

**ASIAN DEVELOPMENT BANK**

**REVIEW OF THE LOAN TERMS  
FOR THE ASIAN DEVELOPMENT FUND**

**Treasurer's Department  
November 1998**

## ABBREVIATIONS

ADF	Asian Development Fund
DMC	Developing Member Country
EACA	Expanded Advance Commitment Authority
OCR	Ordinary Capital Resources

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## I. INTRODUCTION

1. ADF VII: Report of the Donors includes a request that the Bank review the terms of Asian Development Fund (ADF) lending and prepare a policy paper on the subject for Board consideration within one year of ADF VII becoming effective.<sup>1</sup> Section 3.08(a) of the Regulations of the Asian Development Fund includes the following statement: "The grace period and maturities of loans financed from the Fund, and any fees and charges payable in respect thereof, shall be such as the Board of Directors determines to be appropriate, having regard to the concessional nature of such loans."<sup>2</sup>

2. A working paper on the review of ADF loan terms was discussed by the Board on 30 September 1998.<sup>3</sup> Taking into account the concerns expressed by Board members, this policy paper summarizes the main issues and sets out for Board consideration specific recommendations regarding changes in the terms of loans financed by the Bank's ADF.

## II. THE BANK'S CONCESSIONAL LOAN TERMS

3. Concessional lending is a credit that provides a measurable benefit to the borrower compared with a loan at market terms. The degree or measure of concessionality of a credit is known as the grant element. The grant element is defined as the difference between the discounted present value of disbursements and the discounted present value of the service payments, expressed as a percentage of the discounted present value of disbursements. The grant element concept is not applied to the market-based nonconcessional operations of multilateral development banks.

4. Prior to the adoption of the Special Funds Supplementation Scheme in June 1973, the Bank determined the specific terms of each Special Funds loan primarily by considering the country's economic situation, with the nature of the project being taken into account in suitable cases. In mid-1973, after a review of the available Special Funds resources, the Bank adopted the Special Funds Supplementation Scheme, under which loans from Special Funds resources were blended with loans from ordinary capital resources (OCR). These softer terms did not make the overall lending under the scheme more concessional, as the additional concessionality provided by these softer terms was offset by the blend lending from the OCR. With the establishment of the ADF, loans approved since March 1974 carry standardized terms, namely, an annual service charge of 1 percent with no interest and, except in the case of loans approved since September 1987 for OCR/ADF blend countries,<sup>4</sup> a maturity of 40 years, including a grace period of 10 years, with repayment of principal at a rate of 2 percent a year for the first 10 years after the grace period and 4 percent a year thereafter.<sup>5</sup> Consequently, the grant element

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<sup>1</sup> R15-97: *ADF VII: Report of the Donors*, January, p.14, para. 62.

<sup>2</sup> "Regulations of the Asian Development Fund," 15 April 1997, p. 6.

<sup>3</sup> W5-98: *Review of ADF Loan Terms*, 7 September.

<sup>4</sup> In September 1987, following a reduction in the final maturity of International Development Assistance (IDA) credits, the terms of ADF loans were again reviewed. For loans to OCR and ADF blend countries the Board approved a reduction in the maturity from 40 to 35 years, with repayment of principal at the rate of 2.5 percent a year for the first 10 years after the grace period and 5 percent a year thereafter. The terms for loans for ADF-only countries remained unchanged.

<sup>5</sup> R33-74: *Terms of Special Funds Loans*, 29 March.

of ADF loans to ADF-only borrowers is 77.0 percent, while it is 74.7 percent for blend borrowers.<sup>1</sup>

### III. ADF FINANCIAL PLANNING AND RESOURCE MOBILIZATION

5. Donors have indicated that the effective and efficient financial management of concessional resources by the Bank will increasingly be a precondition for resource mobilization through donor funding for ADF, and that there is a need for greater integration of donor and nondonor resources for larger internal resource generation over time. Donors have appreciated that, starting with ADF VII, replenishments will be triggered when the legitimate concessional needs of borrowers exceed the internal capacity of the Bank to generate the required concessional resources. Donors have also recognized that their significant financial support will help achieve the long-term objective of ADF becoming progressively self-financing; however, this support will hinge on efforts by the Bank to strengthen resource mobilization from sources other than new donor contributions.<sup>2</sup>

6. The ADF VII: Report of the Donors recommended that the commitment authority from existing resources be maximized in a prudent and sustainable manner.<sup>3</sup> It was agreed that this will be done by adopting various initiatives to increase (i) the efficiency with which existing resources are used to generate ADF commitment authority, and (ii) the volume of existing resources. Together, these will eventually reduce the amount of donor contributions needed to achieve a given level of concessional lending. The first of these two approaches has already been implemented, as reflected in the Board's approval and subsequent establishment by the Bank of the new financial planning framework for the management of ADF resources.<sup>4</sup> This new planning framework includes the expanded advance commitment authority (EACA) scheme, which allows the Bank to substantially increase commitment authority on the basis of existing resources, in particular repayments from past ADF loans. To support the augmentation of the volume of existing resources, this paper focuses on hardening ADF loan terms and their impact on the level of the EACA. Changes in ADF loan concessionality resulting from amended loan terms are also considered.

### IV. OBJECTIVES AND CRITERIA FOR HARDENED ADF LOAN TERMS

7. The financial and developmental objectives for hardened ADF loan terms are that the EACA be increased to sustain ADF resources in support of the Bank's strategic role in assisting long-term economic and social progress in the poorer developing member countries (DMCs). These objectives should be achieved subject to the following criteria: (i) the ADF continues to provide substantial loan concessionality; (ii) total concessionality generated through the EACA over the next half a generation

<sup>1</sup> The grant element for the ADF-financed program loans (i.e., quick-disbursing) is about 4 percentage points higher; the additional concessionality results from the fact that the disbursement profile of a loan is also a factor determining the grant element.

<sup>2</sup> R15-97: *ADF VII: Report of the Donors*, January, p. 18, paras. 80 and 83.

<sup>3</sup> Existing resources consist of (i) reflows, i.e., repayments of past ADF loans, revenue from service charges paid to ADF net of ADF administrative expenses, and investment income; (ii) residual resources from past replenishments, including clearing of arrears; (iii) resources set aside from the OCR; and (iv) OCR net income transfer.

<sup>4</sup> R49-97: "Review of the Financial Planning Framework for the Management of ADF Resources," 25 March 1997, approved by the Board of Directors on 15 April 1997.

should not be reduced,<sup>1</sup> (iii) the structure of the interest charge should be the same for ADF-only and blend borrowers; this is to ensure that blend borrowers are not required to cross subsidize ADF-only borrowers through the payment of higher interest charges; and (iv) the grant element for ADF-financed quick-disbursing program loans should be equivalent to the grant element for project loans.

## V. PROPOSED HARDENING OF ADF LOAN TERMS

8. On the basis of the preceding and considering the comments of the Board on the working paper, it is proposed that ADF loan terms for new loans to all ADF borrowers be amended as follows:

- (i) for project loans, i.e., other than quick-disbursing program loans: 32-year maturity, 8-year grace period, 1 percent interest charge during the grace period and 1.5 percent during the amortization period, and equal amortization; and
- (ii) for quick-disbursing program loans: 24-year maturity, 8-year grace period, 1 percent interest charge during the grace period and 1.5 percent during the amortization period, and equal amortization.

9. The grant element for the revised terms is 65 percent. With these changes the total EACA and total concessionality operating on the existing stock of ADF resources over the period ADF VII – ADF XI would be \$2,598 million and \$276 million more, respectively, than under current ADF loan terms.

10. In accordance with Section 2.04 of the Bank's standard loan agreement (special operations) stipulations are regularly included in loan agreements with borrowers of ADF resources that provide for a hardening of terms in the event that the borrower's per capita income has exceeded for five consecutive years a certain limit and that the borrower has achieved the ability to borrow from the Bank's OCR.<sup>2</sup> In such a case, the Bank may either increase by 100 percent the amount of each maturity or, at the request of the borrower, charge a higher interest rate. Section 2.04 of the Bank's

<sup>1</sup> Total concessionality derived from EACA is equal to a specified amount of the EACA multiplied by the grant element associated with standard ADF loan terms. The financial burden to the DMCs from borrowing from the EACA is equal to:  $EACA * [1 - \text{Grant Element}]$ . Conversely, compared with a nonconcessional loan, the financial burden avoided by the DMCs is equal to the  $EACA * [\text{Grant Element}]$ .

<sup>2</sup> Section 2.04(b) states; "If the Bank shall determine, after due consideration by its Board of Directors, that (i) the Borrower's gross national product per capita (per capita GNP) has exceeded \$690 in constant 1985 dollars for five consecutive years and (ii) the Borrower has achieved the capacity to borrow from the Bank's ordinary capital resources, the Bank may, by notice to the Borrower, modify the terms of repayment of the Loan by increasing by 100 percent the amount of each maturity due thereafter until the principal amount of the Loan shall have been fully repaid. However, at the request of the borrower, the Bank may, in lieu of so increasing any such maturity amounts, charge interest, at an annual rate to be agreed between the Borrower and the Bank, on the principal amount of the Loan withdrawn and outstanding from time to time in such manner and to such extent as to yield the same grant element as would be obtained under the above stated increase of maturity amounts." However, Section 2.04(c) goes on to say; "If, at any time after a modification of the lending terms pursuant to the provisions of paragraph (b) above, the Bank shall, after due consideration by its Board of Directors, determine that the Borrower's economic condition has deteriorated significantly, the Bank may, at the request of the Borrower, restore the original lending terms with respect to the remaining amount of the Loan withdrawn and outstanding."

standard loan agreement will continue to apply to loans with the proposed new ADF loan terms.

## VI. RECOMMENDATION

11. Management seeks the Board's approval of the following recommendation for ADF loan terms:

- (i) the service charge will be redesignated as an interest charge and will include a portion to cover administrative expenses and a portion that does not; and
- (ii) the recommended redesignation of the service charge in (i) and the terms proposed in para.8 will take effect from 1 January 1999 and apply only to new loans for which formal loan negotiations are completed on or after 1 January 1999.