ABBREVIATIONS

ADB	–	Asian Development Bank
ACCSF	–	Asian Currency Crisis Support Facility
DMC	–	developing member country
JSF	–	Japan Special Fund
OCR	–	ordinary capital resources
OECD	–	Organization for Economic Co-operation and Development
PCG	–	partial credit guarantee
PRG	–	partial risk guarantee
RLR	–	reserves-to-loans ratio
ROE	–	return-on-equity

NOTE

In this report, "$" refers to US dollars and ¥ refers to Japanese yen.

-I. INTRODUCTION

1. This paper reviews the guarantee fees of the Asian Development Bank (ADB) as a supplement to the *Review of the Bank's Guarantee Operations*[1] and suggests a framework for and the level of guarantee charges. ADB, which formally adopted a guarantee policy in 1988, has two guarantee instruments: the partial credit guarantee (PCG), and the partial risk guarantee (PRG). PCGs cover commercial and sovereign risks associated with a portion of debt service on commercial borrowings, typically debt servicing of later maturities. PRGs provide cover for sovereign risks associated with commercial borrowing for private sector projects.

2. This paper deals with pricing associated with PCGs for both public and private sector borrowers with host government counterguarantee and for private sector borrowers without government counterguarantee. ADB's policy on partial risk guarantee is being separately reviewed.

3. Section II reviews ADB's guarantee charges. Section III provides the underlying pricing principle and framework and proposes charges for both ordinary capital resources (OCR) and Asian Currency Crisis Support Facility (ACCSF) guarantees. Sections IV and V provide methodologies for determining the loan equivalent guarantee charges and the exposure and the fee base. Section V compares ADB's current and proposed guarantee charges with those of other guarantors. Section VI summarizes the main recommendations.

II. CURRENT GUARANTEE CHARGES

4. ADB has issued 10 PCGs totaling $1.1 billion, all with host government counterguarantee. During the 10 years of its guarantee operations, ADB has experimented with both market-based pricing and cost-based pricing. Initially, market-based pricing was adopted in line with the benefits provided to developing member countries (DMCs) and the risks assumed by ADB. However, market-based pricing proved difficult to implement. The experience with the guarantees for Indonesia (1989) and Papua New Guinea (1990) demonstrated that there was little market guidance where DMCs had no access to international capital markets, or in circumstances where the external payments situation was temporarily strained.

5. In the 1995 review of ADB guarantee operations, for PCGs provided to the public sector, ADB adopted a uniform fee in place of market-based pricing. The change was based on the following considerations. First, as part of its cooperative nature, ADB does not discriminate between DMCs in its ordinary lending operations. Second, ADB had to consider the "signaling effect" of its pricing on the market perception of a DMC's creditworthiness. Third, ADB clearly was taking no greater risk in providing a guarantee to a public borrower than with direct OCR lending of the equivalent amount.

6. Since the guarantee is ADB's commitment to disburse in the event of default, the guarantee fee of 40 basis points per annum was determined by drawing equivalence to ADB's commitment charge on OCR loans. The annual spread equivalent of ADB's loan commitment charge of 75 basis points per annum was calculated at about 34 basis points per annum. The guarantee fee was slightly marked up to 40 basis points to make it the same as the OCR loan spread, and so that commercial users of the guarantee facility could easily understand the fee.

[1] R135-99: *Review of the Bank's Guarantee Operations*, 8 October.

For providing PCGs for public sector borrowers with host government counterguarantee, a fee of 40 basis points per annum is charged based on the discounted present value of the guarantee obligations. Pricing of guarantees of private sector borrowers is market-based. However, in the case of guarantees for private sector borrowers where the host government has provided a counterguarantee, the guarantee fee would be divided between ADB and the host government, with ADB retaining the 40 basis points per annum and the balance going to the government in compensation for the counterguarantee. In all cases, the guarantee fee can be charged either to the borrower or to the lender, depending on administrative considerations and the prevailing commercial practice. The guarantee fee may be collected periodically or in one payment up-front.

III. UNDERLYING PRICING PRINCIPLE AND FRAMEWORK

7. ADB has an income risk management policy, to ensure that it has the capacity to withstand credit risks. Although this policy is heavily influenced by ADB's use of direct loans as its principal product, it should also apply to guarantees because the credit risk on guarantees is no different than that of loans. The financial impact of making a disbursement against a called guarantee is no different from the alternative of having granted a regular loan earlier to the defaulting borrower. The only difference is the timing of disbursements.

8. Like OCR loans, one of the most important impacts of guarantees on ADB's income requirements is the need to provide adequate reserves. Under the current policy, the present value of guarantees is added to the denominator of the reserves-to-loans ratio (RLR) starting from the time the guarantee is made. The present value rises as time passes or it drops as portions of guarantees expire. This policy ensures that reserves against guarantees will be built up gradually and reach full equivalence to loans on the call date. As far as exposure measurement for RLR determination is concerned, present value guarantees and outstanding balance concepts are the same.

9. OCR loans have different impacts on the RLR depending on a loan's disbursement and repayment profiles. Program loans have an immediate impact on the RLR because such loans are disbursed immediately. The impact of project loans on the RLR is gradual because such loans are disbursed slowly over a long period of time. The impact of guarantees on the RLR may be somewhere between those of program loans and medium-term project loans given the present system of measuring exposure on the basis of present value. In this context, guarantees could be considered as another type of loan with a different disbursement and repayment profile. Because ADB applies its loan charges uniformly across all types of loans regardless of their disbursement profiles and maturity structures, there is no reason to treat guarantees differently as far as pricing is concerned.

10. Guarantees, like loans, are charged against ADB's lending and borrowing headrooms. If ADB would start to establish general loan loss provisions for OCR public sector operations, exposure on guarantees would be treated like loan exposure. Guarantees would also have an impact on the liquidity requirements. Although guarantees can be viewed as undisbursed loan balances, the present minimum liquidity policy of 40 percent on the total amount of guarantees need not be applied. The comparative level of liquidity needs for guarantees could be significantly lower.

11. Thus, from ADB's perspective, guarantees are structurally similar to loans. During its life, a guarantee, whether it is eventually be called or not, will have a defined impact on (i) ADB's income requirements through the mechanism of the RLR, (ii) lending and borrowing headrooms, and (iii) liquidity policy. The risk that a guarantee may be called is the same risk that a loan may default.

12. From the borrowers' perspective, guarantees could help borrowers mobilize additional private financing and provide the option of access to the deeper capital markets with longer maturities than would otherwise be available, although the cost of ADB-guaranteed commercial loan would tend to be higher than the cost of a direct ADB loan once the commercial lenders' costs of funds and return for risk on the unguaranteed portion are included.

13. As a cooperative institution, ADB applies its loan charges uniformly to all its clients because, given its preferred creditor status, ADB expects all its loans to be repaid. A logical extension of this philosophy will be for ADB to adopt a pricing principle that ensures that the level of guarantee charges is not subsidizing the loan clients, or vice-versa. In other words, guarantee charges must be set in such a way that the net impact on income is no different from that of loans.

14. While guarantees are structurally similar to loans in many ways, the processing costs of guarantees can be different from those of loans. The additional administrative costs connected with the extension of guarantees are considered to be very small given that the guarantee will be extended in conjunction with a direct loan. In some cases, however, the guarantee extended may be for a significantly larger amount than that of ADB's direct loan. Such "highly leveraged" guarantees (relative to the direct loan) would have to absorb the processing costs.

15. On the basis of foregoing discussions, it is suggested that ADB adopt a pricing principle of net income neutrality for guarantees. Under this principle, guarantee charges should be set on a loan equivalent basis to yield the same return to ADB as if ADB had made the underlying loan itself, but adjusted to take account of the structural difference between loans and guarantees. This principle of loan equivalency should serve as the guideline for determining (i) the level of guarantee charges, and (ii) the fee base upon which these charges are applied.

III. METHODOLOGY FOR DETERMINING THE LOAN EQUIVALENT GUARANTEE CHARGES

A. OCR Guarantee Charges

16. In commercial practices for financial guarantees, the guarantee charges, usually referred to as the "premium rate," are generally set at a level that will generate sufficient premium income to cover the administrative costs, expected losses (either individually or on portfolio basis), and some contribution to reserves. This principle is no different from that underlying ADB's present OCR loan charge structure. Under the present system, a component of the OCR loan charges is used to cover administrative expenses and the rest covers the income risks, such as unexpected large-scale nonaccrual shocks. Setting guarantee charges on a loan equivalency basis would in principle be in line with commercial practices. The difference would lie in the assessment of credit risks.

17. In pricing guarantees, the starting point would therefore be the present OCR loan charges consisting of three fees applied on three fee bases—a 1.0 percent front-end fee on the principal amount, a 0.75 percent per annum commitment fee on the undisbursed balance, and a 0.60 percent per annum lending spread on the outstanding loan balance. To simplify, the benchmark for determining the loan equivalent guarantee charges would be the total annualized spread equivalent of OCR loan charges, which is currently equal to 115 basis points. The spread equivalent means that the three elements of OCR loan charges applied on three different bases have been transformed into an annualized rate applicable on outstanding balances. Under the proposed approach, guarantee charges would consist of two elements: (i) a guarantee fee (annualized spread concept) to cover the loan equivalent risks of guarantee, and (ii) a front-end (one-time) fee to cover administrative costs. A two-tier approach is suggested to provide flexibility in pricing guarantees that may have different processing costs. The guarantee fee would be applied uniformly across all types of guarantees regardless of maturities, etc.

18. The guarantee fee would be equivalent to the risk premium implicit in OCR loan charges. In effect, this risk premium is equal to the annualized spread equivalent of OCR loan charges, i.e., 115 basis points less that portion attributable to administrative expenses. The implicit risk premium in OCR loans is considered the “subsidized” risk premium being borne by borrowers to cover the risk of potential nonaccruals. It is subsidized because equity capital generates the other portion of the risk premium. By passing the same risk premium implicit on OCR loan charges to guarantee charges, loans and guarantees are treated equitably as far as the allocation of the equity capital is concerned.

19. The front-end fee on guarantees would depend on the estimate of the processing cost. “Highly leveraged” guarantees would have to absorb higher processing costs.

20. Thus, given the level of OCR loan charges, the first step in determining the guarantee charges is to estimate the portion of the total spread equivalent of loan charges (i.e., 115 basis points) that can be attributed to administrative costs. ADB’s old OCR loan charges, which were just enough to cover administrative expenses, consisted of a 0.75 percent commitment fee and a 40 basis-point lending spread, with a total spread equivalent of about 74 basis points.

21. The administrative cost structure in lending can be analyzed to derive the marginal impact of a new loan on the administrative expenses over the life of a loan. The marginal impact can be divided into two components—the processing or origination costs and the supervision and other indirect costs related to lending. Appendix 1 provides historical data on administrative cost structure in lending. On average, the total OCR administrative expenses represent about 0.72 percent of the average outstanding loans. Total processing costs in relation to new loan commitment averaged about 0.74 percent during the past six years. This average figure is somewhat distorted by the abnormal surge in lending during 1997 and 1998. In 1999, the processing cost is estimated to represent about one percent of new loan commitments. Processing costs in 2000 are estimated to remain at this level. Accordingly, for this paper, it is assumed that future loans will entail a processing cost of 0.90 percent of the principal amount.

22. Appendix 1 also provides historical information about the supervision and other indirect costs. On average, they represent about 0.51 percent of average outstanding loans. In reality, the supervision costs of new loans will be higher during the disbursement period and lower during the post-disbursement period.

23. Appendix 2 illustrates the calculation of the annualized spread equivalent of the administrative cost structure over the life of a new loan. The calculation assumes processing costs of 0.90 percent of the principal amount. The supervision cost in relation to the outstanding loan balance is assumed on the basis of either a flat rate of 0.51 percent throughout the life of the loan or a declining rate starting from 0.65 percent (to reflect higher supervision costs during the disbursement period). On a flat rate of 0.51 percent, the spread equivalent of administrative expenses is about 70 basis points. On the basis of a higher rate during the disbursement period, the spread equivalent is about 75 basis points. Accordingly, it is assumed that out of the total 115 basis point spread equivalent of OCR loan charges, 75 basis points would be to cover administrative costs, and the remaining 40 basis points would cover the implicit risk premium on OCR loans.

24. **Guarantee Fee.** Accordingly, it is suggested that the guarantee fee for a public sector PCG be set at 40 basis points[2] to be applied on the present value of the outstanding guarantees. For a private sector PCG with a host government counterguarantee, the fee will also be 40 basis points and the borrower will compensate the host government for the counterguarantee[3] directly. For a private sector PCG without a host government counterguarantee,[4] ADB's existing Guarantee Committee—chaired by a representative from the Office of the Cofinancing Operations and with representatives from the Treasury Department and the project team concerned[5]—will price the guarantee fee based on similar procedures to those for pricing private sector loans. Like OCR loans, the guarantee fee will be paid in arrears on the basis of the actual outstanding amount of guarantees on a present value basis.

25. **Front-End Fee.** Given the loan participation requirement for a guarantee, it is suggested that front-end fees for a public sector PCG be set based on the size of the associated loan vis-a-vis that of the guarantee within a range of 10-90 basis points of the nominal guaranteed amount. Specifically, for a PCG with a guarantee to loan ratio of 1 and above (where the guarantee is greater than the associated loan), it is proposed that the front-end fee be at maximum of 90 basis points and for a PCG with the ratio of 0.1 and below the fee be at least 10 basis points. For a PCG with a guarantee to loan ratio between 0.1 and 1.0, the front-end fee will be on a pro rata basis within 10-90 basis points.

26. The front-end fee of 10-90 basis points is justified because the processing cost for the project concerned would also be covered by the front-end fee on the associated loan. The larger the loan vis-à-vis the guarantee, the more the project processing will be covered by the front-end fee of the loan, and the less the front-end fee on the guarantee should be. Appendix 3 summarizes the proposed guarantee charges.

B. Emergency Public Sector Partial Credit Guarantee[6]

27. ADB has established a special program loan (SPL) modality under the *Review of ADB's Program Lending Policies*[7] to assist its eligible DMCs to cope with an unanticipated financial

[2] Subject to the changes in OCR loan charges and in administrative expenses, the guarantee fee will change accordingly.
[3] ADB will advise the host government on the appropriate market rate it should charge for the counterguarantee.
[4] The net present value of PCGs without a host government counterguarantee will be included in the commitment limit for ADB private sector operations.
[5] A representative from the Controller's Department will also take part in pricing the private sector PCG fee.
[6] Emergency PCGs will be provided based on the same criteria as SPLs.

crisis. Given its potential adverse effect on ADB financial indicators, the SPLs will carry the minimum loan spread of 400 basis points above London interbank offered rate (LIBOR). In addition, there will be a 100 basis points front-end fee and a 75 basis points flat commitment fee for the SPLs. Based on the loan equivalency principle, the fee for an emergency public sector PCG will therefore be the PCG risk premium of 40 basis points plus an incremental SPL risk premium per annum, equivalent to the difference between SPL and OCR loan spreads. In addition, borrowers will also be subjected to the same front-end fee of 10-90 basis points of the nominal guaranteed amount, depending on the size of the guarantee vis-à-vis that of the associated ADB loan. The front-end fee will be paid up-front and the emergency guarantee fee in arrears on the basis of actual outstanding amount of guarantees on a present value basis.

C. ACCSF Guarantees

28. The Government of Japan launched a plan to assist Asian countries affected by the Asian currency crisis[8] precipitated in mid-1997; this plan is commonly referred to as the New Miyazawa Initiative. As part of the overall plan, the ACCSF was established within ADB as a special-purpose component of the Japan Special Fund (JSF).[9] The ACCSF complements ADB's assistance to crisis-affected member countries by helping to mobilize cofinancing and private financial resources for projects and programs in these countries. The ACCSF has three modalities of assistance: (i) interest payment assistance, (ii) technical assistance, and (iii) guarantees.

29. Under the ACCSF, the guarantees are provided to assist ADB projects and programs principally for supporting the implementation of structural adjustment in the financial and key real sectors, establishment of social safety nets, and other measures to address social impacts of the crisis. An ACCSF guarantee requires a counterguarantee from the concerned government. The guarantees can cover a variety of debt instruments, including commercial syndicated loans and sovereign bonds denominated in foreign currency.

30. ADB's guarantee obligations under ACCSF guarantees are backed at full face value by the Government of Japan's contribution to ACCSF. Japan has contributed Y360 billion in a noninterest-bearing, nonnegotiable government note that has been deposited in a separate account. ADB can encash the note at any time to meet a call on ADB's obligations under ACCSF guarantees. The ACCSF will not make any claim on ADB's OCR lending or borrowing headrooms. If guarantees are extended to debt instruments not denominated in Japanese yen, exchange rate risks will be taken into account to prevent the amount of the guarantee outstanding from exceeding the capital backing available under the ACCSF.

31. To ensure consistency between the pricing of ADB's OCR-backed guarantees and those backed by the ACCSF, ACCSF guarantee charges should remain the same as those proposed for ADB's OCR guarantees. It is also suggested that income earned from ACCSF guarantee fees be placed in the ACCSF account and that from the front-end fees be paid to ADB to cover the processing or origination costs of new guarantees. When the ACCSF is terminated, the Government of Japan and ADB will determine how to use residual funds available in cash.

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7 R210-99: *Review of ADB's Program Lending Policies,* 14 December.

8 The beneficiary countries for ACCSF guarantees include, but are not limited to, Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.

9 R33-99, Revision 1: *Establishment of a New Facility in the Existing Japan Special Fund to assist Currency Crisis-Affected Member Countries*, 23 March.

V. METHODOLOGY FOR DETERMINING THE EXPOSURE AND THE FEE BASE

32. The two issues are: (i) Should the present value of the guarantee exposure be measured in terms of the full amount of guarantees or in terms of outstanding guarantees that are affected by disbursements by the commercial lender? and (ii) What should be the appropriate discount rate?

A. Present Value of Outstanding Guarantee

33. Under the present system, the exposure or fee base is measured as the present value of the full amount of the guarantee regardless of the actual drawdown of the underlying loan. This practice is not consistent with the underlying pricing principle that guarantees should be treated as if ADB has made the underlying loan. In direct lending, exposure is an "outstanding balance" concept. This is logical because credit risks on loans cannot exceed what the borrowers have actually received. From the viewpoint of the lender, the potential financial impact of default cannot exceed the amount it has actually disbursed to the borrower. Further, for RLR determination, exposure is also defined as an "outstanding balance" concept.

34. In direct lending, the creditor cannot charge on a certain balance a fee that is more than the actual liability of the borrower. The lending spread in OCR loans, for example, is applied on the outstanding loan balance. The proposed guarantee fee of 40 basis points is a spread concept, which is the difference between the annual spread equivalent of 115 basis points and the administrative expense equivalent of 75 basis points spread. It is logical therefore to apply the proposed guarantee fee on the outstanding present value exposure on guarantees. This approach is in line with commercial practices.

35. Accordingly, it is suggested that the present value exposure or fee base be measured in terms of actual amount disbursed by the commercial lender. The amounts of the guarantee made and disbursed by the commercial lender can be discounted to their present value either from the first callable date or from the date the average life of the loan falls due. These two alternatives would produce the same results if the underlying loan has a one-time repayment at maturity. If the guaranteed portion of the underlying loan has serial maturities, the correct technical approach is to discount the various disbursed portions from the different dates of the repayments. To avoid the technical problem associated with the matching of disbursements and repayments, the average life concept can be used. This will produce lower present values. Under both alternatives, once the guaranteed portion is fully disbursed by the lender, all the individual tranches of present value exposure would be bundled into one exposure value.[10]

36. From the borrowers' perspective, the suggested new approach may be considered more transparent as exposure would be measured on the basis of actual funds drawn and disbursed. This is a more rational approach because, from their viewpoint, guarantees would be interruptible during the disbursement period. This approach offers borrowers the flexibility of phased disbursements that match underlying expenditures and reduce potential cost of carry.[11] Usually, commercial lenders can provide borrowers a maximum five-year drawdown period.

[10] At that point, exposure measurement under both the new and old approaches would be the same.

[11] If the underlying loan is disbursed immediately, the borrower would incur potential cost of carrying liquidity prior to the project's actual expenditures. Under the present system, the present value of exposure is based on the full amount of a guarantee regardless of whether it is disbursed or not. Thus, the present system somewhat encourages the borrower to seek an immediate drawdown of the underlying loan.

37. The proposed methodology for measuring the exposure and fee base is strictly based on financial consideration of the need to maintain the loan equivalency of guarantees. The methodology for measuring exposure for purposes of the application of Article 12.1 of ADB's Charter regarding lending limitation is a separate legal issue. In other words, if the required exposure measurement for Article 12.1 would be different because of the need to comply with the "commitment" principle of the relevant provision, then two measures of exposure could be maintained—one based on the commitment principle for purposes of the lending and borrowing headrooms and the other based on the actual disbursement for purposes of RLR determination and fee base calculation for the borrower.

B. Discount Rate

38. Prior to the final approval of the level and structure of OCR loan charges, which have a direct bearing on the structure of guarantee charges, the Board approved in October 1999 the use of two discount rates for computing the present value of the guarantee obligation.[12] ADB's average return-on-equity (ROE) for the five years preceding the year in which a guarantee is approved will be used for determining the present value guarantee obligations for lending headroom purposes. For determining the fee base, the discount rate will be the average cost of ADB's outstanding borrowings for the currency in which the guarantee is issued as determined at the end of the calendar year preceding the year of approval. The use of average cost of outstanding borrowings was primarily driven by the need to make the present value calculations currency specific. With the approval by ADB's Board of a new structure for loan charges in December 1999 and the proposed new underlying principle of "loan equivalency" for determining guarantee charges, the Board's 1999 decision on the choice of discount rate for present value calculations should be reassessed.

39. For lending headroom purposes, the earning power of ADB's capital provides a better measure of how future capital growth would cover future potential obligations from guarantees. The ROE is therefore the most appropriate rate to be used as the discount rate for present value calculations for lending headroom purposes.

40. For purposes of the fee base calculation, the objective is to determine the "loan equivalent" disbursement profile of guarantees. Here, the borrowers' concern is not so much about the need to be currency specific but the need to have a higher discount rate in order to reduce the fee base. In the market, loan charges and credit spreads are not influenced by choice of currency. Neither is the disbursement profile.

41. OCR loan charges are applied uniformly across all types of loans regardless of maturities, disbursement profiles, and currency of disbursements. Further, disbursement profiles of OCR loans are not influenced by choice of currency by borrowers. Thus, given the principle of "loan equivalency," guarantee charges are to be applied without currency distinction. To make the present value calculation for fee base purposes consistent with the principle of loan equivalency, there is no need to make the present value calculations currency specific. Thus, the use of a uniform discount rate is suggested for all types of guarantees regardless of the currency of denomination. For this purpose, ADB's ROE should be used as the discount rate for the fee base calculations. This proposed revision would result in the use of one common discount rate for both the lending headroom and fee base calculations.

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[12] R135-99 *Review of the Bank's Guarantee Operations,* 8 October.

42. It is difficult to forecast ADB's earning power over the life of a guarantee. ROE itself changes from year to year. What is important, however, is not the annual changes in the ROE per se but how the changes eventually affect ADB's average long-term ROE. While the assumption of a stable ROE is desirable for present value calculations, it is equally important that the discount rate reflect the long-term trend of ADB's ROE. For this purpose, it is suggested that ADB use a 10-year moving average of its ROE as a basis for assessing the adequacy of the level of the discount rate. This 10-year moving average would consist of the past five years and the next five years (as indicated in ADB's annual income outlook assessment). The discount rate would be changed only if the 10-year moving ROE average were to change by 50 basis points in any direction. Preliminary calculations based on this approach indicate that a discount rate of 6.0 percent may be appropriate.

43. For a private sector PCG with a host government counterguarantee, it is proposed that a 10-year moving average of ADB's ROE also be used as the discount rate. For private sector PCGs without the host government counterguarantee, ADB's Guarantee Committee would determine the appropriate discount rate.

VI. COMPARISON WITH OTHER GUARANTORS

44. Under the present system, ADB charges a guarantee fee of 40 basis points on the present value of the full amount of a guarantee, discounted at the rate equal to the average of the cost of ADB's outstanding borrowings for the currency in which the currency is issued as determined at the end of the calendar year preceding the year of approval. By comparison, the proposed system would retain 40 basis points as the guarantee fee and the exposure or fee base would also be calculated on the basis of actual drawdown using the discount rate of 6.0 percent. In addition, a one-time front-end fee of 10-90 basis points would be charged on the full amount of the guarantee, depending on the ratio of guarantee to the associated ADB loan. In terms of spread equivalent, the range of the front-end fee would increase the effective guarantee fee to 27-37 basis points.

45. The Inter-American Development Bank (IADB) has explicitly adopted a pricing principle of net income neutrality. In accordance with this principle, the guarantee fee would be reviewed annually to take account of changes in its loan charges, particularly the waivers. Currently, IADB's facility fee is about a 50 basis-point spread applied on the full amount of a guarantee.

46. The World Bank's guarantee charges consist of three elements: (i) a standby fee of 25 basis points applied on the present value of the undisbursed guarantee, which is equivalent to its commitment fee on direct loans; (ii) a guarantee fee of 50 basis points applied on the present value of outstanding exposure, which is equivalent to its lending spread on direct loans; and (iii) a front-end fee of 1 percent on all guarantees.

47. There are some parallels with the ADB guarantee in private markets. The Organization for Economic Co-operation and Development (OECD) has recently introduced new harmonization guidelines that establish the minimum premium of an export credit agency for an export credit provided to a sovereign borrower by way of guarantee, insurance, or direct loan. These guidelines require export credit agencies to charge a higher premium in terms of spread equivalent for long-term export credits than for short-term export credits to properly reflect the associated risks. The guidelines also rank sovereign borrowers in seven categories, with category 1 being countries with the highest credit worthiness (generally OECD countries), while countries in category 7 are the least credit worthy. For each category, the OECD then

established the minimum premium that an export credit agency must charge. With country risk as the most important variable, the minimum fees charged by these agencies varied from category to category. The fees, however, are therefore not comparable because ADB enjoys preferred creditor status, and its guarantees will have DMC counterguarantees.

48. Probably, the closest comparators to ADB are the bond insurers in the United States. These triple-A rated financial institutions grant guarantees only for bonds issued by borrowers with stand-alone ratings no lower than investment grade. The investment grade default risk may be considered as the closest proxy to the risks faced by a creditor enjoying preferred creditor status, such as ADB. The average premium rate charged in the bond insurance industry over the past five years has ranged from 22 to 38 basis points, or an average of about 30 basis points. The premium rate is applied on the nominal amount.

49. The table compares the present proposal with the methodology and levels of guarantee fee charged by financial institutions issuing financial guarantees. The analysis is based on a hypothetical $100 million guarantee for an underlying loan with a 15-year single-payment maturity and a 5-year disbursement drawdown schedule. These institutions have different levels of guarantee fees and different methodologies for determining the fee base. To put them all on a comparative basis, the present value of the stream of guarantee fee income is calculated using a discount rate of 6.0 percent per annum. The lower the present value of the stream of guarantee fee income, the lower is the burden to the borrower. Another way of conveying the same information is to calculate the effective spread equivalent of the institutions' guarantee charges. The effective spread equivalent of the new proposal is the lowest among the comparable guarantors in the market.

Present Value of Guarantee Charges Levied by Various Financial Institutions Assuming Hypothetical $100 million Guarantee with 15-year Single-Payment Maturity

Institution	Guarantee Charges	Present value Of Income From Guarantee Charges (in $million)	Spread Equivalent of Guarantee Charges[a] (basis points)
1. ADB, Proposal	0.40% p.a. on Present Value of Outstanding guarantee	1.99 - 1.99	26 - 26
	0.10% - 0.90% one-time fee on full amount of Guarantee	0.09 - 0.85	1 - 11
	Total	**2.08 - 2.84**	**27 - 37**
2. ADB, Present System	0.40% p.a. on Present Value full amount of Guarantee	**2.36**	**31**
3. IADB	0.50% p.a. on full Amount of guarantee	**4.86**	**64**
4. World Bank	0.25% stand-by fee Based on undisbursed Amount of guarantee	0.23	3
	0.50% p.a. on Present Value of Outstanding Guarantee	**2.49**	33
	1.0% front-end fee on full amount of guarantee	0.94	12
	Total	**3.66**	**48**
5. Bond Insurers	0.30% p.a. on full Amount of guarantee	**2.91**	**38**

ADB = Asian Development Bank; IADB = Inter-American Development Bank; PA=per annum.
[a] Based on the underlying loan of a guarantee using a multiple disbursement profile as shown in Appendix 4.

Source: staff estimates.

VII. RECOMMENDATIONS

50. The key recommendations under the proposed guarantee charges for Board consideration are as follows:

(i) **Income Neutrality for Guarantees.** It is recommended that ADB adopt a pricing principle of net income neutrality for guarantees. Under this principle, guarantee charges should be set on a loan equivalent basis to yield the same return to ADB as if ADB had made the underlying loan, but adjusted to take account of the structural difference between loans and guarantees. This principle of loan equivalency should serve as the guideline for determining (a) the level of guarantee charges, and (b) the fee base upon which these charges are applied.

(ii) **Guarantee Fee.** For a public sector PCG, it is proposed that the guarantee fee be set at 40 basis points[13] to be applied on the present value of the outstanding guarantees. For a private sector PCG with a host government counterguarantee, the fee would also be 40 basis points and the borrower would compensate the host government for the counterguarantee directly. For a private sector PCG without a host government counterguarantee, ADB's existing Guarantee Committee would price the guarantee fee based on procedures similar to those for the pricing of private sector loans. Like OCR loans, the guarantee fee would be paid in arrears on the basis of the actual outstanding amount of guarantees on a present value basis.

(iii) **Front-End Fee.** For a public sector PCG, it is recommended that the front-end fee be set based on the ratio of the guarantee vis-à-vis the associated ADB loan within 10-90 basis points of the nominal guaranteed amount. For a private sector PCG, it is recommended that the front-end fee be at a market rate, which is currently at about 100 basis points. The front-end fee will be paid up-front.

(iv) **Emergency Public Sector PCG Charges.** It is recommended that the emergency guarantee fee for a public sector PCG be equivalent to the PCG risk premium of 40 basis points plus an incremental SPL risk premium per annum, equivalent to the difference between the SPL and OCR loan spread. The front-end fee would also be 10-90 basis points of the nominal guaranteed amount, depending on the size of the guarantee vis-à-vis that of associated ADB loan. The front-end would be paid up-front and the emergency guarantee fee in arrears on the basis of actual outstanding amount of guarantees on a present value basis.

(v) **ACCSF Guarantee Charges.** To ensure consistency between the pricing of ADB's OCR-backed guarantees and those backed by the ACCSF, it is recommended that ACCSF guarantee charges remain the same as those proposed for ADB's OCR guarantees. It is also suggested that income earned from ACCSF guarantee fees be placed in the ACCSF account and that from the front-end fees be paid to ADB to cover the processing or origination costs of new

[13] Subject to the changes in OCR loan charges and in administrative expenses, the guarantee fee would change accordingly.

guarantees. When the ACCSF is terminated, the Government of Japan and ADB will determine how to use residual funds available in cash.

(vi) **Discount Rate.** It is recommended that the present practice of currency differentiated discount rate be discontinued. Instead, a uniform discount rate would be used for all guarantees regardless of currency of denomination. For a public sector PCG and a private sector PCG with a host government counterguarantee, the discount rate used for calculation of the present value exposure would be based on a 10-year moving average of ADB's ROE, consisting of past five years and next five years (as indicated in ADB's annual income outlook assessment). For a private sector PCG without a host government counterguarantee, ADB's Guarantee Committee would determine the discount rate as appropriate.

Appendixes

SPREAD EQUIVALENT AND BREAKDOWN OF TOTAL ADMINISTRATIVE EXPENSES

	1994	1995	1996	1997	1998	1999	Average
1. Total OCR Administrative Expenses[a]	133.5	122.2	111.7	128.6	159.2	160.8	
2. Average Outstanding Loan[b]	15,536	17,931	16,750	16,978	21,426	26,321	
3. Spread Equivalent of Expenses (Ratio of [1] to [2]) (%)	0.86	0.68	0.67	0.76	0.74	0.61	0.72
4. New OCR Commitments	3,737	5,614	5,652	9,488	6,045	3,915	
5. Total Processing Costs	33.0	34.4	40.1	43.8	42.0	42.1	
6. Ratio 5 to 4 (%)	0.88	0.61	0.71	0.46	0.69	1.08	0.74
7. Supervision and Other Costs (Item 1 less Item 5)	100.4	87.8	71.7	84.8	117.2	118.7	
8. Ratio of 7 to 2 (%)	0.65	0.49	0.43	0.50	0.55	0.45	0.51

OCR=ordinary capital resources
Note:

Spread equivalent of old loan charges:

Commitment fee	34	basis points
Lending spread	40	basis points
	74	basis points

[a] including provision for loan losses
[b] including equity investments

Source: ADB's Treasurer's Department.

ANNUALIZED SPREAD EQUIVALENT OF ADMINISTRATIVE EXPENSES[A]
($ million)[b]

Year	Disbursements	Repayments	Outstanding Loan Balance	Administrative Expenses Alternative 1	Administrative Expenses Alternative 2
0					
1	0.02		0.02	0.90	0.90
2	4.09		4.11	0.02	0.03
3	16.51		20.62	0.11	0.13
4	20.97		41.59	0.21	0.27
5	18.68	2.72	57.55	0.29	0.37
6	14.52	3.00	69.07	0.35	0.45
7	9.87	3.31	75.63	0.39	0.49
8	6.43	3.65	78.41	0.40	0.51
9	4.49	4.02	78.88	0.40	0.47
10	4.42	4.43	78.86	0.40	0.39
11		4.89	73.97	0.38	0.30
12		5.39	68.58	0.35	0.27
13		5.94	62.64	0.32	0.25
14		6.55	56.09	0.29	0.22
15		7.22	48.86	0.25	0.20
16		7.96	40.90	0.21	0.16
17		8.78	32.12	0.16	0.13
18		9.68	22.44	0.11	0.09
19		10.67	11.77	0.06	0.05
20		11.77	0.00	0.00	0.00
Total	**100.00**	**100.00**	**922.09**	**5.60**	**5.69**
Present Value			441.10	3.08	3.26
Annualized Spread Equivalent				**0.70%**	**0.74%**

[a] Using the information in Appendix 1, the marginal impact of a new loan on administrative expenses can be measured as follows: alternative 1 equals to 0.90 percent of the principal amount as the processing cost and a direct charge of 0.51 percent across the outstanding loan balances as its contribution to other administrative costs. Alternative 2 similarly applies a 0.90 percent of principal amount as the processing cost, and a gradually declining cost rate starting from 0.65 percent to 0.40 percent of outstanding loans representing supervision and other administrative costs. The structure is premised on the basis of higher supervision and other administrative costs during the disbursement period. The sums for both alternatives are more or less the same.

[b] Totals may not add due to rounding.

Source: ADB's Treasurer's Department.

SUMMARY OF THE PROPOSED GUARANTEE CHARGES

Guarantee Charges	Public Sector PCG	Private Sector PCG With DMC Counter-Guarantee	Private Sector PCG Without DMC Counter-Guarantee	Emergency Public Sector PCG
Guarantee Fee	40 basis points on the present value of the guarantee. The guarantee fee will be paid in arrears on the basis of actual outstanding amount of guarantees on a present value basis.	40 basis points on the present value of the guarantee amount.[1] The guarantee fee will be paid in arrears on the basis of actual outstanding amount of guarantees on a present value basis.	Market-based and will be determined by the Guarantee Committee. The guarantee fee to be paid up-front.	40 basis points plus an incremental SPL risk premium equivalent to the difference in SPL and OCR loan spread. The guarantee fee will be paid in arrears on the basis of actual outstanding amount of guarantees on a present value basis.
Front-End Fee	10-90 basis points on the actual guarantee depending on the guarantee to associated ADB loan. The fee to be paid up-front.	Market-based rate, currently at 100 basis points, on the actual guarantee. The fee to be paid up-front.	Market-based rate, currently at 100 basis points, on the actual guarantee. The fee to be paid up-front.	10-90 basis points on the actual guarantee depending on the guarantee to associated ADB loan. The fee to be paid up-front.

ADB=Asian Development Bank; DMC=developing member country; OCR=ordinary capital resources; SPL=special program loan

[1] The counter-guarantee fee will be paid directly by borrowers to the host government.

PRESENT VALUES OF GUARANTEES UNDER NEW METHOD FOR DETERMINING EXPOSURE AND FEE BASE

(assuming $100 million guarantee, multiple disbursements, and single payment at maturity)

	Multiple Disbursement Tranches of Underlying Loan [a]						Total Exposure on all Tranches	Fee Base: Proposed Method Multi-Tranche at 6%	Fee Base: Present Method Single-Tranche at 6%
	1st year	2nd year	3rd year	4th year	5th year	Total			
Drawdown	7%	17%	25%	35%	16%	100%			
					(in $ million)				
	7	17	25	35	16	100			
End of Year									
0	2.921						2.921	2.921	41.727
1	3.096	7.519					10.615	10.615	44.230
2	3.282	7.970	11.721				22.973	22.973	46.884
3	3.479	8.448	12.424	17.394			41.745	41.745	49.697
4	3.688	8.955	13.170	18.438	8.429		52.679	52.679	52.679
5	3.909	9.493	13.960	19.544	8.934		55.839	55.839	55.839
6	4.143	10.062	14.797	20.716	9.470		59.190	59.190	59.190
7	4.392	10.666	15.685	21.959	10.039		62.741	62.741	62.741
8	4.655	11.306	16.626	23.277	10.641		66.506	66.506	66.506
9	4.935	11.984	17.624	24.674	11.279		70.496	70.496	70.496
10	5.231	12.703	18.681	26.154	11.956		74.726	74.726	74.726
11	5.545	13.466	19.802	27.723	12.673		79.209	79.209	79.209
12	5.877	14.274	20.990	29.387	13.434		83.962	83.962	83.962
13	6.230	15.130	22.250	31.150	14.240		89.000	89.000	89.000
14	6.604	16.038	23.585	33.019	15.094		94.340	94.340	94.340
15	-	-	-	-	-		-	-	-
	This can be bundled after full disbursements. Total present value grows at the compound rate equal to the discount rate.								

[a] Assumed to take place beginning of the year.

Source: ADB's Treasurer's Department.