Working paper 2

Legal and Regulatory Matters

1. Introduction

As highlighted in the report 'Enhancing multilateral development banks' capacity through local currency financing', respondents to the survey identified two critical barriers to local currency (LC) financing: a lack of familiarity and expertise in LC arrangements, and legal and regulatory factors. This paper delves deeper into these issues, examining the primary challenges and constraints faced by Multilateral Development Banks (MDBs) in their LC financing operations from a legal and regulatory perspective. It employs an integrated methodology, combining survey responses, semi-structured interviews, and desk-based research from both academic and official sources.

The paper begins by exploring statutory and non-statutory constraints within MDBs that limit their ability to provide LC financing. It examines how legal frameworks—often inherited from the Bretton Woods system—have historically restricted MDBs to lending primarily in foreign currencies and analyses how these limitations are reflected in both statutory and non-statutory rules.

The analysis then shifts to domestic legal and regulatory frameworks in Low- and Middle-Income Countries (LMICs), exploring how various aspects of domestic law affect the capacity of MDBs to operate onshore and provide LC financing. Lastly, the paper discusses the complexities associated with LC financing contractual terms.

2. Statutory and non-statutory constraints

A key constraint to the ability of MDBs to provide LC financing stems from the institutional legacy of the Bretton Woods system, which was based on fixed (though adjustable) exchange rates tied to the US dollar, with the dollar itself pegged to gold.[1] Although the international monetary system shifted towards floating exchange rates following the collapse of Bretton

[1] JA Ocampo, 'A Brief History of the International Monetary System since Bretton Woods' in *Resetting the International Monetary (Non)System* (Oxford University Press 2017).

Woods in the early 1970s, MDBs have continued to lend primarily in FC.[2] This legacy persists and is largely reflected in the legal and institutional practices of MDBs, including both statutory and non-statutory frameworks.

In this context, statutory frameworks refer to the formal, legally binding provisions enshrined in the founding agreements or charters of MDBs, which define their legal authority and operational limits. In contrast, non-statutory frameworks consist of internal policies and guidelines adopted by MDBs' governing bodies, which—though not legally entrenched in international law—are binding within the institution and guide its internal decision-making processes, including treasury and risk management activities.

2.1. Statutory provisions

The Articles of Agreement governing MDBs typically address various aspects of currency usage, including: (1) the authorised capital of the MDB, (2) the currency for payment of subscriptions, (3) the terms and conditions for loans and guarantees, specifying the currency of lending and repayment, (4) authorisations and limitations on the bank's power to use or exchange the currencies of its members, (5) provisions on the bank's authority to borrow currencies from or within the jurisdictions of its members, as well as the currency of payment for such loans, (6) the valuation of currencies and determination of their convertibility, (7) the use of currencies by members, particularly prohibiting members from imposing restrictions on the receipt, holding, use, or transfer of currencies by the bank or any recipient of bank funds for specified purposes, (8) the currency of dividend payments, where applicable, and (9) provisions on the maintenance of the value of the bank's currency holdings vis-à-vis the paid-in subscriptions of its members.

These provisions form the core legal and operational framework for MDB activities, especially in relation to currency management. Notably, most MDBs have their authorised capital denominated in US dollars.[3] While these provisions shape the predominantly dollar-based structure of MDB balance sheets and risk management frameworks, they do not, in themselves, preclude LC lending. The most significant statutory constraints to such transactions typically

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[2] S Kapoor, H Hirschhofer, D Kapoor, and N Klieterp, 'A Multilateral Solution to Hedging Currency Risk in Developing Country Finance' https://shorturl.at/4y8d8 accessed 9 September 2024.

[3] There are a few exceptions to this, including the European Bank for Reconstruction and Development (EBRD), whose authorised capital stock is set in the European Currency Unit (ECU), the predecessor of the Euro. The Islamic Development Bank designates the Islamic Dinar—valued equivalent to one SDR—as its unit of account for authorised and subscribed capital. The West African Development Bank (BOAD) specifies its authorised capital in CFA francs, which aligns with its membership in the West African Monetary Union. Similarly, the Council of Europe Development Bank (CEB) issues participating certificates denominated in euros, the currency adopted by most of its members.

arise from provisions governing MDB operations, which often require strict back-to-back hedging—also known as 'perfect hedging'—against foreign exchange risk.

For example, Article 15(3) of the Agreement Establishing the African Development Bank (AfDB)[4] and Article 12(2) of the Articles of Agreement establishing the Asian Development Bank (ADB)[5] limit ordinary operations by stipulating that the principal amount outstanding and payable to the bank in a specific currency must not exceed the total principal amount of funds borrowed by the bank in that currency. Similarly, Article III(5)(b) of the Agreement Establishing the Inter-American Development Bank (IDB) contains comparable provisions, requiring the bank to maintain a balance between the amount it owes and the amount it is due to receive in any given currency.

While these mechanisms do not preclude MDBs from maintaining sufficient liquidity to meet obligations in the relevant currency if needed, they limit their capacity to provide LC loans to those which can be perfectly hedged. This creates a tension between the statutory requirement for perfect hedging and the developmental need to finance projects in LC, particularly in jurisdictions where LC markets are underdeveloped.

In contrast, some MDBs have less stringent statutory provisions that do not impose the requirement of perfect hedging. These frameworks delegate the management of currency risk to non-statutory frameworks that are more flexible. For example, the Agreement Establishing the European Bank for Reconstruction and Development (EBRD) contains no specific provisions regarding currency risk management, requiring only that the bank applies sound banking principles in Article 13(i).[6] Similarly, Article 14(4) of the Articles of Agreement of the Asian Infrastructure Investment Bank (AIIB) allows for financing in LC, provided it is done in accordance with policies that minimise currency risk.[7]

2.2. Non-statutory provisions

In addition to the statutory provisions, MDBs operate under non-statutory frameworks. These frameworks, often consisting of internal policies and guidelines, are not legally entrenched in the institutions' founding charters but are adopted by governing boards to regulate their

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[4] African Development Bank, *Agreement Establishing the African Development Bank* https://shorturl.at/LZktR accessed 9 September 2024.

[5] Asian Development Bank, *Agreement Establishing the Asian Development Bank* https://shorturl.at/tyhnH accessed 9 September 2024.

[6] European Bank for Reconstruction and Development, *Agreement Establishing the European Bank for Reconstruction and Development* https://shorturl.at/V63Qo accessed 9 September 2024.

[7] Asian Infrastructure Investment Bank, *Articles of Agreement of the Asian Infrastructure Investment Bank* https://shorturl.at/cy79l accessed 9 September 2024.

activities. While not legally binding under public international law, these rules are binding within the internal decision-making processes of MDBs, including those related to LC financing.

Non-statutory frameworks establish general policies related to treasury operations, including LC funding and financing. For example, they typically define the roles of key officers, such as the Chief Financial Officer and the Chief Risk Officer, in managing the risks associated with such activities. Additionally, specific guidelines, such as treasury authority and liquidity procedures, often provide detailed instructions on foreign exchange and LC transactions.[8]

Non-statutory rules frequently limit LC financing through prohibitions on assuming most forms of currency risk. For instance, Chapter IV, Section 4 of the Development Bank of Latin America and the Caribbean (CAF)'s *Management Policies* states that the institution 'will not assume currency risk in its transactions, except in the case of equity investments denominated in local currency'. For these investments, 'CAF will evaluate the currency risk and ensure that it is acceptable, based on a satisfactory compensation between the yield projection and risk taken'.[9]

Such provisions may even apply in concessional lending contexts, avoiding any foreign exchange risk by shifting it entirely onto the borrower.[10] For example, Section III(2)(a)(ii)(A) of the International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA)'s *Financial Terms and Conditions of Bank Financing* stipulates that IDA concessional credits are to be offered in either Special Drawing Rights (SDRs) or as single currency credits, with the recipient bearing the foreign exchange risk between the currency of payment and the SDR.[11]

Another common non-statutory provision is that the availability and terms of LC financing are subject to prevailing market conditions, which can constrain the provision of such financing. For example, while the AfDB has been able to lend in local African currencies since 2010, its policy framework stipulates that such loans depend on the Bank's ability to fund itself in those

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[8] Interview 14, B Bonizzi, A Kaltenbrunner, G Klein Martins, K Kohler, K Patrício Ferreira Lima, IW Martínez, 'Enhancing multilateral development banks' capacity through local currency financing' (October 2024), preliminary report https://business.leeds.ac.uk/download/downloads/id/535/enhancing-multilateral-development-banks-capacity-through-local-currency-financing.pdf accessed 15 October 2024.

[9] Development Bank of Latin America and the Caribbean, *Management Policies* (September 2019) https://shorturl.at/GN694 accessed 9 September 2024.

[10] Bonizzi and others (n 8), Chapter 2, Section 2.1.

[11] International Bank for Reconstruction and Development and International Development Association, *Bank Policy: Financial Terms and Conditions of Bank Financing*, OPS5.09-POL.178 (7 July 2023) https://shorturl.at/KyhNw accessed 9 September 2024.

currencies through bond issuances or market-based hedging strategies.[12] Similarly, Section 8 of its *Guidelines for Synthetic Local Currency Loans* provides that in such transactions, the availability of a hedge or non-deliverable forward contract (NDF) with a market counterparty is essential. The NDF transaction amount includes the lending margin to ensure that the Bank's margin is not exposed to currency risk.[13]

The IDB also reflects this approach. For example, Article 5.02 of its *General Conditions for Investment Loans Chargeable to Ordinary Capital Resources* provides that any currency conversion in financing arrangements shall be subject to the bank's ability to execute the conversion, which depends on its capacity to source funding or enter a hedge on terms acceptable to the bank, in accordance with prevailing market conditions. [14]

Subjecting LC financing to market conditions as a general policy increases the cost and complexity of raising such funds. New bond issuances or premium hedging fees are often required before loans can be disbursed, making LC financing significantly more costly in certain contexts. This reliance on market mechanisms for hedging presumes that financial markets will consistently offer the most cost-effective solution for managing exchange rate risk. However, this assumption is somewhat at odds with the core purpose of MDBs. Indeed, currency volatility lies at the heart of this issue. Viewing currency risk management through a narrow, transactional lens—focusing exclusively on the exchange rate risk of individual contracts—overlooks the broader macroeconomic perspective that typically informs MDB investment portfolio strategies.

3. Domestic legal and regulatory challenges

Beyond the legal and institutional frameworks of MDBs, the domestic legal and regulatory environments in borrowing countries significantly influence MDBs' ability to provide LC financing, as identified by survey respondents.

This section draws on both academic and policy literature, as well as the semi-structured interviews conducted by Bonizzi and others, to explore key aspects such as capital markets law

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[12] See Section 6.2.9 and Article 3.3 on Annex 3 of the African Development Bank Group's *Policy on Non-Sovereign Operations* (29 May 2019) https://shorturl.at/Npll5 accessed 2 September 2024.

[13] African Development Bank, *Guidelines for Synthetic Local Currency Loans* (May 2008) https://shorturl.at/FwbgP accessed 2 September 2024.

[14] Inter-American Development Bank, *General Conditions for Investment Loans Chargeable to Ordinary Capital Resources* (September 2023) https://shorturl.at/SSXok accessed 2 September 2024.

and regulation, banking law and regulation, tax law, exchange restrictions, and issues related to the civil and criminal liability of public officials.

3.1. Onshore issuance of local currency bonds

One way of hedging the currency risk of LC lending is to issue bonds in that currency, either offshore or onshore. Onshore LC bond issuance is particularly important, as the surveys in 'Enhancing multilateral development banks' capacity through local currency financing' indicates it is the most common method for raising LC liabilities, providing MDBs with a direct source of local currency liquidity.

However, in issuing bonds onshore, MDBs encounter numerous challenges arising from the domestic legal and regulatory infrastructures of the capital markets in which they operate. Addressing these issues often requires MDBs to collaborate actively with local authorities and law firms, offering technical advice to facilitate domestic legal reforms aimed at developing LC debt markets.[15]

These challenges can be broadly divided into two areas: general capital markets law and regulation, linked to the broader policy objective of developing local capital markets, and the specific legal and regulatory challenges facing MDB activities due to their unique status as international financial institutions operating onshore.

3.1.1. General capital markets law and regulation

a. Contractual framework of local currency bonds

In many LMICs, LC government bonds often lack a well-developed contractual framework.[16] In contrast, government bonds issued in foreign currency are typically governed by foreign law—usually English or New York law—and include detailed contractual provisions. The absence of comparable provisions for locally issued government bonds, which are often among the most significant financial assets in the market, contributes to the underdevelopment of domestic

[15] See, e.g., European Bank for Reconstruction and Development, *Building the Foundations for Financial Market Development: A Retrospective of More than 10 Years of EBRD Engagement in Georgia* (EBRD 2023).

[16] W Bossu W, C Hillier, and W Bergthaler, 'Local Currency Bond Markets Law Reform: A Methodology for Emerging Markets and Developing Economies', IMF Working Paper (20 November 2020) 22-25.

bond markets. Establishing a comprehensive contractual framework for LC government bonds is therefore essential.[17]

The lack of a comprehensive contractual framework for LC government bonds also affects MDB bonds, given their unique status as international financial institutions operating onshore. Clear rules are needed to address key issues, such as the permissible governing law for locally issued debt securities. Local law must explicitly specify whether such bonds can be governed by foreign law, as is often the case with government bonds issued offshore in foreign currency, or if only local law is permissible. Similar considerations relate to the use of foreign languages in bond documentation, often preferred by foreign investors.[18]

b. Enforcement of investor rights in case of default

Effective enforcement of investor rights plays a critical role in the development of local bond markets. While large institutional investors and banks often ensure their payment rights due to their influence and access to information, smaller investors rely more heavily on the legal system to protect their interests. However, in many jurisdictions, obstacles such as unclear legal frameworks or practical difficulties in the enforcement of rights—particularly in the context of issuer insolvency—create uncertainties.[19] For example, some local laws require creditor consent for corporate debt restructuring, which can be challenging to implement. Additionally, inconsistent application of the law, limited use of collective action clauses, and lengthy, costly enforcement procedures further complicate the situation.

These uncertainties may deter investors, particularly smaller ones, from participating in local bond markets, which in turn limits the depth of these markets. For MDBs seeking to raise funds onshore, a reduced investor base diminishes demand for LC bonds, which in turn affects their ability to raise funds onshore.[20]

c. Disclosure rules and procedures

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[17] W Bossu and EA Awadzi, 'Private Law Underpinnings of Public Debt Securities Markets' (2014) 18(3) Uniform Law Review 564-88.

[18] F Dahan, J Kubas, L Cohen, Y Mihaleva, and M Welsh, 'The EBRD's Legal and Regulatory Assessment – What Limits Development of Local Capital Markets?' in European Bank for Reconstruction and Development, *Law in Transition 2012: Developing Local Capital Markets* (EBRD 2012) 37.

[19] ibid 34-35.

[20] ibid.

Inconsistencies, inefficiencies, and cumbersome disclosure rules and procedures hinder the development of local debt markets in many jurisdictions. Challenges may include onerous documentation requirements, unclear processes for the approval and filing of marketing materials, inadequate staffing and training of reviewing agencies, inconsistent review procedures for offering documentation or prospectuses, unclear rules for updating disclosures, and the lack of a central repository for public access to documents.[21]

These factors may dissuade domestic and foreign actors from investing in locally issued bonds, leading to a lack of depth in local capital markets. This has crucial implications for MDBs seeking to raise funds in those markets, compounded by other regulatory challenges facing MDBs specifically, which are discussed below.

d. Credit rating requirements

Despite the scrutiny faced by credit rating agencies during the global financial crisis, they continue to provide investors with valuable market information, particularly where cost-effective alternatives for evaluating credit risk are lacking. These agencies operate on different scales, from global players like Moody's, Standard & Poor's (S&P), and Fitch (often referred to as the 'big three') to regional or national agencies that cater to local market dynamics.

The absence of formal credit rating requirements or reputable agencies with local expertise in many countries presents significant challenges to the development of local debt markets. Locally issued debt securities are typically expected to be rated by an agency with relevant local market experience, either as a legal requirement or based on established market practices.[22] However, in some jurisdictions, local regulations mandate ratings only on a national or regional scale, assessing an issuer's creditworthiness relative to others within the same area, which limits comparability on an international level.

The variability in credit rating requirements across jurisdictions has significant implications for MDBs' ability to raise funds in local markets. Local regulations may favour different types of ratings, sometimes prioritising local agencies over international ones.[23] For instance, while one jurisdiction may accept an international rating from a well-known global agency, another may strictly require a local rating reflecting specific market conditions. Additionally, regulations may

[21] ibid 36.

[22] ibid.

[23] Interview 10, Bonizzi and others (n 8).

even mandate the use of the lowest rating among multiple agencies. In some cases, short-term ratings are prioritised over long-term ones, particularly in more volatile markets.[24]

Another consideration is how an MDB's credit rating is influenced by the location of its headquarters.[25] In some jurisdictions, an MDB's rating may be affected by the sovereign rating of the country in which it is based, impacting the cost of raising funds. This treatment can alter the feasibility of issuing bonds in certain markets, disproportionately disadvantaging MDBs headquartered in LMICs.

e. Use of repo and collateral

The use of repo transactions is vital for injecting liquidity into local financial markets, allowing institutions to secure financing using debt securities as collateral. A repo transaction involves the sale of securities with an agreement to repurchase them at a later date, while a reverse repo refers to the purchase of securities with a commitment to resell them in the future. Repos gained prominence post-global financial crisis due to their potential to minimise counterparty credit risks.

A robust short-term yield curve, coupled with an active repo market, forms the foundation for issuing long-term securities and fostering the development of secondary markets. However, in many jurisdictions, the legal and regulatory frameworks governing repo transactions remain either underdeveloped or ambiguous. These legal gaps restrict the effective use of locally issued debt securities as collateral, thereby limiting the growth of LC markets.

Although repos are legally structured as a sale and repurchase of securities, they are, in economic terms, a form of collateralised borrowing. This duality can lead to complex legal challenges, particularly in jurisdictions lacking a clear framework for repo transactions. Standardised master agreements, such as the Global Master Repurchase Agreement (GMRA)[26] and the Master Repurchase Agreement (MRA)[27], have been established to provide uniform documentation for these transactions. However, the GMRA is governed by English law, and the MRA by New York law, which may lead to contentious issues of applicability across jurisdictions. Local legislation is often necessary to address legal transplantation issues,

[24] ibid.

[25] Interview 10, Bonizzi and others (n 8).

[26] International Capital Markets Association (ICMA), 'Global Master Repurchase Agreement (GMRA)' https://shorturl.at/UjI3j accessed 18 September 2024.

[27] Securities Industry and Financial Markets Association (SIFMA), 'Master Repurchase Agreement (MRA)' https://shorturl.at/JDdG7 accessed 18 September 2024.

including the recognition of collateral ownership and enforceability of close-out netting rights in insolvency cases.[28]

In jurisdictions lacking such legislation, courts may refuse to recognise the transfer of title to the collateral, instead recharacterising the repo as a collateralised loan. This can place the collateral holder at risk, granting them no greater rights than other creditors in insolvency proceedings, or invalidating netting agreements altogether.[29]

Additionally, the legal framework must provide clarity regarding the operational flexibility for managing repo portfolios. It should specify whether different types of repo transactions are permitted, including the right of substitution, whereby the seller may retrieve the securities and replace them with equivalent assets during the term of the agreement. Similarly, the framework should clarify whether rehypothecation of collateral is allowed, enabling buyers to reuse the securities as collateral in separate transactions. Without such clarity, the effectiveness of repo transactions could be significantly diminished, discouraging participation from financial institutions.[30]

f. Local settlement systems

Effective local settlement systems are vital to the operation of capital markets, particularly for MDBs issuing bonds onshore. These systems facilitate the clearing and settlement of bond transactions, ensuring efficient transfer of securities and payments. In jurisdictions with well-developed infrastructures, such as Central Securities Depositories (CSDs) and real-time gross settlement (RTGS) systems, market participants face fewer barriers to bond transactions.

However, in certain jurisdictions, legal provisions governing the transfer of locally issued debt securities require bilateral settlement by physical delivery, which leads to delays and increases costs, thereby reducing the efficiency of transactions.[31] These regulatory frameworks pose

[28] H Hashimoto, Y Mooi, G Pedras, A Roy, K Chung, T Galeza, MG Papaioannou, P Katz, Z Bango, JA Gragnani, B Gurhy, and C Paladines, *Guidance Notes: Developing Government Local Currency Bond Markets* (IMF and World Bank 2021) 21 https://shorturl.at/IAR1R accessed 19 September 2024.

[29] ibid.

[30] W Bossu W, C Hillier, and W Bergthaler, 'Local Currency Bond Markets Law Reform: A Methodology for Emerging Markets and Developing Economies', IMF Working Paper (20 November 2020) 31-33.

[31] Dahan and others (n 18) 37.

challenges for MDBs operating onshore by deterring potential investors and complicating local bond issuance strategies.[32]

A key legal consideration in settlement systems is the concept of 'finality' in settlements. In some legal frameworks, the finality of payments and the transfer of securities—meaning the point at which these transfers are definitive—is clearly protected by law. This provides market participants with certainty that once a transaction is completed, it cannot be reversed, even in cases of insolvency.[33] However, in jurisdictions lacking such legal clarity, there may be a heightened risk that insolvency courts could intervene in settled transactions. Such uncertainties can discourage market participation and contribute to a lack of depth in local bond markets.

The integration of CSDs with central bank RTGS systems also raises legal questions. In markets where CSDs and RTGS systems are linked, the legal framework may provide for delivery versus payment (DVP) mechanisms, ensuring that the transfer of securities and corresponding cash payments occur simultaneously.[34] This mechanism reduces the risk of one party failing to meet its obligations, offering greater safety in transactions. For MDBs, such integrated systems are important as they minimise counterparty risk, particularly when issuing bonds in volatile markets.

Another aspect of the legal framework that impacts settlement systems is the reliance on intermediaries, such as banks and investment firms.[35] The role of these intermediaries, and the legal obligations placed upon them, can vary significantly across jurisdictions, influencing both the speed and efficiency of settlement. In jurisdictions where intermediaries are legally required to execute trades—in some cases, despite the existence of established CSDs—this reliance may slow settlement processes, thereby constraining the liquidity of MDB bonds.

g. Investor remedies for market abuse

In some jurisdictions, the absence of effective legal remedies for market actors issuing or trading debt securities based on false or misleading information can undermine investor confidence and hinder local capital market participation.[36] Weak enforcement mechanisms,

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[32] Frontclear and OGResearch, *Diagnostic Handbook for Money Market Development* (2018) 27-31 https://shorturl.at/8Ze80 accessed 18 September 2024.

[33] Hashimoto and others (n 28) 46.

[34] ibid.

[35] Dahan and others (n 18) 37.

[36] ibid 38-39.

limited access to legal protections, and the lack of a regulatory institution capable of bringing enforcement claims, along with the absence of ombudsman services, leave investors vulnerable to misconduct. This lack of protection can discourage investment, particularly in markets with weaker regulatory frameworks, leading to shallow local capital markets and a limited investor base for locally issued MDB bonds.

h. Availability of shelf registration

Shelf registration is a regime that allows issuers to register a large amount of generic, unspecified securities with the securities regulator upfront. This enables issuers to 'take securities off the shelf' for immediate sale when market conditions are favourable, without the need for prior regulatory review of each individual offering. The main advantage of this approach lies in its flexibility and efficiency, enabling issuers to avoid delays typically associated with the traditional method of registering each offering separately. Additionally, shelf registration facilitates the use of short-form prospectuses that incorporate information already filed with the securities regulator by reference, thereby reducing administrative burdens and expediting market access.

In the United States, the shelf registration regime was introduced by the Securities and Exchange Commission (SEC) in 1982 concerning corporate issuers,[37] having undergone various enhancements since then. The SEC's most recent enhancement, under the Securities Offering Reform initiative of 2005, permits certain reporting corporate issuers to undertake registered offerings without the regulatory delays typically associated with the registration process.[38]

For international financial institutions such as MDBs and foreign governments, the shelf registration system has been implemented through statements of policy rather than formal rules.[39] Specifically, the SEC published statements in 1980 and 1982 that allow international financial institutions to file a base prospectus disclosing political, economic, and statistical information appropriate for Schedule B registration.[40] Subsequently, when an offering is planned, the issuer prepares a prospectus supplement outlining the use of proceeds, detailed security information, the plan of distribution, and recent material developments. Although the SEC's policy does not explicitly provide for incorporation by reference, an informal process exists whereby MDBs can request permission to use this approach by explaining their plans to

[37] Securities and Exchange Commission, *Rule 415: Delayed or Continuous Offering and Sale of Securities*, 17 CFR § 230.415 (1982).

[38] Securities and Exchange Commission, *Securities Offering Reform*, 17 CFR Parts 200 et seq (2005).

[39] P Dudek, 'Regulation of Offerings by International Financial Institutions under the US Federal Securities Laws' in C Smith, X Gao, and T Dollmaier (eds), *Funding International Development Organizations* (Brill 2023) 80, 82-88.

[40] ibid.

set up a shelf registration for debt securities.[41] Through this process, numerous MDBs have successfully utilised the shelf registration system, offering a streamlined process that reduces issuance costs and administrative hurdles.

In jurisdictions where a shelf registration programme is not available or is underdeveloped, issuers face greater challenges in making multiple public offerings. The absence of a system for pre-approving offerings means that each issuance requires separate regulatory approval, which can slow the process and limit fundraising activities by MDBs.[42]

3.1.2. Challenges specific to MDBs

a. Regulatory misalignment

MDBs frequently face domestic legal and regulatory frameworks designed for local issuers, which create significant obstacles when issuing LC bonds onshore. While these frameworks are typically intended to safeguard market integrity, they often fail to align with the unique status and operational models of MDBs, resulting in higher transaction costs and delays.[43]

For instance, stringent disclosure requirements aimed at protecting local investors are not always flexible enough to accommodate MDB-issued bonds. Unlike corporate issuers, MDBs are international financial institutions governed by representatives of member countries rather than private shareholders.[44] They typically disclose material information in international markets according to their treaties, internal by-laws, and procedures, which makes it difficult to comply with local disclosure rules requiring different formats, languages, and timelines.[45] In the European Union (EU), MDBs with an EU member state as a participant are exempt from prospectus requirements, and no mandatory ongoing disclosure is required for non-equity

[41] ibid.

[42] Dahan and others (n 18) 40.

[43] E Sulima, 'Development of Domestic Capital Markets: The EBRD Experience' in C Smith, X Gao, and T Dollmaier (eds), *Funding International Development Organizations* (Brill 2023) 9, 13-14.

[44] Interview 7, Bonizzi and others (n 8).

[45] Sulima (n 43) 9, 13-14.

securities.[46] Other countries have adopted similar exemptions, allowing MDBs to disclose information according to their established practices while meeting ongoing disclosure requirements.[47] However, in many cases, no such exemptions exist, and local rules fail to account for the unique structures of MDBs, creating unnecessary friction in the issuance process.

Another substantial regulatory barrier in the issuance of debt securities by MDBs involves national legal frameworks that prohibit non-resident entities from issuing bonds.[48] This prohibition often stems from concerns within ministries of finance about competition with government bond issuers, particularly when the competing entity holds a AAA rating.[49] Domestic banks may also oppose such issuances, fearing competition from MDBs in the LC market.[50] As a result, MDBs frequently need to persuade national authorities that permitting their bond issuances would benefit the local economy. Moreover, extensive documentation requirements and the need for multiple approvals from central banks, ministries of finance, local securities regulators, and exchanges can significantly delay the process. As one interviewee familiar with the matter noted, these delays can extend up to five years from the initial conversations with local authorities to the actual bond issuance.[51]

Due to these regulatory hurdles, when MDBs first enter a market, they often need to engage in extensive dialogue with local regulators. Internal resources and external counsel are required to secure exemptions, approvals, and waivers from various requirements, including disclosure rules and documentation.[52] These processes not only delay the issuance of LC bonds but also substantially increase transaction costs. However, once local bond programmes are established, MDBs can issue bonds more efficiently, reducing the burden on future issuances and streamlining operations.[53] As mentioned in an interview, the costs associated with gaining

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[46] Article 8.1(a) of Directive 2013/ 50/ EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/ 109/ EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC.

[47] Sulima (n 43) 9, 13-14.

[48] Interview 18, Bonizzi and others (n 8).

[49] C Fink, HP Lankes, and C Sacchetto, *Mitigating Foreign Exchange Risk in Local Currency Lending in Fragile States: Review and Options* (International Growth Centre, June 2023) 27.

[50] ibid.

[51] Interview 2, Bonizzi and others (n 8).

[52] Interview 7, Bonizzi and others (n 8).

[53] See, e.g., Y Chen, 'Inspiring Opening- Up, Innovation and Transparency: International Organizations in the Development of China's Debt Capital Market' in C Smith, X Gao, and T Dollmaier (eds), *Funding International Development Organizations* (Brill 2023) 36-51.

the necessary approvals and negotiating exemptions are considerable—issuing a single bond is costly, but issuing multiple bonds allows MDBs to benefit from economies of scale.[54]

Even when permission to issue a bond is obtained, restrictions on the use proceeds by non-resident issuers may still apply. Local regulations may require government approval for the use of proceeds or impose limits on the types of potential investment targets.[55]

Due to these challenges, MDBs are often disincentivised from issuing bonds onshore until substantial legal reforms are implemented. However, such reforms can take years to negotiate. It is not uncommon for reform processes to take a decade, with MDBs often working alongside local law firms to engage governments in making local legal frameworks more favourable for MDB operations.[56] This includes ensuring that local regulations align with the privileges and immunities granted to MDBs under international law and do not conflict with treaty obligations, particularly in countries that are members of the MDB in question.[57]

As a result, MDBs often find that hedging, including with local counterparties, is a more flexible and efficient approach in economies lacking the scale necessary to make multiple bond issuances cost-effective. As stated by an interviewee:

> 'Generally, we find that developing instruments other than bonds is much easier and more flexible. For example, we often use derivative instruments with onshore local counterparts before legal reforms are fully enacted, even though this involves increased risk, which we consider in our credit assessment. However, we are more likely to proceed with derivatives than with local bond issuances until all necessary legal changes are in place. It is much more challenging and time-consuming to reach the point where we are ready to issue a domestic bond compared to executing a domestic derivative transaction'.[58]

b. Repo eligibility

A crucial regulatory issue concerning MDB-specific legal and regulatory matters is the repo eligibility of MDB bonds. Securing central bank approval for bonds to qualify for repo

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[54] Interview 7, Bonizzi and others (n 8).

[55] Sulima (n 43) 9, 16.

[56] Interview 14, Bonizzi and others (n 8).

[57] Sulima (n 43) 9, 15-16.

[58] Interview 9, Bonizzi and others (n 8).

transactions significantly enhances their attractiveness to local financial institutions, particularly banks.[59] Repo eligibility enables banks to use MDB bonds as collateral in transactions with the central bank, thereby improving liquidity and incentivising local banks to invest in these instruments.

However, the process of securing repo eligibility is often complicated by legal and regulatory frameworks primarily designed to accommodate sovereign and corporate bonds.[60] In many jurisdictions, MDB bonds do not automatically qualify for repo transactions,[61] and obtaining such eligibility typically requires a range of reforms to domestic securities laws.[62] Without these adjustments, MDB bonds may struggle to gain traction in the domestic market, as local banks are less likely to invest in bonds that are not eligible for central bank repo transactions.[63]

3.2. Onshore hedging and derivatives

Hedging LC risk is crucial for managing foreign exchange volatility, serving as a key mechanism enabling LC financing by MDBs. As discussed above, hedging is particularly important where local capital markets lack depth. This section examines the legal and regulatory challenges associated with the onshore hedging activities of MDBs, considering both general local derivatives law and the specific operational frameworks of MDBs.

3.2.1. Local derivatives law

According to the Bank for International Settlements (BIS), only 10% of global derivatives turnover is in contracts denominated in the currencies of emerging market economies, which mostly comprise LMICs—a figure significantly lower than the share of these economies in global GDP or world trade. Derivatives in LMIC currencies also tend to be less complex and are more frequently traded outside their home economies compared to those in advanced economies.[64]

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[59] Bossu (n 16) 33-34.

[60] ibid 45-48.

[61] Interview 16, Bonizzi and others (n 8).

[62] See, e.g., European Bank for Reconstruction and Development (n 15)

[63] Interview 16, Bonizzi and others (n 8).

[64] Bank for International Settlements, 'Emerging Derivatives Markets' (2016) BIS Quarterly Review, December 67 https://www.bis.org/publ/qtrpdf/r_qt1612.htm accessed 14 October 2024.

While there are many reasons for this disparity, a key factor is the presence of legal and regulatory barriers, along with uncertainty surrounding the validity of derivative contracts.[65] In some jurisdictions, banks and other investors face restrictions on freely purchasing and selling derivative instruments or hedging risks associated with debt securities. Additionally, significant uncertainty often exists regarding the enforceability of derivatives transactions and the validity of their underlying legal documentation.

One example of enforceability issues relates to the distinction between deliverable and non-deliverable derivative transactions. In a deliverable transaction, the underlying currencies are physically exchanged at maturity, requiring both parties to deliver and receive the currencies at the agreed rate. Conversely, non-deliverable transactions do not involve the physical exchange of currencies—they are pegged to the domestic currency, but payments at maturity are made in a convertible currency, usually the US dollar.

Some jurisdictions recognise only deliverable transactions, excluding non-deliverable ones. This is problematic for MDBs, which often rely on non-deliverable derivatives in situations where local forex market limitations or central bank regulations restrict full currency convertibility. Since most LMIC currencies are not fully convertible, non-deliverable derivatives are essential for managing foreign exchange risk while ensuring payments are made in a convertible currency.[66]

Despite their crucial role in MDBs' LC financing operations, some jurisdictions may classify non-deliverable derivatives as wagering or gambling contracts, making them unenforceable under local law.[67] In such cases, counterparties may be required to prove that the transaction is linked to the 'real economy' rather than being speculative.[68] This increases counterparty risks for MDBs, as there is a possibility that local courts may invalidate these transactions.

Additionally, the absence of established mechanisms such as netting, collateral agreements, and close-out frameworks—standard in developed capital markets—further increases MDBs' exposure to exchange rate and credit risks. Without these mechanisms, MDBs cannot effectively manage potential losses resulting from currency fluctuations or counterparty insolvency.[69]

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[65] Sulima (n 43) 9, 17-19.

[66] Interview 11, Bonizzi and others (n 8).

[67] Frontclear and OGResearch (n 32) 43; Abbas and Hazzaa (n 18) 62.

[68] Frontclear and OGResearch (n 32) 42-43.

[69] PM Werner, 'Close-out Netting and the World of Derivatives in Central and Eastern Europe and Beyond—ISDA's Perspective' in European Bank for Reconstruction and Development, *Law in Transition 2012: Developing Local Capital Markets* (EBRD 2012) 48-55; Frontclear and OGResearch (n 32) 43.

While derivatives laws in LMICs must consider their potential to become a source of systemic risk,[70] it is important to recognise that an appropriate legal framework for derivatives, tailored to the vulnerabilities of these economies, can foster the development of local capital markets. This, in turn, could enhance financial stability by promoting greater reliance on LC financing rather than foreign currency debt.

3.2.2. Challenges specific to MDBs

a. Counterparty credit risk restrictions

MDBs typically maintain strict internal guidelines that limit their capacity to transact with local financial institutions unless these counterparties meet stringent credit rating thresholds. These frameworks often require counterparties to hold a AAA in global scales or similarly high credit rating,[71] significantly narrowing the pool of eligible local entities for hedging operations. This presents a substantial challenge in LMICs, where few local financial institutions—particularly those most exposed to domestic currency volatility—meet the credit rating requirements to engage in derivative transactions such as currency swaps or forwards. The situation becomes even more problematic during economic downturns, when the credit ratings of local banks are likely to decline further.

These restrictions reduce the availability of hedging options in local markets, forcing reliance on international financial institutions for hedging operations. While hedging with local institutions may not always reduce costs, it would provide MDBs with greater flexibility in managing currency risks in the jurisdictions where they operate.

b. Cross-currency swaps with local central banks

In some cases, MDBs have utilised cross-currency swaps with local central banks to secure access to LC liquidity and mitigate foreign exchange risks.[72] These swaps not only support MDBs' LC financing operations but also help central banks stabilise currency demand and manage foreign exchange reserves during periods of economic instability. Such transactions

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[70] D Gabor, *Understanding the Financialisation of International Development Through 11 FAQs* (Heinrich Böll Stiftung North America, August 2018).

[71] Fink, Lankes, and Sacchetto (n 49) 26.

[72] See, e.g., TC Hoschka, 'Local Currency Financing: The Next Frontier for MDBs?', Economics and Research Department (ERD) Working Paper No 68 (Asian Development Bank, April 2005) 15 https://shorturl.at/mHw6c accessed 25 September 2024.

benefit both parties, provided the legal and regulatory frameworks surrounding derivatives are well-developed.[73]

However, the effectiveness of cross-currency swaps depends on the creditworthiness of the central bank involved and the strength of the legal environment governing derivative transactions. While there may be room for ad hoc negotiations with the central bank, MDBs must exercise greater caution when entering swap transactions in jurisdictions where the legal framework for derivatives is underdeveloped. The absence of clear regulations or comprehensive legal documentation introduces counterparty risks and increases exposure to regulatory uncertainty.[74]

3.3. Banking law and regulations

The regulatory framework governing local banks in LMICs can present significant challenges for MDBs operating onshore. These challenges arise from both the structure of banking law and the regulatory environment in which local financial institutions operate. This section explores several relevant legal and regulatory barriers to MDBs' local financing activities, including restrictions on non-residents' operations, local banking operations, and prudential regulation and capital requirements.

3.3.1. Restrictions on non-residents' operations

When operating onshore, MDBs may face limitations or restrictions on non-residents both seeking to access liquidity and lend in LC. Regarding borrowing, it is sometimes the case that MDBs attempt to access LC from domestic financial institutions to on-lend within local markets. However, central banks or other regulators may impose restrictions on non-residents accessing local liquidity. These restrictions are typically designed to protect LC markets from external pressures and manage foreign exchange risks. Consequently, MDBs may need to seek interpretations from local authorities and obtain exemptions or approvals to access LC.[75]

In addition to these restrictions, there may also be legal limitations on MDBs' ability to lend. In some jurisdictions, banking regulations may prevent non-resident entities from fully participating in local markets, requiring MDBs to obtain specific permissions or exemptions from relevant authorities to engage in local lending.[76]

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[73] Frontclear and OGResearch (n 32) 42-43.

[74] See, e.g., Werner (n 69).

[75] Interview 7, Bonizzi and others (n 8).

[76] Ibid.

To circumvent these regulatory hurdles, MDBs typically rely on alternative strategies such as engaging in cross-currency swaps, using local financial intermediaries, or issuing LC bonds.

3.3.2. Local banking infrastructures

A critical challenge MDBs face in LMICs is the underdevelopment of local financial infrastructure. In many jurisdictions, key operational components such as payment systems and local custody accounts are not fully developed.[77] The lack of integrated settlement systems and automated processes introduces delays and operational risks, generally increasing the cost and time involved in MDB operations onshore.

The requirements for opening local banking and custody accounts can be particularly burdensome for MDBs, as local banks often have limited experience working with international institutions. For instance, local banks may require specific documentation to open an account that does not align with the operations of international financial institutions.[78] Also, even small fees—such as taxes on bank transfers, typically reimbursed only at the end of the fiscal year—can affect how MDBs manage onshore financing.[79]

There are also instances of regulatory misalignment with the specific mandates of MDBs as international financial institutions. For instance, non-nationals may face specific restrictions when attempting to open bank or securities accounts with local financial institutions, registrars, or custodians. These restrictions can affect their ability to issue, repurchase, or redeem bonds, or manage payments such as interest and income distributions to investors.[80] Overall, the regulatory divergences across jurisdictions concerning local banking operations—such as opening exclusive accounts to deposit raised currency and then disbursing it—can be onerous for MDBs to manage.[81]

In cases where local counsel is unsure of the applicable regulatory framework, MDBs may need to consult the local central bank. This can result in lengthy discussions with local authorities, who are often protective of their regulatory domains, especially in countries that have undergone banking reforms.[82] Central banks have valid reasons for maintaining oversight, such as preventing financial institutions from engaging in risky activities. However, certain regulatory

[77] Frontclear and OGResearch (n 32) 27-31.

[78] Interview 10, Bonizzi and others (n 8).

[79] Ibid.

[80] Sulima (n 43) 9, 16.

[81] Interview 7, Bonizzi and others (n 8).

[82] Ibid.

restrictions—sometimes unintentionally—add an extra layer of complexity to the onshore operations of MDBs. This causes delays, even for transactions that appear relatively straightforward, such as opening a bank account.

3.3.3. Prudential regulation and capital requirements

In some jurisdictions, prudential regulations impose restrictive capital requirements on local institutional investors, such as pension funds and insurance companies. Regulatory frameworks may place caps on certain asset classes—such as corporate and government bonds—and set restrictions on both domestic and foreign investments. This is the case, for instance, in some Latin American[83] and Sub-Saharan African countries.[84]

As part of these prudential regulatory frameworks, capital requirement regulations often impose unfavourable risk weightings on locally issued debt securities. Such overly stringent liquidity standards increase the required capital that financial institutions must hold, disincentivising investment in local bonds.[85] Moreover, the absence of clear rules for risk weightings may exacerbate the problem, creating uncertainty about banks' regulatory obligations when investing in local securities.[86] These regulatory policies may create barriers to entry for potential investors, which in turn reduces liquidity and overall demand for local securities.

Within these frameworks, capital requirement regulations often treat MDB bonds as higher risk than local government bonds, limiting the ability of institutional investors to purchase them, despite the typically strong credit ratings of MDBs.[87] As a result, MDB bonds may experience reduced demand from local institutional investors, who are incentivised to favour domestic government bonds due to these regulatory provisions. The exclusion of MDB bonds from more favourable capital requirement regulations limits the options available for local institutional investors to diversify their portfolios in local capital markets, which often offer limited access to higher-quality assets.

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[83] B Bonizzi, D Guevara and J Churchill, 'Variegated Financialization and Pension Fund Asset Demand: The Case of Colombia and Perú' (2021) 19(2) Socio-Economic Review 789.

[84] E Osano, M Fuchs, A Mugi, and J Gathumi, *A Local Currency Solution for Multilateral Development Bank Portfolio Transfer* (FSD Africa 2024) https://fsdafrica.org/wp-content/uploads/2024/06/Report-Local-Currency-Solution-for-Multilateral-Development-Bank-Portfolio-Transfer-004.pdf accessed 10 October 2024.

[85] Hashimoto and others (n 28) 79.

[86] Dahan and others (n 18) 39.

[87] Interview 8 and Interview 16, Bonizzi and others (n 8).

3.4. Tax legislation

Tax legislation plays a critical role in shaping the attractiveness and viability of local capital markets, with important implications for the issuance of bonds by MDBs. In many jurisdictions, the legal frameworks that govern tax treatment are often fragmented or underdeveloped, creating negative incentives for the purchase of locally issued MDB bonds. These disincentives stem from various tax policies, such as those relating to withholding taxes, value-added tax (VAT), and capital gains tax.

One of the main challenges faced by MDBs in developing markets is the unequal tax treatment between government securities and bonds issued by non-domestic entities like MDBs.[88] In numerous jurisdictions, locally issued government securities benefit from more favourable tax treatment, often being exempt from withholding taxes, while MDB bonds remain subject to such levies.[89] For instance, domestic investors may be liable for withholding tax or VAT when purchasing MDB bonds, effectively penalising them for choosing MDB-issued securities over government bonds.[90] This disparity undermines the attractiveness of MDB bonds for domestic investors.

The absence of tax uniformity across different categories of issuers creates a barrier for MDBs that rely on tax-neutral environments to ensure competitive pricing for their debt instruments. MDBs typically issue bonds with the expectation that the proceeds will be used to fund LC lending or project finance in the issuing country. However, the imposition of negative tax incentives for the purchase of these bonds can undermine the development objectives that MDBs seek to advance.

Another key factor is regulatory uncertainty regarding the tax treatment of MDB bonds. When tax regimes do not clearly address the treatment of MDB bonds relative to government securities, investors in the local market—particularly local institutional investors such as pension funds and insurance companies—may be discouraged from including MDB bonds in their portfolios.

3.5. Exchange restrictions

Exchange restrictions take various forms and serve different purposes, including capital outflow or inflow controls, general and selective controls, market-based and quantitative controls, prudential controls, and controls imposed for macroeconomic or balance of payment

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[88] Interview 16, Bonizzi and others (n 8).

[89] Hashimoto and others (n 28) 40.

[90] Interview 16, Bonizzi and others (n 8).

reasons.[91] According to the IMF, an exchange restriction is 'a direct governmental limitation on the availability or use of exchange as such'.[92]

Given the limited foreign currency liquidity in many LMICs, exchange restrictions lead to what this report has previously referred to as convertibility and transfer risks. Convertibility risk refers to the inability to convert LC into foreign currency on repayment dates, while transfer risk involves capital outflow controls that prevent fund transfers to offshore creditors, even after the currency has been converted.[93]

MDBs often benefit from privileges and immunities that exempt them from local exchange and capital controls in their member countries. This special status, granted under their Articles of Agreement or founding treaties, generally allows MDBs to transfer funds, repatriate capital, and convert currencies without being subject to local restrictions. These treaty provisions mean that obligations to MDBs by both sovereign borrowers and private entities hold a priority claim on the international reserves of the central bank of the country of operations. Furthermore, MDBs hold a preferred creditor status (PCS) through customary international law, meaning that if a sovereign borrower cannot meet its international financial obligations, the debt claims of MDBs are typically treated as senior to those of bilateral and commercial creditors.[94] These conventions grant MDBs a senior claim on the balance of external payments, net of interest payments on external debt, and, in the case of sovereign loans, a senior claim on primary fiscal balances. In turn, the seniority of MDB claims on private borrowers is determined by the contractual terms of their financing.[95]

Despite their treaty-based privileges and immunities, MDBs may still face challenges in countries where extraordinary circumstances, such as sanctions or a shortage of foreign reserves, restrict cross-border payments.[96] In such cases, MDBs generally negotiate with national authorities to ensure that their senior claim on the country's external payments is upheld.[97] However, when conducting bond issuances or hedging transactions outside the

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[91] M Waibel, 'BIT by BIT: The Silent Liberalization of the Capital Account' in C Binder, U Kriebaum, A Reinisch, and S Wittich (eds), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer* (Oxford University Press 2009).

[92] Decision No. 1034-(60/27), 1 June 1960, *Selected Decisions of the International Monetary Fund and Selected Documents* (Washington, 10 May 1976), at 139.

[93] Fink, Lankes, and Sacchetto (n 49) 23.

[94] RSJ Martha, *The Financial Obligations in International Law* (Oxford University Press 2015) 492-513.

[95] W Buiter and S Fries, 'What Should the Multilateral Development Banks Do?', Working Paper No 74 (EBRD, June 2002) 8-9 https://www.ebrd.com/downloads/research/economics/workingpapers/wp0074.pdf accessed 26 September 2024.

[96] Interview 6 and Interview 14, Bonizzi and others (n 8)

[97] Ibid.

jurisdiction of a member state, the treaty-based privileges and immunities do not apply. This may expose MDBs to local exchange and capital transfer regulations adopted by the relevant authorities.[98]

In contrast, private entities and foreign investors purchasing MDB-issued LC bonds do not automatically benefit from the privileges or immunities of MDBs. As a result, they may be subject to exchange restrictions. For example, there may be restrictions on non-residents' ability to engage in forward foreign exchange contracts, limiting their capacity to hedge LC-denominated assets. Additional restrictions may apply to borrowing in LC, often affecting non-resident stockbrokers or custodian banks that require overdraft facilities to settle security purchases.[99]

These currency control restrictions can adversely affect the attractiveness of LC debt markets to foreign investors—including MDB bonds—contributing to greater shallowness of those markets.[100] As highlighted by one interviewee:

> 'One important thing that hampers the development of local currency is the local regulatory environment, particularly the existence of capital controls or obstacles to moving currency in and out of the country… The risks of investing in a country and repatriating the repayment… are important to consider… It is often not just about the amount of capital but the possibility of moving it, which can be challenging.'[101]

Certain provisions within Bilateral Investment Treaties (BITs) may offer exemptions from exchange restrictions for foreign investors. These treaties often include free transfer clauses that protect investors' rights to transfer capital, profits, dividends, loan repayments, and proceeds from partial or total liquidation or disposition of the investment freely and without undue restrictions. They may also require host states to allow such transfers in a freely convertible currency at the market exchange rate.[102] However, these clauses can be subject to balance-of-payments safeguards, permitting the state to impose exchange restrictions during serious balance-of-payments crises or external financial difficulties, or when capital

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[98] Interview 6, Bonizzi and others (n 8).

[99] See, e.g., Hashimoto and others (n 28) 100.

[100] Sulima (n 43) 9, 16.

[101] Interview 16, Bonizzi and others (n 8).

[102] M Waibel, 'BIT by BIT: The Silent Liberalization of the Capital Account' in C Binder, U Kriebaum, A Reinisch, and S Wittich (eds), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer* (Oxford University Press 2009), at 91.

movements pose significant threats to macroeconomic stability, particularly concerning monetary and exchange rate policies.[103]

3.6. Criminal and civil liability of public officials

A residual and often overlooked factor posing challenges to currency conversions of existing loans into LC, which emerged during interviews conducted by Bonizzi and others, is the local legal frameworks concerning the criminal and civil liability of public officials.[104] In some jurisdictions, officials may hesitate to make active decisions, such as seeking the conversion of MDB loans initially issued in hard currency into LC, due to concerns about being held liable if market conditions following the conversion result in financial losses for the state.

As a result, there is often reluctance to pursue conversions to LC, even when it may better align with the borrowing country's economic needs and debt management strategy. As summarised by an interviewee: 'Once a loan is issued in dollars, it is hard to change because everyone is afraid of making a decision—although by not deciding, you're still deciding. There is an inertia due to these incentives.'[105]

4. Complexities and tailoring of contracts

As previously noted in this paper, MDBs have traditionally operated as dollar-based institutions, conducting most of their financing activities in hard currency. A legal repercussion of this institutional legacy is that, when engaging in LC financing, MDBs often replicate the contractual provisions used in their FC agreements in their facility agreements in LC. This includes maintaining governing laws such as New York or English law, which provide a familiar legal framework for both MDBs and international investors.[106]

The widespread adoption of these core governing laws in international finance, reflecting broader global monetary hierarchies,[107] is generally interpreted by practitioners as a means of

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[103] ibid.

[104] Interview 11, Bonizzi and others (n 8).

[105] Ibid.

[106] Interview 7 and Interview 14, Bonizzi and others (n 8).

[107] K Patrício Ferreira Lima, 'Sovereign Solvency as Monetary Power' (2022) 25(3) *Journal of International Economic Law* 424–446; A Kaltenbrunner, 'Financialised Internationalisation and Structural Hierarchies: A Mixed-Method Study of Exchange Rate Determination in Emerging Economies' (2018) 42(5) Cambridge Journal of Economics 1315–1341.

utilising standardised agreements that facilitate harmonisation in lending processes and ensure legal certainty.[108] As one interviewee remarked:

> 'If we were to lend based on local law and forum in all those jurisdictions, it would be incredibly challenging. We'd need to know all the laws of those places, which is not feasible. The only way we can have an efficient lending platform is if we have legal standards that are enforceable under English law and New York law'.[109]

However, some regional MDBs, particularly those more embedded within local legal and financial systems, may occasionally opt to use local law, particularly when dealing with longstanding clients or less complex transactions.[110] This practice is seen as aligning more closely with the expectations and practices of local clients, as 'there is a big push by the market for local law and local currency'.[111] Nonetheless, for larger transactions or those involving new clients, especially where multiple international lenders are involved, New York or English law is generally preferred.[112]

While loan agreements may be governed by New York or English law, certain instruments—such as equity subscription agreements, mortgage agreements, and security interests on equipment, collateral, and other assets—are necessarily governed by local law.[113] This is because the assets securing the loan are usually located within the borrower's jurisdiction. To ensure that these arrangements are properly perfected and enforceable under domestic legal frameworks, MDBs engage local counsel.[114] As one interviewee explained, 'typically, the security would be governed by local law, though sometimes we might get an English law guarantee from a sponsor'.[115]

Despite similarities between the contractual provisions of local and hard currency financing, LC contracts are inherently more complex due to the challenges of sourcing LC and managing associated risks. These challenges require a greater degree of tailoring in contractual

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[108] Interview 7, Interview 13, and Interview 14, Bonizzi and others (n 8).

[109] Interview 7, Bonizzi and others (n 8).

[110] Interview 13, Bonizzi and others (n 8).

[111] Ibid.

[112] Ibid.

[113] Article 5.2 of the Asian Infrastructure Investment Bank's *Operational Policy on Financing* (26 June 2024).

[114] Interview 14, Bonizzi and others (n 8).

[115] Ibid.

provisions, particularly in matching funding sources with lending terms and adapting to local market practices. As succinctly summarised by one interviewee:

> 'There are always going to be unusual elements in our local currency financing that are required by the fact that we are a dollar-based institution and that we want to minimise costs and risks associated with doing things that are not in dollars'.[116]

4.1. Matching funding sources with lending terms

Funding and hedging-related clauses are crucial in LC financing arrangements due to the specific funding mechanics employed by MDBs and the need to match funding or hedging sources with lending terms.

One such clause pertains to temporary currency substitution, addressing situations where the MDB is unable to source the LC for the financing arrangement. For example, Article IV, Section 4.04(a) of the *General Conditions applicable to Loan, Guarantee, and Grant Agreements of the African Development Bank and the African Development Fund* states that 'if the Bank reasonably determines that an extraordinary situation, whether factual or legal, has arisen under which the Bank is unable to provide the loan currency', it 'shall promptly notify the Borrower of its inability to access or procure' such currency. Additionally, if the parties cannot agree on a substitute currency, 'the Borrower may cancel the undisbursed portion of the Loan for which an agreement has not been reached as to the currency of substitution'.[117]

Another distinctive feature of LC financing arrangements is their pricing clauses, influenced by the costs incurred by the MDB in sourcing LC. While hard currency loans are typically based on established benchmarks such as LIBOR or SOFR, the interest rates and fees in LC loans are affected by the costs of issuing LC bonds or engaging in currency swaps to hedge against exchange rate risks. Thus, the pricing process in LC lending involves bespoke interactions with borrowers to ensure they understand the variability in costs associated with different funding structures. As explained by an interviewee:

> 'We engage with borrowers to ensure they have control over pricing, which can vary significantly if funded through swaps or bonds. This is crucial because once we commit to a swap or bond, we are obligated to our counterparty or investors, regardless of whether the borrower finds the rate

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[116] Interview 7, Bonizzi and others (n 8).

[117] African Development Bank Group, *General Conditions applicable to Loan, Guarantee and Grant Agreements of the African Development Bank and the African Development Fund* (February 2009) https://shorturl.at/NCoOk accessed 26 July 2024.

acceptable. This involvement of the borrower in the pricing process is what distinguishes local currency lending from dollar lending.'[118]

Notably, pricing clauses addressing market disruption and increased costs enable MDBs to manage the risk if sourcing LC becomes prohibitively expensive or impossible. These clauses provide mechanisms for either continuing or exiting the arrangement under specific terms.[119] For instance, Article III, Section 3.03(b) of the *General Conditions applicable to Loan, Guarantee, and Grant Agreements of the African Development Bank and the African Development Fund* provides that 'the Bank may establish an alternate interest rate [other than the rate specified in the Loan Agreement] which shall be applicable if, for any reason, including, but not limited to, financial market disruption, the Bank determines that it has become impossible to calculate the interest rate in the manner agreed upon in the Loan Agreement'. If the costs of LC sourcing increase, the same provision continues: 'the Borrower shall have the right to prepay the Loan without thereby incurring any penalty or prepayment costs'.[120]

Another important type of pricing clause addresses unwinding costs, applicable when a borrower seeks to prepay a loan or terminate the financing early.[121] These costs are passed onto the borrower,[122] potentially increasing transaction costs depending on market conditions. For example, Article III, Section 3.06(c) of the *General Conditions applicable to Loan, Guarantee, and Grant Agreements of the African Development Bank and the African Development Fund* establishes that 'prepayment costs ... on prepayment of any maturity shall... be an amount reasonably determined by the Bank to represent any cost to the Bank of redeploying the amount to be prepaid from the date of prepayment to the maturity date...'.[123]

These costs include those incurred in engaging in currency swaps with third parties, from which the lender must then withdraw, incurring transactional costs for the MDB. As one interviewee observed:

> 'If the borrower wants to prepay, we have to terminate the swap we entered into, and there could be a cost associated with that... All these costs associated with getting out of a local currency financing early have to be part of the equation agreed to upfront with the borrower.'[124]

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[118] Interview 7, Bonizzi and others (n 8).

[119] Interview 14, Bonizzi and others (n 8).

[120] African Development Bank Group (n 117).

[121] Interview 14, Bonizzi and others (n 8).

[122] Interview 7, Bonizzi and others (n 8).

[123] African Development Bank Group (n 117).

[124] Interview 7, Bonizzi and others (n 8).

4.2. Specific definitions and operational provisions

Another set of distinct terms in LC financing involves specific definitions and operational clauses tailored to local market practices. This includes defining business days, interest payment dates, and the method for calculating interest in line with the practices adopted in the local market.[125] Additionally, adaptations may be required to ensure payment mechanisms, settlement instructions, and communication protocols align with the local financial infrastructure. This often involves modifying standard contractual terms to accommodate local payment systems and clearing mechanisms.[126]

While these may seem like minor adjustments, they may require the engagement of local counsel to ensure the arrangement operates effectively within the market practices and financial infrastructure of the borrower's country.

[125] Interview 14, Bonizzi and others (n 8).

[126] Interview 13, Bonizzi and others (n 8).

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