

OPERATIONS MANUAL POLICIES AND PROCEDURES

These policies and procedures were prepared for use by ADB staff and are not necessarily a complete treatment of the subject. This *Operations Manual* was prepared by the Finance Sector Office and issued by the Strategy, Policy, and Partnerships Department with the approval of the President and is subject to compliance review. Questions may be directed to the senior sector director of the Finance Sector Group.

FINANCIAL INTERMEDIATION LENDING

A. Scope

1. Article 14(i) of the Agreement Establishing the Asian Development Bank (ADB) (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 public 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. **Objectives.** Financial intermediation loans (FILs) seek to help achieve several 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 financial intermediaries; and (iv) helping increase the outreach, efficiency, infrastructure, and stability of the financial system.

3. **Financial intermediation lending operations.** 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 *Operations Manual* section applies to all forms of FIL undertaken by ADB.

4. **Definitions.** Under FIL, ADB provides funds to eligible 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 financial intermediary to a subborrower out of the proceeds of an ADB-financed FIL. A "subproject" is the subborrower's

¹ Apex institutions are (usually) financial institutions through which donor-funded FILs 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. In this *Operations Manual*, "FIL" refers to financial intermediation lending or a financial intermediation loan, as the context requires. The term "borrower" includes loan and grant recipients.

² ADB. 2023. Lending Policies for Sovereign and Sovereign-Guaranteed Borrowers (Regular Ordinary Capital Resources). *Operations Manual*. OM D1. Manila; and ADB. 2022. Lending and Grant Policies (Concessional Assistance). *Operations Manual*. OM D2. Manila.

³ For FILs with government guarantees financed from ADB's regular ordinary capital resources or concessional ordinary capital resources lending, also refer to footnote 2. For FILs under ADB's private sector window without government guarantees, also refer to ADB. 2016. Nonsovereign Operations. *Operations Manual*. OM D10. Manila.

OPERATIONS MANUAL POLICIES AND PROCEDURES

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 end users 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.

B. Strategic Considerations for Financial Intermediation Lending

5. Through 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. FIL activities must be consistent with ADB’s overall strategy for finance sector development in developing member countries (DMCs), as reflected in the country partnership strategy. 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.

C. Eligibility of Financial Intermediaries

8. **Eligible financial intermediaries.** 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.

OPERATIONS MANUAL POLICIES AND PROCEDURES

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.

D. 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 enterprises 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 the DMC's poverty reduction and economic growth strategies, as reflected in the country partnership strategy. However, beneficiaries should be defined broadly enough to enable financial intermediaries to make prudent lending decisions 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 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 financing charges during implementation. 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

⁴ ADB. 2013. Safeguard Policy Statement. *Operations Manual*. OM F1. Manila.

OPERATIONS MANUAL POLICIES AND PROCEDURES

may consider permitting an existing or new credit line to be used for financing imports of essential inputs needed by the financial intermediaries' clients. This is 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 costs⁵ 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,⁶ if justified on country and project grounds.

E. 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) the procedures foster economy and efficiency.⁷ ADB requires financial intermediaries to ensure, through suitable monitoring mechanisms, that subborrowers adopt and implement appropriate procurement procedures for subprojects.

F. Financing Terms

17. **Interest rates.** Relending rates from the borrower of 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 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. Generally, the financial intermediary 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

⁵ ADB. 2023. Cost Sharing and Eligibility of Expenditures for ADB Financing. *Operations Manual*. OM H3. Manila.

⁶ ADB. 2023. Financing of Interest and Other Charges During Implementation. *Operations Manual*. OM H1. Manila.

⁷ ADB. 2013. Procurement. *Operations Manual*. OM J3. Manila.

OPERATIONS MANUAL POLICIES AND PROCEDURES

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.⁸

20. **Repayment.** 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 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.

Basis

ADB. 1987. *Review of ADB Policies on Credit Lines to Development Finance Institutions*. Manila.

Other background information and references

ADB. 2000. *Finance for the Poor Microfinance Development Strategy*. Manila.

ADB. 2000. *Private Sector Development Strategy*. Manila.

⁸ ADB. 2023. Foreign Exchange Risk. *Operations Manual*. OM H7. Manila.