

# OPERATIONS MANUAL

## BANK POLICIES (BP)

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

### INVESTMENT LIMITATIONS ON NONSOVEREIGN OPERATIONS

#### A. Introduction

1. Controlling limits on credit is an essential element of an integrated risk management system to safeguard a lending institution's financial strength. The Asian Development Bank's (ADB) credit exposure limits can be classified into three main groups: (i) limits that are stipulated in ADB's Charter, (ii) strategic limits adopted by ADB that determine ceilings for certain operations and average credit quality of its operations and (iii) prudential exposure limits that ensure a certain level of diversification and cap the maximum amount of loss.

2. ADB's Charter<sup>1</sup> limits ensure that ADB's exposures are commensurate with the level of its capital. ADB's Charter has two such limits (see para. 21).

3. Strategic limits allow ADB to ensure that the average risk level entailed in its operations is commensurate with ADB's risk appetite. They also ensure that the total risk undertaken at each operational and at the aggregate level do not exceed the level that its allocated economic capital can still support.

4. Prudential exposure limits ensure that a portfolio is adequately diversified across different risk factors to minimize potential loss. A more diversified portfolio is less prone to large losses, and thus requires less economic capital than less diversified portfolios.<sup>2</sup>

#### B. Purpose

5. This section of the OM provides guidance on prudential limits in relation to nonsovereign operations. In the course of conducting its businesses for nonsovereign as well as sovereign operations, ADB will always be guided by three high-level objectives, i.e.: (i) maintenance of its AAA rating, (ii) efficient use of its economic capital, and (iii) diversification of its portfolio.

#### C. Definitions

6. "Aggregate Net Exposure" means the sum of all Net Exposure calculated in accordance with paras. 25–30.

<sup>1</sup> ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

<sup>2</sup> Because of ADB's highly concentrated portfolio, the unexpected loss estimate could easily increase to 40% should another Asian financial crisis hit the region. This is why ADB set its target equity-to-loan ratio at 35% despite estimated unexpected losses of less than 20%.

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7. “Comprehensive Guarantee” means a guarantee of all credit and political risks, representing in effect the same risk as that of the underlying loan to which ADB will subrogate following a payment under the guarantee.

8. “Counterparty Risk” means the credit and other risk to ADB associated with a Risk Counterparty under a Syndication Arrangement.

9. “Eligible Counterparty” means any of the following:

- (i) a business entity with a credit rating of not less than A- (for that class of transaction) assigned by at least one international rating agency; or
- (ii) a business entity with the equivalent of an A- rating assigned by reputable local rating agency, if it is domiciled in the same country as the borrower or guarantee beneficiary; or
- (iii) an official export credit agency, export-import bank, or a similar entity that is guaranteed by or carries the full faith and credit of its government.

10. “Exposure” means, with regard to any time period,

- (i) with respect to loans: ADB’s total commitments at that time outstanding;<sup>3</sup>
- (ii) with respect to guarantees: the present value (at such time) of the future scheduled payments,<sup>4</sup> provided that if the relevant guarantee permits a party other than ADB at any time to accelerate ADB’s obligations under the guarantee, the present value will be assessed as if the permitted acceleration were scheduled to occur at the earliest of such time;
- (iii) with respect to equity investments: the market value or fair value of such investment, including the value of any commitment to subscribe for shares that have not been paid-up;

and, in the case of subparagraphs (i) and (ii), less the amount of any Exposure that has been transferred by ADB to a third party under a Fronting Arrangement.

11. “Financing Recipient” means any borrower, investee, or guarantee beneficiary under, respectively, an ADB loan, investment, or guarantee.

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<sup>3</sup> Outstanding total commitments include disbursed and outstanding plus undisbursed amount.

<sup>4</sup> To derive the present value of future guarantee obligations, the discount rates used must be currency specific, incorporate the credit spread appropriate for the credit rating of the guaranteed party, and take into account the tenor of the guarantee.

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12. “Fronting Arrangement” means a Syndication Arrangement under which ADB does not assume any Counterparty Risk.<sup>5</sup>
13. “Group” means two or more persons, whether natural or legal, to which ADB has Exposure, on a joint or separate basis, and which are mutually associated in that (i) one of them directly or indirectly holds power of control over the other; or (ii) their cumulated Exposures represent to ADB a single risk because they are so interconnected that if one of them experiences financial problems, the other or all of them, are likely to encounter repayment difficulties.<sup>6</sup>
14. “Independent Counterparty” means a Risk Counterparty other than a Related Counterparty, which has entered into any Syndication Arrangement with ADB.
15. “Limited Guarantee” means a guarantee of one or more of the risks of currency inconvertibility/non-transferability, political violence, expropriation and breach of contract, or of certain credit risks that, in either case, represents less risk than a Comprehensive Guarantee.
16. “Net Exposure” or “NE” means Exposure less such reductions as are commensurate with the sharing or transfer of risk to any Risk Counterparty under a Syndication Arrangement.
17. “Nonsovereign Operations” means any loan, guarantee, equity investment, and similar financing arrangement that ADB provides from its ordinary capital resources (OCR) that is (i) without government guarantee or counter-indemnity, or (ii) with government guarantee or counter-indemnity, under terms that do not allow ADB to accelerate, suspend, or cancel upon default by the government of such guarantee or counter-indemnity, any other loan, or guarantee between ADB and the related sovereign.<sup>7</sup>
18. “Related Counterparty” means a Risk Counterparty that has entered into a Syndication Arrangement; and is a member of the Group to which the Financing Recipient belongs.
19. “Risk Counterparty” means an Eligible Counterparty which is an Independent Counterparty or a Related Counterparty.
20. “Syndication Arrangement” means a contractual arrangement under which ADB transfers some or all of its risks associated with a financing to a Risk Counterparty (footnote 5).

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<sup>5</sup> See ADB. 2006. *Review of Asian Development Bank’s Credit Enhancement Operations* (para. 57). Manila.

<sup>6</sup> Bank for International Settlements. 1991. *Measuring and Controlling Large Credit Exposures*. Basel, Switzerland.

<sup>7</sup> A cross default clause provides that should a borrowing member country default on any of its obligations to ADB under any loan agreement or guarantee agreement with ADB, ADB is entitled to suspend and cancel all other loan and guarantee agreements with that borrower.

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**D. Applicable Limits**

**1. ADB's Charter Limits**

21. Article 12.1 of the ADB Charter imposes a composite ceiling on the aggregate of loans, guarantees, and equity operations (both sovereign and nonsovereign) of not more than the total amount of ADB's unimpaired subscribed capital, reserves, and surplus included in its OCR (exclusive of special reserves). Article 12.3 imposes a limit on the total amount of funds invested in equity capital out of the OCR of ADB, which must not exceed an amount equal to 10% of the aggregate amount of ADB's unimpaired paid-in capital stock actually paid up at any given time together with the reserves and surplus included in its OCR (exclusive of special reserves).

**2. Strategic Limits**

22. To ensure that at any time the level of credit risk taken by ADB is consistent with its risk appetite, target business volume, and AAA rating objective, ADB will maintain a diversified portfolio of equity investments, loans, and guarantees. This portfolio composition should also ensure that the provisioning/loan loss reserve requirements<sup>8</sup> would not result in severe adverse impact on ADB's annual net income performance. Table 1 indicates the benchmark portfolio with which the portfolio of loans and guarantees by rating should comply.

**Table 1: Benchmark Portfolio**

Risk Rating Bucket <sup>a</sup>	% of Portfolio
1–2	Equal to or greater than 5%
3	Equal to or greater than 15%
4–6	About 60%
7–9	Equal to or less than 15%
10	Less than 5%

<sup>a</sup> See Appendix for indicative definition of each risk rating bucket.

**3. Prudential Limits**

**a. Introduction to Non-Aggregated and Aggregated Limits**

23. Each proposed financing is subject to a number of separate exposure assessments and will be evaluated to ensure that, both on a stand-alone basis and when aggregated with other Exposures to the applicable Financing Recipient, Risk Counterparty, or Group, it complies with relevant limits. Non-aggregated limits are those set out in paras. 25 through 30. Aggregated limits are those set out in paras. 31 through 36.

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<sup>8</sup> ADB. 2006. *Review of Loss Provisioning Policy for Nonsovereign Operations*. Manila.

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24. The prudential limits set out below apply to each proposed financing. However, subject to the provisions of the ADB Charter and the prudential exposure limits policy,<sup>9</sup> the Management may waive the requirements of this OM on a case-by-case basis, considering the structure and objectives of such financing, including any of its risk mitigation aspects.

**b. Single Exposure Limits (Non-Aggregated)**

25. NE limits for single Financing Recipients benefiting from only one form of financing (i.e., either debt, equity, or guarantee, but no combination of these) (Single Exposure Limits) are as follows:

- (i) for loans that are not guaranteed by a Risk Counterparty or Comprehensive Guarantees that are not counter-guaranteed by a Risk Counterparty: the lesser of (a) \$250 million, and (b) an amount equal to 25% of (1) the Total Project Cost,<sup>10</sup> or, in the case of a corporate loan, (2) the total assets of the relevant borrower, provided that in the event the project costs or total assets, as the case may be, are less than \$50 million, the amount under (b) shall be equal to 50% of such project costs or total assets, respectively;<sup>11</sup>
- (ii) for loans that are fully guaranteed by a Related Counterparty, or by Comprehensive Guarantees that are fully counter-guaranteed by a Related Counterparty: the lesser of (a) \$400 million,<sup>12</sup> and (b) an amount equal to 70% of the Total Project Cost, or, in the case of a corporate loan, total assets of the relevant borrower;
- (iii) for Limited Guarantees: the lesser of (a) \$400 million, and (b) an amount equal to 40% of the Total Project Cost, or, in the case of a corporate loan, total assets of the relevant borrower; and
- (iv) for equity investments: the lesser of (a) \$75 million, and (b) an amount equal to 25% of the aggregate issued share capital of the investee or net worth, at the time of ADB's commitment to invest. ADB must not be the largest single investor in an enterprise, and must not assume responsibility for managing the enterprise, except where necessary to safeguard its own investment.<sup>13</sup>

26. To ensure that the amount of economic capital used to support any one NE is capped, with regard to relative risk, at a consistent level,

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<sup>9</sup> ADB. 2007. *Review of Prudential Exposure Limits for Nonsovereign Operations*. Manila.

<sup>10</sup> Total Project Cost as referred to in this paragraph applies to limited recourse project financings, as distinct from corporate financings.

<sup>11</sup> Exposure to any structured financing transaction will be assessed by the Project team on a case-by-case basis, subject to review by Management.

<sup>12</sup> Exposure to Related Counterparty cannot be netted off.

<sup>13</sup> Article 12.4 of the Charter.

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- (i) the Single Exposure Limit of \$250 million referred to in para. 25 (i) will be applicable only to those financings with assigned risk ratings of 1 through 6, while those with ratings between 7 and 10 will, as shown in Table 2, attract lower Single Exposure Limits; and
- (ii) the Single Exposure Limit of \$400 million referred to in para. 25 (iii) will be applicable only to those financings with assigned risk ratings of 1 through 6, while those with ratings between 7 and 10 will, as shown in Table 2, attract lower Single Exposure Limits.

**Table 2: Single Exposure Limits by Rating for Loans and Guarantees**

<b>Assigned Risk Rating Bucket<sup>a</sup></b>	<b>Limit for Loans and Comprehensive Guarantees</b>	<b>Limit for Limited Guarantees</b>
1	\$250 million	\$400 million
2	\$250 million	\$400 million
3	\$250 million	\$400 million
4	\$250 million	\$400 million
5	\$250 million	\$400 million
6	\$250 million	\$400 million
7	\$200 million	\$320 million
8	\$150 million	\$240 million
9	\$100 million	\$160 million
10	\$75 million	\$120 million

<sup>a</sup> See Appendix for indicative definition of each risk rating bucket.

**c. Industry Exposure Limit (Non-Aggregated)**

27. NE to an industry is limited to 30% of the aggregate committed NE with respect to Nonsovereign Operations. NE to an industry includes existing Exposure to all Risk Counterparties including Exposures to Independent Counterparties domiciled in Organization for Economic Cooperation and Development (OECD) or other equivalent countries.

**d. Country Exposure Limit (Non-Aggregated)**

28. NE to a single country is limited to 25% of the aggregate committed NE for Nonsovereign Operations. Actual allocation to individual country limits will be consistent with the country partnership strategy and each country's creditworthiness. NE to a country excludes Exposures to all Risk Counterparties domiciled in OECD or other equivalent countries.

**e. Portfolio Limit – Private Equity Funds**

29. In addition to the prudential Exposure limits set out above, Exposure to equity investments in private equity funds is limited, in aggregate, to 5% of ADB's unimpaired paid-in capital plus reserves and surplus (PRS), calculated at the time of investment.

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**f. Risk Counterparty Limit (Non-Aggregated)**

30. The Exposure in relation to each Related Counterparty under a Syndication Arrangement is limited to the lesser of (i) \$400 million, and (ii) an amount equal to 70% of (a) the Total Project Cost in the case of a limited recourse project financing, and (b) total assets of the relevant borrower, in the case of a corporate loan.

**E. Aggregate Exposure**

**1. Aggregate Exposure to Single Financing Recipient**

31. When ADB provides more than one form of financing to any one Financing Recipient, Aggregate NE must not exceed the following limits:

- (i) for the aggregation of (a) loans, (b) Comprehensive Guarantees, and (c) equity investments: \$250 million; and
- (ii) for the aggregation of (a) any of the financings set out in subparagraph (i), and (b) Limited Guarantees: \$250 million, provided that ADB will discount NE related to Limited Guarantees by a factor of between 10% and 90%, on a case-by-case basis, to reflect the applicable risk taken by ADB.<sup>14</sup>

**2. Aggregate Exposure to Risk Counterparty**

32. The Aggregate NE to any one Related Counterparty is limited to \$600 million.

33. The Aggregate NE to any one Independent Counterparty will be determined on a case-by-case basis by the Management.

**3. Group Exposure Limit (Aggregated)**

34. Aggregate NE limits to a Group are as follows:

- (i) for loans, comprehensive guarantees and equity: \$400 million;
- (ii) for Limited Guarantees: \$600 million; and
- (iii) for equity investments: \$125 million.

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<sup>14</sup> This determination will be made by the Management. Such determination will recognize that a guarantee covering, for example, currency inconvertibility/non-transferability risk associated with a short-term trade-related letter of credit confirmation represents only a fraction of the risk associated with, for example, a "4 point" guarantee covering currency inconvertibility/non-transferability, political violence, expropriation, and breach of contract risks associated with a long-dated project finance transaction in a country with limited foreign exchange reserves, weak governance, and political uncertainty.

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**4. Exposure to Equity Investments**

35. Exposure to equity investments held by ADB will be recalculated from time to time by reference to market value (if a market quotation is available) or fair value of such investment. Should, as a result of such adjustment, ADB's Exposure in respect of equity investments exceed \$250 million in respect of a single investment, or \$400 million in respect of aggregate investments in Financing Recipients within a Group, ADB will use reasonable efforts (subject to legal or contractual restrictions) to enter into a sell-down arrangement, which will bring the Exposure within the limits provided herein.

**5. Aggregate NE to Industry, Country, or Portfolio**

36. The limits for NE to any industry, country, or portfolio when various forms of ADB financing are aggregated are the same as those that apply on a non-aggregated basis (see paras. 27 through 29).

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

ADB. 2007. Doc. R54-07, Review of Prudential Exposure Limits for Nonsovereign Operations. 30 March 2007. Manila.

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

**For inquiries:** Questions may be directed to the Head, Risk Management Unit.

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<b>ADB Rating of Risk Buckets</b>	<b>Rating Definition</b>
1	Has superior debt servicing capacity and no record of nonpayment to ADB or other preferred creditors. This is the highest rating that ADB can assign to its nonsovereign borrowers.
2	Has very strong debt servicing capacity and no record of nonpayment to ADB, but is likely to be affected by adverse regional/global economic conditions and outlook than a borrower receiving Rating 1.
3	Has strong debt servicing capacity, but is more likely to be affected by adverse regional/global economic conditions and outlook than a borrower receiving Rating 2.
4	Has good debt servicing capacity, but such capacity can become marginal should regional/global economic conditions and outlook deteriorate.
5	Has adequate debt servicing capacity and is more likely to become marginal than borrowers that are rated higher, should business, financial, and regional/global economic conditions and outlook deteriorate
6	Has adequate debt servicing capacity and is more likely to default than borrowers that are rated higher, should business, financial, and regional/global economic conditions and outlook deteriorate.
7	Has weak debt servicing capacity and is more likely to default than borrowers that are rated higher, should business, financial, and regional/global economic conditions and outlook deteriorate.
8	Has very weak debt servicing capacity and, to be able to continue servicing its debt obligations to ADB and other preferred creditors, is dependent on nondeterioration of business, financial, and regional/global economic conditions and outlook.
9	Has extremely weak debt servicing capacity and may have some delinquencies on its obligations to commercial lenders. To continue servicing its debt obligation, a borrower receiving Rating 9 is more dependent on positive business, financial, and regional/global economic conditions and outlook than borrowers receiving Rating 8.
10	Borrower has been placed in nonaccrual status.

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**INVESTMENT LIMITATIONS ON NONSOVEREIGN OPERATIONS**

This OM Section does not contain operational procedures.