

## **OPERATIONS MANUAL POLICIES AND PROCEDURES**

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These policies and procedures were prepared for use by ADB staff and is not necessarily a complete treatment of the subject. This *Operations Manual* was prepared by the Treasury Department (TD) and issued by the Strategy, Policy, and Partnerships Department with the approval of the President and is subject to compliance review. Questions may be directed to the assistant treasurer, Financial Policy and Planning Division of TD.

### **FOREIGN EXCHANGE RISK**

#### **A. Scope**

1. Article 13 of the *Agreement Establishing the Asian Development Bank* (the Charter) provides that the Asian Development Bank (ADB) may provide financing by (i) lending in a currency other than the local currency of the member country to meet the foreign exchange costs of a project in that member country, or (ii) lending in a local currency to meet local expenditures where it can do so without selling its holdings in gold or a convertible currency.<sup>1</sup> Article 15 of the Charter further stipulates that ADB cannot accept foreign exchange risk in its lending operations.

2. This *Operations Manual* section deals with the question of attributing the foreign exchange risk associated with ADB's lending operations.

#### **B. Policy on Lending Operations**

##### **1. General Principles**

##### **a. Regular Ordinary Capital Resources**

3. ADB manages the exchange risk in its operations by matching the currency or currencies loaned with those of the borrowings used to fund loans on an after-swap basis. As a result, ADB does not accept foreign exchange risk in its ordinary capital resource (OCR) lending operations.

4. Regular OCR borrowers can choose between two loan products: (i) the Flexible Loan Product (FLP) and (ii) the local currency loan (LCL) product (available only in selected markets). For the FLP, borrowers may choose to denominate their loans in euro, Japanese yen, United States (US) dollars, or other major currencies in which ADB can efficiently intermediate. For the LCL product, the Treasury Department will be able to advise borrowers on the details of the product for each specific market.

5. Under the FLP, during the life of the loan borrowers are also given the option to convert the currency or currencies the loan is denominated in into another major currency or, in selected cases, to a local currency, subject to ADB being able to enter into appropriate hedging transactions.

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<sup>1</sup> ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

## **OPERATIONS MANUAL POLICIES AND PROCEDURES**

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### **b. Concessional Ordinary Capital Resources**

6. Prior to 2017, Asian Development Fund (ADF) loans were only committed in special drawing rights (SDR). Following the combination of ADF loans with the OCR balance sheet effective on 1 January 2017, ADF loans were transferred to the OCR concessional window.<sup>2</sup>

7. The exchange rate risk associated with concessional loans is managed through ADB's asset and liability management framework by aligning the currency of equity with concessional loan exposure at the balance sheet level within OCR.<sup>3</sup> The Treasury Department monitors the currency composition of the ADB balance sheet and carries out currency alignment operations as needed with prior Board approval. In 2016, the Board approved the undertaking of conversions of currencies from time to time for currency alignment in accordance with a currency management strategy endorsed by the Asset and Liability Management Committee and approved by the President.<sup>4</sup>

8. Concessional OCR borrowers have the option to denominate the currency of their concessional loans. Following the transfer, additional currency options were offered to concessional borrowers. They can choose between SDR and a currency that is available under ADB's FLP and is also a currency in the SDR basket, subject to confirmation of the availability of such currency by ADB.

9. For borrowers that choose to denominate their loan in SDR, borrowers can choose the repayment currency from one of the SDR currencies that is predetermined at loan negotiations. The borrower may subsequently change the repayment currency during the life of the loan to another of the SDR currencies upon advance notice. For a loan denominated in a currency other than in SDR, the borrower shall repay the loan in such currency.

### **2. Relending and Onlending**

10. Special considerations are required when ADB loans are relent to one or more beneficiaries, and particularly when they are onlent by intermediaries to subborrowers.

11. ADB normally expects that any foreign exchange risk is passed on to the beneficiary. This may be achieved either directly through the beneficiary servicing the loan in foreign exchange or indirectly by reflecting the cost of bearing the risk in the relending rates charged to the beneficiary. When loan proceeds are onlent by a financial intermediary (which may or may not be the borrower of ADB's loan) to several subborrowers, ADB requires, as a matter of prudent banking practice, that the intermediary hedge the foreign exchange risk arising from the ADB loan. Generally, this risk should be passed on to subborrowers. The operational procedures of the development finance institution should, however, ensure that the risk assumed by the subborrower is adequately mitigated.

12. Regardless of who the borrower is, ADB may agree to a developing member country

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<sup>2</sup> ADB. 2017. *Transfer of Asian Development Fund Loans and Other Assets to Ordinary Capital Resources*. Manila.

<sup>3</sup> ADB. 2016. *Review of the Asian Development Bank's Financial Policies*. Manila.

<sup>4</sup> ADB (Treasury Department). 2016. Request for Approval of ADB's Currency Management Strategy. Memorandum. 16 December (internal).

## OPERATIONS MANUAL POLICIES AND PROCEDURES

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(DMC) government assuming the foreign exchange risk, normally expecting the related cost to be shifted to the beneficiary. In some DMCs, governments may be willing to undertake the risk and may charge the beneficiaries or subborrowers a fee (usually by way of increased lending rates) to ensure risk protection. As a matter of principle, a government subsidy to cover such costs should be avoided. However, in exceptional cases, ADB may consider such subsidization, if warranted by country- and/or project-specific considerations.

### C. Policy on Equity Operations

13. In contrast to lending operations, any foreign exchange risk arising in the context of ADB's private sector operations, such as investment in shares, units of mutual funds, and underwriting commitments, is borne by ADB.

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#### Bases

- i. ADB. 2022. *Ordinary Operations (Concessional) Loan Regulations*. Manila.
- ii. ADB. 2021. *Reference Rate Transition for the Asian Development Bank's Financial Loan Product*. Manila (R61-21).
- iii. ADB. 2016. *Review of the Asian Development Bank's Financial Policies*. Manila (R134-16).
- iv. ADB. 2015. *Enhancing ADB's Financial Capacity for Reducing Poverty in Asia and the Pacific*. Manila (R15-15).
- v. ADB. 2007. *Review of the Financial Framework of the Asian Development Fund*. Manila (R211-07).
- vi. ADB. 2006. *Enhancements for the Asian Development Bank's Loan and Debt Management Products*. Manila (R221-06).
- vii. ADB. 2005. *Proposed Revisions to the Regulations of the Asian Development Fund and the Special Operations Loan Regulations*. Manila (R359-05).
- viii. ADB. 2005. *Board of Governors' Resolution No. 311: Conversion of ADF Resources into Other Currencies*. Manila.
- ix. ADB. 2005. *Asian Development Fund Currency Management Proposal*. Manila (R265-05).
- x. ADB. 2005. *Introducing the Local Currency Loan Product*. Manila (R195-05).
- xi. ADB. 2002. *Pricing Local Currency Loans in Private Sector Operations*. Manila (R215-02).
- xii. ADB. 2001. *Review of the Asian Development Bank's Financial Loan Products*. Manila (R79-01).
- xiii. ADB. 2000. *Currency Risk Management in ADF*. Manila.
- xiv. ADB. 1994. *A Proposal to Introduce a Market-Based Loan Window*. Manila (R210-94).
- xv. ADB. 1992. *Improving the Manageability of Borrowers' Foreign Exchange Exposure on OCR Loans*. Manila (R76-92).
- xvi. ADB. 1983. *Equity Investment Operations by the Bank*. Manila (R38-83, Revision 2, Final).
- xvii. ADB. 1982. *Denomination of ADF Loans in SDR*. Manila (R153-82).
- xviii. ADB. 1981. *Exchange Risk Pooling System*. Manila (R50-81).