

**OPERATIONS MANUAL  
BANK POLICIES (BP)**

*These policies were prepared for use by ADB staff and are not necessarily a complete treatment of the subject.*

**LENDING POLICIES FOR SOVEREIGN AND SOVEREIGN-GUARANTEED BORROWERS  
(Ordinary Capital Resources)<sup>1</sup>**

**A. Definitions**

“Cap”	A ceiling that sets an upper limit for a floating interest rate.
“Floor”	A floor that sets a lower limit for a floating interest rate.
“Collar”	A combination of a cap and a floor that sets an upper and lower limit for a floating interest rate.
“Prepayment”	Repayment of a loan in advance of the maturity period specified in the loan agreement.

**B. Introduction**

1. The lending operations of the Asian Development Bank (ADB) consist of ordinary and special operations pursuant to Article 9 of the Agreement Establishing the Asian Development Bank (the Charter). Loans under ordinary operations are financed from ADB's ordinary capital resources (OCR) described in Article 7 of the Charter. Article 11 specifies to whom ADB may lend and the methods of operation. Article 13 authorizes lending by ADB in local currencies that are not obtained from sales of gold or convertible currencies to finance local expenditures of a project. Article 14 refers to the principles under which ADB's lending operations are conducted.

**C. Expenditures Financed by ADB**

2. ADB loans finance the foreign exchange costs and local expenditures of projects, subject to the rules on cost sharing and eligibility of expenditures.<sup>2</sup>

**D. LIBOR-Based Loans**

**1. Terms of Lending**

3. ADB offers its sovereign and sovereign guaranteed borrowers London interbank offered rate (LIBOR)-based loans (LBLs) that carry a floating lending rate consisting of the 6-month LIBOR or another relevant floating rate benchmark, as applicable, and an effective contractual spread fixed over the life of the loan. An LBL has market-based features that provide a

<sup>1</sup> Applicable to London interbank offered rate (LIBOR)-based loans and local currency loans made from ADB's ordinary capital resources to sovereign and sovereign-guaranteed borrowers. See *Operations Manual* (OM) section D10 for loans made to nonsovereign borrowers.

<sup>2</sup> See OM section H3 (Cost Sharing and Eligibility of Expenditures for ADB Financing).

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transparent basis for borrowers to compare the terms of ADB loan products with those of other lenders and to be amenable to efficient intermediation by ADB on the best possible terms.

4. The LBL product provides a high degree of flexibility to borrowers, while providing low intermediation risk to ADB. Borrowers are given (i) the choice of currency and interest rate basis; (ii) various repayment options; (iii) the ability to change certain terms of the original loan agreement at any time during the life of the loan, subject to certain conditions;<sup>3</sup> and (iv) the option to purchase a cap or a collar on the floating lending rate at any time during the life of the loan.

5. Loans may be made on a floating-rate basis<sup>4</sup> and may be denominated in euros, yen, US dollars (standard currencies), or other foreign currencies in which ADB can efficiently intermediate (nonstandard currencies). With a floating-rate loan, the lending rate is reset every 6 months on each interest payment date. The lending rate is the cost-base rate plus an effective contractual spread (fixed spread less permanent credit) that is fixed in the loan agreement. The cost-base rate is equal to the 6-month LIBOR for US dollar- and yen-denominated loans, and the 6-month euro interbank offered rate for euro-denominated loans, or an appropriate floating rate benchmark for nonstandard currencies other than for local currency loans, and is reset every 6 months. The effective contractual spread is 30 basis points for loans negotiated from 1 July 2010 to 30 June 2011, and 40 basis points for loans negotiated on or after 1 July 2011.<sup>5</sup> Borrowers may direct ADB to implement a series of interest rate fixings automatically either by period or by amount. For project loans, borrowers also may capitalize the interest.

6. LBLs provide for rebates and surcharges. Since the principle of automatic cost pass-through pricing is maintained for LBLs, ADB returns the actual sub-benchmark funding cost margin achieved to its LBL borrowers through rebates. A surcharge could arise if ADB's funding cost is above the benchmark. The rebate and surcharge are calculated on 1 January and 1 July each year, based on the actual average funding cost margin for the preceding 6 months for each currency. Rebates and surcharges shall be applied to the upcoming interest period.

7. For loans negotiated before 1 October 2007, ADB's Board of Directors may approve certain waivers applicable to ADB loan charges, including the lending spread, front-end fee, and commitment charge.<sup>6</sup> Waivers will apply only to loans without arrears. The waiver mechanism has been discontinued for loans negotiated on or after 1 October 2007.

8. A commitment charge of 0.15% per year is levied on undisbursed balances of all project and program loans, beginning 60 days after the applicable loan agreement is signed and accruing when the loan becomes effective.<sup>7</sup> For project loans, borrowers may capitalize the commitment charge.

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<sup>3</sup> Borrowers may change the interest rate basis or currency of the original loan agreement, subject to certain minimum and maximum amounts. However, borrowers may not revise or otherwise amend the term of the loan or the stated grace period for the loan.

<sup>4</sup> Borrowers may request an interest rate conversion (para. 14).

<sup>5</sup> A fixed spread of 60 basis points net of a permanent credit of 30 basis points for loans negotiated from 1 July 2010 to 30 June 2011, and a permanent credit of 20 basis points for loans negotiated on or after 1 July 2011.

<sup>6</sup> The waivers that are in effect at any point are available at ADB's website.

<sup>7</sup> Applicable to project and program loans negotiated on or after 1 October 2007.

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9. The repayment term on an OCR loan is based primarily on the economic life of the project. The financial condition of the borrowing entity and the revenue-earning capacity of the project may also be taken into account. Subject to these primary project considerations, the repayment period also takes into account the debt-service capacity of the borrowing DMC. The grace period is based mainly on the time needed for the project to become operational but may be modified to reflect country considerations (i.e., the debt-service capacity of the borrowing DMC) and other project considerations (e.g., the social benefits of the project and the revenue-earning capacity of the executing agency). Program loans and technical assistance loans have fixed repayment and grace periods that are shorter than those for investment projects. ADB offers two types of repayment schedules for borrowers:<sup>8</sup> (i) commitment-linked repayment schedules in which the loan's repayment schedule starts from the beginning of the interest period following loan signing, and (ii) disbursement-linked repayment schedules in which disbursed amounts have individual repayment schedules that start from the beginning of the interest period following disbursement. In either case, repayment can be made on the basis of any of the following options: (i) annuity-style method, (ii) straight-line repayment, (iii) bullet repayment, and (iv) custom-tailored repayment to match the cash flow projections of the borrower.<sup>9</sup> ADB does not participate in debt rescheduling agreements for sovereign loans.

### **2. Prepayment and Cancellation of Loan**

10. Borrowers may prepay in part or in full the disbursed and outstanding loan balance at any time during the life of a loan by notifying ADB in writing at least 45 days before the prepayment. Partial prepayments are applied to the amortization schedule in inverse order of maturity, with the most distant maturity being repaid first. Partial prepayment should be at least equal to all of the principal amount of any one or more maturities of the loan. In case of financial intermediation loans, the disbursed amount that has been withdrawn last should be repaid first.

11. For floating-rate loans, borrowers may prepay outstanding amounts on the interest payment date of the loan without a prepayment premium. However, prepayments of floating-rate loans on dates other than interest payment dates are charged a prepayment premium based on the difference, if any, between the rate at which the proceeds from the prepayment can be reinvested and ADB's funding cost for the period up to the next interest payment date. In the event of prepayment of fixed-rate loans or floating-rate loans that involve conversions, and if the corresponding hedge transactions have to be terminated, the borrowers are charged the unwinding costs of the hedge transactions that ADB incurs.

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<sup>8</sup> When loan signing is delayed beyond 1 year because of exceptional circumstances, and ADB consequently approves an extension to the loan signing date, the repayment schedule may, if so requested by the borrower, be revised at the time ADB approves the extension.

<sup>9</sup> Applicable to project loans negotiated after 1 January 2007. Bullet repayment refers to one single repayment at the end of the loan term. Custom-tailored repayment refers to an amortization structure that would meet the exact cash-flow structure of the project. However, such customization will be limited to determining the repayment structure in (potentially uneven) percentage terms that cannot be changed after loan signing.

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12. With the concurrence of the guarantor (if any), borrowers may cancel all or part of the undisbursed loan balance at any time during the life of the loan without a fee, subject to the same notice period.

### **3. Loan Conversion Options**

13. Borrowers may request a currency conversion of all or a portion of the principal amount of the loan after review of its original currency choice and interest rate structure. At any time after loan effectiveness, borrowers may (i) for conversions to any standard currency, change the loan currency of all or part of the undisbursed or disbursed loan amounts at any time during the life of the loan; (ii) for conversions to any nonstandard currency in which ADB can effectively intermediate (other than for conversions to a local currency), change the loan currency of all or a part of the undisbursed or disbursed loan amounts at any time during the life of the loan, provided that ADB can enter into the necessary hedging transaction; (iii) request an interest rate conversion from floating to fixed or vice versa during the life of the loan; or (iv) establish an interest rate cap or collar on a floating rate, subject to relevant swap market opportunities available to ADB. The use of the conversion provisions in the loan agreement is subject to the relevant provisions of the applicable loan regulations and conversion guidelines.<sup>10</sup>

14. For conversions to a local currency, borrowers may request a conversion of all or a portion of the withdrawn and outstanding amount of the loan on a case-by-case basis upon the advice of the Treasury Department. Conversions to a local currency are permissible only for fully disbursed loans. An annual fee of 0.02% will be charged on the outstanding principal hedged amount of the loan. Subject to availability in the local market, local currency loans, upon conversion, can be offered at a floating rate or fixed rate.

15. Local currency conversions of withdrawn and outstanding loan balances will be an approximate hedge only. They do not include the lending spread or any potentially applicable rebates, surcharges, or waivers, which will remain in the original loan currency.

16. Before conversion to a local currency can be undertaken, the loan agreement shall be amended to allow for the conversion. The loan regulations applicable to local currency ordinary operations shall apply to that portion of the loan converted to a local currency.

### **E. Local Currency Loans**

#### **1. Terms of Lending**

17. In selected developing member countries, ADB offers its borrowers local currency loans (LCLs) to finance the local expenditures of a project. An LCL has market-based features that provide a transparent basis for borrowers to compare the terms of ADB loan products with those of other lenders and to be amenable to efficient intermediation by ADB on the best possible terms.

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<sup>10</sup> This is a unilateral document that ADB can change anytime to provide flexibility in executing conversion requests. The guidelines set out the procedures for requesting, accepting, and effecting conversions as specified in the loan agreement.

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18. Loans may be made on a floating rate basis.<sup>11</sup> With a floating rate loan, the lending rate is typically reset every 3 or 6 months on each interest payment date. The lending rate is the cost-base rate plus an effective contractual spread (fixed spread less permanent credit) that is fixed in the loan agreement. The cost-base rate depends on whether financing in a local currency is based on back-to-back funding or the pool-based approach.<sup>12</sup> For back-to-back funding, the cost-base rate comprises ADB's cost of a funding transaction undertaken to finance a specific loan, including related swap costs and negative carry, if any. For a pool-based funding approach, the cost-base rate is based on the local floating-rate benchmark (equivalent to LIBOR), adjusted by ADB's funding spread over or below the benchmark. The effective contractual spread is 30 basis points for loans negotiated from 1 July 2010 to 30 June 2011, and 40 basis points for loans negotiated on or after 1 July 2011.

19. A commitment fee of 0.15% per year is levied on undisbursed balances of all LCLs, beginning 60 days after signing of the applicable loan agreement and accruing when the loan becomes effective.

20. LCLs funded under the pool-based approach provide for rebates and surcharges. Since the principle of automatic cost pass-through pricing is maintained for LCLs, ADB returns the actual sub-benchmark funding cost margin achieved to its qualifying LCL borrowers through rebates. A surcharge could arise if ADB's funding cost is above the benchmark. The rebate and surcharge are calculated on 1 January and 1 July each year based on the actual average funding cost margin for the preceding 6 months.

### **2. Prepayment and Cancellation of Loan**

21. Borrowers may prepay in part or in full the disbursed and outstanding loan balance during the life of a loan by notifying ADB in writing at least 45 days before the prepayment. However, prepayment charges will apply based on the estimated negative carry, if any, that ADB incurs as a result of the prepayment for the remainder of the term of the prepaid loan. As in prepayments of LBLs, the negative carry would be calculated based on the difference, if any, between the rate at which the proceeds from the prepayment could be reinvested and ADB's funding liability for the prepaid amount. If a fixed-rate loan is prepaid, and the corresponding hedge transactions terminated, the borrowers will be charged the unwinding costs of the hedge transaction, if any. No prepayment charge will apply for floating-rate loans funded under the pool-based funding approach if prepayments occur on interest payment dates.

22. Borrowers may cancel all or part of the undisbursed balance at any time. No cancellation charge will apply if ADB follows a pool-based funding approach for the specific local currency. For back-to-back funding, if ADB has agreed with the borrower to pre-fund the local currency requirement for a particular loan, and the borrower later decides to wholly or partially cancel the

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<sup>11</sup> Borrowers may request an interest rate conversion (para. 25).

<sup>12</sup> The Treasury Department will advise whether funding for a specific project will be undertaken on a back-to-back or pool basis.

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loan, a cancellation charge will apply based on the same principle used for prepayments (i.e., to compensate ADB for negative carry costs, if any, resulting from the loan cancellation).

23. Charges for prepayment and cancellation, and their calculation principles, will be included in the loan documents to ensure full transparency for borrowers.

### **3. Interest Rate Conversion Options**

24. Borrowers will be allowed to change the interest rate basis of an LCL at any time during the life of the loan by requesting a conversion to fix or unfix their interest rate, subject to relevant swap market opportunities available to ADB in the local market. The terms and conditions that ADB can achieve by executing the necessary hedging transactions will be passed on to the borrower, plus a transaction fee of 0.0625%, except for the first series of interest rate conversions for which no fee shall be charged.

### **4. Currency Substitution**

25. The local currency loan agreement includes a currency substitution clause. This will allow ADB to temporarily substitute another currency for the loan currency selected by the borrower if an extraordinary situation arises that prevents ADB from providing the selected currency for funding the loan because of access constraints in the local currency capital market.

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**Basis:** This OM section is based on:

ADB. 2010. Doc. R38-10. *Review of the Asian Development Bank's Loan Charges and Allocation of 2009 Net Income*. 12 April. Manila.

ADB. 2007. Doc. R210-07. *Review of the Asian Development Bank's Loan Charges*. 7 December. Manila.

ADB. 2006. Doc. R221-06. *Enhancements for the Asian Development Bank's Loan and Debt Management Products*. 27 November. Manila.

ADB. 2005. Doc. R195-05. *Introducing the Local Currency Loan Product*. 25 August. Manila.

ADB. 2001. *Ordinary Operations Loan Regulations (Applicable to LIBOR-Based Loans Made from ADB's Ordinary Capital Resources)*, 1 July. Manila.

ADB. 2001. Doc. R79-01. Revision 1, Final. *Review of Asian Development Bank's Financial Loan Products*. 19 June. Manila.

**Compliance:** This OM section is subject to compliance review.

**For inquiries:** Questions may be directed to the Assistant Treasurer, Financial Policy and Planning Division or the Assistant Treasurer, Funding Division, Treasury Department.

**OPERATIONS MANUAL  
OPERATIONAL PROCEDURES**

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*These procedures were prepared for use by ADB staff and are not necessarily a complete treatment of the subject.*

**LENDING POLICIES FOR SOVEREIGN AND SOVEREIGN-GUARANTEED BORROWERS  
(Ordinary Capital Resources)**

This *Operations Manual* section does not contain operational procedures.