PROPOSAL RELATED TO THE USE OF LOCAL CURRENCY LOANS UNDER THE SCF TRUST FUND

I. INTRODUCTION

1. At its meeting in November 2012, the joint CTF and SCF Trust Fund Committees requested the Trustee to prepare a proposal as to resources that should be set aside to allow the CTF and SCF Trust Funds, as an interim measure pending the development of the Enterprise Risk Management Framework, to bear the currency risks related to the use of local currencies in private sector projects up to May 2013. The Trustee was requested to base its quantitative analysis on the following information, to be disaggregated for the CTF and SCF Trust Funds, to allow the Committees to take an informed decision on this issue:

a) the maximum amount that can be allocated to the MDBs to use for local currency lending;

b) the amount of the foreign exchange reserve to cover potential foreign exchange losses; and

c) projections of the number and size of local currency loans they are expected to be committed between now and May 2013.

2. In the course of the research, analysis and discussions with MDB focal points, it was reiterated that there are significant differences in financial risks, risk tolerance and complexity in the SCF and CTF Trust Funds arising from the different financial structures of each of the Trust Funds. In order to provide the necessary space for the respective Trust Fund Committees to discuss and make independent decisions on the local currency issue, it was determined that it would be beneficial to separate the proposals for each Trust Fund. Therefore, the SCF and CTF proposals for authorizing local currency lending up to May 2013 are being presented in separate documents.[1]

3. This document presents the proposal for the SCF Trust Fund. Section II presents the rationale for separating the proposals. Section III presents the proposed maximum amount for local currency lending for the Strategic Climate Fund (SCF) pending the development of the Enterprise Risk Management Framework. Section IV presents the details of the arrangement for sharing of losses and gains under the SCF resulting from local currency lending.

II. RATIONALE FOR SEPARATING THE PROPOSALS

4. One of the key differences between the SCF Trust Fund and the CTF Trust Fund is that the SCF Trust Fund allows for grant and capital contributions only. Thus, the SCF Trust Fund does not have liabilities to loan contributors and therefore does not have to meet semi-annual debt service obligations as in the case of the CTF Trust Fund. Consequently, under the SCF Trust Fund, the financial impact of potential losses due to exchange rate fluctuations on local currency loans would be limited to the calculated final shares of the SCF grant and capital contributors at the close of the SCF Trust Fund. In the CTF Trust Fund, however, potential losses on local

[1] The Proposal related to the use of local currency loans in the CTF Trust Fund will be circulated to the members of the joint meeting of the CTF and SCF Trust Fund Committees on or before January 31, 2013.

currency loans due to exchange rate fluctuations could impact the CTF Trust Fund's ability to repay loan contributors any time up to the maturity of the loan contributions.

5. Given this fundamental difference between the two trust funds, the Trustee has established different financial risk management and monitoring measures for each of the CIF trust funds. For instance, in the CTF Trust Fund, the Trustee has put in place the following risk monitoring measures: (a) maintaining a minimum liquidity reserve in order to ensure debt service payments to loan contributors can be met; (b) preparing quarterly projections on project repayments and possible default scenarios to monitor the ability of the CTF Trust Fund to cover debt service payments to loan contributors, (c) simulating the default sharing mechanism to determine the overall impact on the loan payout to loan contributors; and (d) keeping track of interest rates on private sector projects to ensure that the terms of the private sector loans are no more concessional than the terms of loan contributions.

6. None of these measures are critical to the financial management and risk monitoring of the SCF Trust Fund. Therefore, the analysis needed to develop a proposal for the CTF Trust Fund is more complex than what is needed for the SCF Trust Fund. Based on this, it was determined that it would be beneficial to separate the proposals for each Trust Fund.

III. Proposed Maximum Amount for Local Currency Lending for the Strategic Climate Fund (SCF) Pending the Development of the Enterprise Risk Management Framework

7. Following the November 2012 meeting, the MDBs provided to the Trustee an estimate of local currency needs pending the development of an Enterprise Risk Management Framework. These estimates represented the possible demand for local currency lending for private sector projects under the SCF Trust Fund.

8. As per the information provided by the MDBs (shown in Table 1 below), local currency needs up to May 2013 for the SCF Trust Fund total USD 24 million, which includes funding for projects to be jointly implemented by IFC and ADB in Nepal and Maldives under the SREP.

Table 1. MDB Estimates of SREP local currency needs up to May 2013

Country	Sub-Program	Currency	Amount estimated to be required for local currency lending (in USD millions)
Nepal	SREP	NPR	19
Maldives	SREP	MVR	5
Total			**24**

9. The Trustee proposes that the joint meeting of the SCF Trust Fund Committee agree that USD 24 million requested by the MDBs for two programs under SREP may be used for local currency financing pending the development of the Enterprise Risk Management Framework. Further, the Trustee confirms that no foreign exchange reserve is required to be set aside under the SREP for loss provisioning due to local currency exchange rate movements.

10. The amount designated as the upper limit for local currency lending under the SREP will be reviewed in May 2013 along with local currency needs for the FIP and PPCR as a part of the SCF risk assessment to be carried out under the ERM Framework, as approved at the joint meeting of the CTF and SCF Trust Fund Committees.

IV. LOSS/GAIN SHARING APPROACH FOR CONTRIBUTORS

11. Losses or gains on local currency loans can arise when the exchange rate of the loan currency fluctuates against the USD over the life of the loan and at the time of repayment. This results in a higher or lower repayment amount when converted back into USD. The following is the agreed process to record and manage local currency loans:

a) The Committee approves a USD amount for a private sector program and agrees that the program may employ local currency lending;

b) The Trustee records the USD approved amount in its system and flags the program as 'approved' for local currency lending;

c) The Trustee commits the USD amount to the MDB and transfers such funds in accordance with the Financial Procedures Agreement (FPA) between the Trustee and the MDB;

d) Following the procedures for the relevant MDB, upon receipt of transferred funds from the Trustee, the MDBs or the country borrower converts the USD amounts disbursed from the SCF Trust Fund into local currency;

e) Repayments from the borrower to the MDB will follow the procedures of the relevant MDB and are governed by the agreements between the borrower and the MDB;

f) The MDB will return all proceeds received by borrowers to the SCF Trust Fund in USDs and in accordance with the FPA; and

g) Losses or gains incurred due to the use of local currency lending will be taken into account for the final balance of the SCF Trust Fund. When the SCF Trust Fund is liquidated, the balance of funds remaining in the Fund will be returned to Contributors based on the type and amount of contribution as provided in the Standard Provisions Applicable to the Strategic Climate Fund, attached to the Contribution Agreements between the Trustee and the SCF contributors.