

Project Administration Instructions

PAI 5.03
Revised December 2001
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REVIEWING COMPLIANCE WITH LOAN COVENANTS

A. Introduction

1. This PAI outlines procedures reviewing the compliance of the borrower, executing agency (EA), or guarantor (if applicable) with the covenants in the loan documents. For the purposes of this PAI, the loan documents include the loan agreement, any project agreement or guarantee agreement, and the minutes of loan negotiations.

B. Review of Covenants¹

2. Review missions assess the borrower's or EA's actions in complying with covenants stipulated in the loan documents. The covenants listed for a project relate to the long-term development objective (goal) and immediate development objective (purpose) of a project as indicated in the project framework.

3. Major covenants are included in the project and program-specific covenants section of the project performance report (PPR). The PPR classifies loan covenants into six categories: sector, environmental, social, economic, financial, and others; and indicates the status of compliance and assessed rating of each covenant.

4. Review missions assess the status of compliance in comparison with that indicated in the PPR. PAI 5.10 provides the four compliance criteria: (i) full compliance on time, (ii) compliance between 80 and 99 percent or full compliance with slight delays, (iii) compliance between 50 and 79 percent or full compliance with substantial delays, and (iv) compliance less than 50 percent. Where appropriate, the missions also assess and report on the continued applicability of loan covenants. The mission ensures that its findings and assessment of the status of compliance with all loan covenants are discussed with the borrower or EA and are included in the aide memoire or memorandum of understanding. The borrower or EA is notified of any noncompliance, and the mission follows up on these covenants with the borrower or EA, and determines remedial measures taken or to be taken, and the date by which compliance is to be achieved.

C. Follow-Up Actions

5. The back-to-office report (BTOR) indicates which covenants have not been complied with or if compliance status has changed. The PPR is updated to reflect the revised compliance status of covenants and, if necessary, its revised rating (highly satisfactory, satisfactory, partly satisfactory, or unsatisfactory). (PAI 5.10, Appendix 1 provides details on the rating criteria.) As indicated in PAI 6.03, the revised PPR is attached to the BTOR. The BTOR also summarizes the assurances of remedial actions and timing of the borrower or EA for full compliance. In the case of persistent noncompliance with major loan covenants, ADB may, by notice to the borrower and guarantor, suspend all or part of their rights to make withdrawals from the loan account. In consultation with the Loan Administration Division and the Office of the General Counsel, and after due notice to the borrower and EA, the director, sector division

¹ For compliance with submission of audited project accounts and agency financial statements, refer to PAIs 4.04 and 5.09.

(or country director, regional or resident mission for a delegated project) forwards the recommendation to the director general for consideration.

6. Missions impress upon the borrower or EA the need to comply with covenants to achieve a project's objectives. Midterm review (MTR) missions undertake detailed assessment of the covenants. Review and MTR missions may find that the borrower or EA's failure to comply with a specific covenant is due to circumstance beyond their control or that the covenant itself has become irrelevant. In such cases, the missions examine the circumstances and consider whether to recommend that

- the date for compliance be extended,
- alternative measures be adopted to achieve the original covenants' purpose,
- the covenant be amended, or
- the covenant be deleted or waived.

Any recommendations to amend, extend the date, adopt alternative measures, or delete or waive a covenant include detailed justifications.

7. Such a change is treated as a change in project implementation arrangements, and the procedures and approval authorities stipulated in PAI 5.04 apply. In the case of program loans, conditions for release of tranche(s) stipulated in the loan agreement are not amended or deleted, although an extension of time for compliance until the next tranche release may be approved by the President or Board when considering the release of a tranche.