

ASIAN DEVELOPMENT BANK

INNOVATION AND EFFICIENCY INITIATIVE: PILOT FINANCING INSTRUMENTS AND MODALITIES

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ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AFR	–	annual financing requirement
BOT	–	build-operate-transfer
CSP	–	country strategy and program
DMC	–	developing member country
EA	–	executing agency
EBRD	–	European Bank for Reconstruction and Development
EIB	–	European Investment Bank
FFA	–	framework financing agreement
IADB	–	Inter-American Development Bank
IBRD	–	International Bank for Reconstruction and Development
IEI	–	innovation and efficiency initiative
LIBOR	–	London interbank offered rate
MDB	–	multilateral development bank
MDG	–	Millenium Development Goal
MIGA	–	Multilateral Investment Guarantee Agency
MFF	–	multitranche financing facility
OCO	–	Office of Cofinancing Operations
OCR	–	ordinary capital resources
OGC	–	Office of the General Counsel
OM	–	Operations Manual
PFR	–	periodic financing requirement
PRI	–	political risk insurance
PSOD	–	Private Sector Operations Department
RRP	–	report and recommendation of the President
RSDD	–	Regional and Sustainable Development Department
SME	–	small and medium enterprises
SOE	–	state-owned enterprise
SWG	–	strategy working group
TA	–	technical assistance
TD	–	Treasury Department

NOTE

In this report, “\$” refers to US dollars.

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I. INTRODUCTION

1. The purpose of this paper is to introduce, on a pilot basis, several new financial instruments and modalities. The proposals aim to strengthen ADB's capacity to mobilize development finance and knowledge for its developing member countries (DMC) by reinforcing the flexibility and client orientation of its financial products. The proposals are also designed to make ADB more compatible with existing and evolving market practices, and to help ADB work better with its development partners and the private sector.

2. This paper is one of several being prepared under the Innovation and Efficiency Initiative (IEI),¹ launched in November 2003. IEI aims to improve ADB's business model by removing bottlenecks that constrain its capacity to respond better and more quickly to its clients. The proposals and recommendations contained in this and other IEI papers represent important steps toward achieving the objectives and goals of ADB's corporate strategic agenda.

3. Section II of the paper briefly explains the regional development context, which underscores the urgency for ADB to strengthen its role as a development financier for the region. Section III summarizes ADB's existing financial instruments and modalities, and provides a brief account of the key shortcomings in their application. Section IV outlines the pilot concepts, some of which require an exemption from, or changes to, ADB's operating policies. Section V focuses on some operational implications, especially on risk evaluation and risk management and the conditions necessary for ADB staff to work with the proposed pilot concepts.

II. REGIONAL DEVELOPMENT AND STRATEGIC CONTEXT

4. Despite progress made, the Asia and Pacific region continues to face major challenges in achieving prosperity and poverty reduction. Almost 700 million people still struggle on less than \$1 a day. Many countries face considerable risks in trying to attain the non-income Millennium Development Goals (MDG)². For the region to achieve these MDGs and other development objectives, it must mobilize resources and knowledge quickly and effectively to improve efficiency, productivity, quality and access to productive activities and services.

5. A large financing gap persists across the region, jeopardizing sustained growth and poverty reduction. Infrastructure alone requires annual financing of several hundred billion dollars per year over the next 5–10 years. Despite ample domestic savings, public sector budgets are under pressure in many DMCs, as well as in countries that normally provide development assistance. Yet the world has huge amounts of private capital in search of worthwhile investments. Financing from official sources, including ADB, needs to become much more proactive and innovative to help DMCs mobilize private investment. Progress in this area has been far too limited. Much more can, and should be done.

6. Despite recent well-intentioned efforts, many development agencies, including ADB, have had difficulty keeping pace with the significant shifts in global and regional finance. Development agencies have gone from being primary sources of capital to secondary sources,

¹ In addition to pilot financing instruments and modalities, IEI proposals focus on (i) country strategy and program, (ii) business processes, (iii) consulting services and procurement, (iv) safeguards in relation to policy implementation, and (v) cost sharing and expenditure eligibility. Further background information on IEI and its results framework are in Appendix 1.

² For details on the MDGs, see: UN. 2000. *United Nations Millennium Declaration*. New York.

thus becoming less important as providers of fresh financing, in particular for infrastructure finance.³ As a result, development finance agencies urgently need to reposition themselves to focus on their comparative value relative to the private sector. In addition, they must shift their mandate, when appropriate, from being primary providers of funds to being a catalyst to help attract private investors (foreign and domestic) into productive investments and services. This is part of the challenge faced by ADB and others like it.

7. Changes in the nature of DMC governments, and their relationship with development partners, have compounded this challenge. With the decentralization of investment and management in many DMCs, development agencies are being asked to respond to the needs of subsovereign and other public sector entities such as provinces or states, municipalities, state owned enterprises (SOE) and utilities, in addition to their traditional sovereign clients. These entities play an important role in creating employment, and providing infrastructure and basic public services. Giving them access to affordable long-term debt, working capital and equity finance is critical to promoting economic growth and pro-poor employment and prosperity. However, many governments are not in a position to provide the required finance to make the decentralization process work. Increasingly, they are also unable or unwilling to provide sovereign guarantees to support their long-term financing needs. Regionally, countries are demanding cross-border initiatives to create new and integrated transport and communication networks and power facilities, critical to ensure successful national development strategies.

8. But to meet these emerging challenges, ADB and other development agencies must transform themselves. Institutions that traditionally have been lenders to sovereigns must emphasize their role as mediators and facilitators at the sovereign, subsovereign, and regional level, creating value by attracting private sector capital and harnessing business management or technical expertise for application to specific sectors and public services. Navigating the transition from direct lender of official funds to enabler of private investment will require a major change in the culture, products, processes, and rules. Increasingly, the market will measure the success of this transition by the extent to which private investors perceive their services and transaction costs as being relevant, practical, competitive and attractive.

9. ADB's Long-Term Strategic Framework 2001–2015 and its associated first Medium Term Strategy 2001–2005⁴ explain the strategic context and functioning of ADB. These corporate-wide strategic frameworks call on ADB to respond better to the needs of its DMCs by improving organizational effectiveness through greater flexibility in its structure, skill base, processes, and financial instruments and modalities. Further, the original ADB Poverty Reduction Strategy (1999) and its recent review in 2004⁵ urge ADB to widen the range of available modalities and instruments, and to tailor assistance to the complex needs of poverty reduction and conditions in DMCs.

10. Within the context of the new global development architecture that emerged following the Millennium Declaration (footnote 2), ADB has renewed its commitment to improving development effectiveness. To contribute to the global commitment on aid effectiveness

³ Especially for middle income countries with improved access to financial markets, the relevance of multilateral loans and services in filling the investment-savings gap has diminished.

⁴ ADB. 2001. *The Long Term Strategic Framework of the Asian Development Bank (2001–2005)*. Manila; ADB. 2001. *The Medium Term Strategy (2001–2005)*. Manila.

⁵ ADB. 2004. *Review of the Poverty Reduction Strategy of the Asian Development Bank*. Manila.

articulated in early 2005 the Paris Declaration,⁶ ADB defined for itself an ambitious reform agenda (the Reform Agenda) to enhance its organizational effectiveness and to make ADB a more effective, dynamic, and results-driven catalyst for poverty reduction and prosperity in the region.⁷ IEI is a core reform initiative under the Reform Agenda. Further background information on IEI and its results framework are in Appendix 1.

III. EXISTING INSTRUMENTS AND MARKET CHANGES

A. Financing Instruments—Applications, Strengths, and Weaknesses

11. Over the years, ADB has developed a variety of instruments to finance stand-alone public and private sector projects, as well as broader sector and subsector investment programs. It also provides credit lines to financial intermediaries for onlending to private companies, normally small and medium enterprises (SME). With these instruments, ADB supports physical investments, as well as policy, sector, and thematic reforms. In addition, it provides technical assistance (TA) grants for project and program preparation and implementation, knowledge gathering, and knowledge sharing on various sectors and themes, including for capacity building, and regional cooperation and integration.

12. The main project finance instruments include debt, equity, and guarantees.⁸ Guarantees leverage ADB's own financing to help mobilize cofinancing from external sources. These guarantees address political or credit risks, anchored in public or private sector loans. ADB also issues local currency bonds and, more recently, has tried to tap into cross-currency swaps to complement its traditional financing in foreign currency. All these facilities are variations on one theme—the provision of long-term debt or equity finance for development purposes. Quasi-equity and mezzanine financing also fall into this category, although ADB has not put together these types of transactions yet.

13. In this paper, “instrument” (or “product”) covers the generic means of providing or facilitating financing—debt (mostly loans), equity, guarantees, or grants. A transaction or investment “modality” involves the specific application of these products within defined legal, policy, and operational structures, such as: (i) program loans for sector adjustments; (ii) investment loans; (iii) bond issues and capital market transactions; (iv) swaps; (v) mezzanine financing; (vi) quasi-equity; (vii) public-private initiatives, such as financing and guarantee support for build-operate-transfer (BOT), concessions and joint ventures; (viii) political risk ‘carve-outs’; and (ix) financial risk-sharing partnerships. A modality may be covered under a specific policy paper (generally once it is mainstreamed) or through project specific applications (generally when it has a novel character). The pilot concepts covered in this paper deal with

⁶ 2005. *High-Level Forum on Joint Progress Towards Aid Effectiveness, Harmonization, Alignment, Results*. Paris. Also, the Development Committee in September 2003 noted in its communiqué: “Changes are needed in the way that aid is provided, as highlighted in the Declaration of the Rome High-Level Forum on Harmonization. In addition to streamlining procedures and lowering transaction costs, assistance will have to be better aligned to country needs, to country priorities and processes, to countries that demonstrate the ability to achieve measurable development results, and to support the development of the countries’ capacity.”

⁷ ADB. 2004. *ADB Reform Agenda*. Available: <http://adb.org/ReformAgenda/adb.asp>

⁸ Since the Asian Development Fund IX replenishment, ADB also can offer limited grant financing for projects in certain countries under certain conditions. However, grant financing is restricted and not accessible to all clients.

debt financing instruments which constitute the core of ADB's operations, i.e., loans and guarantees, and related transaction modalities.⁹

14. The fundamental requirements for loans provided to clients from ordinary capital resources (OCR) and Asian Development Fund (ADF) resources¹⁰ are contained in (i) the Charter, (ii) loan regulations for ordinary operations and special operations, (iii) policy papers, and (iv) corresponding sections of the Operations Manual (OM).¹¹

15. In addition to regular project loans for investment lending, which account for the bulk of ADB's project finance operations, ADB's debt financing modalities comprise (i) program lending, and variations such as sector development programs and program cluster loans;¹² (ii) sector lending;¹³ (iii) financial intermediation lending;¹⁴ and (vi) emergency assistance lending.¹⁵ Additional policy papers and related sections in the OM regulate aspects such as security and guarantee arrangements for loans,¹⁶ guarantee operations to mobilize cofinancing,¹⁷ financing eligibility criteria,¹⁸ and financial and risk management considerations.¹⁹

⁹ Proposals on equity financing are specific to ADB's private sector operations and will be addressed separately. Likewise, proposals involving grant financing are dealt with in separate papers on ADF IX, TA financing and cofinancing, as appropriate.

¹⁰ ADB. 2001. *Ordinary Operations Loan Regulations (Applicable to LIBOR-based Loans made from ADB's Ordinary Capital Resources)*. Manila; and ADB. 2004. *Special Operations Loan Regulations*. Manila.

¹¹ For OCR lending, see ADB. 2001. *Review of Asian Development Bank's Financial Loan Products*. Manila (Doc. R79-01); ADB. 1999. *A Review of OCR Loan Charges*. Manila (Doc. R205-99); ADB. 1994. *A Proposal to Introduce A Market-Based Loan Window*. Manila (Doc. R210-94); ADB. 1980. *Lending and Relending Policies*. Manila (Doc. R35-80); and ADB. 1979. *A Review of Lending and Relending Policies*. Manila (Doc. R124-79). For ADF lending, see ADB. 2001. *Policy on Performance-Based Allocation for Asian Development Fund Resources*. Manila (Doc. R29-01); ADB. 1998. *A Graduation Policy for ADB's DMCs*. Manila (Doc. R204-98); and ADB. 1998. *Review of the Loan Terms for the Asian Development Fund*. Manila (Doc. R205-98).

¹² ADB. 1999. *Review of ADB's Program Lending Policies*, Corrigendum 1. Manila (Doc. R210-99); ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila (Doc. R50-98); ADB. 1996. *Review of Bank's Program-Lending Policies*. Manila (Doc. R143-96).

¹³ ADB. 1999. *Review of the Bank's Sector Lending Policies*. Manila (Doc. IN181-99); ADB. 1984. *A Review of Sector Lending Operations*. Manila (Doc. R186-84); ADB. 1980. *Sector Lending*. Manila (Doc. R52-80).

¹⁴ ADB. 1987. *Review of ADB Policies on Credit Lines to Development Finance Institutions*. Manila (Doc. R27-87).

¹⁵ ADB. 2004. *Disaster and Emergency Assistance Policy*. Manila (Doc R71-04).

¹⁶ ADB. 1970. *Guarantee and Other Security Arrangements*. Manila (26 August. Doc. R45-70).

¹⁷ ADB. 2000. *Review of the Partial Risk Guarantee of ADB*. Manila (Doc. R299-00). ADB. 2000. *Partial Credit Guarantee Charges*. Manila (Doc. R88-00). ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila (Doc. R135-99). ADB. 1995. *Review of the Bank's Guarantee Operations*. Manila (Doc. R81-95). ADB. 1987. *Bank's Guarantee Operations*. Manila (Doc. R140-87).

¹⁸ ADB. 2002. *Review of Cost-Sharing Limits for Project Financing as an Element of ADB's 1998 Graduation Policy*. Manila (Doc. R247-02); ADB. 1998. *A Graduation Policy for the Bank's DMCs*. Manila (Doc. R204-98); ADB. 1990. *A Review of the Bank's Policy on the Financing of Interest and Other Charges during Construction*. Manila (Doc. R138-90); ADB. 1995. *A Review of Lending Foreign Exchange for Local Currency Expenditures on Projects*. Manila (Doc. R1-95); ADB. 2001. *Loan Disbursement Handbook*. Manila; ADB. 2001. *Project Administration Instructions*. Manila; ADB. 1999. *Guidelines for Procurement under Asian Development Bank Loans*. Manila; ADB. 1991. *Streamlining of Loan Administration Procedures and Reporting Requirements*. Manila (Doc. R34-91); ADB. 1989. *Simplification of Board Documentation for Supplementary Loans*. Manila (Doc. Sec. M48-89); ADB. 1988. *Review of Policy on Supplementary Financing of Cost Overruns of Bank-financed Projects*. Manila (Doc. R17-88).

¹⁹ ADB. 2000. *Currency Risk Management in ADF*. Manila; ADB. 1994. *Guidelines on Rescheduling of Loans to Private Enterprises without Government Guarantee*. Manila; ADB. 1994. *Provisions for Investment Losses in the Bank's Private Sector Operations*. Manila (Doc. R15-94); ADB. 1992. *Improving the Manageability of Borrowers' Foreign Exchange Exposure on OCR Loans*. Manila (Doc. R76-92); ADB. 2004. *Guidelines for the Financial Governance and Management of Investment Projects financed by the Asian Development Bank*. Manila.

In addition, some provisions are specific to private sector operations.²⁰

16. Appendix 2 summarizes the main features of the key lending modalities, such as choice of currency, lending terms and fee structure, guarantee and security package, and documentation. While this list is not exhaustive, the purpose is to highlight areas where some adjustments are needed.

17. ADB's financial modalities are both complex and simplistic. The numerous policies, guidelines and restrictions that limit their understanding by clients, ease of application, and adaptation to a changing business environment make them complex. But the financial modalities are also simplistic because, despite the elaborate policy framework and some built-in flexibility, most offer little differentiation with regard to key terms and conditions. Differences are primarily in terms of tenors and disbursement profiles.

18. Within this framework, the bulk of ADB's business is stand-alone investment lending from concessional ADF or market-based OCR windows to public sector borrowers, backed by sovereign guarantees. Eligibility for financing depends on a set of development, income, and broad economic criteria of the borrowing country, which generally were defined long ago. Private sector finance involves debt, equity, or guarantees for cofinancing to private sector investors without sovereign counterguarantee, or a combination thereof, with debt extended normally on a limited or on a nonrecourse basis.²¹ Political and partial credit risk guarantees are used to encourage commercial cofinancing for public and private sector projects. However, these constitute a relatively small part of ADB's total portfolio due to cumbersome procedures, lack of adequate incentive structures, and policy or charter restrictions.

19. ADB in the past has not financed local government entities or SOEs on a purely nonrecourse or limited recourse basis.²² However, this is routinely done by institutions such as the European Bank for Reconstruction and Development (EBRD), European Investment Bank, and Kreditanstalt für Wiederaufbau. Municipal governments and SOEs potentially constitute a "third generation" of clients, increasingly important as borrowers in their own right in most DMCs as a result of decentralization.²³ Refinancing, a standard feature in infrastructure and public services finance, has not been part of ADB's regular business either.²⁴ Nor has ADB extended local currency financing to public sector clients.

²⁰ ADB. 2002. *Pricing Local Currency Loans in Private Sector Operations*. Manila (Doc. R215-02); ADB. 2001. *Private Sector Operations: Review and Strategic Directions*. Manila (Doc. R122-01); ADB. 2000. *Private Sector Development Strategy*. Manila (Doc. R78-00); ADB. 1985. *Lending to Private Sector without Government Guarantees*. Manila (Doc. R93-85); ADB. 1983. *Equity Investment Operations by the Bank*. Manila (Doc. R38-83).

²¹ Non-recourse finance implies that the lending bank secures its principal and interest repayments primarily via the cashflow generated by the project (often structured around a special purpose vehicle company), not from pledges on the assets and other income of the individual sponsors or shareholders. These transactions are not secured against a sovereign guarantee. They require a sound evaluation of the underlying technical, operational, commercial, legal, financial, safeguard and other areas underpinning the quality or robustness of the cash flow. Limited recourse financing 'ring fences' assets and income streams beyond those associated with a project company.

²² In a few selected cases, ADB has extended credit lines for onlending to the private sector through government owned development finance institutions without sovereign guarantee. These were generally linked to reforms that support eventual privatization, or facilitate commercial cofinancing with partial credit guarantees.

²³ Central government and the private sector are the so-called first and second generations of clients, respectively.

²⁴ On few occasions, there has been selective financing of expenditures occurred earlier. This has been addressed within the narrow scope of ADB's guidelines for retroactive financing.

20. Private sector operations also include arbitrary restrictions. ADB's cost sharing limit is comparatively low at 25%.²⁵ The country and sponsor limits (\$75 million per transaction) are misaligned with market practice and business opportunities. In addition, ADB policy does not support various forms of refinancing, securitization, transactions structured around capital and operating leases, and acquisition finance. Restrictions on guarantee operations also make it incompatible with market needs and practices and limit cofinancing opportunities. ADB can take greater advantage of financing opportunities (in both the public and private sector) without necessarily compromising its AAA rating and standard credit risk considerations which are built around the concept of sound banking principles, while maintaining a high development impact and project quality.

21. Notwithstanding the above, ADB debt instruments do offer a reasonable degree of currency and interest rate flexibility to clients, especially since the introduction of OCR lending based on the London inter-bank offered rate (LIBOR). This has given ADB and its clients much greater flexibility and market alignment than was the case with the fixed-rate currency basket system used in the past. It also has allowed ADB to broaden the scope, range, and flexibility of debt financing, through the incorporation of currency and interest rate swap options. Maturity periods and repayment schedules follow fairly standard formats. This allows, in principle, the use of more diverse structures, essentially to match the risk and cost recovery profile of individual investments with the principal and interest margin obligations. But despite this flexibility, some constraints remain, especially in terms of administration and financial management features. Borrowers are generally unable to calculate and accrue independently relevant loan charges. In addition, ADB cannot easily establish and maintain loan accounts at the sub-borrower level. The current progressive commitment fee structure exacerbates these problems.

22. Besides the interest margin over LIBOR, ADB normally charges clients front-end and commitment fees. In some instances, these charges can be waived temporarily (as is the case currently with the front-end fee). Also, public sector borrowers have consistently received the benefit of ADB's sub-LIBOR borrowing costs through rebates. Commitment fees have always applied to undisbursed loan amounts. In addition to generating some income,²⁶ the commitment fee is intended to instill ownership among clients and provide an incentive for speedier implementation of projects. However, commitment fees are charged on an upward sliding scale spread over the implementation period, assumed to be four years on average. Clients, who generally dislike these fees, feel that ownership of projects and commitment to efficient implementation plans are more a function of other considerations, such as (i) design aspects; (ii) disbursement schedules; (iii) executing agency capacities; (iv) working capital financing (budget allocations); and (v) ADB's operational conditionalities, including those on procurement, safeguards, and administrative procedures. For large projects with long implementation periods, commitment fees act as a real disincentive. They also force ADB and its clients to focus on shorter-term slices of investment programs. Given the time required to process projects, this practice increases transaction costs and takes resources away from implementation tasks (and possibly from a more effective policy dialogue and implementation of governance and safeguard oversight). In addition, the contingent nature of the fee in lieu of disbursements makes the real cost of ADB's loans less transparent than it should be. While other multilateral development banks (MDB) historically have charged these types of fees, some are considering abolishing them or applying flat fee structures. These banks intend to rely on other means to generate income, improve implementation efficiency, and enhance client commitment and ownership.

²⁵ In comparison, EBRD can finance up to 35%.

²⁶ In recent years, commitment fees have generated about \$50 million a year.

23. To raise funds in the market for subsequent onlending to clients at competitive rates, normally on a long-term basis, ADB relies on its AAA credit rating. ADB raises funds on fairly attractive terms because of (i) this rating, (ii) the nature and characteristics of its private placements, and (iii) the type and size of the bonds it issues. Lending conditions also compare favorably with those of other MDBs. The main problems are the nonfinancial costs of doing business, and the way in which instruments are used. Appendix 3 compares the terms provided by ADB with those of various MDBs.

B. Market Trends, Opportunities, and Challenges

24. Notwithstanding the financial terms of its current instruments, ADB's appeal is diminishing in a number of markets. On the one hand, the rising nonfinancial (or hidden) costs, mainly driven by the plethora of policies and the increasing complexity of their application, has made ADB operations less attractive. On the other hand, a broader range of financing alternatives has emerged, especially in OCR countries, including national, regional, and international capital markets. Sustained high domestic savings and liquidity in the region have supported this trend. An increasing number of countries are willing and able to pay substantial premiums for speed and flexibility. They also have the option of working directly with export credit agencies. While these agencies might be more expensive and tie financing to the procurement of goods and services from their own country, they provide funds quickly and more flexibly. Other MDBs and bilateral financing partners are reviewing their instruments and modes of cooperation. Most are becoming more client-friendly. Taken together, this represents a major challenge for ADB.

25. ADB's comparative advantage lies principally in the long maturity, grace periods, and attractive pricing of its financing; as well as in its potential to provide innovative and integrated solutions to development challenges (i.e., technical and other expert advice, and policy reforms). ADB also can provide ideas to mobilize other money with its own. This advantage is compatible with at least one of the core mandates of a development bank—to provide or help mobilize long-term financing for countries and projects that have difficulty raising such financing at reasonable terms and when needed. Even in countries with comparatively mature and liquid capital markets, as well as an active commercial debt sector, ADB can make a difference. By blending maturity and interest margins with other finance, ADB can improve financing terms of projects and programs without “crowding out” other partners. ADB can play a so-called catalytic, or value-added, role in investment and non-investment projects.

26. To play this role, though, ADB must have (i) innovative instruments and modalities; (ii) sensible ideas (i.e., expert advice) to accompany its money; and (iii) a business model that can accommodate and be accommodated by its development partners, and the private sector. ADB needs to change the focus of its current business model substantially to achieve this. Specifically, ADB must become more client-oriented. The introduction of new instruments and modalities, and the modification of existing ones, is just one part of this change. The financial world is changing faster than ever, particularly in Asia with its huge financial savings. If ADB ignores these trends, it will be marginalized. While Asia has been growing, development banking has not.

27. Another noteworthy market development, beyond the increased accessibility of capital markets to various ADB clients, is the revised Basel II Capital Accord²⁷ for banks. This accord increases the emphasis on risk weightings for credit extended by commercial banks, which impacts on their willingness and ability to provide long-term finance. With its considerable risk-bearing capacity and high credit rating, ADB is a natural partner for banks to develop new cofinancing and partnership modalities. This would increase credit flows to target areas, such as infrastructure and social sector development, and underpin the poverty reduction agenda and attainment of the MDGs.

28. Potential partners would look to ADB to provide funds on a parallel cofinancing basis and to share risks. The market can provide direct funding and ADB credit enhancements through its complementary financing schemes and guarantee instruments. With its regional focus and ability to operate with various instruments (as well as with public and private sector clients), ADB is uniquely positioned to add value by offering integrated financial solutions. The institution can play a key role to mobilize domestic savings and external finance. The inflexibility of ADB's current policy framework, reflecting a culture of risk aversion and a tendency to be a market follower rather than a leader, prevent it from tapping this potential. The lack of adequate incentive structures, business processes, and practices also discourage the search for appropriate and attractive financing arrangements for investment programs, as opposed to dealing principally with stand-alone project lending. These business processes and practices must be changed. Another IEI proposal focuses on this through the reform of the country strategy and program (CSP) and transaction-based business processes (footnote 1). The proposed financial instruments and modalities are also part of this endeavor. Other institutions have similar limitations, but most are now in the process of changing them.²⁸

C. Issues

29. Clearly, despite the considerable flexibility in ADB's existing financing instruments framework, a combination of policy restrictions, outdated practices, constraints in the applicability of various products on offer, and deficiencies in terms of staff skills and incentives is undermining ADB's relevance, responsiveness, and marketability to clients. Ultimately, this affects results. A summary of some key issues (the list is not intended to be exhaustive) follows:

- (i) **Changing client base and decentralization.** In line with trends in other parts of the world, an increasing number of infrastructure facilities and public services across the Asia and Pacific region are being transferred to local governments. The decentralization process affects states (or provinces), as well as small, medium, and large municipalities. Indeed, the region has more megacities than any other part of the world, and a major share of the population continues to move to the cities. While decentralization and urbanization trends differ across countries, a common denominator is the absence of a corresponding transfer of financial resources.

²⁷ Basel Committee on Banking Supervision. 2004. *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*. Basel.

²⁸ Unlike ADB, the International Bank for Reconstruction and Development (IBRD) cannot extend credit or guarantees without sovereign guarantees. The Multilateral Investment Guarantee Agency (MIGA) has restrictions on debt and local currency financing. However, IBRD is looking into the viability of establishing a special purpose vehicle to finance on a direct basis SOEs (mostly utilities) and local government.

This situation, if not addressed, eventually will lead to the deterioration in the quality of the public services, increased budget deficits, or both.²⁹ Decentralization means that local government assumes an obligation to deliver these services to end-users in an efficient manner and at an affordable price. End-users have a right to expect that. Thus, local government, and their financing, matter to ADB in the context of its poverty reduction agenda and with regard to key MDGs.³⁰ SOEs are also an important part of the decentralization process. Many already operate outside the central government budget, at least in terms of financing requirements for capital and recurrent expenditures. These companies are undergoing changes through their restructuring into corporations and, in several instances, through partial sales. This process is often accompanied by improved corporate governance, including the autonomous management structures, the appointment and involvement of nonexecutive and independent directors, and adherence to cost recovery and profit or financial sustainability principles. Many of these companies already tap into local and international markets to finance their investment programs. However, more can be done to advance these efforts. ADB currently serves local governments and SOEs through lending with the support of the central government. However, these entities increasingly will become clients in their own right. Relying on sovereign guarantees to finance their development programs and projects no longer will be an automatic choice. New, albeit risk-averse, instruments must be put in place to meet the demand in this market.

- (ii) **Focus on investment programs versus project finance.** Most transactions that ADB finances on a stand-alone project basis form part of a broader, often long-term investment program. Yet, ADB normally does not finance a slice of such investments for longer than 3–5 years. This is a function of business practices, as well as the cost implications of existing instruments. Particular client concerns related to this are the balance sheet impact of ADB's financing, as well as the commitment fee structure that discourages large scale programs. Given the financial charges made on undisbursed amounts and long implementation periods of most projects, governments tend to favor loans that finance smaller time slices of investments from a financial cost perspective. However, this practice raises interrelated issues. First, financing smaller time slices increases the time and resources required to process operations, which are part of the 'hidden cost' of doing business, particularly when the due diligence and documentation is repeated each time as if the project or sector operation were new. Second, an upfront commitment by ADB to finance a larger and longer time slice of an investment program would allow clients to plan more systematically, especially if ADB's financing were off balance sheet at the outset. To be more programmatic in its investment lending, ADB needs instruments and modalities that would allow that to happen.
- (iii) **Financial statement implications.** Board approval of ADB financing is recognized as a contingent financial commitment (footnoted in the ADB annual report) for the undisbursed amount on the date of approval. This practice affects ADB's

²⁹ The most important services transferred include water, wastewater, waste management, education, health, urban transport, and housing. These services have constant and, on average, major capital investment requirements. Although the actual requirements are not known precisely, infrastructure alone will require several hundred billion dollars a year over the next 5–10 years.

³⁰ The quality of urban services also has a major impact on (a) the development of city clusters, (b) the improvement of logistics, (c) competitiveness, and (d) foreign direct investment.

borrowing and lending headroom and cash flow. A significant mismatch between the financing and disbursement schedules is common. The financing also affects the client's financial statements from the date of loan effectiveness, with contingent liabilities created (which usually may be reported as off balance sheet item). The impact on the client's financial statements is important, particularly if the client also taps other long-term financing via capital markets and commercial banks. This situation is exacerbated in the case of clients with longer-term investment programs to be financed primarily through non-ADB sources, a situation relevant, but not necessarily confined, to middle-income countries and larger SOEs. The contingent nature of existing financing structures can affect a client's financial gearing and, ultimately, its ability to secure financing from other sources, especially if this has to be obtained on a limited or nonrecourse basis. To some clients, balance sheet management can be far more important than ADB's financial charge on its loans. Clients generally welcome ADB's involvement not only because of the generally attractive financial terms and long tenors ADB can offer, but also because it will help attract additional cofinanciers.³¹ Yet, the strength of the balance sheet would be a distinguishing feature behind a cofinancier's decision to provide nonrecourse or limited recourse cofinancing.

- (iv) **Currency mismatch.** Most investment projects and sector investment programs generate only local currency revenues. Local government utility operations (water, wastewater, waste management, electricity, and urban transport) fall into this category. Social sector stand-alone projects and investment programs (such as those in health and education) normally do not generate revenues at all. In these and other instances, the viability of the investments would be improved, other things being equal, if ADB extended financing in local currency. ADB would be more relevant, responsive and have better results on the ground if it could help clients cut the currency risks associated with financing investment programs with only local currency revenues. ADB's Private Sector Operations Department (PSOD) has made inroads into local currency lending. The operations under the public sector window have not followed suit.
- (v) **Instrument range.** The current range of financial instruments is too narrow for ADB to service clients effectively. E.g., ADB does not refinance operations once they enter the commercial phase. Such operations might include investment projects supported by other institutions with financing plans that have become inappropriate. Such projects might be viable and contribute significantly to development if the financing plan could be restructured. ADB also has difficulty financing long-term slices of investment programs and to effectively apply its instruments in working directly with SOEs and local government entities on a nonrecourse or limited recourse basis. The ADB instrument range also remains narrow and constrained in terms of coinsurance and reinsurance capabilities. A change in instruments characteristics and new modalities are needed to address different investment and client scenarios.
- (vi) **Potential for cofinancing and guarantees.** The relevance of ADB's assistance is not only defined by the amount of resources it provides from its own account. ADB

³¹ ADB financing provides credibility to borrowers searching for additional financing, and comfort to cofinanciers on various aspects of the borrower and its investment program, especially with regard to financial management, policy and regulatory risk, safeguards, structural reforms, corporate governance, and general fiduciary oversight.

can also catalyze the mobilization of additional development financing from domestic and other sources. However, the type, nature, and application of ADB's project financing instruments and modalities can constrain the mobilization of other funds. Institutional incentives, which are not sufficiently supportive of cofinancing, must figure much more prominently in the work carried out during the processing cycle. In particular, new and more innovative risk-sharing partnerships are needed, including reinsurance or the sell-down of loan exposure to third parties after a certain period. This would allow both more flexible balance sheet management for ADB and new forms of crowding in commercial sources, mainly from the private sector, into ADB financed transactions.

- (vii) **Costs and charges.** The financial terms of standard ADB sovereign debt are generally on par with those offered by similar institutions, including the maturity, margin, and front-end fees. However, the 'all-in' cost of ADB financing is affected by the nature and application of its existing instruments, policies, operating procedures and implementation performance, and not easy to calculate despite some simplifications in the past. The contingent liability of at least part of the financing, and the disconnect between the approved amounts and the timing of the disbursements, can increase commitment fees beyond levels acceptable to borrowers. The problem is exacerbated for large investment programs with longer time horizons. The 'all-in' cost can be made more transparent and competitive through the introduction and application of alternative instruments and funding structures, as well as further simplification in the fee structure.

IV. INNOVATION AND PILOT CONCEPTS

30. Clients across the region are becoming more sophisticated and sensitive to "all-in" cost. To remain engaged, relevant and responsive, ADB needs to change aspects of its business model. Some of the changes will need to be strategic, aiming at focus and selectivity. Through these changes, ADB would provide critical mass and continuity in key sectors. Other changes involve simplifying ADB's procedures and practices, particularly for (i) consulting services, (ii) procurement, (iii) cost sharing and expenditure eligibility, (iv) investment and non-investment portfolio development and processing, (v) approval processes, and (vi) implementation. However, ADB also needs new financing instruments and modalities. Essentially, these would allow ADB to offer the most optimal transaction structures on attractive terms, target investment programs over time, and catalyze the mobilization of domestic savings and international finance. Cofinancing will involve other MDBs and bilateral agencies, export credit agencies as well as commercial banks, private equity, private companies, and capital markets. Innovative instruments can help ADB mobilize its own and other financing at attractive terms without crowding out others or increasing risks to DMCs or ADB.

31. The challenge and opportunity for ADB in the longer run is to make its interventions more programmatic, its products more innovative, and its practices and procedures more efficient. The following sections make the case for introducing new financial concepts on a pilot basis. These are not intended to replace existing instruments or weaken ADB's credit standing. Rather, the objective is to provide ADB operational teams and its clients with more flexible alternatives to help finance individual projects and investment programs, and extend credit lines and guarantees.

A. An Innovation Framework

32. The proposal for new pilot financing concepts is anchored in the following guiding principles:

- (i) **Fit with the strategic framework.** The proposed concepts should advance, rather than hinder, choices ADB has made under its existing strategic framework. However, they also should be flexible enough to help the institution move in new directions. These directions are likely to be articulated under a future medium-term strategic framework. Without preempting the nature and characteristics of this framework, future instruments and modalities should support greater selectivity in investment programs, reforms, and public-private initiatives targeting poverty reduction in ADF and OCR countries. They should be fully compatible with the Reform Agenda and the harmonization programs. Further, the new instruments and modalities should encourage the results-based initiatives now under way. In addition, the concepts should be simple to understand and operate, and should not compromise any of the basic guiding principles, including (but not limited to) those related to safeguards and fiduciary oversight.
- (ii) **Demand-driven and client-oriented.** The concepts should be driven by demand, and focused on client needs and requirements. They must be validated against real operations to test their on-the-ground relevance, effectiveness, and value-added. The proposed instruments are intended first and foremost to service clients better and more efficiently, not to support supply-driven interventions. A systematic demand assessment will be conducted in 2006 to identify priority clients, focusing on subsovereign borrowers and SOEs. It also will examine the potential market for refinancing facilities, reinsurance and coinsurance, and the multitranches financing concept. The assessment will look at the existing and projected market structure, as well as key features of the enabling environment. The review of the enabling environment will focus on legal and regulatory frameworks, as well as on structural reforms backing the decentralization process. It will examine the financial standing, investment programs, and borrowing requirements of key players. The assessment will identify critical issues, particularly in governance, safeguards, capacity, financial management, regulation, and tariff regimes. The assessment also will review cofinancing possibilities, the market for public-private initiatives, and the development of local capital markets. Its findings will be shared with the Board.
- (iii) **Sound banking principles and preservation of AAA credit rating.** The application of the proposed concepts must follow at all times the concept of sound banking principles. ADB's AAA credit rating is non-negotiable. The new Credit Risk Management Unit (CRMU)³² and other relevant departments and offices across ADB, as appropriate, will work together with operational teams to safeguard the credit rating. The CRMU, in particular, is essential for the success of the new financing instruments and modalities. The risk profile of each of the transactions will be evaluated professionally and independently by the CRMU. Risk mitigation measures will be proposed and monitored. Provisioning requirements will take into account individual and collective transaction risk profiles. Portfolio management

³² The CRMU was established effective 1 August 2005 as precondition for the pilot instruments and modalities presented in this paper. It will cover all ADB operations without sovereign guarantee, which may be processed by regional departments, PSOD, or by joint teams, as appropriate. For details, see: ADB. 2005. *Establishment of an Independent Credit Risk Management Unit*. Manila

will be monitored, and any 'workouts' reviewed. In addition to its functional independence, CRMU's mandate is to be accompanied by two fundamental procedural changes: (i) project teams will complete substantially all the standard project due diligence backing each transaction before the CRMU undertakes risk evaluations and sign-offs; and (ii) term sheet negotiations will be completed before any submissions are made to Management and the Board. This also implies the *ex ante* involvement of the CRMU in key issues, such as pricing, valuations related to equity subscriptions, guarantee 'carve outs', specific loan/equity transaction covenants, and the definition of the security package and exit strategies.

- (iv) **Compliance with ADB's Charter.** All proposals submitted in this paper must comply with the Charter. The Office of the General Counsel (OGC) will vet such compliance with respect to each transaction before ADB enters into any legally binding agreement with clients.
- (v) **Alignment with existing policies.** The concepts should follow prevailing ADB operational policies and procedures, with some changes resulting from the introduction of the pilot financing instruments and modalities. Some procedures will be tightened or strengthened, especially those related to credit risk management. Any changes that are found necessary will be evaluated and considered during pilot testing. No exemptions or changes are envisaged regarding safeguards, financial management, procurement, governance, or any other standard ADB policy, other than those taken up under IEI. The pilot instruments and modalities will adhere to provisions in place today, and adjust to any changes that might be incorporated in future. As the proposals made in this paper represent new concepts, they will be tested selectively and introduced gradually. Thus, not all staff will be familiar with the specific application requirements and approaches under them, at least in the short term. Training or coaching will be required and will be provided by the Regional and Sustainable Development Department (RSDD).
- (vi) **Harmonization.** The proposals seek to align ADB's financial instruments and modalities with those of comparator organizations. The concepts also will take ADB closer to the type of instruments used by other financiers. Capital markets operators, commercial banks, and private equity groups are major players in financing investments in emerging markets. ADB is expected to work more closely with them on projects and programs. What is more important is that ADB no longer can act as a sole agent in project financing. Partnerships and cofinancing with others will enhance greatly ADB's impact and effectiveness at the DMC level. However, to achieve this, ADB's financial instruments and modalities must mirror more closely those used by the market, rather than the other way around.
- (vii) **Simplicity.** The new concepts should be simple to apply. Any deviation from this important principle will stifle creativity and client uptake. A growing inventory of modalities each with their own access and applicability conditions, but only incrementally different in substance and benefit, will be impractical and difficult to manage.³³ A better approach is to simplify, while maintaining flexibility.

³³ ADB's comparator organizations in the past have developed a wider array of "new" instruments and modalities. Although this might have worked well for them, it is not proposed that ADB should emulate the approach. Instead, it is proposed that ADB should expand its range of instruments on a more gradual basis, based on demand and results.

- (viii) **Pilot testing.** The concepts are to be pilot tested initially over three years (para. 67). This period is the minimum necessary to develop a pipeline of operations suitable for innovation. Few, if any, of these operations would have entered their full operational phase by the end of the test period. However, by that time, some preliminary results will be available, including the extent to which borrowers took up the instruments, how the due diligence process was conducted, what cofinancing was being put in place or envisaged, and how far ADB has progressed in investment program financing and implementation arrangements. It also should be possible to judge the fit with overall ADB strategy, the application of sound banking principles, the risk profile to clients and ADB, the uptake and relevance to OCR and ADF clients, and the range of borrowers serviced.³⁴

B. Pilot Concepts

33. New concepts have been developed that aim to provide ADB and DMCs with alternative instruments and modalities to respond better and more effectively to development financing needs. Specifically, the proposals will enable ADB to (i) improve service to existing and new clients; (ii) be more programmatic; (iii) mobilize other resources more efficiently, including domestic savings, and international finance; (iv) minimize currency mismatches at the project and client level; (v) reduce transaction costs; and (vi) provide refinancing to fundamentally sound projects with high development impact but weak financing plans.

1. Multitranche Financing Facility

34. The proposed pilot concept calls for the establishment of a debt financing facility to target (i) discrete, sequential components of large stand-alone projects, (ii) slices (or tranches) of sector investment programs over a longer time frame than the current norm, (iii) financial intermediary credit lines, and (iv) guarantees. The proposed multitranche financing facility (MFF) incorporates features of sector and cluster loans, although with the client and ADB adhering to much sounder cash and balance sheet management principles.

35. Investments with long gestation periods require phased disbursements. This implies large commitment fees, as well as more substantial balance sheet commitments. As a result, clients often agree to undergo repetitive processing tasks, and endure the cost of slow ADB processing and implementation procedures, rather than carry a major transaction on their books, or pay commitment fees on undisbursed amounts for a considerable period. Financial discipline and sound balance sheet management matter to most, particularly if large portions of the investment programs are cofinanced. Financing instruments and financing arrangements that are inflexible on these two fronts are not compatible with the long-term and programmatic sector investments that are so important from the perspective of developmental impact.

36. ADB needs to take a more programmatic approach toward the investment needs of clients. This is the only way to increase ADB's productivity, provide critical mass and continuity, and improve quality (through greater attention to implementation and policy dialogue, instead of focusing on repetitive processing tasks). These objectives can be addressed through the application of more structured financial instruments. A programmatic approach would not

³⁴ A results framework is in Appendix 1. This captures the main performance criteria for IEI as a whole. Further details on monitoring and reporting are in para. 76 and specific quantitative and qualitative parameters for each of the proposed instruments are in Appendix 10.

compromise guiding principles such as safeguards, fiduciary oversight, and reforms. Indeed, the opposite should be true. Through the provision of greater critical mass, and particularly by ensuring continuity, project teams should be able to spend more time on these issues, and keep Management and the Board informed accordingly.

37. The MFF addresses the issue of commitment fees. However, its most interesting feature is its ability to minimize the negative impact that standard ADB financing now has on a client's balance sheet and cofinancing capabilities. This is an increasingly important consideration for nonsovereign public sector borrowers rely more and more on capital markets, private equity, and commercial bank financing. Under a traditional public sector loan extended by ADB (stand-alone or sector), only the amounts formally withdrawn are registered as an obligation on the balance sheet.³⁵ However, the amounts undisbursed also have to be reported in the audited annual accounts as off balance sheet items. Although these are not formally recognized as contingent liabilities, few financiers would contemplate direct nonrecourse or limited recourse lending without considering the overall loan amount. Off balance sheet audited accounts notes can be as important as the loan amount registered as a contingent liability. ADB certainly would look at these in the context of any nonrecourse lending.

38. In practice, most projects take 4–7 years to implement. This means that funding is truly required in tranches, in line with implementation schedules. The commitment fee on undisbursed loan amounts contributes to the financial cost structure. The off balance sheet recognition of the total financing affects the financial standing of a client, particularly for operations that need to be cofinanced with others. At times, cofinancing can exceed ADB's financing by several fold. Such fundraising efforts with third parties require a healthy or robust balance sheet, rather than sovereign guarantees, which quite often are unavailable to others. The stronger the balance sheet, the higher the chances of securing this other finance and the better the terms and conditions. ADB instruments and modalities should be tailored to allow clients to target longer-term investments and greater levels of cofinancing. An MFF would go a long way in helping clients achieve these objectives.

39. An MFF is akin to a standby letter of credit, or purpose-specific credit line. However, it does not become a contingent liability on the books of ADB clients or on ADB itself on approval. The unused parts of the facility are not registered as off balance sheet items. The MFF can be applicable to large stand-alone projects with discreet components, though it is particularly relevant to sector investment programs, to the provision of financial intermediary credit lines (e.g., those targeting SMEs), and guarantees. The MFF can be used across all sectors and in OCR- and ADF-eligible countries alike.

40. ADB approval arrangements normally involve a one-time submission to the Board. This would continue to be the case under the proposed MFF. The Board would be requested to approve the expected financing under clear terms, conditions, and eligibility criteria. This approval would be for a specified maximum amount, and for a given utilization period.

41. Entries in ADB and client balance sheets (and off balance sheets) under the MFF would be made only after loan agreements related to specific periodic commitments have been signed and made effective—in line with the terms, conditions, and criteria approved by the Board.

³⁵ ADB operations generally involve two clients, but simultaneous “bookings”: (i) the state, at the time of effectiveness and through the issuance of the sovereign guarantee; and (ii) the executing agency, local government-owned company, and/or a financial intermediary, at the time and through the signing and effectiveness of direct or subsidiary loan agreements, as applicable. While the debt agreement is immediate, the disbursement schedule is not.

Commitment fees would only apply with respect to such signed loan agreements in accordance with ADB's policies. In the case of public sector recourse financing, the respective governments also would approve a global sovereign guarantee at the same time. However, the guarantee would be structured in tranches through a standardized procedure to cover each of the individual loans. Most financial requests or commitments under the MFF are expected to be made annually. However, clients would be given the option to make more frequent or, in some instances, less frequent requests. This would be reflected in the report and recommendation of the President (RRP), taking into account the nature and characteristics of the investment program and the specific subproject preparation and implementation schedules.

42. The MFF can apply to stand-alone project loans, guarantees, sector loans, and credit lines processed by the regional departments. It would provide the equivalent of recurrent business to ADB, which should help prevent the inflation of booked achievements and counter the approval culture by shifting the focus from processing to execution or implementation.

43. The MFF essentially would be structured and staggered into multiple loans. In this manner, ADB could finance a longer-term investment program without creating large financial entries in the balance sheet of its clients, and triggering commitment fees only with respect to signed loan agreements in accordance with ADB's policies. With the standby nature of the financing, the MFF would finance subprojects as they come up ("finance as you go"). Commercial banks follow this practice. EBRD and the Inter-American Development Bank (IADB), have instruments with similar characteristics. The World Bank's Adjustable Program Loan facility shares some features with the proposed MFF. Appendix 4 provides a more detailed account of the proposed instrument, as well as the main guidelines for its application. IEI, through the Special Initiatives Group in RSDD, will work with project teams on the first set of transactions structured around the MFF. Staff instructions will also be prepared to help project teams work efficiently with this facility.

2. Sub-Sovereign and Nonsovereign Public Sector Financing

44. The proposed pilot concept calls for the provision of debt finance (loans and guarantees) directly to selected subsovereign, quasi-sovereign and other nonsovereign public sector entities, including SOEs, on a nonrecourse or limited recourse basis. The introduction of the concept requires a number of preconditions, including the establishment and operation of the independent CRMU (footnote 32). Processing this type of financing requires detailed due diligence with independent risk assessment on a range of standard project finance areas, and strengthened processing procedures conforming to best market practice. The latter should include the substantial completion of due diligence on standard areas such as technical, commercial, financial, legal, regulatory, safeguards, management, governance, institutional and other matters, and term sheet negotiations (including pricing, equity subscription valuations, exit strategies and security package agreements) on the final transaction structure before any formal submission is made to Management and the Board.

45. The decentralization process witnessed across the Asia and Pacific region has become an irreversible trend. Effectively, this is transferring ownership of, and responsibility for, investment and management of key services and projects to local government. The driving forces behind this trend are political and economic. Decentralization takes place in two stages and at two levels of local government. First, it targets the provincial or state administration. Second, the provincial or state administrations replicate the process vis-à-vis municipal entities. This is not an easy undertaking. In addition to strong political will, decentralization requires the necessary financial means, suitable and predictable legal and regulatory frameworks, and local

capacity. These frameworks are generally weak, or at best incomplete, which probably constitutes the single biggest bottleneck faced by local government in assuming these new responsibilities. This is also a considerable obstacle to private sector involvement.

46. Increased urbanization leads to huge financing requirements of provincial and municipal entities, particularly for utilities (e.g., water, wastewater, and waste management), urban transport and the infrastructure and systems to run it, housing, health, and education. The transfer of ownership and responsibility for these services has not always been matched by a pro rata transfer of financial resources, which is a major issue across the region. This can lead to budget deficits, which in turn increase local governments' difficulties in raising financing. It also can lead to a rapid deterioration in the quality and efficiency of service delivery, as measured in terms of quality, coverage, and continuity. This affects end-users and, ultimately, the achievement of the MDGs. However, some public entities are bound to be sound credit risks, particularly if they continue to deepen and expand structural reforms to cut deficits, and introduce transparent financial management systems and better governance. These entities are potential demonstration cases, and a reference for others that have not introduced reforms.

47. In addition to local governments and other subsovereign entities, this form of financing also is useful for selected SOEs across the region. Special financing arrangements are required for these enterprises to deliver the services they were set up to provide. A number of these SOEs are financially sound, transparent, and well-managed due to (i) increased emphasis on sound corporate governance; (ii) stronger regulatory regimes and sector reforms; and, (iii) in some instances, partial sales through public offerings, private placements, and joint ventures. The SOEs targeted under the proposed facility are focused on businesses that provide access to public goods and services and have a high development impact, such as water, wastewater, waste management, power, energy, transport, telecommunications, or improve business competitiveness. This means they may in many cases not be hugely profitable, though they should be financially sustainable in the long run. In many cases, they are long-standing clients of ADB (albeit financed with sovereign guarantees). As a result, ADB has built up a considerable knowledge base on the sector and on their functioning and operations. Under certain conditions, these companies could be acceptable credit risks for direct ADB financing. ADB's involvement should help bring about improvements such as specific reforms, mobilization of domestic savings, direct foreign investment or trade, stronger corporate governance, better financial management and information systems, and the incorporation of the private sector in either the enterprises themselves or in their investment programs. The incorporation of the private sector can take place through a variety of modalities, including selected domestic and international public offerings, partial sales, joint ventures, concessions, BOTs, and management contracts. Outright sales also could be encouraged and figure in the reform agenda of DMCs, particularly in relation to sectors such telecommunications, power and energy.

48. Nonrecourse and limited recourse financing under this facility should normally be coordinated through the regional departments, and be embedded in the CSP.³⁶ This approach does not limit the involvement of PSOD in these transactions. New internal incentives structures will be required to encourage teams to work together more effectively (para 72). However, most of these transactions would have a major impact on the sector and reforms, and in this sense go well beyond actual deal structuring. Hence, the overall coordination of these operations would be the responsibility of regional departments.

³⁶ Some flexibility may be required during the first year of the pilot phase as operations start up.

49. The decentralization process suggests that local government financing sooner or later will become a part of ADB's core business activities. SOEs also might be appropriate for direct ADB financing, if such financing were to pave the way for (i) cofinancing, (ii) significant reforms on sector-wide issues, (iii) better internal corporate governance, (iv) enhanced regulatory frameworks, (v) improved tariff regimes, (vi) public and private placements in the local and international markets, and (vii) privatization. This form of financing would encourage central governments to move away from a 'doing business' mode toward a more regulatory function. Although central governments will remain a major source of financing to local governments, they also will call upon institutions such as ADB and others to provide assistance through new financing modalities and approaches that can bring about new solutions to old problems.

50. Sovereign guarantees will not always be available to finance local governments and SOEs. Some middle-income countries already are asking financiers such as ADB to share risks, a trend that will spread. Indeed, this trend will accelerate once local government finances strengthen further. Provincial, and particularly selected municipal entities, eventually will secure nonrecourse or limited recourse financing from the market, as will some SOEs. Such a process obviously will have to be tightly regulated at the center to avoid the development of a debt overhang and 'moral hazard'. Loss of confidence in local governments and SOEs could have major negative repercussions on the financial, economic, and investment standing and climate of a country.

51. ADB is in a unique position to start the process of working directly with selected subsovereign entities, especially municipal entities. Unlike the World Bank, ADB's Charter does not impede its working with these clients without a sovereign guarantee. However, direct, limited, or nonrecourse financing would need to be accompanied by major reform preconditions and the application of sound banking principles. It also would involve tailored pricing and security package arrangements, aligned with market practices and with the terms offered by other cofinanciers. ADB's role must be to bring in other financiers, not to crowd them out.

52. Few SOEs and local government entities in the market now are likely to qualify for direct financing without sovereign guarantees. ADB could work with the eligible ones in the short term. Meanwhile, others could start the reforms needed to qualify for this financing down the road. Some of ADB's development partners, such as the World Bank, are recognizing the importance of this "third generation" of clients. The latter is considering setting up a special vehicle to work outside its charter restrictions, probably through the establishment of an off balance sheet special fund. IADB also is planning to lend directly to subsovereigns and SOEs. Starting with a small operation in Budapest in 1993, EBRD has been providing nonrecourse financing to local government entities for more than a decade. It has also financed SOEs in the process of transition to becoming predominantly privately owned. The European Investment Bank (EIB) was the first, and is still the most effective, of the multilateral institutions in this area. Its municipal financing portfolio is large and growing. Appendix 5 provides more detailed information on the proposed instrument. It provides information on the main conditions and eligibility criteria for extending finance on a nonrecourse or limited recourse basis, and the key procedures and due diligence required to do so. These key procedures and due diligence cover financial, technical, legal, regulatory, commercial, capacity, governance, sector and internal entity reforms, safeguards, fiduciary oversight, institutional arrangements, and social aspects. Local government and SOE entities are divided into three categories (green, amber, and red) based on their suitability for direct nonrecourse or limited recourse financing. The transactions to be supported by ADB on this basis would need to follow prevailing operational policies and procedures, have a high developmental impact, and be compatible with the country's and ADB's poverty reduction agenda.

3. Local Currency Financing for the Public Sector

53. Associated with the decentralization process is the potential mismatch between borrowing in hard currency and having income streams in the domestic one. This currency mismatch occurs irrespective of the strength or suitability of the policy and tariff regime governing a specific service or project. In addition, the local cost component of projects has generally increased over time. While there is little rationale to provide local currency to central governments (which can raise local currency on terms similar to or better than ADB can), in the case of SOEs and local government, ADB might offer a significant comparative advantage.

54. Local currency financing is particularly important in the case of public services, utilities, and infrastructure projects that are subject to tight tariff regimes. It is also applicable to countries that face higher than average exchange rate volatility. The long gestation period can adversely affect the viability of these operations. Tariff regimes might become unsuitable or insufficient for political and social reasons. In fact, governments have often hidden the true cost of services in the past. However, although regimes can be modified, one bottleneck that is more difficult to overcome is the ability and capacity to pay. The elimination, or at least the partial reduction of the currency risk, might go some way to cutting overall project risks and make investments and reforms more viable.

55. There is considerable interest in local currency financing among a wide range of stakeholders, including project sponsors, commercial lenders, international development financing institutions, and export credit agencies. Demand for local currency financing by ADB is likely to be significant, in particular when combined with extension of financing to other public sector borrowers on a limited or nonrecourse basis. Demand is expected to be significant, even if extended with sovereign guarantees. Local currency financing is also likely to lead to considerable financing partnership opportunities.

56. A key challenge for ADB will be treasury related. In structuring this type of transaction, there will always be a concern about currency-related risks, especially when trying to match funding and lending operations in quite often illiquid markets and with limited hedging opportunities. ADB has, in principle, the capability to structure transactions around local currency financing, and is well placed to respond to the challenge. But this must be done in a careful and measured way. A proposal for a pilot concept to extend local currency financing to public sector borrowers, as well as draft guidelines for its application, is detailed in Appendix 6.

4. Refinancing

57. The proposed concept calls on ADB to help restructure or expand projects involving public or private sector assets, or assets under public-private partnerships. This facility should be used selectively. Whenever possible, it should be accompanied by new investments and by adequate reform measures to ensure the long-term viability of the restructured operations. The facility would not be used to cancel ADB or other MDB loans. Refinancing would not be used to bail out governments or sponsors that performed poorly, or to finance cost overruns. The latter are addressed through ADB's supplementary financing policy.³⁷

58. A number of investment operations with a high development impact might have been exposed to high interest and foreign exchange rate volatility. As a result, these projects might

³⁷ A revision of this policy is envisaged and will include consultations with the Board. Work has been initiated.

have encountered difficulties during their commercial phase. The repayment and risk profile of the financing plans (debt and/or equity finance provided by development or commercial banks, private sponsors, and private equity groups) might have become inappropriate as conditions on the ground changed. The maturity periods of the debt financed might be tighter than average, at least in relation to the current and projected cash flow. Working capital finance³⁸ also might be narrower than needed. The original financing plan structures might have missed out on hedging possibilities through interest and currency swaps. In the case of equity finance, this might have been extended more efficiently through other alternatives, such as quasi-equity or mezzanine finance. On the other hand, debt might have been more suitable for the longer-term viability of the project if put together based on temporary cumulative preference share schemes. Repayment schedules might have been mismatched with the projected cash flow. Guarantees might have been used to encourage shareholder advances and better debt financing packages from third parties. Local currency might have been more suited to the transaction instead of foreign exchange financing. Transition strategies might have been put in place to help overcome inappropriate tariff regimes of the past, thus to reinforce the cash flow. The list of problems with financing plans can be extensive.

59. Although these projects might be technically, economically, and socially viable, some might falter purely due to the inadequacy of their financing plans. In some instances, project targets (measured in terms of quality, coverage, and continuity) might be at risk due to these financing considerations, rather the project concept itself. Increasing tariffs could be part of the solution, though this might not be sufficient to ensure viability. While some investment plan components could have been phased differently over a longer period (or even phased out), this might have compromised the integrity of the project. Given the exclusive focus on operations in the commercial phase, this option would be academic in any case. A number of these projects might be close to reaching their full operational capacity point, or they might be at a stage where they need upkeep, rehabilitation, or extensions. However, their original financing plans might make such undertakings difficult, if not impossible. Financial plan restructuring might be an effective way to save these projects.

60. This assumes, of course, that cost recovery is an integral part of the project structure. Refinancing purely due to the wrong tariff regime, or the wrong cost recovery arrangements, would be unjustified, unwarranted, and uncalled for. It would merit a different set of actions, not refinancing. Similarly, financial problems resulting from operating inefficiencies or poor management should not be addressed through a refinancing facility.

61. An increase in fees or tariffs, or a capital increase, can effectively address a high financial cost structure. Refinancing can and should be accompanied by these reforms whenever feasible and ADB's role would include making available its expertise and resources in relation to the related industry, sector, as well as the project itself. However, these changes alone might not be enough to compensate for a distressed financing plan and ensure a project's longer-term financial viability.

62. In view of this assessment, ADB should allow refinancing on a selective basis where such refinancing has a high and demonstrable development impact. To the extent possible, ADB should encourage third party financing which may be credit enhanced through ADB guarantees, including the utilization of securitization structures to tap into capital markets for

³⁸ Working capital, calculated by deducting current liabilities from current assets, indicates the ability of a project company to pay its short-term debts. It shows a project company's liquidity situation to meet obligations over a coming year of operations.

mobilizing required capital. In such case, the same strict credit analysis as that made with regard to fresh financing would apply. ADB's prevailing operational policies and procedures in respect of safeguards and themes will also apply. Appendix 7 details the concept, conditions for refinancing, and basic guidelines for its application.

5. Financing Syndications and Risk-Sharing

63. The proposal recommends the introduction of new forms of cofinancing through active financial syndications and risk sharing with commercial financing partners in the public and private sector. These could include "sell-down" of nonsovereign exposure by ADB, as well as reinsurance and counterguarantee agreements with nonsovereign third parties. This would be important to bringing in commercial financing to ADB operations, and improving ADB's risk management, particularly for nonrecourse and limited recourse financing operations. Pricing information provided by cofinancing partners would be an important indicator for ADB's own price determination. Financial syndication and risk-sharing arrangements would be carried out in collaboration with leading commercial banks, and with the financial industry. Within ADB, the Office of Cofinancing Operations (OCO) will coordinate this process in close consultation with CRMU, OGC and operational departments. OCO is adjusting its skill base, and recently recruited specialist staff with extensive expertise in financial syndications and political risk insurance in the private and public sector.

64. ADB has not taken full advantage of the considerable potential that its credit enhancement instruments offer for market collaboration and risk-sharing partnerships. Generally, cofinancing or guarantees have been agreed at the beginning of a project and remained largely static throughout the project period. Counter-guarantees have been limited to sovereign guarantees. Reinsurance, or 'sell-down' of risk to bilateral or commercial agencies, has not taken place, even if those agencies operate on a commercial basis and with untied procurement. Recently, commercial financial institutions, from the private sector as well as public sector, have shown increased interest in entering into risk-sharing agreements with ADB. In conjunction with the other proposals formulated in this paper (e.g., public sector lending without sovereign guarantees, local currency financing, and the MFF), the scope for sharing project risks with third parties potentially is significant. This would facilitate more efficient risk allocation among the financing partners with commercial banks focusing on short-term and commercial risk, and ADB on longer-term and political risks. Cofinancing partners clearly value the benefit of ADB's AAA rating, as well as its privileged relationship with host governments. Some limited experience has already been gained with public-private risk sharing partnerships in ADB's private sector operations.³⁹

65. Reinsurance and sell downs would reduce and better balance ADB's risk profile, and allow ADB to manage its balance sheet more flexibly. These activities would be closely coordinated with the new CRMU. If properly managed, risk-sharing agreements could increase significantly ADB's role and relevance as a catalyst for development finance, while enhancing ADB's income position. Appendix 8 provides additional background on the concept, exposure limits, and guidelines for implementation. The proposal would be refined, if needed, during the upcoming review of ADB's cofinancing strategy and policy review of credit enhancement and guarantee products.

³⁹ This includes a "guarantor-of-record" structure under the Phu My 2.2 power project in Viet Nam (2002), as well as risk-sharing and reinsurance agreements with EBRD and Proparco under the Trade Facilitation Finance Program (2003).

6. Flexibility in Commitment Charges

66. Commitment fees can deter business development across countries and penalize projects vis-à-vis programs, especially those with a limited number of tranches or short implementation periods. However, commitment fees do have an impact on ADB income. This paper does not provide a specific proposal to the Board on the subject. Instead, it suggests that Treasury Department look into the matter and, as appropriate, submit to Management and the Board a separate paper with a specific proposal to achieve greater flexibility. This is currently planned for October 2005. Some options are highlighted in Appendix 9.

V. IMPLEMENTATION

A. Pilot Testing

67. The proposed concepts would be for implementation on a pilot basis for an initial period of three years. While the proposed concepts are new to ADB, they have been implemented elsewhere in comparator development banks or in the commercial banking sector. Pilot testing would allow ADB's Management and Board to monitor and assess their viability, relevance, effectiveness, and uptake (para 76). At the end of this period, their performance, suitability, outcome and impact would be evaluated. Based on this evaluation, Management and the Board can decide to extend them as they are for another pilot period, incorporate them into ADB's core business model, or discontinue them⁴⁰. Consequential and specific changes would be incorporated into ADB's policies and operating procedures then or earlier, as required.

B. Other Reforms

68. The introduction of the new financing concepts requires a number of changes to ADB's business processes and the establishment of an independent credit risk management function. These conditions must precede work, particularly on subsovereign, refinancing, and local currency nonrecourse or limited recourse lending operations. General business processes reforms are contained in a separate IEI paper which targets changes in the CSP, project processing, approvals, and implementation arrangements. The most important changes needed in relation to nonrecourse and limited recourse finance involve the substantial completion of due diligence on standard project finance areas and term sheet negotiations before Credit Committee and/or Management Review meetings, and Board presentations. An independent CRMU was established on August 2005. Reviews of ADB's cofinancing strategy as well as ADB's credit enhancement policies are ongoing. These reviews are aimed at strengthening the framework for financing partnerships, financial syndications and risk sharing arrangements.

C. Organizational, Operational and Resource Implications

69. The pilot concepts will be introduced initially within the existing organizational framework. Further reviews of organizational and skill-mix implications will be undertaken once some experience has been gained with the pilot concepts. The skills base will need to be strengthened over time if the pilot concepts are to be mainstreamed into ADB operations.

⁴⁰ In such case, proposals in the CSP that have not obtained concept clearance would no longer be processed under the IEI pilot instruments and modalities, but could possibly be retained for consideration under ADB's traditional instruments and modalities, with sovereign guarantee.

70. Traditionally, lending operations in regional departments have been geared towards lending to governments with sovereign guarantees. In recent years, there have been more public-private partnerships as regional departments started to “think private sector development” in public sector operations. Regional departments now have some of the required expertise, though only enough to undertake a limited number of transactions at a time. These departments recognize the need to further develop existing skills and to bring in new and additional expertise. In the meantime, pilot transactions can be processed through the establishment of multidisciplinary teams that combine expertise in public sector operations with nonrecourse and limited recourse financing. It is envisaged that the two sides of ADB (the regional and the private sector operations departments) will increasingly work together to define and deliver sound and unified “ADB brand” financial solutions to clients in areas where neither of the two are currently active. Local government and SOE financing are such areas. Public-private partnerships also could be expanded through this collaboration. In the medium-term, this should also help to improve project quality, as ADB will become more closely involved with the client. The newly established Special Initiatives Group in RSDD will support the project teams in the short term, especially in (i) defining concept papers, (ii) mapping out part or all of the due diligence, (iii) carrying out financial modeling work, and (iv) assisting with final transaction structuring. Due diligence in specialist areas may be outsourced to independent external advisors, as appropriate.⁴¹ While these proposed financial instruments and modalities will not change the character of ADB overnight, they might do so in the medium to longer term.

71. Over the medium term, the pilot concepts might have important resource implications at various levels. At the staffing level, certain activities, such as credit risk management will receive increased attention. New activities will be required to process some of the transactions, including more extensive communications with clients. On the other hand, the MFF will save considerable resources at the processing level, at least over the medium term. These resources can be reallocated to focus on implementation, as well as other transactions. Subsovereign and nonsovereign lending, refinancing, and local currency lending fall in this category. These transactions will need extensive due diligence. The due diligence will be carried out after concept clearance. This means that highlighting key issues, establishing the basis for the formation of joint processing teams, and defining precise terms of reference for external experts will be done at this early stage. Other processing activities currently carried out but supportive of outcomes might be de-emphasized. On the whole, this should not cost more than that associated with current standard public sector operations. Some specific tasks, particularly legal and financial ones, will cost more but project preparation as a whole may not need to be more costly. Rather, it will be different. Over time, project teams will need to be strengthened with more nonrecourse finance skills. This will require not only a change in the recruitment pattern, but also extensive coaching and training of existing staff. How all of this will balance out is not clear yet. The operational and resource implications should be much clearer as initial experience is gained in implementation and following the more detailed demand assessment described in para. 32(ii). To cope with the immediate requirements of the pilot phase, the existing resource framework is expected to be sufficient.

72. The proposed pilot financing instruments and modalities will also have implications on ADB's reporting framework. The MFF, in particular, will shift year-end reporting away from Board approval towards effective legal commitments and implementation. Consequently, this may result in reporting of lower lending approval figures during the initial phase of the pilot period. Over the medium term, this is expected to provide a more accurate reflection of ADB's

⁴¹ Commercial banks, private equity groups, and investment banks routinely outsource specialist aspects of due diligence.

legal financing commitments. For the subsovereign and nonsovereign public sector financing facility, a separate reporting category for lending and guarantees without sovereign guarantee, outside of private sector operations and regional lending with sovereign guarantee, will need to be established to capture the composition of ADB's exposure in a transparent manner. This new category should be linked to internal incentive structures that encourage teamwork across divisional boundaries, rather than single departments.

73. The head of the Special Initiatives Group of RSDD will provide management advice on the overall interpretation of the pilot concepts and be responsible for their implementation in accordance with this paper. This will be done in close consultation with operational and key support departments and offices, as required.

D. Financial Risk and Income Implications

74. TD has projected that up to \$3 billion could be used for non recourse and limited recourse financing under the IEI pilot schemes. This is considered a prudent ceiling from a credit risk exposure perspective, as it would most likely cap ADB's equity capital exposure to non recourse and limited resource financing (including PSOD lending under reasonable growth assumption) for the next three years to within 10% of ADB's risk bearing capital.⁴² However, it is mandatory that the independent CRMU should introduce a formal exposure limit within one year to replace the temporary guidance.

75. The income impact will to a considerable degree depend on the disbursement pattern and the pricing of non recourse and limited recourse financing in light of prevailing market conditions, as well as whether the pilot financing instruments and modalities result in additional business volumes for ADB or substitute for traditional lending operations. In any case, it is expected that disbursements will be modest during the initial phase and increase only gradually over the pilot period. Thus, the income implication during the pilot phase relative to ADB's overall income is expected to be small.⁴³ Yet, the objective of the new instruments is not to increase ADB income *per se*. The aim is to help ADB service its clients in a more efficient and effective manner while safeguarding ADB's financial integrity.

E. Monitoring and Reporting

76. Finally, the Board will be kept informed of the progress of IEI, as a whole, and the pilot instruments and modalities, in particular. In addition to specific submissions made under each pilot concept, Management also will compile and submit to the Board an annual report on the overall performance of the package. This will be based on the results framework in Appendix 1 and the monitoring indicators given in Appendix 10. Some of these indicators will suggest trends, rather than precise quantitative targets. As such, new yardsticks might be considered during the pilot period to help evaluate the level of success or failure. This report will include a list of the projects being processed or funded in this fashion, the impact that the approaches might have had on ADB's clients and business plan, the progress made, and problems encountered.

⁴² This ceiling is a risk limit parameter and should not to be understood as a planning figure for non-sovereign public sector operations. Actual uptake will depend on the effective demand and the quality of proposals.

⁴³ Assuming on average 100 basis points spread pick up for non recourse and limited recourse financing over regular OCR loans with sovereign guarantee, income would increase by \$1 million per annum for every \$100 million disbursed.

VI. RECOMMENDATION

77. The President recommends that the Board approve the implementation of the proposed financing instruments and modalities, substantially as outlined in this paper, on a pilot basis for an initial period of three years.

INNOVATION AND EFFICIENCY INITIATIVE - OVERVIEW

1. The Innovation and Efficiency Initiative (IEI) mandate aims to make and keep the Asian Development Bank (ADB) more client and results-oriented, efficient, and effective. Coordinated from the Regional and Sustainable Development Department (RSDD), IEI is a bank-wide initiative. It is also an integral part of the Reform Agenda. RSDD will monitor and report the progress of IEI implementation, and suggest improvements if any, based on the results framework shown below.

2. A strategy working group (SWG) was formed to work on IEI. The group has identified and evaluated a list of priority issues related to operational bottlenecks. These relate to the various stages of ADB's operational cycle, including (i) the development of the business pipeline or the country strategy and program (CSP), (ii) processing and internal approval systems for investment and other operations, and (iii) implementation and disbursement arrangements. Based on the identified issues, IEI focuses on developing change proposals in the following priority areas:

- (i) **Country strategy.** Ways to improve strategic clarity and results-orientation, quality at entry and thereafter the development of a sound business pipeline covering investment and other forms of assistance (financial and nonfinancial);
- (ii) **Business processes.** Approaches, procedures, and practices related to the development of the pipeline, and the efficient conversion of this into investment and noninvestment operations thereafter (i.e., processing, approvals and implementation);
- (iii) **Procurement.** Approaches, practices, and policies covering consultancy services and the procurement of goods and works, and harmonization with other development partners;
- (iv) **Cost-sharing and expenditure eligibility.** Proposals to improve the cost sharing system and the widening of expenditure eligibility criteria. The rationale is client responsiveness and harmonization with other development partners;
- (v) **Safeguards.** A separate process calling for proposals to improve quality and efficiency during processing and implementation;
- (vi) **Financial instruments and modalities.** Development of new instruments and modalities on a pilot basis, accompanied by an independent credit risk management function and improved procedures and practices.

3. In coordination with IEI, the Treasury Department has developed a proposal to enhance introduce local currency lending to private and public sector clients.

4. To address each of these priority areas, SWG set up subteams comprising staff from key departments across ADB, including operational and support departments. SWG has worked on the basis of a "bottom up" approach, undertaking consultations with team leaders, team members, directors, Management and the Board.

5. A significant part of the work has been anchored on projects, and some procedural changes have already been reflected in a number of operations submitted to the Board in 2004. However, most of these changes fall in the area of procurement, rather than in the area of financial instruments and modalities. The approach taken thus far has allowed SWG members to engage directly with operational and support teams, but more importantly, it has facilitated direct contact with clients while the work was being done. Client feedback was further reinforced during 2004 and 2005 through the Middle Income and Ordinary Capital Resources Country Partnership Framework consultations. DMCs and shareholders in general suggest that ADB needs to be more flexible in terms of its systems and procedures, much faster in relation to processing, pay greater attention to implementation, expand and innovate its financial instrument and modalities range, raise the level of cofinancing, align its business cycle to that of DMCs, simplify documentation, cut nonfinancial costs, be much more selective in terms of sector coverage, provide critical mass, and deliver money with ideas.

6. The IEI proposals are categorized into those that fall under the jurisdiction of Management and those that require formal Board approval. Management-related proposals involve primarily changes to business processes, as well as to resource reallocation, incentives and accountability. A number of the proposals reflect the views of the Independent Panel commissioned to look at the results of the 2002 reorganization of ADB. Board-related proposals involve changes to existing operational policies and procedures. Both sets of proposals are complementary and intertwined.

IEI Results Framework

Design Summary	Indicators/(Targets)	Monitoring Mechanism/(Data Source)	Key Assumptions
Impact (by 2015)			
<ul style="list-style-type: none"> Demonstrable improvements in the development impact of ADB operations in reducing poverty in DMCs (<i>see Reform Agenda results framework</i>) 	<ul style="list-style-type: none"> CSP post-evaluation ratings (fully satisfactory rating for all CSPs evaluated by 2012) Improving client and partner satisfaction levels on impact of ADB operations 	<ul style="list-style-type: none"> Annual PRS progress report by RSDD (post-evaluation reports on CSPs or CAPEs by OED) Annual PRS progress report by RSDD (client and partnership surveys every 3 years by SPD) 	<ul style="list-style-type: none"> Global and regional economic and political stability Continued commitment and support of the development community and DMCs to poverty reduction DMC capacity to plan and implement poverty reduction strategy strengthened Political and social stability within DMCs Continued shareholders support

Design Summary	Indicators/(Targets)	Monitoring Mechanism/(Data Source)	Key Assumptions
Outcomes (by end 2007)			
<ul style="list-style-type: none"> Enhanced organizational effectiveness of ADB (see Reform Agenda results framework). More specifically, ADB as a more efficient, responsive, and larger catalyst for finance and knowledge to meet DMCs' poverty reduction needs 	<ul style="list-style-type: none"> Quality-at-entry of CSPs and projects (baseline established in 2006, and continuous improvements in the following years) Net transfer of resources Commercial cofinancing under complementary financing and guarantee operations (with increase recorded in 2006–2007 over the 2005 level) 	<ul style="list-style-type: none"> Retrospective reviews of CSPs and projects Financial statements OCO database 	<ul style="list-style-type: none"> Clear and focused medium-term strategy (2006–2010) of ADB in place All the other initiatives (outputs), including the HR strategy, under the Reform Agenda fully implemented ADB Management recognize staff promoting IEI implementation ADB culture aligned to support the reform initiatives Adequate staff resources and skills available to support IEI implementation
Outputs (2006–2007)			
1. CSP design process reflect sharper results orientation and strategic clarity	<ul style="list-style-type: none"> CSPs developed based on problem analysis and accompanied with clear and focused sector roadmaps and country results framework (All CSPs beginning preparation in 2006) 	<ul style="list-style-type: none"> IEI monitoring report (assessment of CSPs by RSDD/SPD) 	<ul style="list-style-type: none"> Management approves recommendations in 2005 Necessary organizational changes (including skills and staff incentives) effectively managed
2. ADB's business processes and practice improved to enhance accountability for quality and efficiency across operations	<ul style="list-style-type: none"> Improved concept paper review and clearance system in place by 1Q 2006 Months taken from project concept clearance to effectivity reduced to 18 months by 2007 (baseline: 32 months in 2004) 	<ul style="list-style-type: none"> IEI monitoring report (RSDD) (COSO) 	<ul style="list-style-type: none"> Management approves recommendations in 2005 Necessary organizational changes effectively managed
3. ADB's policies processes and practices on procurement (consultancy, goods and works) streamlined and harmonized with those of DMCs' and other development partners	<ul style="list-style-type: none"> Non-policy related procurement and consulting services practices and procedures approved by end 2004. New guidelines applied to all new projects by mid-2006 Environmentally-responsive procurement guide and e-bidding guide introduced by end 2005 Contract signed and FIDIC terms and conditions introduced for all standard bidding documents by end 2005 Harmonized standard bidding document introduced for small works contract and design, supply and install contract by end 2005 	<ul style="list-style-type: none"> IEI monitoring report (COSO) 	<ul style="list-style-type: none"> Board approves the R-paper on new policy and guidelines for procurement and consulting by end 2005 Necessary organizational changes effectively managed

Design Summary	Indicators/(Targets)	Monitoring Mechanism/(Data Source)	Key Assumptions
4. ADB's safeguards policy implementation processes during project processing and implementation updated to improve effectiveness and relevance to clients	<ul style="list-style-type: none"> Safeguards policy review launched by 2Q 2005 W-paper submitted by 1Q 2006 R-paper and revised OM submitted by end 2006 No of staff trained 	<ul style="list-style-type: none"> IEI monitoring report (RSDD) 	<ul style="list-style-type: none"> Constructive feedback from governments, civil society, and other development partners. Board approves the R-paper in 2006 Necessary organizational changes effectively managed
5. ADB's cost sharing and local cost financing parameters, and expenditure eligibility updated, made more flexible, and aligned with those of DMCs and other development partners	<ul style="list-style-type: none"> Number of country teams briefed (all teams by 1Q 2006) New country-wide cost-sharing ceilings for all DMCs by 2007 Number of approved investment projects with new expenditure items Improving quality of fiduciary oversight in ADB projects 	<ul style="list-style-type: none"> IEI monitoring report (RSDD) (RSDD/SPD) (RSDD) Financial management retrospective review (RSDD) 	<ul style="list-style-type: none"> Board approves the R-paper by 3Q 2005 Necessary organizational changes effectively managed
6. ADB's financial instruments and modalities expanded and upgraded to enhance flexibility and responsiveness, and successfully implemented	<ul style="list-style-type: none"> Pilot-testing of new financing instruments and modalities launched by 3Q 2005 No. of staff briefed and trained Assessment of pilot-tests based on specific criteria^a Review of ADB's credit enhancement policies (including guarantee products) submitted to the Board. OM updated and staff instructions issues in 2006 Recommendations to mainstream new instruments/modalities approved by 2008 	<ul style="list-style-type: none"> IEI monitoring report (RSDD) (BPMSD) (RSDD) (OCO) (RSDD) 	<ul style="list-style-type: none"> Board approves the recommendation paper by 3Q 2005 Necessary organizational changes (culture, processes, structure, staff skills, budget, etc.) effectively managed

CAPE = country assistance program evaluation; CFS = complementary financing scheme; CSP = country strategy and program; DMC = developing member country; FIDIC = International Federation of Consulting Engineers; HR = human resource; PRS = poverty reduction strategy; TA = technical assistance.

^a For the criteria, see Appendix 10.

SELECTED CHARACTERISTICS OF ORDINARY CAPITAL RESOURCES LENDING INSTRUMENTS AND MODALITIES

Parameter	Instrument	Modalities				
		Private Sector	Public Sector			
	LBL	IL	IL/SL	PL/SDP	FIL	EAL
Currency	Various, with Swap Option	Foreign or Local Currency	Foreign Currency	Foreign Currency	Foreign Currency	Foreign Currency
Interest	Floating or Fixed, with Swap Option	Transaction risk based	Policy-based (standard)	Policy-based (standard)	Policy-based (standard)	Policy-based (standard)
Fees	Front-end fixed; Commitment fixed	Based on market practice	Fixed (standard conditions)	Fixed (standard conditions)	Fixed (standard conditions)	Fixed (standard conditions)
Term	Flexible, based on economic life of project	Normally up to 10–15 years	Normally up to 24 years	15 years (fixed)	Normally 15 years	Up to 32 years
Grace period	Flexible	Flexible	5–8 years (flexible)	3 years (fixed)	Normally 3 year	Up to 8 years
Sovereign Guarantee	Not mandatory	No	Yes	Yes	Yes	Yes
EAs/IAs	—	Private Sector	Line Departments; Local govts; SOEs	MOF/Line Departments	MOF/ Commercial Banks	MOF/Line Departments
Disbursement schedules	Flexible	Based on private sector practice	Progressive and expenditure based (follows S-curve)	In tranches, based on reform progress (often delayed)	In tranches, based on demand and promotion by FIs	Accelerated, based expenditure
Approval authority for disbursement	—	Management	Management	Management (if compliance)	Management	Management
Finalization of loan documents	—	After Board Approval	Prior to Board Approval	Prior to Board Approval	Prior to Board Approval	Prior to Board Approval
Repayment	Bullet or Amortized	Bullet or Amortized	Amortized	Amortized	Amortized	Amortized
Financing/Eligibility Restrictions	—	Standard, as per policy	Standard, as per policy	Negative list	Standard, as per policy	Standard, as per policy

— = not applicable, EAL = emergency assistance loan, FIL = financial intermediation loan, IL = investment loan, LBL = LIBOR-based loan; PL = program loan; SL = sector loan; FI= financial intermediary; MOF= ministry of finance; EA/IA= execution agency/implementation agency; SOE= state-owned enterprise.

**PRICING OF LENDING INSTRUMENTS OF MULTILATERAL DEVELOPMENT BANKS:
COMPARATIVE SOVEREIGN MDB LOAN CHARGES
LIBOR-BASED DOLLAR SINGLE CURRENCY LOANS OF ADB AND OTHER MDBS**
(basis points, May 2004-May 2005)

Item	ADB (%)			IBRD (%)		IADB (%)	AfDB (%)
	2004	2003	Pre- 2003	July 2004 VSL	July 2004 FSL	July 2004	July 2004
Interest Spread:							
Contractual Spread	0.60	0.60	0.60	0.75	0.75	0.30	0.50
Risk Premium		0.00		0.00	0.05	0.50	0.00
Benefit of Sub-LIBOR Funding Cost	(0.35)	(0.35)	(0.39)	(0.31)	(0.30)	(0.34)	(0.15)
Waivers	(0.20)	0.00	0.00	(0.25)	(0.25)	0.00	0.00
Net Spread over LIBOR (I)	0.05	0.25	0.21	0.19	0.25	0.46	0.35
Charges							
Commitment Charge	0.75	0.75	0.75	0.75	0.85	0.25	0.75
Waiver	0.00	0.00	0.00	(0.50)	(0.50)	0.00	(0.50)
Net Commitment Fee	0.75	0.75	0.75	0.25	0.35	0.25	0.25
Spread Equivalent of Commitment Fee (II)	0.34	0.34	0.34	0.17	0.22	0.17	0.17
Front-End Fee							
Contractual Front-End Fee	1.00	1.00	1.00	1.00	1.00	0.00	0.00
Waiver	(1.00)	(0.50)	0.00	0.00	0.00	0.00	0.00
Net Front-End Fee	0.00	0.50	1.00	1.00	1.00	0.00	0.00
Spread Equivalent of Front-End Fee (III)	0.00	0.11	0.21	0.20	0.20	0.00	0.00
Total Spread-Equivalent over LIBOR (I+II+III)	0.39	0.70	0.94	0.56	0.67	0.63	0.52

ADB = Asian Development Bank, AfDB = African Development Bank, FSL = fixed-spread loan, IADB = Inter-American Development Bank, IBRD = International Bank for Reconstruction and Development, LIBOR = London interbank offered rate, MDB = multilateral development bank, VSL = variable-spread loan.

Sources: Asian Development Bank estimates; IBRD. 2004. *Allocation of FY04 Net Income and Waivers of Loan Charges for FY05*. Washington, DC.

MULTITRANCHE FINANCING FACILITY

A. Background

1. Project and investment program financing is becoming much more structured and complex. Mainstream operations are now more likely to be cofinanced by more than one institution. The latter can include public and private entities, which implies a combination of financing from perhaps a multilateral development bank, bilateral agency, private equity group, a commercial bank, and capital market operators. “Softer” or the more traditional social sectors might still remain an exception for some time to the multisourcing concept, but even here the trend is moving in the same direction as with infrastructure and utility finance.

2. The range and type of financiers is also changing. But so is the type of deals and their size. There is a distinct and perhaps irreversible trend toward public-private initiatives across most sectors in Asia and the Pacific, especially in the infrastructure and utility arena. This reflects the inability of governments to go it alone, and the fact that private investors are simply not able to finance all the investments on their own. The way forward points towards a partnership between the two, structured around a range of project modalities—management contracts, joint ventures, concessions, build-operate-transfer (BOT), etc. In this scenario, the Asian Development Bank (ADB) will be called upon to develop and work with new products and approaches capable of providing long-term finance faster and at more attractive terms. The mobilization of other resources and balance sheet management are also important consideration and requirements.

3. Financial contributions from financiers—debt, equity, and guarantees—are often made on a pro rata basis. In these circumstances, the timing, terms and conditions, and the ultimate deal structures have to cater to this fact, and as far as possible be similar—or at the very least compatible. Multilateral development banks face the challenge of having to readapt their business models and financial instruments to stay the course and remain relevant.

4. Financial costs can account for an important share of total operational or business cost in projects. The development of optimal or cost-efficient financing solutions and related financial packages is now integral to the requirement to remain engaged in key sectors, especially in those areas where the cash-flow and cost-recovery profile of transactions is driven much more by budget allocations (or by the tariff regimes approved by independent regulators) than by the actual ability of state-owned enterprises (SOE) agencies, or operators to raise their productivity and efficiency during the commercial phase of an operation.

5. Fund raising is also now a more professional task at the level of both central government ministries and their executing agencies. These ministries and agencies blend public and private monies at the same time, in many instances for programs rather than for stand-alone projects. Economies of scale, critical mass, and continuity come into play here. In the case of SOEs, fund raising can also involve and combine recourse with nonrecourse financing.

6. The above suggests the need for strong balance sheets, sound income streams (based on adequate tariff regimes and reforms), good investment climate, well-thought out business or investment concepts, promising market conditions, and experienced management teams. Nonrecourse and limited recourse financing can at times account for the major share of a financing plan, at least in some countries, sectors, and companies. The implication is that public

sector sovereign-backed lending also needs to be structured in ways that can complement rather than hinder the mobilization of other forms of financing.

7. Social projects and investment programs need the same level of flexibility as operations in other sectors. Nonetheless, the financial cost and its timing are even more critical in this case. ADB, and others like it, will need to modify its lending approaches to meet these needs. Transfer of responsibilities to local government and municipal entities makes this even more important. Another trigger is the increasing importance and role played by capital markets and commercial banks.

8. The above suggests that financing must become more aligned to a project's cost recovery and implementation profile and that ADB financing is likely to be part of a global fund-raising program, rather than being a purely stand-alone endeavor. If that were to be the case, then ADB would need to find ways to accommodate and be accommodated by others. It also implies that ADB instruments and funding structures would need to mirror much more closely those of others. In future, a combination of public and private monies, as well as recourse and nonrecourse finance, may become the norm rather than the exception. ADB needs to prepare and start practicing for this.

B. Proposal

9. The proposed concept calls for the establishment of a Multitranches Financing Facility (MFF), akin to a standby letter of credit in the commercial banking sector. The MFF would be applicable to large, stand-alone projects with discrete, sequential components, but is especially suited to sector investment programs. Selected financial intermediary credit lines—those targeting small and medium enterprises (SME)—and guarantees would also qualify. The MFF can be used by the regional departments across all sectors in all developing member countries (DMC)—ordinary capital resources (OCR) - and Asian Development Fund (ADF)-eligible countries alike.

10. The current ADB financing/guarantee approval arrangements normally involve a one-time submission to the Board of Directors. The financial and accounting practices resulting from this approval thereafter takes place at the time of signing/effectivity, always for the full amount of the facility. But although drawdowns (in the case of loans) are often staggered, the approval process and the financial entries in the balance sheet of both the client and ADB are not. The proposed MFF is an attempt to reconcile the balance sheet entry with the requirements of clients. The proposal is to provide finance “as you go,” thereby linking the lending by ADB much more closely to the client's requirement. Commitment fees will apply only with respect to the smaller amounts within the total MFF that are committed periodically through individually executed loan agreements in accordance with ADB's policies.

11. In the case of guarantees, commitments can also be used as a yardstick. Under the proposed MFF, ADB and each client will convert into formal guarantees (and thus create a balance sheet entry) periodic guarantee commitments for a given risk “carve-out” arrangement.

C. Processing and Due Diligence

12. The steps involved in processing an MFF are largely similar to those of existing sector and project loan modalities. This means that ADB staff will follow the same arrangements currently in place for the purposes of a project loan, sector loan, or credit line processing.

13. In the case of an MFF for sector investment program financing, key start-up parameters include the existence or preparation of a detailed sector investment program (medium to long term), and a detailed account of sector policy parameters, safeguard frameworks, governance, capacity and institutional stances, modes of procurement, financial management and fiduciary oversight. The investment program should also be consistent with the poverty reduction agenda. The client and ADB will evaluate this information and agree on a concept paper for a transaction. Key issues will be identified and discussed at this stage. The parties will agree, if need be through the equivalent of a mandate letter, to engage the services of expert advisors to carry out specific due diligence and help structure the MFF. Due diligence should cover technical, commercial, financial, institutional, legal, environmental, social, safeguards, governance, and capacity and fiduciary oversight matters. Processing thereafter will follow existing practices, policies and business processes at ADB for public sector operations.

14. The processing of the proposal involves two interrelated steps: development of a framework financing agreement (FFA) and execution of the related MFF loan agreements.

1. Step 1 — Framework Financing Agreement

15. The first step calls for the establishment of an FFA between ADB and its client. This follows the due diligence work by ADB on the specific investment (program), including its rationale, nature, and characteristics. The FFA effectively records the main objectives and scope of the investment (program) and its financing needs and the role of ADB in this. The FFA embodies basic terms and conditions, including tentative financing, utilization period (sunset clause), component or subproject eligibility criteria, fiduciary oversight arrangements, procurement plans, cost recovery and sustainability commitments (application of sound banking principles), cofinancing arrangements, safeguards frameworks, and disbursement and implementation plans. It will also record general monitoring and evaluation arrangements. Under the FFA, ADB conveys its intention to provide a maximum amount of financing to a client (or guarantees financing) over a period of time under a set of detailed pre-negotiated “warranties and representations”. The FFA is the equivalent of a special negotiated term sheet. For clients that cannot be financed on a nonrecourse or limited recourse basis, the FFA will be accompanied by a negotiated sovereign guarantee agreement, including fast-track procedures to automatically activate this with each formal request for financing. The FFA provides the basis for ADB to finance a specific investment (program) over time. It is not a formal commitment nor a contingent liability on the balance sheet of a client or ADB. It is a standby financing arrangement, with actual financing to be made available by ADB, but at the sole discretion of ADB and only if certain conditions are met.

16. There will be a particular emphasis on outputs and outcomes and hence on quality and success at the implementation stage. The MFF will enable both parties to allocate more resources and time to the latter by covering a longer time slice of an investment program, a project, a guarantee scheme, or a credit line. Instead of providing financing for a standard 3–5 year project period, the MFF will cater for longer investment periods.

17. The implication is greater certainty and upfront agreement with a client through financing that fits clearly within the client’s longer-term plan. It means less time spent on processing and more time on implementation. If financing conditions are not met, the financing is not provided. Clients are compensated for doing the right thing over time, not for agreeing to borrow specific amount of money on day one. This approach allows ADB to put in place the equivalent of what in the private sector would be considered recurrent business. This is efficient, cost effective, and does not cut corners in terms of policies and procedures.

18. The FFA does not represent a formal obligation by ADB to lend or by the client to borrow. The FFA sets out a credible intention and the principles by which ADB would provide and the client would avail itself of such financing. Business will be conducted strictly within the confines of a properly prepared investment program (or a project, risk sharing proposal or credit line). The standard due diligence will be carried out by project teams prior to a Management Review Meeting. This work will form the basis for the definition of warranties and representations for each transaction.

19. The approval of the FFA involves a one-off or single submission to the Board, as is the case today with any other financing facility. The Board will be requested to approve financing for a specific investment program, project, or credit line. This submission will specify the maximum amount to be approved and the conditions under which such financing is to be made available to the client. The key differences with existing instruments and modalities are that the MFF amount to be approved will extend over a longer time period, and the actual availability of funds will be related strictly to requests or commitments by the client and the execution and effectiveness of loan agreements with ADB. Another difference is that the MFF will not be recognized in the ADB balance sheet on the date of its approval. Bookings will be made following the periodic commitments by clients and the execution and effectiveness of loan agreements with ADB. Each MFF will have a “sunset” clause or maximum utilization period. Clients will need to meet pre-agreed conditions under each periodic commitment to avail themselves of financing. In this sense, the approach taken is similar to that used in the case of a sector loan.

2. Step 2 — Loan Agreements

20. After the MFF is approved, the client will submit a periodic financing requirement (PFR) to ADB to obtain the actual funds. The submission period is expected to be on an annual basis, but this can differ with each transaction. The level of preparation readiness of subprojects in the investment (program) will differ from sector to sector and client to client. In some cases, the financing requirement might be made every six months or even more frequently, in others it could be made every 15 months or later. In all cases, the PFR will be related strictly to actual investment needs. The PFR will then be converted into an individual loan agreement (or guarantee agreement) prepared by the Office of the General Counsel. This loan agreement will incorporate all the warranties and representations made by the client in the context of the FFA as approved by the Board. It can also go further, covering, if need be, other specific considerations related to the PFR. For clients that cannot be financed on a nonrecourse or limited recourse basis, the conversion of each PFR into a loan agreement will trigger the execution and delivery of a related sovereign guarantee.

21. The first PFR should be submitted to the Board at the same time as the corresponding MFF. This approach enhances the credibility of the MFF itself and demonstrates to the Board the nature, characteristics, and type of subprojects (or risk carve-outs) targeted over time. For subsequent PFRs, the requested financing will be approved through the execution of a loan agreement within 30 days. The client will notify ADB of a forthcoming request at least 15 days in advance, in order for staff to deal with any relevant treasury matters, handle support administrative and legal issues and, as needed, arrange notifications to Management and, if need be, the Board. Each loan agreement signed between ADB and the client (based on the PFR) will have its own range of individual drawdowns, just like any other loan or guarantee currently made available by ADB.

22. Commitment fees will apply to those amounts within an MFF that are subject to executed loan agreements in accordance with ADB's policies. The trigger for individual loans is the PFR. Each PFR will be legally separated from the others as far as balance sheet entries are concerned. The common denominator between them will be the investment program, the project, guarantee package, or credit line, and the set of warranties and representations incorporated in the FFA. Each loan (or guarantee) will thus be treated as a stand-alone transaction, within a global investment financing framework.

23. PFRs will be presented to ADB in a standardized report format. These will be prepared by project teams as part of each investment (program). The submissions will be evaluated by teams in the same manner as done today under sector loans. However, in this case, the concerned operational vice presidency convenes a special meeting to evaluate and endorse the individual requests. Management can call upon support departments to provide comments on the merits of the requests. One of the major issues to be looked into is that all prevailing ADB operational policies and procedures on safeguards and standard themes are adhered to in full.

24. The MFF cannot work well unless accompanied by an efficient approval process. During the pilot period, it is proposed that this process mirror that currently in place for sector loans. It is imperative that a fast-track arrangement be established to trigger and put in place the approvals (and sovereign guarantees for transactions and clients that cannot be supported on a nonrecourse or limited recourse basis) required by each PFR and related loan agreement. The concept of multitranches can only work efficiently if processed on this basis.

25. Besides applying checks and balances on the periodic commitments by clients, Management will monitor the adherence of specific warranties and representations agreed under the FFA, and endorsed by the Board. A report will be submitted to the Board addressing, among other things, the overall development impact of the MFF, the actual level of utilization, the nature and characteristics of the subprojects financed, fiduciary oversight, procurement arrangements, and the adherence to ADB's safeguard and standard thematic requirements. No additional PFR will be approved for financing unless all key warranties and representations made by the client under the FFA and the previous approved periodic commitment have been met in full. More detailed staff instructions with steps and requirements for processing and due diligence of financing requests under this facility will be prepared.

D. Eligibility Criteria

26. For an investment program, the MFF involves extending multiple loans (or guarantees) to finance a range of subprojects. Credit line-type finance can qualify under the MFF since in general this involves several sub-borrowers (small and medium sized enterprises) and therefore multiple loans. Stand-alone projects can also be funded in this manner, although here the starting point will be the existence of substantial individual components with an implementation plan spread over a longer than average period of time. Subprojects will need to meet pre-agreed eligibility criteria. This will be defined by the project teams on the basis of technical and other due diligence. Environmental and other ADB safeguard policies and procedures will figure prominently among these criteria. The formal submission of the MFF to the Board will include these criteria. It will also include, as with sector loans, framework plans for environment, involuntary resettlement and indigenous peoples, as the case may be.

27. As with existing OCR and ADF loans, ADB will retain the right at all times to carry out spot checks on the status of all warranties and representations, and may cancel a part or the full amount of a loan under an MFF if there is any breach. ADB will also have the prerogative at all

times to withdraw financing from a client who fails to adhere to pre-agreed conditions, operational policies, or procedures.

28. Conversely, a client will have the right not to continue with the use of the MFF at any time. It will obviously have to abide by the terms and conditions of the individual loan agreements signed previously. ADB and its client will hold regular program implementation meetings to examine issues and decide on solutions to problems. The frequency of these meetings will be dictated by the complexity of the transaction and the track record and execution capabilities of each client. Safeguards, policy regime and fiduciary oversight will be major components of these implementation meetings. One of the main advantages of the MFF is precisely the release of staff resources from processing into the implementation function. Any significant breach of warranties and representations will be reported to Management and, if need be, to the Board.

29. The MFF is especially suited to provide financing for an investment program. This needs to be described in detail, including its rationale, linkage to poverty reduction, relevance to the overall sector plan and the strategy agreed between the DMC and ADB, the investment costs (capital and recurrent expenditure), and the potential funding sources. The prospective level of financing to be provided by the government or the executing agency must be described. This financing from government will be split into two areas (i) commitments made during the implementation phase of subprojects; and (ii) commitments made during the operational phase. This split provides an indication of the level of ownership, commitment and sustainability of the program in the longer run. Cofinancing may involve other financiers, development partners and the commercial sector. The investment program will outline the governance setup, including the specific tariff regime and formulas for change (in the case of utilities and public/private partnerships). The documentation supporting the MFF will also need to highlight sector capacity and the organizational and budget resources to deal with it. Finally, the MFF will be supported by information on the policy front as a whole, including the stance taken on private sector involvement and development, competition, productivity, and efficiency. ADB can provide support with the definition of parts of the sector plan, primarily through the use of advisory services.

30. In the case of credit lines, the eligibility criteria for relending, and the end-user configuration, will be agreed in each case between ADB and the financial intermediary during the due diligence and structuring of the line under the MFF. The financing of SMEs is expected to include capital and recurrent expenditure requirements and apply to both new and existing businesses. Finance might also be universal rather than sector specific. Each transaction will be backed by the submission of a business plan (in a standardized format) to the financial intermediary. ADB and the financial institution will agree upfront basic guiding criteria for the approval of each deal under the MFF. All transactions must follow sound banking principles, which in turn implies adherence to adequate equity/debt structures and debt service coverage ratios. The financial institution will have (or put in place) adequate credit assessment systems to evaluate individual submissions. ADB can carry out spot checks on the utilization of the credit line, including the credit assessment capability, although the rationale for a credit line is to rely on the systems and procedures put in place by the financial intermediary itself.

31. In the case of a specific investment project, the same principles outlined above will apply, although instead of a specific sector investment program with a variety of subprojects, the focus will be on the components of the investment itself, the financing plan, the governance arrangements, and the capacity setup. For the MFF to be applicable to a stand-alone project, the latter should be structured into discrete and sequential components, executed either through

an engineering, procurement, and construction turnkey contract or via separate and easily identifiable subcontracts (to facilitate the estimation of clear-cut periodic commitments convertible into loans). The project might also be cofinanced with third parties. The policy stance will also be of interest to ADB, particularly if this concerns issues of financial management, cost recovery, and sustainability.

32. A guarantee facility can include either political or credit risks. The specific carve-outs can be defined during the preparatory and negotiation stages. As guarantees are intended to mobilize cofinancing, all applications for guarantees will be screened and cleared by the Office of Cofinancing Operations. The guarantees can apply to projects and programs. They might even apply to credit lines, although this is less likely to be a core ADB transaction.

E. Terms

33. ADB terms under an MFF will mirror those of other operations. The pilot concepts do not call for changes to the current financial policies. That commitment fees are not charged on the overall MFF amount follows from the specific legal structure of the MFF, timing, and booking of the periodic commitments made within each MFF, rather from the commitment fee policy as such. One of the main attractions of the MFF to clients is the scope and flexibility it offers to apply different debt finance structures to each tranche or loan. Under the current financing policy, clients already have the option to apply different currency and interest rate swaps. Repayment schedules can also be arranged on a case by case basis to match principal and interest repayments to the cash flow and cost recovery profile of each transaction. Grace and maturity periods can also be structured for the same purpose. This flexibility is available to clients today. However, the MFF provides greater scope for its application. These features make it easier for each transaction to adhere to sound banking principles. Guarantees will be priced in line with existing policies.

F. Implementation Aspects

34. **Use of Loan Proceeds.** The funding provided under the MFF may be used to cover the capital cost and the working capital needs of projects, subprojects, and SME investments. The investment plans of projects and subprojects will follow the prevailing rules on cost sharing and expenditure eligibility. Procurement of goods, works, and services will be undertaken in line with prevailing ADB guidelines.

35. **Disbursement.** ADB's standard disbursement procedures under each individual loan will apply. Imprest accounts and statement of expenditures procedures may be used whenever they are deemed reasonable and necessary.

36. **Supervision and Monitoring.** ADB and the client will spend time and money on ensuring the efficient implementation of the investment (program) targeted under the MFF. The application of safeguards and fiduciary and other theme oversight will benefit from this approach. The MFF cuts considerably processing time and costs but it implies more attention to detail during the implementation phase.

G. Documentation

37. The MFF requires a number of documents, namely:

- (i) **Framework financing agreement.** A document describing the scope and objectives of the MFF, including the main terms and conditions (maximum financing, sunset clause, subproject criteria, etc) and general warranties and representations agreed between the parties. It will be structured in the form of a term sheet and negotiated prior to a formal submission to the Management Review Meeting.
- (ii) **Periodic financing request.** A specific financing request for an annual or any other specific period, presented to ADB in a standard format.
- (iii) **Individual loan agreements.** Standard loan agreements, capturing specific warranties and representations, other relevant loan covenants, pricing, detailed subproject description, implementation arrangements, disbursement and repayment schedules, etc. Where applicable, a sovereign guarantee agreement will be entered into between ADB and the DMC concerned. Fast-track approval procedures will be put in place to support each individual loan agreement.
- (iv) **Board information report.** A standard document to provide the Board with a detailed account of the implementation of the investment program, project, guarantee, or credit line and the utilization of the MFF and the status of adherence to all warranties and representations.

H. Other Procedural Aspects

38. **Safeguards.** The approach to be taken in the case of sector investment financing will be the preparation of the appropriate frameworks (in line with existing policies). In the case of credit lines, the approach will be that applicable to both sector and financial intermediaries. In the case of projects, the approach will be that followed for projects (covering each of the existing safeguard policies, as applicable to stand-alone projects). In the case of guarantees, the approach will be based on the type of deal covered—project or sector program. MFF is about improving the application of debt finance and guarantees; it is not about cutting corners with safeguards or with any other operational principles. One of the advantages of the MFF is that it provides clients time to complete all these due diligence tasks without penalizing them financially in the process. The PFRs will be prepared based on the level of readiness of individual investments.

39. **Maximum Finance Approvals.** The approval from the Board will be for a maximum amount of financing under each MFF. The submissions to the Board will include all warranties and representations (terms and conditions), utilization period (sunset clause), investment subproject eligibility criteria, pricing, fiduciary and other monitoring and evaluation oversight proposals, procurement arrangements, disbursement plans, and other standard terms and conditions followed under existing financing facilities.

40. **Cost Recovery and Sustainability.** The use of the MFF will follow sound banking principles. Cost recovery will be applied in the case of commercially oriented projects and subprojects. Other projects will have a different approach, with a key condition being the availability of adequate budget support during and after MFF utilization (sustainability).

41. **Policy Dialogue.** ADB and the authorities will engage in an active policy dialogue in relation to the sector, project, or investment program. The same will apply in the case of

financial intermediaries supported through credit lines. One of the most important considerations will be the efficient implementation of the operations and their sustainability.

42. **Conditionality.** ADB will request suitable warranties and representations at the level of the FFA and the individual loan agreements. The focus will be on safeguards, governance, fiduciary oversight, capacity, and other standard themes. Where applicable and appropriate, commercial practices will also be considered (tariff regimes and formulas), mainly on account of cost recovery.

43. **Coordination.** ADB will work closely with other development financiers such as the World Bank and key bilaterals. It will also work closely with the government and commercial cofinanciers involved in each of the operations.

I. Benefits

44. The MFF provides financial and operational flexibility to clients and ADB, and encourages the financing of operations only when these fall due and are ready for execution. The use of the MFF binds clients to the delivery of specific warranties and representations, covering safeguards, governance, capacity, sector policies, and economic, social, financial, legal, and technical aspects.

45. The MFF allows ADB to provide finance or guarantees over a longer-term period, covering key slices of investment programs, and in this manner increase efficiency, productivity, critical mass, and in particular continuity to a given sector, project, or SME.

46. The MFF allows ADB to plan its financial operations without impinging on its lending headroom capability as standard loans do today. It also contributes to freeing up cash flow.

47. The MFF enables ADB and its clients to focus more on implementation issues and less on repeat processing tasks or actions. Those require time and money, thus contributing to the cost of doing business with ADB.

48. Although the MFF precludes commitment fees from being charged on amounts that are not subject to executed loan agreements, the most important advantage to clients and to ADB itself is the positive impact on the balance sheet. Only financing required in a given period is converted into assets and liabilities through a loan agreement. In the case of clients, this practice frees up the balance sheet space to raise other financing from domestic or international sources. The contingent liability on the client's balance sheet is only registered alongside each periodic commitment that has been converted into a loan, not when the FFA is approved.

49. The MFF assures finance for a series of investments over time. Disbursement planning becomes easier and more realistic for all parties. Clients have time and a real incentive to put in place the right operational and project systems, and to plan for safeguards and other policies without incurring financial penalties in the process.

50. Finally, the MFF allows both parties to enter into a more constructive dialogue over policies, capacity issues, and governance, and for ADB to offer greater critical mass and a continued presence in a sector.

SUBSOVEREIGN AND NONSOVEREIGN PUBLIC SECTOR FINANCING FACILITY

A. Background

1. Decentralization calls for the transfer of ownership and responsibility to local administrations for the running, investment, and maintenance of selected public services and facilities. The most important of these include utilities (such as water, wastewater, and waste management), urban transport (both the infrastructure and system part), housing, health and education. A major issue across the region (but also much further afield) is that this transfer of responsibility has not always been matched by a pro rata transfer of financial resources. The problem is further compounded when the legal and administrative arrangements are either unstable or incomplete. Budget deficits soon ensue and the quality of the services falls. End-users are affected by this.

2. Sustainable public service delivery requires constant, and at times large, capital and recurrent expenditure outlays. Many local governments seem to operate on a “70% rule”. This means that about 70% of their total income comes from the central budget; recurrent expenditures account for about 70% of spending; and wages represent about 70% of this outlay. The remaining 30% of the financing need is a key challenge to most local governments. Revenue-raising powers are generally limited, which means that funds for investments are extremely scarce.

3. In the meantime, end-users demand the delivery of more efficient services, as measured by coverage, quality and continuity. Increasingly, they consider these an undeniable right for them to have, and for the (local) government to provide.

4. Besides the lack of financial resources, service providers (corporatized public entities or government line departments) are frequently “politicized,” employ far more people than they need to be efficient, and poorly managed. Cost recovery is not always a priority in the local government agenda and the true cost of providing the service can remain hidden for years, thus exacerbating financial, efficiency, and quality problems. Breaking the vicious cycle of budget deficits, inefficiency, and quality problems requires major structural and fiscal reforms, as well as different and more imaginative local government financing approaches.

5. The city is both a substantial and an expanding market. Indeed, the region has some of the world’s largest and fastest-growing megacities. Most problems in development, and particularly poverty, are or will be mirrored there. The development of city clusters is a new and exciting phenomenon. In a number of countries, the city cluster is already a focal point for foreign direct investment, and thus for manufacturing and services, logistics, and exports. The city cluster combines an economic function with a residential one. But for it to grow and remain of interest to investors (domestic and foreign) it will require constant investment in infrastructure, utilities, and other key public services, ranging from transport to water, wastewater, housing, health, and education. Investment, employment, and growth (and thus poverty reduction) will all be associated with the development of the city, the city cluster, and the decentralization process as a whole.

6. There are also many state-owned enterprises (SOE) across the region that require special financing approaches for them to deliver the services for which they were set up. These enterprises remain on the whole under central government ownership and are not therefore part of the decentralization process. Most face difficulties in securing finance on a nonrecourse or limited recourse basis, especially from the international market and development banks. Such

SOEs are generally confined to regulated businesses such as power, energy, transport, water, wastewater, waste management and telecommunications. Under certain conditions, these companies can be reasonable credit risks for the Asian Development Bank (ADB). A diversified financial base, and the introduction of corporate governance measures and sector operating and policy reforms brought about through ADB interventions, might help governments improve the viability of these businesses, or pave the way for private placements in domestic and international markets, the incorporation of the private sector (through a range of modalities) and even outright sales. These companies often play a major role in economic development and contribute to poverty reduction.

7. ADB and institutions like it have generally been providing financing to local governments but only with the backing of a sovereign guarantee. This financing has been structured around different schemes. Some financing has been extended to central governments, followed by specific subsidiary loan agreements to subsovereigns or SOEs. Other financing has been extended directly to local administrations, with the prior consent and approval of the central government and backed by a sovereign guarantee.

8. ADB in the past has not financed local government entities or SOEs on a purely nonrecourse or limited recourse basis.¹ The Private Sector Operations Department (PSOD) has financed operations at the municipal level, but these have involved transactions owned and led by private sponsors, with the security package provided either by the private sponsors directly, or, in the case of a joint venture company by them and municipal entities.

9. This form of financing (i.e., nonrecourse or limited recourse) has to follow sound banking principles. It will have to distinguish more clearly than is the case today with recourse financing between entity or “sponsor” risk, project risk, commercial risk, and regulatory risk. Local government funding of this nature should only be made available under specific conditions, and in accordance with a set of pre-agreed structural and fiscal reforms. In the case of SOEs, finance should only be made available against sector and entity reforms. Examples of such reforms are the creation of a sound financial base and specific undertakings on financial management, safeguards, operational matters and ownership. Possible private sector involvement could include partial and outright sales through selected private placements and initial public offerings. The acid test for the provision of finance on a nonrecourse or limited recourse basis would be the financial standing of the entities and nature and depth of specific undertakings and reforms.

B. Proposal

10. It is proposed that ADB provide finance on a nonrecourse or limited recourse basis to selected municipalities and other forms of local government and SOEs that are able to meet a minimum set of financial, operational and reform criteria. It is proposed that this finance be extended through the regional departments without the existing restrictions on individual transactions, sponsor and country limits applying today to PSOD. Criteria to extending this finance to local government entities and SOEs are described below.

¹ In few selected cases has ADB extended credit lines for onlending to the private sector through government owned development finance institutions without sovereign guarantee. These were generally linked to reforms that support eventual privatization, or facilitate commercial cofinancing with partial credit guarantees.

1. Green Entities — Nonrecourse or Limited Recourse Financing

11. “Green” local government entities will be those with a sound financial standing (based on an evaluation of several ratios recorded in audited accounts), sound operational efficiencies and tested/advanced structural reforms. These entities will qualify in principle for either limited or nonrecourse finance. Limited recourse implies “ring fencing” specific income streams.

12. The list of candidates in this category is expected to be limited at this point in time, and could involve small, medium, and large entities. The list of SOEs likely to qualify for this form of financing is also small, mainly on account of limited creditworthiness and sector reforms.

13. Nonrecourse and limited recourse financing to local government and SOEs would be provided only with the prior knowledge and approval of central or state/provincial governments (on account of “moral hazard” and administrative rules), and on the basis of clearly defined investment and reform programs. Existing reform programs might need adjustments in order to meet ADB criteria. The level of exposure by ADB would be limited to a small share of the total net asset base of each client to start with, and the maturity periods might be considerably shorter than those applicable to central government loans, at least during the pilot-testing period.

14. Pricing would closely reflect market conditions. ADB’s project teams, Treasury Department (TD) and the Credit Risk Management Unit (CRMU) will provide the required advice to Management on this matter, as well as on the most appropriate security package and “ring fencing” alternatives. Income stream “ring fencing” will need to be a priority at the outset; even if some of these streams are then freed up over time based on actual financial and reform performance.

15. Each of the transactions will undergo extensive due diligence, particularly on the technical, financial, legal, regulatory, safeguards, social, governance and policy fronts. ADB will engage the services of qualified external independent advisors for the purpose of due diligence, prepare upfront concept papers (cleared at the level of Management), and sign appropriate mandate letters with each of the entities prior to starting the formal due diligence process.

16. A special ADB multidisciplinary team would be formed to handle this work. It is envisaged that, as appropriate, PSOD and other key support departments will ‘join up’ with the regional departments for the purpose of processing of these transactions. The Regional and Sustainable Development Department’s Special Initiatives Group will provide support to the project teams, especially with regard to the preparation of concept papers, planning and overseeing the due diligence process and evaluating the preliminary risk profile of each transaction. Security package conditions and loan provisioning will be based on the recommendations made by the CRMU. Loan administration will remain the responsibility of the team that processed the facility, at least during the pilot concept period. The Board will be kept up to date of the performance of each facility approved during the pilot period.

2. Amber Entities — Issuance of Temporary Sovereign Guarantees

17. “Amber” local government entities will only be financed with the backing of a sovereign guarantee (i.e., recourse finance). These entities will fail at the outset to meet several of the preconditions set for “green”-type clients, either on the financial front or on the reform program, or both.

18. Nonrecourse financing will not be possible for any of these entities until all basic “green” preconditions are met. It might be possible to entertain limited recourse finance in some of these cases, but this would effectively mean “ring fencing” a substantial share of the entity’s income base. The most logical alternative would be for the central government to issue a sovereign guarantee for a period of time, in any event until ADB satisfies itself that the entity in question has met, and will be able to maintain in place, all the standard nonrecourse finance preconditions established for a “green” client. The objective of working with this type of client is to start the process of developing strong demonstration cases, support balanced investment programs and encourage the introduction of reforms. The sovereign guarantee will provide the parties with time and space to introduce these reforms.

19. Although ADB would be protected at all times by this sovereign cover, actual loan processing would follow the same procedures and due diligence requirements established for “green” entities. The objective here is to apply the same sound banking principles criteria and/or identify the financial and reform steps needed to convert an “amber” city into a “green” one.

20. Funding to “amber” entities might be provided on a slightly longer term basis than for “green” ones (because of the sovereign cover). Disbursements will be tranching in accordance with the pace and quality of the reforms agreed and made. The relinquishing of the sovereign guarantee cover will not be a function of the reform process alone. It will also be a function of the results of the reform process and in particular the financial status of the entity in question. The “amber” city market is expected to be more substantial than the “green” one. During the pilot period, ADB will only be able to handle a limited number of operations under this category.

3. Red Entities — Issuance of Permanent Sovereign Guarantees

21. These entities are in some ways similar to most of those financed today by ADB and others under the cover of sovereign guarantees. The difference between past programs and the current pilot proposal is that under the new scheme ADB would only work with municipal and other local government entities willing and able to introduce the reforms suggested for “green” and “amber” cities. The aim is to strengthen their financial standing over a period of time, develop a strong working relationship with ADB and establish the basis for direct financing over time. ADB will look for a few good demonstration cases over the pilot period.

22. ADB will target only cities willing and able to make changes. It is expected that several of these cases might be converted over time into “amber”-type entities. The processing arrangements and the approach taken by ADB will be similar to those followed for the other entities.

23. However, it is expected that more work will be needed upfront, both in terms of financial audits and in particular in terms of defining and introducing structural reforms. The collaboration between ADB and the entities in question will also need to be much closer at the outset. There will be a greater ‘coaching’ function involved. In addition to ADB’s involvement, it is also hoped that these entities could be ‘twinned’ with others in the region and even further afield.

24. It is not far-fetched to conceive establishing such twinning arrangements with cities in the European Union, Japan, United States, as well as in some countries in the region. This program has been applied in the past between several European Union cities and counterparts in Eastern Europe, in some instances with considerable success. ADB might even consider encouraging and expanding this concept to the other categories of cities shown above.

4. SOE Eligibility Criteria

25. In the case of SOEs, project teams will review carefully internal corporate aspects and external sector conditions, including institutional reforms and financial soundness. Eligible SOEs must be creditworthy and linked to corporate or sector reforms. Internal aspects will include the overall financial standing of the entity (balance sheet, profit and loss and cash flow statements); adequacy of management and information systems; corporate governance (including the appointment of nonexecutive directors and independence relating to strategy formulation and operational decision-making); quality of the management team; safeguard audit and monitoring capacities; depth of the investment program; and the nature of the overall borrowing plan and liabilities. External aspects include, among others, the nature and strength of the regulatory and tariff regime; legal framework; the relevance of the entity for public goods and service provision, economic development and poverty reduction; and possible plans to incorporate the private sector in the investment program, either through joint ventures, management contracts, build-operate-transfers, concessions, initial public offerings, and outright sales.

D. Processing Aspects and Due Diligence

26. Processing under this facility will normally be undertaken by the regional departments through steps and arrangements usually associated with nonrecourse financing (even though “amber” and “red” cities will be backed by sovereign guarantees). These procedures are quite similar to those applied to private sector operations, although the process here may be tighter than at present in several areas. Each transaction will need to be ‘bankable’, which means that the level of exposure by ADB will always be contained in relation to the repayment capacity of each client. The equity and net worth base of each entity will figure in any analysis and govern the amount of finance possible under each transaction. The financing to be provided by ADB will essentially be akin to standard corporate finance transactions seen in the private sector.

27. The processing steps to be followed will be similar for all types of clients, whether cities or SOEs. Following an initial review of operations and the financial standing of the entities in question, the work will then include the preparation of a concept paper (cleared at the level of Management), signing of a mandate letter, independent due diligence, transaction structuring, draft term sheet negotiations, presentation to the CRMU, submission to Management, final documentation preparation, Board submission, and legal documentation finalization and signing.

28. The terms and conditions necessary to consider nonrecourse or limited recourse finance will be defined by project teams, with assistance, as needed, from other teams across ADB. The CRMU will play a crucial role in this regard. It can be consulted by teams prior to starting processing work. Due diligence will be substantially completed before credit risk evaluations are undertaken. Final terms and conditions will be defined on the basis of proposed risk mitigation measures. Separate staff instructions with details on steps and requirements will be prepared for processing and due diligence of financing requests under this facility.

E. Terms

29. The project team, the CRMU, Office of the General Counsel, Treasury Department (TD) and the Office of Cofinancing Operations (OCO) will work together on the pricing of each loan and the security package and submit formal proposals to Management. Management, with the assistance of the CRMU, will also agree on the most appropriate provisioning requirements. TD and OCO will further look into existing and projected pricing references from the commercial market.

F. Use of Proceeds

30. The funding to be provided under this facility will be used to cover the capital cost and the working capital needs of projects and subprojects under the clients' investment programs. Budget support will be part of the mandate in the case of local governments, provided the reforms suggested above are also put and kept in place. In the case of SOEs, the finance from ADB will target operational and investment programs.

G. Cost Recovery and Sustainability

31. The use of the facility will follow sound banking principles, irrespective of whether or not the facility is extended and with or without sovereign guarantees. Cost recovery will be applied in the case of all commercially oriented projects and subprojects. Other projects might have a different cost recovery approach, although here a key condition will be availability and allocation of adequate budget support after the implementation phase.

H. Disbursements

32. The disbursement arrangements under the facility will be similar to those currently in place for standard nonrecourse finance operations. Nonetheless, given the linkage to reform programs, the disbursements will be conditional on their execution and upkeep. In this sense, the arrangements are somewhat similar to those applying to program loans. The difference here is that Management will handle each tranche without repeat formal Board submissions. Given the nature of the facility (pilot concept and financial as well as a reform-oriented transaction), Management will provide the Board with a report on an annual basis describing the status and performance of each transaction funded in this manner.

I. Supervision and Monitoring

33. The team responsible for processing will be responsible for implementation during the pilot period. It is important to maintain continuity and to make those responsible accountable for the execution of all the reform conditions agreed upfront with each client.

J. Documentation

34. Documentation as specified in the draft staff instructions for nonrecourse financing operations will apply.

K. Benefits

35. The proposed facility will allow ADB to target important and increasingly relevant customers. It will increase its nonrecourse finance portfolio and pave the way for more private sector operations (as a result of the reform program calling for the incorporation of private operations in key services—water, wastewater, waste management, urban transport, etc.). The facility will allow ADB to diversify its customer base. It will also create important fiscal space for central government, currently the most important, and in many instances, the only financier of local government. The facility will encourage reforms, support fiscal policy changes across public administrations, increase private sector involvement, and open the way for direct investment in services, expanding their coverage, quality and continuity. It will help bring about efficiencies in public administration, create indirect and direct employment, leave governments

free to pursue more social-type investments, and generally fit with the poverty reduction mandate of ADB and the results agenda. The facility will be demand driven and allow ADB to work directly with viable SOEs, opening in the process the way to promote operating efficiencies as well as management, investment and ownership reforms.

LOCAL CURRENCY LENDING FOR THE PUBLIC SECTOR

A. Background

1. The proposed pilot concept follows and complements a separate paper prepared by the Treasury Department (TD) on the subject of local currency lending in general.¹ This paper will be submitted separately to the Board and will cover local currency lending to both public and private sector borrowers. This Innovation and Efficiency Initiative (IEI) paper calls for the expansion of the current product portfolio of the Asian Development Bank (ADB) to include local currency lending for public sector borrowers. Traditionally, loans by ADB have been offered exclusively in foreign currency and have been extended or channeled with the backing of a sovereign guarantee. In most cases, the principal borrower has been central government itself (and in such cases, there is little rationale for ADB offering local currency finance). However, the decentralization process, and recent economic reforms in a number of developing member countries (DMC), have created new exciting opportunities and a growing market. This market has quite similar investment needs—infrastructure, utilities and social sectors. Yet, the financing schemes required to support them are different, reflecting the different client base, risk profiles and varying financing characteristics. Although the revenue streams of projects led by central government and local government are denominated in the same currency, the foreign exchange risk hedging capabilities of the parties, if they were to borrow in hard currency, are not.

2. Local government and state-owned enterprises (SOE) do not control the monetary or fiscal policy stance of a country. In several instances they do not even control utility tariffs or pricing regimes. In the case of local government, the tax revenue-raising powers are not only still fairly limited but in general the tax base is narrow. In instances where local government and SOE credit ratings and credit standings might be higher than those of the sovereign itself, such ratings will be always placed at par or even below that of the sovereign for the purposes of capital market and commercial banking interventions.

3. Notwithstanding the above, this new market has a growing financing need, especially for long-term debt. Providing long term finance is not only the business but also one of the key attributes of ADB. However, such financing cannot be automatically denominated in foreign currency in all instances. Local government and SOEs require a variety of financing schemes, both for investment programs and individual projects. Local currency lending, if extended, needs to be structured or tailored to specific client and project conditions. Financing schemes in these circumstances should follow or be structured around client and project needs rather than the other way around.

4. The issue of whether ADB should or should not entertain local currency lending to public sector borrowers has been around for some time. The issue has been stepped up as a result of the greater sensitivity by clients to foreign currency mismatches following the Asian financial crisis. Some DMCs have also accumulated substantial foreign reserves. This curtails external hard currency needs, but not necessarily local currency financing. In fact, the need for financing in the region has never been greater.

5. It is also important to highlight that an increasing number of ADB financed projects are registering an increasing local currency component. Unless financed through local currency, these projects might falter along the way. Maturity periods and interest margins play a role in the overall financial viability of projects. But so does the currency in which the financing takes place.

¹ ADB. 2005. *Introducing the Local Currency Loan Product*. Manila.

6. The proposal here calls for the introduction of local currency financing to public sector borrowers on a pilot basis. It is thus expected to be applied selectively. Some key considerations governing the concept are included in the paper submitted by TD (footnote 1). Several key aspects of this are pointed out below. It is understood that any pilot operations under this proposal will be conditioned on the acceptance of, and the specific arrangements made under, the TD paper on introducing the local currency loan product.

7. A paramount consideration is the retention by ADB of its AAA credit rating. The local currency proposal is aimed at delivering suitable financial solutions tailored to client needs (and in this way may also lead to increase in ADB's income), not the other way around. Another consideration is the need to improve the compatibility and profile of ADB concepts in relation to other financiers, especially capital market operators and commercial banks. The rationale here is that ADB is increasingly part of a fund-raising program rather than the sole project financing agent. Financial products, instruments, and modalities ought to be changing and be tailored to specific project structures. Competition, competitiveness, speed, efficiency in the use and allocation of resources, flexibility, and cofinancing emanate from this.

B. Local Currency by other International Financing Institutions

8. Local currency financing is a relatively new and recent practice among international financing institutions. The World Bank has yet to extend local currency loans to public sector clients. But the International Finance Corporation has done so on various occasions. In the case of the World Bank, this is partly due to charter restrictions, particularly in relation to lending to subsovereigns without a counter guarantee. At present, the World Bank only has on offer a local currency swap product.

9. Among the other regional development banks, the European Bank for Reconstruction and Development (EBRD) has provided a significant number of local currency loans to clients in Eastern and Central Europe and the Commonwealth of Independent States. Most of these loans have been extended to private sector clients, although this situation is driven more by the portfolio preferences of EBRD rather than by product/client distinctions. In other words, EBRD has the capacity to extend local currency financing to public sector clients, provided that the projects have a high transition impact and the financing structures meet sound banking principles.

10. The Inter-American Development Bank has not yet extended local currency loans to its public sector clients, but it is presently looking into this. The African Development Bank has begun to lend to South Africa in rand. The European Investment Bank is perhaps of the most advanced and successful of the multilaterals in this area. It has provided significant amounts of finance in local currency to public sector borrowers across the EU, even prior to the advent of the single currency. More recently it has done the same in several countries in Eastern and Central Europe. The European Investment Bank's ability to lend in local currency is of course driven by its low subgovernment borrowing costs in currencies within the European Union accession countries—a phenomenon unlikely to be replicated in other parts of the world at this point in time.

C. Charter, Policies, Market, and Practices

11. ADB's charter provides the necessary flexibility to extend local currency financing to public sector borrowers, with or without a guarantee by the central government. Current policies

do not prevent ADB from financing local currency; they stipulate directly or indirectly the various conditions under which it can or cannot be done. Although in a strict sense, most project investment plans prepared by either strategic sponsors and local governments do not really distinguish between foreign and local currency denominated components, an analysis of ADB's current expenditures shows that around 30% of all disbursements to the largest five ordinary capital resources borrowers in 2003 covered local costs.

12. Local cost-denominated project components are expected to increase significantly over the years on account of a lower reliance on imported goods, works, and services. The emergence of increasingly powerful and competitive local industries implies greater domestic supplies to projects. This justifies the provision of local currency loans to finance local expenditures.

D. Treasury Issues of Local Currency Products

13. The introduction of local currency products requires a series of actions upfront and several conditions precedent. A key consideration from the point of view of ADB, endorsed by Management and the Board, is that such a product must only be offered on a financially sound basis, which means that it must not impact negatively on ADB's financial standing. Some of issues that need to be dealt with in the context of this instrument include the following.

1. Funding

14. ADB has two main options to raise local currency funds: (i) bonds and (ii) cross-currency swaps. Some matters to take into account in both instances include the right matching of funding, carry and pricing considerations, and the regulatory regimes in the countries in question. Local currency financing can become an efficient product for the ADB only if DMC governments support the process by creating a conducive or enabling environment for ADB to raise funds on a cost-efficient basis in their markets. Some DMCs are more advanced than others on this front.

2. Financial Policy

15. Local currency financing raises a host of financial policy issues, which include, for example, asset-liability management and pricing. The Treasury paper to be distributed to the Board discusses the specific asset-liability management issues, reviews the experience of the Indian rupee bond issue, and proposes the possibility of introducing a local currency pool funding approach. A proposal for the pricing of local currency loans to public sector borrowers is also outlined.

3. Other Treasury-related Issues

16. Local currency loans raise issues associated with investment management and in particular financial risk management. Each of these issues can be dealt with within the existing financial and operational policy framework.

E. Processing Aspects and Due Diligence

17. The processing of the proposed local currency lending facility will follow the steps and arrangements associated with nonrecourse financing. No operation will be considered until TD has had a chance to evaluate in detail the conditions on the ground to either issue a bond or

consider a swap. In addition, it is imperative that in each case, ADB is fully aware of the market dimension and real deal flow. A bond issue without a deal flow will incur losses. The same will happen with a swap. If local currency lending is extended without a sovereign guarantee, then each transaction will need to be considered “bankable,” which means that the level of exposure from ADB should always be contained in relation to the balance sheet and repayment capacity of each client. The equity and net worth base of each entity must figure strongly in any analysis and govern the amounts possible under each transaction. The operations will be subject to the same due diligence as any nonrecourse finance deal. Some of the due diligence steps used by ADB today require reforms. These have been proposed by the Innovation and Efficiency Initiative in a paper dealing with the country strategy and program and business processes.

18. Similar information requirements applying to subsovereign financing will be taken into account, particularly if the onlending part of the process depends on sponsor cash flows rather than on a sovereign guarantee. Sovereign guaranteed projects should also undergo the type of due diligence proposed. More detailed staff instructions with steps and requirements for processing and due diligence of financing requests under this facility will be prepared.

G. Eligibility and Client types

19. Local government entities, SOEs and public financial institutions are the principal target for local currency financing. The ones likely to qualify for such financing on a nonrecourse basis are those in the “green” shown under Appendix 5. Other entities are likely to require sovereign guarantee support, either on a temporary basis or during the entire period of the financing. SOEs and public financial institutions will qualify for this financing provided they meet strict financial, operational, and management criteria (also shown in Appendix 5). The level of ADB exposure per sector and client will be determined in each case by the project team, in consultation with the Credit Risk Management Unit (CRMU), TD, and the Office of the General Counsel (OGC), subject to the approval of Management and Board.

20. This form of financing will also follow ‘sound banking’ principles and in this sense distinguish between entity or ‘sponsor’ risk, project risk, commercial risk, and regulatory risk. In the case of municipal entities, funding will only be made available under specific conditions, and in accordance with a set of pre-agreed structural and fiscal reforms shown in Appendix 5. In the case of SOEs and public financial institutions, finance would be made available against sound financial statements, but also, as appropriate, against operational undertakings and reforms. A crucial parameter in all cases would be the financial standing of the entities and nature of the reform programs.

H. Terms

21. The terms and conditions for nonrecourse or limited recourse local currency finance will be defined by Management on the basis of a concept paper from the project team. The CRMU, Office of Cofinancing Operations (OCO), OGC and TD will advise Management on the appropriate structure and terms and conditions. No operation will be undertaken without the full involvement of these teams.

I. Use of Proceeds

22. The funding to be provided under the facility will be used to cover the local expenditure capital cost and the working capital needs of projects and subprojects under investment programs.

J. Cost Recovery

23. The use of the facility will follow in all instances sound banking principles, irrespective of whether or not the facility is extended with or without sovereign guarantees. Cost recovery will be applied in the case of commercially oriented projects and subprojects. Social sector financing might have a different cost recovery approach, although here a key condition will be availability and allocation of adequate budget support after the implementation phase.

K. Disbursements

24. The disbursement arrangements under local currency financing facility will be similar to those currently in place for standard recourse and nonrecourse finance operations.

L. Supervision and Monitoring

25. Standard procedures as specified in the draft staff instructions will be followed.

M. Conditions Precedent

26. One of the triggers for working with the local currency facility is the availability of funds. Treasury Department will need to review and make recommendations to the project teams and Management on this. The position and level of support of government and the expected deal flow will be other key considerations. Internally, ADB will need to put in place improved systems and procedures to address credit risks, risk management, and approval processes.

N. Piloting

27. The proposed local currency lending facility to public borrowers will be new to ADB, although not to other development banks. Lending in local currency will follow standard operational policies and procedures. Projects will be looked into in the same manner as transactions financed through hard currency. Nonetheless, in order to allay fears regarding its viability and uptake, it is proposed that the concept be introduced on a pilot basis to start with. The initial pilot period will be three years and the exposure limit is proposed to be 10% of ADB's total outstanding and committed loan and equity portfolio. If local currency lending to the public sector proves to be a successful product, Management and the Board will be in a position to discuss how it can be expanded and incorporated into the ADB mainstream operational and policy framework.

O. Benefits of Local Currency Lending

28. Local government, SOEs, and public financial institutions stand to benefit considerably from the availability of currency financing. The most obvious of these benefits is reduced currency risks, especially for those clients unable to hedge against them on their own. A local currency loan product will also allow ADB to lend directly to local governments, SOEs, and

public financial institutions, either with or without a guarantee from the central government, depending on the client profile.

29. Such direct lending might support, and to a large extent advance, the process of decentralization and reforms of public sector enterprises. It would allow ADB to encourage the incorporation of the private sector in key services and pave the way for the creation of greater efficiency in their delivery to end-users. The process will also allow governments to reduce their financial transfers to these clients, thereby creating fiscal space and releasing resources for other requirements.

30. Finally, if ADB were to become a local currency player this is also expected to help with capital market development in DMCs. ADB bond issues and swap operations can have a major positive impact on local bond and swap markets. Nonetheless, all of this implies a high degree of selectivity, risk containment, and the existence of the right conditions in place in order to raise and lend local currency.

REFINANCING AND RESTRUCTURING MODALITY

A. Background

1. There are public and private sector projects in their commercial phase that were put together at a time of higher interest rates and greater than average currency volatility. These projects might have been financed by other multilateral development banks, commercial banks, or both. They might have been supported by equity finance from private sponsors and private equity groups. Some projects might have entered their commercial phase later than planned on account of implementation delays, perhaps as a result of budget constraints or cost overruns. All or some of these considerations might affect the commercial viability of the transactions after entering their commercial or operational phase. Project financing plans might have been “built” around income streams and/or regulatory conditions deemed reasonable at the time of design, but the aftermath of the 1997 Asian financial crisis might have made these less attractive. Without sound financing plans, even fundamentally sound projects can falter. There are, of course, good and bad projects, not only bad financing plans. Restructuring a financing plan of poorly conceived projects will not add any value. The concept proposed here relates to the restructuring of refinancing plans of inherently good projects, such definition being built around sound banking principles, adequate financial and economic return profiles, good cost recovery capabilities, sustainability, high development impact, and adequate social, technical, legal, safeguard, and operational content.

2. The refinancing or financial restructuring proposal might apply to operations that are close to the end of their first commercial phase, and that may require either an expansion or an overhaul of basic facilities. New investments might be difficult to entertain while a significant portion of original financing remains outstanding. The number of operations in this category is probably significant. This category comes close to the definition of “repeater” projects. The difference is that the original transaction might have been entirely or partially financed by another party. From the point of view of the Asian Development Bank (ADB), the repeater element might be justified on account of the transaction being in a sector or business area where ADB has a successful track record, either within the country in question or elsewhere, and that an expansion or an overhaul would increase not only its viability but also pave the way for other investments. Refinancing in this instance would be tantamount to putting in place a financial restructuring plan, accompanied perhaps by a new investment in a field that fits well with ADB’s strategy in a given country.

3. There are a number of operations that may be suffering from the effects of tighter than average tariff regimes. This applies to public services and regulated operations. Although originally such regimes might have been suitable for the purposes of securing the original financing plan, changed economic conditions since then might have made it difficult for the authorities to increase fees in the past on account of political difficulties. These difficulties might be out of the way now and the authorities might be willing to reform both the regime and the formulas for tariff changes. However, despite that, the original financing plan might still be inadequate to sustain the project even with higher fees. A significant number of pre-1997 operations within the transport, water, wastewater, waste management, and other public services or utility fields might also have financing plan difficulties. These operations might be perfectly viable under different financing schemes, but highly vulnerable under the original one, in some instances even doomed to closure. These operations are likely to have been part of a phased reform package, calling first for the introduction of greater efficiency measures and even management contracts—a step in the process to successfully incorporate later the private

sector in their running and investment. Some of these services might also be due for partial or even outright sales at some point in the future, with the investments in question being a key input into that process, as well as means to improving the profile of the service provider and/or increase value prior to the sale. Unless financial restructuring is carried out, none of these reforms might be possible. In the meantime, the coverage, quality, and continuity of the services in question might be put at risk, thus creating a vicious circle of problems to end-users and the authorities. Superimposed on the above could be a mismatch between the original borrowing in hard currency and the revenue stream in domestic currency. The latter could be smaller than projected. It could also be as high as projected, but with a lower real value against the borrowing currency because of exchange rate volatility.

4. Financial restructuring can take place at different levels (equity and debt) and through a variety of instruments and modalities. Equity can be converted into quasi-equity and mezzanine finance. Additional sponsor support can also be provided. Debt maturity can be extended and some debt can be converted into equity or quasi equity to give extra “oxygen” to the project. Currency and interest rate swaps might be put in place to mirror income streams and current market conditions. Guarantees might be used to secure local and international finance, including working capital. Local currency could also be raised. Reliable income streams can be financed, for example, through securitizations. Contracts could be restructured to provide a more sound security packages to financiers. “Step-in” rights might also be considered in order to allow financiers to change or bring in a new operator into the project. The latter can be applicable in the case of public service concessions and build-operate-transfer contracts. Refinancing will not be used to bail out governments or sponsors.

5. The number of projects potentially suitable for a refinancing program is difficult to estimate. However, it might not be far-fetched to assume that 15% of all the projects approved by ADB prior to and in the first few years after 1997 might fall into this category. Of course, the pilot modality would include more than just ADB-financed projects. It would target transactions financed by others, which may mean shorter maturity periods and more inflexible terms and conditions than those offered by ADB. The proposal is not intended to bail out other financiers. It is not intended to “crowd out” any other development partner or a commercial financier. The proposal is intended to save viable projects that others will not be able or be willing to refinance and that demonstrate high development impact.

6. Refinancing debt in any project is a difficult and complicated undertaking. Refinancing implies, among other things, “rolling in” and then changing a part of the existing financing facilities in a project, shifting them into a new financing plan from ADB and others, through existing or any of the instruments shown above. It can involve the provision of new money with new maturity periods and interest margins and change other terms of the existing facilities. The proposal also allows for the utilization of securitization structures, which may be credit enhanced through ADB guarantees, to tap into capital markets for mobilizing required capital.

B. Proposal

7. The proposal calls for the establishment of a refinancing modality, to be introduced on a pilot basis, and aimed at refinancing fundamentally sound, but selected public and private sector investment projects.

C. Client Type and Eligibility

8. The client can include an executing agency, a state-owned enterprise, or a private sector project (often involving a joint venture between an international private sector entity and the host government).

D. Processing and Due Diligence

9. The processing of the refinancing or restructuring proposals will follow the existing operations manual and procedures that apply to nonrecourse or limited recourse financing (see Appendix 5 to the extent the refinancing involves a public sector project).

10. The due diligence requirements will be similar as those proposed for nonrecourse and limited recourse finance. This due diligence will be undertaken irrespective of whether the financing is structured around a sovereign guarantee or with security over some or all of the assets of the project. More detailed staff instructions with steps and requirements for processing and due diligence of financing requests under this facility will be prepared.

E. Eligibility Criteria

11. Beneficiaries will include public and private-led sector projects. There are no country, sector or public service limitations. Projects eligible for refinancing and restructuring will be those with a high social, financial, economic and developmental content. These operations need to be evaluated upfront and termed as fundamentally sound on technical, commercial, financial, safeguard, legal, social, gender and operational grounds. Projects subject to refinancing may be accompanied by a new investment.

F. Terms

12. The terms and conditions of the finance to be provided in each case by ADB will mirror those available for recourse and nonrecourse operations (depending on the nature of the transaction). In the case of recourse operations, the terms will follow ordinary capital resources and Asian Development Fund conditions.

G. Use of Proceeds

13. The funding provided for refinancing can be used to cover the capital cost and the working capital needs of projects. The proposal can change the configuration of existing debt and equity. It can also support cofinancing under guarantees. Refinancing provided on a nonrecourse basis will fall under the exposure cap applicable to the three-year pilot test period (\$3 billion for all non-recourse transactions). Cost recovery will be applied in all cases, in line with sound banking principles. Sustainability will be another consideration.

H. Disbursement

14. The facility will follow disbursement arrangements currently in place. Given that in most cases procurement would have already been accomplished, disbursements may be against the merit of the financing plan and thus be immediate. In the case of new investments, disbursements will be linked to the implementation and procurement plans.

I. Supervision and Monitoring

15. The arrangements to be put in place are similar to those followed for existing projects. In this instance, it is proposed that in addition the financial covenants are monitored on a regular basis to ensure that the operation does not enter into a new refinancing mode. At the same time, it is essential to ensure that ADB operational policies and procedures are adhered to at all times.

J. Documentation

16. Documentation as specified in the draft staff instructions will apply.

K. Piloting

17. The proposed facility will be piloted for an initial period of three years. If it works adequately, Management and the Board will discuss how it can be expanded and incorporated into the ADB mainstream operational and policy framework. If it does not work, then the program can be discontinued or modified. The results monitoring framework shows the expected outcomes over this period (Appendix 10).

L. Benefits

18. The proposed facility will help salvage a number of selected projects that, although technically, legally, socially and financially sound, may be impaired by problems with the original financing plan. This facility will ensure the continuity of such projects, thereby making a contribution to development and poverty reduction. The financial restructuring might also pave the way for sector and service reforms. It might also create fiscal space at the level of central and local government, thereby releasing resources to cover financing needs in other sectors.

FINANCING SYNDICATIONS AND RISK-SHARING ARRANGEMENTS

A. Background

1. The financing requirements for infrastructure in Asia over the next decade or so will exceed the financing capabilities of developing member country (DMC) governments and multilateral development banks (MDBs) put together. Yet there is estimated to be \$6 trillion–7 trillion of private capital in the region trying to find a home. Investors and lenders are prepared to invest some of this capital to finance infrastructure in Asia, provided appropriate risk mitigation can be provided by the Asian Development Bank (ADB) and others. ADB, together with official and private political risk or credit insurers, can arrange some of these guarantees and issue credit enhancements to cofinance its operations. To maximize its leverage, ADB can also transfer risks through reinsurance arrangements from its own books to third parties, thereby ‘crowding in’ the private insurance industry while reducing its own net risk exposure. This will be a particularly important aspect to control and manage the risk of growing operations without sovereign guarantees, and allow ADB to perform a truly catalytic role in originating new transactions and subsequent risk transfers to third parties. This process would also allow the generation of important price information for ADB’s own operations. However, to do so in sufficient quantities and acceptable terms requires close cooperation among the various risk-sharing parties, and clear guidelines within ADB on how to manage such a process.

1. Loan Syndications

2. Loan syndications involve the active coordination among a group of creditors and cofinancing partners for a project or borrower, including agreements on loss sharing and recoveries in case of default. The need for such coordination becomes increasingly important for larger projects that involve a number of creditors, and where ADB’s financing share is limited but its involvement in the project still significant, such as may be the case for loans without sovereign guarantee. Some of the MDBs that are involved in nonsovereign financing such as the European Bank for Reconstruction and Development or the International Finance Corporation have a specialist syndication desk to perform this cofinancing function. This actively interfaces with financial markets on financing opportunities, and provides advice to operational units on structuring and pricing of transactions. With the introduction of public sector lending without sovereign guarantee, this activity is expected to become increasingly significant.

2. Credit and Political Risk Insurance and Guarantees¹

3. With continued innovations for financial risk transfers and convergence of financial instruments, the insurance industry and capital markets have become an increasingly important risk-sharing partner for the financial market. Traditionally, political risk insurance (PRI) and comprehensive credit insurance have been provided by official agencies. Official insurers include those that belong to the Berne Union, the association of export credit and investment insurers; the MDBs; regional insurers, like the Islamic Corporation for the Insurance of Investment and Export Credit, which is part of the Islamic Development Bank; and the members of the so-called Prague Club, an association of official political risk insurers from developing countries who usually are not yet eligible to join the Berne Union.

¹ The terms guarantee and insurance are often used interchangeably. They differ in substance as insurance is normally conditional, while guarantees can be unconditional or conditional. In the latter case they are similar to insurance. ADB, through its charter, is authorized to provide guarantees.

4. The PRI and credit insurance sector also developed and expanded as a result of private investment in infrastructure in the 1990s. This has also resulted in the emergence of a private market, and privatization of a number of official export credit agencies that had a lesser focus on infrastructure. Yet some of the smaller and new official agencies do not have the financial capabilities to support large infrastructure projects, while others have programs linked to the national priorities of their government, thereby restricting the availability of their programs to investors and lenders in their home country.

5. As private investment in infrastructure declined in the wake of the Asian financial crisis, so has the private political risk insurance industry's interest in this sector. Experience has shown that infrastructure projects are a high risk for insurers. As a result of large claims paid to investors and lenders, some insurers have withdrawn from this field. The remaining private political risk insurers are more cautious about insuring infrastructure in developing countries. At the same time, international banks are increasingly reluctant to lend to long-term infrastructure projects in emerging markets, as the new capital accord under Basle II requires higher capital backing by international banks for such operations. This has increased demand for high-quality political risk and credit insurance.

6. Private insurers and guarantee providers, in particular, are more comfortable with providing political and credit risk insurance for an infrastructure project if an MDB is also providing guarantees to the project. They take comfort in ADB's knowledge of DMCs and the region, the due diligence it carries out on a project, the social safeguards it applies, its track record of success in the region, its ability to mediate disputes, and its privileges and immunities under its charter. The involvement of ADB in a project will also cause political risk insurers to provide more favorable terms and conditions to investors and lenders.

3. Coinsurance and Facultative Reinsurance

7. The modalities of cooperation in the insurance industry include coinsurance and reinsurance. In coinsurance, an insurer will provide insurance in parallel with another, covering separate investors or lenders, or a portion of the same investment. Each insurer is responsible for determining its own premium structure, and the eligibility of its own claims, and recoveries.

8. Under reinsurance, a direct insurer or guarantor purchases additional amounts of insurance from another insurer, or reinsurer. The reinsurer accepts a portion of the underlying risk in exchange for a portion of the premium paid to the insurer, less a "ceding" commission to cover the administrative expenses of the insurer. With reinsurance, the reinsurer follows "the fortunes" of the insurer (i.e., if the insurer pays, the reinsurer must pay its share of the loss). The presence of a reinsurer is not necessarily known to the investor or lender that purchases insurance from the direct underwriter. For the investor or lender that buys the insurance, the responsibility of payment of a claim lies with the direct insurer. Sell-downs of loans or risk-transfers through collateralized debt obligations may also be considered a form of reinsurance and risk transfer. Reinsurance will normally only be applied for lending and guarantee operations without sovereign guarantee.

9. As the direct insurer is responsible for payment of the entire claim, it must be comfortable with the reinsurer's ability to pay its share of the loss in the event of a claim, as it is essentially assuming the credit risk of the reinsurer. For this reason, reinsurers must have a minimum credit rating to be acceptable to the insurer. The advantage of reinsurance is that it mobilizes additional risk taking capacity, limits the number of direct insurers in a project, and standardizes the terms and conditions, thus reducing the overall cost of the insurance.

Reinsurance of an individual transaction is called “facultative” reinsurance. A direct insurer can also be a reinsurer. Investors and lenders normally prefer to deal with one insurer as opposed to multiple insurers.

10. While investors and lenders seek insurers that can pay a loss, they have a preference for an insurer that can intercede on their behalf with a government to prevent a loss from occurring. Public sector and multilateral insurers and guarantors, such as ADB, have this capability. For this reason, investors and lenders often prefer to obtain political risk insurance from an official insurer that can mobilize additional insurance capacity from private risk reinsurers. Private risk insurers welcome this approach as well.

4. Treaty Reinsurance

11. The private political and financial risk insurance industry is only a small segment of the insurance industry that ADB can access to support investment in infrastructure. The insurance industry is made up of insurance companies and reinsurance companies covering other classes of business. Reinsurance companies have substantial financial resources and search for new and profitable insurance products to reinsure. They often do not have the expertise or human resources to underwrite individual risks, or specific classes of business like political risks, but take comfort in the underwriting capabilities of the direct insurer.

12. Reinsurance of an entire “book” (or portfolio of business) is called “treaty reinsurance.” ADB has learned that certain non-political risk reinsurers would be prepared to provide it with treaty reinsurance covering a portfolio of its guaranteed risks, either in one country or in several countries. The benefits of reinsurance to an insurer include ease of administration, additional insurance capacity, and diversification of its per project, country, and aggregate risks. As with facultative reinsurance, treaty reinsurers receive a portion of the premium paid by the investor and or lender in exchange for a portion of the risk. They also pay the insurer a ceding commission to cover administrative costs.

B. Proposal

13. ADB’s primary objective in cooperating with other insurers and guarantors is to enhance the capacities and effectiveness of participating insurance companies or other risk taking agencies in encouraging investment and trade in DMCs, and to harmonize terms, conditions and administrative practices.

14. ADB needs to cooperate with both private and public insurance organizations and similar entities for the purpose of mobilizing additional guarantee capacity in support of developmentally sound investments and trade transactions in its DMCs. Such cooperation may take the form of coinsurance or reinsurance, whether it is ADB providing reinsurance, or ADB obtaining reinsurance, or any other form of cooperation commonly practiced by the insurance industry and capital markets.

15. Any risk sharing by ADB either through facultative reinsurance or treaty reinsurance, or other forms of sell-down, will be in excess of ADB’s own “net” exposure, i.e., the aggregate of ADB’s net exposure combined together with the amount of reinsurance obtained being referred to as ADB’s “gross” exposure. The initial amounts of reinsurance that can be assumed by the ADB on a facultative or treaty basis per project, per country, and in aggregate, shall be approved by the new CRMU and Management, and reviewed by them from time to time.

16. It is proposed that ADB establish guidelines on the use of reinsurance, which will include, among others, the level of ceding commission to be charged, or paid, as well as the financial criteria to be used in evaluating the credit standing of a reinsurer. These would be approved by Management and reviewed by it from time to time.

C. Reinsurance and Coinsurance Guidelines

1. Objective of Reinsurance

17. ADB's primary objective in cooperating with other insurers is to enhance the capacities and effectiveness of participating insurance companies and agencies in encouraging productive foreign investment and trade in developing member countries. Reinsurance aims to catalyze new lending and investment by crowding in third parties, while minimizing the exposure for guarantee operations that ADB carries on its own balance sheet. In the extreme, ADB may reinsure 100% of its guarantee operations—with the effect that ADB has catalyzed the investment and fully transferred all risks to third parties. Cost recovery will be achieved through appropriate fee structures. Furthermore, cooperation will seek to harmonize or adapt to the divergent terms, conditions, and administrative practices of the various insurers of an investment or trade transaction, to effect administrative economies, and to afford greater convenience to applicants for guarantees by two or more companies or agencies.

2. Ceding Commission

18. In line with market practice, ADB will charge or pay ceding commissions for risk transfers it facilitates or participates in. In the case of facultative reinsurance, it is proposed that ADB charge a ceding commission of about 10–15% of the premium generated to private reinsurers and official reinsurers that are not backed by the full faith and credit of their governments. ADB will charge a ceding commission of about 5–10% to official reinsurers backed by the full faith and credit of their government. With regard to treaty reinsurance, it is proposed that ADB charge a ceding commission of up to 30%.

19. It is proposed that ADB in turn also pay a ceding commission of about 10% to both private and official insurers if they seek reinsurance from counterguarantees from ADB.

3. Financial Criteria for Reinsurance Partners

20. It is proposed that ADB purchase reinsurance from reinsurers with a rating of single-“A” or higher from at least two established credit rating agencies.

4. Premiums

21. It is proposed that ADB ensure that its share of premium received when providing reinsurance is commensurate with the risk.

5. Limits

22. Limits on reinsurance are proposed as follows: (i) project limit of \$100 million per reinsurer per project, and (ii) country limit of \$1 billion. Limits will be further reviewed by the CRMU and may be restricted on a case-by-case basis in light of ADB's overall risk bearing capacity as determined in consultation with the CRMU.

6. Sharing of Recoveries

23. The proposal is for ADB to share its recoveries pari passu with reinsurers.

7. Social Safeguards

24. All of the projects that ADB reinsures should comply with its social safeguards policies and procedures. It will also ensure that any insurance contracts that it reinsures contains, among others, provisions that address the illegal hiring of children, corruption, protection of the environment, and the availability of site monitoring.

8. Eligible Investments and Processing of Risk-Sharing Arrangements

25. ADB may provide credit enhancements, including reinsurance, for any eligible form of investment. Such investments need to have a link to ADB's operations, as required by the charter. Such link could also be established through a programmatic approach, such as ADB lending through existing sector development programs being complemented through private sector investment with guarantee support, including a facility approach such as under the new Multitranche Financing Facility (MFF). Processing of individual guarantees under a guarantee facility or MFF will follow similar due diligence criteria as outlined for the MFF, as well as processing guidelines for nonsovereign lending, in case that no counterguarantee is required for a guarantee. All guarantee operations will be reviewed for compliance and pricing by ADB's Guarantee Review Committee. Reinsurance and risk-sharing arrangements with third parties will be coordinated by OCO in close consultation with operational and other relevant support service departments and offices, including CRMU, TD, OGC, and Controller's Department, for approval on behalf of ADB by the Principal Director, OCO.

9. Reinsurance Percentage

26. ADB may provide up to 100% guarantee coverage through reinsurance, or cede up to 100% of its risks to a reinsurer.

10. Piloting and Review

27. Management will continue to review the effectiveness of ADB's risk-sharing program for further refinement based on experiences gained and reflection in ADB's guarantee policies as appropriate. A detailed review of ADB's cofinancing strategy and credit enhancement policies has been initiated and will further detail this proposal. The parameters of this proposal will then be adjusted as required.

COMMITMENT FEE FLEXIBILITY OPTIONS

A. Background

1. This appendix does not provide a specific proposal to the Board on commitment fees. Instead, it suggests the importance of delivering greater degree of flexibility from the point of view of ADB clients and outlines some options on the subject. It recommends that a separate paper be prepared on the matter, preferably by the Treasury Department. The latter has agreed to do so and intends to submit a formal proposal to the Board before the end of 2005. The starting point to this issue is that the Asian Development Bank (ADB) currently charges borrowers a commitment fee of 0.75% per annum based on a progressive percentage of the undisbursed loan balance. Since its introduction, borrowers have been expressing concerns about the complexity of the structure. Recently, issues were also raised about the level of the charge, as the International Bank for Reconstruction and Development (IBRD) has reduced its commitment fee from 75 to 25 basis points (bp), with a 50 bp waiver. Internally, ADB's current accounting systems have been having difficulty processing the progressive structure efficiently or effectively.

2. This appendix examines the history and background of the commitment fee structure. It highlights the major issues related to the current structure and proposes some possible alternatives to streamline and simplify it. The Treasury Department paper will take into account these proposals, as well as feedback from the Board following the financial instruments and modalities working paper discussions that took place on 17 June 2005.

B. Background

3. ADB first adopted a commitment charge in 1968.¹ Since then the commitment charge has been reviewed 12 times, resulting in five changes to the rate, the structure, or both.

4. The original intent of the commitment charge was to cover ADB's cost of carrying liquidity for loans prior to disbursement. However, in the current market environment, ADB is able to raise long-term funds at sub-London interbank offered rate (LIBOR) cost that results in a positive return on liquidity even when placed in short-term investments. Therefore, as confirmed in a 1987² review of the commitment charge, it is no longer necessary to link the commitment charge to a specific cost. Alternatively, ADB's lending spread together with the commitment charge is considered sufficient to cover ADB's administrative expenses and possible cost of maintaining adequate liquidity. The allocable net income of ADB is derived substantially from the earnings of its cost-free equity funds. With this distinction made, it is appropriate to evaluate the level of the commitment charge in the context of its contribution to total net income.

5. The commitment charge induces borrowers to disburse loans as quickly as possible. However, disbursements are frequently delayed for reasons out of the control of the borrower, which may include the procurement requirements of ADB. As stated in the 1971 review of the commitment charge: "The Bank cannot, and does not, expect that because of the commitment charge withdrawals could be accelerated beyond the rate at which project-construction could proceed with the best efforts."³ Therefore, this can only be considered a secondary purpose of the commitment charge.

¹ ADB. 1968. *Commitment Charge Policy*. Manila (23 January, R3-68).

² ADB. 1987. *Net Income Targets and Reduction in Loan Charges*. Manila (27 July, R84-87).

³ ADB. 1971. *Commitment Charge Policy*. Manila (8 March, R21-71).

6. The commitment charge may, however, provide an incentive for borrowers to cancel loan commitments deemed excess or unusable. Many borrowers obtain the maximum loan commitment amount to avoid seeking additional approval should the project exceed the original approved amount. This results in excess commitment that directly reduces ADB's lending headroom. Without any commitment charge, borrowers may not have any incentive to cancel excess or unusable commitments, which would lead to underutilization of the lending headroom. This factor needs to be considered in the review of the commitment charge.

7. During the last review of the commitment charge in 1987,⁴ the 0.75% rate was retained from the previous review. However, a progressive structure was applied whereby the commitment fee was charged on an increasing percentage of total committed loan amount less cumulative disbursements. These percentages were set at 15% in the first year, 45% in the second year, 85% in the third year, and 100% in the fourth year and thereafter (a similar progressive structure was applied from 1973⁵ to 1976).

8. The purpose of applying the progressive structure was to relieve the burden of the full commitment charge on slow disbursing loans. It was argued that it was unfair to charge the borrowers a commitment fee on the balances that could not be disbursed quickly for a variety of reasons, including the procurement requirements of ADB. The annual progressive percentages were intended to be similar to the pace of awarding procurement contracts. While the intention of the progressive structure was to reduce cost to the borrower, the complexity has raised a number of concerns from both borrowers and from within ADB.

C. Borrowers' Concerns

9. Borrowers have raised concerns in a number of forums that the progressive structure of the commitment charge is too complex. As a result, borrowers cannot calculate the commitment charge properly and have to depend on ADB's accounting records for maintaining their accounts.

10. The progressive structure first becomes a problem in determining the loan commitment for the project. For most project loans, the committed loan amount includes capitalization of loan charges during the project implementation period. However, the progressive structure of the commitment charge makes it difficult to estimate the amount of capitalization. Any overestimation or underestimation would have negative financial impact on the project and the borrower.

11. Some of ADB's loans include subloans. Under some project loans, sector loans, and financial intermediary loans, one overall loan encompasses subloans, which are administered by different sub-borrowers or executing agencies. Borrowers would like accounting records to be maintained on a subloan basis to assist in project implementation and administration. However, under the progressive structure, the commitment charge cannot be calculated at the subloan level. Moreover, if the commitment charge is subject to capitalization, the capitalized commitment charge cannot be allocated to the principal outstanding of each subloan accurately.

12. For those borrowers with subloans, the current accounting practice has caused problems for their loan administration. For example, for some loans to the People's Republic of

⁴ ADB. 1987. *Net Income Targets and Reduction in Loan Charges*. Manila (27 July, R84-87).

⁵ ADB. 1973. *Commitment Charge Review*. Manila (16 July, R61-73).

China and Uzbekistan, the sub-borrowers are responsible for loan service payments and must maintain their records separately. Therefore, accurate subloan data is essential for their accounting and debt servicing. However, as ADB's accounting records and billings are prepared at the overall loan level, it is the borrower's responsibility to break them down for each subloan. For the reasons mentioned above, the progressive commitment charge cannot be allocated accurately among subloans. Moreover, if the commitment charge is subject to capitalization, the allocation has an impact on the principal outstanding of each subloan. Normally, the borrowers allocate the commitment charge among the subloans on a pro rata basis. Executing agencies of the subloans often question the reliability and accuracy of the allocations. Some borrowers have sought ADB's assistance in developing a practical model for breaking down loan records among subprojects. However, no practical solution has been found so far.

13. With the introduction of a 20 bp waiver on the lending spread and a 100 bp waiver on the front-end fee in 2004, ADB's total LIBOR-based loan charge compares favorably with ADB's sister MDBs.⁶ However, on the commitment charge, both the Inter-American Development Bank and IBRD charge a 25 bp flat rate,⁷ compared with ADB's 75 bp progressive rate. On a flat rate basis, ADB's commitment charge translates into an equivalent rate of approximately 35 bp, which is only 10 bp higher than the above two banks. However, the progressive nature of ADB's commitment charge could not be well explained to borrowers. Therefore, ADB's commitment charge compares quite unfavorably with sister MDBs.

D. Systems Issues

14. Accounting procedures for the progressive structure of the commitment charge are also complex. To facilitate the calculation of the charge, the total loan commitment amount is divided into two categories: the amount subject to the commitment charge and the amount not subject to it. Accordingly, a schedule is established to transfer the applicable portion of the committed loan amount to the category subject to the commitment charge annually. The amount subject to the commitment charge is adjusted in line with day-to-day loan transactions, including disbursements, capitalization of loan charges, cancellations, and any refunds of loan proceeds. The relevant accounting adjustments to the commitment charge are tedious and burdensome due to the progressive structure. For example, if a loan commitment is canceled, the cancellation is allocated to the amount subject to commitment charge based on the applicable percentage. As most cancellations are backdated, such allocation and accounting adjustments may affect all relevant loan accounts such as principal, commitment charge, interest, waiver, and rebate. If any proceeds were refunded from the borrower, such accounting adjustments would become even more difficult.

15. As the progressive structure is not common banking industry practice, extensive modifications to accounting systems need to be made to account for the charges accurately. Even with these modifications in place, some manual adjustments cannot be avoided. Furthermore, as previously discussed, borrowers would like subloan accounting but do to system difficulties in handling the progressive structure of the commitment charge is not available to them.

16. The inability to provide accurate subloan accounting for borrowers raises other serious concerns including the following:

⁶ ADB. 2004. *Treasury Report: Third Quarter 2004*. Manila.

⁷ IBRD's commitment charge is 75bp, with 50bp waiver.

- (i) ADB is not able to identify principal outstanding of a subloan. If ADB recalls a loan outstanding under a subproject, or a borrower wants to prepay a loan outstanding under a subproject, ADB would not be able to figure out the exact loan amounts due under the subloan.
- (ii) Compared to other loan products, the progressive commitment charge would cause additional problems for LIBOR-based lending. Under LIBOR-based lending, ADB allows borrowers to make full or partial interest rate or currency conversions. If a borrower has subloans and wants to make conversion for one subloan, exact loan data under the subloan such as loan outstanding or undisbursed amount must be identified precisely before the conversion is executed. However, the information is not available in ADB's existing loan accounting system.

17. Finally, ADB is exploring possibilities to provide borrowers with more flexibility to meet various requirements of different projects, which may deviate from ADB's current standard loan terms. For example, one proposal covers the multitranche lending facility, under which each tranche carries different loan terms. To do this, all loan transactions must be recorded separately by tranche. However, the existing accounting system would have difficulty accommodating this requirement mainly due to the progressive structure of the commitment charge.

E. Suggestions and Next Steps

18. Given the reasons listed in previous sections, it is clear that the structure of the commitment fee needs to be looked into with a view to streamlining or simplifying it. Since cost of carry is no longer the *raison d'être* of specifically charging borrowers the commitment fee (para. 4), it is also possible to examine if the commitment fee could be combined with the lending margin as a single loan charge to borrowers, thereby further simplifying ADB's lending term.

19. Various options aimed at simplifying the commitment charge structure are suggested. These, and others, should be explored through a separate paper for the attention of the Board. The following five options represent the spectrum of possible alternatives:

- (i) Changing the progressive commitment charge structure to a flat commitment charge at an equivalent rate of the current commitment charge. This option is income neutral to ADB.
- (ii) Changing the progressive commitment charge structure to a flat commitment charge and match the commitment charge rate of 25bp of the IBRD. This option is income negative for ADB.
- (iii) Eliminating the commitment charge and increasing the lending spread equivalent of the current commitment charge. This option is income neutral for ADB.
- (iv) Eliminating the commitment charge and increasing the lending spread by 20bp. The new lending spread will be LIBOR + 60bp. This option is income negative for ADB.

- (v) Eliminating the commitment charge and maintain the current lending spread of LIBOR + 40. This option is income negative for ADB.

20. The net income implications of the five options are limited to a static state analysis, i.e., assuming borrower behavior will not change and the current lending volume is maintained. However, if the change in commitment charge provides incentive for increased lending volume, the net income impact will be more favorable.

21. For options (i) and (iii) where ADB's net income will not be affected, individual borrowers will be affected differently depending on the nature of the project. Even for options where ADB's net income will be negatively affected, borrowers may not benefit uniformly, except in option (v). Therefore, further analysis might be needed to identify the differences in income and behavior impact of borrowers with each of the five options. The impact on lending headroom is also an important element to consider when selecting the appropriate options. Prior to engaging in this additional work, it would be necessary to understand the level of support from Management and the Board for the concept.

22. The Innovation and Efficiency Initiative team is of the view that the simplification of commitment fee structure is an important element of the entire Initiative to address real issues raised by borrowers and also to demonstrate ADB's responsiveness moving forward. On the other hand, the simplification of commitment fee should not materially affect ADB's net income.

23. Treasury is the most appropriate department to carry out a detailed analysis on these or any other options.

**PILOT FINANCING INSTRUMENTS AND MODALITIES
MONITORING INDICATORS**

Indicator	Multitranche Financing Facility	Subsovereign and Nonsovereign Public Sector Financing Facility	Local Currency Lending	Refinancing and Restructuring Facility	Financing Syndications and Risk-Sharing Agreements
No. of transactions / deals (per OCR/ADF borrowers)	X	X	X	X	X
Value of transactions	X	X	X	X	X
Volume of cofinancing mobilized					X
Private sector participation (no. of private sector entities and volume of their participation)	X	X	X	X	X
Execution of warranties and representation including fiduciary oversight (% of transactions with successful execution)	X	X	X	X	
Progress of reforms of LGUs and SOEs		X			
No. of bond issues			X		X
No. of new clients and financing partners		X	X		X
Improvement in performance of rescued projects (project implementation rating)				X	

ADF = Asian Development Fund; LGU = local government unit; OCR = ordinary capital resources; SOE = state-owned enterprise.