Vice-presidency of Sectors and Knowledge

KNOWLEDGE NOTES
FEBRUARY 2011

Knowledge and Learning Sector

Initiatives don't sell themselves: Lessons Learned from the IDB Conversion Offer 2009–2010

Staff from five Bank departments (FIN, ITE, VPS, RMG and LEG) formed a core team that designed and executed the largest IDB conversion offer to date, and one of the largest liability management operations ever executed by emerging markets. The team learned that the design of an optional, cost neutral and scalable initiative needs to be accompanied by an effective outreach strategy and constant responsiveness to clients' needs.

Background

With the introduction of new financial products over the past five years, the IDB has been committed to providing flexible, market-based financial solutions to address the needs of its clients. Bank borrowers now have the ability to create their own mix of floating and fixed-rate exposures in new loans, via the Single Currency Facility (SCF)LIBOR and SCF-FIX products. Previously, disbursed and undisbursed adjustable rate loans were not convertible to SCF-LIBOR and SCF-FIX based rates. As a result, borrowers' flexibility to manage interest rate and foreign exchange risks associated with IDB debt was restricted.

The 2008–2009 financial crisis provided a critical incentive for the Bank to recognize the need for a Conversion Offer. Borrowers were faced with large differentials between market- and pool-based rates and the inability to hedge adjustable rate loans. This prompted a number of borrowers to consider prepayment, with important cost implications for other Bank borrowers. The financial crisis made a conversion very attractive for borrowers due to the low interest rates. "*It was the push that took us over the cliff*" as described by one member of the team.

On January 14, 2009, the IDB launched the Conversion Offer, which aligned the Bank with peer institutions that have already moved to fully market-based financial products. This initiative gave borrowers the option to amend loan contracts to convert close to $35bn of disbursed and $5bn of undisbursed loan balances with adjustable rates (ADJ), under the SCF and Currency Pooling System (CPS), to market-based products: USD LIBOR-based, fixed-rate, or any combination thereof; and to dollarize existing CPS loans. In parallel, SCF-ADJ products were closed for new approvals. With the Offer, borrowers now have the flexibility to blend IDB funding with market sources to improve portfolio management strategies and achieve desired asset/liability objectives.

Contributors to this note:

From the Conversion Offer team: Claudia Franco, Carlos Herrera, and Diego Murguiondo (FIN), and Frank Sperling(RMG) participated in the after action review (AAR) coordinated by KNL on February 28, 2010, to identify lessons learned from the Offer and provided valuable feedback on the draft note. Christel Steinvorth (KNL) documented the AAR session.

Author of the note and facilitator of the AAR session: Lina Salazar (KNL).

The results

The Conversion Offer had two execution dates: August 1, 2009 and August 1, 2010, with sign-up periods ending on June 30, 2009 and June 30, 2010, respectively. As conversions require amendments to loan contracts, the two dates aimed to accommodate internal approval processes that different borrowers have.

The Offer was well-received by borrowers, as shown by their high participation rates (see Table 1). Twenty four borrowing countries and 44 other entities with sovereign guaranteed loans participated, for a total $32 billion of outstanding debt and a total participation rate of 92%. Through the Offer, most borrowers were able to take advantage of historically low interest rates in dollars to lock in fixed rates in outstanding debt with the Bank. In addition, borrowers were able to adjust their foreign exchange exposure by dollarizing 88% of outstanding loans under the CPS, the first of its kind offered by the IDB.

Table 1 – Conversion Offer – Final Participation Rates as of July 31, 2009 and as of July 31, 2010 – Summary

Amounts in millions of USD -

	OUTSTANDING 2009			OUTSTANDING 2010			TOTAL		
Borrowers	CPS	SCF	Total	CPS	SCF	Total	CPS	SCF	Total
Eligible CPS and SCF Adjustable									
Sovereign & Sub-sovereign borrowers	$11,383	$23,388	$34,771	$4,058	$4,202	$8,261	$11,036	$23,529	$34,565
Total	**$11,383**	**$23,388**	**$34,771**	**$4,058**	**$4,202**	**$8,261**	**$11,036**	**$23,529**	**$34,565**
Participation amounts									
Sovereign & Sub-sovereign borrowers	$6,978	$19,327	$26,305	$2,697	$2,955	$5,652	$9,675	$22,282	$31,956
Total	**$6,978**	**$19,327**	**$26,305**	**$2,697**	**$2,955**	**$5,652**	**$9,675**	**$22,282**	**$31,956**
	Number of loans		**518**	**Number of loans**		**151**			
Participation rates									
Sovereign & Sub-sovereign borrowers	61%	83%	76%	66%	70%	68%	88%	95%	92%
Total	**61%**	**83%**	**76%**	**66%**	**70%**	**68%**	**88%**	**95%**	**92%**
# of loans			518			151			669
# of borrowers			41			32			68
Sovereign (*)			19			10			24
Sub-sovereign			22			22			44
% Fixed	77%	94%	89%	47%	76%	62%	69%	91%	84%
% Libor Based	23%	6%	11%	53%	24%	38%	31%	9%	16%
Interest Rate Choice									
Fixed	$5,383	$18,112	$23,495	$1,256	$2,240	$3,496	$6,639	$20,352	$26,992
Libor Based	$1,595	$1,214	$2,809	$1,441	$715	$2,156	$3,036	$1,929	$4,965

(*) Five sovereigns participated twice in the conversion offer. One sovereign did not participate.

Table 2 – Largest Debt Exchanges Executed by Emerging Markets Borrowers & MDBs
(USD billions)

Country/MDB	Purpose	Issue date	Amount (USD bill.)
Brazil	Brady Bonds	April 1994	$99
Mexico	Brady Bonds	March 1990	$52
Argentina	Brady Bonds	April 1993	$38
Argentina	Mega Debt Exchange	June 2001	$30
IDB	**Debt exchange**	**August 2009**	**$26**
Russia	Vanesh Debt Exchange	June/July 1998	$20
World Bank	*Debt exchange*	*June2006–June2009*	*$11*
Russia	GKO Debt Exchange	August 2000	$10
Brazil	Debt exchange	August 2005	$5
Venezuela	Debt exchange	September 1997	$4
Asian Dev. Bank	*Debt exchange*	*Dec.2007–Dec.2009*	*<$0.5*

Sources: World Bank, Asian Development Bank and Bloomberg.

In addition to being the largest conversion offer ever executed by the IDB, this is one of the largest liability management operations ever executed by emerging market borrowers. The Bank's Executive Vice President, in his speech during the July, 2009 Governors meeting in Chile, highlighted this achievement. Table 2 provides a comparison of debt exchanges by country and multilateral development banks (MDBs) and the IDB's first Conversion period results.

Savings for borrowers

The dollarization of CPS loans created $458 million in borrowers' savings as of December 31, 2010. These savings are based on the revaluation of the CPS loans' Unit of Account (UAV), which means that those that opted out of the CPS would have incurred an appreciation of their OLB in USD 458 million or 4.7%.

All loan conversions maintain their contractual dates, repayments and maturity conditions and no transaction fees are charged for the conversions. The initiative includes a contractual provision that enables the Bank to pass any loss or gain to the borrower that chooses to prepay.

The Offer also provides borrowers with price transparency in rates and ability to better budget borrowing costs in converted loans with the IDB. Embedded in the pricing of adjustable rate loans is a weighted average cost of pools with a changing composition of fixed and floating rate loans by the IDB. This cost is difficult to project by borrowers. With the Offer, loans with the IDB are now linked to market rates, providing price transparency and the forecasting ability sought by IDB borrowers.

Critical factors and lessons learned

Although the Conversion Offer aligned the IDB with peer institutions that have already moved to fully market-based financial products, the results of the Offer were unprecedented when compared to the offers extended by other MDBs and to the 2003 attempt by the IDB to dollarize CPS loans. Some of the key lessons from its preparation and execution are:

1. **The design of an optional, cost neutral and scalable Offer was crucial in attracting borrowers' interest and fomenting their sense of trust that they were being offered an option that met their best interests.**

   As one member of the team emphasized, the Offer was designed with the borrowers in mind. The guiding questions were: Is it easy to implement? Is it understandable? Does it make sense to borrowers? Over the years, a number of borrowing countries had expressed interest in moving pool-based loans to market-based products. This input, combined with the results of targeted consultations by the team with public credit offices in six countries, and with the LAC Debt Group[1] as a whole provided a solid basis for shaping the instrument's design. During this consultation, the Bank assessed demand and tested features critical to the acceptance of the Offer such as ability to choose interest rate composition between fix and floating rates in one single loan; the fact the it was an optional initiative, and the ability to dollarize CPS loans.

   The main objective of the design phase was to develop an instrument that responded to borrowers' needs while protecting the Bank's equity. To achieve this, the following key characteristics were incorporated:

   - **Optionality**: The Conversion does not require mandatory participation of all borrowers. Those preferring to stay with adjustable rate loans could choose to do so.
   - **Cost Neutrality**: The Conversion is based on current market rates and is cost neutral to the Bank and to borrowers that might choose not to participate.
   - **Scalability**: The Bank has the ability to execute the Conversion independently of the level of borrower participation, with no impact on additional resources.
   - **Maintaining the Cooperative**: Like before the Conversion, all loans that participated in the Offer carry the same base interest rate; that is, new applicable rates post conversion are the same for all converted loans under each product.

The optionality feature resulted in part, from one of the lessons learned from an attempt in 2003 at a compulsory offer. Only one country subscribed to the effort. From that experience, the team also learned that for the initiative to work it had to be scalable and fair for both the Bank and the borrowers.

The legal execution of the Offer was based on a contractual amendment package. A total of 669 loan contracts were modified during both conversion periods. Key to this result was the design of a client friendly, umbrella style, loan contract modification package specifically tailored to facilitate its implementation. This enabled borrowers to modify all eligible loans through one single document, facilitating internal approval processes and reducing the time that otherwise would have been spent to modifying one loan contract at a time.

Attaching specific deadlines to the Offer helped to increase participation. This may in part explain the success of the Offer as compared with other MDBs. As one team member explains "*This kind of initiative can roll for ever if it is open-ended. Deadlines force people to act. This was very important*".

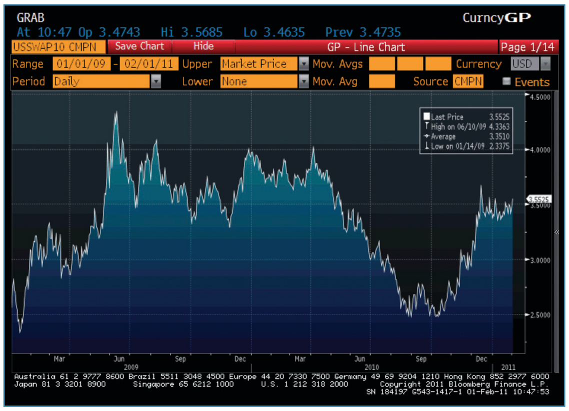
[1] See http://www.iadb.org/lacdebtgroup/ A mediados del año 2008

2. The design of an attractive instrument coupled with a multi-tiered outreach strategy, high responsiveness to clients and periodic rate quotes not only attracted borrowers' interest but also facilitated their understanding and decision-making, while providing a sense of transparency about the Offer.

The establishment of key partnerships with borrowers early in the process proved to be a key lesson. As team members concluded, once a guarantor is on board (typically debt management offices), it as much easier to engage other borrowers in far-reaching initiatives that require guarantor approval. For this reason, during the conversion offer, the dialogue with such borrowers became easier, more productive and less time consuming for all parties involved.

A crucial event during the promotion of the Offer was the IDB Annual Meeting of Governors in Medellín, Colombia, in March 2009. This gathering coincided with the sign up phase of the first conversion period and the team had the opportunity to participate in about 20 one-on-one meetings, where they spoke face to face with many Latin American debt managers. "*This was the initiation of key relationships in this process*" recalls a team member. "*As FIN we do not have lots of direct contact with clients, but from those meetings came out lots of relationships and follow ups… we had little time so we knew that if we went to Medellin we were going to be able to put the issue on the radar screen of the Ministers of Finance, be very efficient about our time and use of Bank resources*".

The message communicated by the Offer team in those meetings was reinforced by the Bank's broad communication strategy. Dissemination efforts were under way to reach as many borrowers as possible in a short period of time. These efforts included



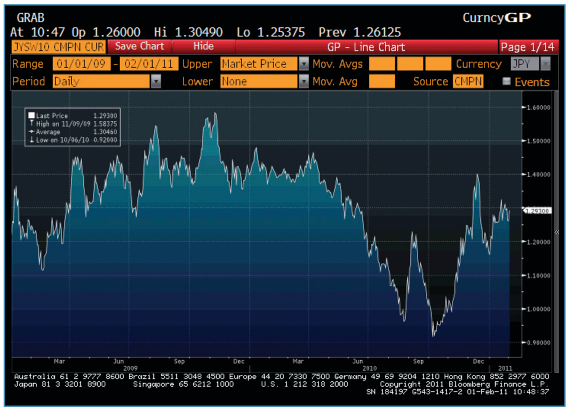
Source: Bloomberg. 10-year USD swap rate from January 1, 2009 to February 1, 2011.

seminars in the field and videoconference presentations or conference calls with all public debt offices in the region; dedicated internet[2] and extranet websites with detailed information on loans eligible to the Conversion Offer, model loan contracts, loan cash flows, and semi-monthly indicative quotes on conversion rates, which contributed to reducing uncertainty for the borrowers.

Marketing materials were also developed to ensure borrower awareness of the Offer at the highest levels, including letters addressed to Ministers of Finance submitted by country managers; brochures distributed to borrowers and country offices (COFs) in three languages; and press releases sent to various venues.

Efforts towards increasing responsiveness to borrowers were undertaken by providing a single point of contact in the Bank. During the execution period this role was assumed by the Head of Client Services (FIN/FIN). The Offer team received an average of ten calls from borrowers

[2] See the Financial Resources, Products and Instruments Portal, implemented in partnership between FIN and KNL: http://knl/frp/pages/299,ENGLISH,HOME.html



Source: Bloomberg. 10-year JPY swap rate from January 1, 2009 to February 1, 2011.

per day. The questions were addressed by that person or were passed to other team members, according to areas of specialization, to be answered as soon as possible. "*This was a key factor…We were available and this allowed us to deepen our relationship with the clients. No matter which borrower, whether it was a tiny one or big one, they could pick up the phone and get an answer right away in most instances if not within 24 houow*".

The conference calls and videoconference worked well: "we did not travel and this allowed us to do much more and with more borrowers". However, the team concludes that more efforts are needed to improve the Bank internet and extranet resources and to use these tools for marketing purposes more efficiently: "*The web pages need to be more inviting; this would increase delivery and we would have an additional communication media, complementing teleconferencing and video conferencing*". The team envisages a facility where borrowers are able to fill in online forms and submit conversion requests and questions this way.

Internal communication across the Bank played a crucial role. In-house training on the Offer was delivered to all COFs via videoconferences. In order to reach borrowers, the team communicated with both representatives and with chiefs of operations and fiduciary specialists: "We were working with whoever wanted to work with us". Communication did not necessarily follow hierarchical lines.

3. Various stakeholders within the Bank participated from the beginning and developed ownership of the Offer. This, in addition to senior management support, enhanced the team's performance and commitment to the initiative.

Given the scope and size of the Conversion Offer, its success relied heavily on a broad team of key Bank stakeholders and staff. The core team was composed of staff from five different departments (FIN, ITE, VPS, RMG and LEG) that participated from the beginning in the design and management of both the financial mechanics of the loan conversion and its implementation strategy, and took ownership. As the Offer progressed, dedicated teams were assembled to focus on different tasks related to the initiative.

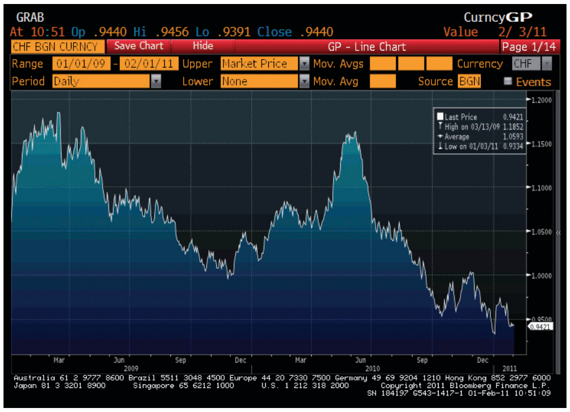
Good team work was accompanied by a sense of urgency. This commitment came in part because the team itself decided on the deadline for sign-up of June 30, 2009. There was a moment when the team thought they were not going to make it, as the proposal for the Offer was finally approved in January 2009: "*We aligned ourselves with the heaviest workload that the Board has in the year (December) … If it did not get approved in the first fifteen days of January they would have had to change the (sign up) deadline*". "*Avoid December for this kind of initiatives. Either you go in November or you wait until January*". An earlier approval would have given borrowers more time for sign-up.

The initiative posed however some challenges for the internal partnerships. In addition to FIN and RMG, getting other departments to understand the nature of the initiative and how it differs from a lending operation was not straightforward: "This initiative required a different approach and that was hard to express". The execution of the Offer demanded a strong client focus and high responsiveness. There was no negotiation involved, as the terms of the conversion were fixed, without the possibility of changing deadlines: "All [these factors] required getting people out of their mind frame of this being a regular operation".

Having a central point of contact with partner departments for coordination purposes was useful. The importance of building capacity in other departments about the financial aspects of loan structuring and about client focus was also underlined.

4. Due to the innovative nature of the offer and its impact on the Bank's financial systems, trials of IT systems contributed to reducing implementation uncertainties

The Offer represented a challenge to the Bank's financial systems. FIN and ITE partnered in the design, testing and implementation of system modifications (Loan Management System, Borrowing Management System and the Extranet web application) that allowed the Bank to automatically convert 669 loans to new interest rates and currencies, and to accommodate the execution of an unusually high volume of interest rate and currency swaps.



Source: Bloomberg. Swiss Franc exchange rate from January 1, 2009 to February 1, 2011.

Although the systems trial helped to fine-tune the process and reduce uncertainties by mapping the information flows needed for implementation, such as loan accounting, reporting and risk, it also helped the team to realize that they had underestimated the costs involved in terms of systems and manpower: "*We found the devil in the details*". They reckon that the Offer could have benefited from an earlier trial, about three months before. This would have enabled them to analyze the implications and costs of the changes with greater time for reaction and adjustment.

Next challenges

The stakes were high for the Bank in terms of reputation and money with this Conversion Offer. This experience has confirmed to the team the importance of reaching key decision makers from the beginning and of being responsive to their needs.

A challenge of the realignment process has been to increase COFs' knowledge about financial products and capacity to provide support to clients in this area. The team pointed out that more progress is needed in this area: "*When questions could not be answered by COFs, this puts the pressure on HQs*". The team emphasizes that this is a critical issue for the IDB, and a long-term

endeavor: "*The Bank needs to identify what key financial knowledge it needs in the countries, at least in the big ones, and then define how those resources would be supported by FIN. This needs to be part of the COFs' work program*".

The Offer reached sub national borrowers during the second conversion period. This was a strategic decision in light of scarce time and resources: "*If the government, who is the guarantor, did not understand the Conversion Offer, we could not have hoped that the municipalities would have understood*"

During the execution of the Offer, the team set a deadline that could not be moved without losing the Bank's credibility in front of borrowers. A different model had to be applied, more financially and client focus driven: "*This was not a loan and could not follow loan channels; those channels did not work for this process*". As always, with new initiatives, there is an element of ingenuity.

Acronyms

ADJ:	Pool-based Adjustable Single Currency Facility
CPS:	Currency Pooling System
ITE:	Information Technology Department
FIN:	Finance Department
LEG:	Legal Department
LIBOR:	London InterBank Offered Rate
RMG:	Office of Risk Management
SCF:	Single Currency Facility
SCF-FIX:	Fixed-Rate Single Currency Facility
SCF-LIBOR:	LIBOR-based Single Currency Facility
VPS:	Vice Presidency for Sectors and Knowledge

References

This note also draws on documents prepared by the Conversion Offer's team:

IDB. 2008. "Conversion option for Currency Pooling System (CPS) and Single Currency Facility (SCF) adjustable rate loan (FN-507-6)". Document presented for consideration of the Budget and Financial Policies Committee. November. Washington, DC.

Yñigo, Fernando and Bartholomew, Ed, 2009. "Loan Pool Conversion Offer". Document submitted to the 2009 Outstanding Team Awards. Washington, DC.

IDB

www.iadb.org