OPERATIONS MANUAL
BANK POLICIES (BP)

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

FINANCIAL INTERMEDIATION LOANS

A. Introduction

1. Article 14(i) of the *Agreement Establishing the Asian Development Bank* (the Charter) stipulates that ADB may provide loans to financial intermediaries to finance specific development projects whose individual financing requirements are not large enough to warrant the direct supervision of ADB. ADB funds can be directly provided to one or several financial intermediaries depending on their management and administrative capabilities or channeled to financial intermediaries through the government and/or Apex wholesale financial mechanisms,[1] where conditions necessary for their sustainable operation exist. Direct lending to financial intermediaries is usually considered in ADB's ordinary and private sector operations, subject to the nature of the project and the financial intermediary's administrative capacity for complying with ADB monitoring and reporting requirements.[2]

2. Financial intermediation loans (FILs) seek to help achieve a number of objectives: (i) furthering policy reforms in the financial and real sectors; (ii) financing real sector investments through market-based allocation mechanisms; (iii) strengthening the capacity, governance, and sustainability of participating financial intermediaries; and (iv) helping increase the outreach, efficiency, infrastructure, and stability of the financial system.

3. FILs can be provided on a stand-alone basis, or as components of sector development programs or sector or project loans. FILs may be used in conjunction with ADB's guarantee products to enhance the availability of external funds for financial intermediaries. FILs can be provided under ADB's public and private sector windows.[3] This OM section applies to all forms of financial intermediation lending undertaken by ADB.

B. Definitions

4. Under FILs, ADB provides funds to eligible participating financial intermediaries for onlending, at the financial intermediary's credit risk, to final borrowers (subborrowers) for eligible subprojects. "Financial intermediaries" are usually financial institutions that provide finance as their principal or subsidiary function. A "subloan" is a loan made by a

[1] Apex institutions are (usually) financial institutions through which donor-funded financial intermediation loans are channeled to a second layer of financial intermediaries, who will in turn onlend such loan proceeds to the subborrowers. Apex institutions will take the credit risk on the second-tier intermediaries.

[2] See OM Section D1 (Lending and Relending Policies [OCR]).

[3] Also see OM Sections D1/D2 (Lending and Relending Policies [OCR]/[ADF] for FILs with Government guarantees financed from ADB's ordinary capital resources or the Asian Development Fund, and OM Section D10 (Private Sector Operations) for FILs under ADB's private sector window without Government guarantees.

financial intermediary to a subborrower out of the proceeds of an ADB-financed FIL. A "subproject" is the subborrower's investment or economic activity, for which a subloan is provided. "Subborrowers" are entities to which part of the proceeds under an FIL are onlent by the borrower or financial intermediary. Financial intermediaries can also make FIL proceeds available to endusers in the form of financial leases. "Financial leasing" is a contractual arrangement that allows one party (the lessee) to use an asset owned by a financial intermediary (the lessor) in exchange for specified periodic payments.

C. The Policy

5. In connection with FILs, ADB may undertake financial and real sector-related policy dialogue, institution building, and resource transfer to eligible financial intermediaries and subprojects in support of private-sector-driven economic growth and poverty reduction.

6. Financial intermediation lending activities must be consistent with ADB's overall strategy for financial sector development in developing member countries (DMCs), as reflected in the country strategy and program. FILs should contribute to the establishment of financial institutions and systems that can raise and can allocate resources in DMCs in an efficient and sustainable manner. FILs should not discourage domestic resource mobilization or cause market distortions. FILs may be considered when there is effective demand for credit by potential subborrowers and the demand cannot be efficiently met through the domestic financial system due to market failure or structural problems, which are expected to be resolved through policy and institutional reforms, capacity building, and/or improvements in the macroeconomic environment over time.

7. Government policies and the economic environment in DMCs should be conducive to FIL operations. If there are significant constraints in the macroeconomic framework and market distortions in the financial and relevant real sectors that would adversely affect the allocation of FIL funds, FIL operations should only be considered if the government has demonstrated commitment to address critical issues and concerns through appropriate measures.

D. Scope of the Policy

1. Eligible Financial Intermediaries

8. ADB requires financial intermediaries that onlend funds under ADB FILs to meet the following criteria:

(i) financial soundness as evidenced by adequate capital, asset quality, liquidity, and profitability;

(ii) adequate credit and risk management policies, operating systems, and procedures;

(iii) compliance with prudential regulations, including exposure limits;

(iv) acceptable corporate and financial governance and management practices including, among other things, transparent financial disclosure policies and practices;

(v) sound business objectives and strategy and/or plan;

(vi) autonomy in lending and pricing decisions; and

(vii) adequate policies, systems, and procedures to assess and monitor the economic, social, and environmental impact of subprojects in accordance with parameters established by ADB for this purpose.

9. In addition, financial intermediaries should have or build up capacity for mobilizing domestic resources. Financial intermediaries that do not meet all eligibility criteria may still participate in an ADB FIL, if they agree to implement measures to meet these criteria in accordance with a time-bound action plan acceptable to ADB.

10. In the case of microfinance institutions (MFIs), eligibility requirements include a clearly stated commitment to the microfinance business by management and an institutional culture, structures, capabilities, operating systems, and financial position that can support the sustained delivery of microfinance services to the poor. MFIs should be financially viable, or, in the case of new MFIs, have the potential for becoming so over the medium term.

2. Use of ADB Funds

11. FILs can finance subprojects for the production of and trade in goods and services and the development of housing and infrastructure. Subprojects are usually undertaken by the private sector, although public sector subprojects can be considered depending on the sector and country situation. Subprojects must meet criteria stipulated and defined by ADB, including financial and economic viability and positive developmental impact. Subprojects should also comply with the requirements of social and environmental legislation and regulations of the DMC, as well as conform to ADB's safeguard policies.[4] Subborrowers must have acceptable debt/equity ratios (in the case of larger small- and medium-sized enterprise or other companies) and the capacity to repay the subloan, and to provide their own funds in cash or other assets acceptable to ADB to cover part of the total subproject cost.

12. ADB generally does not support directed credit schemes, as these involve the allocation of resources outside market-based mechanisms, which can lead to economic inefficiencies. However, ADB may target FILs at specific types of subproject beneficiaries, such as (but not limited to) microenterprises, small- and medium-sized or export-oriented enterprises, women entrepreneurs, low-income groups, and private infrastructure projects. Such targeting would be done to promote certain development objectives in line with a DMC's poverty reduction and economic growth strategies, as reflected in the country strategy and program. However, beneficiaries should be defined broadly enough to enable financial intermediaries to make prudent lending decisions

---

[4] See OM Sections F1 (Environmental Considerations), F2 (Involuntary Resettlement), and F3 (Indigenous Peoples).

based on commercial considerations. Such FILs should be accompanied by programs and policy reforms that address underlying market imperfections and institutional problems inhibiting market-based credit flows to targeted groups, sectors, or regions.

13. For each FIL, ADB usually specifies, on a case-by-case basis, the maximum amount of eligible subloans to ensure a reasonable number of subprojects taking into consideration project objectives.

14. ADB funds may be used by the financial intermediary recipient of the FIL to finance fixed capital requirements of subprojects, as well as subprojects' foreign exchange requirements for initial working capital (such as initial stock of spare parts, tools, and raw materials) and interest and other charges during construction.[5] If acute balance-of-payments difficulties or other macroeconomic conditions lead to severely curtailed capacity utilization by clients of an ADB-assisted financial intermediary, ADB may consider permitting an existing or new credit line to be used for financing imports of essential inputs needed by the financial intermediaries' clients, subject to case-by-case justification and ADB being satisfied with the financial intermediaries' capabilities for end-use supervision.

15. ADB allows financial intermediaries to use funds provided under FILs to finance the direct and indirect foreign exchange costs[6] of subprojects. ADB may allow financial intermediaries to use foreign exchange provided under FILs to finance local currency expenditures of subprojects within the standard percentage limits under ADB's general local cost financing policy,[7] if justified on country and project grounds.

3. Procurement

16. ADB does not insist on international competitive bidding procedures for procurement under FIL-financed subprojects, but encourages such use where (i) the amount of a subproject investment is unusually large, and (ii) of the procedures foster economy and efficiency.[8] ADB requires financial intermediaries to ensure, through suitable monitoring mechanisms, that subborrowers adopt and implement appropriate procurement procedures for subprojects.

4. Interest Rates

17. Relending rates from the borrower of the ADB FIL to the financial intermediary should have local cost anchors, which best reflect the costs of raising such funds locally and avoid discouraging domestic resource mobilization. If ADB lends directly to financial intermediaries under its public sector window, the loan terms should ensure that guarantee fees paid by financial intermediaries to the DMC reflect this principle by making the costs of the FIL consistent with market conditions. In exceptional and well-justified cases, for example when ADB seeks to support the establishment of MFIs by helping build their capital base and institutional capacity at initial stages of their development, ADB, for a certain period, may accept relending rates that are below

[5] See OM Section H2 (Financing Indirect Foreign Exchange Cost of Projects).
[6] See OM Section H3 (Local Cost Financing and Cost Sharing).
[7] See OM Section H1 (Financing of Interest and Other Charges During Construction).
[8] See OM Section J3 (Procurement).

market, but not below ADB's ordinary capital resources lending rates in the case of a foreign currency-denominated loan or the equivalent rate in the case of a local currency loan, which should reflect an adequate foreign exchange risk premium. However, in such cases, relending rates should not be so concessional as to unduly subsidize the financial intermediary and provide a disincentive for financial and managerial efficiency.

18. Financial intermediaries' and MFIs' onlending rates for subborrowers should be market-based. When there is no market-determined benchmark rate, onlending rates should be adequate to cover all costs and risks associated with onlending, and ensure an adequate profit margin for the financial intermediary.

19. ADB's policy is that generally the financial intermediary recipients of FILs should avoid carrying the foreign exchange risk attached to the FIL. ADB normally expects (but does not require) foreign exchange risks to be passed on from financial intermediaries to subborrowers who can service the loan in foreign exchange. Financial intermediaries operational procedures should ensure that risks assumed by subborrowers (or in exceptional cases the financial intermediary) are adequately mitigated. If subloans are made by financial intermediaries to subborrowers in local currency, onlending rates should include an adequate foreign exchange risk premium. ADB does not object to DMC governments assuming the foreign exchange risk under FILs. However, as a matter of principle, a government subsidy of such costs should be avoided.[9]

5. Repayment

20. ADB generally requires FILs to be repayable within a period of 15 years, including a grace period of up to 3 years; however, this is a guideline and not a requirement. Actual maturities of FILs must be determined by ADB based on the cash flow needs of participating financial intermediaries and their capacity for managing long-term interest and, as necessary, foreign exchange risks. Financial intermediary repayments of FILs may be either in substantial conformity with the composite amortization schedules for subloans (mirror amortization), or on the basis of a fixed amortization schedule. The latter applies only if (i) the financial intermediary is mature and well established; (ii) it is able to protect itself against foreign exchange risks in the intervals between repayments by subborrowers and the financial intermediaries' repayments to ADB (if the FIL is direct to the financial intermediary or the government or Apex institution, as required; or (iii) a large number of subloans make mirror amortization arrangement difficult to administer. When financial intermediaries' loan repayments are not on a back-to-back basis, financial intermediaries may, within their overall amortization schedules, use subloan repayments for purposes that are consistent with their business strategies and the FIL's objectives.

[9] See OM Section H7 (Foreign Exchange Risk).

Basis: This OM section is based on:

ADB. 2000. Doc. R106-00, *Finance for the Poor Microfinance Development Strategy*, 16 May. Manila.

ADB. 2000. Doc. R78-00, *Private Sector Development Strategy,* 6 March. Manila.

ADB. 1987. Doc. R27-87, *Review of ADB Policies on Credit Lines to Development Finance Institutions,* 18 February. Manila.

This OM section is to be read with OM section D6/OP.

Compliance: This OM section is subject to compliance review.

For inquiries: Questions may be directed to the Director, Finance and Infrastructure Division, Regional and Sustainable Development Department.

OPERATIONS MANUAL
OPERATIONAL PROCEDURES (OP)

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

FINANCIAL INTERMEDIATION LOANS

A. Introduction

1. The operational policies and procedures applicable to financial intermediation loans (FILs) or financial intermediation components within other types of ADB loans are generally the same as those for processing other project loans. However, more emphasis is given to assessing the overall policy and institutional framework for the financial sector with the aim of identifying impediments to FIL operations and designing FIL projects that contribute to enhancing the outreach, efficiency, and stability of the financial system.

B. Application of the Policy

1. Project Processing

2. Work on related policy and institutional issues in the financial and relevant real sectors generally precedes FIL processing. During the processing of an FIL or an FIL component, ADB will ascertain that (i) the proposed FIL is an appropriate intervention for achieving the project's objectives and can contribute to sustainable economic growth and poverty reduction, (ii) the proposed FIL will support the development of sustainable finance mechanisms and financial institutions, (iii) the proposed FIL will promote, rather than conflict with, ADB's policy dialogue on financial and real sector issues, (iv) FIL performance will not be unduly affected by market distortions or institutional constraints, and (v) participating financial intermediaries meet general eligibility criteria.[1] Any substantial market failures and distortions that could have an impact on FIL performance need to be thoroughly analyzed during project processing, and FIL disbursements should be made conditional on the adoption and implementation of reforms to overcome such distortions.

3. The selection of financial intermediaries also takes into consideration the nature, size, and location of the target beneficiaries under ABD projects and their financing needs. The financial position and performance of financial intermediaries will be assessed in accordance with special financial intermediary provisions under the *Guidelines for the Financial Governance and Management of Investment Projects Financed by the Asian Development Bank.*[2]

4. The report and recommendation of the President (RRP) for an FIL, or a project with an FIL component, must provide adequate information on the (i) status of and

[1] See OM Section D6/BP, paras. 8 and 9. Financial performance indicators will generally be based on international prudential norms and best practices.
[2] See OM Section G2 (Financial Management Systems, Financial Analysis, and Financial Performance Indicators).

relevant issues for financial sector development; (ii) project's contributions to creating sustainable and efficient financial mechanisms and institutions; (iii) effective demand for the FIL; and (iv) business strategy; financial and operational performance; governance practices; and credit and risk management policies, systems, and procedures of participating financial intermediaries. The RRP must also address eligibility criteria for subprojects and subborrowers, relending rates and justification for any implicit subsidy, onlending conditions, procurement requirements, environmental requirements, and repayment obligations, as required by ADB policies.

2. Monitoring

5. Through appropriate monitoring procedures, ADB seeks to ensure that its funds are used according to the policies and criteria specified in the loan agreement and that the overall viability and the soundness of the financial intermediary is maintained and even strengthened. Monitoring requires a continuous flow of information from financial intermediaries and the government through regular reporting requirements that are specified at FIL appraisal, including the submission of financial statements, project reports, and regulatory agencies' supervision reports of financial intermediaries to ADB, and visits by ADB staff. Project reports should include sufficient information on emerging sector policy issues, financial intermediary performance, subproject performance, subborrowers repayment performance, and subprojects' contributions towards achieving project objectives. In addition, ADB requires financial intermediaries to advise ADB in advance of major decisions on internal and external events, such as mergers and acquisitions, changes in key management officers, and charter changes that may have a significant impact on their organization, management, policies, procedures, and operations.

6. ADB requires participating financial intermediaries to achieve specified minimum levels of performance in terms of solvency, profitability, portfolio quality, and liquidity as reflected by adequate financial ratios throughout FIL implementation, and confirmed by financial statements that are based on accounting and audit principles acceptable to ADB and audited annually by independent auditors acceptable to ADB.[3] ADB may suspend disbursement to financial intermediaries that do not comply with performance criteria for an extended period of time or do not implement acceptable corporate and financial governance practices.

7. ADB generally allows financial intermediaries to enter into subloans meeting agreed criteria without submitting subloan proposals to ADB for amounts up to an agreed "free limit". The requirement of a free limit, above which subloan proposals need to be submitted by the financial intermediary to ADB for prior approval, enables ADB to satisfy itself on the quality of the financial intermediary's appraisal of projects and advise on appraisal techniques and methodology. The free limit is decided on a case-by-case basis during FIL appraisal, taking into consideration the financial intermediary's record of performance, its management competence, appraisal standards, portfolio quality, average loan size, and the type and expected size of subloans under the FIL. In addition, ADB normally requires the financial intermediaries to submit the first two or three subloans to be financed under the FIL for ADB's review.

---

[3] See also ADB. 2002. *Guidelines for the Financial Governance and Management of Investment Projects Financed by the ADB.* Manila, for financial intermediary financial reporting requirements.

8. ADB will regularly assess FILs' contributions to financial sector and socioeconomic development, including improvements in the subborrowers' financial and operational performance and the impact of subprojects on employment, regional development, and poverty reduction, as appropriate. If subprojects are unable to achieve the required performance targets as a consequence of significant distortions in the market environment, ADB will seek to discuss appropriate remedial measures with the Government.

9. Financial intermediaries must adopt an appropriate environmental management system that will cover the environmental assessment process of all subprojects to be financed with ADB funds. However, for FILs for microfinance projects where all subprojects will result in insignificant environmental impacts, or for other FILs where it can be clearly demonstrated that this is the case, financial intermediaries are not required to adopt an environmental management system or environmental assessment report. For category A and environmentally sensitive B subprojects above the free limit, the environmental impact assessment (EIA) or initial environmental examination (IEE) must be cleared by ADB before subproject approval. The summary EIA or summary IEE must be disclosed to the public at least 120 days before the subproject is approved. For these subprojects, ADB will review compliance with its environmental assessment requirements, including those related to consultation and information disclosure. For subprojects below the free limit, ADB reserves the right to review the subproject proposal and its EIA or IEE.[4]

10. ADB review missions will assess financial intermediaries' monitoring of FIL subborrowers' procurement practices by reviewing, on a random basis, relevant documentation obtained by financial intermediaries. To facilitate monitoring by ADB and financial intermediaries, ADB may request that subborrowers obtain a preshipment inspection certificate for items whose values exceed a certain limit, certifying the free on board value and the country of origin of such procurement from an agency acceptable to ADB.

3. Confidentiality

11. In processing of subproject proposals and reviewing financial intermediaries and ADB-assisted subprojects, ADB respects the confidentiality of commercially and market sensitive information received from financial intermediaries and subborrowers, as well as other sources, regarding subprojects and the financial position of financial intermediaries.[5]

---

[4] See OM Section F1 (Environmental Considerations).
[5] See OM Section L3 (Confidentiality and Disclosure of Information).

Basis: This OM section is based on OM Section D6/BP and the documents cited therein.

This OM section is to be read with OM Section D3/BP.

Compliance: This OM section is subject to compliance review.

For inquiries: Questions may be directed to the Director, Finance and Infrastructure Division, Regional and Sustainable Development Department.