

## CASE STUDY

# Local Currency Financing at the Sub-national Level in Mexico

## OVERVIEW

The Mexican peso financing of US\$108 million equivalent for the Decentralized Infrastructure Reform and Development Project was the first IBRD loan conversion into local currency. The transaction eliminated currency risk for the sub-national government, the domestic development bank, and the federal government.



## Background

Providing financing to Mexican sub-national governments was challenging due to various market conditions and regulations. First, specific constitutional provisions required the states to borrow exclusively in local currency and from local financial institutions. Secondly, the spread charged over the IBRD cost of funds by the local financial intermediary (state-owned development bank, BANOBRAS) to states and municipalities resulted in an uncompetitive overall cost.

Lastly, the financial intermediaries had traditionally hedged against foreign currency exposure through a foreign exchange trust fund established by the Ministry of Finance, effectively concentrating all foreign exchange risk relating to foreign currency borrowing by sub-nationals in the hands of the

federal government. These issues and constraints all contributed to an unattractive pricing structure for IBRD loans to sub-sovereigns in Mexico and an inefficient allocation of foreign exchange exposure for the government.

## Financing Objectives

IBRD's objective was to devise a mechanism to efficiently provide local currency financing to Mexican sub-national governments at a competitive cost while, simultaneously, reducing the currency and interest rate risks to BANOBRAS and the guarantor (the Government of Mexico).

## IBRD Financial Solution

IBRD was able to efficiently provide Mexican peso financing to sub-nationals using the well-developed Mexican peso swap market. The transaction worked

as follows:

- Borrower submits request to withdraw funds. IBRD executes swap transactions with an international financial intermediary matching the conditions of the disbursement.
- An initial exchange of US dollars into pesos takes place under the swap transaction.
- The peso amount is disbursed to BANOBRAS, which has to service and repay that disbursed amount in pesos.
- Pricing is dependent on the price IBRD gets from the market.
- BANOBRAS adds its own lending spread and passes the cost on to the final beneficiary.

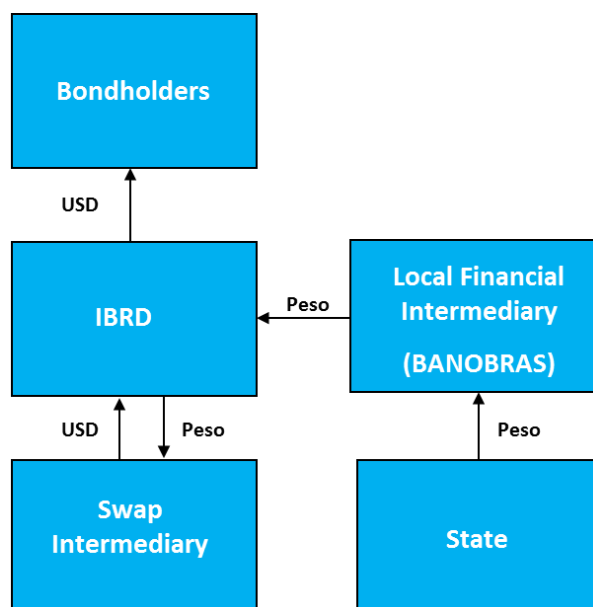
## Outcome

The sub-national government was able to obtain IBRD local currency financing at a very attractive cost through the proper combination of financial products. For practical purposes, IBRD's local currency financing resembles a line of credit denominated in US dollars that is disbursed, serviced, and repaid in pesos. This financing structure transfers foreign currency risk from the borrower to the market. As a consequence, the currency and interest rate risks to the borrower, the guarantor, and the final beneficiary are drastically reduced.

## Terms & Conditions

|                    |                                   |
|--------------------|-----------------------------------|
| Amount             | US\$108 million                   |
| Approval Date      | June 8, 2004                      |
| Maturity           | 18 years with 3-year grace period |
| Lending Instrument | Investment Loan                   |
| Lending Terms      | Fixed Spread Loan                 |

**Figure 1: Financial Structure of Mexico's Foreign Currency Management via the Swap Market**



## For information:

Miguel Navarro-Martin, Head of Banking Products, [mnavarromartin@worldbank.org](mailto:mnavarromartin@worldbank.org), +1 (202) 458 4722