ADB

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Review of ADB's Credit Enhancement Operations

Asian Development Bank

ABBREVIATIONS

ADB	—	Asian Development Bank
CEC	–	Credit Enhancement Committee
CEP	–	credit enhancement product
CEPG	–	Credit Enhancement Practice Group
CFS	–	Complementary Financing Scheme
CTL	–	Controllers Department
DMC	–	developing member country
EBRD	–	European Bank for Reconstruction and Development
ECA	–	export credit agency
FDI	–	foreign direct investment
FPS	–	Financing Partnership Strategy
GOR	–	guarantor-of-record
IEI	–	Innovation and Efficiency Initiative
IFC	–	International Finance Corporation
LOR	–	lender-of-record
MDB	–	multilateral development bank
MIGA	–	Multilateral Investment Guarantee Agency
MTS II	–	second medium-term strategy
OCO	–	Office of Cofinancing Operations
OCR	–	Ordinary Capital Resources
OECD	–	Organization for Economic Cooperation and Development
OGC	–	Office of the General Counsel
OM	–	Operations Manual
PCG	–	partial credit guarantee
PPP	–	public-private partnership
PRG	–	political risk guarantee
PRI	–	political risk insurance
PSOD	–	Private Sector Operations Department
RDs	–	Regional Departments
RMU	–	Risk Management Unit
SI	–	staff instruction
TCI	–	trade credit insurance
TD	–	Treasury Department

GLOSSARY

“A” loan	–	An ADB loan funded by ADB with its own resources.
“B” loan	–	An ADB loan funded by third parties without recourse to ADB. A form of “funded risk participation” by the third parties, with ADB acting as lender-of-record.
credit enhancement	–	The improvement in the risk profile of a credit, and reduction in a creditor’s risk of financial loss due to default of the obligor, through risk transfer or sharing with a third party.
credit enhancement product	–	A financial instrument that provides credit enhancement.
cofinancing	–	Shared financing with a third party (other than the project sponsor) on a transaction-specific basis for a project or program associated with ADB funds, risk taking, or administrative involvement.

complementary financing scheme	–	A prearranged sale by ADB as a lender-of-record to commercial lenders of participations in a “B” loan.
export credit agency	–	A government-owned or -supported organization designed to support the flow of exports from its home country through the provision of loans, guarantees, and other forms of credit.
guarantee	–	An undertaking by the issuer of a guarantee (guarantor) to an assigned beneficiary (guarantee holder) to honor a financial or performance obligation on behalf of an obligor, thereby reducing the guaranteed risks to such beneficiary. A credit enhancement to the beneficiary and a contingent liability to the guarantor.
guarantor-of-record	–	A guarantor who issues a guarantee contract in its name on behalf of one or more other guarantors, which assume all guaranteed risks under a syndication or participation arrangement. The guarantor-of-record maintains sole responsibility for administering all aspects of the guarantee on behalf of the participants.
insurance	–	A contract (policy) whereby a party (the insured) receives compensation from another (the insurer) for losses arising from certain defined risks under certain conditions, in exchange for the payment of a premium. It is based on a concept of mutual risk sharing and loss probabilities, whereby premiums received are pooled to cover expected claims.
lender-of-record	–	A lender who issues loan documents in its name on behalf of one or more financing participants, subject to all credit risk relating to such loan being borne by the financing participants, each of whom has entered into a participation agreement with the lender-of-record (LOR). The LOR maintains sole responsibility for administering disbursements and repayments of the entire loan amount. LOR facilities may be used in conjunction with other CEP arrangements, whereby the LOR will reassume certain of the risks originally passed through to the participants.
non-sovereign operation	–	A financing operation without direct sovereign indemnity or any other form of direct recourse to a sovereign government as obligor.
moral hazard	–	The risk that a guaranteed or insured party will act negligently as a result of the passage of risk to the guarantor or insurer.
obligor	–	A person or legal entity that has contractually committed to perform an obligation (for example, the payment of principal or interest, or both, due under a loan).
partial credit guarantee	–	A guarantee that provides comprehensive risk coverage for a specified portion of a debt service obligation.
political risk guarantee	–	A guarantee that covers an obligation (such as debt service) against specific risks of a political nature (usually directly or indirectly related to government action), such as currency inconvertibility or non-transfer, expropriation, or breach of contract. It may also include political violence.
political risk insurance	–	A specialist line of insurance that provides conditional protection against a wide variety of political risks.

preferred creditor status	–	A de facto preferential access to foreign exchange and exemptions from transfer restrictions imposed by a host country.
public-private partnership	–	A cooperative venture between the public and private sectors, often through a contractual arrangement where the private sector supplies assets and/or services of a public nature traditionally provided for by the government. The government may be the main purchaser of the services, but private operators may also sell them directly to private consumers, typically under a concession. Public-private partnership financing is often arranged via a special-purpose vehicle.
reinsurance	–	A contractual agreement by an insurer or guarantor to transfer all or part of a liability to another insurer or guarantor. Loss may be shared for an individual transaction (facultative reinsurance) or for an entire portfolio (treaty reinsurance).
reputation risk	–	The risk of loss of goodwill that financing partners, clients, and other stakeholders place in working with ADB.
sell-down	–	An arrangement that allows the complete transfer (sale) of a financing or risk by one financier to another, without any further obligation to such seller.
sovereign operation	–	A financing operation with a sovereign government as primary or secondary obligor under a contractual arrangement.
sub-sovereign operation	–	A financing operation to a government entity other than a sovereign government, without direct sovereign indemnity.
syndication	–	The pooling of financing and sharing of risk among financiers. One financier (arranger) may lead the process and issue a single document in its name to represent all participating financiers.
syndicated loan	–	A usually large loan in which a group of lenders work together to provide funds to a borrower. The arranger usually keeps only a small percentage of the loan and syndicates the rest to other banks.

NOTES

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

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EXECUTIVE SUMMARY

Substantial investment gaps impede sustainable development and poverty reduction in many developing countries in Asia and the Pacific. The financing needs of these countries far exceed their resources and those of the official agencies created to assist them. At the same time, there is high liquidity within the region and elsewhere, but this is often not directed toward development projects as a result of perceived political or credit risk.

The Asian Development Bank's (ADB's) credit enhancement products (CEPs) in the form of guarantees and syndication arrangements can help bridge these investment gaps and contribute significantly to meeting ADB's development objectives. ADB is one of only a few triple-A-rated guarantee providers in the world and its CEPs are highly valued by the market. Yet, ADB has not made the most of their potential.

The changes proposed in ADB's policy and operating framework for CEPs will improve ADB's ability to support commercial cofinancing and leverage investment for projects and programs supported by ADB. The proposals are fully consistent with ADB's strategies and Management for Development Results reform agenda, including its innovation and efficiency initiative, second medium-term term strategy and financing partnership strategy (FPS), among others. They update and define the basic principles underlying the application of ADB's CEPs. In particular, they clarify:

(i) **Scope and scale.** Clear boundaries with flexibility to support a wide range of financing solutions with a wide range of partners are proposed. These facilitate improved access to ADB's guarantees and promote operational relevance in support of ADB's country or regional strategies.

(ii) **Risk management.** Risk management principles, processes, and boundaries are defined more clearly. As strong growth is expected in private sector and public sector operations without direct sovereign recourse, CEPs will encourage risk sharing with competent financing partners at various stages of the project cycle, to ensure a better-balanced portfolio.

(iii) **Pricing.** Pricing structures will be simpler and more transparent. For transactions without direct sovereign indemnity, pricing will consider risk, market and project specific factors, and allow ADB to compete with, but not to distort, the market. Sovereign counter-indemnities for ADB's guarantee operations may also be considered, if this translates into clear project benefits and improved development impact.

The implementation plan of this new framework calls for operational adjustments. It clarifies responsibilities and defines activities and parameters that ensure transparency and integrity of ADB's CEP-related operations. Consistent with the FPS, the changes will include improvements in:

(i) **Transaction and portfolio management**. CEP operations will be better aligned with ADB's business processes and integrated in country operations. Design and due diligence of financing structures will be led by operational departments, with support from other departments as appropriate. The Office of Cofinancing Operations (OCO) will arrange and finalize all reinsurance and syndication arrangements and undertake due diligence related to counterparty risk. Technical committees will ensure the integrity of risk management and pricing, as well as claims management.

(ii) **Product development, innovation, and knowledge management.** Emphasis on these aspects will ensure the continued relevance of ADB's product range and full understanding of those products by ADB staff and the market. OCO will have primary responsibility for this area.

(iii) **Relationship management.** Good relationships are the foundation for the successful application of CEPs, and increased attention will be given to them. Relationships will be maintained at the transaction level by the operational departments, and by OCO at the institutional level. Strong coordination will be required.

(iv) **Monitoring and reporting.** Improved input and access to information will allow for better monitoring of activities, reporting of exposures, and facilitate coordination and oversight.

The new framework will make ADB's CEPs more accessible, transparent, and consistent with best industry practices. It is based on lessons from the past, an analysis of trends and challenges ahead, and feedback from cofinancing partners. These partners want ADB to adapt more quickly to changing conditions in the market. They want better-defined, more comprehensive guarantees. They want more creative solutions to meet the growing needs of public-private partnerships and capital markets. And they want to work with an ADB that delivers on its potential.

The implementation of the new CEP framework will be in line with the phased-in approach of the FPS. Resources will be adjusted further as progress is made. During the first phase, emphasis will be on upgrading skills related to CEPs across ADB and adapting to new processes and approaches. Some activities, in particular those related to knowledge and relationship management, will be emphasized more strongly. Administrative efficiencies will be realized over time through synergies, improved coordination and information systems to avert duplication of efforts.

Teamwork and collaboration within ADB is the key successful credit enhancement operations. An important element in this will be ADB's ability to overcome internal boundaries, capitalize on its synergies, and speak with one voice to clients and financing partners.

If properly translated into action, the new framework for ADB's credit enhancement operations will effectively leverage ADB's balance sheet and development impact for poverty reduction in the Asia and Pacific region.

I. INTRODUCTION

1. **Strategy and Policy Context.** The Asia and Pacific region (the Region) faces ongoing challenges in generating the investment required to provide sustained support for economic growth and poverty reduction. The Asian Development Bank (ADB) is refining its policies and strategies to meet Asia's broader development challenges, and the demand of its clients. The framework provided by the Poverty Reduction Strategy[1] (PRS), Long-Term Strategic Framework[2] (LTSF), and the Second Medium-Term Strategy[3] (MTS II) emphasizes ADB's role as a catalyst in generating investment. The MTS II, in particular, emphasizes the importance of leveraging ADB's resources through improved cofinancing arrangements.

2. ADB's Financing Partnership Strategy (FPS)[4] builds further on the MTS II and other recent ADB initiatives[5] that seek to improve ADB's effectiveness to better address the Region's development needs. The FPS aims to improve development effectiveness, through partnerships that improve project structures and financing terms as well as increase in financial resource transfer along ADB's assistance to its developing member countries (DMCs). It also calls for the review and update of ADB's key partnership instruments to meet the challenges ahead. The increased application of ADB's credit enhancement products (CEPs) is an important element of this.

3. ADB's CEPs are risk-sharing and management tools—in the form of guarantees and syndications—similar to those widely used in the banking and insurance business to reduce or eliminate a range of risks for ADB's commercial cofinancing partners.[6] CEPs support ADB's developmental objectives by facilitating investment, trade, and capital flows into ADB's DMCs, reducing commercial and political risks,[7] and sharing ADB's de facto preferred-creditor status.[8] At present, ADB's range of CEPs comprises the Complementary Financing Scheme (CFS), Political Risk Guarantee (PRG), Partial Credit Guarantee (PCG), and Guarantor-of-Record (GOR) scheme. These products were established through various policy papers,[9] revised most recently in 2000. An overview and summary description of key features of ADB's CEPs is in

[1] ADB. 1999. *Poverty Reduction Strategy*. Manila (R179-99); and ADB. 2004. Review of the ADB's *Poverty Reduction Strategy*. Manila (R95-04).
[2] ADB. 2001*. Long-Term Strategic Framework of ADB 2001–2015*. Manila (Sec.M17-01).
[3] ADB. 2006. *Second Medium-Term Strategy*. Manila (Sec.M26-06).
[4] ADB. 2006. *ADB's Financing Partnership Strategy*. Manila (Sec.M56-06).
[5] This includes a variety of initiatives linked to ADB's Management for Development Reform (MfDR) agenda, such as the innovation and efficiency initiative (IEI) launched by ADB's Management in 2004 to modernize, among others, business processes and financial products; ADB's revised strategic framework for private sector development; reforms related to ADB financing of technical assistance and knowledge products; management of risk exposure limits; and LIBOR-based lending products.
[6] ADB's Charter refers to the term "guarantees." If they are conditional, the insurance market, which is offering similar products, would refer to them as "insurance." If they are unconditional with automatic payout in the event of a claim, they are often referred to as "financial guarantees." ADB's guarantees can be both conditional and unconditional.
[7] Political risks are often also termed "country" or "sovereign" risks. They are non-commercial, and relate to government actions (or inactions) that may cause a payment default. The term "political risk" is used throughout this paper to refer to such risks, consistent with industry terminology.
[8] ADB's de facto preferred-creditor status (PCS) provides for preferential access to foreign exchange and allows for relief in the capital provisioning of banks under the Basel II Capital Accord. ADB will only share its PCS and CEPs for financing that is outside of official development assistance (ODA).
[9] ADB. 1982. *Co-Financing with Commercial and Export Sources*. Manila (R89-82); ADB. 1987. *The Bank's Guarantee Operations*. Manila (R140-87); ADB. 1992. *Review of* the *Bank's Guarantee Operations*. Manila (Working Paper 4-92); ADB. 1995. *The Bank's Cofinancing Strategy*. Manila (R80-95); ADB. 1995. *Review of the Bank's Guarantee Operations.* Manila (R81-95); ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila (R135-99); ADB. 2000. *Partial Credit Guarantee Charges*. Manila (R88-00); and ADB. 2000. *Review of the Partial Risk Guarantee of the ADB.* Manila (R299-00). In addition, reinsurance and syndication activities were further specified in ADB. 2005. *Financing Modalities and Instruments*. Manila (R194-05).

Appendix 1. The ever-changing financial market environment and adjustments in ADB's strategic framework warrant the review and update of ADB's CEPs to ensure their continued relevance and to make the best use of their potential.

4. CEPs similar to those offered by ADB have become important for a variety of public and private sector organizations and have become critical to the flow of capital and goods into developing countries. The ongoing debate about the role of multilateral development banks (MDBs) increasingly recognizes the importance of making greater use of the risk mitigation potential inherent in their unique multilateral structure,[10] which sets MDBs apart from commercial financiers by allowing them to complement, rather than compete with, the global investment marketplace.

5. **Purpose.** The purpose of this paper is to clarify policy principles, operating parameters, and measures for the application of CEPs to support ADB's developmental objectives and overarching goal of poverty reduction. It defines ADB's position on CEPs, consistent with ADB's FPS (footnote 4). It is based on market trends, demands, and a review of ADB's past experience. This shall result in the increased utilization of CEPs to substantially leverage ADB's limited resources, encourage the active engagement of financing partners, and emphasize ADB's comparative advantages in the marketplace.

6. **Structure.** Section II provides an overview of the role and benefits of CEPs, key industry trends, and the history of ADB's CEPs, as well as the lessons learned through their use since the 1980s. Section III proposes a new CEP policy and operating framework to make ADB's CEPs more widely used and to respond to demands of financing partners in DMCs. Section IV outlines key implementation aspects. Section V contains the recommendation.

II. ADB'S CREDIT ENHANCEMENT OPERATIONS IN PERSPECTIVE

A. Why Use CEPs?

7. **Leverage ADB's Capital Base to Finance Development.** A considerable investment gap and widespread poverty continue to impede growth in many developing countries in the Region. The financing requirements of the Region's developing countries far exceed the resources at the disposal of the countries themselves and the official agencies created to assist them. A joint study prepared by ADB, the Japan Bank for International Cooperation (JBIC), and the World Bank[11] and published in 2005 estimated that infrastructure investment needs in 21 developing countries in East Asia would reach $200 billion per year over the next 5 years. The private sector is recognized as a significant financing source for meeting developing country investment requirements, but financial markets remain largely untapped for this purpose and have yet to live up to their potential.[12]

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[10] See the World Economic Forum. 2006. *Building on the Monterrey Consensus: The Untapped Potential of Development Finance Institutions to Catalyse Private Investment,* which argues strongly for MDBs to better use guarantee and risk mitigation instruments and capabilities to attract increased commercial investment in development projects.

[11] ADB, JBIC, and World Bank. 2005. *Connecting East Asia: a New Framework for Infrastructure*. 2005. Manila, Tokyo, and Washington, DC.

[12] It is estimated that less than 15% of all foreign direct investment in Asia is provided for infrastructure.

8. There is broad agreement among the participants in the World Economic Forum's Financing for Development Initiative[13] that development finance institutions (DFIs) such as ADB can do much more to help unlock the potential of the world's private capital markets to help finance development, by promoting risk mitigation products like CEPs. The Forum specifically asserts:

> The weight of DFI activities should shift over time from direct lending to facilitating the mobilization of resources from the world's large private savings pools for development oriented investments through wider use of risk mitigation instruments to alleviate part of the risk faced by investors and stronger direct support for capacity building to strengthen the enabling environment for investment. DFIs should adapt their services, culture and capital allocation to the imperative of crowding in domestic and foreign private investment by placing more emphasis on such risk mitigation instruments as partial (risk) guarantees and on capacity building.[14]

9. This further reinforces ADB's mandate to act as a catalyst for investment in its DMCs and promote sustainable development to help reduce poverty. By assuming risks that commercial institutions are not well equipped to accept, ADB can crowd in a larger number of financing partners with longer-term finance into areas that may be considered commercially too risky to venture in alone. ADB is in a better position to manage some risks because of its understanding of, and potential influence over, regulatory or macroeconomic policy aspects in its DMCs. By promoting risk-sharing arrangements, ADB can magnify DMC developmental benefits while leveraging its capital many times over.

10. **Instill Market Discipline in ADB Operations.** Financing partnerships through credit enhancement not only leverage the impact of ADB's direct assistance but also introduce market discipline into loan structuring and pricing by considering market benchmarks, particularly for financing operations without sovereign guarantees (non-sovereign operations). In particular, syndications can help ensure that guarantees and loans extended by ADB are consistent with prevailing market terms and conditions.

11. **Fulfill ADB's Institutional Mandate.** Financing partnerships are an integral part of ADB's development mandate. The Agreement Establishing the Asian Development Bank (the Charter) directs ADB to promote public and private capital investment in its DMCs and cooperate with other public or private organizations, while providing guarantees to third parties, to leverage its resources for development.[15] The Charter also affords ADB institutional privileges and immunities that place it in a favorable position to absorb political and commercial risks that commercial financiers typically do not want to accept. These privileges and immunities relate primarily to preferential treatment with respect to the risks of currency inconvertibility or non-transfer, and expropriation. The net result of this is a perception in the commercial lending and investment marketplace that MDBs like ADB possess "deterrent benefits" that discourage host governments from taking actions contrary to the interests of the trade and investment

[13] These participants comprise more than 200 global experts from financial institutions, corporations, governments, international organizations, universities, and nongovernmental organizations, who offer their views on improving the effectiveness of official sector efforts to stimulate private sector investment in developing countries.
[14] WEF. 2006. *Building on the Monterrey Consensus: The Untapped Potential of Development Finance Institutions to Catalyze Private Investment*.
[15] Specifically, Article 2 of the Charter mandates ADB to promote public and private capital investment. The article also directs ADB to cooperate with international and national agencies and public and private sector institutions that share the common objective of catalyzing development funds in the Region and to elicit the interest of such institutions in new opportunities for investment and assistance. Article 11 further stipulates that ADB should facilitate financing through guarantees.

transactions in which MDBs participate. DMC membership in ADB and ADB's long-term relationship with host governments also contribute to the deterrent benefits.

B. Why Share Risks with ADB?

12. ADB has unique selling points that provide it with comparative advantages vis-à-vis its public and private sector financing partners in this area. These include its (i) regional focus, (ii) triple-A rating, and (iii) willingness to help facilitate transactions with high perceived political or commercial risk. The Charter protects ADB against the risks of financial loss through expropriation and currency inconvertibility or non-transfer, reinforcing the benefits inherent in its CEPs. Beyond this, ADB has superior relationships with its DMC governments that enable it to better mitigate political risks than many commercial parties.

13. ADB has, to a limited degree, successfully leveraged these advantages to promote development by issuing CEPs for projects in its DMCs. Indeed, ADB is widely recognized as the Region's premier development institution. The commercial financing and insurance marketplace is aware of ADB's CEPs, and many commercial lenders seeking a partner who can assume higher levels of perceived political or commercial risk are keen to work with ADB, provided ADB can offer the right product mix and approaches.

C. Trends and Expectations

1. The Market Environment

14. **Volatile and Dynamic.** A series of financial crises since the 1990s and the catastrophic terrorist attacks in the United States on 11 September 2001 (9/11) dramatically transformed the political risk insurance (PRI), trade credit insurance (TCI), and financial guarantee markets. Not only did underwriting become more conservative, but much greater attention was paid to accounting practices, transparency, and risk management. From a risk management perspective, the net result was positive in the sense that underwriting discipline became more pronounced; however, investors and lenders of risk-laden transactions found it more difficult to obtain protection from insurers and guarantors. Underwriting markets consolidated, to a limited degree, but most providers ultimately weathered the storm successfully and managed to stay afloat. At the same time, the continued challenges fostered a high degree of innovation in the market.

15. **Supply**. The dramatic decline in cross-border project financing as a result of the 1997 Asian Crisis and 9/11 led to a notable weakening of demand for PRI/TCI. Similarly, reinsurers largely withdrew their support for direct insurance underwriters of terrorism, political violence, breach of contract, and similar coverage. These two trends combined, plus a series of losses sustained by underwriters in the aftermath of the Argentine and Russian financial crises, prompted many underwriters to substantially reduce the amount of PRI/TCI coverage that was available. Likewise, some of the specialist monoline credit insurers operating in emerging markets were particularly hit by the Asian and other regional financial crises. In the aftermath, many commercial banks also significantly decreased their lending lines in the developing world. There has been a rebound since 2002, but suppliers of credit enhancement products have learned their lessons and become increasingly risk-conscious.

16. **Demand**. After the 1997 Asian crisis, lenders and investors from the developed world were generally hesitant to make infrastructure investments in the developing world, and Asia in

particular. Also, with insurance premiums becoming more costly in general (partly because of the insurance business cycle, as well as the withdrawal of support from some reinsurers for certain types of business, particularly after 9/11), investors had fewer funds to purchase cover. Risk managers came to view PRI/TCI as a "luxury" that might be purchased if funds were left over from the purchase of "essential" coverages (such as property and liability insurance). Since 2003, however, demand has picked up. Partly, this is because of an increasing recognition that risk mitigation is important to make projects bankable, particular in the competition for international finance, as lenders have become more cautious. Capital flows have returned to Asia, and although there has been little in the way of greenfield infrastructure projects since then, there has been significant merger and acquisition activity, which has fueled demand for PRI/TCI coverage. Also, the commodity boom has served to raise demand for trade-related coverage.

17. **Market Gaps and Challenges.** There remain capacity gaps in medium- and long-term credit insurance, insurance against terrorism and political violence, and insurance against risks associated with large and long-term infrastructure projects. Another acute (and ongoing) area of need is currency devaluation/fluctuation coverage, as well as coverage of regulatory risks. Many market participants agree that hard currency–denominated infrastructure finance will shift increasingly in favor of local currency finance in the future.

2. Product Trends

18. Feedback gathered by ADB from a wide variety of stakeholders from the public and private sector, including banks, export credit agencies, brokers, and insurers, among others, reveals the following key developments in various product segments.

a. Guarantee and Risk Transfer Products

19. **Political Risk Insurance.** The PRI marketplace (which includes PRG providers) evolved from three or four large players in the 1980s to double that number in the 1990s. The investment boom in the developing world in the 1990s, led by project finance, increased the demand for PRI. The reduction in PRI use since 1997 has made PRI providers better attuned to demand for the product.[16] At the same time, they have had to be more creative in providing products that end users actually want to buy, while not pushing the risk-taking envelope so far that reinsurers and their own boards of directors would reject what they are trying to do. Products that cover local currency and sub-sovereign lending are becoming in greater demand. The majority of the PRGs ADB has provided have been private sector–oriented, including PRGs for public-private partnerships (PPPs).

20. **Partial Credit Guarantees.** With the gradual introduction of the Basel II accord on capital adequacy,[17] the banking industry has increasingly been looking at ways and means to remove or reallocate as much risk as possible from bank balance sheets. Demand for comprehensive guarantees (in the form of standby letters of credit issued by specialist banks, export credit guarantees from some OECD export credit agencies (ECAs), or PCGs from MDBs, for example) that address both political and commercial risks has grown considerably since 1997

[16] The fallout from the Asian financial crisis, from the PRI providers' perspective, was that purchasers of PRI became much more selective in their purchases of the product, and underwriters became more attuned to the coverage they were providing. The Asian financial crisis served to raise questions about some rather basic underwriting assumptions, as well as PRI purchasers' beliefs about what they had bought.

[17] Bank for International Settlements. 2006. *Basel II: Revised International Capital Framework.* Basel.

for that reason. Many credit guarantee providers have responded to this leap in demand for comprehensive guarantees by offering more types of products.

21. Substantial growth in demand for this product is expected, as (i) borrowers operating in emerging markets often have difficulty securing long-term financing and banks are generally short- or medium-term lenders (5 to 7 years at most); and (ii) lenders and investors are often uncomfortable lending to or investing in projects in emerging markets.

22. The PCG can be tailored to address issues faced by both borrowers and lenders. Furthermore, the explosive growth in the international and domestic bond markets has provoked much greater interest among emerging market borrowers in accessing the bond markets with an ADB PCG. The flexibility of the PCG product also makes it an ideal tool for the development of the domestic capital markets in Asia, as the PCG can be used to credit-wrap innovative transactions like securitized bond issues.

23. **Trade Products.** Demand for PRI is becoming more and more trade-related. The provision of short-term trade TCI has shifted from a large number of ECAs to a handful of private sector insurance companies. This is generally seen as a positive trend, but could cause a problem in the future should there be a catastrophic event resulting in substantial losses to the insurance sector or a regional financial crisis causing international banks to cut or cancel country and local bank limits without the benefit of an appropriate TCI.

24. **Reinsurance**. Reinsurance is a common risk management tool widely used by guarantors and insurers to reduce their level of retained risk, and to balance the risk profile of their portfolio. The concept is similarly used in the banking business through syndications and risk participations among financial institutions. The use of reinsurance has become more important since the Asian financial crisis and 9/11, given that risk retention appetites have in general diminished. Nearly all PRI/TCI underwriting programs use some form of reinsurance, the most common being facultative reinsurance, which applies to individual transactions (as opposed to treaty reinsurance, wherein every transaction is automatically reinsured).

b. Risk Sharing and Pooling Products

25. **Complementary Financing Scheme and Syndications**. The CFS is a form of loan syndication whereby ADB acts as lender-of-record (LOR) but sub-participates the loan to one or more banks that are providing the financing. The use of the CFS (commonly referred to in comparator organizations as “B” loans) went into a period of decline from the mid-1990s. One reason for this was the fact that users of “B” loans often did not fully understand what they were purchasing. Hence, when a number of transactions met problems, the purchasers of the “B” loans pursued remedies with the issuers of the loans only to learn that the remedies they expected were not there. In short, the deterrence and resolution capabilities they thought they had secured by participating in “B” loans with MDBs largely did not exist.[18] However, requests for “B” loans have started to pick up again. To some extent, this is supported by the favorable treatment of “B” loans under Basle II (footnote 17), refined risk management frameworks at international banks and better product understanding.

[18] In other words, purchasers of “B” loans failed to realize that they were buying little more than “umbrella” protection in the form of having an MDB standing behind them in the event of a claim, with benefits restricted to foreign exchange access, but they did not get the indemnity protection normally associated with insurance or guarantee products.

26. Syndications using “B” loans or otherwise are considered an important activity for some MDBs, such as the International Finance Corporation (IFC) or European Bank for Reconstruction and Development (EBRD). The Multilateral Investment Guarantee Agency (MIGA) also routinely uses syndication for risk sharing on its guarantee operations. These organizations have dedicated operations that syndicate participations in their loans or guarantees to international commercial banks or insurance providers.[19] Syndications play a critical role in mobilizing private sector finance for developing markets, where regulatory regimes are often weak and market conditions challenging, with tenors generally limited to shorter maturities and market access open primarily to top-tier companies only. Furthermore, syndications are required by the credit departments of some MDBs (particularly EBRD) to ensure that guarantee terms are “market tested.”

27. **Guarantor-of-Record Scheme.** The GOR scheme is a “fronting” arrangement wherein ADB is the guarantor-of-record and issues a guarantee contract for the entire amount of a guarantee requested by one or more beneficiaries, and transfers all of the exposure to one or more insurers using ADB’s contract wording or other acceptable wording. Each underwriter has the right to price premium rates according to its own assessment of the risks, but the objective is to achieve harmonized rates among the insurers. Claims payments and recoveries are shared on a pari passu basis. The GOR program has been well received in the market and shows good potential for future use. Perhaps its greatest strength is that it affords users the benefits of ADB’s deterrence capabilities while minimizing the amount of risk ADB actually assumes in a transaction.

28. There is ongoing debate in the guarantee and insurance industry about the types of risk that issuers of cofinancing arrangements like “B” loans and the GOR scheme assume by issuing such products, even though they may not themselves be direct risk takers in a particular transaction, because of how the products are structured. The growing consensus is that issuers of these products do incur some form of implicit delivery, performance, documentary, and reputation risk, but there is little if any accounting for such risks.

29. **Market Collaboration**. The CEPs offered by public and private PRI/TCI providers have much in common. Most of these products accomplish the same thing in much the same way. At the same time, 9/11 left many PRI/TCI providers with less underwriting capacity, since many reinsurers reduced the amount of their support for these classes of business. Public and private sector underwriters therefore have more incentive to collaborate with one another, and they are doing so with greater frequency.

3. Market Expectations

30. An essential part of the mandate of MDBs is to mobilize financial resources from the private sector and channel these into investments that promote development and sustainable poverty reduction in developing countries. Capital flows need to be directed into areas that can lay the foundation for long-term economic growth. The challenge is to convert the demand for investment into viable opportunities that are accessible to investors and creditors, and to unlock

[19] IFC’s Syndication and Resource Mobilization Department mobilizes funds to lend through its syndication (“B” loan) program and through the securitization of the IFC loan portfolio. This department has three divisions: (i) a syndication division; (ii) a “B” loan management division, with a fully dedicated staff of professionals to carefully manage issues related to participants in “B” loans through monitoring and reporting, management of communications with participants on waivers and amendments, and negotiation of restructurings; and (iii) a financial policy and securitization division, which securitizes parts of IFC’s own loan portfolio through risk transfer mechanisms (including credit derivatives) to free up capital for new loans and to transfer credit risk.

the potential of capital markets to finance them.[20] Encouraging new capital investment, particularly in infrastructure, requires promoting balanced PPPs with appropriate risk distribution to leverage private capital, including providing PRI, for which demand remains high. DFIs can support this process by creating the conditions under which investment opportunities can be converted into actual investment flows.

31. **What Lenders and Investors Require.** The unavailability of debt to support investment is still a significant constraint for many emerging economies. Success in attracting private financing to support infrastructure development often depends more on the ability to manage perceptions of risk than on income levels. Given the long-term vulnerability of infrastructure projects to major political and commercial risks, investors base much of their risk assessment on a country's economic and political history. Commercial lenders are likewise particularly concerned with the noncommercial risks that feature prominently in many cross-border investments. Mobilizing commercial debt of adequate volume and maturity is a key constraint in many investments for several reasons:

(i) **Overall risk reduction**. For sponsors to obtain adequate equity returns, they must mobilize significant levels of debt (generally about two thirds of the financing required). Lenders are cautious, however, because while they face many of the same risks as equity investors, there are also inherent limits to the flexibility of loan pricing. In contrast, equity investors typically expect returns of at least 15–20% when they invest in developing countries. Finally, commercial banks generally prefer to remove as much risk as possible from any transaction. Thus, they seek to reduce residual transactional risk through credit enhancements.

(ii) **Local currency finance**. Since some domestic financial markets cannot mobilize large volumes of long-term debt, sponsors often turn to foreign lenders to fill the void. However, this often requires mitigating other political risks that governments control, including currency conversion and transferability risk.

(iii) **Balance sheet management**. Most international banks are now required by internal credit controls or by international banking regulations to make additional provisions for loans to specific developing countries.

(iv) **Increased syndications to pool scarce resources**. Few banks have a strong tradition of project financing in developing countries, although more have entered the market in the recent past. Each bank has limits for its exposure to clients, sectors, and countries. Organizing syndications of lenders is also time-consuming and complex.

(v) **Matching tenors**. Commercial banks cannot prudently lend large volumes of long-term debt because of the short-term nature of their deposit base. However, most infrastructure projects require long-term financing if the tariffs that provide the revenue to service the debt are not to be prohibitively expensive. While institutional sources with long-term depositors, such as pension funds and life assurance companies, may provide better maturities, their inclination to commit funds in developing countries is limited.

[20] From 1992 to 2003, total international investment in developing country infrastructure was about $622 billion, for an average of $52 billion per year during the period, or 3.8% of total gross domestic investment in the developing world.

(vi) **Targeted risk management products**. Particularly in the infrastructure sector, projects are heavily exposed to political risks. These risks arise when investors, lenders, or traders are concerned about the stability and consistency of a government's political policies or economic situation, which could affect a transaction. While some risks (such as expropriation or currency conversion risk) apply to transactions generally, other risks (like payment or regulatory risk) are more specific to the infrastructure sector.[21] Since project sponsors, lenders, or traders cannot remove these risks entirely, CEPs are critical to their risk mitigation.

32. Many international lenders (and a growing number of local lenders) rely on some form of protection against these risks when assuming new long-term exposure in developing countries. Mobilizing financing thus often requires measures to mitigate or share noncommercial risks through the use of appropriate credit enhancements, filling the gap between the investor's, lender's, or trader's risk perception and the requirement for sustained debt service and minimum returns on invested capital. By mitigating political and commercial risks through CEPs, ADB also helps to reduce financing costs so that projects can attract commercial financing even in relatively difficult environments.

33. **What ADB's Financing Partners Say.** ADB remains one of the few AAA-rated guarantee providers in the world, and its CEPs are highly valued by the market. In particular, with the implementation of the Basel II Capital Accord,[22] demand for ADB's CEPs is bound to increase further. This factor, combined with ADB's risk-taking capabilities and comparative advantages, gives ADB the potential to position itself as a premier guarantee provider in Asia over the medium to long term. However, to adequately capture this potential, ADB needs to consider the views of the beneficiaries of its CEPs and leading players in the public and private guarantee, insurance, and banking markets:[23]

(i) ADB will need to adapt quickly to changing market conditions. It is not enough just to say that ADB possesses a range of options from among its CEPs: ADB must offer products that respond quickly to the needs of the market. Product innovation is critical to becoming a more mainstream provider of CEPs.

(ii) The market wants well-defined and more comprehensive guarantees, covering both commercial and political risks. The current distinction between commercial and political risk guarantees may not always be appropriate. In some cases, lenders want 100% indemnity for commercial risk, which ADB's current policy for PCGs does not allow.[24]

(iii) The ability to provide more creative solutions that support projects straddling both the public and private sector operations of ADB (vis-à-vis PPP) is central to ADB's ability to participate in the expansion of this important growth area. The Innovation

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[21] The risks faced by infrastructure projects because of the close involvement of government agencies include: (i) payment risk, (ii) performance risk, (iii) tariff adjustment risk, (iv) permit issuance risk, and (v) breach-of-contract risk.

[22] While the implementation of Basel II may vary across countries, it provides capital relief for CEPs from MDBs. It should thus encourage more risk-sharing partnerships between ADB and the private market.

[23] This includes ongoing discussions with commercial bankers, major insurance underwriters and brokers, export credit agencies, and investors.

[24] While coverage of up to 100% would be considered, the principle of risk sharing would be pursued to the extent possible, with ADB setting the level of the guarantee at the lowest level required to mobilize the necessary financing.

and Efficiency Initiative (IEI)[25] indicates that there is much demand for PPP support and ADB can now provide public sector loans without the need for sovereign counter-guarantees. However, ADB's internal organizational structure and separate approaches and processes for public and private sector operations have limited its ability to respond swiftly.

D. Review of Past Credit Enhancement Operations

1. Evolution of Policies

34. Since the start of CEP operations in the 1980s—involving the introduction of the CFS in 1984 and a guarantee policy in 1987 (footnote 9)—ADB has incrementally expanded and clarified the scope and scale of these operations. However, this has also led to a gradual fragmentation of the policy framework under which CEPs are issued, resulting in conflicting interpretations that are difficult to comprehend and limiting ADB's flexibility to compete effectively in the regional and global cofinancing marketplace.

35. The first credit enhancement transactions were mainly public sector–oriented, with host governments and their executing agencies serving as intermediaries in the administration of the loans. The first CFS transactions for private sector projects took place in the late 1980s and early 1990s. ADB's first guarantee was issued in 1988, and the first guarantees were all credit guarantees in support of commercial cofinancing to the public sector. In the 1990s, ADB positioned its guarantee products more aggressively both as risk-sharing tools and as a deterrent to actions contrary to a project's interests that may be taken by a host government. The first guarantee in support of ADB's private sector operations was approved in 1997. By 2000, ADB's CEPs had evolved further to include PRGs, the GOR, and other co-guarantee schemes (Appendix 1). Guarantees for both public and private sector projects were regularly counter-guaranteed by the host government until 2002 (although this was a policy requirement only for public sector operations). Since then, guarantees to private sector obligors have been without counter-guarantee, while counter-guarantees continued to be pursued for loans to public sector obligors.

36. To modernize its business processes further and make its assistance more relevant, ADB launched the IEI in 2004 and approved new pilot financing schemes in 2005 (footnote 25). ADB made these moves in recognition of the need to expand the scope and scale of its financial intermediation products, including an increase the use of syndications and reinsurance. ADB could thus also pursue public sector financing without the need for sovereign counter-guarantees, but this should be supported by appropriate risk mitigation measures and market collaboration.

2. Performance

37. Since 1986, ADB has approved credit enhancements for 56 projects, at an average rate of 2-3 projects a year, for a total amount of about $4.07 billion. This is less than 5% of ADB' lending. More than 60% of the total amount is linked to public sector operations, but private sector operations received a greater share (about 60%) in the number of CEPs. A total of 30 projects benefited from the CFS, amounting to about $1.24 billion. The majority of the CFS' (76% in number, 75% in volume) supported private sector operations, in particular prior to the

[25] ADB. 2005. *Pilot Financing Modalities and Instruments*. Manila (R194-05).

Asian financial crisis, although CFS operations also include seven infrastructure projects in the public sector with commercial cofinancing. PCGs were approved for 17 projects, totaling $2.06 billion, with a majority (75% in number, 86% in volume) linked to ADB's public sector operations. PRGs have been introduced only in 2000, and so far 8 PRGs totaling $613 million have been approved, in addition to 2 GOR schemes. In contrast to the PCGs, most of the PRGs have been anchored in ADB's private sector operations. Appendix 2 reviews ADB's past credit enhancement operations.

38. In comparison, the International Bank for Reconstruction and Development (IBRD or World Bank) has so far issued 28 guarantees for 26 projects for $2.9 billion,[26] IFC has issued more than 200 "B" loans for about $5 billion,[27] the Inter-American Development Bank has issued four credit guarantees and four PRGs totaling $550 million,[28] and the Multilateral Investment Guarantee Agency (MIGA) has issued nearly 800 PRGs for more than $5 billion.[29]

39. ADB's CEPs have not been used to their full potential for a number of reasons, some of which are outside ADB's control:

(i) Private sector investment in infrastructure in Asia declined from about $135 billion in 1997 to about $50 billion in 2003—a drop of more than 60%.[30] Foreign direct investment (FDI) has also declined significantly since the Asian financial crisis,[31] largely because of a reduced appetite for emerging-market risk among private sector investors. While FDI levels are now recovering, the private sector is in general more selective and cautious about making long-term FDI in developing countries. Furthermore, viable projects are relatively few in emerging markets but abundant in developed economies, which increasingly compete for funds.

(ii) Demand for PRGs has likewise been reduced as a result of the decline in private sector infrastructure investment in the Region.

(iii) PRGs are often considered a discretionary coverage, pursued by investors as the opportunities arise. When the cyclical nature of the insurance business makes other, required forms of insurance[32] more costly to obtain, demand for PRG coverage decreases because there are less funds to pay for it.

(iv) For some time now, and especially following the financial crises of the past 9 years, many commercial banks have shown less interest in using CFS-like products. This is because some banks have not always understood that they were buying a product that did not offer indemnity but rather a form of "umbrella" coverage. Such coverage implied the active involvement of the MDB issuing the "B" loan in a claim situation, and a favorable outcome because of the deterrent benefits usually associated with MDB involvement in such transactions.

(v) The 2002 crisis in Argentina prompted many commercial banks to question the value of PCGs. Many banks felt that the "deterrent benefits" they had hoped to achieve by

[26] IBRD Web site (www.ibrd.org). 2006.
[27] IFC Web site (www.ifc.org). 2006.
[28] According to the Private Sector Department of IADB.
[29] MIGA Web site (www.miga.org). 2006. The differences in the number of transactions are partly due to the size of the other institutions, and the number of staff they have devoted to CEPs, vis-à-vis ADB's.
[30] ADB, JBIC, and World Bank. 2005. *Connecting East Asia, A New Framework for Infrastructure*. p. 62.
[31] UNCTAD notes that between 1999 and 2004 global FDI flows were reduced by more than 40%, from about $1.1 trillion to about $650 billion (World Investment Report 2005, p. 2).
[32] Such as property, casualty, and health insurance.

obtaining guarantees through multilateral financial institutions (MFIs) did not materialize, raising doubts about the value of such instruments.[33] The commercial banks similarly questioned the value of CFS products from MFIs after a variety of financial crises since the mid-1990s. While the CFS delivered what it promised, i.e., preferential access to foreign exchange and exclusion from debt rescheduling, it did not protect against any losses resulting from delays in payment and exchange rate devaluation.

E. Lessons Learned and Challenges Ahead

40. Past experience has brought out several issues that affect ADB's ability to respond to the need of its clients for efficient and meaningful delivery of CEPs. These issues must be addressed in order to mainstream financing partnerships through the application of credit enhancement operations in ADB's business model.

41. **Lender or Arranger of Finance?** ADB's business model as a financial institution is based on borrowing from capital markets and making loans. Accordingly, ADB has little inherent operational incentive to mainstream non-lending activities, including risk sharing. As a result, most of ADB's operational departments in the past have also not been encouraged to promote non-lending activities, or indeed to use CEPs regularly. Loan approvals in a given fiscal year have traditionally been the key performance measure for operational departments, but little recognition has been given to how much leverage they have achieved, how creative or innovative they have been, or how successfully they have responded to market needs and demands. In comparison, some MDBs (notably EBRD and IFC) require staff to actively explore the availability of CEPs and integrate them in processing their transactions.

42. **Clarity of Policy Framework and Product Applications.** Many areas are not addressed in the current policy and product framework, which requires a case-by-case interpretation of its meaning. The framework must be made more transparent, consistent, and easy to apply for ADB and its financing partners.

43. **Participation Requirement**. Article 11 of ADB's Charter states that "...The Bank may carry out its operations: ...(iv) by guaranteeing, whether as primary or secondary obligor, in whole or in part, loans for development participated in by the Bank." [emphasis added] The policy on guarantees allows ADB to satisfy this "participation requirement" by taking a stake in the project or program concerned through a direct loan, bond subscription, or equity investment, which must be processed together with the corresponding guarantees. In addition, as ADB policy and opinions from the Office of the General Counsel (OGC) have clarified:

> the intent of the participation requirement is to ensure that, as off-balance sheet items, Bank obligations in guarantees are not subject to less rigorous financial standards than on balance sheet items (such as direct lending and equity investments). Guarantees should, therefore, be processed with the same due diligence as loans and should be provided generally to borrowers that have established adequate debt-servicing capacity for Bank loans. Such due diligence ensures that the accumulation of contingent liabilities through guarantees does not impair the Bank's financial soundness. Therefore, the participation requirement is

[33] The commercial banks, in some instances and as a result of their association with DFIs, had to inject more funds into transactions after a default, or felt that what had occurred was a result of their association with DFIs or that DFIs did not ultimately press Argentina hard enough to repay its debts.

essentially a measure to reinforce the Bank's due diligence procedures so that the Bank's credit and risk analysis of a guarantee proposal is as rigorous as the analysis applied in processing a direct loan proposal.[34]

44. To respond to the market demand for ADB guarantees in circumstances where no funding (through equity or loans) is required, ADB policies must support a more flexible interpretation of the participation requirement by allowing guarantees to be anchored in any ADB financing, including grant financing or program loans, provided that both the guarantee and ADB's intervention have the same development objective and relate to the same sector or project. Such new approach to ADB's guarantee operations falls within the parameters of the participation requirement, on the condition that appropriate business processes are established for guarantees similar to those for loans or equity investments, to ensure that guarantees are not subject to a less rigorous risk analysis than direct, non-contingent, investments by ADB. In respect of each guarantee, an appropriate risk analysis (including commercial, legal, and financial due diligence) must then be conducted according to sound banking principles. The scope of due diligence shall depend on (i) the cover for which the guarantee is provided, (ii) the risks assumed by ADB inherent in the guaranteed obligations, and (iii) ADB's recourse following a payment under the guarantee, as more particularly set forth in the relevant sections of ADB's *Operations Manual* (OM).

45. **Capital-Backing and Risk-Weighting Guidelines.** ADB's risk management processes do not treat its guarantees differently from its loans with respect to capital allocation limits. ADB accounts for guarantees in the same way as it accounts for its loans and equity investments, i.e. with one dollar capital backing for each dollar of guarantee issued. This is inappropriate for the level of risk assumed when issuing guarantees that cover only part of the risks (such as PRGs), and is also inconsistent with industry practice. Many comparator organizations in the public sector and all in the private sector either weigh risk so as to make greater use of their capital or distinguish between types of risk in a way that reflects the risk assumed.[35] ADB does neither. ADB's current approach does not encourage efficient utilization of capital and can potentially raise the cost of its guarantee products while limiting the scale of assistance, using more statutory headroom than is otherwise necessary.

46. **Internal Coordination and Accountabilities.** To deliver a clear, concise, and consistent message to its clients, ADB must increase coordination between and among the Regional Departments (RDs), the Private Sector Operations Department (PSOD), and the Office of Cofinancing Operations (OCO) and better clarify responsibilities for various activities in the project cycle. These departments should be required to share more information to avoid duplicating effort and issuing mixed messages.

47. **Consistency in Underwriting Approaches.** The processing of guarantee operations is decentralized under current operating procedures,[36] although the approaches and expertise are

[34] See paragraph 26 of "Review of the Bank's Guarantee Operations" (R135-99).

[35] For example, MIGA changed its risk-weighting scheme from 1:1.5 to 1:3.5, allowing it to further leverage its capital. In the private sector, insurers commonly leverage their capital by up to 20 times, and manage their risk weightings by specific risk type with specific weightings, rather than by broad categories with the same weightings. This enables the insurers to have a much more accurate reading of their portfolio risk and allows for more efficient use of capital.

[36] ADB. 2003. Operations Manual. Section D9/OP: The Private Sector Operations Department (PSOD) assumes primary responsibility for formulating and processing guarantees for private sector operations, while OCO takes the lead in formulating and processing guarantees for public sector operations. In practice, PSOD and OCO often work together on private sector transactions, but OCO in many cases is involved only at a later stage in the processing cycle.

not yet well established throughout ADB. Without uniform underwriting guidelines, various ADB departments use different approaches to process CEPs, thus placing ADB at a disadvantage in the assumption of risk. ADB needs consistency in its underwriting approaches, as well as in its guarantee terms and conditions, and a successful performance record to obtain reinsurance for any part of its portfolio.

48. **Internal Controls.** ADB's data input and control systems for monitoring CEPs are not adequately coordinated between departments, nor are they sufficiently integrated with ADB's overall internal control processes to permit instant information access. Data entry tends to be department-specific and may be inconsistent across departments because there is no sharing of common data between and among departments. Furthermore, the support staff often depend on project staff for data and updates, and may have no way to independently monitor project progress and implementation. It would be more useful to have a common database that can be shared between and among departments to eliminate data discrepancies. This would also enable the support staff to operate more efficiently.

49. **Understanding of CEPs and Knowledge Management.** CEPs are not widely understood in ADB. This means that most operational staff cannot explain how CEPs may be used by DMCs. Or if staff do have some knowledge of CEPs, they do not generally know enough to answer the probing questions that may be asked by project sponsors, lenders, or DMC governments about CEPs. ADB's mandated "knowledge center" of CEP operations, OCO, is, for lack of an operational mandate, merely a discretionary service provider that operational departments use ad hoc and inconsistently. This limits the scope of ADB's CEP program. As a result, other departments lack the familiarity with CEP products and structures required to actively pursue them.

50. **Coordination of Marketing Efforts and Outreach.** The various operational units within ADB must speak with one voice in promoting the ADB name and marketing CEPs. There have been occasions when departments have not coordinated their marketing efforts to make efficient use of staff time and ADB resources. Better coordination of departmental marketing efforts is clearly in ADB's interest, making its message to its clients easier to understand and more consistent.

51. **Staff Resources.** Having appropriate resources with the required expertise is important for the wider application of CEPs. In the past, ADB did not have the foundation to effectively support operational departments on a broader scale, and expertise was also not widely available throughout the operational departments. Institutional expertise and knowledge has been concentrated, with only a few having the experience necessary to process CEPs, thereby exposing ADB to key personnel risks. While ADB has expanded its CEP range to match those of other MDBs and has shown its capacity to deliver innovative applications, it has not increased its resource base correspondingly, as other MDBs have done. ADB must pay appropriate attention to staffing issues to build up a critical mass of expertise, over time, to expand its capabilities and mainstream credit enhancement operations in support of commercial cofinancing, consistent with the FPS.

III. REVISED FRAMEWORK FOR CREDIT ENHANCEMENT OPERATIONS

52. This section proposes a new CEP policy and operating framework that supports the growth of ADB's CEPs and emphasizes ADB's relevance as a value-adding financing partner in leveraging financial resources for projects and programs with high development impact. This framework will guide the provision of CEPs by ADB and supersede references made in this regard in previous cofinancing and guarantee policies (footnote 9). Appendix 4 compares the proposed framework with previous policies.

A. Policy Objectives and Guiding Principles

53. The proposals for ADB's credit enhancement operations are anchored in the following six policy objectives and guiding principles:

(i) **Client and development orientation.** The use of CEPs will be driven by, and will benefit, ADB's clients (borrowers) in DMCs, in both the public and private sectors. The CEPs will be anchored in country strategies and partnership frameworks agreed on with DMCs, and will support development goals, directions, and priorities as articulated in ADB's operational framework, including the Charter and various policy and strategy documents.[37]

(ii) **Effectiveness and efficiency.** The application of CEPs will increase the development impact and efficiency of ADB's assistance. ADB will thus forge effective partnerships with a wide variety of cofinanciers to mobilize risk-taking capacity for its public and private sector operations and thereby leverage its balance sheet, fill gaps in the market, promote investment in "frontier" countries or sectors, and encourage the participation of other CEP providers in transactions they would otherwise have no desire to participate in. ADB will focus on its comparative advantages (assuming long-term sovereign and noncommercial risk) while letting its cofinancing partners focus on theirs (short- and medium-term risk). In providing CEPs, ADB may build on the preparatory work done by cofinancing partners. It will also seek to cover the operational cost of its credit enhancement operations, including the risk-adjusted cost of capital.

(iii) **Market orientation.** ADB will seek to complement, rather than compete with, other CEP providers, and not distort markets where they exist. CEPs will conform as closely as possible to best industry practices.

(iv) **Innovation and flexibility.** The policy encourages innovation, new product development, and flexibility in application.

(v) **Transparency and risk awareness.** ADB's triple-A rating is central to its operations and the relevance of its financial assistance. CEPs will follow a principle of risk sharing, to achieve greater development impact with less risk for ADB than in its direct financing operations, thereby helping to diversify and leverage its

[37] In particular, the PRS (footnote 1), LTSF (footnote 2), MTS II (footnote 3), FPS (footnote 4), the revised strategic framework for private sector development (ADB. 2006. *Private Sector Development: A Revised Strategic Framework.* Manila), and IEI (footnote 25), as well as country strategies and programs, as appropriate.

balance sheet. Product application will be transparent and risk assessments sound, in line with standards used by the industry for the risks assumed, and those used by ADB in its comparable direct financing operations, as appropriate.

(vi) **Sustainability and safeguards.** CEPs will comply with ADB's environmental and social safeguard policies.

B. Operating Parameters

54. To make better use of ADB's CEPs in line with the policy objectives, operating parameters must be clarified to: (i) make ADB's CEPs more transparent, accessible, and market-oriented; (ii) improve risk management related to CEPs; and (iii) provide a predictable pricing framework.

1. Product Scope and Scale

55. This section defines the products offered, the risks and instruments that are eligible for cover, eligible participants (financing partners and obligors), tenors, currencies, and other aspects that characterize product application (participation requirement, counter-indemnities, and facilities).

a. CEP Categories and Arrangements

56. **Two Broad Categories.** CEPs will be grouped into two broad categories— guarantees and syndications—to simplify the range of products and make them easier to understand. Both share risks with financing partners, such as lenders, insurers, reinsurers, or other cofinanciers, to facilitate investment, trade, and capital flows in ADB's DMCs.

(i) **Guarantees**. Guarantees allow ADB to cover the commercial and political risks of debt instruments provided by its financing partners. Guarantees may take the form of PCGs or PRGs (para. 59).

(ii) **Syndications.** Syndications enable ADB to transfer some or all of the risk associated with its direct loans and guarantees to its financing partners, thereby reducing its credit exposure.[38]

57. Syndications may be made through a variety of structures including:

(i) **"Fronting"** arrangements, which allow ADB to transfer all risks (i.e., pass through) and share associated recovery rights with other syndicate members. ADB does not assume any credit or counterparty risk in such arrangements.[39]

(ii) **"Reinsurance"** arrangements, which enable ADB to transfer its own risk or assume the risk of other guarantee providers and also share any associated

[38] Depending on whether ADB retains risk or not, it may or may not have a contingent financial liability.
[39] The lender-of-record (LOR) or guarantor-of-record (GOR) arrangements, where the syndicate members bear all the risk, are examples of this. However, fronting arrangements may be combined with other forms of CEPs that transfer risk to ADB. For example, LOR facilities may be used in conjunction with guarantees such that ADB as LOR is also a guarantor.

recovery with other syndicate members. ADB will assume counterparty risk if it is either reinsuring other syndicate members or being reinsured by them.[40]

(iii) **"Sell-down"** arrangements, which allow ADB to transfer certain risks through transfers, assignments, or novations.[41] For those risks that are completely transferred, ADB will have no further obligations.

58. **Branding.** Different names for CEPs corresponding to such categories or arrangements may be used or developed to better characterize specific applications and for marketing and branding purposes.[42] "CFS" as a brand name (for a loan syndication or fronting structure) will be replaced by "B loan," a term widely understood in the banking industry and used by ADB's comparator organizations.

b. Risks Covered

59. **Risks That May Cause Payment Default.** Guarantees may cover, and syndications may allow ADB to share or transfer, a wide range of risks that are a subset of the risks inherent in sovereign and non-sovereign loans. These risks can be categorized as but are not limited to:[43]

(i) **Political risk** (footnote 7) associated with the occurrence of selected events, such as expropriation, currency inconvertibility or non-transfer, political violence, breach of contract, and other political risks commonly addressed in the public and private guarantee marketplace; and

(ii) **Credit risk** of a commercial nature associated with the failure of an obligor to service and repay its debt on time.

60. **Partial Sharing.** CEPs may guarantee or share different percentages or types of risk depending on the transaction and the needs of the market, consistent with industry practice and sound risk management standards (para. 71).

c. Eligible Financing Instruments

61. **Wide Instrument Range, But Debt-Related.** ADB's CEPs may support a variety of financial instruments that constitute debt obligations, but not equity. Debt obligations can be funded or unfunded and take many forms.[44]

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[40] If being reinsured, ADB assumes the payment risk of the reinsurer. Minimum standards will be set for assuming the risk of counterparty syndicate members.
[41] A novation transfers risk from a party substituting an existing contract through a fresh contract with a different party.
[42] Such product brand names will be clarified in the OM, and may be adjusted from time to time to allow for innovations or other industry developments.
[43] Under no circumstance will ADB assume any type of risk exposure that exceeds the risk inherent in the debt financing operations that ADB can undertake directly.
[44] Such as (i) senior, subordinated, mezzanine, and convertible debt; (ii) project or limited-recourse finance; (iii) tier 2 capital raised by banks; (iv) capital market debt instruments including synthetic or structured securities, and the related underwriting and liquidity support arrangements; (v) letters of credit, promissory notes, and bills of exchange; (vi) performance, bid, advance payment, and other payment bonds and forms of bond issuances; and (vii) other forms of financial indebtedness.

d. Eligible Financing Partners and Financing Partnership Modalities

62. **Wide Variety of Partners, but Competent.** In line with ADB's FPS (footnote 4), which encourages a greater variety of financing partnerships, credit enhancement operations may be undertaken with a wide range of international and local financing partners in the public or private sector, including but not limited to commercial banks, development and non-bank financial institutions, insurance companies, pension funds, capital market participants, ECAs, export-import banks, suppliers, investors, insurers, reinsurers, and other commercially oriented entities. ADB may also share risks with official agencies for non-sovereign operations that are provided on commercial terms.[45] However, ADB will not enter into credit enhancement arrangements for financing provided under official development assistance.[46] Appropriate due diligence will be undertaken on financing partners if counterparty risk, including reputation, documentation or delivery risk, is involved.

e. Eligible Countries and Obligors

63. **All DMCs and Entities Operating in DMCs.** Any country that is eligible for lending from ADB's Ordinary Capital Resources (OCR) and the Asian Development Fund (ADF) can benefit from ADB's CEPs. The CEPs can support sovereign, sub-sovereign, or non-sovereign obligors or borrowers, including those under PPPs, with or without direct sovereign counter-indemnity from the host country.

f. Use of Sovereign Counter-Indemnities

64. **Selective Use, to Improve Project Benefits.** Counter-indemnities are an important risk mitigation instrument for ADB that offers certain benefits, in particular to support PPPs. However, ADB does not require a sovereign counter-indemnity for guarantees that it issues. A sovereign counter-indemnity may be considered if it benefits the DMC or the ultimate consumer within the DMC, by reducing transaction cost or improving financial viability. Counter-indemnities may be appropriate, in particular, for political risks under the control of the host government. A counter-indemnity may allow ADB to provide support for projects in "frontier" DMCs or challenging sectors for which financing may not otherwise be available. For countries that have access only to ADF lending,[47] sovereign counter-indemnities will be considered only if the underlying project has strong developmental impact, or special considerations justify their issuance.[48]

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[45] Consistent with the FPS, ADB could also participate as a junior partner in transactions proposed or led by others, providing credit enhancements and benefiting from the due diligence already done by its financing partners.

[46] Defined by the Development Assistance Committee of the Organization for Economic Cooperation and Development as financial flows to developing countries and multilateral institutions from official agencies (including state and local governments, or their executive agencies) that (i) have the main objective of promoting the economic development and welfare of developing countries, and (ii) are concessional, with a grant element of at least 25% (calculated at a discount rate of 10%).

[47] Group A countries under ADB's graduation policy. ADB. 1998. *A Graduation Policy for the Bank's DMCs.* Manila.

[48] In such a case, the counter-indemnity may be counted against the ADF lending ceiling for the country. In circumstances with a very high development impact, or where the underlying project generates foreign exchange revenue on a commercial basis, the counter-indemnity may be funded by market sources, subject to an agreement with the IMF, as appropriate.

g. Participation Requirement

65. **Link to ADB Operations.** Any ADB financing instrument[49] can satisfy the participation requirement for a guarantee if (i) the guarantee and ADB's anchor intervention share the same development objective and relate to the same sector or project, consistent with a country or regional strategy; and (ii) the guarantee is processed no less rigorously than ADB's direct, non-contingent, investments, taking into account (a) the coverage for which the guarantee is provided, (b) the risks to ADB inherent in the guaranteed obligations, and (c) ADB's recourse following a payment under the guarantee.[50]

66. **Flexibility in Timing.** The Board can approve a credit enhancement arrangement when approving ADB's anchor financing, or during the implementation period.[51]

h. Single Transactions and Facilities

67. **Broader Access and Streamlined Implementation.** CEPs can be provided by ADB through individual transactions or through facilities. CEP facilities are particularly suitable in support of sectoral or thematic interventions made by ADB that require a wide variety of interrelated support.[52] These have been used selectively in the past and have been well received by the market.[53] Such facilities allow greater flexibility to respond to opportunities within a defined framework, and may be similar in character to ADB's multi-tranche financing facility,[54] with predefined exposure limits and other qualifying criteria. CEP facilities will require an appropriate level of risk analysis, including legal and financial due diligence on the level of risk taken for each CEP transaction, in accordance with other proposals made in this paper. Any Board paper seeking approval for a guarantee facility will detail the implementation arrangements and the level of delegation of authority for implementation. Once approved, the CEPs to be issued under a facility will be implemented according to streamlined procedures, as outlined and approved by the Board in the paper establishing the facility.

i. Tenor

68. **Long-Term, to Match Project Life.** The tenor of a guarantee should correspond to the extent possible with the tenor of the underlying debt obligation. The tenor is subject to risk considerations as well as market conditions. It would normally not exceed the maximum tenor of

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[49] Such as project loans, program loans, multi-tranche facilities, sector loans, sector development programs, equity, project grants, technical assistance grants, or any other form of financing that may be approved by the Board.

[50] Further aspects related to risk management processes, due diligence, and responsibilities are discussed in the implementation section of this paper.

[51] Where the anchor is an investment project or program loan that was approved before the issuance of the CEP, the implementation of the project or program must still be ongoing at the time the CEP is issued.

[52] The arrangements applicable to the multi-tranche facility concept, which were approved by the Board in 2005 under the Innovation and Efficiency Initiative (ADB. 2005. Financing Modalities and Instruments. Manila. (R194-05)), would be adopted for CEP facilities. Thus, a CEP facility will follow current ADB procedures for Board approval; what will be streamlined is the implementation of individual CEP transactions under a CEP facility that has been approved by the Board (i.e. this would allow for management approval of each CEP transaction).

[53] For example, the Trade Finance Facilitation Program (TFFP), which became operational in November 2004, has three main components: (i) a revolving PCG facility, (ii) a revolving credit facility, and (iii) a portfolio risk–sharing facility. As of June 2006, 65 confirming banks had joined the program and due diligence had been carried out on 29 local banks in 12 countries throughout the Region. Of this number, 19 local banks had been approved to join the program as issuing banks and a total of $111.5 million in issuing bank limits had been approved.

[54] Approved in 2005 under the IEI (footnote 25).

ADB's OCR lending operations,[55] as may be adjusted from time to time, and there is no minimum tenor. In providing credit enhancements, ADB will seek to support longer-term finance and will thus consider extending the tenor of underlying debt, where appropriate, to improve developmental impact, and encourage financing to match the economic life of the underlying project or program.[56]

j. Currencies

69. **Avoidance of Currency Mismatches.** To avoid foreign exchange risk due to the mismatch of project cash flows with debt servicing obligations and to further the development of regional financial markets, guarantees may be denominated in the currency in which the underlying debt obligation is denominated,[57] provided that where ADB is providing a guarantee in local currency it has obtained all relevant approvals required in the host country. Issues that must also be considered are (i) the timing required by ADB to obtain such local currency in view of the payment obligation under the guarantee being on demand, and (ii) the pricing at which ADB would obtain such funding (which may not be reflected in the pricing of the guarantee and the underlying loan in which ADB would subrogate).

2. Risk Management Considerations

70. **Emphasis on Sound Principles and Practices.** The increased scope and scale of ADB's CEPs require increased emphasis on sound risk management principles and practices. In particular, this relates to risk-sharing arrangements for guarantee transactions to limit moral hazard, improved management of exposure limit and capital allocation for credit enhancement operations, and risk transfers through syndication. Further aspects related to risk management processes and due diligence are addressed in the implementation section of this paper.

a. Transactional Risk Sharing and Moral Hazard

71. **As Little Risk as Possible, as Much as Required.** Guarantees may cover, and syndications may allow ADB to share or transfer different percentages or types of risk depending on the transaction and the needs of the market, consistent with industry practice. Guarantees will, in particular, be structured to mitigate the risk of moral hazard (i.e., the risk that the guaranteed party will act negligently as a result of the passage of risk to a third party) by ensuring that the financing partner shares some of the covered risk to the extent possible. While coverage of up to 100% of principal and interest may be considered in certain circumstances,[58] ADB will normally seek risk-sharing arrangements that set the net exposure under a guarantee at the lowest level required to mobilize the necessary financing. A thorough risk analysis,

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[55] Currently 32 years for sovereign loans, and less for loans without sovereign guarantee.

[56] In some cases, CEPs may have a short tenor if the underlying obligations are short-term, such as trade-related products, among others.

[57] In accordance with ADB policies governing the LIBOR-based loan (LBL) product (ADB. 2001. *Review of Asian Development Bank's Financial Loan Products.* Manila; under review in 2006) and the Local Currency Loan (LCL) product (ADB. 2005. *Introducing the Local Currency Loan Product*. Manila), loans can be denominated in US dollars, euros, or yen, or in the local currency of the borrower. By extension, guarantees can be denominated only in such currencies. Any increase in currency choices following a review of the LBL product would thus also apply to ADBs CEPs. Other currencies may also be covered, on a case-by-case basis and subject to approval by ADB's Board, if the coverage helps to eliminate currency mismatches and if exposures can be offset in the market.

[58] This may be required, for example, in the case of guarantees for securitizations with respect to the assets held by an originator. In such cases, ADB will seek to mitigate risks further through syndication arrangements. In the case of PRGs, full indemnity is commonly provided, but the guarantee holder usually retains the commercial risk.

consistent with revised ADB standards and industry practice, will be undertaken to determine the acceptability of the risk, and credit enhancement arrangements and related risk exposures will be presented clearly in the project documents submitted for Board approval.

b. Management of CEP Exposure Limits and Capital Allocations

72. **Clear Guidelines that Account for Relative Risk.** Guarantees represent different levels of risk to ADB's capital base depending on a number of factors, including type of coverage and terms attached to it. Yet, for statutory headroom calculations, ADB has used the same amounts of headroom for all forms of guarantees as for direct loans, at a ratio of 1:1 (para. 45).[59] This approach did not distinguish between transactional risks or between the benefits of syndication and of other risk mitigation measures, and is inconsistent with industry best practices.

73. To facilitate improved risk management and more efficient capital utilization, guidelines will be set to indicate the relative risk of CEP operations and how they compare with non-sovereign direct loans and equity investments made by ADB. Relative risk guidelines will then be used to determine how ADB's adjusted exposure under each CEP, non-sovereign direct loan, and equity investment will be accounted for with respect to (i) statutory limits as measured by headroom, provisioning, and loan equivalency calculations; (ii) strategic limits such as indicative planning figures for each DMC and the IEI limit for pilot financing instruments and modalities; and (iii) prudential limits such as the PSO per project, borrower, and sector, and overall limits.

c. Syndication for Risk Diversification and Exposure Management

74. **Balancing Non-Sovereign Portfolios.** Syndications, including fronting, reinsurance, and sell-down arrangements (para. 57), will be used by ADB to mitigate and diversify the risk profile of its direct loan and guarantee portfolio without direct sovereign counter-indemnity. Syndications can occur before financial close or during the tenor of the underlying debt depending on market conditions, the status of the associated project, and the need for ADB to adjust its portfolio from time to time. Syndications will ensure appropriate balancing of ADB's risk exposures and may be arranged on an individual, portfolio, or any other basis consistent with industry practices.

75. **Supporting Larger Transactions.** To support larger or more complex projects, statutory, strategic, or prudential limits will capture net exposure after any syndication, adjusted for any counterparty risk (i.e., the risk of nonperformance by the financing partner) that ADB may assume under a syndication structure. To the extent that ADB does not retain counterparty risk, that portion of ADB's exposure transferred to other syndicate members shall not be included in the calculation of the relevant limits. Should ADB retain counterparty risk (for example, under a reinsurance arrangement), then ADB—consistent with market practice—will give due consideration to the credit rating of the counterparty, any portfolio diversification gained, and other relevant factors when determining ADB's net exposure for the purpose of calculating relevant limits.

[59] Furthermore, for private sector operations (PSO), according to project prudential limits, guarantees for commercial and political risk have been treated the same way as direct loans, at a ratio of 1:1, while those for political risk are afforded a ratio of up to 2:1.

3. Pricing

76. **Simplified Structure.** The pricing principles applied to CEPs will mirror those for ADB's lending operations, which seek to cover ADB's operating expenses and funding cost for sovereign borrowers, plus a risk spread for non-sovereign operations to support ADB's risk-bearing capacity and in accordance with sound banking principles[60] to compensate ADB for exposure to risk. Pricing for CEPs has two main components: (i) credit enhancement fees to cover cost of capital and general operation (adjusted for risk as appropriate), and (ii) administrative fees to cover transaction-specific costs of processing and implementation. Pricing can be "all in" to improve comparability and transparency (the various components will be calculated separately).

a. Credit Enhancement Fees

(i) Guarantee Fee for Transactions with Sovereign Counter-Indemnity

77. **Sovereign Loan Equivalency.** For any guarantee with sovereign counter-indemnity (sovereign guarantee) in support of public sector obligors (i.e., with more than 50% ownership by the public sector), the guarantee fee will be based on sovereign loan equivalency. This will reflect ADB's cooperative nature and cover its operating cost. Thus, pricing in this case will correspond to ADB's OCR sovereign lending spread, adjusted for the lower risk and lower operating cost of guarantees. The sovereign guarantee fee level will be reviewed from time to time, but will be no greater than an amount equal to ADB's sovereign lending spread (after any waivers or surcharges that may apply at the time the guarantee is issued) for an analogous sovereign loan.[61]

78. **Special Consideration for PPP.** In case of sovereign guarantees in support of private sector obligors,[62] ADB may charge a premium at a market-based rate (para. 79) to avoid distorting markets or suppressing their development,[63] but ADB will retain only the sovereign guarantee fee (para. 77) for its own account.[64] In such a case, the difference between any market-based pricing applied and the sovereign guarantee fee may be paid into an appropriate reserve held in trust by ADB or an acceptable third party. This difference will ultimately be applied or rebated—after an appropriate no-claims period—in a transparent manner that benefits the client country and is acceptable to ADB.[65]

[60] See Article 14 (xiv) of the Charter.
[61] A sovereign guarantee is expected to improve the financing terms for the obligor, and ultimately improve outcomes for the project beneficiaries.
[62] This may be appropriate in selected cases only, for the coverage of political risks under government control or for transactions with high developmental impact in "frontier" markets that would not occur otherwise (para. 64).
[63] Such pricing would normally reflect the risk of the underlying transaction assigned by the market in the absence of a sovereign guarantee, but may be challenging for imperfect markets. In such a case, an internal risk assessment may provide guidance.
[64] For transactions whereby the sovereign counter-indemnity covers only a part of ADB's total guaranteed amount, or only certain types of risk, ADB will retain the fee on a blended basis, with pro-rata distribution between the sovereign guarantee fee (for the guarantee portion with sovereign counter-indemnity) and the market-comparable pricing (for the portion without sovereign counter-indemnity).
[65] For instance, the fee could be used for output-based aid or related capacity-building activities, among others. This allows more transparent and targeted application of any subsidies that may be implied in the counter-indemnity, and avoids merely passing such subsidies on to the private sector obligors or financing partners without public benefit.

(ii) Risk- and Market-based Premium for Non-Sovereign Indemnified Guarantees

79. **Risk- and Market-Based Pricing.** Pricing for guarantees that do not benefit from sovereign counter-indemnity (for both public and private sector obligors) will take into consideration (i) relative risk; (ii) market price indicators; and (iii) project-specific considerations.

80. **An Art More Than a Science, But Systematic.** Actual pricing may thus vary for each transaction depending on its specific characteristics; it shall not distort markets (to the extent such markets exist) or undermine them in their infancy but support their development. At the same time, pricing should allow for tangible benefits in the project outcome to materialize, within acceptable risk parameters. This requires a skillful and considered approach. Inappropriate pricing can undermine developmental impact or ADB's risk position. For each transaction, pricing will thus be determined and approved by a neutral, technically competent, and empowered committee (para. 89) to ensure a balanced approach that minimizes any potential conflict of interest. Pricing will be based on objective analysis, taking into careful consideration the factors outlined above.[66]

(iii) Syndication Fees

81. **Only for Reinsurance.** For syndications of ADB loans through a fronting (pass-through) or sell-down arrangement, no risk-based premium is normally applicable, since ADB does not retain any credit risk, although administrative fees may apply (para 82). For syndications provided through reinsurance arrangements (where ADB retains counterparty and documentation risk), market-based ceding commissions will be charged.

b. Administrative Fees

82. **Transaction Specific.** ADB may charge administrative and other fees that are specific to the processing and implementation of a CEP, consistent with industry practice. Fees for applications and processing, syndications and guarantees (including capital provisioning for undrawn amounts), brokerage, and reinsurance, as well as other fees and commissions,[67] as appropriate, may either be charged to or paid by ADB on a case-by-case basis, in accordance the role ADB plays in a transaction and with best industry practices.[68]

c. Payment Arrangements

83. **Flexible and Pragmatic.** The fees for credit enhancement will be paid to ADB by the assigned beneficiary of a guarantee (guarantee holder) or other acceptable party either directly or through an administrative agent, in the agreed periodic installments, and either in advance or in arrears, in line with market practice and taking into account ease of administration. Fees for syndications can be paid up-front or at the time the related agreements are signed, or spread over the life of the syndication, as appropriate.

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[66] In particular, guidelines for risk assessment and risk-based pricing will be developed (by RMU) and market comparator information will be provided on an objective basis from a neutral source (by OCO).

[67] These could include, for example, fees for the cost of expert consultants, or for the reimbursement of discretionary expenses of ADB staff directly associated with a project.

[68] Such fees may include application fees, front-end fees, commitment or stand-by fees, or any other, as appropriate. They will be charged on a cost recovery principle while maintaining competitiveness of ADB's products.

IV. IMPLEMENTATION

84. **Consistent with FPS and Other MfDR Initiatives** (footnote 5). The effective application of ADB's CEPs requires appropriate operational arrangements with clearly defined accountabilities for various functional aspects, consistent with the FPS. This relates to (i) processing and implementation of guarantees and arranging syndications; (ii) product development, innovation, and related knowledge management; and (iii) relationship management and awareness building for credit enhancement operations. These operational arrangements will be aligned with resource parameters, consistent with the phased approach outlined in the FPS. Adjustments may take place over time, as the growth and demands of ADB's credit enhancement operations, as well as a more detailed workflow analysis, dictate. With the expected increase in credit enhancement operations, increased attention will have to be given to monitoring and reporting.

A. Operational Arrangements and Responsibilities

1. Transaction and Portfolio Management

a. Processes and Responsibilities

85. **Alignment with ADB's Business Processes and Operations.** The processing of CEPs is closely linked to the processes that govern the processing and implementation of ADB's own loans and investments related to the CEP, as well as its financing partnerships. In the case of a CEP in support of direct cofinancing along with an ADB loan or equity investment (to the same obligor), processing and due diligence will normally be in conjunction with the ADB loan or investment. In case of a guarantee in support of ADB's country and sector operations but without direct risk exposure by ADB to the obligor, e.g., linked to a TA or under a sector facility, or related to an earlier investment made by ADB, the processing steps for guarantees will be similar to those that would apply if ADB were processing a direct exposure to the obligor.[69] ADB may draw on the due diligence review performed by parties undertaking a similar role to ADB in any proposed transaction, as appropriate, in order to expedite processing and avoid duplication while ensuring that due diligence standards are observed.

86. **Special CEP Considerations in the Transaction Cycle.** Some considerations specific to CEPs will need to be observed during the operational business cycle. Management will separately give consideration to the following matters: (i) origination of CEP transactions and concept clearance, (ii) due diligence and risk assessment, (iii) price determination and endorsement, (iv) approval and execution of guarantee and syndication arrangements, (v) CEP administration, (vi) monitoring and reporting of credit enhancement operations; (vii) preparation of guidelines for specialized aspects, such as for guarantee underwriting procedures, syndication arrangements and reinsurance procedures, counterparty risk analysis, risk-based pricing, and administrative and back-office support for CEPs.

87. **Functional Responsibilities.** Given the multidisciplinary and specialist skills required to manage CEPs, effective teamwork across various departments in ADB will be emphasized.

(i) At the transaction level, origination, due diligence of the obligor and of project financing risks, and transaction-specific CEP issues will be led by the operational

[69] In the case of guarantee facilities (para. 67), streamlined implementation procedures may apply, as outlined in the project documents describing such facilities and approved by the Board at their establishment.

departments (RDs and PSOD), with specialist advisory support from OCO and other service departments, as appropriate.[70] OCO will arrange and finalize syndications and undertake due diligence related to counterparty risk.[71] Pricing will be determined through an interdisciplinary and objective committee, such as the Credit Enhancement Committee (CEC) (para. 89). In case of a claim, a special claims committee will be formed to provide specific guidance when required.

(ii) At the portfolio, systemic, and institutional level, risk management–related issues will be driven by the Risk Management Unit (RMU), which will develop and maintain appropriate guidelines on relative risk and pricing and credit exposure limits (para. 72, 73). RMU will work closely with OCO on the implementation of portfolio-balancing syndication activities (para. 74). OCO is the primary relationship manager for financing partnerships and has key responsibilities for product development and innovations and for knowledge management. Controller's Department (CTL) will continue to maintain data for financial reporting and overall exposure monitoring. Treasury Department (TD) determines and reviews from time to time loan equivalency fees for guarantees. OGC will continue to develop and maintain standard legal documentation.

b. Institutional Arrangements for Risk Assessment, Pricing, and Claims Management

(i) Credit Enhancement Committee

88. To ensure a consistent and objective approach to risk and return, an independent committee such as the CEC will be established to assess risk aspects related to CEPs and provide guidance and approvals on pricing and other financial terms. It will bring together competent representatives from the operational department processing the transaction (RD or PSOD, or both) and non-operational (technical service and advisory) departments[72] involved in credit enhancement operations. The CEC will be chaired by a non-operational department, to ensure objectivity and consistency in its deliberations and minimize any potential conflict of interest in its decisions (para. 80).[73]

89. Key functions and responsibilities of the CEC include (i) reviewing, and providing guidance on, proposed terms and conditions, risk parameters and mitigation structures, as well as of policy consistency for all CEP transactions; and (ii) approving pricing terms and conditions for all CEP transactions in light of the proposed scope of coverage.

[70] Continuing internal education will increase the operational departments' knowledge of and comfort level with CEPs, and thereby encourage the wider use of these products throughout ADB.
[71] Syndications in particular are relationship-driven and, consistent with best industry practice, are normally carried out through a centralized and specialized syndication unit. This best practice is also observed in comparator organizations with significant commercial cofinancing activities, such as the EBRD or IFC. Typical functions include dealing with financing partners in arranging and finalizing syndication arrangements for improved exposure management, and assessing counterparty risk.
[72] Including CTL, OCO, OGC, RMU and TD.
[73] The CEC will not replace the Management Review Meeting or the Private Sector Credit Committee, both of which are chaired by the operational Vice-Presidents and deal with a wider range of project aspects, including project quality, development impact or other risks such as related to social safeguards or compliance.

90. The CEC will meet at least twice for each project. The first meeting will normally take place early in the project cycle, shortly after concept clearance has endorsed the application of a CEP and before due diligence, to provide initial guidance and set broad parameters for a project's financial structure and the prospects for the issuance of guarantees and syndication. This meeting will help ensure that terms put to the market are consistent with policy and precedent and clear objectives and approach are established.[74] The CEC will meet a second time after the completion of the due diligence review to determine and authorize the finalization of guarantee or syndication terms. The CEC will clear: (i) indicative guarantee or syndication terms before they are issued; and (ii) the CEP-related sections of the Board Paper before its circulation to the Board. It may also meet from time to time during the project processing cycle to provide further guidance as required.

(ii) Claims Committee

91. To minimize potential conflicts of interest associated with ADB's direct lending and equity investment operations and ensure that standard risk management practice is followed in case of a claim, a Claims Committee (CC) will be established and will meet as necessary to address future claims if and when they arise. The CC will respond in a timely fashion, as it becomes aware of potential problems, to future claims at a distance from ADB's direct participation in the transaction. Its membership will be similar to that of the CEC.

2. Product Development, Innovation, and Knowledge Management

a. Product Development and Innovation

92. Continuing product development and innovation will keep ADB's CEPs relevant to its clients. This will require regular consultations with market participants on new market trends and requirements, with the objective of responding to market needs within the ambit of this policy. This includes work to further develop relevant intermediation products, services, and approaches.[75] Such work will be led by OCO, and will also include drafting, maintaining, and updating staff instructions and other guidelines for the processing and implementation of guarantees, syndications, and other credit enhancement operations, as well as for claims and reinsurance management.

b. Knowledge Management

93. Knowledge management is closely related to product development, and OCO will function as ADB's institutional knowledge resource and CEP competency center, responsible for building awareness of ADB's cofinancing products and approaches within ADB and among potential cofinanciers. All operating departments would be encouraged to acquire a minimal degree of competence in CEPs, through mentoring by OCO during the processing of CEP transactions, and other means. OCO will also continue its learning development efforts to ensure common understanding of CEPs in ADB.

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[74] It is common practice for political and credit risk guarantors to routinely provide preliminary indications of pricing to clients at the early stages of negotiations. ADB staff will have the option of providing preliminary pricing indications after the CEC has met to agree on indicative guarantee or syndication terms, so long as the client is notified that such indications are nonbinding and based on prevailing market conditions.

[75] This may also include support for special ADB-wide regional and thematic initiatives, such as regional capital market development, trade promotion, or infrastructure development.

c. Credit Enhancement Practice Group

94. A new technical knowledge sharing group—the Credit Enhancement Practice Group (CEPG)—will be formed. It will be an interdepartmental group composed of representatives from CTL, OCO, OGC, PSOD, RMU, and TD; RD members; and other interested parties. The CEPG will be an interdepartmental knowledge-sharing and consultation platform with OCO as its secretariat, and bring together a broad range of expertise to advise and mentor the operational departments in the processing of guarantee operations.

3. Relationship Management and Awareness Building for Credit Enhancement Operations

95. Effective relationship management is critical in ensuring that ADB's credit enhancement operations can (i) raise additional debt resources on time, efficiently, and cost-competitive basis to facilitate investment; (ii) enable ADB to effectively share some or all of the risk associated with its direct loans and guarantees with other lenders and insurers through timely and cost-effective syndications; (iii) obtain timely guidance from the market and align itself with best industry risk management practices; and (iv) become more responsive to changing market demands.

96. Since strong and effective financial partnerships are a key part of ADB's developmental mandate and its credit enhancement operations, effective coordination and management of relationships with financing partners in this regard will be required. ADB will continue to build and strengthen its relationships with other lenders, cofinanciers, and guarantee providers. This function is normally carried out through a centralized unit in the financial industry. Within ADB, OCO will lead and coordinate the management of relationships with other financing partners or guarantee providers at the institutional level, while operational departments may maintain relationships related to specific transactions, as appropriate. The various units within ADB will have to coordinate closely among themselves to ensure consistency of messages.

97. Finally, OCO will promote the dissemination of information on ADB's products and services and work with the Department of External Relations to raise ADB's external visibility and increase awareness of its credit enhancement operations, through high-profile external events and other means. The effective marketing of ADB's potential value-addition as financing partner and a clear understanding of ADB's product range by prospective cofinanciers are important elements in this campaign.

B. Monitoring, Reporting, and Coordination

98. Information management will be improved to facilitate appropriate monitoring and reporting. Internal mechanisms, systems and procedures that are more conducive to accurate and timely data input, data retrieval, and project monitoring will be developed and updated to better capture relevant information, including e.g. for the registration of applications for projects that could be supported by a CEP, pricing information, or exposure levels.[76] This will also promote common data entry and access between and among relevant operating departments.

[76] The development and maintenance of the information systems will be coordinated with the implementation of ADB's Information Technology strategy, as well as OCO's ongoing work on internal Web site development, to make information related to cofinancing and credit enhancement operations more easily accessible across the institution.

The objective will be to improve information access and transparency and establish criteria to allow instant data retrieval.

99. Financial information on net and gross exposure levels and fee income will be captured and maintained by CTL, and provided to other departments in ADB for further reporting as appropriate.

100. Progress in implementing the new policy overall will be monitored by OCO and reported annually to the Board through the report on cofinancing and financing partnership operations. This report will highlight specific issues and new initiatives and activities taken under this policy.

101. OCO will have overall responsibility for coordinating the implementation of ADB's policy on credit enhancement operations.

C. Resource Implications

102. The implementation of the CEP policy will require appropriate resources at various levels, in both operational and support departments. ADB currently has some professional staff with requisite skills to support limited CEP operations, and expertise must become more widely available and accessible to meet the challenges and complexities ahead. Training and knowledge transfer through structured in-house courses as well as on the job and mentoring by OCO will be an important element to support the broadening of expertise related to credit enhancement operations throughout ADB. Staff who already have the required skills and experience must transfer their knowledge to expand and effectively mainstream CEP operations.

103. CEP operations are expected to increase with the phasing in of the FPS, and the skills and resource mix will likewise adjust gradually, in line with actual business volumes. A more detailed resource analysis will be undertaken to determine appropriate budgetary alignments for 2008. This will also assess resource requirements to adequately support CEP operations during the initial phase of the FPS.

V. RECOMMENDATION

104. I recommend that the Board approve the revised policy and operating framework for credit enhancement operations substantially as outlined in Section III and the implementation plan substantially as outlined in Section IV of this paper.

OVERVIEW AND KEY FEATURES OF ADB'S CURRENT CREDIT ENHANCEMENT PRODUCTS

1. **Overview.** ADB currently distinguishes between two guarantee products and two syndication products. The guarantee products comprise the Partial Credit Guarantee (PCG) and the Political Risk Guarantee (PRG). The syndication products comprise the Complementary Financing Scheme (CFS), which is a loan syndication product, and the Guarantor of Record (GOR) Scheme, which is a guarantee syndication product. Both types of syndication products are "fronting" arrangements, without any credit risk for ADB. In the past, ADB has not entered into any reinsurance or sell down arrangements, although such arrangements have been approved under the Innovation and Efficiency Initiative (IEI).[1]

A. Guarantee Products

1. Partial Credit Guarantee

a. Key Features

2. Under the Partial Credit Guarantee (PCG), ADB provides comprehensive coverage to commercial cofinanciers of all commercial and political risks for a specified portion of a borrower's debt service obligation. PCGs can be used to support commercial cofinancing of both public and private sector projects. Depending on the requirements of the project, the PCG can be used to guarantee various debt instruments. For example, it can be used to guarantee part of the debt service under a syndicated loan, or under a floating rate note or bond, provided these are issued for financing the ADB-assisted project.

3. PCGs have generally been used to guarantee debt service during the later maturities of a commercial cofinancing. This may be appropriate when lenders are not willing or able to provide a financing term long enough to match the cash flow of a project. Alternatively, PCGs can guarantee a portion of principal and interest payments payable throughout the term of a borrowing.

4. Consistent with ADB's policy of risk-sharing with cofinanciers, the PCG is designed to cover that portion of the debt service that the cofinanciers are not prepared to take, leaving the remaining portion to the cofinanciers on an uncovered basis.

5. Approval of PCGs is on a net present value (NPV) basis for the guaranteed amount. This allows some leverage of financing, and the total face value of the debt supported by a PCG is usually higher.

6. Given the Asia and Pacific's evolving financial needs and changing risk perceptions, ADB has increased emphasis on using the PCG to support local currency cofinancing. This is consistent with ADB's initiatives of developing local capital markets and helping project sponsors reduce the foreign exchange risks associated with cross-border loans requiring debt service in currencies different from those of the cash flow of the project.

[1] ADB. 2005. *Pilot Financing Modalities and Instruments*. Manila (R194-05). Para 63-65.

b. Risk Limits

7. There is no limit on the amount of PCGs for public sector projects or programs; however, all public sector PCGs must have a host government counter-guarantee. At present, for *private sector* projects that have no host government counter-guarantee (or indemnity), ADB's single project exposure limit (comprising direct lending, equity investment, PCG support, or underwriting commitment) is $75 million, or 25% of project costs, whichever is less.[2] PCGs are also counted against private sector country limits, based on their NPV.

c. Pricing and Fees

8. At present, for PCGs with government counter-guarantees, ADB charges a standard fee of 40 basis points (0.4%) per annum on the NPV of the outstanding guarantee obligation, plus a front-end fee to cover ADB's processing costs. For private sector PCGs, both the guarantee fee and the front-end fee are charged at market rates.[3]

d. Documentation and Administration

9. PCGs are underwritten with the same documentation required to process a transaction's underlying debt instrument, and may be processed concurrently with that instrument, or separately. It is therefore important that ADB have access to such information as early as possible in the underwriting cycle. For ease of administration, PCG payment periods typically mirror the debt service payment timing of the debt instrument.

e. Applications

10. ADB issued its first PCG in 1988, and its initial guarantee obligations, until 2000, were PCG only, mostly in the public sector and with direct sovereign counter-indemnity. Many PCGs were executed in conjunction with cofinancing under CFS which served to stretch maturities by two-to-five years.

11. PCGs have been issued for a wide range of cofinancing arrangements. The first PCG covered additional private financing alongside an ADB program loan in support of policy and institutional reforms. Subsequent guarantees supported funding from commercial lenders for ADB-financed infrastructure and/or industry projects in the public sector; the issuance of a long-term international bonds, whereby ADB stretched tenors and covered principal repayment for a 20-year maturity; commercial financing to support small-and- medium-sized enterprise (SME) development in the private sector; support to Thailand to regain market access following the Asia Crisis; the issuance of floating rate notes to enable medium and large-sized private enterprises to access long-term commercial financing for capacity expansion and technology upgrading; letter of credit confirmation for regional trade finance support; expansion of small- and medium-sized enterprise lending in local currency by private sector banks; and support for a local currency bond issue to stretch tenors.

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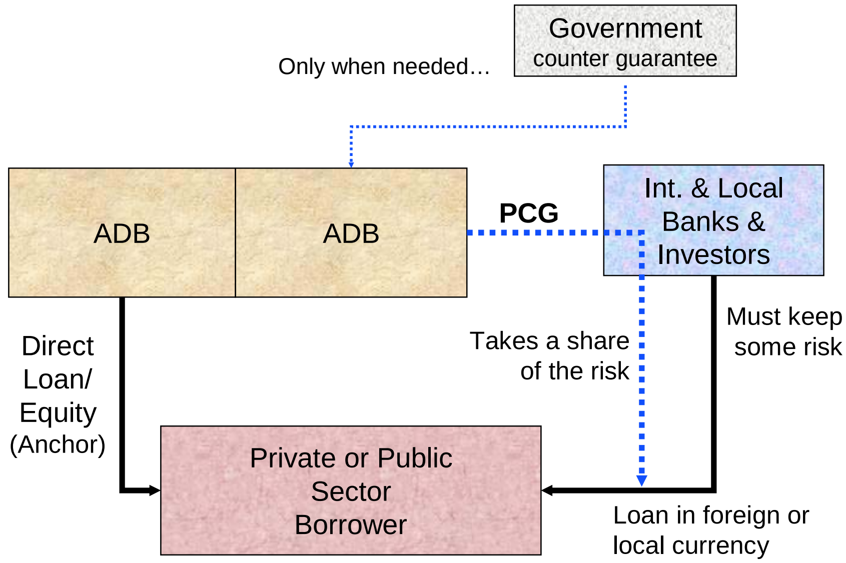
[2] In calculating this limit, ADB's direct lending and/or equity exposure is equal to the *face value* of the commitment, while PCG exposure is calculated based on the NPV of the PCG guarantee obligation.

[3] In the case of PCGs for private sector projects that have a host government counter-guarantee, the guarantee fee and front-end fees payable to ADB are the same as for public sector PCGs.

Figure A1.1: PCG Illustration – Risk and Financing Distribution



Source: ADB.

Box A1.1: PCG Application for Syndicated Lending

Export Financing Facility (Thailand)

Following the Asian financial crisis, ADB put together a $950 million syndicated lending export financing facility (EFF) with 5 year tenor to ensure continued financing access to the Export-Import Bank of Thailand for onlending to SMEs. This was the first term financing arranged for Thailand since the start of the Asian financial crisis in July 1997. A PCG was provided to cover the principal and interest due for years 1 to 3, with extension to year 4 if Thailand was rated below BBB/Baa2. This was in addition to a direct loan by ADB of $50 million. ADB's loan and the PCG were fully counter-guaranteed by Thailand.

The EFF included a syndicate of 68 commercial lenders (from Asia, Europe, and North America), and was an impressive vote of confidence to encourage post-crisis commercial lending to Thailand.

Source: OCO, ADB.

Box A1.2: PCG Application for Syndicated Lending

Power Sector Restructuring Program (Philippines)

To meet the cash flow requirements of the Philippine's Power Sector Assets and Liabilities Management Corporation (PSALM) during the initial stage of privatization, PSALM sought ADB support for a long-dated fixed rate Yen bond issue for up to $500 million equivalent.

The bond was structured in two tranches of 18 and 20 years, with the ADB PCG covering 100% of the repayment of the principal at final maturities, plus partial coverage of up to 10 years of the back-end interest coupons. Republic of the Philippines guarantee will cover 100% of the repayment and interest payments of the bond through direct guarantee.

ADB's PCG was vital for the successful execution of PSALM bond issue at the end of 2002, when world capital markets were very volatile. With the PCG, PSALM was able to borrow at significantly more favorable terms to extend the term by 11–13 years over ROP stand-alone bond issue. This transaction was the largest PCG-assisted bond issue for ADB to date.

Source: ADB.

2. Political Risk Guarantee

a. Key Features

12. The Political Risk Guarantee (PRG) facilitates commercial cofinancing of ADB-assisted projects by guaranteeing payment of all or part of the project's debt service against specific political (or sovereign) risks. PRG coverage can include any combination of the following:

(i) Currency inconvertibility and/or non-transfer;

(ii) Confiscation, expropriation, nationalization, or deprivation of project assets;

(iii) Political violence, such as strikes or civil disturbances, including terrorism, sabotage, that negatively affects the project, and

(iv) Breach of contract, such as non-delivery by state-owned entities of inputs (e.g., fuel supplies) or nonpayment for outputs (e.g., power or water).

13. PRGs are primarily designed to facilitate private sector development, either through public or private sector projects. PRGs are well suited for public-private partnerships, whereby commercial lenders are prepared to take on the commercial (or credit) risks of a project, but require assistance from a multilateral institution or private insurer in mitigating political risks.

14. Since the political risks covered by a PRG relate to outcomes normally under the direct or indirect control of the host government, under certain circumstances the government may provide a guarantee to the project and or a counter-guarantee (or indemnity) to ADB. This provides further assurance to cofinanciers and ADB of the host government's commitment to the project.

15. ADB's PRG can be structured to make it compatible with the Political Risk Insurance (PRI) products offered by other agencies, including the World Bank Group's Multilateral Insurance Guarantee Agency, private sector PRI providers, and export credit agencies (ECAs). Because of the size of some projects requiring PRI cover (particularly large infrastructure

projects), and in recognition of the importance of risk sharing and collaboration, ADB can offer its PRG in parallel with other PRI providers.

16. In case of parallel PRG coverage, public and private PRI providers offer PRI to the same project alongside or in parallel with ADB, under their respective names, terms, and conditions. This arrangement benefits PRI providers that (i) do not need the benefits of ADB's unique status or "umbrella" and (ii) offer insurance, rather than guarantees, on terms that cannot be easily reconciled with those of ADB's PRG.

b. Risk Limits

17. If the PRG is counter-guaranteed by the host government, there is no limit on the amount of the PRG. Currently, for projects with PRG support for which there is no host government counter-guarantee, ADB's total assistance may be up to $150 million or 50% of project costs, whichever is less (with such assistance calculated on face value).[4]

c. Pricing and Fees

18. The PRG fee structure has three components: (i) a front-end fee, (ii) a standby fee, and (iii) a guarantee fee. The amount of each of these fees is determined separately for each PRG by ADB's Guarantee Committee. The front-end fee covers due diligence and other up-front costs. The standby fee applies to the amount of cofinancing covered by the PRG that has not yet been disbursed.[5] The guarantee fee is usually charged as a percent per annum on the amount to be covered (normally comprises the principal outstanding and the amount of accrued interest). The level of guarantee fee depends on the perceived level of the risks covered, and on whether or not the PRG is counter-guaranteed by the host government. If the PRG is counter-guaranteed, ADB charges a guarantee fee based on sovereign loan equivalency. If the PRG is not counter-guaranteed, the guarantee fee is charged at market rates.

d. Documentation and Administration

19. PRGs are underwritten with the same documentation required to process a transaction's underlying debt instrument, and may be processed concurrently with that instrument, or separately. This may include information memoranda, feasibility studies, joint venture agreements, studies supporting technical feasibility, environmental impact assessments, power purchase agreements, fuel supply agreements, and other relevant documentation. It is therefore important that ADB have access to such information as early as possible in the underwriting cycle. For ease of administration, PRG payment periods typically mirror the debt service payment timing of the underlying debt instrument.

e. Applications

20. ADB began underwriting PRGs in 2000, and has approved 9 such guarantees since that time, totaling nearly $550 million. The majority of these were linked to private sector projects. Some PRGs were linked to public sector projects that supported private sector development. PRGs have been used to facilitate investments in many of Asia's poorest countries. Such investment may not otherwise have occurred in the absence of the use of the PRGs. For

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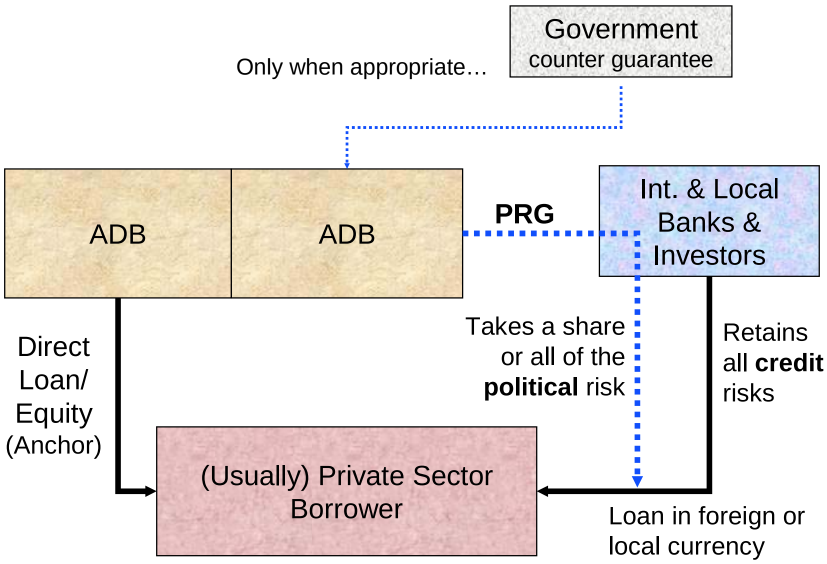
[4] The proportion between ADB's direct participation (e.g., in the form of a loan and/or equity investment) and PRG support is determined on a project-by-project basis, with a view to appropriately leveraging the PRG support.

[5] For PRGs with counter-guarantee, the standby fee is included in the guarantee fee.

example, in 2006, a PRG was used to support the first commercial bank lending for some 30 years in Afghanistan. ADB is also a partner with the World Bank Group in the Afghanistan Investment Guarantee Fund, designed to encourage the flow of foreign direct investment into the country.

Figure A1.2: Risk and Financing Distribution – PRG



Source: ADB.

Box A1.3: PRG Application

AES Kelanitissa (Private) Limited (Sri Lanka)

The Kelanitissa Project in Sri Lanka, approved in 2000, was ADB's second PRG. The project involved construction and operation of a 163-megawatt diesel-based combined-cycle power station. Total project cost was $104 million, including $26 million in sponsor equity and $78 million in debt. ADB provided a direct loan of $26 million, and guaranteed $31 million of commercial cofinancing, in two tranches. PRG covered breach of contract by the Government of Sri Lanka under the implementation and other agreements, change of law and events, which make project agreements unenforceable, and breach of fuel supply and power purchase agreements, as well as payment obligations relating to currency convertibility and transfer risk, expropriation and confiscation. The PRG was fully counter-guaranteed by the Government of Sri Lanka. This allowed the financing syndicate to stretch financing tenors with favorable rates beyond what would have been possible without the PRG.

Source: ADB.

B. Syndication Products

1. Complementary Financing Scheme

a. Key Features

21. ADB's Complementary Financing Scheme (CFS) is a credit enhancement product that involves the prearranged sale to commercial lenders of participation in a cofinanced or "complementary" ADB loan without recourse to ADB for debt service.[6] In the past, the CFS was used solely to facilitate commercial cofinancing of ADB-assisted private sector projects. ADB is the "lender-of-record," since the complementary is made in ADB's name.

22. Any reputable financial institution can participate as a CFS lender, provided it operates commercially (i.e., it finances its loans from the market without government credit support or budgetary allocation). However, financial institutions are not eligible to participate in CFS transactions if their head offices are registered in the same country where the ADB-assisted project is located.

23. Though funded by commercial lenders, the complementary loan receives the benefit of ADB's unique status since ADB is the lender-of-record. The complementary loan thus enjoys the same privileges and immunities as those applicable to ADB's direct loan, including

- (i) exemption from restrictions on currency conversion and on the remittance of interest and repatriation of principal,
- (ii) exemption from withholding tax,
- (iii) reduced likelihood of rescheduling in the event of an external debt crisis in the borrowing country,
- (iv) exemption from special debt provisioning requirements in some countries, and
- (v) benefits from linking the complementary loan with ADB's direct loan through an optional cross-default clause.

24. Cofinanciers providing CFS loans also benefit from ADB's project appraisal, supervision, and loan administration services. Under the CFS, ADB acts as a channel for loan disbursements and debt service payments.

b. Risk Limits

25. There are no formal limits associated with the CFS, but its use is selective for developmental projects to avoid undermining a country's debt sustainability under ADB's umbrella.

c. Pricing and Fees

26. For CFS loans, ADB charges market-based fees for its own account, as well as for the account of the participating institutions (CFS lenders). The fees are based on the estimated costs of arranging and administering the CFS loan, and on standard market practice. The arrangement fee is a one-time front-end fee, and is fixed at the lower end of the normal range of such fees charged by international commercial banks for syndicated term loans. The annual administration fee covers the cost of CFS loan administration expenses.

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6 Complementary loans are commonly referred to as "B-loans" to distinguish them from the direct or "A-loans" provided by other multilateral institutions.

27. Participating CFS lenders normally charge a management fee (or front-end fee) and an annual agency fee to cover their syndication efforts. If the cofinancing is underwritten, the institutions involved may also charge an underwriting fee. These fees, which are market-based, are charged to the borrower.

d. Documentation and Administration

28. CFS documentation comprises:

(i) a direct loan agreement between ADB and the borrower,[7]
(ii) a complementary loan agreement between ADB and the borrower, and
(iii) a participation agreement between ADB and the participating CFS lenders.

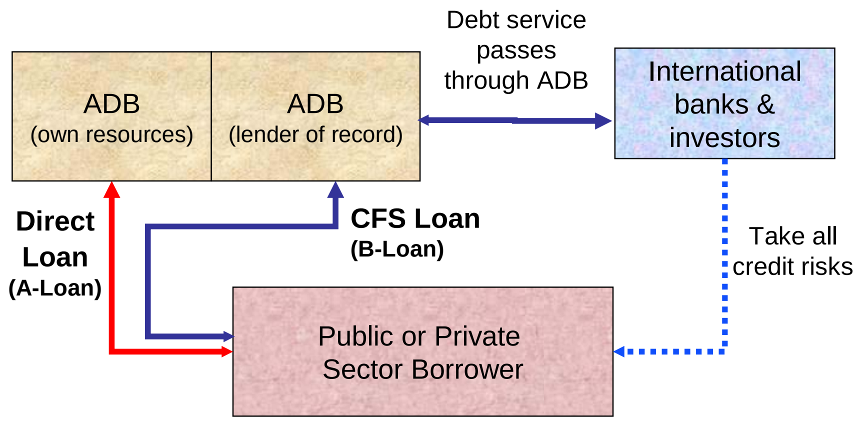
29. The relationship between a CFS lender and the borrower is indirect, although the borrower is informed of the identities of such lenders.

30. As lender-of-record, ADB administers CFS loans on behalf of the participating CFS lenders with the same standard of care it exercises in loans for its own account. In matters of critical importance to CFS lenders, ADB does not act unilaterally, but instead seeks the lenders' views and consent prior to taking action, as specified in the participation agreement.

e. Applications

31. ADB has been issuing CFS syndications since 1986. Since that time, about 30 CFS transactions have been approved. Pakistan has received the largest share of CFS loans, followed by the People's Republic of China, Philippines Indonesia and India. Bangladesh, Nepal PNG and Viet Nam received on CFS, each.

Figure A1.3: CFS Illustration



Source: ADB.

[7] The direct ("anchor") loan fulfills ADB's "direct participation" requirement, making it possible to use the CFS to support commercial cofinancing.

Box A1.4: CFS Application

Chengdu Generale Des Eaux - Marubeni Waterworks Co., Limited (PRC)

The project involved the construction of a modern water supply plant in the People's Republic of China (PRC) with a capacity of 400,000 cubic meters per day to provide reliable water to nearly three million residents in the city of Chengdu. The Project was the first BOT water supply project in the PRC, the first Project financing to rely on municipal risk in the PRC, and the first private sector water project for ADB. The plant will be transferred to the Government after 18 years.

Total project cost was $106.5 million, including $74.5 million international debt financing. ADB supported the project with a 15 year direct loan for $26.5 m from its private sector window, complemented by a $21.5 million CFS loan that brought together 7 commercial lenders. Due to the CFS, the maturity could be stretched to 12 years. The remainder of the debt financing was provided by the European Investment Bank, which matched the tenor of the CFS financing.

The financing transaction won the "deal of the year" awards from *Project Finance International* and *Finance Intelligence Asia*.

Source: ADB.

2. Guarantor-of-Record

a. Key Features

32. Under this arrangement, ADB issues a guarantee for the entire amount of coverage requested by the borrower. ADB is the guarantor-of-record for the entire amount covered and does not assume any liability.

33. To cover the administrative expenses incurred in structuring each transaction and to compensate ADB for "fronting" the other PRI syndicate participants, ADB will charge an administration fee. This fee will be determined by ADB on a case-by-case basis.

34. The PRG collaboration structures described above enable project proponents to utilize PRI cover from multiple providers, thus facilitating projects that, without a sufficient amount of PRI cover, might not go forward. The host government can also take comfort in having a multilateral institution such as ADB involved in the project, to help ensure inter alia the technical and financial viability of the project. Project lenders benefit from the increased PRI cover in more difficult and challenging markets, while enjoying the comfort of an ADB guarantee.

b. Risk Limits

35. Under the GOR program, ADB issues a Guarantee Contract for the entire amount of insurance requested to be issued, subject to certain maximum limits. The extent of ADB's participation in any single project will depend on the willingness of other insurers to contribute capacity for a particular project or country, and ADB's own capacity for that country.

c. Pricing and Fees

36. To cover the administrative expenses incurred to structure each GOR project, ADB will charge the applicant a one-time administrative fee. Should the contract not be issued, or the

GOR not materialize, the fee would be refundable. Following contract issuance, an annual fee will be added to the premium.

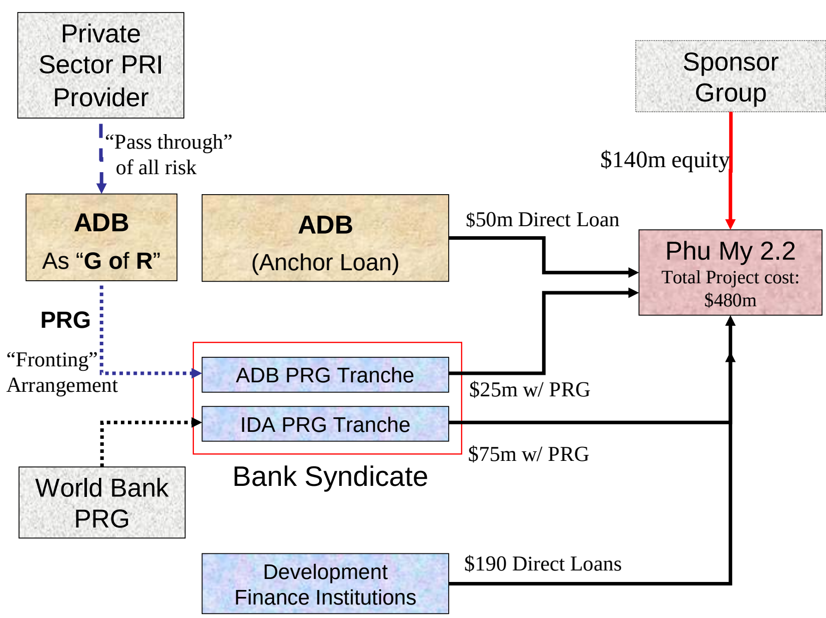
d. Documentation and Administration

37. Only be one guarantee contract issued to the guarantee holder for the entire amount underwritten by ADB under the GOR program. The contract may, however, include two (or more) sets of premium rates to account for the possibility that different rates may be charged by ADB and other insurers or guarantee providers. ADB will be the guarantor-of-record for the entire amount insured. The GOR will be transparent in that both the guarantee holders and the host country government will know of the presence of other insurers/guarantee providers.

e. Application

38. Of the two GOR schemes approved by ADB to date, only one has been made effective, for the $480 million Phu My 2.2 power project in Viet Nam. The Project is a 715MW gas-fired combined cycle power station in the Phu My Power Generation Complex in Ba Ria-Vung Tau Province. The Project was developed and implemented under a 20-year build-operate-transfer contract between the Ministry of Industry and Mekong Energy Company Limited. Electricity of Vietnam, a government owned utility, purchases the capacity and energy output of the plant under a 20-year power purchase agreement. In addition to its direct financing of $50 million, ADB provided a PRG of $25 million under a GOR arrangements to credit enhance commercial cofinanciers, with ADB fronting for an international PRI company. All risks related to the PRG are borne by the PRI company, without any recourse to ADB under the guarantee contract.

Figure A1.4: GOR Application – Phu My 2.2. Project



Source: ADB

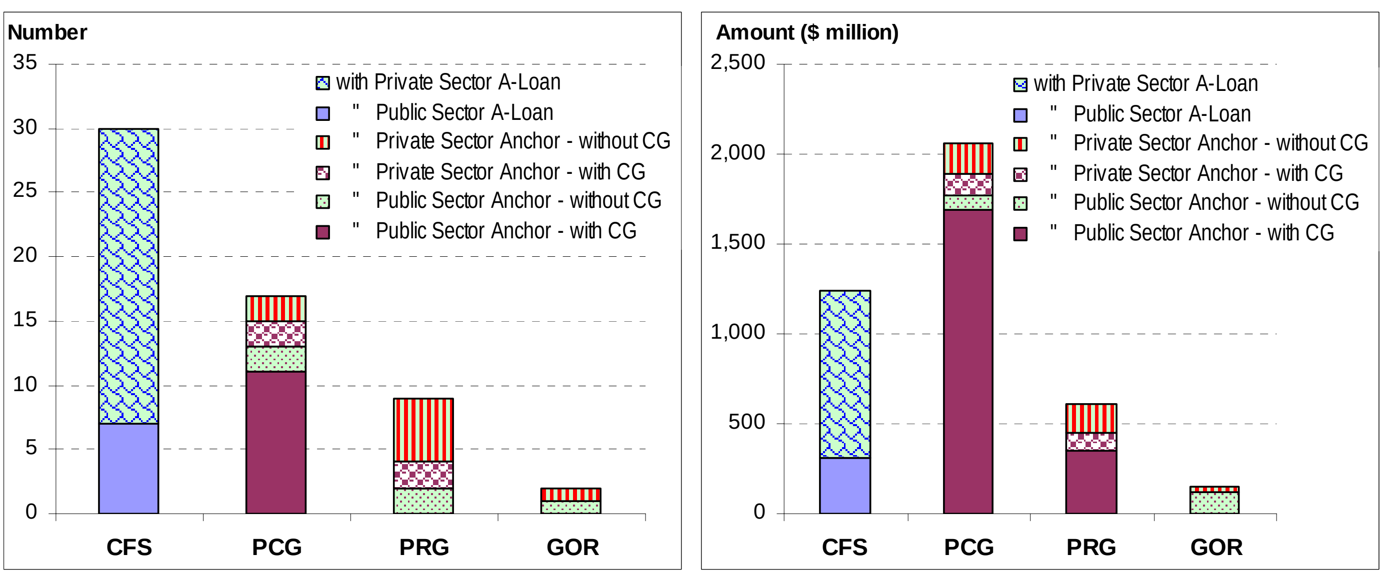
ADB's CREDIT ENHANCEMENT OPERATIONS, 1986–2005

Table A2.1: Credit Enhancement Product (CEP) Approvals, by Number and Amount

Item	CFS (since 1986)	PCG (since 1986)	PRG (since 2000)	GOR (since 2002)
Number of Projects	**30**	**17**	**8**	**2**
Public sector anchored	7	13	2	1
-with counter-guarantee	n/a	11	2	0
-without counter-guarantee	n/a	2	0	1
Private sector anchored	23	4	6	1
-with counter-guarantee	n/a	2	2	0
-without counter-guarantee	n/a	2	4	1
Approved Amounts ($ million)	**1,242**	**2,062**	**613**	**150**
Public sector anchored	312	1,776	350	125
-with counter-guarantee	n/a	1,692	350	0
-without counter-guarantee	n/a	83	0	125
Private sector anchored	930	286	263	25
-with counter-guarantee	n/a	115	101	0
-without counter-guarantee	n/a	171	162	25

CFS = Complementary Finance Scheme; PCG = Partial Credit Guarantee; PRG = Political Risk Guarantee; GOR = Guarantor of Record; n/a = not applicable
Source: ADB.

Figure A2.1: CEP Approvals (1985-2000), by Number and Amount



SUMMARY OF COVERAGES AND FEE STRUCTURES OF SOME MAJOR GUARANTEE/INSURANCE PROVIDERS FOR POLITICAL RISK INSURANCE (PRI)

1. ADB's CEPs possess the same perceived deterrence benefits (the ability to deter a host government from taking actions contrary to the interests of a guaranteed transaction) as those of other MDB and public sector entities. That is a distinct advantage over the private sector. ADB's AAA-rating is also a distinct advantage over most private sector guarantors/insurers, and many entities in the public sector. ADB's reputation and dominance as the premier development institution in Asia are also distinct advantages.

2. However, ADB's CEPs have some shortcomings as well. For example, ADB's range of guarantee instruments is limited compared with those of its competition. ADB's orientation to investment (rather than trade) cover and loans (rather than equity) place limitations on its guarantee operations, as clients often desire full-fledged solutions. ADB does not possess, nor does it routinely provide to the marketplace as its competitors do, coverages that address pure payment risk, private buyer export credit guarantees, wrongful calling of on-demand guarantees, or hybrid coverages that are customized to address the specific needs of individual transactions. This effectively shuts ADB out of a large segment of the guarantee marketplace.

3. The absence of experience in the area of reinsurance and its approach to risk management (treating guarantees in the same manner as loans from a provisioning perspective) also sets ADB apart from much of its competition in a negative way. Apart from one private sector PRI provider,[1] every other PRI provider in the market utilizes some form of reinsurance with regularity, or for every transaction they engage in, as a form of risk management. The Multilateral Investment Guarantee Agency, for example, reinsures 50% of every transaction it underwrites. The total absence of reinsurance as a risk mitigation tool in ADB's portfolio suggests how far behind it is when compared with its private and public sector comparator organizations.

4. All of the major insurance/guarantee providers adhere to a strict set of general underwriting guidelines and risk management principles. ADB's risk management practices are not fully consistent with best practices elsewhere. ADB's approach to risk weighting, for example, is not broadly consistent with industry best practices, and its approach to political risk analysis needs to be strengthened.

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[1] Sovereign Risk Insurance in Bermuda.

Table A3.1: Summary of Coverages and Fee Structures of Some Major Guarantee/Insurance Providers for Political Risk Insurance

Provider	Coverage	Fee Structure	PRI Fees	Maximum Cover and Term[b]
A. Multilateral Institutions[a]				
ADB (PRG)	Loans only against losses arising from transfer restrictions, expropriation, political violence, and breach of contract.	Market-based, comprising a front-end, standby, and guarantee fee.	Minimum guarantee fee on a loan equivalency basis, consistent with ADB's lending operations..	Up to 100% of loan principal and interest; at "stand-alone" PRGs not available; total ADB financial assistance to a guaranteed project (including the PRG) not to exceed twice the PSO limit.
IADB	Covers loans against losses arising from transfer restrictions, expropriation, political violence, and breach of contract.	Market-based with an appraisal and a guarantee fee, but no front-end fee. Guarantee fees are often set at around half of the lending spread.	Appraisal fee of $50,000–$300,000 guarantee fee of (currently) 150–250 basis points.	Up to 100% of the loan principal and interest; limit set at 50% of project cost or $150 million, whichever is less.
MIGA	Equity and loans against losses arising from transfer restrictions, breach of contract.	Market-based, comprising an application, processing, commitment, and guarantee fee.	Currently, base premium rates set at 0.5–1.25%, per single cover.	Up to 95% of loan principal, plus 135% of principal to cover interest. Up to $200 million per project.
B. Bilateral Institutions				
ECGD	Offers both debt and equity coverage against losses arising from transfer restrictions, expropriation, and political violence, as well as breach of government undertakings.	Fees are based on country and project-specific considerations Annual guarantee fees are complemented by an annual commitment fee.	Depending on country/risk specifics. E.g., premium rates for the PRC are 0.7% for expropriation, political violence, and transfer restrictions cover.	Up to 90% of the insured amount for up to 15 years.

Provider	Coverage	Fee Structure	PRI Fees	Maximum Cover and Term
EFIC	Equity and loans against losses arising from transfer restrictions, expropriation, and political violence. Breach of contract may be available under expropriation cover.	Market-based pricing, including an "establishment fee" of 0.3–0.5% (de facto an up-front fee), a standby fee, and a market-based guarantee fee. Pricing is based on a classification of all countries into six risk categories.	Minimum guarantee fees are 10–40 basis points for each type of coverage; they can reach 1.5% for high-risk countries.	100% of loan principal and interest covered for an agreed period.
NEXI	Offers both debt and equity coverage against losses arising from transfer restrictions, expropriation, and political violence, as well as breach of contract.	Fees are based on internally determined pricing criteria, rather than market rates.	Complete coverage against political risks for debt products can be secured for less than 1%.	Up to 100% of principal and interest is covered for the agreed maximum liability.
OPIC	Equity and loans against losses arising from transfer restrictions, expropriation, and political violence. breach of contract may be available under expropriation cover.	Market-based, comprising retainer fee, a standby fee, and a guarantee fee.	Base premium rates range from 0.4 to 0.9%, per single cover.	Up to 100% of loan principal and interest for up to 20 years.
Others (including EDC, COFACE, NCM, SACE)	Equity and loans against losses arising from transfer restrictions, expropriation, and political violence. Breach of contract not always available.	No single approach to PRI pricing; some follow market pricing, others apply pre-approved premium independently of cover offered.	OECD's minimum premium benchmarks for officially supported export credits increasingly used as benchmark for PRI premium.	Maximum coverages set for individual countries or group of countries for up to 20 years.

Provider	Coverage	Fee Structure	PRI Fees	Maximum Cover and Term
C. Private PRI Providers				
Almost all of the major private sector players cover both political and credit risks.	Equity and loans for trade and investment against losses arising from transfer restrictions, expropriation, political violence, breach of contract, payment default, wrongful calling of on-demand guarantees, non-honoring of letters of credit, non-honoring of government guarantees.	Market-based. Depending on the projects, sometimes comprising a standby fee.	There are officially no minimum or maximum premium rates. Fee levels can fluctuate significantly, depending on project specifics, the level of demand, and underwriting capacity.	Maximum limits vary by carrier from $5 to $125 million. Tenors vary from 1 year to 15 years.

EFIC = Export Finance Insurance Corporation; IADB = Inter-American Development Bank; MIGA = Multilateral Investment Guarantee Agency; NEXI = Nippon Export Insurance Company, OPIC = Overseas Private Investment Corporation.

Note: Information in the table applies only to market-based PRI investment cover (i.e. not related to trade).

[a] For loans only.

[b] World Bank PRGs are offered only against a counter-guarantee by the host government. Accordingly, World Bank's PRG charges are not set in accordance with market principles and are not comparable to those of other PRI providers. While the European Bank for Reconstruction and Development can, in principle, offer PRGs, these are currently not a priority area in its operations. Therefore, no clear pricing policy exists.

Source: ADB. Political risk insurance underwriters and brokers.

Table A3.2: Political Risk Insurance Coverages, Capacity and Tenors from Private Sector PRI Providers

Risk Covered:	CR		CEND		CF	
Company:	Size ($ million)	Tenor (Years)	Size ($ million)	Tenor (Years)	Size ($ million)	Tenor (Years)
ACE	25	5	60	10	40	5
AIG	50	2	80	15	80	15
ATI	TBA	TBA	TBA	TBA	TBA	TBA
Atradius	€60	5	€15	3	€60	5
Atrium	TBA	5	TBA	5	TBA	5
Axis	150	10	150	10		
Chubb			40	10	40	10
Exporters	20	5	20	5	20	5
FCIA					40	5
Garant	12.5	5	12.5	5	12.5	5
HCC	10	5	10	5	10	5
Inter Hanover-re			10	3		
Lancashire			75	None		
Lloyd's - Ascot			15	5	15	5
Lloyd's - Beazley	13	7	13	7	13	7
Lloyd's - Catlin	5	2	50	7	25	7
Lloyd's - Hardy	€15	5	€15	5	€15	5
Lloyd's - Hayward/Chaucer	5	3.5	12.5	3.5	12.5	3.5
Lloyd's - Hiscox	10	5	10	5	10	5
Lloyd's - Kiln	10	3	25	3	20	3
Lloyd's - Liberty	1-2	2	20	3	20	3
Lloyd's - Limit			10	3	10	3
Lloyd's - SVB	2	5	15	5	15	5
Lloyd's - Talbot	10	3	10	3	10	3
Lloyd's - Wellington	3	3	40	3	25	3
Lloyd's - XL	7.5	5	20	15	15	5
QBE International	A$50	1				
Quanta	10	5	10	5	10	5
Sovereign Risk & Insurance			125	15	50	10
Unistrat	€50	5	€50	5	€50	5
Zurich	35	5			80	15

CR = credit risk; CEND = confiscation, expropriation, nationalization, deprivation; CF = contract frustration; TBA = to be announced

Source: Jardine Lloyd Thompson, London.

SUMMARY OF PROPOSED CHANGES IN GUARANTEE POLICIES

1. The proposed new CEP policy will supersede the following policy papers that relate to credit enhancement operations:

(i) ADB. 1982. Co-Financing with Commercial and Export Sources. Manila (R89-82).
(ii) ADB. 1987. Bank's Guarantee Operations. Manila (R140-87): The Bank's Guarantee Operations.
(iii) ADB. 1992. Review of the Bank's Guarantee Operations. Manila (Working Paper 4-92),
(iv) ADB. 1995. The Bank's Cofinancing Strategy. Manila (R80-95) (1995 Cofinancing Paper).
(v) ADB. 1995. Review of the Bank's Guarantee Operations. Manila (R81-95) (1995 Paper).
(vi) ADB. 1999. Review of the Bank's Guarantee Operations. (R135-99) (1999 Paper).
(vii) ADB. 2000. Partial Credit Guarantee Charges. Manila (R88-00) (2000 Charges Paper).
(viii) ADB. 2000. Review of the Partial Risk Guarantee of the ADB. Manila (R299-00) (2000 PRG Paper).
(ix) ADB. 2005. Pilot Financing Modalities and Instruments. Manila (R194-05) (IEI Paper).

2. The following is a summary of the proposed changes versus current policy.

Proposed Policy	Current Policies and Main Difference
1.1. Scope and Scale	
Two Broad Categories. CEOs will be offered in two broad categories to simplify the range of products and make them easier to understand:	PCGs, PRGs, the CFS, and the GOR evolved out of various policy papers over time, often as a result of the needs or the lessons being learned from transactions that were being processed at the time.
▪ **Guarantees**	The 1995 and 1999 Papers defined the PCG in some detail and introduced the concept of a PRG, while the 2000 PRG Paper fully defined the PRG.
▪ **Syndications**	The 1982 Paper introduced the CFS and made reference to "A" loans from ADB and "B" loans from commercial lenders, with cross-default.[a] The 2000 PRG Paper introduced and defined the Coguarantee Program, which is now the GOR.[b] The concept of reinsurance was considered when drafting the 2000 PRG Paper, but was not included in the final RRP partly because of the lack of additional resources needed to draft appropriate reinsurance guidelines. Appendix 8 of the IEI Paper, titled "Financing Partnerships and Risk Sharing Agreements," detailed how reinsurance and risk participations should work as a syndication arrangement.

Proposed Policy	Current Policies and Main Difference
Clarifies that guarantees to cover all risks that are inherent in a lending transaction.	The 1977 Paper provided general principles, while the 1987 Paper provided practical guidelines for comprehensive guarantees that could support bond and other forms of debt raised by public sector borrowers from capital markets. The 2000 PRG Paper provided the clarity needed to issue guarantees that covered only certain risks, would allow a claim only after a long waiting period, and had other characteristics similar to those of insurance cover
The differentiation between PCGs and PRGs with regard to limits and pricing will be dropped, with both now being described as “guarantees” and application of uniform principles. Terminology for PCG and PRG may continue, but as branding names to describe the orientation of the product.	Building on Board discussions connected to the 1992 Paper, the 1995 Paper introduced partial risk guarantees, which were renamed “political risk guarantees” (PRGs) in the 2000 PRG Paper. This was done to make the product name more consistent with the market and to highlight the fact that PRGs cover only cross-border political risks. In recent years, however, a number of types of political risk—such as breach of contract—have become a concern to local banks that can issue local and hard-currency finance.
Syndications enable ADB to transfer some or all of the risk associated with its direct loans and guarantees to other financing partners:	The IEI Paper introduced the use of reinsurance or other forms of risk sharing as a way for ADB to mitigate risk associated with loans and guarantees.
▪ “Fronting” arrangements allow ADB to transfer all risks (i.e. pass through) and share associated recovery rights with syndicate members. ADB does not assume any credit or counterparty risk in such arrangements.	No substantial change in the 1982 Paper regarding the CFS, and in 2000 PRG Paper regarding the GOR.
▪ “Reinsurance” arrangements enable ADB to transfer its own risk (or assume the risk of other guarantee/insurance providers) and also share any associated recovery with syndicate members. ADB will assume counterparty risk if it is either reinsuring syndicate members or being reinsured by them.	The IEI Paper also (i) established that such syndications would allow ADB to provide guarantees in excess of ADB’s own “net” exposure (i.e. the aggregate of ADB’s net exposure together with the amount of reinsurance obtained being referred to as ADB’s “gross” exposure); (ii) required approval and periodic review by the new RMU and the Management of the initial amounts of reinsurance that can be assumed through reinsurance by ADB per project, per country, or in the aggregate; and (iii) proposed that ADB purchase reinsurance from reinsurers with a single-A or higher rating from at least two major credit rating agencies.

Proposed Policy	Current Policies and Main Difference
▪ "Sell-down" arrangements allow the transfer of certain risks by ADB through transfers, assignments, or novations. The transfer of these risks is complete, and ADB has no further obligations related to the risks transferred.	No guidance in existing papers..
Branding. Different names for CEPs may be used for marketing purposes. "CFS" as a brand name is henceforth to be replaced by the term "'B loan," which is the term used broadly by the market to describe the same product.	In 1982 the CFS name was used to differentiate ADB's lender-of-record product from the nearly identical product introduced by IFC and other MDBs at the time.[c] Market pressure and a desire to avoid unnecessary competition over terms and conditions encouraged an alignment between the CFS and other "B" loan–type products. Hence, it is now easier and less confusing to call the CFS by its name in the market—"B" loan.
1.2. Risks Covered	
Risks That May Cause Payment Default. Guarantees may cover, and Syndications may allow ADB to share or transfer, a wide range of risks that are a subset of the risks inherent in sovereign and non-sovereign loans.	The 1995 Paper introduced the use of partial risk guarantees for private sector operations, while the 1999 Paper and the 2000 PRG Paper broadly defined the different risks that can be covered. In past papers, the fact that the risks associated with a guarantee operation are a subset of the risks associated with a direct loan was not apparent.
▪ **Political risk** coverage can include but is not limited to the political risks commonly addressed in the public and private guarantee and insurance marketplace.	This broader definition allows ADB to cover newer forms of political or sovereign risks, such as denial of justice or regulatory risk.
▪ **Commercial risk** cover includes but is not limited to risk associated with sub-sovereign payment and performance obligations of a commercial nature and break costs and other financial obligations associated with interest, currency, credit, and other swaps, derivatives, and capital market and structured finance transactions.	This will allow ADB to support projects with sub-sovereign payment and performance obligations, and is consistent with the objectives of the IEI. Covering break costs associated with swaps will allow ADB to help projects mitigate interest rate and currency risk, and also support the development of regional and local capital markets.
Partial Sharing. CEPs may guarantee or share different percentages or types of risk depending on the transaction and the needs of the market.	No change.

Proposed Policy	Current Policies and Main Difference
1.3. Eligible Financing Instruments	
Wide Instrument Range, But Debt-Related. CEPs may support any financial instrument that constitute debt obligations, but not equity. Debt obligations can be funded or unfunded and take many forms.	The 1992 Paper proposed expanding the scope of guarantees to cover a wider set of debt instruments than originally envisioned in the 1987 Paper. Overall guidance provided by the by the Charter (which allows guarantee of "loans", without qualification other then participated in by ADB).
1.4. Eligible Financing Partners	
Public, Private, Domestic, International, and Commercial Partners. CEP arrangements may be undertaken with international and local financing partners in the public or private sector, including but not limited to commercial banks, development and nonbank financial institutions, ECAs, export-import banks, and other commercially oriented entities.	The 1982 Paper introduced the concept of ADB cofinancing projects with ECAs. Subsequent papers talked about collaboration with OECD-based ECAs, where ADB would provide parallel finance or PCG support for local project costs that ECAs could not support. The notion of ADB providing a CEP in favor of an ECA, or an ECA guaranteeing or reinsuring ADB, was not considered until the IEI Paper. Also, the TFFP RRP discussions envisioned the use of such reinsurance once the program exceeded approved limits.
Clarifies that ADB will not enter into credit enhancement arrangements supported by official development assistance.	Previous ADB literature stated that ECAs could not participate in CFS transactions (and by extension the GOR and other syndication arrangements) out of concern about sharing ADB's preferred-creditor status and Charter privileges and immunities with "official" government agencies providing subsidized export credit or tied aid. In recent years, however, many OECD ECAs and export-import banks have opened market windows, been privatized, or operated on a breakeven or better basis, as required under the OECD Arrangement, making them important partners for ADB to work—and share risk—with.
1.5. Eligible Countries and Obligors	
All DMCs and Entities Operating Therein. Any country that is eligible for lending from ADB's OCR and the ADF can benefit from ADB's CEPs.	No substantial change.
CEPs can support sovereign, sub-sovereign, or non-sovereign obligors or borrowers, through PPPs and other forms of lending.	No substantial change.

Proposed Policy	Current Policies and Main Difference
1.6. Use of Sovereign Counter-Indemnities	
Used Selectively to Improve Project Benefits. ADB does not require in every instance a sovereign counter-indemnity for guarantees that it issues, but will do so if it enhances the transaction or reduces transaction costs.	No substantial change.
A sovereign counter-indemnity may: ▪ Be considered if it benefits the DMC or the ultimate consumer within the DMC through reduced transaction cost or improved financial viability; ▪ Be appropriate, particularly for political risks under the control of the host government; and ▪ Allow ADB to provide support for projects in "frontier" DMCs or sectors for which financing may not be available otherwise.	This clarity is new and is a result of recent experience with PRGs requiring full and partial counter-indemnity for projects having private sector involvement in more difficult "frontier" environments.
For countries that have access only to ADF lending, sovereign counter-indemnities will be considered only if the underlying project has strong developmental impact, or there are special considerations that justify the issuance of a counter-guarantee.	No substantial change. New policy provides some additional clarity to the 1999 Paper.[d]
1.7. Participation Requirement	
Linked to ADB's Operations and Country or Regional Strategies. Any ADB financing instrument can satisfy the participation requirement for a guarantee provided that both the guarantee and ADB's anchor intervention have the same development objective and relate to the same sector or project.	No guidance in existing papers, although the IEI Paper introduced the idea.
Flexibility in Timing. Board approval of ADB's anchor financing can be made before or in conjunction with the Board approval of the CEP.	No specific guidance in existing papers. New policy allows more flexibility to accommodate the changing needs of DMC clients.
1.8. Single Transactions and Facilities	
Broader Access and Programs with Streamlined Procedures. CEPs can be provided through individual transactions or through facilities.	The TFFP and other approved guarantee facilities (in Pakistan and the Philippines) initiated the concept of using facilities that allow ADB to issue a guarantee to one lender for risk associated with more than one borrower.

Proposed Policy	Current Policies and Main Difference
1.9. Tenor	
Long-Term Orientation to Match Project Life Cycle. The tenor of CEPs should correspond to the extent possible with the tenor of the underlying debt obligation. There is no maximum or minimum tenor for ADB's CEPs.	Previous papers suggested that CEPs should be used to encourage cofinanciers to extend the tenor beyond the norm. This, however, gave the impression that ADB was only a long-term risk taker and not so focused on matching the project life cycle or interested in short-term trade-related transactions or SME finance.
1.10. Currencies	
Avoidance of Currency Mismatches. Guarantees may be denominated in the currency in which the underlying debt obligation is denominated. Any increase in currency choices, following a review of the LBL product, would thus also apply to ADB's CEPs. Other currencies may also be covered on a case-by-case basis if this helps to eliminate currency mismatches and if exposures can be offset in the market, subject to approval by the Board.	The 1995 Paper clearly established that ADB can guarantee local-currency debt.[e] In accordance with ADB policies governing the LIBOR-based loan (LBL) product (ADB. 2001. *Review of Asian Development Bank's Financial Loan Products*. Manila; under review in 2006) and the local currency loan (LCL) product (ADB. 2005. *Introducing the Local Currency Loan Product*. Manila), loans can be denominated in US dollars, euros, or yen, or in the local currency of the borrower. By extension, guarantees can be denominated only in such currencies, but not in other currencies such as Australian or New Zealand dollars or other regional currency.
2.1. Risk Management	
Emphasis on Sound Principles and Practices. Guarantees may cover, and syndications may allow ADB to share or transfer, different percentages or types of risk depending on the transaction and the needs of the market, consistent with industry practice.	No substantial change.
Keeping Risk as Low as Possible. While coverage of up to 100% may be considered in certain circumstances, ADB will normally seek risk-sharing arrangements that set the net exposure under a guarantee at the lowest level required to mobilize the necessary financing. That said, ADB will not hesitate to provide 100% indemnity if warranted, or to be consistent with common market practice.	This is referred to in previous papers, but the concept of seeking to reduce "net exposure" after risk-sharing arrangements to the lowest level necessary to mobilize financing, is new.

Proposed Policy	Current Policies and Main Difference
2.2. Management of Limits and Capital Allocations	
Clear Guidelines that Account for Relative Risk. Relative-risk guidelines will be set (by RMU) and used to determine how ADB's adjusted exposure under each CEP will be accounted for with respect to:	Except as noted below, generally ADB policy has not differentiated the risk associated with direct loans from risk associated with guarantees, with or without the benefit of syndications.
▪ Statutory limits as measured by headroom, provisioning, and loan equivalency calculations;	The 1999 Paper provided further detail about the use of discount rates to determine the net present value of guarantees for the purposes of calculating statutory headroom and guarantee fees.[f]
▪ Strategic limits such as indicative planning figures (IPF) for each DMC and the IEI limit for pilot financing instruments and modalities; and	The 1999 Paper[g] simply refers to "mainstreaming" guarantees, and to the need for country operational strategies and country assistance plans to attempt to outline a broad strategy for the use of guarantees, among other things. The 1999 Paper did not, however, set targets for or limits to the use of guarantees, or allow guarantees to be used "outside of country-specific" IPFs as the 1995 Paper did.[h]
▪ Prudential limits such as the PSO per project, borrower, sector, and overall limits.	The PRG Paper introduced the concept of PRGs that represent less risk compared with PCGs and direct loans, but only in the context of PSO per project limits.
2.3. Use of Syndications for Risk Diversification and Exposure Management	
Syndications, including fronting, reinsurance, and sell-down arrangements, will be used by ADB to mitigate and diversify the risk profile of its direct loan and guarantee portfolio without direct sovereign indemnity.	The IEI Paper detailed how reinsurance and risk participations can help mitigate or diversify risk associated with non-soverign loans. (Relevant sections of the OMs for the new CEP paper are based on this.) The Guarantee Committee in the past provided guidance on risk for return, but has not been able to "determine" if a direct loan or guarantee has met its full syndication potential.
Syndications can occur before financial close or during the tenor of the underlying debt depending on market conditions, the status of the associated project, and the need from time to time for ADB to adjust its portfolio.	No specific guidance in existing papers.
Syndications will ensure appropriate balancing of ADB's risk exposures and may be arranged on an individual, portfolio, or any other basis consistent with industry practices.	No specific guidance in existing papers. Adds clarity to IEI Paper.

Proposed Policy	Current Policies and Main Difference
Support for Larger Transactions. To support larger or more complex projects, statutory, strategic, or prudential limits will capture net exposure after any syndication, adjusted for any counterparty risk.	No specific guidance in existing papers. Clarified in new policy.
3.1. Pricing	
Simplified Structure. Pricing has two components: ▪ Credit enhancement fees to cover ADB's cost of capital and operation, adjusted for risk as appropriate; and ▪ Administrative fees to cover the cost of processing and implementation.	The 1999 Paper, Charges Paper, and PRG Paper differentiate front-end, standby, commitment, and guarantee fees or premiums for guarantees (with or without counter-indemnity), at times in great detail.
Pricing can be "all in" to improve comparability and transparency, although the various components will be calculated separately.	No specific guidance in existing papers. Clarified in new policy.
3.2. Guarantee Fee for Transactions with Sovereign Counter-Indemnity	
Sovereign Loan Equivalency. For guarantees with sovereign counter-indemnity in support of public sector obligors (i.e. with more the 50% ownership by the public sector), the guarantee fee will be based on sovereign loan equivalency.	The 1995, 1999,[i] and PRG Papers refer to ADB's cooperative nature and the concept of loan equivalency when setting pricing for guarantees that are counter-guaranteed at 0.40% per year. They do not, however, define what a "public sector obligor" is.
"And…will be no greater than an amount equal to ADB's sovereign lending spread (after any waivers or surcharges which may apply at the time the guarantee is issued) for an analogous sovereign loan."	No specific guidance in existing papers. Clarified in new policy..
Special Consideration for PPP. In case of guarantees with counter-indemnity in support of private sector obligors, ADB may charge a premium at a market-based rate to avoid market distortions or suppress market development, but will only retain the sovereign guarantee fee for its own account.	New; but the principle was established in Pakistan with three different PRG facilities that were counter-guaranteed.
The difference between any market-based pricing applied and the counter-indemnified guarantee may be paid into an appropriate reserve held in trust by ADB or an acceptable third party. This difference will ultimately be applied or rebated—after an appropriate no-claims period—in a transparent manner that benefits the client country and is acceptable to ADB.	No specific guidance in existing papers. Clarified in new policy.

Proposed Policy	Current Policies and Main Difference
3.3. Risk, and Market-Based Premium for Guarantees without Counter-Indemnity	
Risk- and Market-Based. Pricing (credit spread, guarantee fees, ceding commissions, and other fees, commissions, or charges) for guarantees that do not benefit from sovereign counter-indemnity (both for public and private sector obligors), will take into consideration, among other things: ▪ Relative risk; and	The concept of systematic pricing for relative risk between guarantees and direct loans is new. In the past, pricing guidance for direct loans was provided by the Interest Rate Committee, while pricing for Guarantees was provided by the Guarantee Committee.
▪ Market price indicators. Such indicators may be derived from syndication arrangements, pricing precedents, extrapolations on a yield curve or otherwise, or the amount other financing partners or competitors charge for taking similar risk in analogous transactions, among others.	The 1999 Paper notes that private sector guarantees (i.e. non-sovereign guarantees) should have market-based pricing.[j] The PRG Paper also notes that PRGs without counter-indemnity should be determined by the Guarantee Committee and be market-based.[k]
An Art More Than a Science, But Systematic. Actual pricing may thus vary for each transaction depending on its specific characteristics, but shall not distort or otherwise undermine markets (to the extent that they exist) but support the development of markets, especially in their infancy.	This adds clarity to previous policies and reinforces concern about not distorting markets.
3.4. Syndication Fees (risk bases)	
Selective. For syndications of ADB loans through a fronting (pass-through) or sell-down arrangement, no risk-based premium is normally applicable since ADB does not retain any credit risk.	No change.
For syndications provided through reinsurance arrangements (whereby ADB retains counterparty and documentation risk), market-based ceding commissions will be charged.	No substantial change for reinsurance arrangements, as set forth in the IEI Paper.
3.5. Administrative Fees	
Transaction-Specific. ADB may charge—or pay—administrative and other fees that are specific to the processing and implementation of a CEP. The OMs on the new CEP policy will consolidate these fees and ensure market consistency. The clear ability of ADB to "pay" such fees is new, although paying brokerage and ceding commissions in connection with reinsurance arrangements was noted in the IEI Paper.	The 1999 Paper, Charges Paper, and PRG Paper most recently prescribed various front-end, standby, commitment, and other fees, and explained how to calculate them depending on the size of the "anchor" loan, and who should pay them and when. The 1995 Cofinancing Paper introduced market-based arrangement and administration fees for CFS transactions with private sector borrowers.[l]

Proposed Policy	Current Policies and Main Difference
3.6. Payment Arrangements	
Flexible and Pragmatic. Fees charged by ADB may be paid at agreed periodic installments, either in advance or in arrears.	This provides increased flexibility over previous policy, which suggested that guarantee fees will normally be paid in arrears.
Fees related to syndications can be paid up-front or at the time related agreements are signed, or can be spread over the life of the syndication, as appropriate.	The CFS currently requires the arrangement fee to be paid up-front and the administration fee to be paid yearly over the life of the CFS loan.
4.1. Implementation	
4.2. Transaction and Portfolio Management: Processes and Responsibilities	
Alignment with ADB's Business Processes and Operations. For a CEP in support of direct cofinancing alongside an ADB loan or equity investment (to the same obligor), processing and due diligence will normally be in conjunction with the ADB loan or investment.	No substantial change.
For a CEP in support of ADB's country and sector operations but without direct risk exposure by ADB to the obligor (e.g., linked to a TA or under a sector facility, or related to an earlier investment made by ADB), the processing steps for guarantees will be similar to those that would apply if ADB were processing a direct exposure to such obligor.	No specific guidance in existing papers. Previously CEPs were provided alongside an ADB loan or equity investment.
ADB may draw on due diligence performed by parties undertaking a similar role to ADB in any proposed transaction, as appropriate, to expedite processing and avoid duplication, while ensuring appropriate due diligence standards are observed.	No specific guidance in existing papers. Previously CEPs were provided alongside an ADB loan or equity investment.
Functional Responsibilities. Given the multidisciplinary and specialist skills required to manage CEPs, emphasis will be placed on effective teamwork across various departments.	No substantial change.
At the transaction level: ▪ Origination, due diligence of the obligor and of project financing risks, and action on transaction-specific CEP issues will be led by the operational departments (RDs and PSOD), with specialist advisory support from OCO and other service departments, as appropriate;	No substantial change.

Proposed Policy	Current Policies and Main Difference
▪ In case syndication arrangements are involved, OCO will arrange and finalize syndications and undertake due diligence on counterparty risk;	The IEI Paper on Pilot Financing Instruments and Modalities indicates that "financial syndication and risk sharing arrangements would be led, coordinated, and documented by the Office of Cofinancing Operations." (See para. 56.) Furthermore, Appendix 8 of that paper provided guidelines on the use of reinsurance, which 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 reinsurers.
▪ Pricing will be determined through an interdisciplinary and objective Credit Enhancement Committee (CEC);	The 1995 Paper established the role of the interdepartmental Guarantee Committee and expected it to review and approve the structure, coverage, and pricing of guarantees.[m]
▪ In case of a claim, a special Claims Committee will be established to provide specific guidance as and when required.	No specific guidance in existing papers..
At the portfolio, systemic, and institutional level: ▪ Risk management–related issues will be driven by the Risk Management Unit (RMU), which will develop and maintain appropriate guidelines on relative risks and limits;	This is consistent with the paper establishing the Credit Risk Management Unit (IN.188-05), which notes that RMU will develop appropriate credit risk assessment and management policies, methodologies, and procedures.
▪ RMU will work closely with OCO as the primary relationship manager for financing partnerships on the implementation of portfolio-balancing syndication activities;	No specific guidance in existing papers.
▪ OCO has key responsibilities for product development and innovations, as well as knowledge management;	No substantial change, but lack of clarity.
▪ CTL maintains data for financial reporting and overall exposure monitoring;	No substantial change.
▪ TD determines and reviews from time to time loan equivalency fees for guarantees; and	No specific guidance in existing papers. In past policies this function was static.
▪ OGC develops and maintains standard legal documentation.	No substantial change.

Proposed Policy	Current Policies and Main Difference
4.3. Institutional Arrangements for Risk Assessment, Pricing, and Claims Management	
CEC will: ▪ Be established to systematically assess risk aspects related to CEPs and provide guidance and approvals on pricing and other financial terms;	Replaces the Guarantee Committee and has a broader mandate.
▪ Be chaired by the head of a non-operational department;	Currently the Guarantee Committee is chaired by the Principal Director, OCO.
▪ Will meet at least twice for each project: (i) normally early in the project cycle shortly after concept clearance has endorsed the application of a CEP; and (ii) after due diligence to determine and authorize the finalization of guarantee or syndication terms.	Procedures for the Guarantee Committee lack clarity. (Required to meeting "early in the processing cycle", but often times this occurs only after due diligence).
Claims Committee. To avoid any potential conflicts of interest with direct lending and equity investment operations and ensure that standard risk management practice is followed in case of a claim, a Claims Committee (CC) will be established and will meet as necessary to address future claims if and when they arise.	No specific guidance in existing papers.
4.4. Product Development, Innovation, and Knowledge Management	
Product Development and Innovation: Credit Enhancement Practice Group. The CEPG will be an interdepartmental group composed of representatives from CTL, OCO, OGC, PSOD, RMU, and TD; RD members; and other interested parties. The CEPG will: (i) be an interdepartmental knowledge-sharing and consultation platform with OCO as its secretariat and having responsibility for its management; and (ii) in addition to OCO, also be able to advise and mentor operational departments in the processing of guarantee operations.	The PRG Paper established the PRG Focus Group, which had a similar mandate in regard to PRGs only.
Relationship Management and Awareness Building for Credit Enhancement Operations. OCO will lead and coordinate the management of relationships with other financing partners or guarantee providers at the institutional level, while operational departments may maintain relationships related to specific transactions, as appropriate.	No substantial change.

[a] ADB. 1982. *Co-financing with Commercial and Export Sources*. Manila (p. 7, paras. 22-23).
[b] ADB. 2000. *Review of the Partial Risk Guarantee of the ADB*. Manila (pp. 13-14, paras. 61-63).
[c] ADB. 1982. *Co-financing with Commercial and Export Sources*. Manila (p. 7, paras. 22-23).
[d] ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila (p. 8, para. 33).
[e] ADB. 1995. *Review of the Bank's Guarantee Operations*. Manila (p. 16, paras. 42-43).
[f] ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila (p. 19, para. 66[i]).
[g] ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila (p. 12, para. 43).
[h] ADB. 1995. *Review of the Bank's Guarantee Operations*. Manila (p. 22, para. 58).
[i] ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila (p. 9, paras. 32-33).
[j] ADB. 1999. *Review of the Bank's Guarantee Operations*. Manila. (p.10, para. 35).
[k] ADB. 2000. *Review of the Partial Risk Guarantee of the ADB*. Manila (pp. 17-18, para. 48).
[l] ADB. 1995. *The Bank's Cofinancing Strategy*. Manila (p. 16, paras. 79-81).
[m] ADB. 1995. *Review of the Bank's Guarantee Operations*. Manila (p. 23, para. 61).

ADB = Asian Development Bank; ADF = Asian Development Fund; CC = Claims committee; CEC = Credit Enhancement Committee; CEP = credit enhancement product; CEPG = Credit Enhancement Practice Group; CFS = Complementary Financing Scheme; CTL = Controller's Department; DMC = developing member country; ECA = export credit agency; GOR = guarantor-of-record; IEI = Innovation and Efficiency Initiative; IPF = indicative planning figure ; LBL = LIBOR-based loan; LCL = local currency loan; OCO = Office of Cofinancing Operations; OCR = ordinary capital resources; OGC = Office of the General Counsel; OM = operations manual; PCG = partial credit guarantee; PPP = public-private partnership; PRG = political risk guarantee; PSO = private sector operations; PSOD = Private Sector Operations Department; RD = regional department; RMU = Risk Management Unit; RRP = report and recommendation of the President; TD = Treasury Department; TFFP = Trade Finance and Facilitation Program

Source: ADB.