOCAL CURRENCY FINANCING

A. Asian Development Bank (ADB) Bond Issues

1. ADB Charter Approvals

1. For ADB to be able to issue bonds, a number of Charter approvals need to be obtained which include:

- (i) Article 21, paragraphs (i)(a), (b), and (c), and paragraph (ii) of the Charter:
 - (a) approval for ADB to sell the bonds in the DMC (Article 21, paragraph [i][a]);
 - (b) approval for ADB to denominate the bonds in the DMC's local currency (Article 21; paragraph [i][b]);
 - (c) approval for ADB to exchange the proceeds of the bonds for the currency of any member of ADB without restriction (Article 21, paragraph [i][c]); and
 - (d) approval to buy and sell securities ADB has issued or guaranteed, or in which it has invested (Article 21, paragraph [ii]).
- (ii) Article 56, paragraph 1 of the Charter:
 - (a) Confirm that interest payments by ADB on the bonds will not be subject to withholding tax, and specifically that ADB and its agents may make interest payments to bondholders on a gross basis without deduction for any withholding tax;
 - (b) Confirm that the issuance of the bonds and registration of any related documents will be exempt from stamp duties and other taxes.

2. These requirements result directly from ADB's Charter, and such approvals and confirmations have been received in all countries in which ADB has issued bonds.

2. Bridge-Financing Approvals

3. In case the underlying local currency loan falls into arrears, ADB needs to bridge-finance its local currency liabilities and therefore requires the following approvals:

- (i) Provide the Charter approvals in paragraph 1 on a standing basis up to the amount of the outstanding bonds plus interest, if any, for as long as ADB has bonds and/or local currency loans outstanding; and
- (ii) Confirm that ADB is allowed to set up a credit line with a local financial institution.

3. Permit Use of ADB's Financial Statements

4. ADB publishes its financial statements according to United States Generally Accepted Accounting Principles. Restating its financial statements according to local accounting standards would incur significant costs and would lead to substantial time delays, which would make local bond issues uneconomical. ADB therefore requests the use of ADB's financial statements for local currency bond issues without any additional requirements to restate them

according to local accounting standards in the relevant issuing country. ADB has received this approval in all of the more than 15 countries in which it has issued bonds.

4. Domestic Rating Exemption

5. ADB is rated by the three international rating agencies, Standard & Poor's, Moody's Investors Service, and Fitch Ratings. In addition to having an issuer rating, local currency bond issues by ADB are typically also rated on an "issue" basis by the international credit rating agencies. ADB therefore requests to waive the requirement to obtain a domestic rating and permit ADB's international ratings to be used. Many of the local credit ratings in DMCs have cooperation agreements with these international credit rating agencies and follow the best practices established by international rating agencies. Local investors are fully familiar with the criteria and methodologies of the international credit rating agencies. As such, requiring an additional domestic rating would add no value to the main objective of credit ratings: helping local investors understand the credit fundamentals of the issuer.

5. Liquidity Management

6. ADB may need to invest local currency liquidity temporarily to avoid any negative carry costs of holding such liquidity. It therefore requires confirmation that it may invest local currency liquidity, as well as interest payments and principal repayments of the local currency loans, in the following instruments: government bonds, bonds guaranteed by the national government, treasury bills and similar instruments, banking instruments (all available instruments such as deposits, bilateral lending, and money market instruments, etc.), and repo transactions (where available).

7. Related to the preceding investment transactions, ADB therefore requests the following approvals from the host government:

- (i) ADB's tax exemptions under Article 56 of its Charter will apply to all investment income,
- (ii) ADB may appoint a local custodian, and
- (iii) ADB may open a cash account to receive the proceeds of bond issues and for investment and interest rate swap transactions.

6. Interest Rate Risk Hedges

8. Interest rate hedging transactions are critical to ADB being able to meet the demands from its borrowers for either fixed rate or floating rate loans. In connection with hedging its interest rate risk through swaps and repo transactions, ADB therefore requests the following approvals and confirmation:

- (i) approval to enter into interest rate swaps associated with the bonds and the local currency loans with eligible swap counterparties of ADB,
- (ii) approval to undertake repo transactions with eligible swap counterparties of ADB, and
- (iii) confirmation that ADB's tax exemptions will apply to any amounts payable by ADB or paid to ADB from all swaps and repo transactions.

7. Eligibility of Domestic and Foreign Institutional Investors.

9. ADB requests approval for qualified domestic and foreign institutional investors to invest in ADB-issued bonds. Wide distribution of ADB bonds helps the pricing of the bonds, and benefits institutional investors keen on diversifying their assets into the AAA-rated asset class.

8. Eligibility of ADB Bonds for Statutory Reserve Requirements of Banks

10. Given the high credit rating of ADB bonds, a number of countries have decided to include ADB bonds on the list of eligible instruments for reserve requirements of banks. Thus, ADB encourages DMCs to designate ADB bonds as eligible instruments for reserve requirements and repo transactions for commercial banks.

9. 0% or 20% Asset-Risk Weighting.

11. ADB requests that ADB bonds will receive a 20% asset-risk weighting in line with the current treatment of financial instruments issued by multilateral development banks promulgated by the Basel Committee on Banking Supervision in International Convergence of Capital Measurements and Capital Standards, or a 0% risk weighting in line with the new Basel II guidelines to be implemented over the next years according to country-specific implementation schedules.

B. ADB Cross-Currency Swaps

1. Conduct Cross-Currency Swaps

12. Cross-currency swaps are a flexible funding instrument to meet specific disbursement and amortization schedules of projects. At the same time, cross-currency swaps serve to provide hedging opportunities for local entities that need to hedge currency and interest rate risks. Thus, these instruments are a “win-win” for all parties involved. ADB’s ability to enter into such transactions is important to provide a flexible funding option to ADB which is to the benefit of its borrowers. ADB therefore requests approval to enter into such cross-currency swaps, when and where appropriate in a local market, on terms and conditions approved by the relevant DMC government.

LOCAL CURRENCY LOAN PRODUCT RESULTS FRAMEWORK

Challenges and Opportunities/ Rationale for the LCL Product	Expected Outcome	Monitoring Indicators	Monitoring Mechanism and Data Sources	Risks and Assumptions
<ul style="list-style-type: none"> • Subsovereign borrowers emerging as an important new borrower class in DMCs • Subsovereign and private sector borrowers often unable to hedge currency risk associated with foreign currency borrowing • To meet this emerging demand, ADB should enhance its product range to include local currency products 	<ul style="list-style-type: none"> • ADB to better be able to meet the demand of subsovereign borrowers in DMCs 	<ul style="list-style-type: none"> • Number of new subsovereign and private sector borrowers using LCL product • Total number of local currency loans • Total volume of local currency loans 	<ul style="list-style-type: none"> • RRP • ADB Treasury Reports • ADB Annual Report 	<ul style="list-style-type: none"> • Assumes that DMCs provide timely regulatory approvals for ADB to raise local currency on a cost-efficient basis • Close cooperation needed between lending and treasury departments to meet the demand of borrowers
<ul style="list-style-type: none"> • Local capital markets are often under-developed, especially for longer maturities • ADB has extensive experience in raising long-term capital in the region 	<ul style="list-style-type: none"> • ADB to contribute to development of long-term local currency capital markets 	<ul style="list-style-type: none"> • Growth rate of local currency capital markets in countries of ADB's LCL operations • Number of innovations launched by ADB bond issues • Number of local investors benefiting from ADB's AAA-rated credit rating • Volume of swap transactions in connection with ADB local currency lending 	<ul style="list-style-type: none"> • ADB Asia Bond Monitor • Bond / Swap Documentation • ADB bond distribution statistics 	<ul style="list-style-type: none"> • ADB to work closely with DMCs on developing long-term capital markets • Close cooperation within ADB to ensure consistent policy dialogue and targeted technical assistance
<ul style="list-style-type: none"> • Local financial institutions are often risk-averse to lend, especially at longer maturities • ADB is in a unique position to catalyze long-term local currency lending, given its long-standing experience as a long-term project lender 	<ul style="list-style-type: none"> • Enhanced role for ADB to catalyze local currency lending in DMCs 	<ul style="list-style-type: none"> • Volume of cofinancing raised • Number and type of co-financiers involved 	<ul style="list-style-type: none"> • ADB Co-financing Reports • RRP • Project Monitoring Reports 	<ul style="list-style-type: none"> • Assumes close cooperation with local financial institutions • Networking with local financial institutions will be required