

# **AFRICAN DEVELOPMENT BANK**



**Guidelines for the use of**

## **RISK MANAGEMENT PRODUCTS**

**January 2002**

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## **1. Introduction**

### **1.1 Definition of risk management products (RMPs)**

A RMP is a financial product, which allows a client to transform the financial risk characteristics of its obligation under a loan or other instrument without renegotiating or amending the terms of the original instrument.

### **1.2 General comments**

These guidelines (the “Guidelines”) are issued pursuant to the General Authority on the Bank’s Financial Products and Services adopted by the Board of Directors of the Bank on 12 January 2000. The General Authority empowers Management to formulate specific operational guidelines for the development, administration, and pricing of the African Development Bank (the “Bank”) financial products and services within the parameters that have been set out therein.

### **1.3 The Guidelines and the General Conditions**

The Guidelines are complementary to the General Conditions Applicable to Loan Agreements and Guarantee Agreements of the Bank, as amended (the “General Conditions”). The Guidelines treat the financial aspects of RMPs, while the General Conditions treat all the questions pertaining to loans and guarantee agreements and the relationship between the Client, the Guarantor and the Bank, including immunities of the Bank, settlement of disputes, and entry into force of the loan and guarantee agreement. However, a cross default clause will be inserted in both the underlying loan agreement and the derivative agreement<sup>1</sup> that the Bank signs with the client.

### **1.4 Purpose of the Guidelines**

The Guidelines describe the principal terms and conditions of RMPs offered by the Bank to all its Clients, whether in the Public or Private Sector.

## **2. Eligibility criteria**

### **2.1 Eligibility of African Development Bank’s loans**

The General Authority provides that the Bank may offer RMPs to its clients only in respect of obligations under outstanding or new Bank loans, whether in whole or in part. Accordingly the Bank cannot offer RMPs for the purpose of enabling the client to manage its obligations to a third party. Any client with an existing or new Bank loan will be eligible for a RMP. Multiple RMPs may be obtained for the same loan and at different period. However, the terms of the new request must be compatible with the existing hedge.

### **2.2 Effect of sanctions**

Clients under sanctions are not eligible for Bank RMPs.

### **2.3 Due diligence - Bank**

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<sup>1</sup> Refer to explanation in section 6.2 on legal documentation.

Prior to entering into RMP transactions with clients, the Bank will conduct due diligence reviews to ensure, among other things, that the client is authorized to enter into such transactions, has the capacity to manage the transactions and that the Bank's preferred creditor status will be preserved in the event of default by the client.

### **3. Objectives, guiding principles and limitations**

#### **3.1 Purpose of offering risk management products**

The Bank offers RMPs to its clients in order to enable them to hedge their exposure to market risks including interest rate, currency exchange and commodity price risks, thus allowing them to engage in debt management. RMPs will be available to clients at the time of loan signature or at any time during the life of the loan.

#### **3.2 The Bank's role and obligations**

The Bank shall **not** act as an advisor to a client in relation to any RMP transaction. Where a client(s) may seek such advice from the Bank, it will be subject to clearly defined terms and conditions that have been reviewed by legal department (GECL) and approved by Management. The Bank will act on a "best effort" basis and exercise reasonable effort to execute the RMP transaction. In addition, the Bank will apply the same procedures as for transactions carried out for its own account. However, the Bank will not be liable if it fails to execute a RMP transaction. Depending on the nature of the loan or portion of loan to be hedged, the client must be aware that the hedge may not be perfect.

#### **3.3 Asset and liability management**

In offering RMPs, the Bank shall apply the "asset and liability matching principle" thereby ensuring that an offsetting transaction is automatically carried out with one of the Bank's approved market counterparts. The Bank does not take open positions in these transactions. It therefore follows that the Bank will only be able to offer to its clients those hedges that are commonly available in the market.

#### **3.4 Pricing methodology**

For RMP pricing, the Bank shall apply the "cost pass through" principle, i.e. the costs related to a specific RMP transaction will reflect the cost of executing an offsetting transaction with a market counterpart. The full cost of that offsetting transaction will be passed through to the client. In addition, a transaction fee will be charged to the client, in accordance with section 8 of these Guidelines.

#### **3.5 Termination/rejection of a RMP transaction**

If the counterpart on the offsetting RMP transaction defaults, the Bank would enter into a new RMP transaction with another counterpart for the remaining maturity of the original RMP transaction, if market conditions permit. In the event that the offsetting transaction is not possible, the Bank reserves the right to terminate the RMP transaction with the client. Clients shall be required to provide a persuasive rationale for the intended use of a RMP when making the request. The Bank reserves the right to refuse a request that does not meet the terms and conditions of the use of RMP or if, in the opinion of the Bank, it is not suitable for the project or other risk management needs. If a client is more than thirty (30) calendar days late in its RMP transaction payment, the Bank reserves the right to terminate the RMP transaction.

### 3.6 The Bank's responsibility during market disturbances

During the Processing period<sup>2</sup>, if events of any nature impact the market in such a way that the Bank judges that its capacity to execute the request is adversely affected, the Bank will suspend the processing of the request and notify the client accordingly. The client and the Bank will then have to decide whether the request should be executed or canceled. If the Bank and the client decide to go ahead with the request, the duration of the Processing period will be extended to account for the suspension.

## 4. Risk management products offered

4.1 The Bank may offer the following RMPs, or combinations thereof, to eligible Clients:

- Interest rate swaps
- Currency swaps
- Commodity/index swaps
- Interest rate caps and collars

4.2 **Interest rate swap.** This is an exchange of cash flows between two parties, which generally transforms floating rate obligations in a particular currency into a fixed rate obligation in that same currency or vice versa. For the Bank's clients, the floating rate on the disbursed balance of a loan may be converted into a fixed rate and vice versa. Interest rates may be fixed (or unfixed) at the client's option for as long a maturity as the interest rate swap markets provide, subject to the final maturity of the loan.

4.3 **Currency swap.** This is an exchange of cash flows denominated in different currencies. The cash flows are based on agreed-upon exchange rates and may or may not include the exchange of principal. Currency swaps will, however, be available only for the disbursed portion of a loan and for as long a maturity as the currency swap markets provide, subject to the final maturity of the loan.

4.4 **Commodity/index swaps.** This is an exchange of cash flows, where one of the cash flows is based on the price of a particular commodity/index or basket of commodities, and the other cash flow is based on an interest rate. For the Bank's clients, the interest rate of disbursed portion of a loan may be converted from an interest rate reference to a commodity price reference and vice-versa for as long a maturity as the commodity swap markets provide, subject to the final maturity of the loan.

4.5 **Interest rate cap.** An interest rate cap limits the maximum interest rate on a floating rate loan regardless of the future level of the market reference rate. By purchasing an interest rate cap, either at loan signature or during the life of the loan, a floating rate client can enjoy lower interest costs while market rates are above the specified maximum rate, for the duration of the cap.

4.6 **Interest rate collar.** An interest rate collar sets maximum (via the purchase of a cap) and a minimum (via the sale of a floor) interest rate on a floating rate loan. By purchasing an interest rate collar, either at loan signature or during the life of the loan, a floating rate client can enjoy, for the duration of the collar, interest costs that are limited between an upper and lower level while market rates are outside the range of the collar. Under no circumstances shall interest rate collars be executed such that there is a net inflow of funds to the client, as

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<sup>2</sup> See definition in the *Manual For Risk Management Products* paragraph 2

this would imply a premium on the floor exceeding that of the cap. “Zero cost” collars are permissible where the premium payable on the cap is exactly offset by the premium received on the floor. Under no circumstances should the client, directly or indirectly, “strip<sup>3</sup>” the collar.

- 4.7 The Bank will use over-the-counter (OTC) market and/or traditional exchanges for RMP transactions.

## 5. Principal terms and conditions of RMPs

**Maximum transaction amount:** The maximum amount will always be limited to the outstanding loan amount.

**Minimum transaction amount:** Generally, the equivalent of USD 3 million. The minimum transaction amounts, however, may vary from one market to the other and are dependent on market conditions at the time of the transaction.

**Maximum maturity:** Dependent on the maturities available in the relevant market but not longer than the outstanding maturity of the underlying loan or the portion of the loan being hedged.

**Currencies:** USD, EUR, JPY, ZAR and other approved Bank lending currencies for which liquid derivative markets exist.

**Starting date:** The starting date on a RMP transaction must coincide with an interest payment date on the underlying loan.

**Ending date:** The ending date on a RMP transaction must coincide with an interest payment date on the underlying loan and be beyond the starting date.

**Payment dates:** Payment dates will coincide with the payment dates on the underlying loan or portion of the loan being hedged.

**Early termination:** The client may terminate the RMP transaction at any time. The client shall pay, as a single payment, within five (5) business days from the date of the termination transaction, the applicable transaction fee on the terminated principal amount in addition to the settlement of the mark-to-market value of the terminated RMP.

**Termination due to late payment:** The Bank retains the right to terminate a RMP transaction, if payment on the RMP transaction is late by more than 30 calendar days. The early termination provision, above, will apply.

**Payment of premiums and fees:** Premiums and fees are payable as a single, up-front payment within five (5) business days from the date of execution of the transaction. Premiums and fees must be paid from the client’s own resources and not from the underlying loan proceeds.

**Currency of payments:** Premiums and fees are paid in the currency of the hedges and not the currency of the underlying loan.

**Loan pre-payment:** the RMP transaction will be automatically terminated if the related portion of the underlying loan is prepaid. The early termination provision, above, will apply.

**Application of partial payments:** A partial payment<sup>4</sup> will be applied first to interest and other charges on the loan, then to the RMP transaction and finally to the loan principal. For public sector clients, if the partial payment net of interest and other loan charges is insufficient to settle the RMP transaction, for consistency with the Sanctions Policy, when applicable, a cure period of thirty (30) days from the payment due date will be granted. However, during the cure period the late payment fee for RMPs will apply.

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<sup>3</sup> To strip a collar means to trade the components of the collar separately

<sup>4</sup> A partial payment is a payment that does not cover the net payment of the loan and the RMP transaction, as specified on the bill

**Late payment<sup>5</sup> fee:** A late payment fee equal to the floating interest base rate in the currency of the payment plus one percent (1%) for public sector clients or two percent (2%) for private sector clients will apply to late payment amounts, in addition to any foreign exchange loss due to the delayed payment on the RMP transaction.

## **6. Legal requirements**

### **6.1 Due diligence - client**

Before requesting for a RMP, the client must ensure that it is legally authorized to enter into the envisaged derivative transaction.

### **6.2 Legal documentation**

Prior to entering into RMP transactions, clients would be required to enter into a market-based Master Derivatives Agreement (the “MDA”) with the Bank. In addition to local legal specific requirements, this agreement would provide the contractual framework between the two parties. In most cases, the Multicurrency-Cross Border Master Agreement published by the International Swaps and Derivatives Association (ISDA) will be used as the basis for the agreement. In cases where the need of a Master Agreement is not justified the Bank can document the RMP transaction by a stand-alone agreement or amend the loan agreement in the case of loan conversion. The loan agreement shall be amended to reflect the Derivative Agreement between the Bank and the client. The Derivative Agreement shall clearly stipulate that RMP transactions and the obligations arising in respect thereof, would be considered to be within the purview of the Bank’s assets for the purposes of the Bank’s preferred creditor status in its Regional Member Countries (RMCs).

### **6.3 Cross default provisions between a loan and the related RMPs**

Cross default provisions will be included in the MDA to ensure that a default under the loan agreement will also trigger a default under the MDA. Concomitantly, the underlying loan agreement shall be amended to provide that a default under the MDA will also trigger a default under the loan agreement.

### **6.4 Guaranteed Loans**

In the event that the underlying loan has a guarantee, the prior consent of the Guarantor will be a condition for the RMP. Furthermore, taking note of Article 18(3)(b) of the Bank Agreement, and the related Bank Policy requiring that public sector loans to non-members be supported by a sovereign guarantee, RMPs to non-members will be accompanied by adequate credit support, specifically provided for in the MDA.

## **7. General procedures for requesting RMPS**

### **7.1 Application procedures**

The client shall submit the request for a RMP transaction by hand, courier, certified mail or facsimile, using the form provided by the Bank. A request for a RMP shall not be considered unless the client and the Bank have already signed a Derivative Agreement. The request for a RMP transaction shall be sent to the Treasury department (FTRY) or the

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<sup>5</sup> A payment is said to be late on the RMP transaction if the amount received net of interest and other loan charges is not sufficient to settle the payment on the RMP transaction on the due date.

client's usual contact point with the Bank. The Financial Products Working Group (FPWG), whose membership has been expanded to include representation from relevant operations departments, shall review the client's request and confirm whether or not the request is acceptable in accordance with the requirements of the project and the RMCs or project's risk management needs.

## 7.2 Processing period

The client may be required to furnish additional information or clarification during the review process. Subject to satisfactory and complete information having been submitted by the client, the Bank will endeavor to execute the transaction within the Processing period<sup>6</sup>. If the Bank is unable to execute the request within the Processing Period, the Bank and the client will decide how to proceed with the request.

## 7.3 Administration of risk management product transactions

Final terms achieved by the Bank for the RMP transaction will be communicated to the client promptly following the execution of the transaction. A legal confirmation containing the terms of the transaction will be submitted to the client for signature. The client will be billed for the transaction cost and fee owed to the Bank and payable within five (5) business days from the date of execution of the transaction.

## 8. **Transaction fees and other costs**

### 8.1 Schedule of transaction fees

In addition to the actual cost of the offsetting transaction that the client shall pay, as stipulated in section 3.5, the Bank will also charge a transaction fee. The schedule of fees for RMP transactions is as follows (expressed as a percentage of the transaction amount):

<b>RMP TRANSACTION</b>	<b>TRANSACTION FEE</b>
Interest Rate Swaps	1 / 8 %
Currency Swaps	1 / 4 %
Commodity/Index Swaps	3 / 8 %
Interest Rate Caps & Collars	1 / 8 %

These fees are non-refundable and are applicable for each individual transaction. Transaction fees may be reviewed, within the range approved by the Board, from time to time, by Management. Fees for RMP transactions are payable as a single, front-end payment within five (5) business days from the date of execution of the transaction.

### 8.2 Transaction fee and Sanctions Policy

Even though RMP transactions are not specifically covered by the Bank's Sanctions Policy, failure to make a payment due on a RMP transaction will result in sanctions given the cross default provisions which will trigger a default in the underlying loan in the event of a default on a RMP.

<sup>6</sup> See definition in the "Manual For Risk Management Products" in paragraph 2

### 8.3 Additional costs

If in the course of processing a request for a RMP the Bank envisages additional costs, such as legal costs, it will inform the client. The Bank will only continue the processing of the request if the client agrees to cover these additional costs. The payment of such costs is immediately due upon demand by the Bank.

## 9. **Accounting treatment of a RMP transaction**

### 9.1 Risk management products will be mark-to-market

Both the client swap/cap/collar and the associated market counterparts offsetting swap/cap/collar will be mark-to-market and reported on the Bank's balance sheet. The net impact is neutral because the two transactions offset each other.

### 9.2 Accounting due diligence - client

Given that derivative transactions are treated differently from one country to the other, as well as on the basis of the applicable accounting standards, the client will be required to carefully consider the accounting and reporting implications of entering into a RMP transaction with the Bank.

### 9.3 Billing of RMP transactions

A single billing statement will be sent to the client, indicating the amount due for each transaction, specifically the loan and the RMP. The billing statement will also net these amounts and indicates the netted amount, which upon payment in full will satisfy the payment obligation of both transactions.

### 9.4 Treatment of early termination settlement

If, the Bank is liable to pay the client, in the event of an early termination of a RMP, the amount due from the Bank net of fees and transactions costs will be applied to the payments on the underlying loan. On the other hand, if the client owes the Bank, it shall pay as stated in section 5 of these Guidelines.