IN RE

Multi-Currency Loans in Ukraine: How Does it Work?

Igor V. KRASOVSKIY,
is a senior associate with Gide Loyrette Nouel, Kyiv

Oleh P. ZAHNITKO,
Ph.D, is a senior associate with Gide Loyrette Nouel, Kyiv

Loans where funds are made available in more than one currency are referred to as "multi-currency" facilities. Multi-currency loans are becoming popular among corporate borrowers struggling with the extreme volatility of exchange rate. Such loans, however, are still only available to Ukrainian borrowers in the simplest of forms, availing little opportunity to tackle the FX risk. This article explains the nature of the multi-currency clause included in cross-border loans and discusses their practical implementation. We also explore alternative multi-currency structures to reduce borrowers' exposure to foreign exchange risk.

Multi-currency loans — what they are

In multi-currency facilities the maximum amount available to the company is denominated in a base currency (X-currency) but the company reserves the right to borrow separate loans in another optional currency (Y-currency) or more than one alternative currency as specified in the loan agreement.

The standard multi-currency clause commonly confers a right on the company to select the currency of any tranche under the facility agreement: pre-defined in the facility agreement or in the disbursement request. At the same time, the lender's commitment is always expressed in the X-currency and the lender sometimes reserve the right to refuse disbursement in the Y-currency at the company's request if the same is unavailable to the lender.

Multi-currency loans are becoming popular among corporate borrowers struggling with the extreme volatility of exchange rate

The mechanics of switching between different currencies imply that the amount of any tranche is fixed in the X-currency (e.g. US Dollars) and does not change subsequently. Along with restrictions imposed by the Ukrainian regulator, if the borrower wishes to borrow in Y-currency (Euro), it has first to repay the amounts drawn in X-currency and then the lender has to advance the tranche in Y-currency — based on the spot rate of exchange. This relates to reserve requirement of the lending institutions and frequent switches may be costly.

Where the loan is disbursed in Y-currency (in our example, Euro) for the next interest period, the amount of Euros disbursed may differ from the amount to be repaid: in each interest period the calculation will be made through the reference to the exchange rate X-currency / Y-currency. Further, if the borrower opts for yet another currency (Z-currency), e.g. Swiss Franc during next time interval, the borrower may be required to repay the amounts due in current Y-currency (Euros) so that the lender can advance the same tranche in new currency. The amount of Z-currency (Swiss Franc) is calculated by reference to the base X-currency (US Dollar) exchange rate, not the Euro/Swiss Franc rate. Thus, the multi-currency option is built on the roll-over principle to ensure that any optional currency amount is aligned with the base currency at the beginning of each loan use interval / interest period.

Importantly, the interest is paid on the actually disbursed currency, whereas the parties bid on the amount of the principal: if the amount of Y-currency decreases (EUR revaluates against USD), the borrower must make up the difference; if Y-currency amount increases (EUR devaluation), the lender makes additional disbursement in the next loan use / interest period. Quite often, the parties agree to ignore volatility less than 5% of the exchange rate.

The currencies that can be simultaneously outstanding are limited in their number and the facility agreement sets details of commitments depending on the hedging strategy of the lender and the funding market available to the lender.

Why is the multi-currency option important?

Borrowers in Ukraine are often exposed to an exchange risk where the borrower's receivables are denominated in a Y-currency and the funds borrowed are in X-currency only. Thus, the borrower is disadvantaged by having to convert the currency of the loan into the contract currency and, *vice versa*, convert the proceeds in one currency into the currency of the loan. Moreover, banks in Ukraine rarely offer direct conversion of a foreign currency pair e.g. EUR to USD and, as a result, not only the exchange rate may be changing adversely, but also the conversion fees accumulate; lately, the required currency may be simply unavailable due to the market disruption. It is important, therefore, to match the currency of the operations and of the loan and, where the company's payables and receivables are denominated in various currencies (e.g. due to diversified markets of operation), the availability of a multi-currency loan would be indispensable.

On top of this, the multi-currency loan may also be used as a tool to benefit from the future currency fluctuations. For example, the company receives the proceeds in US Dollars and anticipates that Euro will devalue against US Dollar over the next three months. In this case it could draw a tranche in Euros for three months and at the time of repayment buy Euros with the proceeds from the US Dollars receivables to finance the repayment. An additional consideration for using this tool will be the rate of interest which the bank offers for the tranches in USD and Euro, respectively.

That is, another benefit of the multi-currency loan is that the company chooses not only from among the currencies but also among the interest rates, — in turn, the borrower assumes the risk of depreciation of the tranche in Y-currency against the base X-currency (the lender risks appreciation of the base X-currency and, thus, shares the exchange rate exposure with the borrower) — the calculation of the principal amount of the tranche to be repaid is always made by reference to the base currency at the time of the conversion.

Practical problems of using different currencies

No practical issues arise when the multi-currency loan agreements stipulate different currencies (e.g. US Dollar and Euro) at predefined amounts. Effectively, this equates to several single-currency facilities. If, however, the borrower cannot forecast the amounts in each currency that may be needed in the future, such a circumscribed structure turns out to be unworkable whereas one or more tranches remain unused despite the commitment fees paid to the lender. On the contrary, a fully operational multi-currency option would be essential as it provides the company with a high level of the flexibility.

Ukrainian companies faced difficulties during the registration of cross-border multi-currency loans with the NBU

Unfortunately, in our experience, Ukrainian companies faced difficulties during the registration of loans with the multi-currency option from non-residents with the NBU.

Despite the fact that Ukrainian companies are allowed by law to borrow in several different currencies from non-residents, the existing loan registration procedure makes no mention of the possibility to register multi-currency loans where the amounts are not pre-set in the loan agreement. Instead, the standard form notification to be submitted for the purposes of registration requires the company indicate the exact amount in each currency it contemplates to borrow and the anticipated schedule of all repayments under the loan agreement; an option, therefore, is effectively reduced to a combination of two or more single-currency facilities.

Another strategy for Ukrainian corporate and individual borrowers is to apply for registration of each tranche to the NBU and amend the registration certificate every time the currency adds up. Going through the NBU registration process every time makes useless the multi-currency option in the cross-border context.

By contrast, the borrowing bank can register separate tranches in different currencies without absolute minimum or maximum thresholds thanks to specific registration procedure which makes the multi-currency bank-to-bank loans consistent with international practice.

Building alternative structure to mitigate FX risk

Where the company relies on UAH-denominated proceeds to repay a loan in hard currency, the company is extremely vulnerable to foreign exchange risk and may be unable to repay the loan in full if the local currency depreciates. In developed jurisdictions, the companies enjoy a great variety of instruments to hedge against the foreign exchange risk by using conventional capital market instruments like over-the-counter derivatives. These instruments are unavailable to the Ukrainian companies due to exchange control limitations and, therefore, non-derivative alternatives have now come to the fore. Furthermore, the National Bank has of late been working hard to reduce a few instruments that were offered randomly on the market, such as foreign swaps and forwards.

In our view, multi-currency mechanics may be used to build a "synthetic" structure linked to the local currency of the country where the company operates to limit the impact of the foreign exchange risk. This product has been developed by international finance funds and institutions (like EFSE, GGF) for small and mid-size borrowers operating in emerging markets to manage currency risk.

Under this structure, the lender commits under the facility agreement to provide a loan in the equivalent of UAH (the base X-currency), but all cash flows under the loan, including disbursements, principal and interest repayments, are actually made by the borrower in Y-currency, such as US dollar or Euro. The official rate published by the National Bank of Ukraine would be the reference exchange rate for disbursement (e.g. at UAH 8 per USD 1) and repayment (e.g. at UAH 16 per USD 1), which saves money for the Ukrainian borrower and encourages the domestic market's development. The liability of the borrower under the loan will be in the local currency and the risk associated with the devaluation of local currency is transferred to the lender's shoulders. As with another multi-currency loan, the borrower takes the risk of revaluation of the base X-currency (UAH) against the Y-currency (USD).

In turn, to hedge the currency risk, an institutional lender enters into a non-deliverable swap with a specialised fund like the Currency Exchange Fund (TCX), an organisation offering derivative products to IFIs and private lenders on the currencies of developed countries. Some lenders are even considering building a hedging fund for exposure to local currencies. Thus, the comfort of the borrower — re-

[1] https://www.imf.org/external/np/sec/memdir/members.aspx#3

lated to the relative stability of UAH denominated liabilities under the loan — comes at a price: the lender includes the costs of derivatives or other hedging instruments in the interest offered to the borrower. As a result, the effective interest rate under the "synthetic" loan may exceed the maximum cap established by the NBU for the loans denominated in the currency of the 1st Group of the Classifier (EUR, USD, GBP, etc.) — see NBU Resolution On Establishing Interest Rates under the Outbound Borrowings by Residents No.363 of 3 August 2004.

The interest rate under synthetic loans can, however, comply with the 20% maximum of the effective rate established for currencies falling in the 2nd Group of the Classifier, including UAH as a currency of the country that ratified Article VIII of the IMF Charter (see NBU Resolution *On Approval of the Foreign Currency Classifier No.34 of 4 February 1998,* Sections 2 and 3 of the table and information on IMF membership[1]). Although it is unclear, which maximum interest rate should apply to such loans — the rate for X-currency (UAH) or the rate for Y-currency of the payment (USD). In our view, consistent approach of the NBU to the maximum interest rate will result in application of the maximum of 20% per annum, which is the limit for softer Ukrainian currency.

> The synthetic loan is yet to be tested in practice and we cannot exclude the appearance of technical obstacles during the registration of such loans with the NBU

As a matter of law, the *Civil Code of Ukraine* expressly distinguishes between the X-currency of the loan and the Y-currency of the payment, allowing the parties to stipulate different currencies in a contract for the obligation and actual payments. The fact that all payments under the described loan structure are made in foreign currency and the local currency is used solely as the reference currency makes the loan compliant with the requirements of currency control rules.

However, the synthetic loan is yet to be tested in practice and we cannot exclude the appearance of technical obstacles during the registration of such loans with the NBU. The first issue, as with other multi-currency loans, is that the standard form of the NBU notification makes no distinction between the currency of obligation and the currency of payment. Nor does the form allow the indication of two currencies at the same time. As a result, the borrower is unable to accurately reflect and register the terms of the loan.

END