



**ASIAN DEVELOPMENT FUND (ADF)**  
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## **New Currency Management Framework for ADF**

**Asian Development Bank**

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## ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
ANE	–	accelerated note encashment
DMC	–	developing member country
EACA	–	expanded advance commitment authority
IDA	–	International Development Association
SDR	–	special drawing right
US	–	United States

## GLOSSARY

special drawing right (SDR)	The SDR is a unit of account of the International Monetary Fund and some other international organizations. Its value is based on a basket of key international currencies. The last review of the currency basket covers 2006–2010.
SDR currencies	Currencies that constitute SDR currently include euro, Japanese yen, pound sterling, and US dollar.

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## EXECUTIVE SUMMARY

This report updates Asian Development Fund (ADF) donors on the background and implementation status of the new ADF currency management policy approved by the Board of Directors of the Asian Development Bank (ADB) in October 2005 and on related areas for further research and improvement.<sup>1</sup> The new framework represents a major improvement to ADF financial management as it will streamline ADB's internal currency practices and enhance the fund's currency risk management capacity. More importantly, this initiative will significantly benefit ADF borrowers.

The implementation started in January 2006. Since then, outreach programs have been conducted for borrowers. A comprehensive multi-currency cash flow model for ADF is currently being developed that will strengthen its financial management capability. ADF liquidity will be maintained in four currencies that constitute special drawing right (SDR) at the end of 2006, and periodic currency alignment to SDR weights will be undertaken based on the results generated by the new model. Progress and issues related to the implementation will be reported to the Board through quarterly treasury reports.

With the introduction of the new framework and the completion of the model, a number of ADF financial policy-related issues will be subject to further review. An ADF-specific liquidity policy with detailed investment guidelines can be initiated. Possible improvements and changes to expanded advance commitment authority may also be proposed during ADF X negotiations.

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<sup>1</sup> ADB. 2005. *Asian Development Fund Currency Management Proposal*. Manila (R265-05).

## I. THE NEW CURRENCY MANAGEMENT FRAMEWORK

1. The new currency management framework simplifies the Asian Development Fund (ADF) currency system by shifting to a full-fledged special drawing right (SDR) approach instead of managing ADF resources in as many as 15 currencies. While ADF donor contributions will still be made in national currencies, United States (US) dollars (\$), or SDR, the Asian Development Bank (ADB) will convert donor contributions and ADF loan reflows into SDR. Borrower's new obligations (i.e., principal and interest payments) will be determined in SDR rather than in national currencies. The new currency framework will:

- (i) benefit borrowers with a simplified and predictable currency practice;
- (ii) create a more consistent loan product for developing member countries (DMCs);
- (iii) harmonize ADB's practices with those of other multilateral development banks, especially the World Bank Group's International Development Association (IDA);
- (iv) manage and mitigate exchange risk exposure for both borrowers and ADB;
- (v) enhance ADF resource management and financial planning capabilities.

2. The new currency framework will not change the manner in which ADF replenishment negotiations are conducted, the performance-based allocation methodology, or ADF loan terms.

## II. IMPLEMENTATION UPDATE

### A. Implementation for Developing Member Countries

3. Since the approval of the new currency framework, Management has taken various measures to smooth implementation. DMCs were fully informed regarding the benefits and salient features of the new policy and brochures were distributed to relevant ministries in DMCs through resident missions. Since November 2005, ADB has conducted workshops in Bangladesh, Cambodia, Mongolia, Nepal, and Pakistan and has distributed presentation materials during loan disbursement seminars in Sri Lanka and Viet Nam. Several participants from DMC ministries of finance confirmed that they would significantly benefit from the new currency policy, citing simplified currency planning and streamlined debt management. Some participants expressed interest in the possibility of ADB offering the option to convert existing loan balances to SDR.

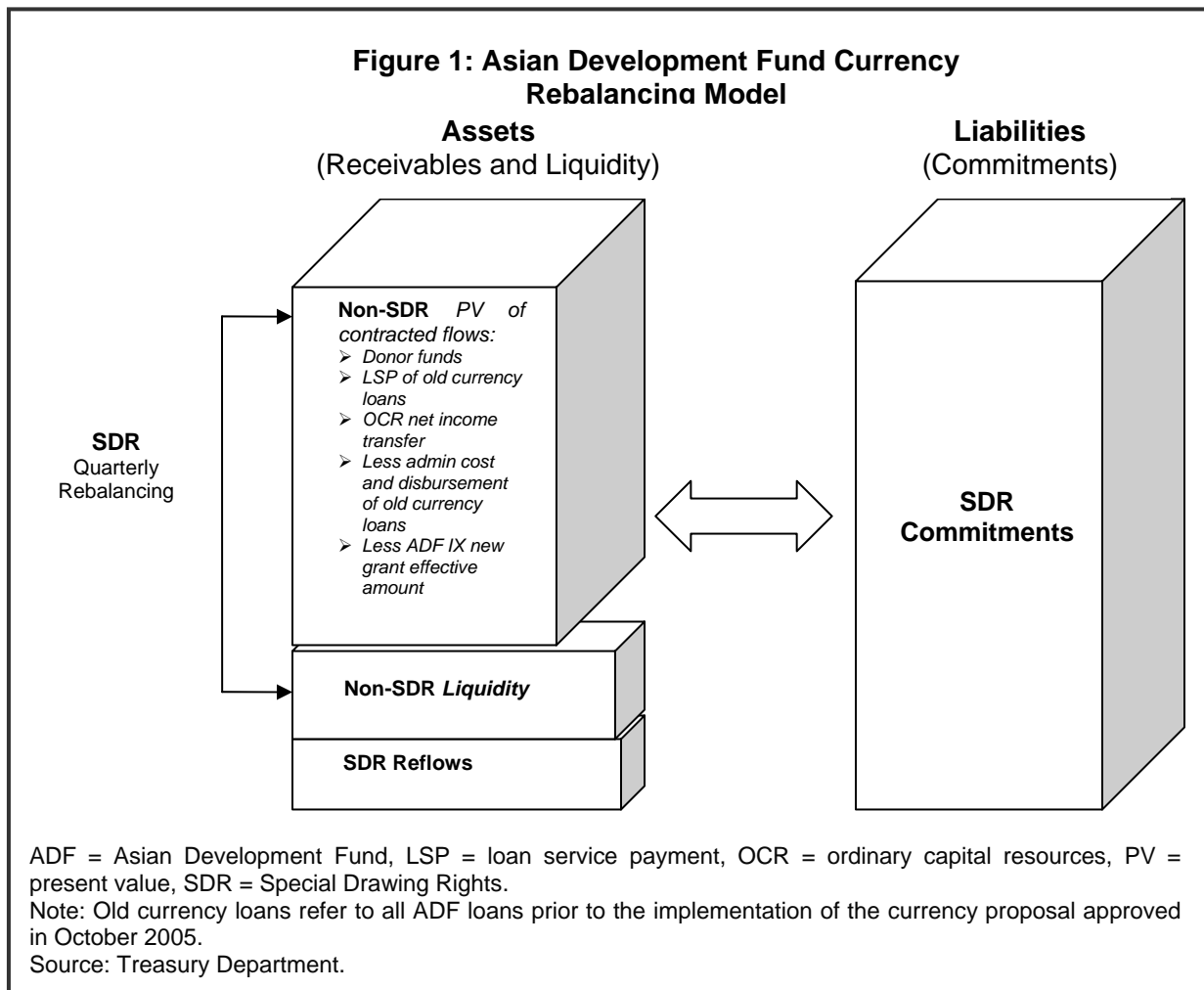
### B. Implications for the Asian Development Bank

4. Implementing the new currency management framework has required extra staff resources and system enhancements; these are currently being accommodated by internal and temporary resources within the existing administrative budget.

5. *Revised currency management:* The new framework directly affects management of ADF liquidity. First, all non-SDR currency portfolios and cash flows will be converted into SDR currencies, except for the ADF grant portfolio and restricted-ADF portfolio. Second, in order to align the SDR commitment with disbursement requirements, periodic currency rebalancing is required. The Treasury Department started the necessary currency conversions in early 2006. As of 30 September 2006, approximately \$1.8 billion in non-SDR currency portfolios and cash flows had been converted into SDR currencies (primarily into US\$), constituting more than 75% of the total conversion needed. The target date to achieve the initial currency rebalancing into SDR weights is early 2007 based on current projections.

6. *Developing the ADF financial projection system:* A comprehensive multicurrency model for ADF is being developed in-house to accommodate the currency rebalancing requirements of the new framework. Under the new system, non-SDR assets will be realigned with SDR-denominated liabilities, thus minimizing currency risks through improved asset and liability management. The new model will be a multi-user system that can store analyzed reports and perform back-testing and scenario analyses. This new model will (i) be cash-flow driven and updated quarterly, (ii) be based on the current ADF financial framework, (iii) assume currency-specific return on investment income, (iv) have clean and protected data, (v) have centralized assumptions, and (vi) be able to group cash flows as required. Figure 1 depicts the general structure of the forward-looking currency rebalancing model from a cash flow perspective; there are many similarities to the approach of IDA.

7. In addition to currency rebalancing and minimizing currency risk, the new financial system will enhance ADF financial management capacity through (i) better projection of ADF financial positions, (ii) enhanced support for ADF lending and resource planning, and (iii) better understanding of expanded advance commitment authority (EACA) and ADF liquidity management through scenario analyses. The initial model test-run began in August 2006.



8. *Adjusted investment of proceeds from the accelerated note encashment program:* With the introduction of the SDR-based framework, existing accelerated note encashment (ANE) portfolio investments in non-SDR currencies are being unwound and converted to SDR currencies during the 2006 transition period. The converted ANE liquidity and future cash inflows are to be invested in SDR currencies for longer-term maturity. ANE portfolios will be monitored in aggregate as a separate sub-pool within the total ADF liquidity pool. The ANE credit that ADB has agreed with the donors remains unchanged. As of 30 September 2006, approximately \$111 million non-SDR ANE portfolios had been converted (primarily to US\$-denominated investments).

9. *Modified loan accounting system:* The ADF loan accounting system has been modified to enable it to generate SDR billings, records of SDR balances and proceeds, and simplified currencies in the loan service payment system.

### III. ADDITIONAL INITIATIVES

#### A. Asian Development Fund Liquidity Management

10. As an integral part of implementing the new currency framework, ADF's liquidity and investment practices should be reviewed. The change from the currency prioritization principle based on previous practices may reduce ADF's investment income.<sup>2</sup> This potential loss can be mitigated by enhanced duration management under the new asset and liability management framework. There are currently no specific liquidity policy or investment guidelines for ADF other than the minimum allowable liquidity guideline under the EACA scheme and the blanket investment guidelines covering all ADB portfolios. The establishment of an effective ADF-specific liquidity policy and of investment guidelines will be critical to achieve an optimal currency rebalancing scheme and to compensate for potential losses in investment income.

11. ADB will undertake a study of the ADF liquidity policy when resources permit. In the interim, detailed ADF investment guidelines need to be created based on the yet-to-be developed liquidity policy. Ideally, a liquidity policy and investment guidelines can be discussed with donors during ADF X negotiations before finalization for approval of the Board of Directors.

#### B. Reflow-Based Resources

12. A key pillar of current ADF resource management is the EACA framework. EACA comprises the reflow-based resources that can be committed in advance while maintaining adequate liquidity. Since its establishment in 1997, several minor revisions have been made. The new currency framework and the new financial projection model provide a timely opportunity for major revisions in the EACA framework and for considering possible improvements during ADF X negotiations.

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<sup>2</sup> Because of the previous requirement to retain the currency composition of ADF resources, ADB adopted a currency prioritization working principle to maximize investment income. Low-yield currencies were disbursed first and recalled last, while high-yield currencies were disbursed last and recalled first.

#### **IV. CONCLUSION**

13. Management believes the new currency framework represents a major improvement in the financial management of ADF and acknowledges the support and approval of ADF donors and shareholders. Progress on and issues related to implementation will be reported to the Board through quarterly Treasury reports.

14. Implementation has many implications for both DMCs and for ADB. The comprehensive multicurrency projection model under development will significantly enhance the financial management capability of ADF. ADF liquidity will be maintained predominantly in four SDR currencies at the end of 2006, and periodic currency alignment to SDR weights will be undertaken based on results generated by the new model once it is completed. Additional initiatives will be taken to establish an ADF-specific liquidity policy with detailed investment guidelines. Possible improvements and changes to EACA may also be proposed during ADF X negotiations.