OPERATIONS MANUAL
POLICIES AND PROCEDURES

These policies and procedures were prepared for use by ADB staff and are not necessarily a complete treatment of the subject. This Operations Manual is prepared by Treasury Department and issued by 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, Treasury Department.

FOREIGN EXCHANGE RISK

A. Scope

1. Article 13 of the *Agreement Establishing the Asian Development Bank* (the Charter) provides that 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) lend in local currency to meet local expenditures where it can do so without selling its holdings in gold or convertible currency. Article 15 of the Charter further stipulates that ADB cannot accept foreign exchange risk in its lending operations.

2. This OM 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. 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. 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 ADB 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 to another major currency or, in selected cases, to a local currency, subject to ADB being able to enter into appropriate hedging transactions.

b. Asian Development Fund

6. Loans from the Asian Development Fund (ADF) are denominated in special drawing rights (SDRs).[1] Before the introduction of the full-fledged SDR currency policy for the ADF in 2005,[2] ADF loans were effectively denominated in currencies that were actually used for disbursements, i.e., the loans were disbursed out of various donor currencies held by ADB and were repayable in the same currencies and in the same amount of currencies as originally used. The borrowers assumed the foreign exchange risk between their repayment currencies and the currencies used for disbursing their ADF loans.

7. The SDR currency management policy approved in 2005 allowed currency conversions and authorized ADB to value disbursements, repayments and charges under all ADF loans in SDR. This change (i) made the currency practices of ADF loans consistent and the future repayments of loans more predictable for developing member countries (DMCs), (ii) reduced the foreign exchange transaction cost for DMCs, and (iii) lowered foreign exchange volatility. The first phase—offering the full-fledged SDR approach in new loans—began in 2006. The second phase—extending an option to DMCs to convert their existing liabilities in various currencies into full-fledged SDR loans—has been implemented since 1 January 2008. With this conversion into SDR, ADF reflows will be aligned with the loan commitment currency, thereby reducing the currency mismatch between multiple reflow currencies and the commitment currency (SDR).

8. Following the approval of the currency policy in 2005, the currency in the liquidity pool used for disbursements of full-fledged SDR loans (either newly approved or converted) is one of SDR component currencies, which is determined by ADB based on transactional and administrative efficiency. The disbursements are recorded and repayments recalled in SDR equivalent. For legacy loans (recorded in multiple currencies), SDR currencies are used for disbursements, while all multicurrencies will be recalled for loan service payments. However, in both circumstances, borrowers can choose repayment currencies from the four SDR currencies based on the valuation currencies either in SDR or multiple currencies. In addition, the borrower may subsequently change the repayment currency during the life of the loan.

9. Currency risk remains one of the ADF's main financial risks because of the currency imbalances between resources received in donor national currencies and loan commitments denominated in SDRs. This results in both commitment risk and disbursement risk. Commitment risk occurs because of the fluctuation of the SDR value of ADF financial resources denominated in national currencies between the time of the replenishment agreement and the time of the development commitment. The commitment risk from donor contributions will be managed through periodic updates and adjustments to the financial resources available for commitment authority. Any shortfall in the commitment authority amount during the last quarter of a replenishment period because of exchange rate fluctuation will be funded by an additional reflow-based commitment authority, subject to a cap of 3% of the total planned operational level.[3]

[1] Loans approved prior to 1983 were denominated in US dollars.
[2] ADB. 2005. *Asian Development Fund Currency Management Proposal*. Manila.
[3] ADB. 2007. *Review of the Financial Framework of the Asian Development Fund*. Manila.

10. Disbursement risk, as an extension of commitment risk, is the risk of a future resource shortfall in meeting the disbursement requirements of SDR-denominated loans already committed. Exchange rate movements over the long disbursement period can create a substantial difference between the amounts of undisbursed SDR-denominated loans and the SDR value of resources financing such amounts. Under the 2007 ADF financial framework, the disbursement risk provisioning of 6.5% was discontinued. Instead, currency risks will be managed as a whole through a portion of the ADF's prudential minimum liquidity (footnote 3). A currency rebalancing mechanism is used to align ADF resources to SDR, with the exception of grants. ADF grants are currently denominated and disbursed in US dollars.

2. Relending and Onlending

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

12. ADB normally expects that a 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 the ADB's loan) to a number of 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.

13. Regardless of who the borrower is, ADB may agree to a 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

14. 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.

Basis

ADB. 2021. *Reference Rate Transition for the Asian Development Bank's Financial Loan Product.* Manila (R61-21).

ADB. 2007. *Review of the Financial Framework of the Asian Development Fund*. Manila (R211-07).

ADB. 2006. *Enhancements for the Asian Development Bank's Loan and Debt Management Products*. Manila (R221-06).

ADB. 2005. *Proposed Revisions to the Regulations of the Asian Development Fund and the Special Operations Loan Regulations*. Manila (R359-05).

ADB. 2005. *Board of Governors' Resolution No. 311: Conversion of ADF Resources into Other Currencies*. Manila.

ADB. 2005. *Asian Development Fund Currency Management Proposal*. Manila (R265-05).

ADB. 2005. *Introducing the Local Currency Loan Product*. Manila (R195-05).

ADB. 2002. *Pricing Local Currency Loans in Private Sector Operations*. Manila (R215-02).

ADB. 2001. *Review of the Asian Development Bank's Financial Loan Products*. Manila (R79-01).

ADB. 2000. *Currency Risk Management in ADF*. Manila.

ADB. 1994. *A Proposal to Introduce a Market-Based Loan Window*. Manila (R210-94).

ADB. 1992. *Improving the Manageability of Borrowers' Foreign Exchange Exposure on OCR Loans*. Manila (R76-92).

ADB. 1983. *Equity Investment Operations by the Bank*. Manila (R38-83, Revision 2, Final).

ADB. 1982. *Denomination of ADF Loans in SDR*. Manila (R153-82).

ADB. 1981. *Exchange Risk Pooling System*. Manila (R50-81).