

# The Local Currency Financing Revolution

by

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and

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## *The local currency financing revolution*

One of the biggest problems in cross border investments is the exchange risk. This is particularly true in emerging countries, where many have sunk millions of dollars in hard currencies into various projects only to watch their investments eroded by currency depreciations. Now the Asian Development Bank has devised a scheme to alleviate the problem, write the bank's Robert Bestani and Ajay Sagar.

One of the principal characteristics of emerging country currencies is their volatility and susceptibility to devaluation. Indeed, this tendency has a self-perpetuating characteristic. As investors see the volatility of a particular currency, they become hesitant to invest. The lack of investment, in turn, leads to a weakening of the macro-economic climate, which results in a weaker currency. This has led to one of the most important and vexing problems in international finance – the inability of capital markets to provide a stable flow of capital to emerging countries.

The highly disruptive experience of the second half of the 1990s also led many emerging countries to avoid exposure to the vagaries of international markets. The result was a weakening of investment flows as countries built up their foreign currency reserves for new upheavals in the future.

But, in the years ahead, developing countries will need to invest billions of dollars and their local currency equivalent to build a strong infrastructure, including roads, power, ports and water supply to spark an investment boom. The requirement is immense. These countries also need to strengthen their financial sector, a prerequisite for achieving even slow growth. So the real question is how to minimize the risks to attract capital.

Most potential investors would, of course, prefer to invest in local currency for at least a part of their funding needs. A mixed funding package, using local and hard currency, provides a measure of protection against market volatility. The precise combination depends on the investor's expectation of what the volatility pattern might be.

Unfortunately, however, in most emerging countries the capital markets are not sufficiently well developed to provide long-term loans in the local currency. At best, only short-term local currency denominated loans are available and these are subject to refinancing risks, interest rate volatility, etc. The higher risk premium in turn leads to a higher price to the consumer.

The Asian Development Bank (ADB) recently introduced an innovative local currency swap mechanism, which has the potential to dramatically change the situation concerning unhedged exchange rate and tenor mismatch risk. It is designed to bridge the gap between the needs of investors and emerging markets. This initiative has the potential for changing not only the profile of private sector financing in Asia but in most emerging economies. Other multilateral institutions, including the IMF, have taken a keen interest in this approach, arguing that, had this instrument been available earlier, it might have prevented or at least contained the crisis that engulfed the Argentinean and Asian economies during the late 90s.

ADB recently approved a \$200 million swap for up to 15 years for the Philippines and this is expected to be the first among many such financings across Asia. ADB anticipates doing similar transactions in most of the 44 countries in which it currently operates.

The initiative involves ADB undertaking a local currency swap with a developing member country (DMC), and using the local currency proceeds to provide long-term lending to private sector financial intermediaries for on-lending to local borrowers. ADB will thus

swap a given amount to the DMC, say \$100 million in exchange for the equivalent in local currency. At the end of 10 years (as per the agreement) the transaction will be unwound and the ADB will repay the local currency in exchange for dollars. In the meantime, ADB will lend the local currency to creditworthy financial institutions in the country at a fixed interest rate.

Underlying these fixed rate, local currency loans are well-crafted agreements to ensure the funds are on-lent to “developmentally friendly” investments and projects. Thus, the ADB will absorb the risk of the country and the resident banks, both domestic and foreign. The resident banks will in turn absorb the commercial risk. In this manner, each player will take on the task for which it is best equipped to handle.

The expectation is that this new funding approach will attract fresh capital to emerging

countries. First, the banking system is strengthened as maturity and currency mismatches are avoided. Second, consumers gain through greater availability of goods and services and protection from abrupt and unpredictable increases in tariffs caused by adverse currency fluctuations. Third, it spurs foreign direct investment. Fourth, it promotes financial sustainability in projects as targeted borrowers overcome associated exchange risks with currency mismatches. Lastly, it improves financial intermediation. By seeking ways to fund in local currency, external lenders would contribute to the creation of an efficient and strengthened financial system.

The initiative is an alternative to the traditional two-step lending offered by multilateral and bilateral agencies to government-owned development finance institutions. State-owned banks have often been used as instruments of directed lending without employing the requisite economic and financial viability tests.

**Philippines: Peso financing facility’s salient features**

**Description:** In the Philippines, ADB has approved a Peso-denominated Financing Facility for targeted sectors through the participation of both local and foreign banks. The Financing Facility is a \$200 million equivalent lending program to participating banks for on-lending to projects, companies or consumers in eligible sectors in the Philippines. These projects or companies could be local or foreign owned business enterprises operating in the Philippines. The Facility is expected to have unambiguously positive benefits for the local economy resulting in job creation, output boost and strengthening of the local banking system. Local consumers are likely to be the biggest beneficiaries.

**Participating Banks:** Following banks operating in the Philippines have been selected as participating banks. ABN Amro Bank, ANZ Banking Group Ltd., Bank of America, N.A., Bank of the Philippine Islands, Bank of Tokyo-Mitsubishi Ltd., Citibank, N.A., Chinatrust, Deutsche Bank, Hong Kong & Shanghai Banking Corp., Internationale Nederlanden Groep Bk, International Commercial Bank of China, JP Morgan Chase Bank, Maybank Philippines, Inc., Metro Bank, Mizuho Corporate Bank Ltd., Standard Chartered Bank, and United Overseas Bank. Participating banks may lend either directly to ultimate borrowers or through local banks and other financial intermediaries. These banks were selected based on a minimum requirement of a Standard & Poor’s (S&P) long-term BBB credit rating (or the equivalent from Moody’s or Fitch) for international banks, and an S&P long-term BB credit rating (or equivalent) for local banks.

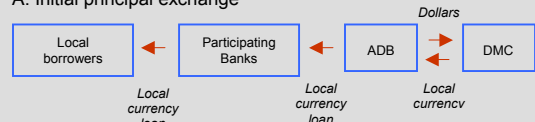
**Eligible Sectors:** The eligible sectors are infrastructure, transport, manufacturing, small and medium enterprises, housing, and environment improvement related expenditure. Proceeds could also be used to finance leasing and non banking finance companies, consumer lending, retailing, modernization and upgrading of production facilities, resolution of non-performing bank loans, securitization, and bond market development. On-lending for sectors such as involving processing of narcotics, spirits, tobacco, and radioactive materials or which are environmentally hazardous is not allowed. ADB may approve any other sector, at its discretion.

The proceeds of the Facility may also be utilized in restructuring of existing infrastructure and transport project that are still exposed to unhedged currency and tenor mismatch risks. ADB’s prior endorsement is required in such cases.

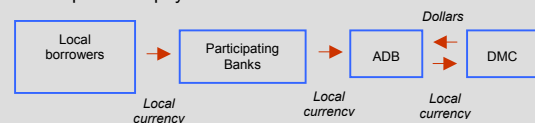
**Main Terms:** Tenors could go up to 15 years inclusive of a suitable grace period based on an agreed amortizing schedule. A market based interest rate, linked to credit rating of the participating bank will be charged. ADB will not provide revolving loans. Loans that have been repaid to ADB may not be re-borrowed. Compliance with all applicable environmental regulations and ADB’s environmental and social policies in respect of their on-lending is mandatory.

**Schematic diagrams**

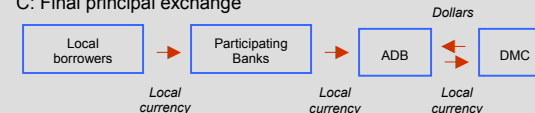
A: Initial principal exchange



B: swap/interest payments



C: Final principal exchange



ADB=Asian Development Bank, DMC=Development Member Country.

In turn, these state-owned banks often incur losses, requiring them to be funded with taxpayer's money.

The old financing patterns made "user pays" based infrastructure projects financially vulnerable. The multinational and bilateral financial institutions that have been working to attract new capital to emerging markets have had to struggle with similar problems. Local currency financing is considered crucial to the success of both financial and infrastructure sectors, especially for projects with revenues denominated in local currency.

ADB's initiative is dictated by market-based pricing mechanisms, thereby avoiding subsidized lending. Another significant feature is that ADB will use only private sector banks—both foreign and domestic - as financial intermediaries without requiring sovereign guarantees. (See box story for salient features of the pilot facility approved in the Philippines.)

In the undertaking local currency lending, individual developing country markets and

regulatory environment will dictate the modality of intervention i.e., currency swap or a bond issue. Some of the factors to be considered include adequacy of foreign currency reserves, maturity profile of foreign currency reserves, balance of payment position, internal savings rate, balance of trade, fixed or floating exchange rate, and depreciating nature of local currency.

ADB looks for alternatives best suited for individual circumstances but the idea is to inject long-term local currency funding whenever possible. In India, ADB has approved direct financing in Indian rupees for health care, power transmission, and housing mortgage projects to be funded through a recently launched local bond issue. While the bond issue in India is the first step in ADB's strategy to tap domestic bond markets, ADB is examining the potential for undertaking similar issues in People's Republic of China and Thailand. At the same time, ADB is also considering undertaking local currency swaps in Bangladesh, Indonesia and Kazakhstan. ADB will also work to provide partial credit

### Promoting Partnerships

Despite the changes in crisis-hit countries after the Asian crisis of 1997 in regulating foreign bank entry, foreign bank penetration in Asia remains low but is expected to increase in the near future. Increased foreign bank penetration in Asia can be expected to increase the competitiveness, efficiency, and the stability of the financial sector. Involvement of foreign financial institutions can then contribute to the stability of a country's banking sector in the face of macroeconomic fluctuations. Involvement of private banks could cut corruption, improve corporate governance, and result in transparency and corporate social responsibility that in turn will generate confidence in the country's financial sector.

Multilateral agencies such as ADB are now required to build up capacity so that international lenders have the capacity and capability to fund in local currency. Moving forward, ADB will seek ways to collaborate on this initiative with multilateral and bilateral agencies in order to create capacity. ADB favors participation of both local and foreign financial institutions. Local banks have the relationships and branch networks but are capital constrained. Foreign banks have capital and risk bearing capacity but no access to clients.

ADB encourages a collaborative and partnership effort between foreign and local banks.

Participation of foreign banks can help nations greatly. Participation of foreign banks is a form of attracting and retaining FDI. The presence of foreign banks results in improvement in financial infrastructure, competition (benefits the consumer), risk management, transparency, and banking regulation. Such presence stimulates the establishment and strengthening of rating agencies, auditors, credit bureaus and the development of the host country's supervisory and legal framework. The benefits include, not just the initial capital inflow itself, but also the introduction of better technology and new management skills. The task of a central bank or a financial regulator is easier if, with the presence of foreign banks and attracting FDI, a higher regulatory standard is created. With a heavy presence of foreign banks, the government is less likely to bail out troubled domestic banks. This in turn brings in discipline and allows governments to monitor the banks properly. It also promotes market mechanisms, allowing unsecured depositors to take informed decisions, as they will feel much less secure if the banks are not functioning properly.

guarantee to local projects to enable banks and project sponsors to directly source local currency from loans or bond issues. Ultimately, it is ADB's hope to be able to provide long-term, fixed rate, local currency funding in all of the countries in which the Bank works.

In Asia, a rising level of demand for debt financing is a natural complement to the recovery of growth in foreign direct investment. The potential is significant as considerable financial resources can be mobilized in emerging countries without adding unnecessary risks. The Asian emerging market is now moving towards transparent accounting standards, similar to international accounting standards that require borrowers to charge any devaluation losses on their borrowings to their income as compared to the earlier practice of capitalizing it.

Borrowers can thus not delay recognition of such losses in their income statements. Borrowers now prefer meeting long-term debt requirements by raising debt denominated in local currency. An increase of local currency lending alternatives structured appropriately holds the prospect of a win-win outcome for all the parties involved. Such a mechanism may broaden the pace of development of local capital markets in developing countries by injection of long-term local currency funding in to the banking system.

Across all of its operations, ADB participation is intended to catalyze financing from local or foreign sources, not to compete with these sources. ADB's dual capability of having public and private sector operations offers important synergies. This combination enables ADB to deliver a 'comprehensive development solution'. The demand for private capital has increased in the Asian region, influenced by the financing needs of large infrastructure development programmes, as well as capitalization needs of financial institutions.

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While official development aid continues to be an important element in the development strategies of ADB and its developing member countries, it is inadequate to meet their growing capital requirements.

Attracting private capital is a major strategic objective for ADB and many of its member governments. ADB is working towards alternatives that generate capacity and in structuring its local currency lending through financial intermediaries, is involving both domestic and foreign lenders. Governments in ADB's developing member countries are understandably eager to promote private sector development. (See Box – Promoting Partnerships.)

Local currency lending is now considered as a better alternative to hard currency lending especially for borrowers that earn their revenues denominated in local currency. Though in some cases the foreign exchange risk can be mitigated through market-based swaps and hedging instruments, the hedge market is still underdeveloped. Long term funding in local currency could either come through local bond markets – which are still under developed, or through a structured initiative of ADB involving a swap with its developing member country. Capital markets in developing countries are in their infancy. They do not only comprise of bond markets but also include equity and derivative markets. While efforts are ongoing for developing local capital markets, ADB's local currency initiative is timely and provides a unique and innovative solution to address concerns of borrowers and sponsors.

ADB's initiative is structured to keep in view the interest of the local consumers and users of local infrastructure. The positive impact on the local industry is enormous, thereby raising national income while lowering prices and benefiting consumers. The spillover benefits are substantial. Increased economic activity generates demand, which is accompanied by creation of new wealth. Providing local currency financing by multilateral agencies is an idea that could help address a number of issues.

