



Rational pricing in local currency non-sovereign lending¹

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Summary

This article proposes a rational pricing approach to local currency (LCY) non-sovereign operations by development finance institutions (DFIs) and multi-lateral development banks (MDBs).² Rational LCY pricing ensures that non-sovereign operations are additional and non-distortionary, and that there are no price discrepancies between LCY lending funded through cross-currency swaps (CCS) and LCY lending funded through LCY bonds.

Appropriate instruments, additionality, and no market distortion

In sovereign operations, because sovereigns can print money, appropriate MDB instruments are foreign currency (FCY) loans. Therefore, loans are usually extended in euros (EUR), Japanese yen (JPY), pound sterling (GBP), or United States dollars (USD), and they are concessional in nature.³ Due to preferred creditor treatment (PCT)⁴, which is related to concessionality and countercyclicality⁵, defaults are extremely rare and relatively inexpensive⁶.

In non-sovereign operations, appropriate DFI and MDB instruments are those that do not create unwarranted currency risk: if a project generates FCY revenue, financing the project in FCY is appropriate; alternatively, if a project generates LCY revenue, financing the project in LCY is appropriate.⁷ In either case, the financing should be additional⁸ and should not distort markets⁹. The “additionality principle” says that the private sector is not to be crowded out; thus, a development challenge or a market failure must be addressed. The “no market distortion principle” says that the normal functioning of markets is not to be disrupted; hence, concessionality, if any, must be minimized.

After-swap pricing and market segmentation

DFIs and MDBs may extend loans only in approved lending currencies. CCS can be attached to loans in order to manage currency risk, and CCS may be transacted only with approved swap counterparties.

DFIs and MDBs use CCS in their funding operations. Specifically, DFIs and MDBs that are interested in USD after-swap borrowing cost issue bonds denominated in EUR, GBP, and JPY, among other currencies, and use EUR-USD, GBP-USD, and JPY-USD CCS, respectively, to convert the exposures to USD. Because only the USD after-swap borrowing cost matters, the EUR, GBP, and JPY borrowing cost is basically irrelevant.¹⁰

A similar situation arises in some sovereign operations. Upon extending FCY loans, MDBs may use CCS to convert the exposures to LCY on behalf of their borrowers.¹¹ MDBs offer this risk management service to their shareholders upon request and charge fees¹², and MDBs can offer the service only when adequate CCS are available¹³. Because the underlying loans are concessional and because the CCS are executed by the MDBs on behalf of their borrowers, the LCY after-swap lending rates do not necessarily reflect the LCY credit profiles of the borrowers.

The situation in non-sovereign operations is only slightly different. Although they do not tend to extend FCY loans and then use CCS to convert the exposures to LCY, DFIs and MDBs price in FCY and use CCS to obtain LCY pricing.¹⁴ Because FCY and LCY markets are segmented and because the CCS are executed by the DFIs and MDBs, the resulting LCY lending rates do not necessarily reflect market, or fair, LCY pricing.¹⁵

Like FCY and LCY markets, deliverable and non-deliverable CCS markets are segmented.¹⁶ Deliverable CCS are not really necessary to manage currency risk, and non-deliverable CCS have the advantage of not

requiring access to LCY. For this reason, with sovereign support, several DFIs and MDBs established The Currency Exchange Fund (TCX) in 2007.¹⁷ TCX's primary function is to transact non-deliverable CCS, converting FCY pricing—predominantly EUR pricing and USD pricing—into LCY pricing whenever LCY loans are the appropriate instruments.

Converting FCY pricing into LCY pricing may be questionable for yet another reason. Given that they reduce risk, appropriate instruments ought to reduce return. Therefore, when an LCY loan is the appropriate instrument, the FCY pricing of the loan when extended in FCY should be worse than the FCY pricing of the loan when extended in LCY through a CCS that converts FCY pricing into LCY pricing.

Lastly, if offering appropriate instruments is a developmental objective, it is unclear why a borrower would be given the option between an FCY loan and an LCY loan. Since LCY rates are higher than FCY rates, if given the option, a borrower may prefer an FCY loan to an LCY loan even when an LCY loan is the appropriate instrument.

Rational LCY pricing

Shareholders of DFIs and MDBs can decide whether offering appropriate non-sovereign instruments is a developmental objective. Also, shareholders can explore, potentially subject to the development objective of offering appropriate instruments, whether additionality in FCY loans can be different from additionality in LCY loans. However, shareholders have already accepted the “no market distortion principle,” so LCY pricing must be rational.

LCY pricing is rational if it reflects LCY risk associated with similar credit quality and identical financing terms and conditions. This means that LCY loans should be priced in LCY; then, whenever desired, LCY

pricing can be converted into FCY pricing, such as EUR pricing and USD pricing, through CCS. In particular, the LCY lending rates offered by DFIs and MDBs should not depend on how LCY is sourced.¹⁸ When pricing is rational, the LCY lending rate for a non-sovereign operation does not depend on whether LCY is sourced through CCS or through LCY bonds. This is a key concept in Finance: the cost of capital associated with an investment depends on the riskiness of the investment. It is the use—not the source—of the funds that matters.¹⁹

In effect, DFIs and MDBs should treat all lending currencies equally, maintaining, or modeling, zero curves for various credit qualities in each lending currency. Correspondingly, TCX's function should be to convert LCY pricing into FCY pricing.

Importantly, if they believe that TCX's model—which is to be short USD and long LCY while relying primarily on LCY diversification—is financially sound, TCX's shareholders should be willing to implement the model within their institutions.²⁰ Since diversification is key, TCX's shareholders could explore non-sovereign exposure exchanges similar to those executed by MDBs in the sovereign space.²¹

Footnotes

1. The article is based on a document of April 3, 2025.
2. In Development Finance, operations are broadly divided into sovereign guaranteed (also known as sovereign) and non-sovereign guaranteed (also known as non-sovereign). Sovereign operations are often referred to as public-sector operations, and non-sovereign operations are often referred to as private-sector operations.
3. An MDB loan is defined as concessional if the borrower cannot obtain a loan on similar or better terms from commercial creditors. In sovereign operations, an MDB's lending rate is related to its borrowing cost. This is why pricing is said to be on a pass-through basis. For instance, see <https://thedocs.worldbank.org/en/doc/77844b3f4182f7519f58add85ecaff3f-0340012021/original/IBRD-Flexible-Loan-IFL-Pricing-Basics-Product-Note.pdf>.
4. PCT, which is a discretionary—not a legal—arrangement, is defined by two elements: 1) exemption from participation in debt rescheduling coordinated by the Paris Club under the principle of “comparability of treatment” and 2) moratorium on new loans by the International Monetary

- Fund and MDBs until default is cured. As a result, sovereign defaults to MDBs tend to be cured before sovereign defaults to commercial creditors.
5. MDBs are supposed to act countercyclically, extending greater financial support during bad economic times than during good economic times; for example, see https://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.
6. All arrears are cleared, and the only cost of default is the time value of money.
7. An argument can be made that currency risk can be managed at the balance sheet level.
8. For instance, see <https://www.ifc.org/content/dam/ifc/doc/2023/ifc-articles-of-agreement-en.pdf>: “the Corporation shall not undertake any financing for which in its opinion sufficient private capital could be obtained on reasonable terms.”
9. For example, see <https://www.ifc.org/content/dam/ifc/doc/2023/ifc-articles-of-agreement-en.pdf>: “the Corporation shall undertake its financing on terms and conditions which it considers appropriate, taking into account the requirements of the enterprise, the risks being undertaken by the Corporation and the terms and conditions normally obtained by private investors for similar financing.”
10. An MDB can issue a fixed-rate EUR bond and swap the exposure to floating-rate USD. The floating-rate USD cost is what matters most.
11. MDBs may also issue LCY bonds. For instance, see <https://thedocs.worldbank.org/en/doc/06fa597117ada0801cc2cdcca0788623-0340012021/original/Local-Currency-Financing-Product-Note.pdf>. In the case of an MDB with a USD balance sheet, currency risks arising from non-USD FCY loans may also need to be managed; for instance, if a borrower needs EUR, the MDB may have to transact a USD-EUR CCS.
12. For example, see <https://projects.worldbank.org/en/about/unit/treasury/ibrd-financial-products/local-currency-financing>.
13. When MDB currency risk is managed through LCY bonds, which is usually more operationally complicated than through CCS, the availability of the service depends on LCY capital markets. In the case of an MDB with a USD balance sheet, LCY bonds create translation risk: while the MDB earns a positive LCY net interest margin (NIM), the USD value of the NIM is affected by LCY-USD exchange rate variation.

14. This is not to say that it is a bad idea for DFIs and MDBs to go through their non-sovereign loan portfolios and, whenever appropriate, convert FCY loans to LCY loans.
15. Consider the parallel case of hedging LCY loans with LCY bonds. DFIs and MDBs would source LCY, manage LCY liquidity pools, and finance projects in LCY. Instead of pricing projects directly in LCY, they would price in FCY and use CCS to reach their LCY pricing. So, when both deliverable and non-deliverable CCS are available, DFIs and MDBs would have to choose between pairs of prices. Moreover, LCY can be sourced either through LCY bond issues or through CCS, and there may be disparities between onshore and offshore markets.
16. In a deliverable CCS, there are initial and final exchanges of notional amounts, and interest payments are made in the individual currencies. In a non-deliverable CCS, everything is settled in one currency; for instance, in an LCY-USD CCS, all settlement is in USD. Hence, in a non-deliverable CCS, there is no need for an initial exchange of notional amounts.
17. <https://www.tcxfund.com/>. The author was the inaugural Deputy Managing Director, as well as one of two Statutory Directors, of TCX Investment Management Company. TCX granted the author a fully delegated responsibility for TCX's transaction process.
18. This is a fundamental difference between sovereign and non-sovereign operations. Sovereign operations are pass-through, while non-sovereign operations are market-based.
19. Thus, the terms “appropriate discount rate,” “cost of capital,” and “required return” have basically the same meaning.
20. <https://www.tcxfund.com/tcx-investors/>
21. <https://www.adb.org/news/features/qa-sovereign-exposure-exchanges-allow-mdb-reduce-portfolio-concentration-risks>